

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 28, 1999 Commission file number 0-3833

MORGAN'S FOODS, INC.

(Exact name of registrant as specified in its charter)

Ohio 34-0562210
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) 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 of Section 12 (b) of the Act:

Table with 2 columns: Title of each class, Name of each exchange on which registered. Row: Common Shares, Without Par Value, American Stock Exchange

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

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

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

As of May 6, 1999, the aggregate market value of the common stock held by nonaffiliates of the Registrant was \$6,923,407.

As of May 6, 1999, the Registrant had 2,910,839 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 1999 annual meeting, to be filed with the Securities and Exchange Commission on or before June 25, 1999.

MORGAN'S FOODS, INC.

PART I

Item 1. Business.

General. The Registrant operates, through wholly-owned subsidiaries, Kentucky Fried Chicken ("KFC") restaurants under franchises from KFC Corporation. The Company also operates East Side Mario's restaurants in the Cleveland/Akron and Columbus, Ohio areas under franchises from East Side Mario's, Inc. As of May 27, 1999, the Company operated 48 KFC restaurants, three of which also offer Taco Bell products, as well as five East Side Mario's restaurants. The headquarters of the Registrant are located in the Cleveland, Ohio metropolitan area. Throughout this Report, the Registrant together with its subsidiaries is referred to as the "Company."

Restaurant Operations. The Company's KFC restaurants prepare and sell the distinctive "Kentucky Fried Chicken" and Tender Roast® chicken along with related food items. All containers and packages bear KFC trademarks. The KFC/Taco Bell "2 in 1" restaurants prepare and sell a limited menu of Taco Bell items using the appropriate Taco Bell containers and packages as well as the full KFC menu. The East Side Mario's restaurants are full service, mid-priced, informal family restaurants inspired by New York City's famous "Little Italy" district of the 1950's. The menu features a variety of All-American grill favorites and authentic Italian specialties.

Of the 48 KFC restaurants operated by the Company as of May 27, 1999, 14 are located in Ohio, 21 in Pennsylvania, 10 in Missouri, 1 in Illinois, 1 in West Virginia and 1 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 KFC units are seasonal to a certain extent, with higher sales generally occurring in the summer months. Five East Side Mario's restaurants operated by the Company are located in the Cleveland/Akron area and one in Columbus, Ohio.

Franchise Agreements. All of the Company's KFC restaurants are operated under franchise agreements with KFC Corporation. The Company considers retention of these agreements to be important to the success of its restaurant business and believes that its relationship with KFC Corporation is satisfactory. For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5% of gross revenues on national and local advertising pursuant to its franchise agreements. In May 1997, the Company renewed substantially all of its franchise agreements for twenty years. Subject to satisfying KFC requirements for restaurant image and other matters, franchise agreements are renewable at the Company's option for successive ten year periods. The franchise agreements provide that each KFC unit is to be inspected by KFC Corporation approximately three or four times per year. These inspections cover product preparation and quality, customer service, and restaurant appearance and operation. Taco Bell products are offered in the Company's KFC/Taco Bell "2 in 1" restaurants under five year license agreements which require the Company to pay royalties at 10% and advertising fund contributions at 1/2% of Taco Bell gross revenue. Both KFC Corporation and Taco Bell Corporation are wholly owned by Tricon Global Restaurants, Inc. The East Side Mario's restaurants are operated under franchise agreements with East Side Mario's, Inc., for remaining terms of 15 to 17 years and are renewable by the Company for one additional term of 10 years. The East Side Mario's franchise agreements require the Company to pay royalties of 4% on gross revenue and

MORGAN'S FOODS, INC.

PART I (cont'd)

1/2% of gross revenue to an advertising fund. The franchise agreements also require the Company to expend an additional 2 1/2% of gross revenue for advertising and promotion. The East Side Mario's franchise agreements also grant the right to East Side Mario's, Inc. to perform quality and franchise compliance inspections without prior notice to the Company. The Company is engaged in legal proceedings against the franchisor of East Side Mario's which are described in Item 3 below.

Competition. The restaurant business is highly competitive. Each of the Company's KFC restaurants competes directly or indirectly with a large number of national and regional restaurant operations, as well as with locally owned restaurants, drive-ins, diners and numerous other establishments which offer low- and medium-priced chicken, steak, pizza and other food to the public. The East Side Mario's restaurants compete with other mid-priced, casual, full service restaurants.

The Company's KFC restaurants and KFC/Taco Bell "2 in 1" 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 program sponsored by KFC Corporation, Taco Bell Corporation and their franchisees. The East Side Mario's restaurants rely on a distinctive themed decor and a variety of Italian and American menu items at moderate prices. 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 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 restaurant and employee appearance. The Company considers the East Side Mario's restaurants to be less competitive against other casual mid-priced restaurants due to inadequate menus, food systems and marketing and operational support provided by the franchisor.

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

Growth. During fiscal 1999, the Company completed construction of a new KFC restaurant in Boardman, OH and acquired four KFC restaurants in the Erie, PA market area, two KFC restaurants in the Jamestown, NY area and two KFC restaurants in the St. Louis market area. Also, the Company entered into a binding agreement to purchase two KFC restaurants in Erie, PA, which transaction is expected to close in early June 1999. Also, in May 1999, the Company signed definitive agreements to purchase 43 KFC restaurant properties and 12 Taco Bell restaurants from KFC Corporation and Taco Bell Corporation respectively and expects to close the transactions in middle to late June 1999. During fiscal 1999, the Company also ceased operations at its East Side Mario's restaurant in Mayfield Heights, OH and liquidated its leasehold interest subsequent to the end of the fiscal year. During fiscal 1998, the Company completed the construction of a new KFC restaurant on leased land in Greensburg, PA and completed the rebuilding of a KFC restaurant in the St. Louis market area.

MORGAN'S FOODS, INC.

PART I (cont'd)

Employees. As of May 27, 1999, the Company employed approximately 1,217 persons, including 31 administrative and 116 managerial employees. The balance are hourly employees, most of whom are part-time. None of the restaurant employees are represented by a labor union. The Company considers its employee relations to be satisfactory.

Item 2. Properties.

The Company leases approximately 5,388 square feet of space for its headquarters in Cleveland, Ohio. The lease expires in 2001 and the rent under the current term is \$7,097 per month. The lease also contains a renewal option of five years, which may be exercised by the Company. The Company also leases space for a regional office in Youngstown, OH, which is used to assist in the operation of the KFC restaurants.

Of the 48 KFC restaurants, the Company owns the land and building for 23 locations, owns the building and leases the land for 6 locations and leases the land and building for 19 locations. Twenty of the owned properties are subject to mortgages. Remaining lease terms (including renewal options) range from 1 to 27 years and average approximately 15 years. These leases generally require the Company to pay taxes and utilities, to maintain casualty and liability insurance, and to keep the property in good repair. The Company pays annual rental for each leased KFC restaurant in amounts ranging from \$10,800 to \$78,750. In addition, 16 of these leases require payment of additional rentals based on a percentage of gross sales in excess of certain base amounts. Sales for 7 KFC restaurants exceeded the respective base amounts in fiscal 1999. Of the five East Side Mario's restaurants, the Company owns the building and leases the land on one location and leases the land and the building for four locations. In addition, three of the East Side Mario's restaurant leases require payment of additional rentals based on a percentage of gross sales in excess of certain base amounts. Sales for these East Side Mario's restaurants did not exceed their base amounts for fiscal 1999.

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

Item 3. Legal Proceedings.

On April 20, 1998 the Company and its wholly owned subsidiary, Morgan's Creative Restaurant Concepts, Inc., filed a lawsuit against East Side Mario's, Inc. and other related parties in Federal District Court in Cleveland, Ohio and on July 8, 1998 the Company filed a second suit against the same parties. The suits allege fraud, deceptive trade practices and failure to support the East Side Mario's franchisees among other things and they cover complex business and trade issues involving many counts. As a result of the lawsuits certain royalty and advertising fund payments are in dispute. Because of the complex nature of litigation, the Company is unable to determine the outcome of the matter or to estimate potential recovery, if any.

MORGAN'S FOODS, INC.

PART I (cont'd)

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

There were no matters submitted to security holders for a vote during the last quarter of the Company's fiscal year ended February 28, 1999.

Executive Officers of the Company

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

<u>Name</u>	<u>Age</u>	<u>Position with Registrant</u>	<u>Officer Since</u>
Executive Officers:			
Leonard Stein-Sapir	60	Chairman of the Board and Chief Executive Officer	April 1989
James J. Liguori	50	President and Chief Operating Officer	June 1979
Kenneth L. Hignett	52	Senior Vice President-Chief Financial Officer & Secretary	May 1989
Other Officers:			
Barton J. Craig	50	Senior Vice President - General Counsel	January 1994
Vincent J. Oddi	56	Vice President-Restaurant Development	September 1979
Ramesh J. Gursahaney	50	Vice President-Operations Services	January 1991

Mr. Craig serves as a Law Professor at Albertus Magnus College.

Executive 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.

MORGAN'S FOODS, INC.

PART II

Item 5. Market for the Company's Common Equity and Related Stockholder Matters.

The Company's Common Shares are traded on the American Stock Exchange under the symbol "MR". The following table sets forth, for the periods indicated, the high and low sales prices of the Common Shares as reported on the American Stock Exchange. All prices are adjusted for the 1 for 6 reverse stock split which was effective July 14, 1997.

	Price Range	
	High	Low
Year ended February 28, 1999:		
1st Quarter	\$3 5/8	\$2 1/8
2nd Quarter	2 13/16	2
3rd Quarter	2 3/8	2
4th Quarter	2 3/4	2
Year ended March 1, 1998:		
1st Quarter	\$3	\$2 1/4
2nd Quarter	3	1 11/16
3rd Quarter	3	1 15/16
4th Quarter	2 3/4	1 7/8

As of May 6, 1999, the Company had approximately 1,086 shareholders of record. The Company has paid no dividends since fiscal 1975.

MORGAN'S FOODS, INC.

PART II (cont'd)

Item 6. Selected Financial Data.

The following selected financial information for each of the five fiscal years in the period ended February 28, 1999, 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 28, 1999	March 1, 1998	March 2, 1997	March 3, 1996	February 26, 1995
Revenues.....	\$40,607	\$38,868	\$38,252	\$42,510	\$53,295
Cost of sales:					
Food, paper and beverage.....	12,774	12,259	12,141	13,662	17,282
Labor and benefits.....	10,635	10,456	9,951	11,122	13,807
Restaurant operating expenses.....	11,348	11,001	11,047	12,256	14,632
Depreciation and amortization.....	1,948	1,840	1,888	1,988	2,536
Asset impairments.....	-	-	2,939	-	-
General and administrative expenses.....	3,137	2,799	2,876	2,947	3,759
Operating income (loss).....	765	513	(2,590)	535	1,279
Gain (loss) on sale or disposal of restaurant assets.....	-	(98)	(248)	1,681	-
Income (loss) before extraordinary items.....	(721)	(928)	(4,055)	1,126	(425)
Extraordinary loss on early extinguishment of debt (2).....	(287)	-	-	-	-
Net income (loss).....	(1,008)	(928)	(4,055)	1,126	(425)
Income (loss) per common share (1):					
Income (loss) before extraordinary item.....	(.25)	(.31)	(1.37)	.38	(.14)
Loss on early extinguishment of debt.....	(.10)	-	-	-	-
Net income (loss).....	(.35)	(.31)	(1.37)	.38	(.14)
Working capital (deficiency).....	(2,182)	(2,046)	(884)	(562)	(3,728)
Total assets.....	24,011	20,110	19,312	22,034	29,432
Long-term debt.....	13,094	7,815	6,474	5,448	4,151
Long-term capital lease obligations.....	4,244	5,019	4,847	5,062	3,896
Shareholders' equity.....	1,248	2,256	3,300	7,378	6,249

(1) Computed based upon the weighted average number of common and common equivalent shares outstanding during each year, which were 2,910,839 in 1999, 2,936,877 in 1998, 2,967,574 in 1997, 2,969,355 in 1996 and 2,967,806 in 1995. All share and per share amounts have been restated for the reverse stock split which was effective July 14, 1997.

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

MORGAN'S FOODS, INC.

PART II (cont'd)

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

Results of Operations. During fiscal 1997 through 1999 the Company operated Kentucky Fried Chicken ("KFC") franchised restaurants, of which three also offer Taco Bell products, in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York and East Side Mario's franchised restaurants in Ohio. The average number of KFC restaurants in operation during fiscal 1999 was 44 compared to 39 during fiscal 1998 and 40 during fiscal 1997. During fiscal 1999, the Company acquired 8 KFC restaurants and opened one new KFC restaurant. The Company closed one East Side Mario's during fiscal 1999 and currently operates five of the restaurants.

Revenues. Revenue was \$40,607,000 in fiscal 1999 an increase of \$1,739,000 or 4.5% compared to an increase of \$616,000 or 1.6% in fiscal 1998. KFC revenue was \$33,040,000 in fiscal 1999, an increase of \$3,127,000 or 10.5% compared to an increase of 4.8% in fiscal 1998. East Side Mario's revenue was \$7,567,000 in fiscal 1999, a decrease of \$1,388,000 or 15.5% compared to a decrease of 7.9% in fiscal 1998.

The 10.5% increase in KFC revenue during fiscal 1999 was the result of a 1.0% increase in comparable restaurant revenues and \$2,569,000 in revenues generated by the eight KFC's which were acquired and the one new KFC which was built during fiscal 1999. The 15.5% revenue decrease in the East Side Mario's restaurants during fiscal 1999 was caused by a comparable restaurant decrease of 8.5% combined with the closing of one East Side Mario's during the third quarter of fiscal 1999. The KFC restaurants continue to perform well because of effective support provided by the franchisor and continuing upgrades and improvements made by the Company. The East Side Mario's restaurants continue to perform poorly because of the lack of an effective food system, lack of advertising support and complete failure of the franchisor to make the concept competitive in the mid-priced casual restaurant market. The 1.6% increase in revenue during fiscal 1998 was due to the combination of several factors. First, sales in the comparable KFC restaurants increased 1.8% or \$383,000 primarily due to the addition of Taco Bell products. The two KFC restaurants which were acquired just prior to the beginning of fiscal 1998 and the new KFC opened during the year accounted for an increase of \$1,735,000, which was partially offset by three closed KFC restaurants in the St. Louis market which caused a decline of \$738,000 in sales. Finally, East Side Mario's restaurant sales declined \$764,000 or 7.9% compared to the prior year. Revenues for the comparable KFC restaurants were flat during fiscal 1998 compared to the prior year primarily because fiscal 1997 revenues were extremely strong and many of the Company's KFC restaurants were closed for short periods of time during the fiscal 1998 year to facilitate remodeling and image enhancements.

Revenues for the 16 weeks ended February 28, 1999 were \$11,969,000, an increase of \$745,000 from the 16 weeks ended March 1, 1998. KFC restaurant revenues increased \$1,432,000 to 9,980,000 in the fiscal 1999 quarter compared to the fiscal 1998 quarter due to a comparable restaurant increase of 2.1% and the addition of nine new restaurants, three of which were added during the fiscal fourth quarter. East Side Mario's comparable restaurant revenues declined by \$687,000 to \$1,989,000 for the fiscal 1999 fourth quarter caused by a comparable restaurant revenue decline of 8.5% combined with the closing of one restaurant late in the third quarter. The reasons for these changes are the same as mentioned above in the full year comparisons.

MORGAN'S FOODS, INC.

PART II (cont'd)

Cost of Sales - Food, Paper and Beverage. Food, paper and beverage costs were \$12,774,000 or 31.5% of sales in fiscal 1999 compared to \$12,259,000 or 31.5% of sales in fiscal 1998. Food, paper and beverage costs declined by 0.2% of sales in the KFC's due to efficiencies from higher average restaurant volumes and the continuation of low chicken prices. Food, paper and beverage costs rose 0.2% of sales in the East Side Mario's due to declining revenues and the absence of menu price increases to offset higher food procurement costs. Food, paper and beverage costs were \$12,259,000 or 31.5% of sales in fiscal 1998 compared to \$12,141,000 or 31.7% of sales in fiscal 1997. Food, paper and beverage costs declined by 0.4% of sales in the KFC's due to efficiencies from higher volumes and the absence of high food cost promotions. Food, paper and beverage costs remained constant as a percentage of sales in the East Side Mario's due to more effective operational controls offset by decreased efficiency due to lower volumes.

For the fourth quarter, food, paper and beverage costs in fiscal 1999 increased as a percentage of sales to 31.7% from 31.2% in fiscal 1998. KFC food, paper and beverage cost increased 0.5% of sales due to lower food cost efficiency in the restaurants acquired late in fiscal 1999. The East Side Mario's food, paper and beverage costs increased 0.2% of sales during the fiscal 1999 fourth quarter due to lower restaurant volumes.

Cost of Sales - Labor and Benefits. Labor and benefits decreased to 26.2% of sales or \$10,635,000 in fiscal 1999 from 26.9% of sales or \$10,456,000 in fiscal 1998. Labor and benefit costs in the KFC's decreased 0.5% in fiscal 1999 compared to the prior year primarily due to reduced workers compensation costs. Labor and benefit costs in the East Side Mario's increased 0.2% of sales in fiscal 1999 because of reduced efficiency caused by lower volume levels. Labor and benefit costs in fiscal 1998 increased to 26.9% of sales or \$10,456,000 compared to 26.0% of sales or \$9,951,000 in fiscal 1997. Labor costs in the KFC's increased by approximately 1.6% of sales primarily due to the increase in the minimum wage and the inefficiencies created by many short term restaurant closings during fiscal 1998 to facilitate image enhancements and remodeling. The labor costs in the East Side Mario's remained relatively consistent as a percentage of sales despite lower volumes due to continuing strong management controls.

Labor and benefit costs for the fourth quarter decreased to 26.7% of sales or \$3,201,000 compared to 27.9% of sales or \$3,127,000 in fiscal 1998. Labor costs as a percentage of sales in the KFC's decreased 0.7% in the fiscal 1999 fourth quarter compared to the fiscal 1998 fourth quarter while labor costs in the East Side Mario's increased 1.4% percent of sales for the same periods. The changes were primarily caused by lower workers' compensation rates which were offset, in the East Side Mario's, by decreased efficiency due to lower volumes.

Restaurant Operating Expenses. Restaurant operating expenses in fiscal 1999 decreased to 27.9% of sales or \$11,348,000 compared to 28.3% of sales or \$11,001,000 in the prior year. KFC restaurant operating expenses decreased to 25.7% of sales in fiscal 1999 compared to 26.1% of sales in fiscal 1998 due to increased average sales volumes. Restaurant operating expenses in the East Side Mario's restaurants increased as percentage of sales to 37.8% from 35.8% in the prior year due to lower average volumes and the closing of one restaurant in the third quarter of fiscal 1999. Restaurant operating expenses in fiscal 1998 declined slightly to \$11,001,000 or 28.3% of revenue from \$11,047,000 or 28.9% of revenue in fiscal 1997.

MORGAN'S FOODS, INC.

PART II (cont'd)

KFC operating expenses declined by 0.7% of sales primarily due to lower rent and advertising expenditures and the East Side Mario's increased 1.0% of sales due to lower sales volumes combined with increases in land and building rent.

Restaurant operating expenses for the fourth quarter of fiscal 1999 decreased to 29.2% of sales or \$3,492,000 from 30.8% of sales or \$3,460,000 in the year earlier quarter. KFC restaurant operating expenses decreased to 27.0% of sales in the fiscal 1999 period from 28.3% of sales in the comparable prior year period primarily due to higher restaurant volumes. Restaurant operating expenses for the East Side Mario's restaurants in the fourth quarter of fiscal 1999 rose to 40.2% of sales compared to 38.9% of sales in the year earlier period due to lower restaurant volumes and the closing of one restaurant in the third quarter of fiscal 1999.

Depreciation and Amortization. Depreciation and amortization in fiscal 1999 increased to \$1,948,000 from \$1,840,000 in fiscal 1998. Depreciation for the KFC restaurants increased \$46,000 from the prior year to \$1,198,000 due to the building of one restaurant and the acquisition of eight others during fiscal 1999. Depreciation for the East Side Mario's remained essentially the same at \$559,000. Amortization for fiscal 1999 increased to \$191,000 from \$130,000 in the prior year due to increased balances for franchise fees and deferred financing costs. Depreciation and amortization in fiscal 1998 decreased slightly to \$1,840,000 from \$1,888,000 in fiscal 1997. Depreciation for the KFC restaurants increased to \$1,152,000 in fiscal 1998 from \$1,068,000 in fiscal 1997 due to increased asset balances related to acquisition and image enhancement of several restaurants. Depreciation in the East Side Mario's restaurants decreased to \$558,000 in fiscal 1998 from \$661,000 in fiscal 1997 due to the asset impairment write-down taken in the fourth quarter of fiscal 1997. Amortization decreased to \$130,000 in fiscal 1998 from \$159,000 in fiscal 1997 primarily due to the write off of goodwill in the fourth quarter of fiscal 1997.

Asset Impairments. The Company recorded asset impairments of \$2,939,000 in the fourth quarter of fiscal 1997. These impairments included \$1,700,000 to write-down the carrying value of certain East Side Mario's restaurants and \$1,239,000 to write-off goodwill remaining from a previous KFC acquisition. The write-down of these assets resulted from management's evaluation of recoverability of their carrying values from estimated future cash flows from their operation and/or liquidation, as explained in Note 4 to the Consolidated Financial Statements.

General and Administrative Expenses. General and administrative expenses increased to \$3,137,000 in fiscal 1999 from \$2,799,000 in fiscal 1998. The increase of \$338,000 was the result of adding a KFC market manager to keep pace with the KFC expansion, higher training costs due to KFC acquisitions and \$118,000 of legal expenses in the East Side Mario's litigation which is described in Item 3 of this report. General and administrative expenses decreased to \$2,799,000 in fiscal 1998 from \$2,876,000 in fiscal 1997. The decrease was primarily due to lack of the workers' compensation litigation accrual recorded in fiscal 1997 and reduction of field administration expenses in the East Side Mario's restaurants, partially offset by increased expenses related to the reverse stock split and upgrading of computer systems.

MORGAN'S FOODS, INC.

PART II (cont'd)

Operating Income. Operating income in fiscal 1999 increased \$252,000 to \$765,000 from \$513,000 in fiscal 1998. This increase was the result of expansion of the KFC restaurant segment, partially offset by larger losses in the East Side Mario's restaurants. Operating income in fiscal 1998 was \$513,000 compared to an operating loss of \$2,590,000 in fiscal 1997. The operating loss in fiscal 1997 would have been operating income of \$349,000 without the asset impairment write-down of \$2,939,000, which was taken in fiscal 1997. The improvement in fiscal 1998 is primarily the result of additional KFC restaurants, the addition of Taco Bell products to three existing KFC restaurants, improvement in food costs and reduction in general and administrative expenses as discussed above.

Interest Expense and Other Income. Interest expense from bank debt and notes payable increased to \$992,000 in fiscal 1999 from \$836,000 in fiscal 1998 due to increased borrowings to fund the acquisition and expansion of KFC restaurants. The company acquired eight existing KFC restaurants from other franchisees and built one new KFC restaurant during fiscal 1999. Interest expense from capitalized lease debt remained relatively constant at \$546,000 in fiscal 1999. Interest expense from bank debt and notes payable increased to \$836,000 in fiscal 1998 compared to \$635,000 in fiscal 1997. This increase is the result of additional debt incurred for the purchase of two KFC restaurants late in fiscal 1997, the building of one new KFC, the image enhancement of 12 KFC's, the addition of Taco Bell facilities to three KFC restaurants, and the early renewal of substantially all of the Company's KFC franchise agreements. Interest on capitalized lease debt, at \$554,000 in fiscal 1998, was substantially unchanged from \$564,000 in fiscal 1997.

Gain (Loss) on Sale of Restaurant Assets. In fiscal 1999, the Company recorded losses of \$11,000 for the disposal of equipment related to several KFC restaurant image enhancements. In fiscal 1998 the Company recorded losses of \$98,000 related to the closing of one KFC restaurant and the disposal of equipment during several image enhancements.

Extraordinary Loss on Early Extinguishment of Debt. During fiscal 1999, the Company paid \$4,899,000 of 15 year maturity, fixed rate debt, carrying an interest rate of approximately 10.0%, which was incurred in the third quarter of fiscal 1996, in advance of its scheduled maturity. This prepayment was funded by borrowing \$6,762,000 of 20 year maturity, fixed rate debt carrying an interest rate of approximately 8.7%. The Company paid prepayment penalties of \$98,000, wrote off \$140,000 of deferred financing costs related to this transaction and incurred a loss of \$49,000 on the early buy out of capitalized leases covering equipment at three of the locations. This transaction is more fully described in Note 3 to the consolidated financial statements.

Liquidity and Capital Resources. The Company, like others in the restaurant industry, operates on minimal working capital and relies on cash flow from operations, debt borrowings and lease financing for the construction and refurbishment of restaurant properties and repayment of debt. Cash flow activity for fiscal 1999, 1998 and 1997 is presented in the Consolidated Statements of Cash Flows.

MORGAN'S FOODS, INC.

PART II (cont'd)

Capital expenditures for fiscal 1999 were \$5,379,000, substantially all of which related to KFC restaurants. In fiscal 1999 the Company received \$10,769,000 in mortgage financing for the construction of one new KFC restaurant, the acquisition of eight existing KFC restaurants and the prepayment of \$4,899,000 of debt. The Company made principal payments on long-term debt of \$577,000 in fiscal 1999.

The Company has installed the newest version of its accounting software package and a recent version of the network operating system used at the Home Office, both of which are year 2000 compliant. Management has identified several minor machines and non-critical systems which are not year 2000 compliant and is in the process of replacing them. Management believes that this will be completed well before the end of 1999 and that it has no significant year 2000 operating exposure in its critical core systems. The Company has two major suppliers upon which it relies for food and related restaurant supplies and which are using computerized ordering systems. Both of these suppliers have represented that they will be year 2000 compliant before the end of the year. The Company is requesting certification of year 2000 readiness from these suppliers and is evaluating possible backup solutions since failure of these suppliers to continue operations in the year 2000 could cause material disruptions to the operation of the Company's restaurants. Items disclosed herein constitute "Y2000 Readiness Disclosures" under the Year 2000 Information and Readiness Disclosure Act.

The KFC operations of the Company have historically provided sufficient cash flow to service the Company's debt, refurbish and upgrade KFC restaurant properties and cover administrative overhead. Management believes that operating cash flow will provide sufficient capital to continue to operate and maintain the KFC and East Side Mario's restaurants, service the Company's debt and support required corporate expenses. In addition to the Company's operating cash flow, management believes that additional financing, including long-term leases of build-to-suit restaurants, development lines of credit and sale/leaseback arrangements can be obtained to refurbish and acquire KFC restaurants. Subsequent to the end of fiscal 1999 the Company entered into definitive agreements to purchase forty-three existing KFC restaurants from KFC Corp. and twelve Taco Bell restaurants from Taco Bell Corp. which will be financed under a new mortgage financing commitment.

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

The Company has been financing the expansion and image enhancement of its restaurants primarily through the use of fixed rate long-term debt on which the rate is fixed at the time of funding. At February 28, 1999 there was \$13,671,000 of such debt outstanding at rates ranging from 8.3% to 10.6%. Management has evaluated the potential effect of a 1.0% increase in these rates on future capital spending plans and believes that there would be no material effect.

MORGAN'S FOODS, INC.

PART II (cont'd)

The Company will commit approximately \$3,600,000 to image enhancements and expansions of existing KFC restaurants during fiscal 2000, for which financing is not yet committed, as well as approximately \$1,600,000 to upgrade point of sale devices and add equipment for the roll out, in the third quarter of fiscal 2000, of the KFC sandwich program for which financing requests are in process. There are no plans to add additional East Side Mario's restaurants for the next fiscal year.

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.

New Accounting Standard. The Financial Accounting Standards Board has issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. The Company has not yet completed its analysis of SFAS No. 133 and accordingly has not yet determined what effect, if any, it may have on future financial statements.

Item 8. Financial Statements and Supplementary Data.

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

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

None.

MORGAN'S FOODS, INC.

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 1999 annual meeting to be filed with the Securities and Exchange Commission on or before June 25, 1999.

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 1999 annual meeting to be filed with the Securities and Exchange Commission on or before June 25, 1999.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

Information on security ownership of certain beneficial owners, officers and directors is incorporated herein by reference to the definitive Proxy Statement to security holders for the 1999 annual meeting to be filed with the Securities and Exchange Commission on or before June 25, 1999.

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 1999 annual meeting to be filed with the Securities and Exchange Commission on or before June 25, 1999.

MORGAN'S FOODS, INC.

PART IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K.

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

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

- (a) 3. Exhibits.

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

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

<u>Item 14 (a) 1</u>	<u>Page</u> <u>Reference</u>
Independent Auditors' Report.....	17
Consolidated Balance Sheets at February 28, 1999 and March 1, 1998.....	18
Consolidated Statements of Operations for the years ended February 28, 1999, March 1, 1998 and March 2, 1997.....	19
Consolidated Statements of Shareholders' Equity for the years ended February 28, 1999, March 1, 1998 and March 2, 1997.....	20
Consolidated Statements of Cash Flows for the years ended February 28, 1999, March 1, 1998 and March 2, 1997.....	21
Notes to Consolidated Financial Statements.....	22

Item 14 (a) 2

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

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated balance sheets of Morgan's Foods, Inc. and subsidiaries as of February 28, 1999 and March 1, 1998 and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended February 28, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Morgan's Foods, Inc. and subsidiaries at February 28, 1999 and March 1, 1998 and the results of their operations and their cash flows for each of the three years in the period ended February 28, 1999 in conformity with generally accepted accounting principles.

/s/ Deloitte & Touche LLP
Cleveland, Ohio
May 26, 1999

MORGAN'S FOODS, INC.
Consolidated Balance Sheets
February 28, 1999 and March 1, 1998

ASSETS

	<u>1999</u>	<u>1998</u>
Current assets:		
Cash and equivalents.....	\$ 2,655,000	\$ 2,316,000
Marketable securities	-	102,000
Receivables.....	38,000	74,000
Inventories.....	332,000	325,000
Prepaid expenses.....	<u>218,000</u>	<u>157,000</u>
	3,243,000	2,974,000
 Property and equipment (Notes 7 and 8):		
Land.....	3,379,000	1,949,000
Buildings and improvements.....	9,433,000	7,160,000
Property under capital leases.....	5,089,000	5,621,000
Leasehold improvements.....	3,578,000	3,280,000
Equipment, furniture and fixtures.....	9,915,000	8,995,000
Construction in progress.....	<u>344,000</u>	<u>28,000</u>
	31,738,000	27,033,000
Less accumulated depreciation and amortization.....	<u>13,346,000</u>	<u>11,934,000</u>
	18,392,000	15,099,000
Other assets.....	1,776,000	1,437,000
Deferred taxes (Note 10).....	<u>600,000</u>	<u>600,000</u>
	<u>\$24,011,000</u>	<u>\$20,110,000</u>

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:		
Current maturities of long-term debt (Note 7).....	\$ 577,000	\$ 563,000
Current maturities of capital lease obligations (Note 8).	453,000	503,000
Accounts payable.....	2,066,000	1,969,000
Accrued liabilities (Note 6).....	<u>2,329,000</u>	<u>1,985,000</u>
	5,425,000	5,020,000
 Long-term debt (Notes 3 and 7).....	13,094,000	7,815,000
Long-term capital lease obligations (Note 8).....	4,244,000	5,019,000
 Commitments and contingencies (Notes 5, 7 and 8)		

SHAREHOLDERS' EQUITY

Preferred shares, 1,000,000 shares authorized, no shares outstanding		
Common Stock:		
Authorized shares - 25,000,000		
Issued shares - 2,969,405.....	30,000	30,000
Treasury Shares - 58,566	(139,000)	(139,000)
Capital in excess of stated value.....	28,875,000	28,875,000
Accumulated deficit.....	<u>(27,518,000)</u>	<u>(26,510,000)</u>
Total shareholders' equity.....	<u>1,248,000</u>	<u>2,256,000</u>
	<u>\$24,011,000</u>	<u>\$20,110,000</u>

See notes to consolidated financial statements.

MORGAN'S FOODS, INC.
Consolidated Statements of Operations
Years Ended February 28, 1999, March 1, 1998 and March 2, 1997

	1999	1998	1997
Revenues.....	\$40,607,000	\$38,868,000	\$38,252,000
Cost of sales:			
Food, paper and beverage.....	12,774,000	12,259,000	12,141,000
Labor and benefits.....	10,635,000	10,456,000	9,951,000
Restaurant operating expenses.....	11,348,000	11,001,000	11,047,000
Depreciation and amortization.....	1,948,000	1,840,000	1,888,000
Asset impairments (Note 4).....	-	-	2,939,000
General and administrative expenses.....	<u>3,137,000</u>	<u>2,799,000</u>	<u>2,876,000</u>
Operating income (loss).....	765,000	513,000	(2,590,000)
Interest Expense:			
Bank debt and notes payable.....	(992,000)	(836,000)	(635,000)
Capital leases.....	(546,000)	(554,000)	(564,000)
Loss on sale or disposal of restaurant assets (Note 5).....	(11,000)	(98,000)	(248,000)
Other income and expense, net.....	<u>83,000</u>	<u>61,000</u>	<u>7,000</u>
Loss before extraordinary item and income taxes.....		(701,000)	(914,000)
(4,030,000)			
Provision for income taxes (Note 10).....	<u>20,000</u>	<u>14,000</u>	<u>25,000</u>
Loss before extraordinary item.....	(721,000)	(928,000)	(4,055,000)
Extraordinary loss on early extinguishment of debt (Note 3).....	<u>(287,000)</u>	-	-
Net loss.....	<u><u>\$ (1,008,000)</u></u>	<u><u>\$ (928,000)</u></u>	<u><u>\$ (4,055,000)</u></u>
Income (loss) per common share:			
Loss before extraordinary item.....	\$ (.25)	\$ (.31)	\$ (1.37)
Loss on early extinguishment of debt.....	(.10)	-	-
Net loss per share.....	<u><u>\$ (.35)</u></u>	<u><u>\$ (.31)</u></u>	<u><u>\$ (1.37)</u></u>

See notes to consolidated financial statements.

MORGAN'S FOODS, INC.
Consolidated Statements of Shareholders' Equity
Years Ended February 28, 1999, March 1, 1998 and March 2, 1997

	<u>Common Shares</u>		<u>Treasury Shares</u>		<u>Capital in excess of stated value</u>	<u>Accumulated Deficit</u>	<u>Total Shareholders' Equity</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>			
Balance, March 3, 1996.....	2,969,405	2,969,000	-	-	25,936,000	(21,527,000)	7,378,000
Change in stated value (Note 9).			(2,939,000)			2,939,000	
Net loss.....						(4,055,000)	(4,055,000)
Purchase of treasury shares.....			(8,333)	(23,000)			(23,000)
Balance, March 2, 1997.....	<u>3,300,000</u>	<u>2,969,405</u>	<u>30,000</u>	<u>(8,333)</u>	<u>(23,000)</u>	<u>28,875,000</u>	<u>(25,582,000)</u>
Net loss.....						(928,000)	(928,000)
Purchase of treasury shares.....			(50,233)	(116,000)			(116,000)
Balance, March 1, 1998.....	<u>2,969,405</u>	<u>\$ 30,000</u>	<u>(58,566)</u>	<u>\$(139,000)</u>	<u>\$ 28,875,000</u>	<u>\$(26,510,000)</u>	<u>\$2,256,000</u>
Net loss.....						(1,008,000)	(1,008,000)
Balance, February 28, 1999.....	<u>2,969,405</u>	<u>\$ 30,000</u>	<u>(58,566)</u>	<u>\$(139,000)</u>	<u>\$ 28,875,000</u>	<u>\$(27,518,000)</u>	<u>\$1,248,000</u>

See notes to consolidated financial statements.

MORGAN'S FOODS, INC.
Consolidated Statements of Cash Flows
Years Ended February 28, 1999, March 1, 1998 and March 2, 1997

	1999	1998	1997
Cash flows from operating activities:			
Net loss.....	\$ (1,008,000)	\$ (928,000)	\$
Adjustments to reconcile to net cash provided by operating activities:			
Depreciation and amortization.....	1,948,000	1,840,000	
Asset impairments.....	-	-	
Loss on sale or disposal of restaurant assets.....	11,000	98,000	
Changes in assets and liabilities:			
Decrease in receivables.....	36,000	38,000	
Decrease (Increase) in inventories.....	(7,000)	(32,000)	
Decrease (Increase) in prepaid expenses. (Increase) in other assets.....	(69,000)	34,000	
Increase in accounts payable.....	96,000	55,000	
Increase (Decrease) in accrued liabilities.....	344,000	(60,000)	
Net cash provided by operating activities..	<u>1,148,000</u>	<u>954,000</u>	<u></u>
Cash flows from investing activities:			
Sale of restaurants.....	-	15,000	
Capital expenditures.....	(5,379,000)	(2,203,000)	
	(3,074,000)		
Proceeds from sale and maturity of marketable securities.....	102,000	96,000	
Net cash provided by (used in) investing activities.....	<u>(5,277,000)</u>	<u>(2,095,000)</u>	<u></u>
	(2,963,000)		
Cash flows from financing activities:			
Proceeds from issuance of long-term debt, net of financing costs.....	10,769,000	1,651,000	
Principal payments on long-term debt.....	(577,000)	(490,000)	
Principal payments on capital lease obligations.....	(825,000)	(431,000)	
Bank debt repayment in advance of scheduled maturities.....	(4,899,000)	-	
Proceeds from sale/leaseback transactions..		698,000	
Purchase of treasury shares.....	-	(116,000)	
Net cash provided by (used in) financing activities.....	<u>4,468,000</u>	<u>1,312,000</u>	<u></u>
Net change in cash and equivalents.....	339,000	(697,000)	
Cash and equivalents, beginning balance....	2,316,000	3,013,000	
Cash and equivalents, ending balance.....	<u>\$ 2,655,000</u>	<u>\$ 2,316,000</u>	<u>\$</u>
Noncash investing and financing activities- franchise fees and capital leases.....	<u>\$ -</u>	<u>\$ 418,000</u>	<u>\$</u>

See notes to consolidated financial statements.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

Note 1. Description of Business and Summary of Significant Accounting Policies.

Description of Business. Morgan's Foods, Inc. ("The Company") operates 48 Kentucky Fried Chicken ("KFC") restaurants, of which three also offer Taco Bell products, in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York which comprised 81% of total revenues for fiscal 1999. The Company also operates, as franchisee, 5 East Side Mario's ("ESM") restaurants as well as an additional ESM which was operated through the first 33 weeks of fiscal 1999, in the Cleveland/Akron and Columbus, Ohio areas which comprised 19% of total revenues for fiscal 1999. The Company's fiscal year is a 52-53 week year ending on the Sunday nearest the last day of February.

Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions pending completion of related events. These estimates and assumptions affect the amounts reported at the date of the financial statements for assets, liabilities, revenues and expenses and the disclosure of contingencies. Actual results could differ from those estimates.

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

Cash and Equivalents. The Company considers all highly liquid debt instruments purchased with an initial maturity of three months or less to be cash equivalents.

Marketable Securities. Marketable securities consist of U.S. Treasury Notes and Bills, including those pledged as collateral for long-term debt. These securities are classified as held to maturity and accordingly, are carried at amortized cost unless there is a permanent impairment of their value.

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

Property and Equipment. Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets as follows: buildings and improvements - 3 to 20 years; equipment, furniture and fixtures - 10 years. Leasehold improvements are amortized over 3 to 15 years, which is the shorter of the life of the asset or life of the lease. The asset values of the capitalized leases are amortized using the straight-line method over the lives of the respective leases which range from 15 to 20 years. Depreciation and amortization expense for fiscal 1999, 1998 and 1997 was \$1,863,000, \$1,772,000 and \$1,770,000, respectively.

Management evaluates the net carrying value of property and equipment periodically in light of both the estimated future cash flows resulting from the use of the assets as well as the estimated liquidation value of such assets. Management believes the carrying value of property and equipment at February 28, 1999 will be recovered from future cash flows.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

Franchise Agreements. Franchise agreements are recorded at cost. Amortization is computed on the straight-line method over the term of the franchise agreement. The Company's franchise agreements are predominantly 20 years in length. Annual amortization expense was \$43,000, \$29,000 and \$12,000 for fiscal years 1999, 1998 and 1997. Franchise fees and accumulated amortization were \$872,000 and \$104,000 for fiscal 1999 and \$659,000 and \$61,000 for fiscal 1998, respectively.

Deferred Financing Costs. Costs related to the acquisition of long-term debt are capitalized and expensed over the term of the related debt. Annual amortization expense was \$34,000, \$29,000 and \$56,000 for fiscal years 1999, 1998 and 1997. The balance of deferred financing costs was \$500,000 for fiscal 1999 and \$367,000 for fiscal 1998.

Goodwill. Goodwill was amortized over forty years on a straight-line basis. Annual amortization expense was \$40,000 for fiscal 1997. Management evaluated the carrying amount of goodwill periodically based upon past and projected cash flows from operations and the estimated fair value of related assets and as a result, wrote off the remaining balance of goodwill in fiscal 1997 (see Note 4).

Income Taxes. The provision for income taxes is based upon income or loss before tax for financial reporting purposes. Deferred tax assets or liabilities are recognized for the expected future tax consequences of temporary differences between the tax basis of assets and liabilities and their carrying values for financial reporting purposes. A deferred tax asset is recorded for the benefits of future deductible temporary differences and operating loss and tax credit carryforwards. A valuation allowance is recorded to reduce deferred tax assets to the amount more likely than not to be realized in the future, based on an evaluation of historical and projected profitability.

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

Note 2. Segment Reporting

For the fiscal year ended February 28, 1999, the Company adopted Statement of Financial Accounting Standards ("SFAS") 131 requiring the disclosure of certain information regarding the business segments of an enterprise. Management has determined that the operations of the Company consist of two reportable segments. The first segment includes the Company's KFC and KFC/Taco Bell "2 in 1" restaurants while the second segment contains the ESM restaurants. Management and the Board of Directors use financial information separately from each of the KFC and ESM segments to analyze restaurant operations from revenue through restaurant contribution. Home Office and supervisory overhead and financing costs are not allocated to the business segments. The following is the operating segment information and reportable segment asset information for fiscal years ending in 1999, 1998 and 1997:

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

<u>1999 (in thousands)</u>	<u>KFC</u>	<u>ESM</u>	<u>Total</u>	<u>1998 (in thousands)</u>	<u>KFC</u>	<u>ESM</u>	<u>Total</u>
Revenues	\$33,040	\$7,567	\$40,607	Revenues	\$29,913	\$8,955	\$38,868
Cost of Sales	18,404	5,005	23,409	Cost of Sales	16,885	5,830	22,715
Operating Expenses	8,486	2,862	11,348	Operating Expenses	7,800	3,201	11,001
Depreciation	<u>1,198</u>	<u>559</u>	<u>1,757</u>	Depreciation	<u>1,152</u>	<u>558</u>	<u>1,710</u>
Restaurant Contribution	<u>\$ 4,952</u>	<u>\$ (859)</u>	4,093	Restaurant Contribution	<u>\$ 4,076</u>	<u>\$ (634)</u>	3,442
General & Administrative			3,137	General & Administrative			2,799
Interest Expense			1,538	Interest Expense			1,390
Amortization			191	Amortization			130
Other			<u>(72)</u>	Other			<u>37</u>
Loss before extraordinary item & income taxes			<u>\$ (701)</u>	Loss before income taxes			<u>\$ (914)</u>

<u>1997 (in thousands)</u>	<u>KFC</u>	<u>ESM</u>	<u>Total</u>
Revenues	\$28,533	\$9,719	\$38,252
Cost of Sales	15,762	6,330	22,092
Operating Expenses	7,663	3,384	11,047
Depreciation	<u>1,068</u>	<u>661</u>	<u>1,729</u>
Restaurant Contribution	<u>\$ 4,040</u>	<u>\$ (656)</u>	3,384
General & Administrative			2,876
Interest Expense			1,199
Amortization			159
Asset Impairment			2,939
Other			<u>241</u>
Loss before Income taxes			<u>\$(4,030)</u>

<u>(in thousands)</u>	<u>KFC</u>	<u>ESM</u>	<u>PARENT</u>	<u>TOTAL</u>
1999 Total Assets	\$ 15,939	\$ 4,476	\$ 3,596	\$ 24,011
Capital Expenditures	5,330	0	49	5,379
1998 Total Assets	11,663	5,110	3,337	20,110
Capital Expenditures	3,001	6	67	3,074

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

Note 3. Early Extinguishment of Debt.

In the fourth quarter of fiscal 1999, the Company paid, in advance of scheduled maturity, seven mortgage loans with a combined balance of \$4,899,000. The seven loans were originated in September 1995 with an original balance of \$5,509,000, 15 year terms, fixed interest rates of approximately 10.0% and were secured by mortgages on seven of the Company's KFC restaurants. The loans were replaced by new mortgage loans having 20 year terms, 8.7% fixed interest rates, secured by the same seven KFC properties and having an initial, combined balance of \$6,762,000. In consummating this transaction, the Company incurred prepayment penalties of \$98,000 and expensed \$140,000 of deferred financing costs related to the loans, which were paid early. As part of the refinancing transaction, the Company also incurred a loss of \$49,000 to buy out capitalized leases covering equipment at three of the locations. In addition, the Company received \$1,205,000 in cash net of loan costs and replaced annual debt service of \$785,000 with new annual debt service of \$716,000.

Note 4. Asset Impairments.

The Company recorded asset impairments of \$2,939,000 in the fourth quarter of fiscal 1997. These impairments included \$1,700,000 to write-down the carrying value of certain East Side Mario's restaurants and \$1,239,000 to write-off goodwill remaining from a previous KFC acquisition. The write-down of these assets resulted from management's evaluation of recoverability of their carrying values from estimated future cash flows from their operation and/or liquidation, as explained below:

Comparable restaurant revenues, operating income and cash flows of East Side Mario's restaurants had decreased in fiscal 1996. The franchisor and the Company instituted a number of changes in fiscal 1997 which were expected to improve the financial performance of the East Side Mario's restaurants. However, in spite of those changes, the financial performance of these restaurants further declined significantly in fiscal 1997. Also, in February 1997, East Side Mario's, Inc., the franchisor of these restaurants, was sold by Pizza Hut, Inc., a subsidiary of PepsiCo, Inc., to another franchisor. Based upon the poor financial performance of the East Side Mario's restaurants, which management expects to continue unless changes are made to this restaurant concept, and the uncertainty of when or if such improvements may be made by the new franchisor, management determined that the carrying value of property and equipment of certain East Side Mario's restaurants was impaired. Accordingly, the Company recorded asset impairments of \$1,700,000 to write-down property and equipment of certain East Side Mario's restaurants, based upon the present value of estimated future cash flows of the restaurants.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

The Company also wrote off remaining goodwill of \$1,239,000 related to the 1987 purchase of KFC restaurants in the St. Louis, Missouri market. This impairment resulted from new requirements for expenditures to upgrade facilities due to the August 1996 settlement of the long-standing lawsuit between the Association of KFC Franchisees and KFC Corporation. This settlement included a requirement that franchisees upgrade their restaurants to current KFC standards in order to obtain new 20 year franchise agreements under favorable terms. The specific facility upgrade requirements were communicated to the Company and all other KFC franchisees in January 1997 after facility inspections by representatives of KFC Corporation. Including these expenditures, management estimated that future cash flows from operation or liquidation of these restaurants would not recover the carrying value of goodwill.

These asset impairments resulted from management's estimates of future cash flows from operation and/or liquidation of the assets. It is reasonably possible that actual cash flows in the future from these assets could be greater, or less, than management's current estimates, and such differences could be material. Differences between management's current estimates of future cash flows and revised estimates, or actual cash flows, in the future could result in additional gains or losses in future periods from operation or liquidation of these assets.

Note 5. Disposition of Assets.

During fiscal 1999, 1998 and 1997, the Company recognized losses totaling \$11,000, \$98,000 and \$248,000, respectively from the sale or disposal of restaurant assets and the closing of unprofitable restaurants. These restaurants did not have a material effect upon the Company's consolidated results of operations or financial position. As of February 28, 1999, the Company remains as the guarantor on two leases from the sale of 24 KFC restaurants in May 1995.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

Note 6. Accrued Liabilities.

Accrued liabilities consist of the following at February 28, 1999 and March 1, 1998:

	1999	1998
Accrued compensation.....	\$ 738,000	\$ 631,000
Accrued taxes other than income taxes.....	411,000	291,000
Accrued liabilities related to sold restaurants.....	172,000	266,000
Accrued royalties and advertising.....	430,000	104,000
Other accrued expenses.....	578,000	693,000
	<u>\$2,329,000</u>	<u>\$1,985,000</u>

Note 7. Long-Term Debt.

Long-term debt consists of the following at February 28, 1999 and March 1, 1998:

	<u>1999</u>	<u>1998</u>
Mortgage debt, monthly payments of \$91,000 including interest at 8.3% to 10.6%, through 2012, collateralized by twenty restaurants having a net book value at February 28, 1999 of \$7,830,000.....		\$ 13,144,000
Equipment loans, monthly payments of \$7,000 including interest at 10.1% through February 2004 collateralized by equipment at four KFC restaurants.....		314,000
Notes payable, monthly payments of \$12,000 including interest at 7.0% through June 2000 for early renewal franchise fees....		190,000
Note payable at 9.0%, monthly payments of \$9,100 including interest through October 1998 and thereafter \$500 through October 2003.....		23,000
	13,671,000	<u>8,378,000</u>
Less current maturities.....	<u>577,000</u>	<u>563,000</u>
	<u>\$13,094,000</u>	<u>\$7,815,000</u>

Certain of the Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1.0.

The Company paid interest relating to long-term debt of approximately \$1,100,000, \$800,000 and \$590,000 in fiscal 1999, 1998 and 1997, respectively.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

Note 8. Lease Obligations and Other Commitments.

Property under capital leases at February 28, 1999 and March 1, 1998 are as follows:

	1999	1998
Leased property:		
Buildings	\$ 3,720,000	
\$3,895,000		
Equipment, furniture and fixtures		1,369,000
<u>1,726,000</u>		
Total		5,089,000
5,621,000		
Less accumulated amortization		1,946,000
<u>1,723,000</u>		
	\$ 3,143,000	\$3,898,000

Amortization of leased property under capital leases was \$545,000, \$482,000 and \$495,000 in fiscal 1999, 1998 and 1997, respectively.

Related obligations under capital leases at February 28, 1999 and March 1, 1998 are as follows:

	1999	1998
Capital lease obligations.....	\$4,697,000	\$5,522,000
Less current maturities.....	453,000	503,000
Long-term capital lease obligations..	<u>\$ 4,244,000</u>	<u>\$5,019,000</u>

The Company paid interest of approximately \$546,000, \$554,000 and \$564,000 relating to capital lease obligations in fiscal 1999, 1998 and 1997, respectively.

Future minimum rental payments to be made under capital leases at February 28, 1999, are as follows:

2000	\$ 907,000
2001	723,000
2002	650,000
2003	600,000
2004	592,000
Later years	5,226,000
	8,698,000
Less amount representing interest	4,001,000
Total obligations under capital leases	<u>\$4,697,000</u>

The Company's leases for restaurant land and buildings are noncancellable and expire on various dates through 2014. The leases have renewal options ranging from 1 to 26 years. Certain restaurant land and building leases require the payment of additional rent equal to an amount by which a percentage of annual

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

sales exceeds annual minimum rentals. The interest rates on the leases range predominantly from 9.5% to 13.0%. Total contingent rentals were \$75,000, \$72,000 and \$63,000 in fiscal 1999, 1998 and 1997, respectively. Future noncancellable minimum rental payments under operating leases at February 28, 1999, are as follows: 2000 - \$1,379,000; 2001 - \$1,327,000; 2002 - \$1,160,000; 2003 - \$982,000; 2004 - \$981,000; and an aggregate \$7,535,000 for the years thereafter. Rental expense for all operating leases was \$1,867,000, \$1,620,000, and \$1,915,000 for fiscal 1999, 1998 and 1997, respectively.

For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5% of gross revenues on national and local advertising pursuant to its franchise agreements. In addition, for Taco Bell products, the Company pays royalties of 10% and advertising fees of 0.5% of gross revenues under the five year license agreements for the KFC/Taco Bell "2 in 1" locations.

The East Side Mario's franchise agreement requires the Company to pay royalties of 4% on gross revenues and 1/2% of gross revenues to an advertising fund. The franchise agreement also requires the Company to expend an additional 2 1/2% of gross revenues for advertising and promotion. On April 20, 1998 the Company and its wholly owned subsidiary, Morgan's Creative Restaurant Concepts, Inc., filed a lawsuit against East Side Mario's, Inc. and other related parties in Federal District Court in Cleveland, Ohio. The suit alleges fraud, deceptive trade practices and failure to support the East Side Mario's franchisees among other things and sets forth a demand for \$20 million in damages. The Company filed a second suit against the same parties on July 8, 1998, which brought the total claim for damages to \$60 million. Royalty and advertising fund payments have been accrued but have not been made since prior to the filing of the first lawsuit (see Note 6).

Note 9. Net Income (Loss) Per Common Share.

All net income (loss) per common share amounts have been computed based on the weighted average number of common shares outstanding during each year which totaled 2,910,839, 2,936,877 and 2,967,574 for fiscal 1999, 1998 and 1997, respectively. A one for six reverse stock split was effective on July 14, 1997. All share and per share data have been restated to reflect the one for six reverse stock split.

Note 10. Income Taxes.

The current provision for income taxes, which approximates tax payments, consists of state and local taxes of \$20,000, \$14,000 and \$25,000 for fiscal 1999, 1998 and 1997, respectively. There was no deferred provision for income taxes during each of the fiscal years 1999, 1998 and 1997.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

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

	<u>1999</u>	<u>1998</u>	<u>1997</u>
Tax provision (benefit) at statutory rate.....	\$ (336,000)	\$ (320,000)	\$ (1,411,000)
Goodwill amortization/write-off..	-	-	448,000
State and local taxes, net of federal benefit.....	13,000	9,000	16,000
Losses (income) and temporary differences with no tax benefit (expense).....	338,000	321,000	970,000
Other.....	5,000	4,000	2,000
	<u>\$ 20,000</u>	<u>\$ 14,000</u>	<u>\$ 25,000</u>

The components of deferred tax assets (liabilities) at February 28, 1999 and March 1, 1998 are as follows:

	<u>1999</u>	<u>1998</u>
Operating loss carryforwards.....	\$ 5,942,000	
Tax credit carryforwards.....	93,000	
Property and equipment.....	1,134,000	
Accrued expenses not currently deductible.....	355,000	
Inventory valuation.....	4,000	
Deferred tax asset valuation adjustment.....	(6,928,000)	
Net deferred tax asset.....	<u>\$ 600,000</u>	<u>\$</u>

The valuation allowance increased \$296,000 and \$827,000 during fiscal 1998 and 1997, respectively and decreased \$2,729,000 during fiscal 1999.

At February 28, 1999, the Company has net operating loss carryforwards which, if not utilized, will expire as follows:

2000	\$ 4,513,000
2001	4,055,000
2004	737,000
2005	2,786,000
2009	1,077,000
2012	744,000
2013	728,000
2014	215,000
Total	<u>\$14,855,000</u>

The Company also has alternative minimum tax net operating loss carryforwards of \$12,866,000 which will expire, if not utilized, in varying amounts through fiscal 2014. These carryforwards are available to offset up to 90% of any alternative minimum taxable income which would otherwise be taxable.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

As of February 28, 1999, the Company has an alternative minimum tax credit carryforward of \$56,000. In addition, the Company has approximately \$37,000 of investment tax credits (after reduction pursuant to the Tax Reform Act of 1986) available to offset future federal income tax liabilities through fiscal 2000.

Note 11. Stock Options and Shareholders' Equity.

As of June 28, 1996, the Board of Directors of the Company changed the stated value of the Company's common shares to \$0.01 per share from \$1.00 per share.

The Company previously had an Incentive Stock Option Plan ("Incentive Plan") and a Non-Qualified Stock Option Plan ("Stock Option Plan") which provided options exercisable at the market value of the underlying common shares on the date of the grant. Both plans expired during fiscal 1995. Options granted under the Incentive Plan remain outstanding with option exercise prices of \$10.50 to \$16.125 until they individually expire through January 2004 according to the terms of the plan.

Information with respect to these option plans follows:

<u>Number of Shares</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
Outstanding, beginning of year.....	57,500	60,167	65,167
Expired during year.....	<u>(33,334)</u>	<u>(2,667)</u>	<u>(5,000)</u>
Outstanding, end of year.....	<u>24,166</u>	<u>57,500</u>	<u>60,167</u>
Exercisable, end of year.....	<u>24,166</u>	<u>57,500</u>	<u>60,167</u>

On April 2, 1999, the Company adopted the Non-qualified Stock Option Plan for Executives and Managers. The plan allows for the granting of options to purchase 145,500 shares of the Company's common stock. All of the available options were granted on April 2, 1999 at an exercise price of \$4 1/8 per share. The options are exercisable after six months and expire after ten years.

There will be submitted at the Annual Meeting of Shareholders for action by the holders of Common Shares a proposal to adopt the Key Employees Nonqualified Stock Option Plan (the "Plan"). The Plan was approved by the board of directors on April 2, 1999. No awards relating to the Plan have been made. If the Plan is approved by the holders of Common Shares, the Plan Committee (the "Committee") will from time to time consider awards for key employees of the Company under the Plan. Subject to certain provisions in the Plan, an aggregate of 291,000 Common Shares of the Company may be issued pursuant to the Plan.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

On April 8, 1999, the Company adopted a Shareholder Rights Plan in which the Board declared a distribution of one Right for each of the Company's outstanding Common Shares. Each Right entitles the holder to purchase from the Company one one-thousandth of a Series A Preferred Share (a "Preferred Share") at a purchase price of \$30.00 per right, subject to adjustment. One one-thousandth of a Preferred Share is intended to be approximately the economic equivalent of one Common Share. The Rights will expire on April 7, 2009, unless redeemed by the Company as described below.

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

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

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

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

Note 12. 401-K Retirement Plan.

The Company has a 401-K Retirement Plan in which employees age 21 or older who have completed one year of service with the Company, working at least 1,000 hours, are eligible to participate. The Company matches, in Company stock, a percentage of employee contributions. During fiscal 1999, 1998 and 1997, respectively, the Company incurred \$19,000, \$20,000 and \$25,000, respectively, in expenses for matching contributions to the plan.

MORGAN'S FOODS, INC.
Notes to Consolidated Financial Statements
February 28, 1999, March 1, 1998 and March 2, 1997

Note 13. Fair Value of Financial Instruments

Management believes that the fair value of the Company's debt at February 28, 1999 approximates carrying value, based upon interest rates obtained in recent financing transactions.

Note 14. New Accounting Standard

The Financial Accounting Standards Board has issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. The Company has not yet completed its analysis of SFAS No. 133 and accordingly has not yet determined what effect, if any, it may have on future financial statements.

Note 15. Subsequent Events

In May 1999, the Company signed definitive agreements to purchase 43 KFC restaurant properties and 12 Taco Bell restaurants from KFC Corporation and Taco Bell Corporation respectively and expects to close the transactions in middle to late June 1999. The Company expects to finance these purchases under a new mortgage financing commitment. During fiscal 1999, the Company also ceased operations at its East Side Mario's restaurant in Mayfield Heights, OH and liquidated its leasehold interest subsequent to the end of the fiscal year.

MORGAN'S FOODS, INC.
INDEX TO EXHIBITS
Item 14 (a) (3)

<u>Exhibit Number</u>	<u>Exhibit Description</u>
3.1	Amended Articles of Incorporation, as amended (1)
3.2	Amended Code of Regulations (1)
4.1	Specimen Certificate for Common Shares (2)
10.1	Specimen KFC Franchise Agreements (3)
10.2	Amended and Restated Incentive Stock Option Plan (4)
10.5	Form of East Side Mario's Area Development Agreement and Franchise Agreement (4)
10.6	Form of Mortgage Loan Agreement with Captec Financial Group, Inc. (5)
19	Form of Indemnification Contract between Registrant and its Officers and Directors (4)
21	Subsidiaries
23	Independent Auditors' Consent
27	Financial Data Schedule
(1)	Filed as an exhibit to Registrant's Form 10-K for the 1992 fiscal year and incorporated herein by reference.
(2)	Filed as an exhibit to the Registrant's Registration Statement (No. 33-35772) on Form S-2 and incorporated herein by reference.
(3)	Filed as an exhibit to the Registrant's Registration Statement (No. 2-78035) on Form S-1 and incorporated herein by reference.
(4)	Filed as an exhibit to the Registrant's Form 10-K for the 1993 fiscal year and incorporated herein by reference.
(5)	Filed as an exhibit to the Registrant's Form 10-K for the 1996 fiscal year and incorporated herein by reference.

Highland Park, Michigan, 1914. The photograph shows the main building of the Highland Park Hotel, a grand structure with a prominent central tower and classical architectural details. The building is surrounded by a well-maintained lawn and trees. The image is a black and white photograph, likely a postcard or a historical record.
