Audited Consolidated Financial Statements and Footnotes

January 2, 2011 and January 3, 2010

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Mexican Restaurants, Inc. and Subsidiaries:

We have audited the accompanying consolidated balance sheets of Mexican Restaurants, Inc. and Subsidiaries (the "Company") as of January 2, 2011 and January 3, 2010, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Mexican Restaurants, Inc. and Subsidiaries as of January 2, 2011 and January 3, 2010, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

/s/UHY LLP

Houston, Texas
May 2, 2011

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
As of January 2, 2011 and January 3, 2010

ASSETS	Jan 2, 2011	Jan 3, 2010
Current assets:		
Cash	$ 319,449	$ 719,944
Royalties receivable	101,800	61,194
Other receivables, net	457,933	639,019
Inventory	538,636	562,682
Income taxes receivable	--	284,724
Prepaid expenses and other current assets	938,310	1,065,056
Assets related to discontinued operations, net	100,000	161,523
Total current assets	2,456,128	3,494,142
Property and equipment, net	14,921,126	17,491,335
Goodwill	--	5,017,243
Deferred tax assets	3,899,704	1,542,999
Other assets	162,770	147,667
Other assets related to discontinued operations	33,878	33,878
Total Assets	$21,473,606	$27,727,264
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$2,388,605	$1,929,864
Accrued sales, liquor and payroll taxes	803,735	979,735
Accrued expenses	990,640	1,104,185
Income taxes payable	102,803	--
Current liabilities related to discontinued operations	3,180	39,554
Current portion of liabilities associated with leasing and exit activities	222,914	107,381
Total current liabilities	4,511,877	4,160,719
Long-term debt	4,400,000	5,150,000
Liabilities associated with leasing and exit activities, net of current portion	247,671	611,392
Deferred gain	520,357	728,500
Other liabilities	1,951,799	2,149,313
Total liabilities	11,631,704	12,799,924
Commitments and Contingencies		
Stockholders' equity:		
Preferred stock, $0.01 par value, 1,000,000 shares authorized, none issued	--	--
Common stock, $0.01 par value, 20,000,000 shares authorized, 4,732,705 shares issued, 3,413,099 and 3,290,141 shares outstanding at 1/2/2011 and 1/3/2010, respectively	47,327	47,327
Additional paid-in capital	18,716,827	19,390,702
Retained earnings	2,771,215	8,272,186
Treasury stock at cost, 1,319,606 and 1,442,564 common shares, at 1/2/2011 and 1/3/2010, respectively	(11,693,467)	(12,782,875)
Total stockholders' equity	9,841,902	14,927,340
Total Liabilities and Stockholders' Equity	$21,473,606	$27,727,264

See accompanying notes to consolidated financial statements.

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
For the fiscal years ended January 2, 2011 and January 3, 2010

	Jan 2, 2011	Jan 3, 2010
Revenues:		
Restaurant sales	$65,708,717	$71,252,615
Franchise fees, royalties and other	473,381	554,439
Business interruption	--	210,847
	$66,182,098	72,017,901
Costs and expenses:		
Cost of sales	19,310,658	20,411,454
Labor	22,729,647	23,730,414
Restaurant operating expenses	17,088,675	17,899,872
General and administrative	5,315,255	6,483,391
Depreciation and amortization	3,427,418	3,522,503
Pre-opening costs	--	21,745
Goodwill impairment	5,017,243	--
Other impairment and restaurant closure costs	1,071,521	358,291
Loss on involuntary disposals	--	20,620
Loss on sale of other property and equipment	27,493	127,293
	73,987,910	72,575,583
Operating loss	(7,805,812)	(557,682)
Other income (expense):		
Interest income	13,428	3,322
Interest expense	(218,127)	(194,493)
Other, net	36,513	31,535
	(168,186)	(159,636)
Loss from continuing operations before income taxes	(7,973,998)	(717,318)
Income tax benefit (expense)	2,362,991	(71,585)
Loss from continuing operations	(5,611,007)	(788,903)
Discontinued operations:		
Income from discontinued operations	--	36,021
Restaurant closure income (expense)	156,376	(201,229)
Gain on sale of assets	--	386,502
Income from discontinued operations before income taxes	156,376	221,294
Income tax expense	(46,340)	(281,090)
Income (loss) from discontinued operations	110,036	(59,796)
Net loss	$(5,500,971)	$ (848,699)

See accompanying notes to consolidated financial statements.

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the fiscal years ended January 2, 2011 and January 3, 2010

	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balances at December 28, 2008	$47,327	$19,442,049	$9,120,885	$(13,123,985)	$15,486,276
Issuance of vested restricted stock from treasury	--	(341,110)	--	341,110	--
Stock based compensation expense	--	274,000	--	--	274,000
Excess tax benefit-stock based compensation	--	15,763	--	--	15,763
Net loss	--	--	(848,699)	--	(848,699)
Balances at January 3, 2010	47,327	19,390,702	8,272,186	(12,782,875)	14,927,340
Issuance of vested restricted stock from treasury	--	(84,170)	--	84,170	--
Stock based compensation expense	--	169,516	--	--	169,516
Issuance of common stock from treasury	--	(727,266)	--	1,005,238	277,972
Excess tax expense-stock based compensation	--	(31,955)	--	--	(31,955)
Net loss	--	--	(5,500,971)	--	(5,500,971)
Balances at January 2, 2011	$47,327	$18,716,827	$2,771,215	$(11,693,467)	$9,841,902

See accompanying notes to consolidated financial statements.

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the fiscal years ended January 2, 2011 and January 3, 2010

	Jan 2, 2011	Jan 3, 2010
Cash flows from operating activities:		
Net loss	$(5,500,971)	$ (848,699)
(Income) loss from discontinued operations	(110,036)	59,796
Loss from continuing operations	(5,611,007)	(788,903)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	3,427,418	3,522,503
Deferred gain amortization	(208,143)	(208,142)
Other impairment and restaurant closure expense	1,071,521	358,291
Other non-cash income	(16,454)	--
Goodwill impairment	5,017,243	--
Loss on involuntary disposals	--	20,620
Loss on sale of other property and equipment	27,493	127,293
Stock based compensation expense	169,516	274,000
Excess tax expense (benefit)-stock based compensation expense	31,955	(15,763)
Deferred income tax expense (benefit)	(2,435,000)	488,942
Changes in operating assets and liabilities		
Royalties receivable	(40,606)	83,002
Other receivables	11,001	424,380
Income taxes receivable/payable	387,527	(129,619)
Inventory	24,046	34,554
Prepaid and other current assets	126,746	(162,716)
Other assets	(36,378)	18,107
Accounts payable	520,994	(396,602)
Accrued expenses and other liabilities	(261,297)	(346,023)
Liabilities associated with leasing and exit activities	(119,134)	80,137
Deferred rent and other long-term liabilities	(120,519)	(72,983)
Total adjustments	7,577,929	4,099,981
Net cash provided by continuing operations	1,966,922	3,311,078
Net cash provided by (used in) discontinued operations	25,149	(613,509)
Net cash provided by operating activities	1,992,071	2,697,569
Cash flows from investing activities:		
Insurance proceeds received from involuntary disposals	--	71,564
Purchase of property and equipment	(1,895,607)	(3,407,352)
Proceeds from landlord for lease buildout	--	269,332
Proceeds from sale of property and equipment	7,024	1,509
Net cash used in continuing operations	(1,888,583)	(3,064,947)
Purchase of property and equipment	--	(15,250)
Business divestitures, net proceeds (sale of La Senorita)	--	2,557,603
Net cash provided by discontinued operations	--	2,542,353
Net cash used in investing activities	(1,888,583)	(522,594)
Cash flows from financing activities:		
Borrowings under line of credit agreement	1,250,000	1,250,000
Payments under line of credit agreement	(2,000,000)	(3,600,000)
Issuance of treasury stock	277,972	--
Excess tax benefit (expense)-stock-based compensation expense	(31,955)	15,763
Net cash used in financing activities	(503,983)	(2,334,237)
Net decrease in cash	(400,495)	(159,262)
Cash at beginning of year	719,944	879,206
Cash at end of year	$ 319,449	$ 719,944
Supplemental disclosure of cash flow information:		
Cash paid during the year:		
Interest	$ 195,399	$ 189,323
Income taxes	$ 286,570	$ 95,873

See accompanying notes to consolidated financial statements.

(1) Organization and nature of business

General overview:

Mexican Restaurants, Inc. (the "Company") was incorporated under the name "Casa Olé Restaurants, Inc." under the laws of the State of Texas in February 1996, and had its initial public offering of Common Stock in April 1996. In May 1999, the corporate name was changed to "Mexican Restaurants, Inc". In November 2010, the Company deregistered its common stock and suspended its reporting obligations under the Securities Exchange Act of 1934 (the "Exchange Act"). The Company maintains a market in its common shares by having the shares listed on the Pink Sheets, a quotation service that does not require an issuer to be registered with the Securities and Exchange Commission ("SEC"). The Company was eligible to deregister its common stock under the Exchange Act because it had fewer than 300 shareholders of record. The Company operates as a holding company and conducts substantially all of its operations through its subsidiaries. All references to the Company include the Company and its subsidiaries, unless otherwise stated.

The Company operates and franchises full-service Mexican-theme restaurants featuring various elements associated with the casual dining experience under the names Casa Olé®, Monterey's Little Mexico®, Tortuga Coastal Cantina® and Crazy Jose's®. The Company also operates a burrito fast casual concept under the name Mission Burrito™. The Casa Olé, Monterey, Tortuga, Crazy Jose's and Mission Burrito concepts have been in business for 39, 56, 17, 24 and 14 years, respectively. Today, the Company operates 54 restaurants, franchises 16 restaurants and licenses one restaurant in various communities across Texas, Louisiana and Oklahoma. The Casa Olé, Monterey and Crazy Jose's restaurants are designed to appeal to a broad range of customers, and are located primarily in small and medium-sized communities and in middle-income areas of larger markets. The Tortuga Coastal Cantina and Mission Burrito restaurants, which are also designed to appeal to a broad range of customers, are located primarily in the Houston market. The restaurants offer fresh, quality food, affordable prices, friendly service and comfortable surroundings. The full-service menus feature a variety of traditional Mexican and Tex-Mex selections, complemented by the Company's own original Mexican-based recipes, designed to have broad appeal. The Mission Burrito restaurants offer freshly made burritos, tacos, quesadillas, soups, salads and chips with guacamole and/or chili con queso.

Company-operated restaurants:

The Company's primary source of revenues is the sale of food and beverages at company-owned restaurants. All of the company-owned restaurant sites are leased. Real estate leased for company-owned restaurants is typically leased under triple net leases that require the Company to pay real estate taxes and utilities, to maintain insurance with respect to the premises and in certain cases to pay contingent rent based on sales in excess of specified amounts. Generally the non-mall locations for the company-owned restaurants have initial terms of 10 to 20 years with renewal options. No new company-owned restaurants were opened during fiscal 2010. One underperforming Tortuga Coastal Cantina was closed during the fourth quarter of 2010 and is presented in the financial statements in continuing operations.

Franchisee-operated restaurants:

The Company also derives revenues from franchise fees, royalties and other franchise-related activities. Franchise fee revenue from an individual franchise sale is recognized when all services relating to the sale have been performed and the restaurant has commenced operations. Initial franchise fees relating to area franchise sales are recognized ratably in proportion to services that are required to be performed pursuant to the area franchise or development agreements and proportionately as the restaurants within the area are opened.

The Company currently has seven Casa Olé franchisees operating a total of 16 restaurants and one licensee operating one Monterey's Little Mexico restaurant. Most franchisees operate one or two restaurants. No new franchise restaurants were opened during fiscal 2010. One underperforming Casa Olé franchise location was closed during the second quarter of 2010.

(2) Significant accounting policies

Basis of presentation

The consolidated financial statements of the Company include the accounts of Mexican Restaurants, Inc. and its wholly-owned subsidiaries, after elimination of all significant inter-company transactions, and were prepared in accordance with generally accepted accounting principles in the United States of America. The Company maintains its accounting records on a 52/53 week fiscal year ending on the Sunday nearest December 31. References in this report to fiscal years 2010 and 2009 relate to the periods ended January 2, 2011 and January 3, 2010, respectively. Fiscal year 2010 presented herein consisted of 52 weeks. Fiscal year 2009 presented herein consisted of 53 weeks.

Use of estimates and assumptions

The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Concentration of credit risks

The Company maintains a banking relationship with Wells Fargo Bank. Wells Fargo provides the Company with a credit facility as well as treasury services. Consequently, the majority of the Company's cash concentration held by Wells Fargo Bank is insured to the current maximum Federal Deposit Insurance Corporation's limit.

Cash

The cash account includes restricted funds that are segregated from operating funds. The restricted funds are used at the discretion of the Company's employees and management for community relation purposes. The restricted fund balance was approximately $90,000 as of January 2, 2011.

Revenue recognition

Revenue from the sale of food, soft beverages and alcoholic beverages are recognized as products are sold. Franchise fee revenue from an individual franchise sale is recognized when all services relating to the sale have been performed and the restaurant has commenced operations. Initial franchise fees relating to area franchise sales are recognized ratably in proportion to services that are required to be performed pursuant to the area franchise or development agreements and proportionately as the restaurants within the area are opened. The Company's current standard franchise agreement also provides for a royalty payment which is a percentage of gross sales. Royalty income is recognized when it is earned.

Revenues from gift card sales are recognized upon redemption. Prior to redemption, the outstanding balances of all gift cards are included in accounts payable in the consolidated balance sheets.

Sales taxes

Sales taxes collected from customers are excluded from revenues. The obligation is included in accrued liabilities until the taxes are remitted to the appropriate taxing authorities.

Pre-opening costs

Pre-opening costs primarily consist of hiring and training employees associated with the opening of a new restaurant and are expensed as incurred. No new restaurants were opened in fiscal year 2010.

Discontinued operations and leasing exit activities

The results of operations, assets and liabilities for all units that have been disposed of, either individually or in the aggregate, are reclassified to discontinued operations or to liabilities associated with leasing and exit activities in the consolidated statements of operations and balance sheets for all periods presented.

As of January 2, 2011, assets related to discontinued operations of $100,000 consisted of rent receivable from a subleased restaurant. Other assets related to discontinued operations of $33,878 consisted of security deposits for leases in the state of Michigan that were assigned to a third party in 2009 and which expire in 2019. Current and long-term liabilities related to leasing and exit activities consisted primarily of accrued closure costs related to two non-interest bearing notes payable made in 2011 to exit two leases and of rent differential for two other closed restaurants for which the Company has subleased the restaurants. One of the notes payable has twelve month payment terms and the other has thirty-six month payment terms. See footnote 8 "Subsequent Events" for more details regarding the notes payable. Rent differential represents the difference between the Company's future contractual lease payment obligations for closed restaurants and contractual future rent payments to be received in accordance with the terms of the subleases. During fiscal year 2010, restaurant closure income from discontinued operations of $156,376 was related to the negotiated settlement costs to exit a lease which resulted in a partial reversal of the liability as recorded under the terms of the original lease.

On April 7, 2009, the Company sold substantially all of the operating assets and liabilities of its La Senorita restaurant chain (consisting of five site locations) located in Michigan for $2,557,603 as adjusted under the terms of the purchase agreement. Proceeds from the sale were used to pay down long-term debt. On January 24, 2009, the Company closed one underperforming Mission Burrito restaurant. The results of operations for fiscal year 2009 for the La Senorita chain and the closed Mission Burrito restaurant are reported as discontinued operations. Income from discontinued operations of $36,021 during fiscal year 2009 reflects operating income from the La Senorita restaurants, partially offset by operating losses from the closed Mission Burrito restaurant. Restaurant closure costs of $201,229, during fiscal year 2009, primarily reflect costs associated with the closure of the Mission Burrito restaurant. Gain on sale of assets of $386,502 during fiscal year 2009 resulted primarily from the sale of La Senorita.

Insurance proceeds

The consolidated statement of operations for the year ended January 3, 2010 includes a separate line item for a loss of $20,620 resulting from assets damaged by two restaurant fires and Hurricane Ike both of which occurred in fiscal year 2008. The loss resulted from costs to settle the insurance claim offset by receipt of insurance proceeds. As of January 3, 2010, the Company received $71,564 from its insurance carriers for property damages. The consolidated statement of operations for the year ended January 3, 2010, also includes a separate line item for business interruption insurance proceeds of $210,847 related to the same events.

Inventory

Inventory, which is comprised of food and beverages, is stated at the lower of cost or market. Cost is determined using the first-in, first-out method. Miscellaneous restaurant supplies are included in inventory and valued on a specific identification basis.

Property and equipment

Property and equipment are stated at cost. Depreciation on equipment and vehicles is calculated on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized on a straight-line basis over the shorter of the lease term plus options reasonably assured or estimated useful life of the assets.

Leasehold improvements	2-20 years
Vehicles	5 years
Equipment	3-15 years

At the opening of a new restaurant, the initial purchase of smallwares is capitalized as restaurant equipment, but not depreciated. Subsequent purchases of smallwares are expensed as incurred.

Significant expenditures that add materially to the utility or useful lives of property and equipment are capitalized. All other maintenance and repair costs are charged to current operations. Management is often required to exercise judgment in decisions of whether to capitalize an asset or expense an expenditure that is for maintenance and repairs. These judgments may produce materially different amounts of repair and maintenance or depreciation expense if different assumptions were used. The cost and related accumulated depreciation of assets replaced, retired or otherwise disposed of are eliminated from the property accounts and any gain or loss is reflected in costs and expenses.

Property and equipment at January 2, 2011 and January 3, 2010 were as follows:

	Jan 2, 2011	Jan 3, 2010
Land	$ 60,750	$ 60,750
Vehicles	16,874	16,874
Equipment and Smallwares	21,813,597	21,850,478
Leasehold Improvements	17,761,031	17,343,971
	39,652,252	39,272,073
Less: Accumulated Depreciation and Amortization	(24,731,126)	(21,791,354)
	14,921,126	17,480,719
Construction in Progress	--	10,616
Net	$14,921,126	$17,491,335

Impairment of long-lived assets

Long-lived assets, such as property and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the consolidated balance sheets and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the consolidated balance sheets. The revenues and expenses, as well as gains, losses, and impairments, from those assets are reported in the discontinued operations section of the consolidated statements of operations for all periods presented.

Other impairment and restaurant closure costs of $1,071,521 during 2010 primarily related to asset impairments for five under-performing operating restaurants. During fiscal year 2009, we expensed $358,291 to impair the assets primarily related to rent differential adjustments for two subleased restaurants located in Idaho, asset impairments for the corporate office, and to a lesser extent, two under-performing restaurants operating in the Houston area.

Goodwill impairment

Goodwill represents the excess of costs over fair value of net assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. The impairment evaluation for goodwill is conducted using a two-step process. In the first step, management compares the fair value of the reporting unit to its carrying amount, including goodwill. All of the Company's restaurants are considered the reporting unit level, since they have similar economic characteristics, including products and services, production processes, types or classes of customers and distribution methods. If the estimated fair value of the reporting unit is less than the carrying amount of the reporting unit, then a second step is performed in order to determine the implied fair value of the goodwill, and to compare it to the carrying value of goodwill. The activities in the second step include hypothetically valuing all of the tangible and intangible assets and liabilities of the Company as if it had been acquired in a business combination. The implied fair value of the goodwill that results from the application of this second step is then compared to the carrying amount of the reporting unit goodwill and an impairment charge is recorded for the excess carrying value.

Inherent uncertainties and management judgment are required in an analysis of goodwill impairment. The assumptions used in the estimate of fair value are generally based on the past performance of the reporting unit and the intangible asset, and also reflect the projections and assumptions that are inherent in management's current operating plans. These assumptions, particularly in the current economic environment, are subject to change as a result of changing economic and competitive conditions.

At year end 2010, management determined that the estimated fair value of the reporting unit did not exceed the carrying amount of the reporting unit and recorded a goodwill impairment of $5,017,243 for the entire balance of goodwill. As a result, the company had no goodwill at January 2, 2011.
At year end 2009, management determined that the fair value of the reporting unit exceeded the carrying amount of the reporting unit and no impairment was recorded. The fair value exceeded the carrying value by 5.1%. Goodwill amounted to $5,017,243 at January 3, 2010. During 2009, goodwill decreased by approximately $1.3 million related to the disposal of the LaSenorita locations.

Advertising expense

Each year, management prepares a budget for advertising expenses to promote each restaurant brand. Prepaid advertising is deferred and amortized to expense based on estimates of usage. The Company recorded advertising expense in continuing operations of $1,123,062 and $1,630,285 for fiscal years 2010 and 2009, respectively.

Deferred rent

Lease rentals that have escalating rents are recorded as expense on a straight line basis over the life of each lease. Most of these lease agreements require minimum annual rent payments plus contingent rent payments based on a percentage of restaurant sales which exceed the minimum base rent. Contingent rent payments, to the extent they exceed minimum payments, are accrued during the periods in which the liability is incurred. Incentive allowances provided by landlords under leasing arrangements are deferred as a liability and amortized to income as an adjustment to rent expense over the life of the lease.

Deferred gain

On June 25, 1998, the Company completed a sale-leaseback transaction involving the sale and leaseback of land, building and improvements of 13 company-owned restaurants. The properties were sold for $11.5 million and resulted in a gain of approximately $3.5 million that was deferred and is amortized over the terms of the leases, which are 15 years each. The deferred gain at January 2, 2011 and January 3, 2010 was $520,357 and $728,500, respectively. The leases are classified as operating leases. Subsequent to the original transaction, two leases were sold. The remaining 11 leases have a total future minimum lease obligation of $2,940,499 and are included in the future minimum lease payment schedule below.

Commitments and contingencies

Restaurant operating space and equipment are leased by the Company under non-cancelable operating leases which expire at various dates through January 31, 2024. The restaurant operating space base agreements typically provide for a minimum lease rent plus common area maintenance, insurance, and real estate taxes, plus additional percentage rent based upon revenues of the restaurant (generally 2% to 7%) and may be renewed for periods ranging from one to twenty-five years.

Future minimum lease payments (which includes the two closed restaurants scheduled below) under non-cancelable operating leases with initial or remaining lease terms in excess of one year as of January 2, 2011 were approximately:

Fiscal year ending	
2011	$ 5,110,185
2012	5,047,691
2013	3,730,529
2014	2,609,431
2015	2,273,572
Thereafter	10,811,081
	$29,582,489

Two restaurants (which are included in the table above) have been subleased to third party restaurant operators. Each of the sublease terms corresponds with its underlying base lease term. Future minimum lease receipts under non-cancelable operating leases with initial or remaining lease terms in excess of one year as of January 2, 2011 were approximately:

Fiscal year ending	
2011	$ 191,035
2012	194,162
2013	124,228
	$509,425

Total rent expense for restaurant operating space and equipment amounted to $5,531,987 and $5,729,556 for fiscal years 2010 and 2009, respectively.

The Company has litigation, claims and assessments that arise in the normal course of business. Management believes that the Company's financial position or results of operations will not be materially affected by such matters.

Performance units have been granted under the 2005 Long Term Incentive Plan. The performance units vest upon a business combination (as defined in the plan) and are payable in cash in an amount equal to the product of the number of units vested and the average of the high and low prices of the common stock as of the last business day preceding the business combination, which average price must be in excess of $20.00 per share. As of January 2, 2011, there were 245,000 performance units available to be issued.

Income taxes

Income taxes are provided based on the asset and liability method. The Company provides for income taxes based on estimates of federal and state liabilities. These estimates include, among other items, effective rates for state and local income taxes, allowable tax credits for items such as taxes paid on reported tip income, estimates related to depreciation and amortization expense allowable for tax purposes, and the tax deductibility of certain other items. Valuation allowances are provided on deferred tax assets if it is more likely than not that such deferred tax assets will not be utilized in the near future.

Management's estimates are based on the information available to them at the time that they prepare the income tax provision. The Company generally files its annual income tax returns several months after its fiscal year-end. Income tax returns are subject to audit by federal and state governments, generally years after the returns are filed. These returns could be subject to material adjustments or differing interpretations of the tax laws.

Effective January 1, 2007, the Company adopted the accounting standard relating to "Uncertain Tax Positions," which is intended to clarify the accounting for income taxes prescribing a minimum recognition threshold for a tax position (more likely than not) before being recognized in the consolidated financial statements. The standard also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. Interest and penalties, if any, related to uncertain tax positions are included in income tax expense.

The Company is still subject to examination by the IRS for tax years ending 2006, 2008 and 2009. The Company is also subject to examinations by the Texas State Comptroller and Michigan Department of Treasury for tax years ending 2005 through 2009. The Company evaluated all tax years still subject to potential audit under state and federal income tax law in reaching their accounting conclusions. The Company does not believe that the amount of its unrecognized tax benefits will change significantly within the next twelve months. As a result, the Company concluded that it did not have any unrecognized tax benefits or any additional tax liabilities after applying the standard as of January 2, 2011 and January 3, 2010. The adoption had no impact on the Company's consolidated financial statements.

The benefit (expense) for income taxes from continuing operations is summarized as follows for fiscal years 2010 and 2009:

	Jan 2, 2011	**Jan 3, 2010**
Current:		
Federal	$ --	$ 602,344
State and local	(72,009)	(297,938)
Deferred	2,435,000	(375,991)
	$ 2,362,991	$ (71,585)

The benefit (expense) for income taxes from discontinued operations is summarized as follows for fiscal years 2010 and 2009:

	Jan 2, 2011	Jan 3, 2010
Current:		
Federal	$ --	$(139,139)
State and local	--	(29,000)
Deferred	(46,340)	(112,951)
	$(46,340)	$(281,090)

The actual income tax benefit (expense) differs from the expected income tax benefit calculated by applying the U.S. federal corporate tax rate to loss from continuing operations before income tax expense as follows:

	Jan 2, 2011	Jan 3, 2010
Expected tax benefit	$ 2,711,159	$ 243,888
State tax expense, net	(58,079)	(196,639)
Non-deductible amortization	(262,660)	--
Tax credits	252,126	209,248
Tax credit valuation allowance	(169,000)	(391,000)
NOL carryover adjustment	(128,118)	--
Other	17,563	62,918
	$2,362,991	$ (71,585)

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at January 2, 2011 and January 3, 2010 are as follows:

	Jan 2, 2011	Jan 3, 2010
Deferred tax assets:		
Sale-leaseback	176,921	$ 247,690
Tax credit carryforwards	1,815,187	1,433,178
Stock compensation differences	99,475	89,740
Other	24,660	19,041
Capital losses	146,760	146,760
Bad debt expense	60,562	--
Goodwill amortization differences	792,560	--
Asset impairments	767,086	740,587
Net operating losses (NOL's)	685,687	343,769
Accrued expenses	182,649	81,907
	$4,751,547	$3,102,672
Deferred tax liabilities:		
Goodwill amortization differences	--	(545,587)
Depreciation differences	(145,083)	(476,326)
	$(145,083)	$(1,021,913)
Subtotal	$4,606,464	$2,080,759
Valuation allowance	(706,760)	(537,760)
Net deferred taxes	$ 3,899,704	$1,542,999

At January 2, 2011, the Company had federal tax credit carryforwards of approximately $1.8 million and federal NOL carryforwards of approximately $2.0 million all of which expire in years through 2030 and all of which are available to reduce future Federal regular income taxes. The Company also has a capital loss carryover in the amount of approximately $432,000 that expires in 2014.

During 2010, a valuation allowance of $169,000 was recorded on the tax credit carryforwards as management determined it was unlikely to use the full amount of these tax benefits over the periods in which they may be utilized. For the other tax benefits, management believes that it is more likely than not that these tax assets will be realized, and as such, no valuation allowance has been recorded.

Reclassification

Certain amounts in the January 3, 2010 consolidated financial statements have been reclassified to conform to the January 2, 2011 presentation.

Stock-based compensation

The Company accounts for share-based awards through the measurement and recognition of compensation expense for all share-based payment awards to employees, directors, and consultants based on estimated fair values. Compensation expense is recognized for all stock-based compensation with future service requirements over the period that the recipient of the award provides service in exchange for the award. All compensation based plans have been accounted for under the modified prospective method.

Stock options granted are recorded at estimated fair value using an option-pricing model or other applicable valuation technique. No options were granted in fiscal years 2010 or 2009.

Restricted stock shares granted are recorded at estimated fair value based upon the quoted market value of the Company's common stock on the date of grant. The fair value of each share is expensed over the period during which the related restrictions lapse.

(3) Share-based compensation plans

The Company has four stock-based compensation plans under which shares of common stock are issued to employees, officers, directors and consultants. The 2005 Long Term Incentive Plan was approved by shareholders and authorizes the granting of common stock in the form of incentive stock options, non-qualified stock options, and restricted stock. The 2005 Long Term Incentive Plan is the only plan with securities remaining available for future issuance. The 1996 Long Term Incentive Plan and the Stock Option Plan for Non-Employee Directors were both also approved by shareholders and both plans authorized the granting of common stock in the form of incentive stock options and non-qualified stock options. Each of these two plans has terminated by its terms. The 1996 Manager's Stock Option Plan was not approved by shareholders and it authorized the granting of common stock in the form of non-qualified stock options. This plan has also terminated by its terms.

The following table provides information about the shares of common stock that may be issued upon exercise of awards under these four plans as of January 2, 2011.

	Number of Securities to be Issued Upon Exercise of Outstanding Stock Options and Restricted Stock Shares	Weighted Average Exercise Price of Outstanding Stock Options (1)	Number of Securities Remaining Available for Future Issuance Under Stock-based Compensation Plans
Stock-based compensation plans approved by shareholders	399,900	$8.84	59,500
Stock-based compensation plans not approved by shareholders	1,750	$3.08	0

Note (1) Grants of restricted stock are valued as of the date of vesting and have no exercise price. Consequently, they are not included in the calculation of weighted average exercise price.

(a) 2005 Long Term Incentive Plan

The Board of Directors and shareholders of the Company have approved the Mexican Restaurants, Inc. 2005 Long Term Incentive Plan, the "2005 Plan". On May 28, 2008, the shareholders approved an amendment to the 2005 Plan to increase the number of shares authorized for issuance by 75,000 shares, from 350,000 shares to 425,000 shares. The amended 2005 Plan authorizes the granting of up to 425,000 shares of Common Stock in the form of incentive stock options and non-qualified stock options to key executives and other key employees of the Company, including officers of the Company and its

subsidiaries. The purpose of the 2005 Plan is to benefit and advance the interests of the Company by attracting and retaining qualified directors and key executive and managerial employees; motivate employees, by making appropriate awards, to achieve long-range goals; provide incentive compensation that is competitive with other corporations; and further align the interests of directors, employees and other participants with those of other shareholders.

(b) 1996 Long Term Incentive Plan

The Board of Directors and shareholders of the Company approved the Mexican Restaurants, Inc. 1996 Long Term Incentive Plan the "Incentive Plan". The Incentive Plan terminated by its terms on February 29, 2006, and no additional options may be granted there under. The Incentive Plan authorized the granting of up to 500,000 shares of Common Stock in the form of incentive stock options and non-qualified stock options to key executives and other key employees of the Company, including officers of the Company and its subsidiaries. The purpose of the Incentive Plan was to attract and retain key employees, to motivate key employees to achieve long-range goals and to further align the interests of key employees with those of the other shareholders of the Company. Options granted under the Incentive Plan generally vest and become exercisable at the rate of 10% on the first anniversary of the date of grant, 15% on the second anniversary of the date of grant, and 25% on each of the third through fifth anniversaries of the date of grant. All stock options granted pursuant to the 1996 Long Term Incentive Plan are nonqualified stock options and remain exercisable until the earlier of ten years from the date of grant or no more than 90 days after the optionee ceases to be an employee of the Company.

(c) Stock Option Plan for Non-Employee Directors

The Company adopted the Mexican Restaurants, Inc. Stock Option Plan for Non-Employee Directors, the "Directors Plan", for its outside directors and has reserved 200,000 shares of Common Stock for issuance there under. The Directors Plan provides that each outside director will automatically be granted an option to purchase 10,000 shares of Common Stock at the time of becoming a director. However, as of the third quarter of fiscal year 2002, compensation for each outside director was changed from quarterly options to cash payments of $2,500 per quarter and $1,250 per board meeting attended. The chairman of the audit committee receives compensation of $6,250 per quarter. Effective 2009, the chairman of the compensation committee receives $5,000 per quarter. Options granted under the Directors Plan are exercisable in 20% increments and vest equally over the five-year period from the date of grant. Such options are priced at the fair market value at the time an individual is elected as a director. Until the third quarter of fiscal year 2002, each outside director received options to purchase 1,500 shares of Common Stock quarterly, plus additional options for attendance at committee meetings, exercisable at the fair market value of the Common Stock at the close of business on the date immediately preceding the date of grant. Such annual options will vest at the conclusion of one year, so long as the individual remains a director of the Company. All stock options granted pursuant to the Directors Plan are nonqualified stock options and remain exercisable until the earlier of ten years from the date of grant or six months after the optionee ceases to be a director of the Company. The Stock Option Plan for Non-Employee Directors terminated by its terms on December 31, 2005, and no additional options may be granted there under.

(d) 1996 Manager's Stock Option Plan

The Company adopted the 1996 Manager's Stock Option Plan, the "Manager's Plan", specifically for its store-level managers. The Manager's Plan authorized the granting of up to 200,000 shares of Common Stock in the form of non-qualified stock options to store-level managers of the Company. The purpose of the Manager's Plan was to attract, retain and motivate restaurant managers to achieve long-range goals and to further align the interests of those employees with those of the other shareholders of the Company. Options granted under the Manager's Plan generally vest and become exercisable at the rate of 10% on the first anniversary of the date of grant, 15% on the second anniversary of the date of grant, and 25% on each of the third through fifth anniversaries of the date of grant. All stock options granted pursuant to the 1996 Manager's Stock Option Plan are nonqualified stock options and remain exercisable until the earlier of ten years from the date of grant or no more than 90 days after the optionee ceases to be an employee of the Company. The 1996 Manager's Stock Option Plan terminated by its terms on December 31, 2005, and no additional options may be granted there under.

(e) Stock-Based Compensation Group Activities

On May 23, 2006, the Board of Directors approved a restricted stock grant of 3,000 shares to each of the outside directors with ten years of service, with such grants vesting over a four-year period. Two of the directors qualified for this restricted stock grant. Effective December 15, 2006, the Company awarded restricted stock grants for an aggregate of 25,000 shares to four employees, with such grants vesting over a five-year period, and two of these awards provided that the Company was to make additional restricted stock grants on the three following anniversary dates, for an aggregate of 25,000 shares. During

the second quarter of fiscal year 2007, 5,000 restricted shares and 2,500 stock options were forfeited upon the termination of one of those employees.

On May 22, 2007, the Board of Directors approved a restricted stock grant of 10,000 shares to the Company's President, with such grant vesting over a four year period. This award provided that the Company were to make additional restricted stock grants on the four following anniversary dates, for an aggregate of 40,000 shares. Also, restricted stock grants for an aggregate of 11,000 shares were made to four employees of its Michigan operations, with such grants vesting over a five-year period. The Company's Board also approved a stock option grant to the Company's President for 50,000 options with a grant date price of $8.43. The options vest over a five-year period, with no vesting in the first year and vesting of 10%, 20%, 30% and 40% in the second, third, fourth and fifth years, respectively. During the second quarter of 2009, the restricted shares granted to the Michigan employees became fully vested upon the sale of the La Senorita restaurant chain.

In August 2007, the Board of Directors approved restricted stock grants for an aggregate of 20,000 shares to two employees, with one 10,000 share grant vesting over five years and the second 10,000 share grant vesting as follows: 2,000 shares vested on August 30, 2007 with the remaining 8,000 shares vesting at 2,000 shares per year over four years. The Company's Board also approved an aggregate of 25,000 stock options to two employees with such grants vesting over five years. During the fourth quarter of 2009, 12,000 stock options and 4,000 restricted shares were forfeited upon the termination of one of those employees.

On November 13, 2007, the Board of Directors approved restricted stock grants aggregating 10,000 shares to four employees, with such grants vesting over a five-year period. During the second quarter of fiscal year 2008, 2,500 restricted shares were forfeited upon the termination of one of those employees.

On November 13, 2007, the Board also approved a stock option grant to an employee for 5,000 options with a grant date price of $6.90. The options vest over a five-year period.

On May 22, 2008, restricted stock grants in the amount of 10,000 shares to the Company's President were granted pursuant to the May 22, 2007 agreement, with such shares vesting over a four-year period.

On May 28, 2008, the Board of Directors approved restricted stock grants to one Board member for 3,000 shares, vesting over three years, and one consultant for 2,000 shares, vesting over two years.

On December 15, 2008, restricted stock grants in the amount of 10,000 shares to two employees were granted pursuant to the December 15, 2006 agreement, with such shares vesting over a five-year period.

On May 22, 2009, restricted stock grants in the amount of 10,000 shares to the Company's President were granted pursuant to the May 22, 2007 agreement, with such shares vesting over a four-year period.

On December 15, 2009, restricted stock grants in the amount of 5,000 shares to one employee were granted pursuant to the December 15, 2006 agreement, with such shares vesting over a five-year period.

On May 22, 2010, restricted stock grants in the amount of 10,000 shares to the Company's President were granted pursuant to the May 22, 2007 agreement, with such shares vesting over a four-year period.

(g) Stock Option Activity

The following table reflects the stock option activity during 2010 and 2009:

	Options Outstanding			Options Exercisable		
	Shares		Weighted Average Exercise Price	Shares		Weighted Average Exercise Price
Outstanding options at December 28, 2008	373,375	$	7.98	307,375	$	7.74
Granted	-		-			
Exercised	-		-			
Canceled/Forfeited	(15,125)		4.08			
Outstanding options at January 3, 2010	358,250	$	8.15	300,250	$	8.17
Granted	-		-			
Exercised	-		-			
Canceled/Forfeited	(52,100)		8.70			
Outstanding options at January 2, 2011	306,150	$	8.73	267,150	$	8.80

Information relating to significant option groups outstanding at January 2, 2011, is as follows:

	Options Outstanding				Options Exercisable			
Range of Exercise Prices	Amount Outstanding	Weighted Average Remaining Contractual Life		Weighted Average Exercise Price	Number Exercisable	Weighted Average Remaining Contractual Life		Weighted Average Exercise Price
$0.00–3.00	29,050	.79	$	2.74	29,050	.79	$	2.74
$3.01–6.00	57,100	1.36	$	3.22	57,100	1.36	$	3.22
$6.01–9.00	60,000	6.48	$	8.15	21,000	6.52	$	7.95
$12.00	160,000	4.92	$	12.00	160,000	4.92	$	12.00
$0.00–12.00	306,150	4.17	$	8.73	267,150	3.83	$	8.80

The Company receives a tax deduction for certain stock option exercises during the period the options are exercised, generally for the excess of the price at which the options were sold over the exercise prices of the options. During fiscal years 2010 and 2009, no one exercised any stock options. The 306,150 options outstanding at January 2, 2011 had exercise prices ranging from $2.63 to $12.00, of which 160,000 of the options had exercise prices of $12.00. As of January 2, 2011, 267,150 options were vested and exercisable.

The Company did not grant any stock options during fiscal years 2010 or 2009. As of January 2, 2011, the Company had unrecognized stock based compensation expense of $75,568 for all outstanding stock option awards.

(h) Restricted Stock Activity

The following table reflects the restricted stock activity during 2010 and 2009:

	2010			2009		
	Shares	Weighted Average Grant-Date Fair Value	Weighted Average Remaining Contractual Term (years)	Shares	Weighted Average Grant-Date Fair Value	Weighted Average Remaining Contractual Term (years)
Unvested at beginning of year	62,500	$5.36		84,300	$6.85	
Granted	10,000	2.50		15,000	2.62	
Vested	(22,500)	6.26		(32,800)	7.69	
Forfeited	--	--		(4,000)	7.39	
Unvested at end of year	50,000	$4.38	2.42	62,500	$5.36	2.96

The unvested restricted share awards were valued from $2.00 to $10.50 per share based on the grant date stock price and vest over 1 to 4 years. As of January 2, 2011, the unrecognized stock based compensation expense associated with restricted shares was $179,365 and will be recognized over an average period of 2.42 years. During 2010, 9,500 treasury shares were issued for vested restricted stock.

(4) Long term debt

During fiscal year 2010, the Company borrowed $1.25 million on its Wells Fargo Bank line of credit for working capital. The Company paid $2.0 million on its Wells Fargo line of credit during the year of which $277,972 was received from the sale of common stock shares from treasury to a related party in March 2010 (see footnote 7 "Related party transactions" for more details). As of January 2, 2011, the Company's outstanding debt to Wells Fargo Bank was $4.4 million.

The Company entered into a credit agreement (the "Wells Fargo Agreement") with Wells Fargo Bank, N.A. ("Wells Fargo") in June 2007. Originally, the Wells Fargo Agreement provided for a revolving loan of up to $10 million, but the Wells Fargo Agreement was amended effective December 28, 2008, reducing the revolving loan by the amount of the net proceeds received from the sale of La Senorita, which reduced the revolver availability to approximately $7.3 million on April 7, 2009. Under the Wells Fargo Agreement, the Company is required to maintain certain minimum EBITDA levels, leverage ratios and fixed charge coverage ratios. The Company received an amendment to the covenant effective December 28, 2008 eliminating the minimum EBITDA requirement and adding limits on its growth capital expenditures. Under the amendment, the Company must limit its capital expenditures for new restaurant development and/or acquisitions to $1.0 million in fiscal year 2009 and $1.2 million in fiscal year 2010. The Company did not make any capital expenditures for new restaurant development and/or acquisitions during fiscal year 2010.

Effective June 28, 2009, the Wells Fargo Agreement was amended primarily to extend the maturity date of the debt from June 29, 2010 to June 29, 2012. This amendment also provided for the following: (1) increased the stipulated percentages payable in connection with London Interbank Offered Rate ("LIBOR") loans and letters of credit under the Wells Fargo Agreement, (2) added as a condition precedent to loans made to the Company for growth capital expenditures that the Company's total leverage ratio not exceed certain stated amounts, and (3) amended certain financial covenants.

Effective January 3, 2010, the Wells Fargo Agreement was amended primarily to allow for the add-back of severance expense of $190,000 that the Company incurred as part of its reduction in general and administrative expense to the Company's calculation of rolling twelve-month cash flow. This amendment also further reduced the revolver availability to $6.0 million effective July 4, 2010.

As of third quarter 2010, the Company was in default of the Wells Fargo Agreement with regard to a financial covenant. As a result, the Company entered into a forbearance agreement with Wells Fargo on December 9, 2010. The forbearance agreement was effective from November 17, 2010 through January 31, 2011. Concurrent with the forbearance agreement, the Wells Fargo Agreement was amended primarily to further reduce the revolver availability to $5.5 million effective November 17, 2010. On January 20, 2011, the forbearance agreement was amended to extend the forbearance period until February 15, 2011.

As of fourth quarter 2010, the Company was in default of the Wells Fargo Agreement with regard to financial covenants. As a result, the Wells Fargo Agreement was amended on April 8, 2011. Under this amendment, Wells Fargo agreed to waive the third and fourth quarter 2010 defaults subject to amended terms and conditions to the Credit Agreement. The amended terms and conditions primarily include the following changes to the Credit Agreement: (1) the loan maturity date was extended to June 29, 2013, (2) the maximum available credit was reduced to $4,725,000 and will continue to be reduced by $275,000 on the first day of each fiscal quarter beginning July 4, 2011, (3) the rate for borrowing was increased, (4) the calculation of certain financial ratios was redefined and a new financial ratio was added, (5) the measurement periods and certain financial ratio limits were redefined and, (6) a $1,000,000 capital contribution was required (see footnote 8 "Subsequent events" for more details).

At management's option, the revolving loan bears an interest rate equal to the Wells Fargo Base Rate plus a stipulated percentage or LIBOR plus a stipulated percentage. Accordingly, the Company is impacted by changes in the Base Rate and LIBOR. The Company is subject to a non-use fee of 0.50% on the unused portion of the revolver from the date of the Wells Fargo Agreement.

The Wells Fargo Agreement also allows up to $2.0 million in annual stock repurchases. Although the Wells Fargo Agreement permits the Company to implement a share repurchase program for up to $2.0 million annually under certain conditions, the Company currently has no repurchase programs in effect. Shares previously acquired are being held for general corporate purposes, including the offset of the dilutive effect on shareholders from the exercise of stock options. The Company has pledged the stock of its subsidiaries, leasehold interests, patents and trademarks and furniture, fixtures and equipment as collateral for its credit facility with Wells Fargo.

Long-term debt consisted of $4,400,000 and $5,150,000 payable on the Wells Fargo line of credit as of January 2, 2011 and January 3, 2010, respectively.

The entire balance of long-term debt as of January 2, 2011 matures on June 29, 2013.

Management believes that with its operating cash flows and revolving line of credit under the Wells Fargo Agreement, as amended on April 8, 2011, funds will be sufficient to meet operating requirements and to finance routine capital expenditures through the next 12 months. Unless the Company violates a debt covenant, the Company's credit facility with Wells Fargo is not subject to triggering events that would cause the credit facility to become due sooner than the maturity date described in the previous paragraphs. As of the date hereof, management expects to be in compliance with its debt covenants, as amended, during the next 12 months, although management continues to closely monitor the Company's operating results and cash flows.

(5) Related party transactions

On June 15, 2007, Mr. Forehand, a Director and Vice Chairman of the Board, entered into an Asset Purchase Agreement to purchase the assets of the Company's Casa Olé restaurant located in Stafford, Texas, a then-currently under-performing restaurant, for an agreed price of 26,806 shares of the Company's common stock. The stock was valued at $8.14 per share, which was the ten-day weighted average stock price as of June 12, 2007, for a total value of $218,205. The sale resulted in a loss of $79,015. The restaurant operations were taken over by Mr. Forehand after the close of business on July 1, 2007. The Stafford restaurant operates under the Company's uniform franchise agreement and is subject to a monthly royalty fee. For the fiscal years ended January 2, 2011 and January 3, 2010 the Company recognized royalty income of $22,100 and $23,042, respectively, related to this site.

On March 31, 2010, the Company sold 113,458 shares of common stock from its treasury shares to Michael D. Domec, a director of the Company and the largest shareholder of the Company, for $277,972 or $2.45 per share. The per share price was based upon a weighted average based on the preceding 30 days, and the transaction was exempt from registration under Section 4(2) of the Securities Act of 1933. The Company used the proceeds for payment on its line of credit under the Wells Fargo Agreement.

The Company provides accounting and administrative services for the Casa Olé Media and Production Funds. The Casa Olé Media and Production Funds are not-for-profit, unconsolidated entities used to collect money from company-owned and franchise-owned restaurants to pay for the marketing of Casa Olé restaurants. Historically, each restaurant contributed an agreed upon percentage of sales to the funds. However, contributions to the funds were suspended during fiscal year 2010.

(6) 401(k) Plan

Beginning in fiscal year 1998, the Company established a defined contribution 401(k) plan that covers substantially all full-time employees meeting certain age and service requirements. Participating employees may elect to defer a percentage of their qualifying compensation as voluntary employee contributions. The Company may contribute additional amounts at the discretion of management. The Company did not make any contributions to the plan in fiscal years 2010 and 2009.

(7) Stockholders' equity

Dividends

Since the Company's 1996 initial public offering, no cash dividends have been paid on the Common Stock. Management intends to retain earnings of the Company to support operations and pay down debt, and does not intend to pay cash dividends on the Common Stock for the foreseeable future. In addition, the current credit agreement prohibits the payment of any cash dividends. Any payment of cash dividends in the future will be at the discretion of the Board of Directors and will depend upon such factors as earnings levels, capital requirements, the Company's financial condition, the ability to do so under then-existing credit agreements and other factors deemed relevant by the Board of Directors.

Sale of common stock shares from treasury

On March 31, 2010, the Company sold 113,458 shares of common stock from its treasury shares to Michael D. Domec, a director of the Company and the largest shareholder of the Company, for $277,972 or $2.45 per share. The per share price was based upon a weighted average based on the preceding 30 days, and the transaction was exempt from registration under Section 4(2) of the Securities Act of 1933. The Company used the proceeds for payment on its line of credit under the Wells Fargo Agreement.

Stock Repurchases

The Wells Fargo debt agreement allows the Company to repurchase up to $2,000,000 of stock repurchases in each year (as long as the repurchase does not cause the Company to be out of compliance with any debt covenants). The Company did not repurchase any stock in fiscal years 2010 or 2009.

(8) Subsequent Events

The Company evaluates subsequent events that have occurred after the balance sheet date but before the financial statements are available for issuance for either recognition or disclosure. The Company evaluated its financial statements for subsequent events through May 2, 2011, the date the financial statements were available for issuance.

As of third quarter 2010, the Company was in default of the Wells Fargo Agreement with regard to a financial covenant. As a result, the Company entered into a forbearance agreement with Wells Fargo on December 9, 2010. The forbearance agreement was effective from November 17, 2010 through January 31, 2011. Concurrent with the forbearance agreement, the Wells Fargo Agreement was amended primarily to further reduce the revolver availability to $5.5 million effective November 17, 2010. On January 20, 2011, the forbearance agreement was amended to extend the forbearance period until February 15, 2011.

As of fourth quarter 2010, the Company was in default of the Wells Fargo Agreement with regard to financial covenants. As a result, the Wells Fargo Agreement was amended on April 8, 2011. Under this amendment, Wells Fargo agreed to waive the third and fourth quarter 2010 defaults subject to amended terms and conditions to the Credit Agreement. The amended terms and conditions primarily include the following changes to the Credit Agreement: (1) the loan maturity date was extended to June 29, 2013, (2) the maximum available credit was reduced to $4,725,000 and will continue to be reduced by $275,000 on the first day of each fiscal quarter beginning July 4, 2011, (3) the rate for borrowing was increased, (4) the calculation of certain financial ratios was redefined and a new financial ratio was added, (5) the measurement periods and certain financial ratio limits were redefined and, (6) a $1,000,000 capital contribution was required.

On April 11, 2011, the Company received $1,000,000 in cash in exchange for 800,000 Series A Convertible Preferred Stock shares and non-transferable share warrants to purchase up to 125,000 common stock shares. The equity contribution was made pursuant to resolutions adopted by the Board of Directors on February 4, 2011. The Series A Convertible Preferred

Stock has a par value of $.01 per share and a stated value of $1.25 per share and may be converted to Common Stock on a one-for-one basis. Dividends accrue at 8% per annum on the preferred stock with payment dates occurring on or before May 15, 2013 to be paid by issuing additional shares of Series A Convertible Preferred stock in lieu of cash. The holders of the Series A Convertible Preferred stock have voting rights provided by the Texas Business Organization Code as well as additional rights as defined in the designating resolutions. The non-transferable share warrants have an exercise price of $2.00 per share.

On April 18, 2011, the Company paid $800,000 on its Wells Fargo line of credit. Cash proceeds from the issuance of the Series A Convertible Preferred Stock (discussed in the paragraph above) was used to make the principal debt payment. As of April 18, 2011, the Company's outstanding debt to Wells Fargo Bank was $3.6 million.

On February 22, 2011, the Company entered into a "Promissory Note" along with a "Settlement and Release Agreement" to exit the lease related to a store that was closed in November 2010. This $150,000 non-interest bearing promissory note is included in liabilities associated with leasing and exit activities. A down payment of $40,000 was made on February 22, 2011 and the remaining balance of $110,000 is payable in twelve equal monthly installments.

On May 2, 2011, the Company entered into a "Promissory Note" along with a "Compromise Settlement and Release Agreement" to exit the lease related to a store that had been subleased. This $200,000 non-interest bearing promissory note is included in liabilities associated with leasing and exit activities. The principal balance is due in thirty-six equal monthly installments and contains a penalty clause that increases the principal to $600,000, if the Company defaults on the note.