

MEXICAN RESTAURANTS INC

FORM 10-Q (Quarterly Report)

Filed 11/13/07 for the Period Ending 09/30/07

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from _____ to _____

Commission file number: **0-28234**



Mexican Restaurants, Inc.
(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

76-0493269
(IRS Employer Identification Number)

1135 Edgebrook, Houston, Texas
(Address of Principal Executive Offices)

77034-1899
(Zip Code)

Registrant's telephone number, including area code: **713-943-7574**

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

Yes

No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes

No

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

Yes

No

Number of shares outstanding of each of the issuer's classes of common stock, as of November 13, 2007: **3,236,016 shares of common stock,**

par value \$.01.

Table of Contents

Part I – Financial Information

	Page No.	
Item 1.	Financial Statements:	
	Consolidated Balance Sheets	2
	Consolidated Statements of Income	3
	Consolidated Statements of Cash Flows	4
	Notes to Consolidated Financial Statements	5
Item 2.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	9
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	14
Item 4.	Controls and Procedures	14

Part II – Other Information

Item 1A.	Risk Factors	14
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	15
Item 6.	Exhibits	15
Signatures		16
Exhibit 31.1	Section 302 CEO Certification	
Exhibit 31.2	Section 302 CFO Certification	
Exhibit 32.1	Section 906 CEO Certification	
Exhibit 32.2	Section 906 CFO Certification	

PART 1 - FINANCIAL INFORMATION

Item 1. Financial Statements

**Mexican Restaurants, Inc. and Subsidiaries
Consolidated Balance Sheets**

ASSETS	(Unaudited) 9/30/2007	12/31/2006
Current assets:		
Cash	\$ 459,508	\$ 653,310
Royalties receivable	66,795	90,627
Other receivables	813,181	856,704
Inventory	702,397	710,633
Income taxes receivable	465,983	408,787
Prepaid expenses and other current assets	1,045,836	851,580
Total current assets	<u>3,553,700</u>	<u>3,571,641</u>
Property, plant and equipment		
Property, plant and equipment	36,539,557	34,682,615
Less accumulated depreciation	(18,520,726)	(17,171,172)
Net property, plant and equipment	18,018,831	17,511,443
Goodwill	11,403,805	11,403,805
Deferred tax assets	363,771	318,519
Other assets	531,273	470,284
Total Assets	<u>\$ 33,871,380</u>	<u>\$ 33,275,692</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,506,864	\$ 2,087,506
Accrued sales and liquor taxes	130,264	142,787
Accrued payroll and taxes	996,786	1,440,040
Accrued expenses and other	1,747,314	1,828,916
Total current liabilities	<u>4,381,228</u>	<u>5,499,249</u>
Long-term debt	6,828,000	3,800,000
Other liabilities	2,474,936	2,050,272
Deferred gain	1,196,820	1,352,927
Total liabilities	<u>14,880,984</u>	<u>12,702,448</u>
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	47,327	47,327
Additional paid-in capital	19,297,282	19,041,867
Retained earnings	12,908,210	12,759,122
Treasury stock of 1,496,689 and 1,272,383 common shares, at 9/30/07 and 12/31/06, respectively	(13,262,423)	(11,275,072)
Total stockholders' equity	<u>18,990,396</u>	<u>20,573,244</u>
Total Liabilities and Stockholders' Equity	<u>\$ 33,871,380</u>	<u>\$ 33,275,692</u>

See accompanying notes to consolidated financial statements.

Mexican Restaurants, Inc. and Subsidiaries

**Consolidated Statements of Income
(Unaudited)**

	13-Week Period Ended 9/30/2007	13-Week Period Ended 10/1/2006	39-Week Period Ended 9/30/2007	39-Week Period Ended 10/1/2006
Revenues:				
Restaurant sales	\$ 20,713,643	\$ 20,045,681	\$ 61,741,934	\$ 61,188,112
Franchise fees, royalties and other	173,637	195,503	505,598	629,116
Business interruption	-	-	-	59,621
	<u>20,887,280</u>	<u>20,241,184</u>	<u>62,247,532</u>	<u>61,876,849</u>
Costs and expenses:				
Cost of sales	5,929,587	5,521,942	17,572,761	16,827,805
Labor	6,726,294	6,588,986	20,206,367	19,762,053
Restaurant operating expenses	5,095,089	4,866,542	15,273,881	14,144,913
General and administrative	1,855,287	1,703,966	5,690,916	5,403,634
Depreciation and amortization	866,678	796,976	2,544,913	2,276,928
Pre-opening costs	2,777	-	22,771	64,248
Impairment costs	90,858	17,458	90,858	95,589
Hurricane Rita gain	-	-	-	(366,808)
(Gain) loss on sale of assets	107,819	7,156	199,501	(3,797)
	<u>20,674,389</u>	<u>19,503,026</u>	<u>61,601,968</u>	<u>58,204,565</u>
Operating income	<u>212,891</u>	<u>738,158</u>	<u>645,564</u>	<u>3,672,284</u>
Other income (expense):				
Interest income	4,835	4,349	8,658	5,609
Interest expense	(139,056)	(109,230)	(362,639)	(308,222)
Other, net	8,407	21,244	33,910	68,686
	<u>(125,814)</u>	<u>(83,637)</u>	<u>(320,071)</u>	<u>(233,927)</u>
Income from continuing operations before income taxes	87,077	654,521	325,493	3,438,357
Income tax expense (benefit)	(11,611)	200,492	63,783	1,143,893
Income from continuing operations	98,688	454,029	261,710	2,294,464
Discontinued operations:				
Income (loss) from discontinued operations	-	(125,018)	3,090	(230,913)
Restaurant closure costs	(15,767)	-	(185,316)	-
Gain (loss) on sale of assets	-	(573)	3,412	(3,310)
Loss from discontinued operations before income taxes	<u>(15,767)</u>	<u>(125,591)</u>	<u>(178,814)</u>	<u>(234,223)</u>
Income tax benefit	5,829	46,951	66,192	87,562
Loss from discontinued operations	<u>(9,938)</u>	<u>(78,640)</u>	<u>(112,622)</u>	<u>(146,661)</u>
Net income	<u>\$ 88,750</u>	<u>\$ 375,389</u>	<u>\$ 149,088</u>	<u>\$ 2,147,803</u>
Basic income (loss) per share				
Income from continuing operations	\$ 0.03	\$ 0.13	\$ 0.07	\$ 0.67
Loss from discontinued operations	-	(0.02)	(0.03)	(0.04)
Net income	<u>\$ 0.03</u>	<u>\$ 0.11</u>	<u>\$ 0.04</u>	<u>\$ 0.63</u>
Diluted income (loss) per share				
Income from continuing operations	\$ 0.03	\$ 0.12	\$ 0.07	\$ 0.63
Loss from discontinued operations	-	(0.02)	(0.03)	(0.04)
Net income	<u>\$ 0.03</u>	<u>\$ 0.10</u>	<u>\$ 0.04</u>	<u>\$ 0.59</u>
Weighted average number of shares outstanding (basic)	<u>3,418,669</u>	<u>3,400,944</u>	<u>3,371,883</u>	<u>3,386,965</u>
Weighted average number of shares outstanding (diluted)	<u>3,463,126</u>	<u>3,633,868</u>	<u>3,438,601</u>	<u>3,647,249</u>

See accompanying notes to consolidated financial statements.

Mexican Restaurants, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)

	39 Weeks Ended 9/30/2007	39 Weeks Ended 10/1/2006
Cash flows from operating activities:		
Net income	\$ 149,088	\$ 2,147,803
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,544,913	2,276,928
Deferred gain amortization	(156,107)	(156,107)
Loss from discontinued operations	112,622	146,661
Impairment costs	90,858	95,589
Hurricane Rita gain	-	(366,808)
Loss (gain) on sale of assets	199,501	(3,797)
Stock based compensation expense	98,269	44,820
Deferred income taxes (benefit)	(136,793)	374,217
Changes in assets and liabilities:		
Royalties receivable	23,832	52,954
Other receivables	33,206	(446,183)
Inventory	(10,348)	35,112
Income taxes receivable/payable	(57,196)	(81,214)
Prepaid and other current assets	(214,942)	(98,473)
Other assets	(97,737)	13,329
Accounts payable	(617,444)	(183,318)
Accrued expenses and other liabilities	(539,721)	(291,007)
Deferred rent and other long-term liabilities	466,032	246,787
Total adjustments	<u>1,738,945</u>	<u>2,551,856</u>
Net cash provided by continuing operations	<u>1,888,033</u>	<u>4,699,659</u>
Net cash used in discontinued operations	<u>(23,336)</u>	<u>(248,496)</u>
Net cash provided by operating activities	1,864,697	4,451,163
Cash flows from investing activities:		
Insurance proceeds received from Hurricane Rita loss	-	785,028
Purchase of property, plant and equipment	(3,483,799)	(3,731,652)
Proceeds from sale of property, plant and equipment	5,280	765,000
Business acquisition, net of cash acquired	-	(742,490)
Net cash used in continuing operations	<u>(3,478,519)</u>	<u>(2,924,114)</u>
Net cash provided by (used in) discontinued operations	<u>4,020</u>	<u>(71,824)</u>
Net cash used in investing activities	(3,474,499)	(2,995,938)
Cash flows from financing activities:		
Net borrowings under line of credit agreement	3,528,000	450,000
Purchase of treasury stock	(1,628,000)	(261,730)
Excess tax benefit – stock-based compensation expense	7,100	52,462
Exercise of stock options	8,900	502,425
Payments on long-term debt	(500,000)	(2,500,000)
Net cash provided by (used in) financing activities	<u>1,416,000</u>	<u>(1,756,843)</u>
Net decrease in cash	(193,802)	(301,618)
Cash at beginning of period	<u>653,310</u>	<u>788,109</u>
Cash at end of period	<u>\$ 459,508</u>	<u>\$ 486,491</u>
Supplemental disclosure of cash flow information:		
Cash paid during the period:		
Interest	\$ 240,107	\$ 287,091
Income taxes	\$ 93,000	\$ 774,819
Non-cash financing activities:		
Sale of assets for common stock (Note 9)	\$ 218,205	\$ -

See accompanying notes to consolidated financial statements.

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

In the opinion of Mexican Restaurants, Inc. (the “Company”), the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring accruals and adjustments) necessary for a fair presentation of the consolidated financial position as of September 30, 2007, and the consolidated statements of income and cash flows for the 13-week and 39-week periods ended September 30, 2007 and October 1, 2006. The consolidated statements of income for the 13-week and 39-week periods ended September 30, 2007 are not necessarily indicative of the results to be expected for the full year. During the interim periods, the Company follows the accounting policies described in the notes to its consolidated financial statements in its Annual Report and Form 10-K for the year ended December 31, 2006 filed with the Securities and Exchange Commission on April 2, 2007. Reference should be made to such consolidated financial statements for information on such accounting policies and further financial detail.

The consolidated statements of income and cash flows for the 13-week and 39-week periods ended October 1, 2006 have been adjusted to remove the operations of closed restaurants, which have been reclassified as discontinued operations. Consequently, the consolidated statements of income and cash flows for the 13-week and 39-week periods ended October 1, 2006 shown in the accompanying consolidated financial statements have been reclassified to conform to the September 30, 2007 presentation. These reclassifications have no effect on total assets, total liabilities, stockholders’ equity or net income.

Impact of Recently Issued Accounting Standards

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements”. SFAS 157 defines fair value, furnished a framework for measuring fair value under generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. The Company has not yet determined the estimated impact on its financial condition or results of operations, if any, of adopting SFAS No. 157, which becomes effective for the fiscal years beginning after November 15, 2007.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities – including an amendment of FASB Statement No. 115.” SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board’s long-term measurement objectives for accounting for financial instruments. The Company has not yet determined the estimated impact on its financial condition or results of operations, if any, of adopting SFAS No. 159, which becomes effective for the fiscal years beginning after November 15, 2007.

Effective January 1, 2007, the Company adopted FASB Interpretation Number 48, “Accounting for Uncertainty in Income Taxes” (FIN 48), which is intended to clarify the accounting for income taxes prescribing a minimum recognition threshold for a tax position before being recognized in the consolidated financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. In accordance with the requirements of FIN 48, the Company evaluated all tax years still subject to potential audit under state and federal income tax law in reaching its accounting conclusions. As a result, the Company concluded it did not have any unrecognized tax benefits or any additional tax liabilities after applying FIN 48 as of the January 1, 2007 adoption date or during the 13 week and 39 week periods ended September 30, 2007. The adoption of FIN 48 therefore had no impact on the Company’s consolidated financial statements. See Note 2 for further discussion.

2. Income Taxes

The provisions of FIN No. 48 have been applied to all of our material tax positions taken through the date of adoption and during the 13 week and 39 week periods ended September 30, 2007. We have determined that all of our material tax positions taken in our income tax returns met the more likely-than-not recognition threshold prescribed by FIN No. 48. In addition, we have also determined that, based on our judgment, none of these tax positions meet the definition of "uncertain tax positions" that are subject to the non-recognition criteria set forth in the new pronouncement. In future reporting periods, if any interest or penalties are imposed in connection with an income tax liability, we expect to include both of these items in our income tax provision. We also do not believe that it is reasonably possible that the amount of our unrecognized tax benefits will change significantly within the next twelve months. The Company is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2003. During fiscal year 2006, the Internal Revenue Service (IRS) examined the Company's 2004 U.S. income tax return, resulting in the IRS sending a final determination notice of "No Change", dated June 29, 2006. As a result, the Company concluded it did not have any unrecognized tax benefits or any additional tax liabilities after applying FIN 48 as of the January 1, 2007 adoption date or as of the 13 week and 39 week periods ended September 30, 2007. The adoption of FIN 48 therefore had no impact on the Company's consolidated financial statements.

In May 2006, the State of Texas enacted a new business tax that is imposed on gross revenues to replace the State's current franchise tax regime. The new legislation's effective date is January 1, 2008, which means that our first Texas margins tax ("TMT") return will not become due until May 15, 2008 and will be based on our 2007 operations. Although the TMT is imposed on an entity's gross revenues rather than on its net income, certain aspects of the tax make it similar to an income tax. In accordance with the guidance provided in SFAS No. 109, we have properly determined the impact of the newly-enacted legislation in the determination of our reported state current and deferred income tax liability.

3. Stock-Based Compensation

At September 30, 2007, the Company had several equity-based compensation plans from which stock-based compensation awards can be granted to eligible employees, officers or directors. The current plans are the 2005 Long Term Incentive Plan, the 1996 Long Term Incentive Plan, the Stock Option Plan for Non-Employee Directors and the 1996 Manager's Stock Option Plan. These plans are described in more detail in Note 5 of our consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

Effective January 2, 2006, the Company adopted SFAS No. 123 (Revised) Share-Based Payments (SFAS No.123(R)) utilizing the modified prospective approach. Prior to the adoption of SFAS No. 123(R), the Company accounted for the equity-based compensation plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations (the intrinsic value method), and accordingly, did not recognize any compensation expense for stock option grants.

Under the modified prospective approach, SFAS No. 123(R) applies to new awards and to unvested awards that were outstanding on January 2, 2006, and those that are subsequently modified, repurchased or cancelled. Under the modified prospective approach, compensation cost recognized in the consolidated financial statements includes compensation cost for all unvested stock-based payments granted prior to adoption and compensation cost for all stock-based compensation awards granted subsequent to adoption, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R).

On May 23, 2006, the Company's 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. 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 Company's Board of Directors approved a restricted stock grant of 10,000 shares to its President, with such grant vesting over a four year period. Also, restricted stock grants for an aggregate of 11,000 shares was made to four employees of its Michigan operations, with such grants vesting over a five year period. In addition, the Board 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.

On August 17, 2007, the Company's 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 8/30/07 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.

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 for which the options were sold over the exercise prices of the options. There were zero and 44,625 stock options exercised in the 13-week periods ending September 30, 2007 and October 1, 2006, respectively. The Company received cash in the amount of \$255,203 in the third quarter of 2006 from the exercise of these options.

As a result of adopting SFAS No. 123(R) on January 2, 2006, income before income taxes, net income and diluted earnings per share for the 13-week period ended October 1, 2006, were lower by \$18,688, \$11,779 and \$0.00 per share, respectively, and for the 39-week period ended October 1, 2006 were lower by \$44,820, \$28,250 and \$0.01 per share, respectively, than if the Company had continued to account for stock-based compensation under APB Opinion No. 25.

4. Income per Share

Basic income per share is based on the weighted average shares outstanding without any dilutive effects considered. Prior to the adoption of SFAS No. 123(R), diluted income per share recognized the dilution from all contingently issuable shares, including options and warrants.

Since the adoption of SFAS No. 123(R) in fiscal year 2006, diluted income per share is calculated using the treasury stock method, which considers unrecognized compensation expense as well as the potential excess tax benefits that reflect the current market price and total compensation expense to be recognized under SFAS No. 123(R). If the sum of the assumed proceeds, including the unrecognized compensation costs calculated under the treasury stock method, exceeds the average stock price, those options would be considered antidilutive and therefore excluded from the calculation of diluted income per share. For the 13-week and 39-week periods ended September 30, 2007, the incremental shares added in the calculation of diluted income per share were 44,457 and 66,718, respectively. For the 13-week and 39-week periods ended October 1, 2006, the incremental shares added in the calculation of diluted income per share were 232,924 and 260,284, respectively, which affected the determination of diluted income by \$0.01 and \$0.04 per share, respectively.

5. Hurricane Rita

During the second quarter of 2006, the Company reached a resolution with its insurance carrier for the Hurricane Rita insurance claim. As of October 1, 2006 the Company had a receivable due from its insurance carrier of \$426,822 and had received proceeds of \$785,028. All insurance proceeds related to this claim were collected prior to the end of fiscal year 2006.

6. Long-term Debt

On March 31, 2006, the Company prepaid \$2.5 million of the Beaumont-based franchise restaurant seller notes by drawing \$2.0 million on its Bank of America revolving line of credit, with the balance paid from cash reserves.

On March 29, 2007, the Company amended its credit facility with Bank of America, changing its credit facility from a \$10.0 million credit facility consisting of a \$5.0 million term note (remaining balance \$1.5 million) and a \$5.0 million revolving line of credit to a \$7.5 million revolving line of credit, rolling the term note balance into the newly increased revolving line of credit. The revolving line of credit was to mature on December 31, 2011. The amendment allowed for additional capital expenditures, revised certain covenant ratios and increased the amount of allowable stock or vested option repurchases. The interest rate was either the prime rate or LIBOR plus a stipulated percentage. The Company was subject to a non-use fee of 0.75% on the unused portion of the revolver from the date of the credit agreement. The Company pledged the stock of its subsidiaries, its leasehold interests, its patents and trademarks and its furniture, fixtures and equipment as collateral for its credit facility with Bank of America. The amendment was signed March 29, 2007 and was made effective December 31, 2006. The Company was in full compliance with all debt covenants, as amended, as of April 1, 2007.

On June 29, 2007 the Company entered into a Credit Agreement (the “Wells Fargo Agreement”) with Wells Fargo Bank, N.A. (“Wells Fargo”) in order to increase the revolving loan amount available to the Company from \$7.5 million to \$10 million. The Wells Fargo Agreement also allows up to \$2.0 million in annual stock repurchases. In connection with the execution of the Wells Fargo Agreement, the Company prepaid and terminated its existing credit facility between the Company and Bank of America. The Wells Fargo Agreement provides for a revolving loan of up to \$10 million, with an option to increase the revolving loan by an additional \$5 million, for a total of \$15 million. The Wells Fargo Agreement terminates on June 29, 2010. At the Company’s option, the revolving loan bears an interest rate equal to either the Wells Fargo’s 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 Company has pledged the stock of its subsidiaries, its leasehold interests, its patents and trademarks and its furniture, fixtures and equipment as collateral for its credit facility with Wells Fargo Bank, N.A. The Wells Fargo Agreement requires the Company to maintain certain minimum EBITDA levels, leverage ratios and fixed charge coverage ratios. As of September 30, 2007, the Company was in compliance with all debt covenants and expects to be in full compliance with all debt covenants during the balance of fiscal year 2007.

7. Restaurant Closure Costs

For the 13-week and 39-week periods ended September 30, 2007, the Company recorded closure costs of \$15,767 and \$185,316, respectively, all of which is included in discontinued operations. These closure costs related primarily to one under-performing restaurant closed in February, 2007 after its lease expired, and to three other restaurants, closed prior to 2007, two of which the Company subleased and the third in which the Company finalized the common area maintenance and property tax billing recently received from the landlord.

8. Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No. 144, “ *Accounting for the Impairments or Disposal of Long-Lived Assets* ”, long-lived assets, such as property, plant, 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. For the 13-week and 39-week periods ended September 30, 2007, the Company recorded impairment costs of \$90,858 related to two under-performing restaurants that are operating in the Houston area. For the 13-week and 39-week periods ended October 1, 2006, the Company recorded impairment costs of \$17,458 and \$95,589, related to previously closed restaurants in Idaho.

9. Related Party Transactions

On June 12, 2007, the Company’s Director of Franchise Operations, Mr. Forehand, resigned his position and entered into a five year employment agreement, which provides for a reduced operational role with the Company. He will continue to serve as a Director and as Vice Chairman of the Company’s Board of Directors.

On June 15, 2007, Mr. Forehand entered into an Asset Purchase Agreement to purchase the assets of the Company’s Casa Olé restaurant located in Stafford, Texas, an 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 13-week period ended September 30, 2007, the Company recognized royalty income of \$5,061.

On June 13, 2007, Mr. Forehand entered into a Stock Purchase Agreement to sell 200,000 shares of his personally-owned common stock back to the Company. The stock was valued at \$8.14 per share, which was the ten-day weighted average stock price as of June 12, 2007, and the Company finalized the stock purchase on July 6, 2007.

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

Special Note Regarding Forward-Looking Statements

This Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others, the following: growth strategy; dependence on executive officers; geographic concentration; increasing susceptibility to adverse conditions in the region; changes in consumer tastes and eating and discretionary spending habits; the risk of food-borne illness; national, regional or local economic and real estate conditions; demographic trends; inclement weather; traffic patterns; the type, number and location of competing restaurants; inflation; increased food, labor and benefit costs; the availability of experienced management and hourly employees; seasonality and the timing of new restaurant openings; changes in governmental regulations; dram shop exposure; and other factors not yet experienced by the Company. The use of words such as "believes", "anticipates", "expects", "intends" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Readers are urged to carefully review and consider the various disclosures made by the Company in this report and in the Company's most recently filed Annual Report and Form 10-K that attempt to advise interested parties of the risks and factors that may affect the Company's business. The Company undertakes no obligation to update any such statements or publicly announce any updates or revisions to any of the forward-looking statements contained herein, to reflect any change in its expectations with regard thereto or any change in events, conditions, circumstances or assumptions underlying such statements.

General

The Company operates and franchises Mexican-theme restaurants featuring various elements associated with the casual dining experience under the names Casa Olé, Monterey's Tex-Mex Café, Monterey's Little Mexico, Tortuga Coastal Cantina, Crazy Jose's, La Señorita and Mission Burritos. At September 30, 2007 the Company operated 58 restaurants, franchised 19 restaurants and licensed one restaurant in various communities in Texas, Louisiana, Oklahoma and Michigan.

The Company's primary source of revenues is the sale of food and beverages at Company-owned restaurants. The Company also derives revenues from franchise fees, royalties and other franchise-related activities with respect to its franchised restaurants. 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 operation. Initial franchise fees relating to area franchise sales are recognized ratably in proportion to the 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 consolidated statements of income and cash flows for the 13-week and 39-week periods ended October 1, 2006 have been adjusted to remove the operations of closed restaurants, which have been reclassified as discontinued operations. Consequently, the consolidated statements of income and cash flows for the 13-week and 39-week periods ended October 1, 2006 shown in the accompanying consolidated financial statements have been reclassified to conform to the September 30, 2007 presentation. These reclassifications have no effect on total assets, total liabilities, stockholders' equity or net income.

Since its inception as a public company in 1996, the Company has primarily grown through the acquisition of other Mexican food restaurant companies.

In 1997, the Company purchased all of the outstanding stock of Monterey's Acquisition Corp. ("MAC"). At the time of the acquisition, MAC owned and operated 26 restaurants in Texas and Oklahoma under the names "Monterey's Tex-Mex Café," "Monterey's Little Mexico" and "Tortuga Coastal Cantina."

In 1999, the Company purchased 100% of the outstanding stock of La Señorita Restaurants, a Mexican restaurant chain operated in the State of Michigan. At the time of the acquisition, La Señorita operated five company-owned restaurants, and three franchise restaurants.

In January 2004, the Company completed its purchase of 13 restaurants and related assets from its Beaumont-based franchisee and affiliates for a total consideration of approximately \$13.75 million. The restaurants acquired include eight Casa Olé restaurants located in Southeast Texas, two Casa Olé restaurants located in Southwest Louisiana, and three Crazy Jose's restaurants located in Southeast Texas.

In October 2004, the Company completed its purchase of one franchise restaurant in Brenham, Texas for approximately \$215,000. The restaurant was closed, remodeled and re-opened on November 22, 2004.

In August 2006, the Company purchased two Mission Burritos restaurants and related assets located in Houston, Texas for approximately \$725,000.

Results of Operations

Revenues. The Company's revenues for the third quarter of fiscal year 2007 increased \$646,096 or 3.2% to \$20.9 million compared with \$20.2 million for the same quarter in fiscal year 2006. Restaurant sales for third quarter 2007 increased \$667,962 or 3.3% to \$20.7 million compared with \$20.0 million for the third quarter of fiscal year 2006. Approximately half of the increase reflects positive same-store sales. The other half of the increase in revenue reflects one new restaurant addition and revenues from the Company's Mission Burritos stores acquired in August 2006. For the third quarter ended September 30, 2007, Company-owned same-restaurant sales increased approximately 1.8% and franchised-owned same-restaurant sales, as reported by franchisees, increased approximately 5.4%.

On a year-to-date basis, the Company's revenue increased \$370,683 or 0.6% to \$62.2 million compared with \$61.9 million for the same 39-week period in fiscal 2006. Restaurant sales for the 39-week period ended September 30, 2007 increased \$553,822 or 0.9% to \$61.7 million compared with \$61.2 million for the same 39-week period of fiscal 2006. The increase in revenue reflects new restaurant additions and revenues from the Company's Mission Burritos stores, partially offset by an approximate \$1.5 million decline in same-store sales and the loss of sales of one closed restaurant for remodeling. For the 39-week period ended September 30, 2007, Company-owned same-restaurant sales decreased approximately 2.6% and franchised-owned same-restaurant sales, as reported by franchisees, increased approximately 1.9%.

For the quarter ended September 30, 2007, franchise fees, royalties and other decreased \$21,866 or 11.2% to \$173,637 compared with \$195,503 for the same quarter a year ago. The decrease primarily reflects the closure of one franchise location.

On a year-to-date basis, franchise fees, royalties and other decreased \$183,139 or 26.6% to \$505,598 compared with \$688,737 for the same quarter a year ago. The decrease primarily reflects business interruption proceeds of \$59,621 received during the second quarter ended July 2, 2006 and \$80,000 recognition in royalties due to the correction of understated royalty income which was also recorded in the second quarter ended July 2, 2006.

Costs and Expenses . Costs of sales, consisting of food, beverage, liquor, supplies and paper costs, increased as a percent of restaurant sales 110 basis points to 28.6% compared with 27.5% in the third quarter of fiscal year 2006. The increase primarily reflects higher commodity prices, especially produce, cheese and dry goods. In April and May of 2007, the Company raised menu prices at most of our concepts in an effort to offset some of the rise in commodity costs.

On a year-to-date basis, costs of sales increased as a percent of restaurant sales 100 basis points to 28.5% compared with 27.5% for the same 39-week period a year ago. The increase was due to the same reasons discussed above.

Labor and other related expenses decreased as a percentage of restaurant sales 40 basis points to 32.5% as compared with 32.9% in the third quarter of fiscal year 2006. The decrease primarily reflects improved hourly labor utilization. On a year-to-date basis, labor and other related expense increased as a percentage of restaurant sales 40 basis points to 32.7% compared with 32.3% for the 39-week period a year ago. The increase primarily reflects the lingering impact of the first quarter of fiscal 2007, which had labor cost of 33.8%, reflecting hourly labor that was not scheduled in proportion to declining same-restaurant sales during that period. Since the first quarter, labor cost improved to 32.0% in the second quarter and 32.5% in the third. Labor utilization improvements were approximately the same for both the second and third quarters. The second quarter benefited from a one-time adjustment to worker's compensation insurance and unemployment tax adjustments related to a policy audit and a refund due to excess funding from the State of Texas Workforce Commission.

Restaurant operating expenses, which primarily include rent, property taxes, utilities, repair and maintenance, liquor taxes, property insurance, general liability insurance and advertising, increased as a percentage of restaurant sales 30 basis points to 24.6% as compared with 24.3% in the third quarter of fiscal year 2006. The increase primarily reflects higher repair and maintenance expenses and advertising expense. On a year-to-date basis, restaurant operating expenses increased 160 basis points to 24.7% compared with 23.1% for the 39-week period in fiscal year 2006. The increase reflects higher property insurance premiums (resulting from perceived greater hurricane threats in the Gulf Coast Region), repair and maintenance, a one-time rent related common area maintenance adjustment and security costs.

General and administrative expenses consist of expenses associated with corporate and administrative functions that support restaurant operations. As a percentage of total revenue, general and administrative expenses increased 50 basis points to 8.9% for the third quarter of fiscal year 2007 as compared with 8.4% for the third quarter of fiscal year 2006. In absolute dollars, general and administrative costs were \$151,321 higher in the third quarter of fiscal year 2007 compared with the third quarter of fiscal year 2006. The increase primarily reflects an increase in stock option expense, employee finder fees, legal expenses and consulting fees related to Sarbanes-Oxley required internal control documentation and testing. On a year-to-date basis, general and administrative expenses increased 40 basis points to 9.1% compared with 8.7% for the 39-week period a year ago. In absolute dollars, general and administrative costs were \$287,282 higher in the 39-week period of fiscal 2007 compared with the 39-week period a year ago. The increase was due to the same reasons discussed above, and also due to a \$31,250 executive search fee recorded in the first quarter of fiscal 2007.

Depreciation and amortization expenses include the depreciation of fixed assets and the amortization of intangible assets. Depreciation and amortization expense increased as a percentage of total sales 20 basis points to 4.1% for the third quarter of fiscal year 2007 as compared with 3.9% the same quarter in fiscal year 2006. Such expense for the third quarter of fiscal year 2007 was \$69,702 higher than for the third quarter in fiscal year 2006. The increase reflects additional depreciation expense for remodeled restaurants, new restaurants, and the replacement of equipment and leasehold improvements in various existing restaurants. On a year-to-date basis, depreciation and amortization expenses increased as a percentage of total sales 40 basis points to 4.1% for the 39-week period of fiscal year 2007 as compared with 3.7% the same 39-week period in fiscal year 2006. The increase was due to the reasons discussed above and the write-off of Bank of America loan costs.

The Company did not open any new restaurants during the third quarter of 2007. The Company, however, reopened a completely remodeled restaurant (closed for eight weeks during the second quarter of 2007) and incurred \$19,994 of pre-opening costs in the second quarter and \$2,777 in the third quarter for a total of \$22,771 for the 39-week period of 2007. Last year, the Company opened one new restaurant at the end of the first quarter of 2006 and incurred \$49,738 in pre-opening costs in the first quarter of 2006 and \$14,510 in the second quarter of 2006, for a total of \$64,248 for the 39-week period of 2006.

Impairment Costs. In accordance with Statement of Financial Accounting Standards No. 144, “ *Accounting for the Impairments or Disposal of Long-Lived Assets* ”, long-lived assets, such as property, plant, 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. For the 13-week and 39-week periods ended September 30, 2007, the Company recorded impairment costs of \$90,858 related to two under-performing restaurants that are operating in the Houston area. For the 13-week and 39-week periods ended October 1, 2006, the Company recorded impairment costs of \$17,458 and \$95,589, related to previously closed restaurants in Idaho.

Gain/Loss on Sale of Assets . During the third quarter of fiscal year 2007, the Company recorded losses of \$107,819, primarily related to the loss on disposal of assets of two remodeled restaurants. Year-to-date, the Company recorded losses of \$199,501, reflecting the loss from the two remodeled restaurants mentioned above and from the sale of one under-performing restaurant to Mr. Forehand, Vice Chairman of the Company, who purchased the assets of the Company’s Casa Olé restaurant located in Stafford, Texas 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 Stafford restaurant will operate under the Company’s uniform franchise agreement and is subject to a monthly royalty fee.

Other Income (Expense). Net expense increased \$42,177 to \$125,814 in the third quarter of fiscal year 2007 compared with a net expense of \$83,637 in the third quarter of fiscal year 2006. Interest expense increased \$29,826 to \$139,056 in the third quarter of fiscal year 2007 compared with interest expense of \$109,230 in the third quarter of fiscal year 2006. On a year-to-date basis, net expense for the 39-week period of fiscal year 2007 increased \$86,144 to \$320,071 as compared to \$233,927 for the 39-week period for fiscal year 2006. Interest expense increased \$54,417 to \$362,639 for the 39-week period of fiscal year 2007 compared to interest expense of \$308,222 in the 39-week period of fiscal year 2006. As of September 30, 2007, the Company's outstanding debt was \$6.8 million. The Company did not incur any additional debt during the third quarter of fiscal year 2007. During the 39-week period ended September 30, 2007, the Company's outstanding debt increased \$3.0 million resulting from drawing \$3.5 million on its line of credit and partially offset by the \$0.5 million prepayment of the Beaumont-based franchise restaurant seller notes. The increase in interest expense reflects the higher average debt outstanding.

Income Tax Expense. The Company's effective tax rate from continuing operations for the third quarter of fiscal year 2007 was a benefit of 13.3% as compared to an expense of 30.6% for the third quarter of fiscal year 2006. On a year-to-date basis, the Company's effective tax rate from continuing operations for the 39-week period of fiscal year 2007 was 19.6% as compared to 33.3% for the 39-week period for fiscal year 2006. For the third quarter of fiscal year 2007, the Company had tax credits that were larger than the tax expense resulting in a net tax benefit. This created a deferred tax asset which will be available to offset future income taxes. In determining the quarterly provision for income taxes, the Company uses an estimated annual effective tax rate based on forecasted annual income and permanent items, statutory tax rates and tax planning opportunities in the various jurisdictions in which the Company operates. The impact of significant discrete items is separately recognized in the quarter in which they occur.

Restaurant Closure Costs and Discontinued Operations . For the 13-week and 39-week periods ended September 30, 2007, the Company recorded closure costs of \$15,767 and \$185,316, respectively, all of which is included in discontinued operations. These closure costs related primarily to one under-performing restaurant closed in February, 2007 after its lease expired, and to three other restaurants, closed prior to 2007, two of which the Company subleased and the third in which the Company finalized the common area maintenance and property tax billing recently received from the landlord.

Liquidity and Capital Resources

The Company met capital requirements for the 39-week period of fiscal year 2007 primarily by drawing on its cash reserves and line of credit. In the 39-week period for fiscal year 2007, the Company had cash flow from operating activities of \$1.9 million, compared with cash flow from operating activities of \$4.5 million in the 39-week period of fiscal year 2006. The decrease in cash flow from operating activities primarily reflects the decrease in operating income. Financing activities provided \$1.4 million in the 39-weeks of fiscal year 2007, in which \$3.5 million was drawn from the Company's line of credit with \$1.6 million used for the purchase of 200,000 shares of the Company's common stock and \$0.5 million for the prepayment of the Beaumont-based franchise restaurant seller note, compared to a use of cash of \$1.8 million primarily related to long term debt payments in fiscal year 2006. As of September 30, 2007, the Company had a working capital deficit of approximately \$828,000 compared with a working capital deficit of approximately \$1.9 million at December 31, 2006 and approximately \$2.4 million at October 1, 2006. A working capital deficit is common in the restaurant industry, since restaurant companies do not typically require a significant investment in either accounts receivable or inventory.

The Company's principal capital requirements are the funding of routine capital expenditures, new restaurant development or acquisitions and remodeling of older units. During the 39-week period ended September 30, 2007, total cash used for capital requirements was approximately \$3.5 million, which included approximately \$453,000 spent for new PosiTouch point-of-sale register systems for 15 restaurants (all Company-owned restaurants now have PosiTouch) and \$1.3 million for restaurant remodels. The Company did not open any new restaurants during the 39-week period of 2007, but did sign two new leases for Mission Burritos restaurants it plans to open during the first quarter of 2008. One lease previously signed for a future Casa Olé restaurant was terminated due to the landlord's failure to perform. During the 39-week period ended September 30, 2007, the Company completed the remodel of one Casa Olé restaurant at a total cost of approximately \$822,000. Sales for the remodeled Casa Olé restaurant were up over 50% since its reopening. The Company's management anticipates that it will spend approximately \$1.0 million for capital expenditures during the remainder of fiscal year 2007.

The Company has incurred debt to carry out acquisitions, to repurchase its common stock, to develop new restaurants and to remodel existing restaurants, as well as to accommodate other working capital needs. During the 39-week period ended September 30, 2007, the Company drew \$3.5 million on its line of credit, prepaid the remaining seller note of \$500,000 from the Beaumont-based franchise restaurant acquisition in 2004, and repurchased 200,000 shares of the Company's common stock for \$1.6 million. As of September 30, 2007, the Company had \$6.8 million drawn on its line of credit.

On March 29, 2007, the Company amended its credit facility with Bank of America, changing its credit facility from a \$10.0 million credit facility consisting of a \$5.0 million term note (remaining balance \$1.5 million) and a \$5.0 million revolving line of credit to a \$7.5 million revolving line of credit, rolling the term note balance into the newly increased revolving line of credit. The revolving line of credit was to mature on December 31, 2011. The amendment allowed for additional capital expenditures, revised certain covenant ratios and increased the amount of allowable stock or vested option repurchases. The interest rate was either the prime rate or LIBOR plus a stipulated percentage. Accordingly, the Company is impacted by changes in the prime rate and LIBOR. The Company was subject to a non-use fee of 0.75% on the unused portion of the revolver from the date of the credit agreement. The Company pledged the stock of its subsidiaries, its leasehold interests, its patents and trademarks and its furniture, fixtures and equipment as collateral for its credit facility with Bank of America. The amendment was signed March 29, 2007 and was effective December 31, 2006.

On June 29, 2007 the Company entered into a Credit Agreement (the "Wells Fargo Agreement") with Wells Fargo Bank, N.A. ("Wells Fargo") in order to increase the revolving loan amount available to the Company from \$7.5 million to \$10 million. The Wells Fargo Agreement also allows up to \$2.0 million in annual stock repurchases. In connection with the execution of the Wells Fargo Agreement, the Company prepaid and terminated its existing credit facility between the Company and Bank of America. The Wells Fargo Agreement provides for a revolving loan of up to \$10 million, with an option to increase the revolving loan by an additional \$5 million, for a total of \$15 million. The Wells Fargo Agreement terminates on June 29, 2010. At the Company's option, the revolving loan bears an interest rate equal to either the Wells Fargo's 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 Company has pledged the stock of its subsidiaries, its leasehold interests, its patents and trademarks and its furniture, fixtures and equipment as collateral for its credit facility with Wells Fargo Bank, N.A. The Wells Fargo Agreement requires the Company to maintain certain minimum EBITDA levels, leverage ratios and fixed charge coverage ratios. As of September 30, 2007, the Company was in compliance with all debt covenants and expects to be in full compliance with all debt covenants during the balance of fiscal year 2007.

On May 9, 2005, the Company announced its plan to implement a limited stock repurchase program in a manner permitted under its bank financing agreement. The Company entered into a repurchase plan designed to comply with Rules 10b5-1 and 10b-18 under the Securities and Exchange Act of 1934 under which an agent appointed by the Company determined the time, amount, and price at which purchases of common stock were made, subject to certain parameters established in advance by the Company. Under this program, the Company purchased shares through the third quarter of fiscal year 2006. The Company presently has no further authority to repurchase outstanding shares of its common stock under this program. 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's management believes that with its operating cash flow and the Company's revolving line of credit under the Wells Fargo Agreement, funds will be sufficient to meet operating requirements and to finance routine capital expenditures and new restaurant growth 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 dates described in the previous paragraphs.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risk from changes in interest rates on debt and changes in commodity prices. Our exposure to interest rate fluctuations is limited to our outstanding bank debt. At September 30, 2007, there was \$6,828,000 outstanding under our revolving credit facility which currently bears interest at 225 basis points (depending on our leverage ratios) over the London Interbank Offered Rate. Should interest rates based on these borrowings increase by one percentage point, our estimated quarterly interest expense would increase by \$17,070.

Many of the products and the ingredients used in the products sold in our restaurants are commodities that are subject to unpredictable price volatility. There are no established fixed price markets for certain commodities such as produce and cheese, and we are subject to prevailing market conditions when purchasing those types of commodities. For other commodities, we employ various purchasing and pricing contract techniques in an effort to minimize volatility, including fixed price contracts for terms of one year or less and negotiating prices with vendors with reference to fluctuating market prices. We currently do not use financial instruments to hedge commodity prices, but we will continue to evaluate their effectiveness. Extreme and/or long term increases in commodity prices could adversely affect our future results, especially if we are unable, primarily due to competitive reasons, to increase menu prices. Additionally, if there is a time lag between the increasing commodity prices and our ability to increase menu prices, or if we believe the commodity price increase to be short in duration and we choose not to pass on the cost increases, our short-term financial results could be negatively affected.

We are subject to business risk as our beef and chicken supplies are highly dependent upon four vendors. If these vendors were unable to fulfill their obligations under their contracts, we may encounter supply shortages and incur higher costs to secure adequate supplies, any of which would harm our business.

Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) that are designed to ensure that information required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), as appropriate, to allow timely decisions regarding required disclosure.

The Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of the end of the period covered by this report. Based on the evaluation, performed under the supervision and with the participation of our management, including the CEO and the CFO, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of the period covered by this report.

Changes in Internal Control

During the period covered by this report, there were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in the Company's risk factors from the disclosure included in the Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

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

Items 2(a) and (b) are not applicable.

(c) The following table provides information about the Company's purchases of shares of its Common Stock:

<u>Period</u>	<u>Total Number of Shares Purchased (Note 2)</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of Shares (or Approximate Dollar Value) That May Yet Be Purchased Under the Plans or Programs (Note 1)</u>
1/1/07—4/01/07	<u>0</u>	<u>\$ 0.00</u>	<u>0</u>	<u>\$ 0</u>
4/2/07—7/01/07	<u>200,000</u>	<u>\$ 8.14</u>	<u>0</u>	<u>\$ 0</u>
4/2/07—7/01/07	<u>26,806</u>	<u>\$ 8.14</u>	<u>0</u>	<u>\$ 0</u>
7/2/07—9/30/07	<u>0</u>	<u>\$ 0.00</u>	<u>0</u>	<u>\$ 0</u>

(1) Under a share repurchase program approved by the Board of Directors of the Company on May 2, 2005, and amended September 7, 2005, the Company was authorized to repurchase up to \$2,000,000 in maximum aggregate amount of the Company's Common Stock (not to exceed repurchases up to \$500,000 in any one quarter). The repurchase program was designed to comply with Rules 10b-18 and Rule 10b5-1 under the Securities Exchange Act of 1934 under which an agent appointed by the Company was to determine the time, amount, and price at which purchases of common stock were to be made, subject to certain parameters established in advance by the Company. As of September 30, 2007, the Company has no remaining repurchase authority remaining under this program.

(2) On June 13, 2007, Mr. Forehand entered into a Stock Purchase Agreement to sell 200,000 shares of his personally-owned common stock back to the Company. The stock was valued at \$8.14 per share, which was the ten-day weighted average stock price as of June 12, 2007. Payment of \$1,628,000 was made on July 6, 2007.

On June 15, 2007, Mr. Forehand entered into an Asset Purchase Agreement to purchase the assets of the Company's Casa Olé restaurant located in Stafford, Texas for an agreed price of 26,806 shares of the Company's common stock. The stock was valued at \$8.14 per share, for a total value of \$218,205.

Item 6. Exhibits

<u>Exhibit Number</u>	<u>Document Description</u>
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Items 1, 3, 4 and 5 of this Part II are not applicable and have been omitted.

SIGNATURES

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

Mexican Restaurants, Inc .

Dated: November 13, 2007
Curt Glowacki
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Curt Glowacki

Dated: November 13, 2007
Andrew J. Dennard
Executive Vice President, Chief Financial Officer & Treasurer
(Principal Financial Officer and Principal Accounting Officer)

By: /s/ Andrew J. Dennard

**CERTIFICATION PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Curt Glowacki, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mexican Restaurants, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in the report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by other within those entities, particularly during the period in which the report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonable likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonable likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 13, 2007

/s/ Curt Glowacki

By: Curt Glowacki,
Chief Executive Officer

**CERTIFICATION PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Andrew J. Dennard, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mexican Restaurants, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in the report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by other within those entities, particularly during the period in which the report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonable likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonable likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 13, 2007

/s/ Andrew J. Dennard

By: Andrew J. Dennard,
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Mexican Restaurants, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2007 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Curt Glowacki, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Curt Glowacki

Curt Glowacki
Chief Executive Officer
November 13, 2007

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Mexican Restaurants, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2007 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Andrew J. Dennard, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Andrew J. Dennard

Andrew J. Dennard
Chief Financial Officer
November 13, 2007