KONA GRILL INC
Form 10-Q
October 29, 2010

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

FORM 10-Q

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

For the quarterly period ended September 30, 2010

or

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

For the transition period from to

Commission File Number 001-34082

Kona Grill, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	20-0216690
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

7150 East Camelback Road, Suite 220
Scottsdale, Arizona 85251
(480) 922-8100
(Address, including zip code, and telephone number, including area code, of principal executive offices)

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 S No £

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer £	Accelerated filer £
Non-accelerated filer S (Do not check if a smaller reporting company)	Smaller reporting company £

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

As of October 29, 2010 there were 9,171,871 shares of the registrant’s common stock outstanding.

KONA GRILL, INC.

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PART I – FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

KONA GRILL, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

ASSETS	September 30, 2010 (Unaudited)	December 31, 2009 (Note 1)
Current assets:		
Cash and cash equivalents	$2,011	$2,404
Investments	174	6,282
Receivables	134	308
Other current assets	1,156	1,111
Total current assets	3,475	10,105
Other assets	653	668
Property and equipment, net	38,282	39,190
Total assets	$42,410	$49,963
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$2,099	$2,922
Accrued expenses	5,843	5,753
Current portion of notes payable	570	684
Line of credit	—	5,800
Total current liabilities	8,512	15,159
Notes payable	219	636
Deferred rent	16,390	16,185
Total liabilities	25,121	31,980
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, $0.01 par value, 2,000,000 shares authorized, none issued	—	—
Common stock, $0.01 par value, 15,000,000 shares authorized, 9,288,071shares issued and 9,171,871 shares outstanding at September 30, 2010 and 9,262,895 shares issued and 9,146,695 shares outstanding at December 31, 2009	93	93
Additional paid-in capital	58,041	57,649
Accumulated deficit	(39,845)	(38,759)
Treasury stock, at cost, 116,200 shares at September 30, 2010 and December 31, 2009	(1,000)	(1,000)
Total stockholders' equity	17,289	17,983
Total liabilities and stockholders' equity	$42,410	$49,963

See accompanying notes to the unaudited consolidated financial statements.

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KONA GRILL, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Restaurant sales	$21,605	$20,173	$65,343	$61,096
Costs and expenses:				
Cost of sales	5,936	5,267	17,525	15,825
Labor	7,535	7,117	22,900	21,135
Occupancy	1,777	1,655	5,327	4,711
Restaurant operating expenses	3,582	3,296	10,456	9,568
General and administrative	1,446	1,590	5,456	6,138
Preopening expense	382	480	509	1,332
Depreciation and amortization	1,384	1,820	4,178	5,373
Total costs and expenses	22,042	21,225	66,351	64,082
Loss from operations	(437)	(1,052)	(1,008)	(2,986)
Nonoperating income (expense):				
Interest income and other, net	—	44	51	169
Interest expense	(4)	(22)	(119)	(153)
Loss from continuing operations before provision for income taxes	(441)	(1,030)	(1,076)	(2,970)
Provision for income taxes	—	5	10	65
Loss from continuing operations	(441)	(1,035)	(1,086)	(3,035)
Gain from discontinued operations, net of tax	—	—	—	690
Net loss	$(441)	$(1,035)	$(1,086)	$(2,345)
Net (loss) income per share–basic and diluted (Note 5):				
Continuing operations	$(0.05)	$(0.11)	$(0.12)	$(0.36)
Discontinued operations	—	—	—	0.08
Net loss	$(0.05)	$(0.11)	$(0.12)	$(0.28)
Weighted average shares used in computation (Note 5):				
Basic	9,168	9,141	9,163	8,478
Diluted	9,168	9,141	9,163	8,478

See accompanying notes to the unaudited consolidated financial statements.

KONA GRILL, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30, 2010	2009
Operating activities		
Net loss	$(1,086)	$ (2,345)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	4,178	5,373
Stock-based compensation expense	329	392
Amortization of debt discount	—	70
Change in operating assets and liabilities:		
Receivables	174	479
Other current assets	(45)	(169)
Accounts payable	(615)	(40)
Accrued expenses	90	952
Deferred rent	205	(439)
Net cash provided by operating activities	3,230	4,273
Investing activities		
Purchase of property and equipment	(3,478)	(10,994)
Decrease in other assets	15	92
Net purchases and sales of investments	6,108	593
Net cash provided by (used in) investing activities	2,645	(10,309)
Financing activities		
Net (repayment) borrowings on line of credit	(5,800)	3,310
Proceeds from bridge loan	—	1,200
Repayment of bridge loan	—	(1,200)
Repayments of notes payable	(531)	(533)
Proceeds from issuance of common stock, net of issuance costs	—	3,245
Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options and warrants	63	53
Net cash (used in) provided by financing activities	(6,268))	6,075
Net (decrease) increase in cash and cash equivalents	(393)	39
Cash and cash equivalents at the beginning of the period	2,404	2,477
Cash and cash equivalents at the end of the period	$2,011	$ 2,516
Supplemental disclosure of cash flow information		
Cash paid for interest, net of capitalization	$79	$ 83
Noncash investing activities		
Decrease in accounts payable related to property and equipment additions	$(208)	$ (2,534)

See accompanying notes to the unaudited consolidated financial statements.

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KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

Kona Grill, Inc. (referred to herein as the “Company” or “we,” “us,” and “our”) develops, owns and operates upscale casual dining restaurants under the name “Kona Grill.” Our restaurants feature a diverse selection of mainstream American dishes and award-winning sushi that are prepared fresh daily. We currently own and operate 25 restaurants in 16 states throughout the United States.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

The consolidated balance sheet at December 31, 2009 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Accordingly, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2009.

Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2010-06, Fair Value Measurements and Disclosures, which adds new disclosure requirements for transfers into and out of Levels 1 and 2 in the fair value hierarchy and additional disclosures about purchases, sales, issuances, and settlements relating to Level 3 fair value measurements. This ASU also clarifies existing fair value disclosures about the level of disaggregation about inputs and valuation techniques used to measure fair value. The ASU is effective for the first reporting period beginning after December 15, 2009, except for the requirement to provide Level 3 activity on a gross basis, which is effective for fiscal year ends beginning after December 15, 2010 and interim periods within those years. The adoption did not have a material effect on our financial condition or results of operations.

2. Discontinued Operations

Discontinued operations include exit costs associated with our Naples, Florida restaurant that was closed during the third quarter of 2008. During the second quarter of 2009, we entered into a settlement agreement for the termination of the lease for $700,000 which resulted in a gain from discontinued operations as it was less than the amount originally recorded. The lease settlement required an initial payment of $350,000 and the remaining amount, including interest at a 6% annual rate, was paid in 12 equal monthly installments.

Gain from discontinued operations, net of tax is comprised of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Restaurant sales	$—	$ —	$—	$ —

Gain from discontinued operations before income tax benefit	$—	$ —	$—	$ 690
Income tax benefit	—	—	—	—
Gain from discontinued operations, net of tax	$—	$ —	$—	$ 690

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Activity associated with the lease termination accrual is summarized below (in thousands):

Balance at December 31, 2009	$181
Cash payments	(181)
Balance at September 30, 2010	$—

3. Investments

The following is a summary of our investments (in thousands):

	Adjusted Cost	Gross Unrealized Losses	Estimated Fair Value
September 30, 2010			
Short-term investments:			
Certificates of deposit	$174	$—	$174
Total investments	$174	$—	$174
December 31, 2009			
Short-term investments:			
Certificates of deposit	$172	$—	$172
Money market securities	314	—	314
Auction rate securities	5,433	—	5,433
Put option on auction rate securities	363	—	363
Total investments	$6,282	$—	$6,282

As of June 30, 2010, we exercised our put option with UBS and sold our auction rate securities at par value. These securities were AAA rated long term debt obligations secured by student loans, substantially all of which were guaranteed by the federal government under the Federal Family Education Loan Program. Liquidity for these securities was historically provided by an auction process that reset the applicable interest rate at pre-determined calendar intervals. Since February 2008, events in the credit markets adversely affected the auction market for these types of securities and auctions for our securities failed to settle on their respective settlement dates.

Prior to the sale of the auction rate securities, we classified these investments as trading securities as they were subject to an agreement we entered into with UBS during October 2008 pursuant to which UBS issued to us Series C-2 Auction Rate Securities Rights. The agreement allowed us the right to sell our auction rate securities to UBS at full par value between June 30, 2010 and July 2, 2012. In conjunction with this agreement, we elected to apply the provisions of fair value accounting to this put option because the put option did not provide for net settlement, and the auction rate securities themselves were not readily convertible to cash. The put option did not meet the definition of a derivative, and thus, would not have been marked to fair value. We therefore elected to apply fair value accounting to the put option as the put option acted as an economic hedge against any further price movement in the auction rate securities and enabled us to recognize future changes in the fair value of the put option as those changes occurred to offset fair value movements in the auction rate securities. Prior to the sale, both the put option and auction rate securities were marked to market value through the consolidated statements of operations each period (see Note 4 for discussion of how fair value measurements were determined). Also as part of this agreement, UBS provided a line of credit through June 30, 2010 that was secured by the auction rate securities held with UBS (see Note 7). Interest earned on the auction rate securities was used to reduce the outstanding balance under the line of credit.

4. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, a three-tier value hierarchy was established, which prioritizes the inputs used in the valuation methodologies in measuring fair value.

Level 1: Fair values determined by quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access.

Level 2: Fair values utilize inputs other than quoted prices that are observable for the asset or liability, and may include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability.

Level 3: Fair values determined by unobservable inputs that are not corroborated by market data and may reflect the reporting entity's own assumptions market participants would use in pricing the asset or liability.

Our short-term investments in fixed income and money market securities represent available-for-sale securities that are valued primarily using quoted market prices or alternative pricing sources and models utilizing market observable inputs.

Our investment in auction rate securities were classified within Level 3 because they were valued using a discounted cash flow model. We estimated the fair value of auction rate securities using valuation models provided by third parties and internal analyses. The valuation models required numerous assumptions and assessments, including the following: (i) collateralization underlying each security; (ii) present value of future principal and interest payments discounted at rates considered to reflect current market conditions; (iii) creditworthiness of the counterparty; and (iv) current illiquidity of the investments.

Prior to the exercise of the put option, the fair value of the put option was determined through comparison of the fair value of each auction rate security to its par value and then discounted by a rate reflective of the risk of default by UBS between the valuation date and the expected exercise date of the put option. A discounted cash flow approach was used to value the difference between the par value and fair value of each security using a discount rate that considered the credit risk associated with UBS and the expected timing of when the put option would be exercised. The put option was adjusted on each balance sheet date based on its then fair value. The fair value of the put option was based on unobservable inputs and was therefore classified within Level 3 in the hierarchy. The following tables present information about our assets measured at fair value on a recurring basis at September 30, 2010 and December 31, 2009, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in thousands):

	Fair Value Measurements at Reporting Date Using			
Description	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total as of September 30, 2010
Certificates of deposit	$ 174	$ —	$ —	$ 174

	Fair Value Measurements at Reporting Date Using			
Description	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total as of December 31, 2009
Certificates of deposit	$172	$—	$—	$172
Money market securities	314	—	—	314

Auction rate securities	—	—	5,433	5,433
Put option on auction rate securities	—	—	363	363
	$486	$—	$5,796	$6,282

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The following table summarizes the changes in fair value of our Level 3 assets (in thousands):

	Auction rate securities	Put option on auction rate securities
Balance at December 31, 2009	$5,433	$363
Transfer to Level 3	—	—
Total gains or losses (realized and unrealized)		
Included in earnings	367	(363)
Included in other comprehensive loss	—	—
Net settlements	(5,800)	—
Balance at September 30, 2010	$—	$—

5. Net Loss Per Share

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share excludes the dilutive effect of potential stock option and warrant exercises as these shares are anti-dilutive.

The following table sets forth the computation of basic and diluted net loss per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(In thousands, except per share data)			
Numerator:				
Loss from continuing operations	$(441)	$(1,035)	$(1,086)	$(3,035)
Gain from discontinued operations	—	—	—	690
Net loss	$(441)	$(1,035)	$(1,086)	$(2,345)
Denominator:				
Weighted average shares — Basic	9,168	9,141	9,163	8,478
Effect of dilutive stock options and warrants	—	—	—	—
Weighted average shares — Diluted	9,168	9,141	9,163	8,478
Basic and diluted net loss per share:				
Loss from continuing operations	$(0.05)	$(0.11)	$(0.12)	$(0.36)
Gain from discontinued operations	—	—	—	0.08
Basic and diluted net loss per share	$(0.05)	$(0.11)	$(0.12)	$(0.28)

On June 9, 2009, we completed our rights offering for which each holder of common stock as of the April 17, 2009 record date received one non-transferrable subscription right for every 2.5 shares of common stock. Each subscription right entitled our stockholders to purchase one share of common stock at a purchase price of $1.35 per share. The market price of our common stock was $3.93 per share on June 5, 2009, which was the expiration date of the rights offering. Since the $1.35 per share subscription price of common stock issued under the rights offering was lower than the $3.93 per share market price on June 5, 2009, the rights offering contained a bonus element. As a result, we retroactively increased the weighted average common shares outstanding used to compute basic and diluted income (loss) per share by an adjustment factor of 1.2309 for all periods presented prior to the completion of the rights offering.

For the three and nine months ended September 30, 2010 and 2009, there were 1,000,000 and 795,000 stock options and warrants outstanding that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive.

6. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	September 30, 2010	December 31, 2009
Accrued payroll	$ 2,331	$ 1,875
Sales taxes	704	686
Business and income taxes	703	739
Gift cards	654	859
Accrued occupancy	139	192
Lease termination accrual	—	181
Other	1,312	1,221
	$ 5,843	$ 5,753

7. Debt and Credit Agreements

Credit Facility

During October 2008, as part of the settlement agreement with UBS, our broker from which we purchased auction rate security instruments, we entered into a line of credit that was secured by the auction rate security instruments held with UBS. On June 30, 2010, we exercised a put option with UBS on our auction rate security instruments and used the proceeds from the sale of the auction rate securities to repay the outstanding balance under the line of credit, which was then cancelled by UBS.

Equipment Loans

As of September 30, 2010, we had four equipment term loans with a lender, each collateralized by restaurant equipment. The outstanding principal balance under these loans was $789,000 at September 30, 2010. The loans bear interest at rates ranging from 7.9% to 8.5% and require monthly principal and interest payments aggregating approximately $56,000. The loans mature between May 2011 and June 2012. The loans also require us to maintain certain financial covenants, including a Fixed Charge Coverage Ratio of 1.25:1.00 calculated at the end of each calendar year, and we were in compliance with all such financial covenants as of December 31, 2009.

8. Stock-Based Compensation

We have two stock option plans under which we may issue incentive stock options, non-qualified stock options, restricted stock, and other types of awards to employees, directors, and consultants. Upon effectiveness of the 2005 Stock Award Plan, the 2002 Stock Award Plan was closed for purposes of new grants. Stock options issued under these plans are granted with an exercise price at or above the fair market value of the underlying common stock on the date of grant and generally expire five years from the date of grant. Employee stock options generally vest 25% each year over a four-year period, while annual recurring awards for non-employee director options vest 25% each quarter over a one-year period.

The fair value of stock options granted during the nine months ended September 30, 2010 and 2009 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

Nine Months Ended September 30,

	2010		2009	
Expected volatility	64.3	%	55.0	%
Risk-free interest rate	1.7	%	1.6	%
Expected option life (in years)	3.7		3.8	
Dividend yield	0.0	%	0.0	%
Weighted average fair value per option granted	$1.64		$0.86	

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The following table summarizes activity under our stock award plans for the nine months ended September 30, 2010:

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding options at December 31, 2009	854,856	$7.67		
Granted	223,750	3.41		
Forfeited	(170,900)	9.39		
Exercised	(17,400)	2.06		
Outstanding options at September 30, 2010	890,306	$6.37	3.3 years	$230,000
Exercisable at September 30, 2010	456,697	$8.33	2.8 years	$101,000

We recognized stock-based compensation expense of $121,000 and $85,000 during the three months ended September 30, 2010 and 2009, respectively, and $329,000 and $392,000 during the nine months ended September 30, 2010 and 2009, respectively. As of September 30, 2010, there was $590,000 of unrecognized stock-based compensation expense related to unvested stock-based compensation arrangements, which is expected to be recognized over a weighted average period of 2.0 years.

9. Commitments and Contingencies

We are engaged in various legal actions, which arise in the ordinary course of our business. Although there can be no assurance as to the ultimate disposition of these matters, we believe, based upon the information available at this time, that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the results of operations or financial condition of our company. See discussion of Legal Proceedings in Item 1 of Part II of this Quarterly Report.

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

The following discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and notes thereto included in Item 1 of Part I of this Quarterly Report and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2009 contained in our 2009 Annual Report on Form 10-K. This discussion contains certain forward-looking statements that involve known and unknown risks and uncertainties, such as statements relating to our future economic performance, plans and objectives for future operations, and projections of restaurant sales and other financial items that are based on our beliefs as well as assumptions made by and information currently available to us. Factors that might cause actual events or results to differ materially from those indicated by these forward-looking statements may include the matters under Item 1A, "Risk Factors" in this report, our Annual Report on Form 10-K for the year ended December 31, 2009 and other reports filed from time to time with the SEC.

Overview

We currently own and operate 25 restaurants located in 16 states. We offer freshly prepared food, personalized service, and a contemporary ambiance that create a satisfying yet affordable dining experience that we believe exceeds many traditional casual dining restaurants with which we compete. Our high-volume upscale casual restaurants feature a diverse selection of mainstream American favorites as well as a variety of appetizers and entrees with an international influence, including an extensive selection of sushi items. Our menu items are freshly prepared and incorporate over 40 signature sauces and dressings that we make from scratch, creating broad-based appeal for the lifestyle and taste trends of a diverse group of guests. Our menu is mostly standardized for all of our restaurants, allowing us to deliver consistent quality meals. We believe that our diverse menu and generous portions, combined with an average check of approximately $23, offers our guests an attractive price-value proposition.

Over the last five years, we have funded development of new restaurants primarily from the proceeds of our initial public offering, a private offering of common stock completed during November 2007, a rights offering completed during June 2009, and cash flows from operations. We opened our newest restaurant in Baltimore, Maryland on October 5, 2010. We opened four restaurants during 2009 in Richmond, Virginia; Woodbridge, New Jersey; Eden Prairie, Minnesota; and Tampa, Florida. We intend to pursue additional leases based on significant economic opportunity, subject to the availability of capital on terms acceptable to us.

As a result of the continued weakness of the U.S. economy, our comparable restaurant sales were flat during the third quarter of 2010. We believe improvement in the job market, coupled with improvement in consumer confidence and spending in general, will be important and necessary catalysts to drive guest traffic and higher guest check averages in casual dining restaurants in general and our restaurants in particular. Customer traffic and sales patterns have shown improvement throughout the first nine months of 2010 as evidenced by the sequential improvement in comparable restaurant sales from (2.5)% during the first quarter of 2010 to (0.3)% during the second quarter of 2010 to flat for the third quarter of 2010.

We target our restaurants to achieve an average annual unit volume of $4.5 million following 24 months of operations. Certain of our recent openings are trending lower than our targeted volume during the current economic environment. We believe our typical new restaurants experience gradually increasing unit volumes as guests discover our concept and we generate market awareness. Our restaurants are also subject to seasonal fluctuations. Sales in most of our restaurants typically are higher during the spring and summer months and winter holiday season.

During the fourth quarter of 2009, we recorded non-cash asset impairment charges for six underperforming restaurants. The asset impairment charges resulted from an evaluation of the long-term prospects of each of these restaurants that have not been meeting sales, profitability, and cash flow targets. We will continue to focus on each of these restaurants to determine whether operating performance can be improved.

We experience various patterns in our operating cost structure. Cost of sales, labor, and other operating expenses for our restaurants open at least 12 months generally trend consistent with restaurant sales, and we analyze those costs as a percentage of restaurant sales. We anticipate that our new restaurants will take approximately six months to achieve operating efficiencies as a result of challenges typically associated with opening new restaurants, including lack of market recognition and the need to hire and sufficiently train employees, as well as other factors. We expect cost of sales and labor expenses as a percentage of restaurant sales to be higher when we open a new restaurant, but decrease as a percentage of restaurant sales as the restaurant matures and as the restaurant management and employees become more efficient operating that unit. Occupancy and a portion of restaurant operating expenses are fixed. As a result, the volume and timing of newly opened restaurants has had, and is expected to continue to have, an impact on costs of sales, labor, occupancy, and restaurant operating expenses measured as a percentage of restaurant sales. The majority of our general and administrative costs are fixed costs. We expect our general and administrative spending to decrease as a percentage of restaurant sales as we leverage these investments and realize the benefits of higher sales volumes.

Key Measures We Use to Evaluate Our Company

Key measures we use to evaluate and assess our business include the following:

Number of Restaurant Openings. Number of restaurant openings reflects the number of restaurants opened during a particular reporting period.

Same-Store Sales Percentage Change. Same-store sales percentage change reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating the percentage change in same-store sales, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months. Same-store sales growth can be generated by an increase in guest traffic counts or by increases in the per person average check amount. Menu price changes and the mix of menu items sold can affect the per person average check amount.

Average Weekly Sales. Average weekly sales represents the average of restaurant sales measured over consecutive Monday through Sunday time periods.

Average Unit Volume. Average unit volume represents the average restaurant sales for the comparable restaurant base.

Sales Per Square Foot. Sales per square foot represents the restaurant sales for our comparable restaurant base, divided by the total leasable square feet for such restaurants.

Restaurant Operating Profit. Restaurant operating profit is defined as restaurant sales minus cost of sales, labor, occupancy, and restaurant operating expenses. Restaurant operating profit does not include general and administrative expenses, depreciation and amortization, or preopening expenses. We believe restaurant operating profit is an important component of financial results because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance prior to application of corporate overhead. We use restaurant operating profit as a percentage of restaurant sales as a key metric to evaluate our restaurants' financial performance compared with our competitors. This measure provides useful information regarding our financial condition and results of operations and allows investors to more easily determine future financial results driven by growth and allows investors to more easily compare restaurant level profitability.

Key Financial Definitions

Restaurant Sales. Restaurant sales include gross food and beverage sales, net of promotions and discounts.

Cost of Sales. Cost of sales consists of food and beverage costs.

Labor. Labor includes all direct and indirect labor costs incurred in operations.

Occupancy. Occupancy includes all rent payments associated with the leasing of real estate, including base, percentage and straight-line rent, property taxes, and common area maintenance expense. We record tenant improvement allowances as a reduction of occupancy expense over the initial term of the lease.

Restaurant Operating Expenses. Restaurant operating expenses consist of all other restaurant-level operating costs, the major components of which are utilities, credit card fees, advertising, supplies, marketing, repair and maintenance, and other expenses. Other operating expenses contain both variable and fixed components.

General and Administrative. General and administrative includes all corporate and administrative functions that support operations and provide infrastructure to facilitate our future growth. Components of this category include management and staff salaries, bonuses, stock-based compensation and related employee benefits, travel, information systems, human resources, training, corporate rent, professional and consulting fees, and corporate insurance costs.

Preopening Expense. Preopening expense consists of costs incurred prior to opening a new restaurant and is comprised principally of manager salaries and relocation, payroll and related training costs for new employees, including food and beverage costs associated with practice and rehearsal of service activities, and rent expense incurred from the date we obtain possession of the property until opening. We expense restaurant preopening expenses as incurred, and we expect preopening expenses to be similar for each new restaurant opening, which typically commence six to eight months prior to a restaurant opening. Our preopening costs will fluctuate from period to period depending upon the number of restaurants opened, the timing of new restaurant openings, the location of the restaurants, and the complexity of the staff hiring and training process.

Depreciation and Amortization. Depreciation and amortization expense consists of the depreciation of property and equipment and gains and losses on disposal of assets.

Interest Income and Other, Net. Interest income and other, net consists of interest earned on our cash and investments and any gains or losses on our investments.

Interest Expense. Interest expense includes the cost of servicing our debt obligations, net of capitalized interest.

Financial Performance Overview

The following table sets forth certain information regarding our financial performance for the three and nine months ended September 30, 2010 and 2009.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Restaurant sales growth	7.1 %	3.7 %	7.0 %	6.7 %
Same-store sales percentage change (1)	0.0 %	(9.9)%	(0.9)%	(9.7)%
Average weekly sales – comparable restaurant base (2)	$71,664	$71,690	$73,153	$73,826
Average weekly sales – non-comparable restaurant base (3)	$58,542	$56,138	$59,430	$64,218
Average unit volume (in thousands) (2)	$932	$974	$2,853	$2,959
Sales per square foot (2)	$132	$138	$404	$420
Restaurant operating profit (in thousands) (4)	$2,775	$2,838	$9,135	$9,857
Restaurant operating profit as a percentage of sales (4)	12.8 %	14.1 %	14.0 %	16.1 %

(1) Same-store sales percentage change reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating the percentage change for same-store sales, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months.

(2)Includes only those restaurants in the comparable restaurant base.

(3)Includes only those restaurants that are not in the comparable restaurant base that were open for the entire period.

(4)Restaurant operating profit is not a financial measurement determined in accordance with U.S. generally accepted accounting principles and should not be considered in isolation or as an alternative to loss from operations. Restaurant operating profit may not be comparable to the same or similarly titled measures computed by other companies. We believe restaurant operating profit is an important component of financial results because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance. We use restaurant operating profit as a percentage of restaurant sales as a key metric to evaluate our restaurants' financial performance compared with our competitors.

The following tables set forth our calculation of restaurant operating profit and reconciliation to loss from operations, the most comparable GAAP measure.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(In thousands)			
Restaurant sales	$ 21,605	$ 20,173	$ 65,343	$ 61,096
Costs and expenses:				
Cost of sales	5,936	5,267	17,525	15,825
Labor	7,535	7,117	22,900	21,135
Occupancy	1,777	1,655	5,327	4,711
Restaurant operating expenses	3,582	3,296	10,456	9,568
Restaurant operating profit	2,775	2,838	9,135	9,857
Deduct – other costs and expenses				
General and administrative	1,446	1,590	5,456	6,138
Preopening expense	382	480	509	1,332
Depreciation and amortization	1,384	1,820	4,178	5,373
Loss from operations	$ (437)	$ (1,052)	$ (1,008)	$ (2,986)

	Percentage of Restaurant Sales Three Months Ended September 30,		Percentage of Restaurant Sales Nine Months Ended September 30,	
	2010	2009	2010	2009
Restaurant sales	100.0 %	100.0 %	100.0 %	100.0 %
Costs and expenses:				
Cost of sales	27.5	26.1	26.8	25.9
Labor	34.9	35.3	35.0	34.6
Occupancy	8.2	8.2	8.2	7.7
Restaurant operating expenses	16.6	16.3	16.0	15.7
Restaurant operating profit	12.8	14.1	14.0	16.1
Deduct – other costs and expenses				
General and administrative	6.7	7.9	8.4	10.0
Preopening expense	1.8	2.4	0.8	2.2
Depreciation and amortization	6.4	9.0	6.4	8.8
Loss from operations	(2.0)%	(5.2)%	(1.5)%	(4.9)%

Certain percentage amounts do not sum to total due to rounding.

The following table sets forth changes in the number of restaurants opened for the periods indicated:

	Nine Months Ended September 30, 2010	Year Ended December 31, 2009
Beginning of period	24	20
Openings	—	4
Closings	—	—
End of period	24	24

Results of Operations

The following table sets forth, for the periods indicated, the percentage of restaurant sales of certain items in our financial statements.

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Restaurant sales	100.0 %	100.0 %	100.0 %	100.0 %
Costs and expenses:				
Cost of sales	27.5	26.1	26.8	25.9
Labor	34.9	35.3	35.0	34.6
Occupancy	8.2	8.2	8.2	7.7
Restaurant operating expenses	16.6	16.3	16.0	15.7
General and administrative	6.7	7.9	8.4	10.0
Preopening expense	1.8	2.4	0.8	2.2
Depreciation and amortization	6.4	9.0	6.4	8.8
Total costs and expenses	102.0	105.2	101.5	104.9
Loss from operations	(2.0)	(5.2)	(1.5)	(4.9)
Nonoperating income (expense):				
Interest income and other, net	—	0.2	0.1	0.3
Interest expense	—	(0.1)	(0.2)	(0.3)
Loss from continuing operations before provision for income taxes	(2.0)	(5.1)	(1.7)	(4.9)
Provision for income taxes	—	—	—	0.1
Loss from continuing operations	(2.0)	(5.1)	(1.7)	(5.0)
Gain from discontinued operations, net of tax	—	—	—	1.1
Net loss	(2.0)%	(5.1)%	(1.7)%	(3.9)%

Certain percentage amounts do not sum to total due to rounding.

Three Months Ended September 30, 2010 Compared with Three Months Ended September 30, 2009

Restaurant Sales. Restaurant sales increased $1.4 million, or 7.1% to $21.6 million during the third quarter of 2010 from $20.2 million during the prior year period. The sales increase was primarily the result of restaurant sales associated with the opening of two new restaurants since August 2009. Comparable restaurant sales were flat during the third quarter of 2010 as a 4% increase in guest traffic was offset by a 4% decline in the average guest check.

Cost of Sales. Cost of sales increased $0.7 million, or 12.7% to $5.9 million during the third quarter of 2010 from $5.3 million during the third quarter of 2009. Cost of sales as a percentage of restaurant sales increased 1.4% to

27.5% during the third quarter of 2010 from 26.1% during the prior year period. Cost of sales during the third quarter of 2010 primarily reflects higher year-over-year pricing for beef, chicken, pork and certain seafood items. The increase in cost of sales as a percentage of restaurant sales is also attributable to upgrades in certain ingredients as part of our menu evolution project and increased discounts due to marketing programs. The food and beverage costs of these marketing programs are recorded in cost of sales as the intent is to generate additional restaurant sales through driving guest traffic.

Labor. Labor costs for our restaurants increased $0.4 million, or 5.9% to $7.5 million during the third quarter of 2010 from $7.1 million during the prior year period. This increase was primarily the result of the opening of two new restaurants since August 2009. Labor expenses as a percentage of restaurant sales decreased 0.4% to 34.9% during the third quarter of 2010 from 35.3% during the third quarter of 2009. The decrease in labor costs as a percentage of restaurant sales was primarily due to lower benefit costs and better leverage of fixed labor costs attributable to adjusting restaurant management staff sizes to align with sales volumes at certain restaurants.

Occupancy. Occupancy expense increased $0.1 million, or 7.4% to $1.8 million during the third quarter of 2010 from $1.7 million during the prior year period. Occupancy expenses as a percentage of restaurant sales was flat at 8.2% during both the third quarter of 2010 and 2009.

Restaurant Operating Expenses. Restaurant operating expenses increased $0.3 million, or 8.7% to $3.6 million during the third quarter of 2010 from $3.3 million during the third quarter of 2009. The increase in restaurant operating expenses is attributable to higher training and relocation costs, an increase in personal property taxes and higher expenditures for supplies and smallwares associated with our new menu items. Restaurant operating expenses as a percentage of restaurant sales increased 0.3% to 16.6% during the third quarter of 2010 as compared to 16.3% during the third quarter of 2009.

General and Administrative. General and administrative expenses decreased $0.1 million, or 9.1% to $1.5 million during the third quarter of 2010 compared to $1.6 million during the third quarter of 2009. The decrease in general and administrative expenses during the third quarter of 2010 is attributable to a reduction in legal and professional fee expenditures. General and administrative expenses as a percentage of restaurant sales decreased 1.2% to 6.7% of restaurant sales during the third quarter of 2010 compared to 7.9% of restaurant sales during the prior year period.

Preopening Expense. Preopening expense decreased $0.1 million, or 20.4% to $0.4 million during the third quarter of 2010 compared to $0.5 million during the third quarter of 2009. Preopening expense for the third quarter of 2010 reflects training, travel and preopening rent for our Baltimore restaurant which opened at the beginning of the fourth quarter of 2010. Preopening expense varies each quarter based upon the number of restaurants opened and the timing of new restaurant openings as the majority of preopening expense is incurred during the two months preceding an opening. During the third quarter of 2009, we incurred preopening expenses for our Eden Prairie, Minnesota and Tampa, Florida restaurants, which opened in September 2009 and November 2009, respectively.

Depreciation and Amortization. Depreciation and amortization expense decreased $0.4 million, or 23.9% to $1.4 million during the third quarter of 2010 from $1.8 million during the prior year period. The decrease is due to a $0.6 million reduction in depreciation expense associated with the fourth quarter 2009 impairment of long-lived assets at six underperforming restaurants, partially offset by depreciation expense for two restaurants that opened since August 2009. Depreciation and amortization expense as a percentage of restaurant sales decreased 2.6% to 6.4% during the third quarter of 2010 from 9.0% during the prior year period.

Provision for Income Taxes. During the third quarter of 2010, we did not record a provision for income taxes based upon our assessment of our current tax position.

Nine Months Ended September 30, 2010 Compared with Nine Months Ended September 30, 2009

Restaurant Sales. Restaurant sales increased by $4.2 million, or 7.0% to $65.3 million during the first nine months of 2010 from $61.1 million during the prior year period, primarily attributable to restaurant sales generated from the opening of three new restaurants since April 2009, partially offset by a 0.9% decrease in comparable restaurant sales. The decrease in comparable restaurant sales is due to a lower average guest check, which we believe was attributable to economic uncertainty and weak consumer confidence. The lower average guest check was partially offset by a 6% increase in guest traffic during the first nine months of 2010.

Cost of Sales. Cost of sales increased $1.7 million, or 10.7% to $17.5 million during the first nine months of 2010 from $15.8 million during the first nine months of 2009. Cost of sales as a percentage of restaurant sales increased 0.9% to 26.8% during the first nine months of 2010 from 25.9% during the prior year period. The increase in cost of sales as a percentage of restaurant sales during the first nine months of 2010 reflects an increase in year-over-year costs for certain seafood, meat and produce items. The increase in cost of sales is also attributable to increased levels of marketing programs launched during 2010.

Labor. Labor costs for our restaurants increased $1.8 million, or 8.4% to $22.9 million during the first nine months of 2010 from $21.1 million during the prior year period. The increase was primarily the result of the opening of three new restaurants since April 2009. As a percentage of restaurant sales, labor costs increased 0.4% to 35.0% during the first nine months of 2010 from 34.6% during the first nine months of 2009. The increase in labor costs as a percentage of restaurant sales was primarily the result of reduced leverage of fixed labor costs and hourly labor expense resulting from lower average weekly sales. In addition, federal and state minimum wage increases, implemented during the second half of 2009 and at the beginning of 2010, contributed to increased labor costs as a percentage of sales.

Occupancy. Occupancy expense increased by $0.6 million, or 13.1% to $5.3 million during the first nine months of 2010 compared to $4.7 million during the prior year period. Occupancy expenses as a percentage of restaurant sales increased 0.5% to 8.2% during the first nine months of 2010 from 7.7% during the first nine months of 2009. The increase as a percentage of sales reflects decreased leverage of the fixed portion of these costs resulting from lower average weekly sales and increased common area maintenance expenses at many locations.

Restaurant Operating Expenses. Restaurant operating expenses increased by $0.9 million, or 9.3% to $10.5 million during the first nine months of 2010 compared to $9.6 million during the prior year period. Restaurant operating expenses as a percentage of restaurant sales increased 0.3% to 16.0% during the first nine months of 2010 from 15.7% during the prior year period. During the first nine months of 2010, higher marketing, training and relocation costs and personal property taxes combined with reduced leverage of fixed operating costs resulting from lower average weekly sales contributed to the increase in restaurant operating expenses as a percentage of sales.

General and Administrative. General and administrative expenses decreased $0.7 million, or 11.1% to $5.4 million during the first nine months of 2010 compared to $6.1 million during the first nine months of 2009. The decrease in general and administrative expenses during the first nine months of 2010 is primarily attributable to a reduction in severance and other unusual charges. During the first nine months of 2010, we incurred $0.5 million for legal and professional fees associated with the contested proxy solicitation and ongoing derivative suit compared to the first nine months of 2009 when we recorded approximately $1.1 million in unusual charges. These charges included $0.4 million in severance and related benefits for the resignation of our former CEO, $0.5 million in legal and professional fees associated with stockholder activities, including financial advisory fees to evaluate an unsolicited offer to purchase our company, and $0.2 million write-off for architectural drawings and permit costs associated with amending the lease for our Baltimore restaurant. General and administrative expenses as a percentage of restaurant sales decreased 1.6% to 8.4% of restaurant sales during the first nine months of 2010 compared to 10.0% of restaurant sales during the prior year period.

Preopening Expense. Preopening expense decreased $0.8 million to $0.5 million during the first nine months of 2010 compared to $1.3 million during the first nine months of 2009. The decrease in preopening expense is attributable to three restaurant openings during the first nine months of 2009 as compared to the first nine months of 2010 when preopening expenses were incurred for our Baltimore, Maryland restaurant opened on October 5, 2010.

Depreciation and Amortization. Depreciation and amortization expense decreased $1.2 million, or 22.2% to $4.2 million during the first nine months of 2010 from $5.4 million during the prior year period. The decrease is primarily the result of a $1.8 million reduction in depreciation expense associated with the fourth quarter 2009 impairment of long-lived assets at six underperforming restaurants, partially offset by depreciation expense for three restaurants that opened since April 2009. Depreciation and amortization expense as a percentage of restaurant sales decreased 2.4% to 6.4% during the first nine months of 2010 from 8.8% during the prior year period.

Interest Income and Other, Net. Interest income and other, net decreased during the first nine months of 2010 due to lower average investment balances as compared to the prior year period resulting from the sale of auction rate securities during the second quarter of 2010.

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Interest Expense. Interest expense decreased during the first nine months of 2010 as compared to the first nine months of 2009 due to interest costs incurred in the prior year period for the $1.2 million bridge loan that was issued during March 2009 and subsequently repaid during June 2009.

Provision for Income Taxes. During the first nine months of 2010, we recorded a $10,000 provision for income taxes compared to $65,000 during the prior year period. The provision for the first nine months of 2010 reflects the benefit recorded by us for the anticipated refund of prior year taxes due to a change in tax legislation regarding net operating loss carrybacks, offset by taxes for certain states in which we operate that do not calculate tax based upon net income.

Gain from Discontinued Operations. During the second quarter of 2009, we reached a settlement agreement regarding the lease for our closed Naples, Florida restaurant. We recorded a gain of approximately $0.7 million as the settlement amount was less than the lease termination costs originally recorded when the restaurant was closed during 2008.

Our quarterly operating results may fluctuate significantly as a result of a variety of factors, including the following:

- timing of new restaurant openings and related expenses;
- restaurant operating costs and preopening costs for our newly-opened restaurants, which are often materially greater during the first several months of operation than thereafter;
- labor availability and costs for hourly and management personnel;
- profitability of our restaurants, especially in new markets;
- increases and decreases in comparable restaurant sales;
- impairment of long-lived assets and any loss on restaurant closures;
- changes in borrowings and interest rates;
- general economic conditions;
- weather conditions or natural disasters;
- timing of certain holidays;
- changes in government regulations;
- outside stockholder activities;
- settlements, damages and legal costs associated with litigation;
- new or revised regulatory requirements and accounting pronouncements;
- changes in consumer preferences and competitive conditions; and
- fluctuations in commodity prices.

Our business is also subject to seasonal fluctuations. Historically, sales in most of our restaurants have been higher during the spring and summer months and winter holiday season. Consequently, our quarterly and annual operating results and comparable restaurant sales may fluctuate significantly as a result of seasonality and the factors discussed above. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for any other quarter or for any year and comparable restaurant sales for any particular future period may decrease. In the future, operating results may fall below the expectations of our investors. In that event, the price of our common stock would likely decrease.

Liquidity and Capital Resources

Our primary capital requirements are for new restaurant development and remodeling of existing restaurants. Subject to availability of capital on terms acceptable to us, we will pursue additional leases based on significant economic opportunity. Similar to many restaurant chains, we utilize operating lease arrangements for all of our restaurant locations. We believe that our operating lease arrangements provide appropriate leverage for our capital structure in a financially efficient manner. We are typically required to expend cash to perform site-related work and to construct and equip each restaurant. The average investment cost for our restaurants depends upon the type of lease entered into, the amount of tenant improvement allowance we receive from landlords, and whether we assume responsibility for the construction of the building. We expect the cash investment cost of our typical restaurant to be approximately $2.5 million, net of landlord tenant improvement allowances of between $0.7 million and $1.2 million, and excluding cash preopening expenses of approximately $0.4 million. We expect these costs will vary from one market to another based on real estate values, zoning regulations, permitting requirements, labor markets and other variables. Restaurants that are subject to ground leases and do not receive landlord tenant improvement allowances typically require a significantly higher cash investment. We also require capital resources to maintain our existing base of restaurants and to further expand and strengthen the capabilities of our corporate and information technology infrastructures.

The following tables set forth, for the periods indicated, a summary of our key liquidity measurements (amounts in thousands):

	September 30, 2010	December 31, 2009
Cash and short-term investments(1)	$ 2,185	$ 2,890
Net working capital (deficit)(2)	(5,037)	(5,054)

(1) At December 31, 2009, cash and short-term investments excluded $5.8 million in auction rate securities that were used as collateral for a line of credit. As of September 30, 2010, all auction rate securities were sold and the proceeds were used to pay off the outstanding balance on the line of credit.

(2) The working capital deficit at September 30, 2010 and December 31, 2009, is primarily attributable to accruals for payroll, legal, and professional fees.

	Nine Months Ended September 30,	
	2010	2009
Cash provided by operating activities	$3,230	$ 4,273
Capital expenditures	3,478	10,994

Future Capital Requirements

Our capital requirements, including development costs related to the opening of new restaurants, have historically been significant. Over the last several years, we funded development of new restaurants primarily from the proceeds of equity financing and cash flows from operations. Our future cash requirements and the adequacy of available funds will depend on many factors, including the operating performance of our restaurants, the pace of expansion, real estate markets, site locations, the nature of the arrangements negotiated with landlords and the credit market environment.

Our current operations generate sufficient cash flow to fund operations and general and administrative costs. We believe existing cash and short-term investments of $2.2 million in addition to cash flow from operations is sufficient to fund development costs required for our Baltimore restaurant and planned renovation of existing restaurants. Any reduction of our cash flow from operations may cause a delay or cancellation of planned restaurant development or renovation of existing restaurants. As of September 30, 2010, we had a working capital deficit of $5.0 million. We plan to reduce this deficit through cost containment efforts and cash flow from operations. Financing to construct new restaurants may not be available on acceptable terms, or at all, and our failure to raise capital when needed could impact our growth plans, financial condition, and results of operations. Additional equity financing may result in dilution to current stockholders and debt financing, if available, may involve significant cash payment obligations or financial covenants and ratios that may restrict our ability to operate our business.

Equipment Loans

As of September 30, 2010, we had four equipment term loans with a lender, each collateralized by restaurant equipment. The outstanding principal balance under these loans was $789,000 at September 30, 2010. The loans bear interest at rates ranging from 7.9% to 8.5% and require monthly principal and interest payments aggregating approximately $56,000. The loans mature between May 2011 and June 2012. The loans also require us to maintain certain financial covenants, including a Fixed Charge Coverage Ratio of 1.25:1.00 calculated at the end of each calendar year, and we were in compliance with all such financial covenants as of December 31, 2009.

Credit Facility

During October 2008, as part of the settlement agreement with UBS, our broker from which we purchased auction rate security instruments, we entered into a line of credit that was secured by the auction rate security instruments held with UBS. On June 30, 2010, we exercised a put option with UBS on our auction rate security instruments and used the proceeds from the sale of the auction rate securities to repay the outstanding balance under the line of credit, which was then cancelled by UBS.

Cash Flows

The following table summarizes our primary sources and uses of cash during the periods presented (in thousands).

	Nine Months Ended September 30,	
	2010	2009
Net cash provided by (used in):		
Operating activities	$ 3,230	$ 4,273
Investing activities	2,645	(10,309)
Financing activities	(6,268)	6,075
Net (decrease) increase in cash and cash equivalents	$ (393)	$ 39

Operating Activities. Our cash flows from operating activities, as detailed in the Unaudited Consolidated Statements of Cash Flows, provided $3.2 million of net cash during the first nine months of 2010. The net decrease in cash from operating activities for the first nine months of 2010 in comparison to the first nine months of 2009, is primarily the result of the timing of vendor payments and the collection of tenant improvement allowances from our landlords.

Investing Activities. We fund the development and construction of our new restaurants primarily with cash flows from operations and proceeds from equity transactions. Our capital expenditures for the first nine months of 2010 were $3.5 million primarily attributable to the funding of construction for our Baltimore, Maryland restaurant which opened on October 5, 2010 and contractor payments for our Eden Prairie, Minnesota and Tampa, Florida restaurants that were opened during the second half of 2009. Investing activities for the first nine months of 2010 also reflects the sale of $5.8 million in auction rate securities and $0.3 million in other investments. Net cash used in investing activities was $10.3 million during the first nine months of 2009 reflecting $11.0 million to fund construction at our four restaurants opened during 2009.

Financing Activities. Net cash used in financing activities was $6.3 million during the first nine months of 2010 reflecting the repayment of $5.8 million in borrowings under our line of credit with UBS and $0.5 million in principal payments on equipment loans. Net cash provided by financing activities was $6.1 million during the nine months ended September 30, 2009 reflecting $3.3 million in net borrowings under our line of credit and $3.2 million in net proceeds from the subscription rights offering completed during June 2009, partially offset by $0.5 million in principal payments on equipment loans.

Critical Accounting Policies

Critical accounting policies are those that we believe are most important to the portrayal of our financial condition and results of operations and also require our most difficult, subjective, or complex judgments. Judgments or uncertainties regarding the application of these policies may result in materially different amounts being reported under various conditions or using different assumptions. There have been no material changes to the critical accounting policies previously reported in our Annual Report on Form 10-K for the year ended December 31, 2009.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discussion of market risks contains forward-looking statements. Actual results may differ materially from the following discussion based on general conditions in the commodity markets.

Primary Market Risk Exposures

Our primary market risk exposure is commodity costs. Many of the food products purchased by us can be subject to volatility due to changes in weather, production, availability, seasonality, international demand, and other factors outside our control. Substantially all of our food and supplies are available from several sources, which helps to diversify our overall commodity cost risk. We also believe that we have the ability to increase certain menu prices in response to food commodity price increases.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We have evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have each concluded that our disclosure controls and procedures are effective to ensure that we record, process, summarize, and report information required to be disclosed by us in our quarterly reports filed under the Exchange Act within the time periods specified by the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

During the quarterly period covered by this report, there have not been any changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Reference is made to the disclosure contained in Part II, Item 1 of our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2010. The litigation arises out of a stockholder derivative action in the Court of Chancery of the state of Delaware instituted during the first quarter of fiscal 2009 and a books and records demand on our company during February 2009 pursuant to Section 220 of the Delaware General Corporation Law. During the quarter ended September 30, 2010, there were no material developments in the litigation disclosed except that during September 2010, we submitted additional requested documentation to the plaintiff. Following plaintiff's inspection of the documents, we anticipate that the plaintiff will amend the complaint following the review of submitted materials, at which time we will determine the proper response to such amended complaint. We continue to believe the purported derivative action is without merit, and we intend to defend vigorously this lawsuit if the Court-ordered stay entered in the derivative action is lifted. We also continue to believe that based on information produced in response to the books and records demands, the books and records action is moot and that the books and records action should be dismissed by the Court.

Item 1A. Risk Factors

A description of the risk factors associated with our business is contained in Part I, Item 1A, "Risk Factors," of our Annual Report on Form 10-K for the year ended December 31, 2009. These cautionary statements are to be used as a reference in connection with any forward-looking statements. The factors, risks, and uncertainties identified in these cautionary statements are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the SEC.

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

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. (Removed and Reserved).

Item 5. Other Information

Not applicable.

Item 6. Exhibits

Exhibit Number	Exhibit
3.1	Amended and Restated Certificate of Incorporation of the Registrant (1)
3.3	Amended and Restated Bylaws of Kona Grill, Inc., as of October 30, 2007 (3)
4.1	Form of Common Stock Certificate (2)
4.3	Kona Grill, Inc. Series A Investor Rights Agreement, dated August 29, 2003 (2)
4.4	Amendment No. 1 to Kona Grill, Inc. Series A Investor Rights Agreement, dated May 31, 2005 (2)
4.9	Form of First Amended and Restated Promissory Note, dated April 7, 2009, among Kona Grill, Inc. and the investor parties thereto (4)
4.10	Form of Warrant (5)
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to Amendment No. 1 to the Registrant's Registration Statement on Form S-1 (Registration No. 333-125506), as filed on July 8, 2005.
(2) Incorporated by reference to Amendment No. 2 to the Registrant's Registration Statement on Form S-1 (Registration No. 333-125506), as filed on July 21, 2005.
(3) Incorporated by reference to the Registrant's Form 8-K filed on November 5, 2007.
(4) Incorporated by reference to the Registrant's Form 8-K filed on April 10, 2009.
(5) Incorporated by reference to the Registrant's Form 10-K filed on March 4, 2010.

SIGNATURES

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

Kona Grill, Inc.

/s/ Marc A. Buehler
Marc A. Buehler
President and Chief Executive Officer

/s/ Mark S. Robinow
Mark S. Robinow
Executive Vice President, Chief Financial Officer, and Secretary
(Principal Accounting and Financial Officer)

Date: October 29, 2010