KONA GRILL INC
Form 10-Q
August 14, 2009

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

FORM 10-Q

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

For the quarterly period ended June 30, 2009

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 þ No o

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 o No o

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 o	Accelerated filer o	Non-accelerated filer þ (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of July 31, 2009, there were 9,141,121 shares of the registrant s common stock outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

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

	June 30, 2009 (Unaudited)	December 31, 2008 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,994	$ 2,477
Investments	7,036	370
Receivables	351	980
Other current assets	1,456	938
Total current assets	13,837	4,765
Long-term investments		6,491
Other assets	748	794
Property and equipment, net	55,157	53,504
Total assets	$ 69,742	$ 65,554
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,938	$ 4,335
Accrued expenses	6,072	4,878
Current portion of notes payable	745	717
Line of credit	6,586	2,488
Total current liabilities	15,341	12,418
Notes payable	940	1,320
Deferred rent	15,506	16,218
Total liabilities	31,787	29,956
Commitments and contingencies (Note 11)		
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, 9,257,321 shares issued and 9,141,121 shares outstanding at June 30, 2009 and 6,628,191 shares issued and 6,511,991 shares outstanding at December 31, 2008	92	66
Additional paid-in capital	57,380	53,739
Treasury stock, at cost, 116,200 shares at June 30, 2009 and December 31, 2008	(1,000)	(1,000)
Accumulated deficit	(18,517)	(17,207)

Total stockholders equity		37,955		35,598
Total liabilities and stockholders equity	$	69,742	$	65,554

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 June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
Restaurant sales	$ 21,468	$ 19,685	$ 40,923	$ 37,788
Costs and expenses:				
Cost of sales	5,461	5,369	10,558	10,562
Labor	7,269	6,380	14,018	12,507
Occupancy	1,536	1,244	3,056	2,500
Restaurant operating expenses	3,242	2,902	6,272	5,490
General and administrative	2,661	2,026	4,548	3,878
Preopening expense	352	541	852	719
Depreciation and amortization	1,812	1,584	3,553	3,150
Total costs and expenses	22,333	20,046	42,857	38,806
Loss from operations	(865)	(361)	(1,934)	(1,018)
Nonoperating income (expense):				
Interest income and other, net	77	105	125	309
Interest expense	(99)	(17)	(131)	(51)
Loss from continuing operations before provision for income taxes	(887)	(273)	(1,940)	(760)
Provision for income taxes	30	75	60	150
Loss from continuing operations	(917)	(348)	(2,000)	(910)
Gain (loss) from discontinued operations, net of tax	703	(187)	690	(298)
Net loss	$ (214)	$ (535)	$ (1,310)	$ (1,208)
Net (loss) income per share basic and diluted (Note 5):				
Continuing operations	$ (0.11)	$ (0.04)	$ (0.25)	$ (0.11)
Discontinued operations	0.08	(0.03)	0.09	(0.04)
Net loss	$ (0.03)	$ (0.07)	$ (0.16)	$ (0.15)
Weighted average shares used in computation (Note 5):				
Basic	8,278	8,081	8,147	8,108
Diluted	8,278	8,081	8,147	8,108

See accompanying notes to the unaudited consolidated financial statements.

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

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Operating activities		
Net loss	$ (1,310)	$ (1,208)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	3,553	3,333
Stock-based compensation expense	307	265
Amortization of debt discount	70	
Change in operating assets and liabilities:		
Receivables	629	(769)
Other current assets	(518)	(104)
Accounts payable	20	790
Accrued expenses	1,194	190
Deferred rent	(712)	1,112
Net cash provided by operating activities	3,233	3,609
Investing activities		
Purchase of property and equipment	(7,623)	(6,539)
Decrease (increase) in other assets	46	(47)
Net purchases and sales of investments	(175)	7,222
Net cash (used in) provided by investing activities	(7,752)	636
Financing activities		
Net borrowings on line of credit	4,098	
Proceeds from bridge loan	1,200	
Repayment of bridge loan	(1,200)	
Repayments of notes payable	(352)	(326)
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	45	46
Purchase of treasury stock		(1,000)
Net cash provided by (used in) financing activities	7,036	(1,280)
Net increase in cash and cash equivalents	2,517	2,965
Cash and cash equivalents at the beginning of the period	2,477	4,991
Cash and cash equivalents at the end of the period	$ 4,994	$ 7,956
Supplemental disclosure of cash flow information		
Cash paid for interest, net of capitalization	$ 62	$ 51

Noncash investing activities				
Decrease in accounts payable related to property and equipment	$	(2,417)	$	(661)

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) 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 22 restaurants in 14 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 six month periods ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

The consolidated balance sheet at December 31, 2008 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, 2008.

Recent Accounting Pronouncements

Effective January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements* (SFAS 157) for financial assets and liabilities. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. See Note 4 for further discussion of fair value measurements. We adopted SFAS 157 for non-financial assets and liabilities effective January 1, 2009.

Effective January 1, 2008, we adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). Under this Statement, we may elect to report financial instruments and certain other items at fair value on a contract-by-contract basis with changes in value reported in earnings. We elected the fair value option for rights issued by our broker related to our investments in auction rate securities. See Note 3 for further discussion of these rights.

In April 2009, the FASB issued three FASB Staff Positions (FSPs) in order to provide additional application guidance and enhance disclosures regarding fair value measurements and impairment of securities.

FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, provides guidance on how to determine the fair value of assets and liabilities when the volume and level of activity for the asset or liability has significantly decreased. This FSP reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. In addition, this FSP requires disclosure in interim and annual periods of the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques.

FSP FAS 115-2 and FAS 124-2 *Recognition and Presentation of Other-Than-Temporary Impairments*, amends the requirements for the recognition and measurement of other-than-temporary impairments for debt securities by modifying the pre-existing intent and ability indicator. Under FSP FAS 115-2 and FAS 124-2, an other-than-temporary impairment is triggered when there is an intent to sell the security, it is more likely than not that the security will be required to be sold before recovery, or the security is not expected to recover the entire amortized cost basis of the security. Additionally, this FSP changes the presentation of an other-than-temporary impairment in the income statement for those impairments involving credit losses. The credit loss component is recognized in earnings and the remainder of the impairment is recorded in other comprehensive income.

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FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments,* requires interim disclosures regarding the fair values of financial instruments that are not currently reflected on the balance sheet at fair value. Additionally, this FSP requires disclosure on the methods and significant assumptions used to estimate the fair value of financial instruments on an interim basis as well as changes of the methods and significant assumptions from prior periods.

We adopted these FSP s for our second quarter ended June 30, 2009. The adoption did not have a material effect on our financial condition or results of operations.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (SFAS 165), which provides guidance to establish general standards of accounting for, and disclosures of, events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS 165 is effective for interim or fiscal periods ending after June 15, 2009. In connection with preparation of the consolidated financial statements, we evaluated subsequent events after the balance sheet date of June 30, 2009 through August 14, 2009, the date the financial statements were issued.

2. Discontinued Operations

Discontinued operations include results attributable to our Naples, Florida restaurant that was closed during the third quarter of 2008. Gain (loss) from discontinued operations includes both the historical results of operations as well as exit costs. During the second quarter of 2009, we entered into a settlement agreement for the termination of the lease for $700,000. As the settlement amount was less than the lease termination accrual previously recorded in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, we recorded a gain of $703,000, after deducting fees and other expenses, during the second quarter of 2009. Gain (loss) from discontinued operations, net of tax is comprised of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Restaurant sales	$	$ 498	$	$ 1,191
Gain (loss) from discontinued operations before income tax benefit	$ 703	$ (212)	$ 690	$ (348)
Income tax benefit		25		50
Gain (loss) from discontinued operations, net of tax	$ 703	$ (187)	$ 690	$ (298)

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

Balance at December 31, 2008	$ 1,417
Cash payments	
Non-cash activity	(690)
Balance at June 30, 2009	$ 727

Non-cash activity reflects the updated estimate of lease termination costs based upon the settlement agreement discussed above. The lease settlement requires an initial payment of $350,000 that was paid during July 2009 and the remaining amount due of $361,000, including interest at a 6% annual rate, is payable in 12 equal monthly installments beginning in August 2009. Settlement fees, including legal expenses, of $667,000 and $60,000 are included in accrued expenses and deferred rent, respectively, on the consolidated balance sheet as of June 30, 2009 based upon the estimated timing of the payments.

3. Investments

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

	Adjusted Cost	Gross Unrealized Losses	Estimated Fair Value
June 30, 2009			
Short-term investments:			
Certificates of deposit	$ 170	$	$ 170
Money market securities	314		314
Auction rate securities	5,965		5,965
Put option on auction rate securities	587		587
Total investments	$ 7,036	$	$ 7,036
December 31, 2008			
Short-term investments:			
Certificates of deposit	$ 370	$	$ 370
Long-term investments:			
Auction rate securities	5,858		5,858
Put option on auction rate securities	633		633
	6,491		6,491
Total investments	$ 6,861	$	$ 6,861

As of June 30, 2009, our investment portfolio included auction rate securities with a par value of $6.6 million. These securities are primarily AAA rated long term debt obligations secured by student loans, of which approximately $6.0 million or 90% of the par value is guaranteed by the federal government under the Federal Family Education Loan Program. In addition, one of the securities not fully comprised of federal government guaranteed loans is A rated, but has an insurance policy guaranteeing both the principal and accrued interest. While the maturity dates of our auction rate securities range from 2029 to 2046, liquidity for these securities has historically been provided by an auction process that resets the applicable interest rate at pre-determined calendar intervals, generally every 28 days. Since February 2008, events in the credit markets have adversely affected the auction market for these types of securities and auctions for these securities have failed to settle on their respective settlement dates. As a result of the liquidity issues experienced in the credit markets, all of our auction rate securities have experienced failed auctions since February 13, 2008 and therefore do not currently have a readily determinable market value. We estimated the fair value of our auction rate securities using valuation models provided by third parties and internal analyses. The valuation models require numerous assumptions and assessments, including the following: (i) collateralization underlying each security; (ii) the present value of future principal and interest payments discounted at rates considered to reflect current market conditions; (iii) the creditworthiness of the counterparty; and (iv) the current illiquidity of the investments.

Our auction rate securities are classified as trading securities as they are 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 allows us the right to put the securities back 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 SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* to this put option because the put option does not provide for net settlement, and the auction rate securities themselves are not readily convertible to cash, the put option does not meet the definition of a derivative in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and thus, would not be marked to fair value under that statement. We therefore elected the fair value option for our put option as the put option acts as an economic hedge against any further price movement in the auction rate securities and enables us to recognize future changes in the fair value of the put option as those changes occur to offset fair value movements in the auction rate securities. Also as part of this agreement, UBS agreed to provide a line of credit through June 30, 2010 that is secured by the auction rate securities held with UBS. Both the put option and the auction rate securities are being marked to market value through the consolidated statements of operations each period (see Note 4 for discussion of how fair value measurements are determined). At June 30, 2009, the fair value of the put option was $587,000 and the fair value of the auction rate securities was $5,965,000. We recorded a net gain of $39,000 and $61,000 for the three and six months ended June 30, 2009, respectively, for the fair value measurement of both the auction rate securities and the put option that is included in interest income and other, net. As of June 30, 2009, we reclassified our auction rate securities and put option from long-term to short-term investments on our consolidated balance sheet due to the expected timing of when these securities will be redeemed at par value by our broker. We continue to earn interest on our auction rate securities at the maximum contractual rate.

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4. Fair Value Measurements

Effective January 1, 2008, we adopted SFAS 157 for our financial instruments. SFAS 157 defines fair value 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 should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier value hierarchy, 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 Company 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. Money market securities represent collateral for a letter of credit required under certain lease obligations.

Our investments in auction rate securities are classified within level 3 because they are valued using a discounted cash flow model (see Note 3). 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 will be exercised. This put option is adjusted on each balance sheet date based on its then fair value. The fair value of the put option is based on unobservable inputs and is therefore classified within level 3 in the hierarchy. The following table presents information about our assets measured at fair value on a recurring basis at June 30, 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)	June 30, 2009
Certificates of deposit	$ 170	$	$	$ 170
Money market securities	314			314
Auction rate securities			5,965	5,965
Put option on auction rate securities			587	587
	$ 484	$	$ 6,552	$ 7,036

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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, 2008	$ 5,858	$ 633
Transfer to Level 3		
Total gains or losses (realized and unrealized)		
Included in earnings	107	(46)
Included in other comprehensive loss		
Net settlements		
Balance at June 30, 2009	$ 5,965	$ 587

5. Net Loss Per Share

Basic net loss 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, which are calculated using the treasury stock method.

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2009	**2008**	**2009**	**2008**
	(In thousands, except per share data)			
Numerator:				
Loss from continuing operations	$ (917)	$ (348)	$ (2,000)	$ (910)
Gain (loss) from discontinued operations	703	(187)	690	(298)
Net loss	$ (214)	$ (535)	$ (1,310)	$ (1,208)
Denominator:				
Weighted average shares Basic	8,278	8,081	8,147	8,108
Effect of dilutive stock options and warrants				
Weighted average shares Diluted	8,278	8,081	8,147	8,108
Basic and diluted net (loss) income per share:				
Loss from continuing operations	$ (0.11)	$ (0.04)	$ (0.25)	$ (0.11)
Gain (loss) from discontinued operations	0.08	(0.03)	0.09	(0.04)
Net loss	$ (0.03)	$ (0.07)	$ (0.16)	$ (0.15)

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 defined under SFAS No. 128, *Earnings per Share*. As a result, we retroactively increased the weighted average common shares outstanding used to compute basic earnings (loss) per share by an adjustment factor of 1.2309 for all periods presented, including those prior to the rights issue.

For the three and six months ended June 30, 2009, there were approximately 1,215,000 stock options and warrants outstanding that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive. For the three and six months ended June 30, 2008, there were approximately 1,020,000 stock options and warrants outstanding that were excluded from the dilutive earnings per share calculation for the same reason.

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6. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	June 30, 2009	December 31, 2008
Accrued payroll	$ 2,306	$ 1,846
Business and income taxes	679	663
Lease termination accrual	667	
Sales taxes	596	643
Gift cards	569	654
Accrued occupancy	141	255
Other	1,114	817
	$ 6,072	$ 4,878

7. Debt and Credit Agreements

Credit Facility

During October 2008, as part of the settlement agreement with UBS, our broker in which we have invested in auction rate security instruments, we entered into a line of credit that is secured by the auction rate security instruments held with the broker. Available borrowings under the line of credit are based upon terms specified in the agreement and are subject to adjustment by UBS after consideration of various factors. At June 30, 2009, $6,586,000 was outstanding under the line of credit. Borrowings under the line of credit are callable by the broker at any time. The line of credit is classified as short-term in the accompanying consolidated balance sheets as the loan expires on June 30, 2010. The line of credit is structured at a cost that effectively offsets the interest earned on the auction rate securities. See Note 3 for further information on the auction rate securities and the settlement agreement.

Bridge Loan

On March 6, 2009, and as amended on April 7, 2009, we entered into a Note and Warrant Purchase Agreement (the Agreement) with certain accredited investors whereby we sold $1,200,000 aggregate principal amount of 10% unsecured subordinated notes (Notes) and warrants to purchase shares of our common stock. The principal and accrued interest outstanding under the Notes were due and payable upon the closing of any offering of equity securities by us generating gross proceeds to us of at least $2,500,000. As described in Note 8 below, we completed a rights offering during June 2009 and used a portion of the proceeds to repay amounts owed on the Notes.

For each $100,000 issued in Notes, we issued to the noteholder three-year warrants to purchase 10,000 shares of our common stock at an aggregate exercise price per share of $2.29, which was equal to 120% of the five-day average of the closing price of our common stock during the five trading days prior to the date of issuance. In connection with the issuance of the warrants, we recorded a discount to the bridge loan and a corresponding increase in stockholders equity of $70,000 due to the warrants. The value of the warrants was derived through application of the Black-Scholes option pricing model. We amortized the debt discount to interest expense in the amount of $60,000 and $70,000 for the three and six months ended June 30, 2009, respectively.

8. Rights Offering

As part of the Agreement, we filed with the SEC a registration statement on Form S-3 to conduct a subscription rights offering with targeted gross proceeds to the Company of $3,520,000 (the Rights Offering) pursuant to which each stockholder of the Company received one non-transferrable subscription right for every 2.5 shares of common stock owned on April 17, 2009. Each subscription right entitled the holder to purchase one share of common stock at a price of $1.35 per share. The terms of the Agreement provided that any shares of common stock that were not subscribed for in the Rights Offering by existing stockholders were offered to the investors of the Notes on a pro rata basis based on the aggregate principal amount of Notes outstanding and at the same subscription price as offered to the existing stockholders in the Rights Offering. We sold 2,608,045 shares of common stock in the Rights Offering and received net proceeds of $3,245,000 after deducting $276,000 in expenses, including the exercise of over-subscription rights by the noteholders for the purchase of 482,178 shares or 18.5% of the total shares sold. A portion of the net proceeds was used to repay amounts owed on the Notes, and the remaining proceeds are being utilized to fund capital expenditure requirements.

9. Stock-Based Compensation

We maintain stock award plans which provide for discretionary grants of incentive and nonstatutory stock options, restricted stock, and other types of awards to our employees and non-employee directors. 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 or ten years from the date of grant. Employee stock options generally vest 25 percent each year over a four-year period, while annual recurring awards for non-employee director options vest 25 percent each quarter over a one-year period.

The fair value of stock options granted during the six months ended June 30, 2009 and 2008 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Expected volatility	55.0%	35.7%
Risk-free interest rate	1.6%	2.5%
Expected option life (in years)	3.8	3.7
Dividend yield	0.0%	0.0%
Weighted average fair value per option granted	$ 0.86	$ 3.53

The following table summarizes activity under our stock award plans for the six months ended June 30, 2009:

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding options at December 31, 2008	824,056	$ 12.34		
Granted	197,100	2.03		
Forfeited	(116,000)	9.56		
Exercised				
Outstanding options at June 30, 2009	905,156	$ 10.26	3.4 years	$ 230,000
Exercisable at June 30, 2009	580,743	$ 10.88	3.2 years	$ 35,000

We recognized stock-based compensation expense of $180,000 and $138,000 during the three months ended June 30, 2009 and 2008, respectively and $307,000 and $266,000 during the six months ended June 30, 2009 and 2008, respectively. As of June 30, 2009, there was approximately $620,000 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 2.3 years.

10. Comprehensive Loss

Comprehensive loss is defined as the aggregate change in stockholders equity, excluding changes in ownership interests. It is the sum of net loss and changes in unrealized losses on available-for-sale securities. The components of comprehensive loss for the three and six months ended June 30, 2009 and 2008 were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
Net loss	$ (214)	$ (535)	$ (1,310)	$ (1,208)
Net unrealized loss on available-for-sale securities		(105)		(458)
Total comprehensive loss	$ (214)	$ (640)	$ (1,310)	$ (1,666)

11. 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, it is the opinion of our management, 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 our results of operations or financial condition.

On April 1, 2009, Samuel Beren, as trustee for the Samuel Beren Trust, filed a stockholder derivative suit in the Court of Chancery of the State of Delaware. The suit was brought on behalf of us against our directors and the purchasers of our promissory notes issued on March 5, 2009, and named us as a nominal defendant. The complaint alleged that our directors breached their fiduciary duties of loyalty, good faith, and due care to us, and that the noteholders aided and abetted such breach, in connection with certain of our fundraising efforts. The suit originally sought unspecified damages, interest, reasonable attorneys fees, expert witness fees, and other costs, and any further relief the court deems just and proper.

During June 2009, the plaintiffs filed an amended complaint that, among other things, eliminated the allegation that the noteholders aided and abetted the alleged breaches of fiduciary duty; seeks to include in the litigation as a class all owners of our common stock; and sought to enjoin us from effecting the subscription rights offering, or, if the subscription rights offering was consummated, to rescind and set aside the subscription rights offering.

On June 16, 2009, we filed a motion to dismiss the claim. We believe that the allegations in the complaint, including the amended complaint, are without merit and we intend to defend vigorously this action.

12. Subsequent Event

On August 6, 2009, we entered into a Separation Agreement (the Agreement) with Marcus E. Jundt relating to Mr. Jundt s resignation from the Company during May 2009. Pursuant to the terms of the Agreement, Mr. Jundt will receive severance compensation equal to his base salary in effect at the time of termination for a period of twelve months, in the manner and at such times as the base salary otherwise would have been payable, and continuation of medical and dental benefits in effect under COBRA for a period of twelve months. In addition, pursuant to the Agreement, all unvested portions of Mr. Jundt s stock options that were scheduled to vest over a period of twelve months following the date of termination became vested and immediately exercisable for a period of three months following the separation date. The Agreement contains customary confidentiality provisions and a full release of any claims, known or unknown, that Mr. Jundt may currently have against us. We recognized approximately $400,000 in general and administrative expenses for the three and six months ended June 30, 2009 related to severance and benefits provided for under this Agreement.

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

This information 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, 2008 contained in our 2008 Annual Report on Form 10-K. The following 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, 2008 and other reports filed from time to time with the SEC.

Overview

We currently own and operate 22 restaurants located in 14 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 whom we compete. Our high-volume upscale casual restaurants feature a diverse selection of mainstream American dishes 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 vast menu and generous portions, combined with an average check of approximately $24.00 per guest, offers our guests an attractive price-value proposition.

We continue to follow a disciplined growth plan focused largely on expanding our presence in new markets. Over the last four years, we have funded development of new restaurants primarily from the proceeds of our initial public offering, our private offering of common stock completed during November 2007, our rights offering completed during June 2009, and cash flows from operations. We plan to open four restaurants during 2009, including our Richmond, Virginia restaurant which opened on January 22, 2009 and our Woodbridge, New Jersey restaurant which opened on April 28, 2009. We target our restaurants to achieve an average annual unit volume of $4.5 million following 24 months of operations. We believe that in a stable economic environment our typical new restaurants experience gradually increasing unit volumes as guests begin to discover our concept and we begin to 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.

As of September 13, 2008, we closed our restaurant in Naples, Florida to focus more on our profitable locations. As a result, we classified the Naples restaurant operations and related closure costs as discontinued operations in our consolidated financial statements.

We experience various trends in our operating cost structure. Cost of sales, labor, occupancy, 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. 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, restaurant operating expenses, and preopening expenses. 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.

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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 all of our restaurants open for at least 12 months before the beginning of the period measured.

Sales Per Square Foot. Sales per square foot represents the restaurant sales for our restaurants open for at least 12 months, 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. 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.

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.

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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 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.

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 six months ended June 30, 2009 and 2008.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
Restaurant sales growth	9.1%	5.8%	8.3%	13.1%
Same-store sales percentage change (1)	(9.5)%	(5.6)%	(9.6)%	(4.1)%
Average weekly sales comparable restaurant base (2)	$ 79,470	$ 87,853	$ 76,409	$ 84,488
Average weekly sales non-comparable restaurant base (3)	$ 69,190	$ 84,328	$ 67,891	$ 82,025
Average unit volume (in thousands) (4)	$ 1,014	$ 1,130	$ 1,949	$ 2,192
Sales per square foot (4)	$ 144	$ 161	$ 276	$ 311
Restaurant operating profit (in thousands) (5)	$ 3,960	$ 3,790	$ 7,019	$ 6,729
Restaurant operating profit as a percentage of sales (5)	18.4%	19.3%	17.2%	17.8%

(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) Includes only those restaurants open for at least 12 months before the beginning of the period measured.

(5) 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 income (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.

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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 June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
	(In thousands)			
Restaurant sales	$ 21,468	$ 19,685	$ 40,923	$ 37,788
Costs and expenses:				
Cost of sales	5,461	5,369	10,558	10,562
Labor	7,269	6,380	14,018	12,507
Occupancy	1,536	1,244	3,056	2,500
Restaurant operating expenses	3,242	2,902	6,272	5,490
Restaurant operating profit	3,960	3,790	7,019	6,729
Deduct other costs and expenses				
General and administrative	2,661	2,026	4,548	3,878
Preopening expense	352	541	852	719
Depreciation and amortization	1,812	1,584	3,553	3,150
Loss from operations	$ (865)	$ (361)	$ (1,934)	$ (1,018)

	Percentage of Restaurant Sales Three Months Ended June 30,		Percentage of Restaurant Sales Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
Restaurant sales	100.0%	100.0%	100.0%	100.0%
Costs and expenses:				
Cost of sales	25.4	27.3	25.8	27.9
Labor	33.9	32.4	34.3	33.1
Occupancy	7.2	6.3	7.5	6.6
Restaurant operating expenses	15.1	14.7	15.3	14.5
Restaurant operating profit	18.4	19.3	17.2	17.8
Deduct other costs and expenses				
General and administrative	12.4	10.3	11.1	10.3
Preopening expense	1.6	2.8	2.1	1.9
Depreciation and amortization	8.4	8.0	8.7	8.3
Loss from operations	(4.0)%	(1.8)%	(4.7)%	(2.7)%

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:

	Six Months Ended June 30, 2009	Year Ended December 31, 2008
Beginning of period	20	18
Openings	2	3
Closings		(1)
End of period	22	20

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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 June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Restaurant sales	100.0%	100.0%	100.0%	100.0%
Costs and expenses:				
Cost of sales	25.4	27.3	25.8	27.9
Labor	33.9	32.4	34.3	33.1
Occupancy	7.2	6.3	7.5	6.6
Restaurant operating expenses	15.1	14.7	15.3	14.5
General and administrative	12.4	10.3	11.1	10.3
Preopening expense	1.6	2.8	2.1	1.9
Depreciation and amortization	8.4	8.0	8.7	8.3
Total costs and expenses	104.0	101.8	104.7	102.7
Loss from operations	(4.0)	(1.8)	(4.7)	(2.7)
Nonoperating income (expense):				
Interest income and other, net	0.4	0.5	0.3	0.8
Interest expense	(0.5)	(0.1)	(0.3)	(0.1)
Loss from continuing operations before provision for income taxes	(4.1)	(1.4)	(4.7)	(2.0)
Provision for income taxes	0.2	0.4	0.2	0.4
Loss from continuing operations	(4.3)	(1.8)	(4.9)	(2.4)
Gain (loss) from discontinued operations, net of tax	3.3	(0.9)	1.7	(0.8)
Net loss	(1.0)%	(2.7)%	(3.2)%	(3.2)%

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

Three Months Ended June 30, 2009 Compared with Three Months Ended June 30, 2008

Restaurant Sales. Restaurant sales increased by $1.8 million, or 9.1% to $21.5 million during the second quarter of 2009 from $19.7 million during the prior year period. The sales increase was primarily the result of restaurant sales associated with the opening of five new restaurants since June 2008, partially offset by an overall reduction in guest traffic for our comparable restaurant base. Lower guest traffic attributable to the slowdown in the U.S. economy, increasing unemployment rates and reduced consumer spending resulted in a comparable restaurant sales base decline of 9.5% during the second quarter of 2009, inclusive of an effective menu price increase of approximately 2.0%. In particular, lower levels of guest traffic were experienced by our restaurants located in areas greatly affected by the housing and economic crisis, including Arizona, Nevada, and Michigan.

Cost of Sales. Cost of sales increased $0.1 million, or 1.7% to $5.5 million during the second quarter of 2009 from $5.4 million during the prior year period. Cost of sales as a percentage of restaurant sales decreased 1.9% to 25.4% during the second quarter of 2009 from 27.3% during the prior year period. Cost of sales during the second quarter of

2009 benefited from operational efficiencies, including continued benefits from the rollout of an automated food cost and inventory management system that was completed during July 2008, and favorable year-over-year pricing for certain proteins and produce.

Labor. Labor costs for our restaurants increased $0.9 million, or 13.9% to $7.3 million during the second quarter of 2009 from $6.4 million during the prior year period. This increase was primarily due to the opening of five new restaurants since June 2008. Labor expenses as a percentage of restaurant sales increased 1.5% to 33.9% during the second quarter of 2009 from 32.4% during the second quarter of 2008. This increase was primarily the result of reduced leverage of fixed labor costs resulting from lower average sales volumes and a higher percentage of restaurant weeks for new restaurants during the second quarter of 2009 as compared to the prior year quarter. For new restaurants, our labor expenses will typically be higher than normal during the first several months of operations as restaurant management teams become more accustomed to optimally predicting, managing, and servicing the sales volumes expected at our new restaurants.

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Occupancy. Occupancy expense increased by $0.3 million, or 23.5% to $1.5 million during the second quarter of 2009 from $1.2 million during the prior year period. Occupancy expenses as a percentage of restaurant sales increased 0.9% to 7.2% during the second quarter of 2009 from 6.3% during the second quarter of 2008. The increase as a percentage of sales reflects decreased leverage of the fixed portion of these costs from lower average weekly sales, partially offset by reduced percentage rent.

Restaurant Operating Expenses. Restaurant operating expenses increased by $0.3 million, or 11.7% to $3.2 million during the second quarter of 2009 from $2.9 million during the second quarter of 2008. Restaurant operating expenses as a percentage of restaurant sales increased 0.4% to 15.1% during the second quarter of 2009 from 14.7% during the prior year period. During the second quarter of 2009, higher utilities costs and increased printing costs associated with the rollout of a new menu, combined with reduced leverage of fixed operating costs from lower average weekly sales, resulted in an increase in restaurant operating expenses as a percentage of sales.

General and Administrative. General and administrative expenses increased $0.6 million during the second quarter of 2009 as compared to the second quarter of 2008. During the second quarter of 2009, we recorded approximately $0.9 million in unusual charges including $0.4 million in severance and related benefits related to the May 2009 resignation of our former CEO, $0.3 million in legal and professional fees associated with stockholder activities, including financial advisory fees to evaluate an unsolicited offer to purchase the Company, and $0.2 million write-off for architectural drawings and permit costs associated with amending the lease for our Baltimore, Maryland restaurant expected to open in 2010. This increase in expenses was partially offset by lower salary costs resulting from the January 2009 downsizing and realignment of certain corporate office staff. General and administrative expenses as a percentage of restaurant sales increased 2.1% to 12.4% of restaurant sales during the second quarter of 2009 compared to 10.3% of restaurant sales during the prior year period.

Preopening Expense. Preopening expense decreased $0.2 million to $0.3 million during the second quarter of 2009 compared to $0.5 million during the second quarter of 2008. The reduction in preopening expense is attributable to the timing of new restaurant openings as the majority of preopening expense is incurred during the two months preceding an opening. We opened our Woodbridge, New Jersey restaurant on April 28, 2009 as compared to the second quarter of 2008 when we incurred the majority of preopening costs for our Gilbert, Arizona restaurant during the quarter as the restaurant opened on June 19, 2008.

Depreciation and Amortization. Depreciation and amortization expense increased $0.2 million, or 14.4% to $1.8 million during the second quarter of 2009 from $1.6 million during the prior year period. The increase is attributable to five restaurants that opened since June 2008, partially offset by a reduction of $0.1 million due to the fourth quarter of 2008 impairment of long-lived assets at our Lincolnshire, Illinois restaurant. Depreciation and amortization expense as a percentage of restaurant sales increased 0.4% to 8.4% during the second quarter of 2009 from 8.0% during the second quarter of 2008, reflecting reduced leverage of these fixed costs from lower average weekly sales.

Interest Income and Other, Net. Interest income and other, net decreased during the second quarter of 2009 due to lower average interest rates coupled with lower average investment balances, as compared to the prior year. Please refer to Note 3 to the unaudited consolidated financial statements for discussion of our investment in auction rate securities.

Interest Expense. Interest expense increased $82,000 from the second quarter of 2008 due to interest costs associated with the $1.2 million bridge loan issued during March 2009 and subsequently repaid during June 2009, including amortization of the debt discount associated with warrants issued to the noteholders that was charged to interest expense.

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Provision for Income Taxes. During the second quarter of 2009, we recorded income taxes of $30,000 compared to $75,000 during the second quarter of 2008. The provision for income taxes for both periods reflects taxes for states in which taxes are not calculated 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 under SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*.

Six Months Ended June 30, 2009 Compared with Six Months Ended June 30, 2008

Restaurant Sales. Restaurant sales increased by $3.1 million, or 8.3% to $40.9 million during the first half of 2009 from $37.8 million during the prior year period, primarily attributable to restaurant sales generated from the opening of five new restaurants since June 2008, partially offset by overall traffic declines at our comparable restaurant sales base resulting from the slowing U.S. economy, increasing unemployment rates, and lower consumer confidence. Higher menu pricing of approximately 3.0% was more than offset by reduced guest traffic, primarily at our Arizona, Michigan and Nevada restaurants, as comparable restaurant sales declined 9.6% during the first half of 2009.

Cost of Sales. Cost of sales was essentially flat at $10.6 million during both the first six months of 2009 and 2008. Cost of sales as a percentage of restaurant sales decreased 2.1% to 25.8% during the first half of 2009 from 27.9% during the prior year period. Cost of sales during the first half of 2009 was positively affected by operating efficiencies attributed to the rollout of an automated food cost and inventory management system and favorable year-over-year pricing on certain proteins and produce.

Labor. Labor costs for our restaurants increased $1.5 million, or 12.1% to $14.0 million during the first half of 2009 from $12.5 million during the prior year period. The increase was primarily due to the opening of five new restaurants since June 2008. As a percentage of restaurant sales, labor costs increased 1.2% to 34.3% during the first half of 2009 from 33.1% during the first half of 2008. The increase in labor costs as a percentage of restaurant sales was primarily due to reduced leverage of fixed labor costs resulting from lower average sales volume. In addition, federal and state minimum wage increases, implemented during the second half of 2008 and at the beginning of 2009, contributed to increased labor costs as a percentage of sales.

Occupancy. Occupancy expense increased by $0.6 million, or 22.2% to $3.1 million during the first six months of 2009 from $2.5 million during the prior year period. Occupancy expenses as a percentage of restaurant sales increased 0.9% to 7.5% during the first half of 2009 from 6.6% during the first half of 2008. The increase reflects decreased leverage of fixed rental costs from lower average sales volume, partially offset by reduced percentage rent.

Restaurant Operating Expenses. Restaurant operating expenses increased by $0.8 million, or 14.3% to $6.3 million during the first half of 2009 from $5.5 million during the prior year period. Restaurant operating expenses as a percentage of restaurant sales increased 0.8% to 15.3% during the first half of 2009 from 14.5% during the prior year period. During the first half of 2009, higher repair and maintenance, utilities, and property taxes combined with reduced leverage of fixed operating costs resulting from lower average sales volume contributed to the increase in restaurant operating expenses as a percentage of sales.

General and Administrative. General and administrative expenses increased $0.7 million during the first half of 2009 as compared to the first half of 2008. The increase is primarily attributable to approximately $1.0 million in unusual charges including $0.4 million in severance and related benefits related to the May 2009 resignation of our former CEO, $0.4 million in legal and professional fees associated with stockholder activities, including financial advisory fees to evaluate an unsolicited offer to purchase the Company, and $0.2 million write-off for architectural drawings and permit costs associated with amending the lease for our Baltimore, Maryland restaurant expected to open in 2010. This increase in expenses was partially offset by lower salary costs resulting from the January 2009 downsizing and realignment of certain corporate office staff. General and administrative expenses as a percentage of restaurant sales increased 0.8% to 11.1% of restaurant sales during the first six months of 2009 compared to 10.3% of restaurant sales during the prior year period.

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Preopening Expense. Preopening expense increased $0.1 million, or 18.4% to $0.8 million during the first half of 2009 compared to $0.7 million during the first half of 2008. The increase in preopening expense is attributable to two restaurant openings during the first half of 2009 as compared to one restaurant opening during the first half of 2008.

Depreciation and Amortization. Depreciation and amortization expense increased $0.4 million, or 12.8% to $3.6 million during the first half of 2009 from $3.2 million during the prior year period. The increase was primarily attributable to five restaurants opened since June 2008, partially offset by a reduction of $0.2 million due to the fourth quarter of 2008 impairment of long-lived assets at our Lincolnshire, Illinois restaurant. Depreciation and amortization expense as a percentage of restaurant sales increased 0.4% to 8.7% during the first half of 2009 from 8.3% during the first half of 2008 reflecting decreased leverage from lower average sales volume.

Interest Income and Other, Net. Interest income and other, net decreased $0.2 million during the first six months of 2009 compared to the prior year period due to lower average interest rates coupled with lower average investment balances, as compared to the prior year. Please refer to Note 3 to the unaudited consolidated financial statements for discussion of our investment in auction rate securities.

Interest Expense. Interest expense increased $0.1 million due to interest costs associated with the $1.2 million bridge loan issued during March 2009 and subsequently repaid during June 2009, including amortization of the debt discount associated with warrants issued to the noteholders that was charged to interest expense.

Provision for Income Taxes. During the first half of 2009, we recorded income taxes of $60,000 primarily for states in which income taxes are not calculated based upon net income compared to $150,000 during the first half of 2008.

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 under SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*.

Potential Fluctuations in Quarterly Results and Seasonality

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 shareholder activities;
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

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

	June 30, 2009	December 31, 2008
Cash and investments	$ 12,030	$ 2,847
Net working capital (deficit)(1)	(1,504)	(7,653)

(1) The working capital deficit at June 30, 2009, is primarily attributable to accruals for legal, severance, and the Naples lease settlement. The working capital deficit at December 31, 2008 is principally due to $6.5 million of investments in auction rate securities which were classified as non-current assets.

	Six Months Ended June 30,	
	2009	2008

Cash provided by operating activities	$	3,233	$	3,609
Capital expenditures		7,623		6,539

Our primary capital requirements are for new restaurant development. Subject to availability of capital on terms acceptable to us, we intend to continue developing new restaurants in markets where we believe our concept will have broad appeal and attractive restaurant-level economics. 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 our restaurants. 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 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.

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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 have funded development of new restaurants primarily from the proceeds of equity financing, debt 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 $5.4 million in addition to cash flow from operations is sufficient to fund restaurant development costs required by existing leases. As of June 30, 2009, we had a working capital deficit of $1.5 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 shareholders 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.

Bridge Loan

On March 6, 2009, and as amended on April 7, 2009, we entered into a Note and Warrant Purchase Agreement (the Agreement) with certain accredited investors whereby we sold $1.2 million aggregate principal amount of 10% unsecured subordinated notes (Notes) and warrants to purchase shares of our common stock. The principal and accrued interest outstanding under the Notes were due and payable upon the closing of any offering of equity securities by the Company generating gross proceeds to us of at least $2.5 million. For each $100,000 issued in Notes, we issued to the noteholder three-year warrants to purchase 10,000 shares of our common stock at an aggregate exercise price per share of $2.29, which was equal to 120% of the five-day average of the closing price of our common stock during the five trading days prior to the date of issuance. The bridge loan, including accrued interest, was repaid during June 2009 upon completion of the rights offering described below. The noteholders exercised over-subscription rights granted in the Agreement and purchased 482,178 shares or 18.5% of the total shares sold in the rights offering.

Rights Offering

As part of the Agreement, we filed with the SEC a registration statement on Form S-3 to conduct a rights offering with targeted gross proceeds to the Company of $3,520,000 (the Rights Offering) pursuant to which each stockholder of the Company received one non-transferrable subscription right for every 2.5 shares of common stock owned on April 17, 2009. Each subscription right entitled the holder to purchase one share of common stock at a price of $1.35 per share. The terms of the Agreement provided that any shares of common stock that were not subscribed for in the Rights Offering by existing stockholders were offered to the investors of the Notes on a pro rata basis based on the aggregate principal amount of Notes outstanding and at the same subscription price as offered to the existing stockholders in the Rights Offering. We sold 2,608,045 shares of common stock in the Rights Offering and received net proceeds of $3,245,000 after deducting $276,000 in expenses. A portion of the net proceeds was used to repay amounts owed on the Notes, and the remaining proceeds are being utilized to fund capital expenditure requirements.

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Equipment Loans

As of June 30, 2009, we had five equipment term loans with lenders, each collateralized by restaurant equipment. The outstanding principal balance under these loans aggregated $1.7 million. The loans bear interest at rates ranging from 7.0% to 8.5% and require monthly principal and interest payments aggregating approximately $71,000. The loans mature between June 2010 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, 2008.

Credit Facility

During October 2008, as part of the settlement agreement with UBS, our broker in which we have invested in auction rate security instruments, we entered into a line of credit that is secured by the auction rate security instruments held with the broker. Available borrowings under the line of credit are based upon terms specified in the agreement and subject to adjustment by UBS after consideration of various factors. At June 30, 2009, $6,586,000 was outstanding under the line of credit. Borrowings under the line of credit are callable by the broker at any time. The line of credit is classified as short-term in the accompanying consolidated balance sheets as the loan expires on June 30, 2010. The line of credit is structured at a cost that effectively offsets the interest earned on the auction rate securities. See Note 3 to the unaudited consolidated financial statements for further information on the auction rate securities and the settlement agreement.

Cash Flows

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

	Six Months Ended June 30,	
	2009	**2008**
Net cash provided by (used in):		
Operating activities	$ 3,233	$ 3,609
Investing activities	(7,752)	636
Financing activities	7,036	(1,280)
Net increase in cash and cash equivalents	$ 2,517	$ 2,965

Operating Activities. During the first six months of 2009, net cash provided by operating activities was $3.2 million and exceeded our net loss by $4.5 million, due principally to the effect of depreciation and amortization and the receipt of landlord tenant improvement allowances. During the first six months of 2008, net cash provided by operating activities was $3.6 million and exceeded our net loss by $4.8 million due principally to the effect of depreciation and amortization and the timing of payment of accounts payable and receipt of tenant improvement allowances.

Investing Activities. We fund the development and construction of our new restaurants primarily with cash, proceeds from debt and equity transactions, and borrowings under our line of credit. Net cash used in investing activities was $7.8 million during the first six months of 2009, reflecting $7.6 million primarily to fund construction of our Richmond, Virginia and Woodbridge, New Jersey restaurants and restaurants scheduled to open during the second half of the year. Net cash provided by investing activities was $0.6 million during the first six months of 2008, reflecting proceeds from the sale of $7.2 million in short-term investments of which $6.5 million was used to fund construction at our Gilbert, Arizona and West Palm Beach, Florida restaurants in addition to capital expenditures for existing restaurants and restaurants scheduled to open in the next 12 months.

Financing Activities. Net cash provided by financing activities was $7.0 million during the first six months of 2009 reflecting $4.1 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, offset by $0.3 million in principal payments on equipment loans. Net cash used in financing activities was $1.3 million for the first six months of 2008, principally consisting of the purchase of 116,200 shares of our common stock at a cost of $1.0 million and $0.3 million in principal payments on equipment loans.

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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, 2008.

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 financial and commodity markets.

Primary Market Risk Exposures

Our primary market risk exposures are in the areas of commodity costs, labor costs, and construction costs. Many of the food products purchased by us are affected by changes in weather, production, availability, seasonality, and other factors outside our control. In addition, we believe that almost all of our food and supplies are available from several sources, which helps to control food commodity risks. We also believe that we have the ability to increase certain menu prices in response to food commodity price increases. Our labor costs are impacted by increases in the minimum wage rate as many of our employees are paid labor rates related to federal and state minimum wage laws. We have exposure to rising construction costs, which may impact our actual cost to develop new restaurants. Although the cost of restaurant construction will not impact significantly the operating results of the restaurant, it would impact the return on investment for such restaurant. In addition, many of our leases require us to pay taxes, maintenance, repairs, insurance, and utilities, all of which are generally subject to inflationary increases.

Item 4. *Controls and Procedures*

Evaluation of Disclosure Controls and Procedures

We have evaluated, with the participation of our Interim 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 Interim 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 Securities 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 Interim 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.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

On April 1, 2009, Samuel Beren, as trustee for the Samuel Beren Trust, filed a stockholder derivative suit in the Court of Chancery of the State of Delaware. The suit was brought on behalf of us against our directors and the purchasers of our promissory notes issued on March 5, 2009, and named us as a nominal defendant. The complaint alleged that our directors breached their fiduciary duties of loyalty, good faith, and due care to us, and that the noteholders aided and abetted such breach, in connection with certain of our fundraising efforts. The suit originally sought unspecified damages, interest, reasonable attorneys fees, expert witness fees, and other costs, and any further relief the court deems just and proper.

During June 2009, the plaintiffs filed an amended complaint that, among other things, eliminated the allegation that the noteholders aided and abetted the alleged breaches of fiduciary duty; seeks to include in the litigation as a class all owners of our common stock; and sought to enjoin us from effecting the subscription rights offering, or, if the subscription rights offering was consummated, to rescind and set aside the subscription rights offering.

On June 16, 2009, we filed a motion to dismiss the claim. We believe that the allegations in the complaint, including the amended complaint, are without merit and we intend to defend vigorously this action.

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, 2008 and the Registration Statement on Form S-3 filed on April 10, 2009 (SEC file no. 333-158278). 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. Submission of Matters to a Vote of Security Holders

We held our annual meeting of stockholders on April 30, 2009. The following items were voted on by our stockholders:

	For	Withheld/ Against
1. Election of Class I member of our Board of Directors for a term expiring in 2012:		
Marcus E. Jundt	2,846,518	3,194,842

	For	Against	Abstain
2. Proposal to approve an amendment to the 2005 Stock Award Plan	3,609,306	1,322,832	3,980

	For	Against	Abstain
3. Proposal to approve the Rights Agreement, dated May 27, 2008 between the Company and Continental Stock Transfer and Trust Company, as rights agent	2,123,342	2,769,887	42,889

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Item 5. Other Information

Not applicable.

Item 6. Exhibits

(a) Exhibits

3.1	Amended and Restated Certificate of Incorporation of Kona Grill, Inc. (1)
3.3	Amended and Restated Bylaws of Kona Grill, Inc. (2)
3.4	Certificate of Designations, Preferences, and Rights of Series A Junior Participating Preferred Stock of Kona Grill, Inc. (4)
4.1	Form of Common Stock Certificate (3)
4.2	Kona Grill, Inc. Stockholders Agreement, dated August 29, 2003 (3)
4.3	Kona Grill, Inc. Series A Investor Rights Agreement, dated August 29, 2003 (3)
4.4	Amendment No. 1 to Kona Grill, Inc. Series A Investor Rights Agreement, dated May 31, 2005 (3)
4.7	Form of Warrant (March 2009 Note Offering) (6)
4.9	Form of First Amended and Restated Promissory Note (March 2009 Note Offering) (5)
10.21	Note and Warrant Purchase Agreement, dated March 6, 2009, among Kona Grill, Inc. and the investor parties thereto (6)
10.23*	Employment Agreement, dated as of May 11, 2009, between the Company and Mark L. Bartholomay (7)
10.24*	Employment Agreement, dated as of May 11, 2009, between the Company and Mark S. Robinow (7)
10.25*	Separation Agreement, dated as of August 6, 2009, between the Company and Marcus E. Jundt (8)
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

* Management contract or compensatory plan or arrangement in which directors or executive officers are eligible to participate.

(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 the Registrant s Form 8-K filed on November 5, 2007.

(3) 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.

(4) Incorporated by reference to the Registrant s Form 8-K filed on May 28, 2008.

(5) Incorporated by reference to the Registrant s Form 8-K filed on April 10, 2009.

(6) Incorporated by reference to the Registrant s Form 8-K filed on March 9, 2009.

(7) Incorporated by reference to the Registrant s Form 8-K filed on May 14, 2009.

(8)

Incorporated by
reference to the
Registrant s Form
8-K filed on
August 12, 2009.

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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/ Mark L. Bartholomay
Mark L. Bartholomay
Interim 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: August 14, 2009

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