

KONA GRILL INC  
Form 10-K  
March 11, 2011

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K

(Mark one)

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

For the fiscal year ended December 31, 2010

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-34082

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

Delaware  
(State or other jurisdiction of incorporation or organization)

20-0216690  
(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)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value \$0.01 per share	NASDAQ Global Market

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No  S

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No  S

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

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 (§

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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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  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

The aggregate market value of common stock held by non-affiliates of the registrant as of the last business day of the registrant's most recently completed second fiscal quarter, June 30, 2010, was \$22,207,000, calculated based on the closing price of the registrant's common stock as reported by the NASDAQ Global Market. For purposes of this computation, all officers, directors, and 10% beneficial owners of the registrant are deemed to be affiliates. Such determination should not be deemed to be an admission that such officers, directors, or 10% beneficial owners are, in fact, affiliates of the registrant.

As of February 28, 2011, there were 9,206,795 shares of the registrant's common stock outstanding.

Documents Incorporated by Reference

Portions of the registrant's definitive proxy statement for the 2011 Annual Meeting of Stockholders are incorporated by reference into Part III of this report.

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KONA GRILL, INC.  
 Annual Report on Form 10-K  
 For the Year Ended December 31, 2010

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Statements Regarding Forward-Looking Statements

The statements contained in this report on Form 10-K that are not purely historical are forward-looking statements within the meaning of applicable securities laws. Forward-looking statements include statements regarding our “expectations,” “anticipation,” “intentions,” “beliefs,” or “strategies” regarding the future. Forward-looking statements relating to our future economic performance, plans and objectives for future operations, and projections of sales and other financial items are based on our beliefs as well as assumptions made by and information currently available to us. Actual results could differ materially from those currently anticipated as a result of a number of factors, including those discussed in Item 1A, “Risk Factors.”

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PART I

Item 1. Business

Overview

Kona Grill, Inc. (referred to herein as the “Company” or “we,” “us,” and “our”) owns and operates 25 upscale casual restaurants in 16 states. Our restaurants offer freshly prepared food, attentive service, and an upscale contemporary ambiance that create an exceptional, yet affordable dining experience that we believe exceeds many traditional casual dining restaurants with whom we compete. Our high-volume polished casual restaurants feature a diverse selection of flavorful American food, internationally influenced appetizers and entrees and an extensive selection of award-winning sushi. Our menu items are prepared from scratch and incorporate over 40 signature sauces and dressings, creating memorable flavor profiles that appeal to a diverse group of guests. Our menu offerings are complemented by a full service bar offering a broad assortment of wines, specialty drinks, and beers. We believe that our innovative high-quality recipes, generous portions, and flexible price points provide guests exceptional value and allows us to attract a diverse customer base.

Our restaurants seat an average of 290 guests and are comprised of multiple dining areas that incorporate modern design elements to create an upscale ambiance that reinforces our high standards of food and service. Our main dining area, full-service bar, outdoor patio, and sushi bar provide a choice of atmospheres and a variety of environments designed to attract new guests and encourage repeat visits from regular guests. We locate our restaurants in high-activity areas such as retail centers, shopping malls, urban entertainment districts, and lifestyle centers that are situated near commercial office space and residential housing to attract guests throughout the day.

We believe that the portability of our concept has been successfully demonstrated in a variety of markets across the United States. Our primary growth objective is to gradually expand the Kona Grill concept in selected markets over the next several years. We intend to continue developing Kona Grill restaurants in high quality, densely populated areas in both new and existing markets. In 2010, we opened a new restaurant in Baltimore, Maryland and in 2009 we opened new restaurants in Richmond, Virginia; Woodbridge, New Jersey; Eden Prairie, Minnesota; and Tampa, Florida. While we do not plan to open any new restaurants in 2011, we expect to be well-positioned to resume growth in 2012. We believe our concept has the potential for over 100 restaurants nationwide.

Our executive offices are located at 7150 East Camelback Road, Suite 220, Scottsdale, Arizona 85251, and our telephone number is (480) 922-8100. Our website is located at [www.konagrill.com](http://www.konagrill.com). Through our website, we make available free of charge our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, and any amendments to those reports filed or furnished to the Securities and Exchange Commission. These reports are available as soon as reasonably practicable after we electronically file these reports with the SEC. We also post on our website the charters of our Audit, Compensation, and Nominating Committees; Code of Business Conduct and Ethics and Code of Ethics for the CEO and Senior Financial Officers; and any other corporate governance materials required by SEC or NASDAQ regulations. These documents are also available in print to any stockholder requesting a copy from our corporate secretary at our executive offices.

Our History

Our predecessor concept was a sushi restaurant that commenced operations during 1994. As our guests frequently requested additional selection and diversity in menu offerings, we developed a successor restaurant concept offering sushi plus innovative menu selections with mainstream appeal that became Kona Grill. We opened the first Kona Grill restaurant in Scottsdale, Arizona in 1998. We sold the predecessor restaurant in 2002 to focus on growing the Kona Grill concept.



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### Competitive Strengths

The restaurant business is intensely competitive with respect to food quality, price-value relationships, ambiance, service and location. We believe that the key strengths of our business include the following:

- **Innovative Menu Selections with Mainstream Appeal.** We offer a menu of freshly prepared, high quality food that includes a diverse selection of mainstream American selections, a variety of appetizers and entrees with an international influence, and award-winning sushi to appeal to a wide range of tastes, preferences, and price points. We prepare our dishes from scratch using original recipes with generous portions and creative and appealing presentations that adhere to standards that we believe are much closer to fine dining than typical casual dining. Our more than 40 signature sauces and dressings create memorable flavor profiles and further differentiate our menu items. With an average check during 2010 of approximately \$23 per guest, we believe we provide an exceptional price-value proposition that helps create a lasting relationship between Kona Grill and our guests.
- **Distinctive Upscale Casual Dining Experience.** Our upscale casual dining concept captures some of the best elements of fine dining including a variety of exceptional food, attentive service, and an extensive wine and drink list, and combines them with more casual qualities, like a broad menu with attractive price points and a choice of environments to fit any dining occasion. Our creative menu, personalized service, and contemporary restaurant design blend together to create a great polished casual dining experience. We design our restaurants with a unique layout and utilize modern, eye-catching design elements such as our signature saltwater aquarium stocked with bright and colorful exotic fish, plants, and coral. Our multiple dining areas provide guests with a number of distinct dining environments and atmospheres to suit a range of dining occasions. Our open exhibition-style kitchen and sushi bar further emphasize the quality and freshness of our food that are the cornerstones of our unique upscale casual dining concept.
- **Significant Bar and Happy Hour Business.** Our high-energy bar and patio offer a distinctive atmosphere where guests can enjoy one of our many alcoholic beverage offerings, while providing a place to be seen and see others. Our patio is a popular place for younger clientele and industry professionals to enjoy our high-value happy hour and reverse happy hour offerings. Our patio, including our enclosed patio in colder climate locations, provides a year-round sales opportunity and is a key driver in generating business during non-traditional periods. Sales during these non-peak periods accounted for 23% of our total sales during 2010, which we believe provides us with a competitive advantage.
- **Personalized Guest Service.** Our commitment to provide prompt, friendly, and efficient service enhances our food, reinforces our upscale ambiance, and helps distinguish us from other traditional casual dining restaurants. We train our service personnel to be cordial, friendly, and knowledgeable about all aspects of the restaurant, especially the menu, which helps us provide personalized guest service that is designed to ensure an enjoyable dining experience and exceed our guests' expectations. Our kitchen staff completes extensive training to ensure that menu items are precisely prepared to provide a consistent quality of taste. We believe our focus on high service standards underscores our guest-centric philosophy.
- **Multiple Daypart Model.** Our appetizers, flatbreads, entrees, and sushi offerings provide a flexible selection of items that can be ordered individually or shared allowing guests to dine with us during traditional lunch and dinner meal periods as well as in between customary dining periods such as in the late afternoon and late night. The lively ambiance of our patio and bar areas provides an energetic social forum that attracts a young professional clientele during non-peak periods, as well as provides a unique atmosphere for all of our guests to enjoy before or after they dine with us. Our sushi bar provides another dining venue for guests while offering a wide selection of creative and flavorful menu items for our health conscious guests. We believe that our ability to attract guests throughout the day distinguishes us from many other casual dining chains and helps us maximize sales and leverage our fixed operating

costs.

- **Attractive Unit Economics.** During 2010, the average unit volume of our comparable base restaurants was \$3.8 million, or \$535 per square foot. We believe our high average unit volume helps us attract high-quality employees, leverage fixed costs, and makes us a desirable tenant for landlords. We expect the average cash investment for our new restaurants to be approximately \$2.5 million, net of landlord tenant improvement allowances and excluding preopening expenses. Restaurants that are subject to ground leases and do not receive landlord tenant improvement allowances may require a significantly higher cash investment, but typically have lower average rental costs over the duration of the lease.



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### Growth Strategy

We believe that there are significant opportunities to grow our sales and increase our brand awareness throughout the United States. The following sets forth the key elements of our growth strategy.

#### Pursue Disciplined Restaurant Growth

We adhere to a disciplined site selection process. We review potential sites in both new and existing markets that meet our demographic, real estate, and investment criteria. We also utilize an empirical site selection model to ensure that potential sites meet our strict site selection criteria. We have no lease commitments signed for new restaurant development; however, we are in ongoing discussions with landlords regarding the availability of quality sites. Beyond 2011, we expect the rate of new unit expansion to moderately increase as the cost of capital becomes more affordable and quality new restaurant sites become available.

Our growth strategy also includes developing restaurants in new and existing markets that have the appropriate demographics to support multiple restaurants. Operating multiple restaurants in existing markets enables us to leverage our brand equity as well as gain operating efficiencies associated with regional supervision, marketing, purchasing, and hiring. In addition, our ability to hire qualified employees is enhanced in markets where we are well-known and we are able to utilize existing employees in new restaurants. Our expansion plans do not involve any franchised restaurant operations.

#### Grow Existing Restaurant Sales

Our goal for existing restaurants is to increase unit volumes through ongoing local and social marketing efforts and local market advertising designed to generate awareness and trial of our concept and increase the frequency of guest visits. During 2010, restaurant sales for our comparable base restaurants, which include those units open for more than 18 months, increased 0.9% compared to 2009 reflecting higher overall guest traffic, partially offset by a reduction in the average guest check as guests continue to manage their spending in this challenging macroeconomic environment. We expect same-store sales to continue to improve as the U.S. economy strengthens.

We continue to implement initiatives designed to increase sales at our restaurants. During 2010, we implemented phases I, II, and III of a four phase menu evolution process designed to introduce creative new items to our menu, improve the flavor profile of certain menu items, and bring back the “wow” factor to the presentation of our dishes. We also periodically introduce food and drink promotions to keep our menu fresh and exciting while also providing a vehicle to test the popularity of new menu items. During 2010, we introduced several marketing and branding initiatives, including our Konavore™ loyalty program, which has grown to over 130,000 guests in 12 months. We have also increased our presence in social marketing and interactive advertising. Furthermore, we utilize a guest satisfaction survey across the entire brand to provide valuable feedback that our management team can respond to immediately. We believe we can generate additional sales through these programs at a reasonable expense per restaurant.

#### Leverage Depth of Existing Corporate Infrastructure

We believe that successful execution of our growth strategies will enable Kona Grill to be a leading upscale casual dining restaurant operator in the United States. During 2010, we made strategic investments in our corporate infrastructure including the hiring of senior personnel with significant restaurant experience. We continue to implement information systems and tools to enhance our business while ensuring that strong financial controls are in place to minimize risks associated with our current growth strategy. We believe that we will be able to leverage our investments in corporate personnel and information systems and realize profits from the increasing sales volume that our company generates.



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## Unit Economics

We target a 35% net cash-on-cash return for our restaurants once they reach their mature level of operations. Maturation periods vary from restaurant to restaurant, but generally range from two to four years. We target our restaurants to achieve average annual unit volume of \$4.5 million following 24 months of operations. During 2010, the average unit volume of our comparable base restaurants was \$3.8 million, or \$535 per square foot. Recent trends are lower than our targeted volume due to the current economic environment. The cash-based performance target for our restaurant operations do not include field supervision, corporate support expenses or non-cash items such as depreciation and amortization; and do not represent a targeted return on investment in our common stock.

Our investment cost for new restaurants vary significantly depending upon the length and 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 prototype 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.

Our ability to generate sales throughout the day is a key strength of our concept. The following table depicts the amount and percentage of contribution for each daypart of overall restaurant sales during 2010.

## 2010 Sales by Daypart

	Sales (Dollars in thousands)	Percent	
Lunch (Open to 3 p.m.)	\$19,708	22	%
Dinner (5 p.m. to 9 p.m.)	47,813	55	%
Non-Peak (3 p.m. to 5 p.m. and 9 p.m. to Close)	20,068	23	%
Total All Day	\$87,589	100	%

## Menu

Our menu offers guests a diverse selection of mainstream American dishes as well as a variety of appetizers and entrees with an international influence, including a broad selection of award-winning sushi. This broad menu is an important factor in differentiating ourselves from other upscale casual dining competitors. We are widely recognized for our selection of over 40 signature sauces and dressings. Our sauces and dressings distinguish and compliment our dishes, creating delicious flavor profiles and artistic presentations for guests. All of our menu items are prepared from scratch using fresh high quality ingredients and adhere to food standards that we believe are much closer to fine dining than typical casual dining.

Our menu features a selection of appetizers, salads, soups, pizzas, flatbreads, sandwiches, noodles, seafood, signature entrees, and desserts. We round out our menu with over 60 hand-made award-winning sushi choices. Our appetizers include socially interactive items that can be eaten individually or easily shared amongst guests such as our Ahi Wonton Crisps, Chicken Satay, and Sweet and Spicy Shrimp. Our signature entrees feature various sauces and offer guests generous portions that are impressive in presentation and in taste. For example, our most popular entrée is the Macadamia Nut Chicken served with shoyu-cream sauce and accompanied by parmesan garlic mashed potatoes and haircots verts. Other favorites include Miso-Sake Marinated Sea Bass served with shrimp and pork fried rice and grilled broccolini and Pan-Seared Ahi Tuna served over steamed white rice with a sweet-chili sauce.

We are also known for our broad assortment of sushi that includes traditional favorites as well as distinct specialty items such as Tuna Carpaccio made with thinly sliced tuna sashimi topped with wasabi mayo and yuzu ponzu sauce and served with fresh arugula, or the Bama Roll made with crab mix, cream cheese and jalapeno in soy paper topped with tuna, avocado, fish roe and spicy mayo. Our menu, coupled with an expansive selection of sushi, offers ample choices for health conscious guests, which the National Restaurant Association expects will continue to be a point of focus for consumers in the future.

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Each of our restaurants has a dedicated kitchen staff member, whom we refer to as our saucier, to oversee the preparation of more than 40 signature sauces and dressings that are made from scratch using only high-quality ingredients and fresh products. Each sauce is designed according to a proprietary recipe for specific menu items and includes unique flavors and combinations such as our honey cilantro, shoyu-cream, and spicy aioli dipping sauces, and our sesame-soy and honey dijon dressings. We believe that these distinctive sauces and dressings provide a unique flavor profile, which further distinguishes Kona Grill from its competitors. Our flavorful sauces and dressings also enhance guests' overall dining experience by allowing them to not only experience new tastes but to also share their favorite sauces with others, helping to create customer loyalty and a socially interactive dining experience.

The versatility of our menu enables us to provide guests with dishes that can be enjoyed outside of the traditional lunch and dinner meal periods as well as to serve guests' requirements for a variety of dining occasions, including everyday dining, business lunches, social gatherings and special occasions. We also offer group dining menus and sushi platters to provide additional opportunities to service our guests. In general our menu is consistent from location to location. We review our menu regularly and make enhancements to existing items or introduce new items based on guest feedback, which helps ensure that we are meeting the needs of our guests.

Our restaurants also offer an extensive selection of domestic and imported bottled and draft beers, over 25 selections of wines by the glass or bottle, and a broad selection of liquors and specialty cocktail drinks. During our weekday happy hour (3 p.m. to 7 p.m.) and reverse happy hour (9 p.m. to 11 p.m.), we offer discounts on selected food and alcoholic beverage items. Happy hour times may vary by location due to local liquor laws. Alcoholic beverage sales represented approximately 31% of our total restaurant sales during 2010.

### Decor and Atmosphere

We have created a consistent restaurant look and feel that is adaptable to varying real estate opportunities. The layout of our restaurants focuses on joined spaces that create multiple dining areas for our guests while also maintaining an open atmosphere that allows guests to have a panoramic view of the entire restaurant and kitchen without negatively impacting the specific ambiance or dining occasion they desire.

Our main dining room area offers a combination of booth seating and central tables of varying sizes. Our full service bar area and covered outdoor patio offer not only a high-energy, socially interactive area for guests to enjoy appetizers or sushi while they wait to dine with us, but also serves as a destination for many of our frequent guests who visit us during the late afternoon and late night periods. Our dining room is strategically placed to ensure that families and other groups that may prefer a quieter, more intimate dining experience are not disturbed. Our sushi bar provides yet another dining alternative for singles, couples, and parties with more sophisticated, health conscious, or adventuresome tastes.

We showcase our signature saltwater aquarium stocked with bright and colorful exotic fish, plants, and coral in each of our restaurants. Our bar surfaces are made of granite and compliment our mahogany finishes to enhance our contemporary design. We use a variety of directional lighting to deliver a warm glow throughout our restaurants and we adjust our dining atmosphere throughout the day by adjusting the lighting, music, and the choice of television programming in our bar and patio areas. Our exhibition-style kitchens are brightly lit to display our kitchen staff at work. Our covered outdoor patio areas seat an average of 60 guests. We utilize heaters suspended from our roof structure to allow us to maximize the use of our patios throughout most of the year while avoiding obtrusive heating mechanisms that could detract from our upscale ambiance. We have enclosed the patio areas in certain of our colder climate locations allowing guests to utilize the patio area throughout the year.

The exterior of our restaurants typically employ cultured stone and slate to create a highly visible and attractive restaurant. We landscape our restaurants where appropriate and vary the exterior design to coordinate with the

surrounding area. We use accent lighting on trees and directional lighting on our buildings to further increase the visual appeal of our restaurants.

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Food Preparation, Quality Control, and Purchasing

We believe that we have some of the highest food quality standards in the industry. Our standards are designed to protect food products throughout the preparation process. We provide detailed specifications to suppliers for food ingredients, products, and supplies. We strive to maintain quality and consistency in our restaurants through careful hiring, training and supervision of personnel. Our restaurant general managers and executive chefs generally receive nine weeks of training while our other restaurant managers and sous chef receive seven weeks of training. We have an annual recertification training for all employees and each employee receives an operations manual relating to food and beverage preparation and restaurant operations. We also instruct kitchen managers and staff on safety, sanitation, housekeeping, repair and maintenance, product and service specifications, ordering and receiving products, and quality assurance. All of our restaurant managers are compliant with Hazard Analysis and Critical Control Point, or HACCP. We monitor minimum cook temperature requirements and conduct twice-a-day kitchen and food quality inspections to further assure the safety and quality of all of the items we use in our restaurants.

We are committed to purchasing high-quality ingredients for our restaurants while managing costs. We use only the freshest ingredients and, as a result, we maintain only modest inventories. We have arrangements with local produce distributors and specialty food suppliers who provide high-quality ingredients and perishable food products. We believe that competitively priced alternative distribution sources are available should those channels be necessary. We source all of our products and supplies with reputable and high-quality providers that are capable of providing consistent, reliable distribution to all of our restaurants.

Our goal is to maximize purchasing efficiencies and obtain the lowest possible prices for ingredients, products, and supplies, while maintaining the highest quality. Our Scottsdale Support Center coordinates national supply contracts, negotiates prices for food supply throughout all of our restaurants, monitors quality control and consistency of the food supplied to restaurants, and oversees delivery of food on a nationwide basis. In order to provide the freshest ingredients and products, and to maximize operating efficiencies between purchase and usage, we utilize an automated food cost and inventory system to assist each restaurant's kitchen manager in determining daily order requirements for food ingredients, products, and supplies. The kitchen manager orders accordingly from approved suppliers and all deliveries are inspected to assure that the items received meet our quality specifications and negotiated prices.

Expansion Strategy and Site Selection

We believe the location of our restaurants is critical to our long-term success and, accordingly, we devote significant time and resources to analyzing each prospective site. Our site selection criteria for new restaurants include locating our restaurants near high traffic areas such as upscale retail centers and shopping malls and lifestyle and entertainment centers. In addition, we focus on areas that have significant commercial and residential populations, have high customer traffic throughout the day from thriving businesses or retail markets, and are convenient for and appealing to business and leisure travelers. Our restaurant expansion strategy focuses primarily on penetrating markets where demographic information supports the building of additional restaurants in major metropolitan areas throughout the United States. In general, we prefer to open restaurants in high-profile sites within specific trade areas with the following considerations:

- suitable demographic characteristics, including residential and commercial population density and above-average household incomes;
- visibility;
- high traffic patterns;

- general accessibility;
- availability of suitable parking;
- proximity of shopping areas and office parks;



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- degree of competition and the revenue level of those competitors within the trade area; and
- general availability of restaurant-level employees.

These sites generally include high-volume retail centers, shopping malls, and lifestyle and entertainment centers.

We thoroughly analyze each prospective site before presenting the site to our Real Estate Committee, comprised of members of the Board of Directors, for review. Prior to committing to a restaurant site and signing a lease, at least three members of our senior management team and a member of the Real Estate Committee visit the prospective site and evaluate the proposed economics of the restaurant based on scores from our site model, demographic data and other relevant criteria to assure that the site will meet our return on investment criteria. We completed a comprehensive custom study of guest profiles and existing restaurant results in December 2009 and used this data to create an empirical site model program to ensure even greater scrutiny when selecting new locations.

We lease all of our restaurant sites under lease terms that vary by restaurant; however, we generally lease space (freestanding or in-line) for 10 to 20 years and negotiate at least two five-year renewal options. Our rent structures vary from lease to lease, but generally provide for the payment of both minimum base rent and contingent rent based on restaurant sales. We are also generally responsible for a proportionate share of common area maintenance, property tax, insurance, and other occupancy-related expenses.

We believe the high sales volumes of our restaurants make us an attractive tenant and provide us with ample opportunities to obtain suitable leasing terms from landlords. As a result of the locations we select, which are often in new retail center or shopping mall developments, our restaurant development timeframes vary according to the landlord's construction schedule and other factors that are beyond our control. Once the site has been turned over to us, the typical lead-time from commencement of construction to opening is approximately six months.

## Restaurant Operations

### Executive and Restaurant Management

Our executive management team continually monitors restaurant operations to assure the quality of products and services and the maintenance of facilities. Restaurant management and our Scottsdale Support Center institute procedures to enhance efficiency, reduce costs and provide centralized and individual restaurant support systems. Our senior vice president of operations, senior director of training, and district managers have primary responsibility for oversight of our restaurants and participate in analyzing restaurant-level performance and strategic planning. We employ four district managers who report directly to our senior vice president of operations and who are each responsible for overseeing the restaurants in a specific region. The district managers' responsibilities include supporting the general managers and helping each general manager achieve the sales and cash flow targets for their restaurant as well as providing insight for decision making in such areas as food and beverage, people development, and systems to enhance the efficiency of operations. As we expand our operations, we expect to hire additional district managers who will each oversee six to eight restaurants. In addition, our support center team includes a senior director of culinary and purchasing, an executive chef and an executive sushi chef who educate, coach, and develop kitchen personnel, implement systems to improve the efficiency of kitchen operations, and develop new menu offerings.

Our typical restaurant management team consists of a general manager, assistant general manager, two front-of-the-house managers, executive chef, sous chef, and head sushi chef. Our restaurants employ on average approximately 75 non-management employees, many of whom work part-time. The general manager is responsible for the day-to-day operations of the restaurant, including the hiring, training, personnel development, execution of local marketing programs, and operating results. The chefs are responsible for overseeing the preparation of menu and

sushi items, maintaining product quality, and closely monitoring food costs and department labor costs. We also employ a kitchen staff member who is dedicated to the preparation of our signature sauces and dressings.

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### Training

In order to maintain quality and consistency in each of our restaurants, we carefully train and supervise restaurant personnel and adhere to high standards related to personnel performance, food and beverage preparation, and maintenance of our restaurants. All of our restaurant personnel participate in both initial and ongoing training programs under the direction of our senior director of training. Each restaurant general manager, assistant general manager, front-of-the-house manager, and kitchen and sushi chef completes a formal training program that is comprised of a mix of classroom and on-the-job instruction. Typical programs for general managers and executive chefs provide nine weeks of training that may include a rotation to different restaurants throughout the country. Typical programs for other managers provide seven weeks of training and may involve work in our other restaurants and cross training of various duties. The training covers all aspects of management philosophy and overall restaurant operations, including supervisory skills, operating and performance standards, accounting procedures, and employee selection and training necessary for top-quality restaurant operations. The training programs also involve intensive understanding and testing of our menu, the ingredients of various menu items, and other key service protocols. In addition, our hourly staff go through a series of in-depth interactive training for their positions.

We implement these programs by hiring dedicated corporate personnel as well as designating high-performing existing restaurant personnel to assist in training. Our training personnel are involved in training for both new employees hired in anticipation of new restaurant openings as well as for ongoing training in existing restaurants. When we open a new restaurant, we provide training to restaurant personnel in every position for several weeks prior to opening to assure the smooth and efficient operation of the restaurant from the first day it opens to the public.

### Recruitment and Retention

Our future growth and success is highly dependent upon our ability to attract, develop, and retain qualified individuals who are capable of successfully managing our high-volume, upscale casual restaurants. We believe that our unit volume, the image and atmosphere of the Kona Grill concept, and career advancement and employee benefit programs enable us to attract high quality management and restaurant personnel. We offer restaurant management personnel competitive wages and benefits, including medical insurance and participation in our 401(k) plan with a company match. We motivate and prepare our restaurant personnel by providing them with opportunities for increased responsibility and advancement. Furthermore, the management team of each restaurant share in a bonus tied to the sales and overall profitability of their restaurant. We believe that our compensation package for managers and restaurant employees is comparable to those provided by other upscale casual restaurants. We believe our compensation policies help us attract quality personnel.

### Information Systems

We believe that our management information systems enable us to increase the speed and accuracy of order-taking and pricing, efficiently schedule labor to better serve guests, monitor labor costs, assist in product purchasing and menu mix management, promptly access financial and operating data, and improve the accuracy and efficiency of restaurant-level information and reporting.

We utilize an integrated information system to manage the flow of information within each of our restaurants and between each restaurant and our support center. This system includes an Aloha point-of-sales (POS) local area network that helps facilitate the operations of the restaurant by recording sales transactions and printing orders in the appropriate locations within the restaurant. Additionally, we utilize the POS system to authorize, batch, and transmit credit card transactions, record employee time clock information, and produce a variety of management reports. Our point of sale system is integrated with food cost and labor scheduling software as well as our financial reporting

system and incorporates a redundancy and back-up emergency operating plan on a temporary basis if the system experiences downtime.

We transmit electronically to the support center on a daily basis select information that is captured from the POS system. This information flow enables senior management to monitor operating results with daily and weekly sales analysis, detailed labor and food cost information, and comparisons between actual and budgeted operating results. We anticipate continually updating both our restaurant information systems and support center information systems to enhance operations. We believe our information systems are secure and scalable as we continue to build our brand.

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### Advertising and Marketing

Our ongoing advertising and marketing strategy consists of loyalty programs, social marketing, interactive advertising, traditional outdoor and print advertising, various public relations activities, direct mail, and word-of-mouth recommendations. We believe that these mediums are a key component in driving guest trial and usage. In 2010, our marketing and advertising expenditures were \$1.2 million, or 1.4% of restaurant sales. We expect to continue to invest in marketing, branding and advertising efforts, primarily to drive trial, increase comparable restaurant sales and build brand awareness.

We implement a coordinated public relations effort in conjunction with each new restaurant opening. Approximately 60 days before a scheduled restaurant opening, we collaborate with the local media to publicize our restaurant and generate awareness of our brand. This effort is usually supplemented by targeted direct mail campaigns, social marketing, and other marketing efforts, including hosting a high profile event for a local charity as part of our preopening practice activities that also serves to introduce our concept to the local market. In addition, we use our website, [www.konagrill.com](http://www.konagrill.com), to help increase our brand awareness as well as gift card sales.

### Competition

The restaurant industry is highly competitive. Key competitive factors in the industry include the taste, quality, and price of food products offered, quality and speed of guest service, brand name identification, attractiveness of facilities, restaurant location, and overall dining experience.

We believe we compete favorably with respect to each of these factors, as follows:

- We offer a diverse selection of fresh high quality mainstream American dishes as well as a variety of appetizers and entrees with an international influence, including an extensive selection of sushi items;
- We appeal to multiple demographic and psychographic profiles;
- We strive to maintain quality and consistency in each of our restaurants through the careful training and supervision of restaurant personnel and adherence to high standards related to personnel performance, food and beverage preparation, and maintenance of our restaurants;
- Our innovative menu with attractive price points, attentive service, and contemporary restaurant design with multiple environments blend together to create our polished casual dining experience and enables us to attract a broad guest demographic.

Although we believe we compete favorably with respect to each of these factors, there are a substantial number of restaurant operations that compete directly and indirectly with us, many of which have significantly greater financial resources, higher revenue, and greater economies of scale. The restaurant business is often affected by changes in consumer tastes and discretionary spending patterns; national and regional economic and public safety conditions; demographic trends; weather conditions; the cost and availability of raw materials, labor, and energy; purchasing power; governmental regulations; and local competitive factors. Any change in these or other related factors could adversely affect our restaurant operations. Accordingly, we must constantly evolve and refine the critical elements of our restaurant concept over time to protect their longer-term competitiveness. Additionally, there is competition for highly qualified restaurant management employees and for attractive locations suitable for upscale, high volume restaurants.



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### Trademarks

We have registered the service marks “Kona Grill” and “Konavore” with the United States Patent and Trademark Office. We believe that our trademarks and other proprietary rights, such as our unique menu offerings and signature sauce recipes, have significant value and are important to the marketing of our concept. We have in the past and expect to continue to protect vigorously our proprietary rights. We cannot predict, however, whether steps taken by us to protect our proprietary rights will be adequate to prevent misappropriation of these rights or the use by others of restaurant features based upon, or otherwise similar to, our concept. It may be difficult for us to prevent others from copying elements of our concept and any litigation to enforce our rights will likely be costly. In addition, other local restaurant companies with names similar to ours may try to prevent us from using our marks in those locales.

### Government Regulation

Each of our restaurants is subject to licensing and regulation by state and local departments and bureaus of alcohol control, health, sanitation, zoning, and fire and to periodic review by state and municipal authorities for areas in which the restaurants are located. In addition, we are subject to local land use, zoning, building, planning, and traffic ordinances and regulations in the selection and acquisition of suitable sites for developing new restaurants. Delays in obtaining, or denials of, or revocation or temporary suspension of, necessary licenses or approvals could have a material adverse impact on our development of restaurants.

Alcoholic beverage control regulations require each of our restaurants to apply to a state authority and, in certain locations, county and municipal authorities for a license and permit to sell alcoholic beverages on the premises. Typically, licenses must be renewed annually and may be subject to penalties, temporary suspension or revocation for cause at any time. Alcoholic beverage control regulations impact many aspects of the daily operations of our restaurants, including the minimum age of patrons and employees, hours of operation, inventory control and handling, and storage and dispensing of alcoholic beverages. We have not encountered any material problems relating to alcoholic beverage licenses or permits to date. The failure of a restaurant to obtain or retain its liquor license would adversely affect that restaurant’s operations and profitability.

We are subject to dram shop statutes in most of the states in which we operate. Those statutes generally provide a person who has been injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to such person. We carry liquor liability coverage as part of our existing comprehensive general liability insurance which we believe is consistent with coverage carried by other companies in the restaurant industry of similar size and scope of operations. Even though we carry liquor liability insurance, a judgment against us under a dram shop statute in excess of our liability coverage could have a material adverse effect on our operations.

Our operations are also subject to federal and state laws governing such matters as wages, working conditions, citizenship requirements, and overtime. Several states have set minimum wage requirements higher than the current federal level. A significant number of hourly personnel at our restaurants are paid at rates related to state and federal minimum wage laws and, accordingly, state minimum wage increases effective during 2010 and the federal minimum wage increase in July 2009 have increased our labor costs. Increases in the minimum wage rate or the cost of workers’ compensation insurance, changes in tip-credit provisions, employee benefit costs (including costs associated with mandated health insurance coverage), or other costs associated with employees could adversely affect our operating results. To our knowledge, we are in compliance in all material respects with all applicable federal, state, and local laws affecting our business.

### Employees

As of February 7, 2011, we employed approximately 1,986 people of whom approximately 1,956 worked in our restaurants and 30 were corporate management and staff personnel. None of our employees are covered by a collective bargaining agreement. We have never experienced a major work stoppage, strike, or labor dispute. We consider our relations with our employees to be favorable.



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## Executive Officers

The following table sets forth certain information regarding our executive officers:

Name	Age	Position
Marc A. Buehler	41	President, Chief Executive Officer and Director
Mark S. Robinow	54	Executive Vice President, Chief Financial Officer and Secretary
Larry J. Ryback	42	Senior Vice President of Operations

Marc A. Buehler has served as our Chief Executive Officer and President since November 2009 and is also a member of our Board of Directors. Prior to joining our company, Mr. Buehler was the Chief Executive Officer of LS Management, Inc., the owner and operator of the Lone Star Steakhouse & Saloon/Texas Land and Cattle Steak House restaurant concepts, as well as Lone Star Business solutions, where he served from July 2007 to May 2009. From July 2002 to July 2007, Mr. Buehler worked at Romacorp, Inc. which operates and franchises more than 200 Tony Roma's casual dining locations, as the Vice President of Marketing and was promoted to Chief Executive Officer, President, and Director of Romacorp during July 2006. Prior to that, Mr. Buehler served as Vice President of Marketing at Eateries, Inc. from March 1999 to July 2002 and Marketing Manager at Applebee's International, Inc. from February 1996 to March 1999. Mr. Buehler also serves as a Board Member of Share Our Strength and is a co-chairperson of the National Restaurant Association's Marketing Executives Group. In addition he is a member of the Young Presidents' Organization.

Mark S. Robinow has served as our Executive Vice President, Chief Financial Officer, and Secretary since October 2004. Prior to joining our company, Mr. Robinow served as the Chief Financial Officer of Integrated Decisions and Systems, Inc. (IDeaS) from July 2000 until October 2004. Mr. Robinow served as the Senior Vice President and Chief Financial Officer of Rainforest Cafe, Inc. from November 1995 until January 2000. Prior to that, Mr. Robinow served as the Chief Financial Officer of Edina Realty, Inc. from 1993 until 1995, and as Chief Financial Officer, Secretary, and Treasurer of Ringer Corporation from 1986 until 1993. Mr. Robinow also served as a senior auditor with Deloitte & Touche from 1980 until 1983. Mr. Robinow is a Certified Public Accountant (inactive license holder).

Larry J. Ryback has served as our Senior Vice President of Operations since February 2010. Mr. Ryback oversees the day-to-day restaurant operations for our brand, culinary operations, training and recruiting. Mr. Ryback brings more than 20 years of restaurant operations experience to our company. Prior to joining our company, Mr. Ryback served as the President and Chief Operating Officer of Redstone American Grill, Inc., a \$35 million privately held company with five high-volume, upscale restaurants in four states. Before joining Redstone during 2005, Mr. Ryback spent 10 years with Champps Entertainment in various operations roles including three years as a Regional Vice President of Operations overseeing 26 restaurants that together generated over \$130 million in revenue.

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Item 1A. Risk Factors

Risks Related to Our Business

We have a history of losses and we may never achieve profitability.

We incurred net losses during each of the last six years. We may find that efforts to achieve profitability are more difficult than we currently anticipate or that our remodel or expansion efforts do not result in proportionate increases in our sales, which would further increase our losses. We cannot predict whether we will be able to achieve profitability in the future.

Our sales and ability to achieve profitability could be adversely affected if comparable restaurant sales increases are less than we expect, and we may not successfully increase comparable restaurant sales.

While future sales growth will depend substantially on opening new restaurants, changes in comparable restaurant sales will also affect our sales growth and will continue to be a critical factor in achieving profitability. This is because the profit margin on comparable restaurant sales is generally higher, as comparable restaurant sales increases enable fixed costs to be spread over a higher sales base. Conversely, declines in comparable restaurant sales can have a significant adverse effect on profitability due to the loss of the higher profit margins associated with comparable restaurant sales. Comparable restaurant sales increased 0.9% during 2010, but had declined 9.3% and 7.2% during 2009 and 2008, respectively. We expect comparable restaurant sales in 2011 to increase at a level greater than that achieved in 2010. However, the impact of ongoing weakness in consumer spending and other factors noted below, may lower our expectations for comparable restaurant sales.

Our ability to increase comparable restaurant sales depends on many factors, including the following:

- changes in consumer preferences and discretionary spending, including weaker consumer spending in difficult economic times, such as those that persisted during 2010;
- consumer understanding and acceptance of the Kona Grill experience;
- our ability to increase menu prices without adversely impacting guest traffic to such a degree that the impact of the decrease in guests equals or exceeds the benefit of the menu price increase;
- executing our strategies effectively, including our menu improvement initiatives and marketing and branding strategies, each of which may not drive an increase in guest traffic;
- weather, road construction and other factors limiting access to our restaurants; and
- changes in government regulation.

A number of these factors are beyond our control. As a result of these factors it is possible that we will not achieve our targeted comparable restaurant sales or that the change in comparable restaurant sales could be negative. If this were to happen, sales and profitability would be adversely affected and our stock price would be likely to decline.

We may require additional capital in the future as a result of changes in our restaurant operations or growth plans, and our inability to raise such capital could harm our operations and restrict our growth.

Changes in our restaurant operations, lower than anticipated restaurant sales, increased food or labor costs, increased property expenses, or other events, including those described in this report, may cause us to seek additional debt or equity financing on an accelerated basis. Financing may not be available to us on acceptable terms, and our failure to raise capital when needed could negatively impact our restaurant growth plans as well as our financial condition and results of operations. Additional equity financing, if available, may be dilutive to the holders of our common stock. Debt financing may involve significant cash payment obligations, covenants, and financial ratios that may restrict our ability to operate and grow our business, and would cause us to incur additional interest expense and financing costs.

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Unexpected expenses and low market acceptance of our restaurant concept could adversely affect the profitability of restaurants that we open in new markets.

As part of our expansion strategy, we have opened and plan to open restaurants in markets in which we have no prior operating experience and in which our brand may not be well-known. These new markets may have different competitive conditions, consumer tastes, and discretionary spending patterns than restaurants in our existing markets. As a result, we may incur costs related to the opening, operation, and promotion of these new restaurants that are greater than those incurred in markets with longer operating history. As a result of these factors, sales at restaurants opening in new markets may take longer to achieve average unit volumes comparable with our existing restaurants, if at all, which would adversely affect the profitability of those new restaurants.

We depend upon high levels of consumer traffic at the sites where our restaurants are located and any adverse change in consumer activity could negatively affect our restaurant sales and may require us to record an impairment charge for restaurants performing below expectations.

Our restaurants are primarily located in high-activity areas such as retail centers, shopping malls, and lifestyle centers. We depend on high consumer traffic rates at these centers to attract guests to our restaurants. In general, such visit frequencies are significantly affected by many factors, including national, regional, or local economic conditions, anchor tenants closing in retail centers or shopping malls in which we operate, changes in consumer preferences or shopping patterns, higher frequency of online shopping, changes in discretionary consumer spending, increasing gasoline prices, or otherwise. If visitor rates to these centers decline, our unit volumes could decline and adversely affect our results of operations, including recording an impairment charge for restaurants that are performing below expectations. During 2009, we recorded \$16.9 million in asset impairment charges for six underperforming restaurants. We may be required to record impairment charges in the future if certain restaurants perform below expectations.

We have a limited operating history and a limited number of restaurants upon which to evaluate our company, and you should not rely on our history as an indication of our future results.

We currently operate 25 restaurants, more than half of which have operated for less than five years. Consequently, the results we have achieved to date with a relatively small number of restaurants may not be indicative of those restaurants' long-term performance or the potential performance of new restaurants. A number of factors historically have affected and are likely to continue to affect our average unit volumes and comparable restaurant sales, including the following:

- our ability to execute effectively our business strategy;
- our ability to successfully select and secure sites for our concept;
- the operating performance of new and existing restaurants;
- competition in our markets;
- consumer trends; and
- changes in political or economic conditions.

Our average unit volume has declined in recent years. Average unit volumes for three of our restaurants opened within the last two years were significantly below the average unit volume of our comparable restaurant base. In addition, we

closed a restaurant in Naples, Florida in September 2008 due to low sales volume. Changes in our average unit volumes and comparable restaurant sales could cause the price of our common stock to fluctuate substantially.

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Disruptions in the capital and credit markets may adversely affect our business, including the availability and cost of funding, which could adversely affect our results of operations, cash flows, and financial condition.

Our growth strategy depends upon the capital markets to expand our operations. Disruptions in the capital and credit markets could adversely affect our ability to borrow money from banks or other potential lenders. Our access to funds under any potential credit facility will depend on the ability of the banks or other lenders to commit to lend funds to us. In the event we enter into a credit facility with banks or other lenders, those parties may not be able to meet their funding commitments to us if they experience shortages of capital or if they experience excessive volumes of borrowing requests from us and other borrowers within a short period of time.

Longer term disruptions in the capital and credit markets as a result of uncertainty, changing or increased regulation, or failures of significant financial institutions could adversely affect our access to capital. Any long-term disruption could require us to take measures to conserve cash until the markets stabilize or until alternative credit arrangements or other funding for our business can be arranged. Such measures could result in deferring capital expenditures or altering our growth strategy to reduce the opening of new restaurants.

Our future expansion in existing markets may cause sales in some of our existing restaurants to decline.

Our future growth strategy includes opening new restaurants in our existing markets. We may be unable to attract enough guests to our new restaurants for them to operate profitably. In addition, guests to our new restaurants may be former guests of one of our existing restaurants in that market, which may reduce guest visits and sales at those existing restaurants, adversely affecting our results of operations.

Our ability to open new restaurants may be adversely affected by delays or problems associated with securing suitable restaurant locations and leases and by other factors, some of which are beyond our control and the timing of which is difficult to forecast accurately.

Due in part to the unique nature of each proposed restaurant location, we cannot predict the timing or ultimate success of our site selection process. Our ability to open new restaurants depends upon a number of factors, many of which are beyond our control, including the following:

- the availability and cost of suitable restaurant locations for development and our ability to compete successfully for those locations;
  - the availability of adequate financing;
  - cash flow generated by our existing restaurants;
- the timing of delivery of leased premises from our landlords so we can commence our build-out construction activities;
  - construction and development costs;
  - labor shortages or disputes experienced by our landlords or outside contractors;
  - unforeseen engineering or environmental problems with the leased premises;
- our ability to secure governmental approvals and permits, including liquor licenses, construction permits, and occupancy permits;

- weather conditions or natural disasters; and
- general economic conditions.

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Our restaurants are subject to natural disasters and other events which are beyond our control and for which we may not be able to obtain insurance at reasonable rates.

We endeavor to insure our restaurants against wind, flood, and other disasters, but we may not be able to obtain insurance for these types of events for all of our restaurants at reasonable rates. A devastating natural disaster or other event in the vicinity of one of our restaurants could result in substantial losses and have a material adverse affect on our results of operations.

If our distributors or suppliers do not provide food and beverages to us in a timely fashion, we may experience short-term supply shortages and increased food and beverage costs.

We currently use a national food distribution service company and other regional distributors to provide food and beverage products to all of our restaurants. If our suppliers cease doing business with us, we could experience short-term supply shortages in some or all of our restaurants and could be required to purchase food and beverage products at higher prices until we are able to secure an alternative supply source. In addition, any delay in replacing suppliers or distributors on acceptable terms could, in extreme cases, require us to remove temporarily items from the menus of one or more of our restaurants, which also could adversely affect our business.

Our failure to protect our trademarks, service marks, or trade secrets could negatively affect our competitive position and the value of the Kona Grill brand.

Our business prospects depend in part on our ability to develop favorable consumer recognition of the Kona Grill name. Although Kona Grill is a federally registered trademark, our trademarks and service marks could be imitated in ways that we cannot prevent. Alternatively, third parties may attempt to cause us to change our name or not operate in a certain geographic region if our name is confusingly similar to their name. In addition, we rely on trade secrets, proprietary know-how, concepts, and recipes. Our methods of protecting this information may not be adequate. Moreover, we may face claims of misappropriation or infringement of third parties' rights that could interfere with our use of this information. Defending these claims may be costly and, if unsuccessful, may prevent us from continuing to use this proprietary information in the future, and may result in a judgment or monetary damages. We do not maintain confidentiality and non-competition agreements with all of our executives, key personnel, or suppliers. If competitors independently develop or otherwise obtain access to our trade secrets, proprietary know-how, or recipes, the appeal of our restaurants could be reduced and our business could be harmed.

### Risks Related to the Restaurant Industry

Changes in food and supply costs could adversely affect our results of operations.

Our profitability depends in part on our ability to anticipate and react to changes in food and supply costs. Like all restaurant companies, we are susceptible to increases in food costs as a result of factors beyond our control, such as adverse weather conditions, demand, food safety concerns, government regulations, product recalls and seasonality. We currently do not purchase seafood, poultry, beef, or produce pursuant to long-term contracts or use financial management strategies to reduce our exposure to price fluctuations. Approximately 30% of our sales are seafood and fish for which we are not able to contract for future supply or pricing. Changes in the price or availability of certain types of seafood, poultry, beef, grains, or produce could affect our ability to offer a broad menu and price offering to guests and could reduce our operating margins and adversely affect our results of operations. We may not be able to anticipate and react to changing food costs through our purchasing practices and menu price adjustments in the future, and failure to do so could negatively impact our sales and results of operations.



Regulations affecting the operation of our restaurants could increase operating costs, restrict our growth, or require us to suspend operations.

Each of our restaurants must obtain licenses from regulatory authorities allowing it to sell liquor, beer, and wine, and each restaurant must obtain a food service license from local health authorities. Each restaurant's liquor license must be renewed annually and may be revoked or suspended at any time for cause, including violation by us or our employees of any laws and regulations relating to the minimum drinking age, over serving, advertising, wholesale purchasing, and inventory control. Each restaurant is also subject to local health inspections. Failure to pass one or multiple inspections may result in temporary or permanent suspension of operations and could significantly impact our reputation. In certain states, including states where we have existing restaurants or where we may open restaurants in the future, the number of liquor licenses available is limited and licenses are traded at market prices. Liquor, beer, and wine sales comprise a significant portion of our sales, representing 31% of our sales during 2010. Therefore, if we are unable to maintain our existing licenses, or if we choose to open a restaurant in those states, the cost of a new license could be significant. Obtaining and maintaining licenses is an important component of each of our restaurant's operations, and the failure to obtain or maintain food and liquor licenses and other required licenses, permits, and approvals would adversely impact our restaurants and our growth strategy.

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Negative publicity surrounding our restaurants or the consumption of beef, seafood, poultry, or produce generally, or shifts in consumer tastes, could negatively impact the popularity of our restaurants, our sales, and our results of operations.

The popularity of our restaurants in general, and our menu offerings in particular, are key factors to the success of our operations. Negative publicity resulting from poor food quality, illness, injury, or other health concerns, whether related to one of our restaurants or to the beef, seafood, poultry, or produce industries in general (such as negative publicity concerning salmonella, e-coli, Hepatitis A, mercury poisoning and other food-borne illnesses), or operating problems related to one or more of our restaurants, could make our brand and menu offerings less appealing to consumers. In addition, other shifts in consumer preferences away from the kinds of food we offer, whether because of dietary or other health concerns or otherwise, would make our restaurants less appealing and adversely affect our sales and results of operations. If our restaurants are unable to compete successfully with other restaurants in new and existing markets, our results of operations will be harmed and we may not achieve profitability.

Litigation concerning our food quality, employment practices, liquor liability, and other issues could result in significant expenses to us and could divert resources from our operations.

Like other restaurants, we may receive complaints or litigation from, and potential liability to, our guests involving food-borne illness or injury or other operational issues. We may also be subject to complaints or allegations from, and potential liability to, our former, existing, or prospective employees involving our restaurant employment practices and procedures. In addition, we are subject to state “dram shop” laws and regulations, which generally provide that a person injured by an intoxicated person may seek to recover damages from an establishment that wrongfully served alcoholic beverages to such person. Recent litigation against restaurant chains has resulted in significant judgments, including punitive damages, under “dram shop” statutes. While we carry liquor liability coverage as part of our existing comprehensive general liability insurance, we may still be subject to a judgment in excess of our insurance coverage and we may not be able to obtain or continue to maintain such insurance coverage at reasonable costs, if at all. Regardless of whether any claims against us are valid or whether we are liable, our sales may be adversely affected by publicity resulting from such claims. Such claims may also be expensive to defend and may divert time and money away from our operations and adversely affect our business.

Labor shortages or increases in labor costs could slow our growth or adversely affect our business.

Our success depends in part on our ability to attract, motivate, and retain a sufficient number of qualified employees, including restaurant general managers and kitchen managers, necessary to continue our operations. This ability is especially critical to our company because of our relatively small number of existing restaurants. If we are unable to recruit and retain a sufficient number of qualified employees, our business and growth strategy could be adversely affected.

Competition for qualified restaurant employees in current or prospective markets could require us to pay higher wages and benefits, which could result in higher labor costs. In addition, we have a substantial number of hourly employees who are paid rates based upon the federal or state minimum wage and who rely on tips for a significant portion of their income. Government-mandated increases in minimum wages, overtime pay, health benefits, or increased tax reporting and tax payment requirements for employees who receive gratuities, or a reduction in the number of states that allow tips to be credited toward minimum wage requirements, could increase our labor costs. We may be unable to increase our prices proportionately in order to pass these increased costs on to our guests, in which case our operating margins would be adversely affected.



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Risks Related to Ownership of Our Common Stock

The market price for our common stock may be volatile.

Many factors could cause the market price of our common stock to rise and fall, including the following:

- actual or anticipated variations in comparable restaurant sales or operating results; whether in our operations or those of our competitors;
  - changes in the consumer spending environment or general economic conditions;
  - changes in the market valuations of other companies in the restaurant industry;
  - recruitment or departure of key restaurant operations or management personnel;
- changes in the estimates of our operating performance or changes in recommendations by any research analysts that follow our stock; and
  - announcements of investigations or regulatory scrutiny of restaurant operations or lawsuits filed against us.

We are a party to a securities complaint alleging breach of fiduciary duty by our board of directors. We also may become the target of additional securities litigation. Securities litigation could result in substantial costs and divert our attention and resources from the business as well as depress the price of our common stock.

Our current principal stockholders own a large percentage of our voting stock, which allows them to control substantially all matters requiring stockholder approval.

Five entities or persons together own approximately 52% of our outstanding common stock, including three of our directors. As a result, these investors may have significant influence over a decision to enter into any corporate transaction and may have the ability to prevent any transaction that requires the approval of stockholders, regardless of whether or not our other stockholders believe that such transaction is in their own best interests. Such concentration of voting power could have the effect of delaying, deterring, or preventing a change of control or other business combination, which could in turn have an adverse effect on the market price of our common stock or prevent our stockholders from realizing a premium over the then-prevailing market price for their shares of common stock.

The large number of shares eligible for public sale and registered for resale could depress the market price of our common stock.

The market price for our common stock could decline as a result of sales of a large number of shares of our common stock in the market, and the perception that these sales could occur may depress the market price. As of December 31, 2010, we had outstanding 9,186,795 shares of common stock, all of which shares are either freely tradable or otherwise eligible for sale under Rule 144 under the Securities Act of 1933. In addition, we have approximately 1,540,000 shares available for issuance under our stock award and employee stock purchase plans. We have filed registration statements under the securities laws to register the common stock to be issued under these plans. As a result, shares issued under these plans will be freely tradable without restriction unless acquired by affiliates of our company, who will be subject to the volume and other limitations of Rule 144.



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Provisions in our certificate of incorporation, our bylaws, and Delaware law could make it more difficult for a third party to acquire us, discourage a takeover, and adversely affect existing stockholders.

Our certificate of incorporation, our bylaws, and the Delaware General Corporation Law contain provisions that may have the effect of making more difficult, delaying, or deterring attempts by others to obtain control of our company, even when these attempts may be in the best interests of stockholders. These include provisions on our maintaining a classified Board of Directors and limiting the stockholders' powers to remove directors or take action by written consent instead of at a stockholders' meeting. Our certificate of incorporation also authorizes our Board of Directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of common stock. Delaware law also imposes conditions on the voting of "control shares" and on certain business combination transactions with "interested stockholders."

These provisions and others that could be adopted in the future could deter unsolicited takeovers or delay or prevent changes in our control or management, including transactions in which stockholders might otherwise receive a premium for their shares over then current market prices. These provisions may also limit the ability of stockholders to approve transactions that they may deem to be in their best interests.

Since we do not expect to pay any dividends for the foreseeable future, holders of our common stock may be forced to sell their stock in order to obtain a return on their investment.

We do not anticipate that we will pay any dividends to holders of our common stock in the foreseeable future. Instead, we plan to reinvest any earnings to finance our restaurant operations and growth plans. Accordingly, stockholders must rely on sales of their common stock after price appreciation, which may never occur, as the only way to realize any return on their investment. As a result, investors seeking cash dividends should not purchase our common stock.

Item 1B.

Unresolved Staff Comments

Not applicable.

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## Item 2. Properties

We currently operate 25 restaurants in 16 states. Each of our restaurants and our support center are located in a leased facility. As of December 31, 2010, our restaurant leases had expiration dates ranging from 2013 to 2029, typically with options to renew for at least a five-year period. We do not anticipate any difficulties renewing existing leases as they expire. The following table sets forth our current restaurant locations.

State	City	Location	Year Opened	Square Footage	Number of Seats (1)
Arizona	Scottsdale	Scottsdale Fashion Square	1998	5,964	274
Arizona	Chandler	Chandler Fashion Center	2001	7,389	326
Missouri	Kansas City	Country Club Plaza	2002	7,455	248
Nevada	Las Vegas	Boca Park Fashion Village	2003	7,380	295
Colorado	Denver	Cherry Creek Mall	2004	5,920	243
Nebraska	Omaha	Village Pointe	2004	7,415	304
Indiana	Carmel	Clay Terrace	2004	7,433	295
Texas	Sugar Land	First Colony Mall	2005	7,127	285
Texas	San Antonio	The Shops at La Cantera	2005	7,200	256
Texas	Dallas	North Park Mall	2006	6,872	299
Illinois	Lincolnshire	Lincolnshire Commons	2006	7,020	305
Texas	Houston	Houston Galleria	2006	7,459	315
Illinois	Oak Brook	Oak Brook Promenade	2006	6,999	298
Texas	Austin	The Domain	2007	6,890	298
Michigan	Troy	Big Beaver Road	2007	7,000	280
Connecticut	Stamford	Stamford Town Center	2007	7,654	305
Louisiana	Baton Rouge	Perkins Rowe	2007	6,900	260
Arizona	Gilbert	San Tan Village	2008	6,770	259
Florida	West Palm Beach	CityPlace	2008	6,750	243
Arizona	Phoenix	CityNorth	2008	7,510	368
Virginia	Richmond	West Broad Village	2009	7,000	282
New Jersey	Woodbridge	Woodbridge Conference Center	2009	7,000	280
Minnesota	Eden Prairie	Windsor Plaza	2009	7,000	310
Florida	Tampa	MetWest International	2009	7,500	338
Maryland	Baltimore	Downtown Baltimore	2010	6,972	280

(1) Number of seats includes dining room, patio seating, sushi bar, bar, and private dining room (where applicable).

## Item 3. Legal Proceedings

We are involved in various legal proceedings arising out of our operations in the ordinary course of business. We do not believe that such proceedings, even if determined adversely, will have a material adverse effect on our business, financial condition, or results of operations.

## Stockholder Derivative Action

On February 6, 2009, Samuel Beren (“Beren” or “plaintiff”), as trustee for the Samuel Beren Trust, served a demand on us pursuant to Section 220 of Delaware’s General Corporation Law (the “DGCL”), which requested that we make available

for inspection certain books and records. During April 2009, Beren, as trustee for the Samuel Beren Trust, commenced a purported stockholder derivative action in the Court of Chancery of the State of Delaware. The derivative action purportedly was brought on behalf of us against our directors and the purchasers of our promissory notes issued during March 2009, for alleged breaches of fiduciary duties by our directors, and for aiding and abetting such breaches by the purchasers of our promissory notes. We also were named as a nominal defendant in the derivative action. The derivative action seeks unspecified damages, interest, reasonable attorneys' fees, expert witness fees, and other costs.



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During June 2009, the director defendants filed a motion to dismiss the derivative action. Separately, during October 2009, plaintiff served a demand on us pursuant to Section 220 of the DGCL, which requested that we make available for inspection certain books and records. During January 2010, we produced books and records in response to the October 26, 2009 demand. Two days later, plaintiff commenced a separate action against us, which sought the production of the books and records requested in plaintiff's February 6, 2009 and October 26, 2009 demand letters. During March 2010, the court granted a stay in the derivative action until the books and records action was resolved. During July 2010, we produced books and records in response to the February 6, 2009 demand, which production was covered by a confidentiality agreement executed between us and Beren. On February 18, 2011, the court dismissed the books and records action with prejudice.

During February 2011, the plaintiff filed an amended complaint including a claim for corporate waste. We are evaluating the amended complaint and will determine the proper response to such amended complaint. We continue to believe that the purported derivative action, as amended, is without merit, and we intend to defend vigorously this lawsuit.

Item 4. Removed and Reserved

## PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

## Market Information

Our common stock has traded on the NASDAQ Global Market under the symbol KONA since our initial public offering on August 16, 2005. The following table sets forth high and low sale prices of our common stock for each calendar quarter indicated as reported on the NASDAQ Global Market.

	High	Low
2010		
First quarter	\$ 3.88	\$ 2.85
Second quarter	\$ 5.62	\$ 3.41
Third quarter	\$ 4.16	\$ 3.00
Fourth quarter	\$ 4.80	\$ 3.25
2009		
First quarter	\$ 3.25	\$ 1.42
Second quarter	\$ 4.34	\$ 1.17
Third quarter	\$ 4.15	\$ 3.16
Fourth quarter	\$ 3.59	\$ 2.32

On February 28, 2011, the closing sale price of our common stock was \$5.23 per share. On February 28, 2011, there were 26 holders of record of our common stock.

## Dividend Policy

We have not paid any dividends to holders of our common stock since our initial public offering and do not anticipate that we will pay any dividends to holders of our common stock in the foreseeable future, but instead we currently plan to retain any earnings to finance our restaurant operations and the growth of our business. Payments of any cash dividends in the future, however, is within the discretion of our Board of Directors and will depend on our financial

condition, results of operations, and capital and legal requirements as well as other factors deemed relevant by our Board of Directors.

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PERFORMANCE GRAPH

In 2010, we changed our peer group to include the following companies: McCormick & Schmick's Seafood Restaurants, Inc.; Benihana, Inc.; Granite City Food & Brewery Ltd.; and J. Alexander's Corporation. We believe that the companies included in the New Peer Group are more reflective of similar sized companies in terms of market capitalization and sales and therefore will provide a more meaningful comparison of stock performance. Previously our peer group consisted of the following companies: P.F. Chang's China Bistro, Inc.; The Cheesecake Factory Incorporated; McCormick & Schmick's Seafood Restaurants, Inc.; Benihana, Inc.; BJ's Restaurants, Inc.; Granite City Food & Brewery Ltd.; and J. Alexander's Corporation (Old Peer Group).

The graph assumes an investment of \$100 on December 31, 2005. The calculations of cumulative stockholder return for the NASDAQ Composite (U.S.) Index, the New Peer Group and the Old Peer Group include reinvestment of dividends, if any, is assumed. The performance shown is not necessarily indicative of future performance. This graph is not "soliciting material," is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference in any of our filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing. The following line graph compares cumulative total stockholder returns for the period from December 31, 2005 through December 31, 2010 for (1) our common stock; (2) the NASDAQ Composite (U.S.) Index; (3) the New Peer Group; and (4) the Old Peer Group.

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## Item 6. Selected Financial Data

The following selected consolidated financial data has been derived from audited financial statements and should be read in conjunction with the consolidated financial statements and notes thereto and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

	Year Ended December 31,				
	2010	2009	2008	2007	2006
	(In thousands, except per share data)				
<b>Consolidated Statement of Operations Data:</b>					
Restaurant sales	\$87,589	\$81,095	\$75,815	\$69,521	\$50,322
Costs and expenses:					
Cost of sales	23,850	21,058	20,730	19,600	14,320
Labor	30,652	28,517	25,396	21,554	15,555
Occupancy	7,099	6,457	5,157	4,465	3,363
Restaurant operating expenses	14,179	13,156	11,314	9,479	6,875
General and administrative	7,072	8,200	8,416	7,294	7,155
Preopening expense	567	1,685	2,073	1,962	1,971
Depreciation and amortization	5,666	7,314	6,547	5,428	3,906
Asset impairment charge	—	16,915	3,219	—	—
Total costs and expenses	89,085	103,302	82,852	69,782	53,145
Loss from operations	(1,496 )	(22,207 )	(7,037 )	(261 )	(2,823 )
Nonoperating expenses:					
Interest income and other, net	52	204	296	617	936
Interest expense	(123 )	(174 )	(51 )	(85 )	(294 )
(Loss) income from continuing operations before provision for income taxes	(1,567 )	(22,177 )	(6,792 )	271	(2,181 )
Provision for income taxes	10	65	205	406	60
Loss from continuing operations	(1,577 )	(22,242 )	(6,997 )	(135 )	(2,241 )
Gain (loss) from discontinued operations (1)	—	690	(3,504 )	(534 )	(503 )
Net loss	\$(1,577 )	\$(21,552 )	\$(10,501 )	\$(669 )	\$(2,744 )
Net (loss) income per share — Basic and Diluted:					
Continuing operations	\$(0.17 )	\$(2.57 )	\$(0.87 )	\$(0.02 )	\$(0.31 )
Discontinued operations	—	.08	(0.43 )	(0.07 )	(0.07 )
Net loss	\$(0.17 )	\$(2.49 )	\$(1.30 )	\$(0.09 )	\$(0.38 )
Weighted average shares outstanding:					
Basic	9,167	8,645	8,054	7,364	7,128
Diluted	9,167	8,645	8,054	7,364	7,128
<b>Balance Sheet Data (end of period):</b>					
Cash and cash equivalents	\$2,555	\$2,404	\$2,477	\$4,991	\$1,934
Investments	174	6,282	6,861	14,188	14,249
Working capital (deficit)	(4,878 )	(5,054 )	(7,653 )	13,656	9,142
Total assets	42,060	49,963	65,554	69,474	58,796
Total debt	636	7,120	4,525	2,700	3,313
Total stockholders' equity	16,989	17,983	35,598	46,431	35,822

(1) As a result of our decision to close our Naples, Florida restaurant during September 2008, the results of operations from this restaurant (including related asset impairment, lease obligation, and restaurant-level closing costs) are classified as discontinued operations for all periods presented as discussed further in Note 2 to our consolidated financial statements.

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

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related notes contained elsewhere in this report. This discussion contains forward-looking statements that involve risks, uncertainties, and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of a variety of factors, including those set forth under Item 1A, "Risk Factors" and elsewhere in this report.

Overview

We currently own and operate 25 restaurants located in 16 states. We offer freshly prepared food, attentive 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. We believe that our diverse menu and generous portions, combined with an average check of approximately \$23 per guest, 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 and 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.

Despite the continued weakness in the U.S. economy, we were able to achieve a modest increase in our comparable restaurant sales of 0.9% in 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 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 and up 6.4% during the fourth 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 of \$16.9 million 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.

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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 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.

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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 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 2010, 2009, and 2008.

	Year Ended December 31,					
	2010	2009		2008		
Restaurant sales growth	8.0	%	7.0	%	9.1	%
Same-store sales percentage change(1)	0.9	%	(9.3	)%	(7.2	)%
Average unit volume (in thousands)(2)	\$3,771		\$3,815		\$4,279	
Sales per square foot (2)	\$535		\$541		\$608	
Restaurant operating profit (in thousands) (3)	\$11,809		\$11,907		\$13,218	
Restaurant operating profit as a percentage of sales (3)	13.5	%	14.7	%	17.4	%

(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) 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.

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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.

	Year Ended December 31,		
	2010	2009	2008
	(In thousands)		
Restaurant sales	\$ 87,589	\$ 81,095	\$ 75,815
Costs and expenses:			
Cost of sales	23,850	21,058	20,730
Labor	30,652	28,517	25,396
Occupancy	7,099	6,457	5,157
Restaurant operating expenses	14,179	13,156	11,314
Restaurant operating profit	11,809	11,907	13,218
Deduct – other costs and expenses			
General and administrative	7,072	8,200	8,416
Preopening expense	567	1,685	2,073
Depreciation and amortization	5,666	7,314	6,547
Asset impairment charge	—	16,915	3,219
Loss from operations	\$ (1,496 )	\$ (22,207 )	\$ (7,037 )

	Percent of Restaurant Sales					
	2010		2009		2008	
Restaurant sales	100.0	%	100.0	%	100.0	%
Costs and expenses:						
Cost of sales	27.2		26.0		27.3	
Labor	35.0		35.2		33.5	
Occupancy	8.1		8.0		6.8	
Restaurant operating expenses	16.2		16.2		14.9	
Restaurant operating profit	13.5		14.7		17.4	
Deduct – other costs and expenses						
General and administrative	8.1		10.1		11.1	
Preopening expense	0.6		2.1		2.7	
Depreciation and amortization	6.5		9.0		8.6	
Asset impairment charge	—		20.9		4.2	
Loss from operations	(1.7	)%	(27.4	)%	(9.3	)%

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

	Year Ended December 31,		
	2010	2009	2008
Store Growth Activity			
Beginning			
Restaurants	24	20	18
Openings	1	4	3
Closings	—	—	(1 )
Total	25	24	20



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## Results of Operations

The following table sets forth, for the years indicated, our Consolidated Statements of Operations expressed as a percentage of restaurant sales.

	Year Ended December 31,					
	2010		2009		2008	
Restaurant sales	100.0	%	100.0	%	100.0	%
Costs and expenses:						
Cost of sales	27.2		26.0		27.3	
Labor	35.0		35.2		33.5	
Occupancy	8.1		8.0		6.8	
Restaurant operating expenses	16.2		16.2		14.9	
General and administrative	8.1		10.1		11.1	
Preopening expense	0.6		2.1		2.7	
Depreciation and amortization	6.5		9.0		8.6	
Asset impairment charge	-		20.9		4.2	
Total costs and expenses	101.7		127.4		109.3	
Loss from operations	(1.7	)	(27.4	)	(9.3	)
Nonoperating expenses:						
Interest income and other, net	0.1		0.3		0.4	
Interest expense	(0.1	)	(0.2	)	(0.1	)
Loss from continuing operations before provision for income taxes	(1.8	)	(27.3	)	(9.0	)
Provision for income taxes	-		0.1		0.3	
Loss from continuing operations	(1.8	)	(27.4	)	(9.3	)
Gain (loss) from discontinued operations, net of tax	-		0.8		(4.6	)
Net loss	(1.8	)%	(26.6	)%	(13.9	)%

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

## Year Ended December 31, 2010 Compared with Year Ended December 31, 2009

**Restaurant Sales.** Restaurant sales increased by \$6.5 million, or 8.0% to \$87.6 million in 2010 from \$81.1 million during the prior year, primarily attributable to restaurant sales from the opening of four new restaurants since April 2009 and a 0.9% increase in comparable restaurant sales. The increase in comparable restaurant sales is attributable to a 6% increase in guest traffic during 2010, partially offset by lower average guest check, which we believe was a result of the current macroeconomic environment and weak consumer confidence.

**Cost of Sales.** Cost of sales increased \$2.8 million, or 13.3% to \$23.9 million during 2010 from \$21.1 million during 2009. Cost of sales as a percentage of restaurant sales increased 1.2% to 27.2% during 2010 from 26.0% during the prior year period. The increase in cost of sales as a percentage of restaurant sales during 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 food and beverage based marketing programs launched during 2010.

**Labor.** Labor costs for our restaurants increased \$2.1 million, or 7.5% to \$30.6 million during 2010 from \$28.5 million during the prior year period. The increase was primarily the result of the opening of four new restaurants since April 2009. As a percentage of restaurant sales, labor costs decreased 0.2% to 35.0% during 2010 from 35.2% during

2009. The slight decrease in labor costs as a percentage of restaurant sales was primarily the result of leverage of fixed management wages, hourly labor expense, and benefit costs resulting from the increase in comparable restaurant sales.

Occupancy. Occupancy expense increased by \$0.6 million, or 9.9% to \$7.1 million in 2010 compared to \$6.5 million during the prior year period. Occupancy expenses as a percentage of restaurant sales increased 0.1% to 8.1% during 2010 from 8.0% during 2009.

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**Restaurant Operating Expenses.** Restaurant operating expenses increased by \$1.0 million, or 7.8% to \$14.2 million during 2010 compared to \$13.2 million during the prior year period. Restaurant operating expenses as a percentage of restaurant sales were flat at 16.2% in both 2010 and 2009. During 2010, we incurred higher marketing, training and relocation costs and personal property taxes as a percentage of restaurant sales; however, these costs were offset by lower repair and maintenance and restaurant services fees as a percentage of sales.

**General and Administrative.** General and administrative expenses decreased \$1.1 million, or 13.8% to \$7.1 million during 2010 compared to \$8.2 million during 2009. The decrease in general and administrative expenses during 2010 is primarily attributable to a reduction in severance and other special charges. During 2010, we incurred \$0.5 million for legal and professional fees associated with the contested proxy solicitation and ongoing derivative suit compared to 2009 when we recorded approximately \$1.6 million in special charges. These charges included \$0.8 million in severance and related benefits for two executive officers, \$0.6 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 2.0% to 8.1% of restaurant sales during 2010 compared to 10.1% of restaurant sales during the prior year period.

**Preopening Expense.** Preopening expense decreased \$1.1 million to \$0.6 million during 2010 compared to \$1.7 million during 2009. The decrease in preopening expense is attributable to four restaurant openings during 2009 compared to 2010 when preopening expenses were incurred for one restaurant opened in Baltimore, Maryland.

**Depreciation and Amortization.** Depreciation and amortization expense decreased \$1.6 million, or 22.5% to \$5.7 million during 2010 from \$7.3 million during the prior year period. The decrease is primarily the result of a \$2.3 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 four restaurants that opened since April 2009. Depreciation and amortization expense as a percentage of restaurant sales decreased 2.5% to 6.5% during 2010 from 9.0% during the prior year period.

**Interest Income and Other, Net.** Interest income and other, net decreased during 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.

**Interest Expense.** Interest expense decreased during 2010 as compared to 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 2010, we recorded a \$10,000 provision for income taxes compared to \$65,000 during the prior year period. The provision for 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.

**Year Ended December 31, 2009 Compared with Year Ended December 31, 2008**

**Restaurant Sales.** Restaurant sales increased \$5.3 million, or 7.0% to \$81.1 million during 2009 from \$75.8 million during 2008. The increase in sales is primarily attributable to restaurant sales generated from the opening of seven new restaurants since June 2008, partially offset by overall traffic declines at our comparable restaurant sales base resulting from the weak U.S. economy, high unemployment rates, and reduced consumer spending. Higher menu pricing of approximately 2.0% was more than offset by reduced guest traffic and a decline in the average guest check as comparable restaurant sales declined 9.3% during 2009.

Cost of Sales. Cost of sales increased \$0.3 million, or 1.6% to \$21.0 million during 2009 from \$20.7 million during 2008. Cost of sales as a percentage of restaurant sales decreased 1.3% to 26.0% during 2009 from 27.3% during the prior year period. Cost of sales during 2009 was positively affected by favorable year-over-year pricing on certain proteins and produce products and operating efficiencies attributed to the rollout of an automated food cost and inventory management system that was completed during July 2008.



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**Labor.** Labor costs for our restaurants increased \$3.1 million, or 12.3% to \$28.5 million during 2009 from \$25.4 million during the prior year period. The increase was primarily due to the opening of seven new restaurants since June 2008. As a percentage of restaurant sales, labor costs increased 1.7% to 35.2% during 2009 from 33.5% during 2008. The increase in labor costs as a percentage of restaurant sales was primarily due to reduced leverage of fixed labor costs and hourly labor expense resulting from lower average weekly sales. In addition, high labor costs from restaurants opened during the year also contributed to the increase in labor expense as labor expenses are typically higher than normal during the first several months of operations. Federal and state minimum wage increases, implemented during the second half of 2008 and during 2009, also contributed to increased labor costs as a percentage of sales.

**Occupancy.** Occupancy expense increased by \$1.3 million, or 25.2% to \$6.5 million during 2009 from \$5.2 million during the prior year period. Occupancy expenses as a percentage of restaurant sales increased 1.2% to 8.0% during 2009 from 6.8% during 2008. The increase reflects increased common area maintenance allocations at many locations, reduction in deferred rent credits at several locations with rent concessions, and 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 \$1.8 million, or 16.3% to \$13.1 million during 2009 from \$11.3 million during the prior year period. Restaurant operating expenses as a percentage of restaurant sales increased 1.3% to 16.2% during 2009 from 14.9% during the prior year period. During 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 decreased \$0.2 million, or 2.6% to \$8.2 million during 2009 compared to \$8.4 million during 2008. The decrease is primarily attributable to lower salary and benefit costs resulting from the January 2009 downsizing and realignment of certain corporate office staff and lower expenditures attributable to cost containment efforts, partially offset by \$1.6 million in special charges including \$0.8 million in severance and related benefits associated with the resignation of two executive officers, \$0.6 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, Maryland restaurant expected to open in 2010. General and administrative expenses as a percentage of restaurant sales decreased 1.0% to 10.1% of restaurant sales during 2009 compared to 11.1% of restaurant sales during the prior year period.

**Preopening Expense.** Preopening expense decreased \$0.4 million, or 18.7% to \$1.7 million during 2009 compared to \$2.1 million during 2008. The decrease in preopening expense is attributable to the timing of new restaurant openings. During 2009, there were four restaurant openings compared to three new restaurants during 2008; however \$0.5 million of expenses were incurred during 2008 for the four restaurants opened during 2009.

**Depreciation and Amortization.** Depreciation and amortization expense increased \$0.8 million, or 11.7% to \$7.3 million during 2009 from \$6.5 million during the prior year period. The increase was primarily attributable to seven restaurants opened since June 2008, partially offset by a reduction of \$0.5 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 9.0% during 2009 from 8.6% during 2008 reflecting decreased leverage from lower average weekly sales.

**Asset Impairment Charge.** During 2009, we recorded non-cash asset impairment charges of \$16.9 million related to the write-down of the carrying value of long-lived assets associated with six underperforming restaurants that have not been meeting sales, profitability, and cash flow targets. The asset impairment charges were based upon an assessment of each restaurant's historical operating performance combined with expected cash flows for these restaurants over the

respective remaining lease term. During 2008, we recorded non-cash asset impairment charges of \$3.2 million for one restaurant. We have no plans to close any of these restaurants; however, we will continue to evaluate each of these restaurants to determine whether operating performance can be improved.

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Interest Income and Other, Net. Interest income and other, net decreased \$0.1 million during 2009 compared to the prior year period due to lower interest rates received and lower investment balances. Please refer to Note 3 to the 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. Interest expense for 2009 includes \$70,000 for amortization of the debt discount associated with warrants issued to the noteholders that was charged to interest expense.

Provision for Income Taxes. During 2009, we recorded income taxes of \$65,000 primarily for states in which income taxes are not calculated based upon net income compared to \$205,000 during 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 during 2008 when the restaurant was closed. During 2008, we recorded a loss of \$3.5 million for asset impairment and lease obligations, along with the sales, costs and expenses attributable to this restaurant.

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;
- fluctuations in commodity and food protein prices;
- 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;
  - settlements, damages and legal costs associated with litigation;
  - new or revised regulatory requirements and accounting pronouncements; and
  - changes in consumer preferences and competitive conditions.

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## Quarterly Results of Operations

The following table presents unaudited consolidated statement of operations data for each of the eight quarters in the period ended December 31, 2010. We believe that all necessary adjustments have been included to present fairly the quarterly information when read in conjunction with our annual financial statements and related notes. The operating results for any quarter are not necessarily indicative of the results for any subsequent quarter.

	Quarter Ended							
	2010		2009		2009		2009	
	March 31	June 30	Sept. 30	Dec. 31	March 31	June 30	Sept. 30	Dec. 31
(In thousands, except per share data)								
Consolidated Statement of Operations Data:								
Restaurant sales	\$ 21,052	\$ 22,686	\$ 21,605	\$ 22,246	\$ 19,455	\$ 21,468	\$ 20,173	\$ 19,999
Costs and expenses:								
Cost of sales	5,575	6,014	5,936	6,325	5,097	5,461	5,267	5,233
Labor	7,583	7,782	7,535	7,752	6,749	7,269	7,117	7,382
Occupancy	1,781	1,769	1,777	1,772	1,520	1,536	1,655	1,746
Restaurant operating expenses	3,456	3,418	3,582	3,723	3,030	3,242	3,296	3,588
General and administrative	2,137	1,873	1,446	1,616	1,887	2,661	1,590	2,062
Preopening expense	8	119	382	58	500	352	480	353
Depreciation and amortization	1,399	1,395	1,384	1,488	1,741	1,812	1,820	1,941
Asset impairment charge	—	—	—	—	—	—	—	16,915
Total costs and expenses	21,939	22,370	22,042	22,734	20,524	22,333	21,225	39,220
(Loss) income from operations	(887 )	316	(437 )	(488 )	(1,069 )	(865 )	(1,052 )	(19,221)
Nonoperating expenses:								
Interest income and other, net	22	29	—	1	48	77	44	35
Interest expense	(42 )	(73 )	(4 )	(4 )	(32 )	(99 )	(22 )	(21 )
(Loss) income from continuing operations before provision for income taxes	(907 )	272	(441 )	(491 )	(1,053 )	(887 )	(1,030 )	(19,207)
Provision for income taxes	—	10	—	—	30	30	5	—
	(907 )	262	(441 )	(491 )	(1,083 )	(917 )	(1,035 )	(19,207)

(Loss) income from continuing operations									
(Loss) gain from discontinued operations	—	—	—	—	(13 )	703	—	—	
Net (loss) income	\$ (907 )	\$ 262	\$ (441 )	\$ (491 )	\$ (1,096 )	\$ (214 )	\$ (1,035 )	\$ (19,207)	
Net (loss) income per share – Basic and diluted:									
Continuing operations	\$ (0.10 )	\$ 0.03	\$ (0.05 )	\$ (0.05 )	\$ (0.14 )	\$ (0.11 )	\$ (0.11 )	\$ (2.10 )	
Discontinued operations	—	—	—	—	—	0.08	—	—	
Net (loss) income	\$ (0.10 )	\$ 0.03	\$ (0.05 )	\$ (0.05 )	\$ (0.14 )	\$ (0.03 )	\$ (0.11 )	\$ (2.10 )	
Weighted average shares outstanding:									
Basic	9,155	9,165	9,168	9,180	8,016	8,278	9,141	9,144	
Diluted	9,155	9,265	9,168	9,180	8,016	8,278	9,141	9,144	

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## 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 restaurant 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):

	December 31, 2010	December 31, 2009
Cash and short-term investments(1)	\$ 2,729	\$ 2,890
Net working capital (deficit)(2)	(4,878 )	(5,054 )

(1) At December 31, 2009, cash and short-term investments exclude \$5.8 million in auction rate securities that were used as collateral for a line of credit. Proceeds from the sale of auction rate securities were used to reduce the outstanding balance on the line of credit. During 2010, the auction rate securities were sold at par value and the line of credit was repaid.

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

	2010	2009
Cash provided by operating activities	\$ 4,718	\$ 5,341
Capital expenditures	4,318	12,021

## 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 \$2.7 million in addition to cash flow from operations is sufficient

to fund planned remodels of existing restaurants. Any reduction of our cash flow from operations may cause a delay or cancellation of future restaurant development or remodels of existing restaurants. As of December 31, 2010, we had a working capital deficit of \$4.9 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.

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### Bridge Loan

On March 6, 2009, and as amended on April 7, 2009, we entered into a Note and Warrant Purchase Agreement with certain accredited investors whereby we sold \$1.2 million aggregate principal amount of 10% unsecured subordinated 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 our 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 holders of the notes 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 Note and Warrant Purchase Agreement, we filed with the SEC a registration statement on Form S-3 to conduct a rights offering with targeted gross proceeds to us of \$3,520,000 pursuant to which each of our stockholders 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 holders 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 holders of subscription rights granted under the rights offering. We sold 2,608,045 shares of common stock pursuant to the rights offering and received net proceeds of \$3,245,000 after deducting \$275,000 in expenses. A portion of the net proceeds was used to repay amounts owed on the notes and the remaining proceeds were utilized to fund capital expenditure requirements.

### Equipment Loans

As of December 31, 2010, we had four equipment term loans with a lender, each collateralized by restaurant equipment. The outstanding principal balance under these loans was \$636,000 at December 31, 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, 2010.

### 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 of \$5.8 million from the sale of the auction rate securities to repay the outstanding balance under the line of credit of \$5.8 million, which was then cancelled by UBS.



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## Cash Flows

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

	Year Ended December 31,		
	2010	2009	2008
	(In thousands)		
Net cash provided by (used in):			
Operating activities	\$4,718	\$5,341	\$6,693
Investing activities	1,808	(11,316 )	(10,118 )
Financing activities	(6,375 )	5,902	911
Net increase (decrease) in cash and cash equivalents	\$151	\$(73 )	\$(2,514 )

**Operating Activities.** Our cash flows from operating activities, as detailed in the Consolidated Statements of Cash Flows, provided \$4.7 million of net cash in 2010. The net decrease in cash from operating activities for 2010 in comparison to 2009, is primarily the result of the timing of vendor payments and the collection of tenant improvement allowances from our landlords. The net decrease in cash from operating activities for 2009 as compared to 2008 is attributable to the timing of deferred rent and vendor payments.

**Investing activities.** We fund the development and construction of new restaurants and remodels primarily with cash and investments. Our capital expenditures for 2010 were \$4.3 million primarily attributable to the funding of construction for our Baltimore, Maryland restaurant which opened on October 5, 2010 and contractor payments for two restaurants that were opened during the second half of 2009. Investing activities for 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 during 2009 was \$11.3 million primarily reflecting \$12.0 million to fund construction of four restaurants opened during 2009. Net cash used in investing activities was \$10.1 million during 2008 reflecting \$17.1 million to fund construction at three restaurants opened during 2008 and one restaurant opened during January 2009, as well as capital expenditures for existing restaurants and other restaurants opened during 2009. This increase was partially offset by \$7.3 million in proceeds from the sale of investments to fund this construction.

**Financing Activities.** Net cash used in financing activities was \$6.4 million during 2010 reflecting the repayment of \$5.8 million in borrowings under a line of credit with UBS and \$0.7 million in principal payments on equipment loans. Net cash provided by financing activities was \$5.9 million during 2009 reflecting \$3.3 million in net borrowings under a line of credit and \$3.2 million in net proceeds from the subscription rights offering completed during June 2009, partially offset by \$0.7 million in principal payments on equipment loans. Net cash provided by financing activities was \$0.9 million during 2008 principally consisting of \$2.5 million in net borrowings under a line of credit offset by the purchase of 116,200 shares of common stock under our stock repurchase program at a total cost of \$1.0 million, and \$0.7 million in principal payments on equipment notes.

## Aggregate Contractual Obligations

The following table sets forth our contractual commitments as of December 31, 2010 (in thousands).

Contractual Obligations	Total	Payments Due by Period			More than 5 years
		Less than 1 year	1-3 years	3-5 years	
Long-term notes payable, including current portion	\$ 636	\$ 504	\$ 132	\$ —	\$ —

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Interest on notes payable	34	31	3	—	—
Operating leases	55,722	6,777	14,331	12,361	22,253
Total	\$ 56,392	\$ 7,312	\$ 14,466	\$ 12,361	\$ 22,253

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The table above does not include obligations related to lease renewal option periods even if it is reasonably assured that we will exercise the related option. In addition, the table above does not reflect unrecognized tax benefits of \$101,000, the timing of which is uncertain. Refer to Note 9 of the Consolidated Financial Statements for additional discussion on unrecognized tax benefits. We have evaluated and determined that we do not have any purchase obligations as defined in the SEC Final Rule No. 67, Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations.

### Off-Balance Sheet Arrangements

We had no off-balance sheet guarantees or off-balance sheet arrangements as of December 31, 2010.

### 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. We consider the following policies to be the most critical in understanding the judgment that is involved in preparing our consolidated financial statements.

### Property and Equipment

We record property and equipment at cost less accumulated depreciation and we select useful lives that reflect the actual economic lives of the underlying assets. We amortize leasehold improvements over the shorter of the useful life of the asset or the related lease term. We calculate depreciation using the straight-line method for financial statement purposes. We capitalize improvements and expense repairs and maintenance costs as incurred. We are often required to exercise judgment in our decision whether to capitalize an asset or expense an expenditure that is for maintenance and repairs. Our judgments may produce materially different amounts of repair and maintenance or depreciation expense if different assumptions were used.

We evaluate property and equipment for impairment whenever events or changes in restaurant operating results indicate that the carrying value of those assets may not be recoverable. Factors considered include, but are not limited to, significant underperformance relative to expected historical or projected future operating results; significant negative industry or economic trends; and significant changes in legal factors or in the business climate. The assessment of impairment is performed on a restaurant-by-restaurant basis. The recoverability is assessed by comparing the carrying value of the asset to the undiscounted cash flows expected to be generated by the asset. This assessment process requires the use of estimates and assumptions regarding future cash flows and estimated useful lives, which are subject to a significant degree of judgment. If indicators of impairment are present and if we determine that the carrying value of the asset exceeds the fair value of the restaurant assets, an impairment charge is recorded to reduce the carrying value of the asset to its fair value. Calculation of fair value requires significant estimates and judgments which could vary significantly based on our assumptions.

During 2009 and 2008, we recorded non-cash asset impairment charges for underperforming restaurants. We continue to monitor the operating performance of each individual restaurant. We may be required to record impairment charges in the future if certain restaurants perform below expectations.

### Leasing Activities

We lease all of our restaurant properties. At the inception of the lease, we evaluate each property and classify the lease as an operating or capital lease in accordance with applicable accounting standards. We exercise significant judgment

in determining the estimated fair value of the restaurant as well as the discount rate used to discount the future minimum lease payments. The term used for this evaluation includes renewal option periods only in instances in which the exercise of the renewal option can reasonably be assured and failure to exercise such option would result in an economic penalty. All of our restaurant leases are classified as operating leases.

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Our lease term used for straight-line rent expense is calculated from the date we take possession of the leased premises through the lease termination date. There is potential for variability in our “rent holiday” period which typically begins on the possession date and ends on the store open date. Factors that may affect the length of the rent holiday period generally include construction related delays. Extension of the rent holiday period due to delays in restaurant opening will result in greater rent expensed during the rent holiday period.

We record contingent rent expense based on a percentage of restaurant sales, which exceeds minimum base rent, over the periods the liability is incurred. Contingent rent expense is recorded prior to achievement of specified sales levels if achievement of such amounts is considered probable and estimable.

## Income Taxes

We provide for income taxes based on our estimate of federal and state tax liabilities. These estimates consider, among other items, effective rates for state and local income taxes, allowable tax credits for items such as taxes paid on reported tip income, estimates related to depreciation and amortization expense allowable for tax purposes, and the tax deductibility of certain other items. Our estimates are based on information available to us at the time we prepare the income tax provision. We generally file our annual income tax returns several months after our fiscal year end. Income tax returns are subject to audit by federal, state, and local governments, generally years after the returns are filed. These returns could be subject to material adjustments or differing interpretations of the tax laws.

Deferred income tax assets and liabilities are recognized for the expected future income tax consequences of carryforwards and temporary differences between the book and tax basis of assets and liabilities. Valuation allowances are established for deferred tax assets that are deemed more likely than not to be realized in the near term. We must assess the likelihood that we will be able to recover our deferred tax assets. If recovery is not likely, we establish valuation allowances to offset any deferred tax asset recorded. The valuation allowance is based on our estimates of future taxable income in each jurisdiction in which we operate, tax planning strategies, and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates, we may be unable to implement certain tax planning strategies or adjust these estimates in future periods. As we update our estimates, we may need to establish an additional valuation allowance which could have a material negative impact on our results of operations or financial position, or we could reduce our valuation allowances which would have a favorable impact on our results of operations and financial position.

## Stock-Based Compensation

We apply the Black-Scholes valuation model in determining the fair value of stock option awards, which requires the use of a number of highly complex and subjective variables. These variables include, but are not limited to the actual and projected employee and director stock option exercise behavior, expected volatility, risk-free interest rate, expected dividends, and expected term. Expected volatility is based on the historical volatility of our stock. We utilize historical data to estimate option exercise and employee termination behavior within the valuation model. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. We also estimate forfeitures at the time of grant and revise these estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We estimate forfeitures based on our expectation of future experience while considering our historical experience. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized in the consolidated statement of operations. We are also required to establish deferred tax assets for expense relating to options that would be expected to generate a tax deduction under their original terms. The recoverability of such assets are dependent upon the actual deduction that may be available at exercise and can further be impaired by either the expiration of the option or an overall valuation reserve on deferred tax assets.

We believe the estimates and assumptions related to these critical accounting policies are appropriate under the circumstances; however, should future events result in unanticipated consequences, there could be a material impact on our future financial condition or results of operations.

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Recent Accounting Pronouncements

See the Recent Accounting Pronouncements section of Note 1 to our consolidated financial statements for a summary of new accounting standards.

Item 7A. 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 8. Financial Statements and Supplementary Data

Reference is made to the consolidated financial statements, the notes thereto, and the report thereon, commencing on page F-1 of this report, which financial statements, notes, and report are incorporated herein by reference.

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

Not applicable.

Item 9A. 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 of December 31, 2010. 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 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.

Management's Report on Internal Control Over Financial Reporting

We are responsible for establishing and maintaining adequate internal control over financial reporting. As defined in the securities laws, internal control over financial reporting is a process designed by, or under the supervision of, our principal executive and principal financial officer and effected by our Board of Directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting

principles, and that our receipts and expenditures are being made only in accordance with authorizations of management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements.



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Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we carried out an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2010 based on the criteria in “Internal Control - Integrated Framework” issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). Based upon this evaluation, we concluded that our internal control over financial reporting was effective as of December 31, 2010.

Changes in Internal Control Over Financial Reporting

There has not been any change in our internal control over financial reporting during our fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

Not applicable.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this Item relating to our directors is incorporated herein by reference to the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2011 Annual Meeting of Stockholders. The information required by this Item relating to our executive officers is included in Part I, Item 1 “Business – Executive Officers.”

Item 11. Executive Compensation

The information required by this Item is incorporated herein by reference to the information contained in the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2011 Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item is incorporated herein by reference to the information contained in the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2011 Annual Meeting of Stockholders.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this Item is incorporated herein by reference to the information contained in the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2011 Annual Meeting of Stockholders.

Item 14. Principal Accountant Fees and Services

The information required by this Item is incorporated herein by reference to the information contained in the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2011 Annual Meeting of Stockholders.



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PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as a part of the report:

(1) Financial Statements

Financial Statements are listed in the Index to Consolidated Financial Statements on page F-1 of this report.

(2) Financial Statement Schedules

No financial statement schedules are included because such schedules are not applicable, are not required, or because required information is included in the consolidated financial statements or notes thereto.

(3) Exhibits

Exhibit Number	Exhibit
3.1	Amended and Restated Certificate of Incorporation of the Registrant (2)
3.3	Amended and Restated Bylaws of Kona Grill, Inc., as of October 30, 2007 (6)
3.4	Certificate of Designations, Preferences, and Rights of Series A Junior Participating Preferred Stock of Kona Grill, Inc. (8)
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)
4.9	Form of First Amended and Restated Promissory Note, dated April 7, 2009, among Kona Grill, Inc. and the investor parties thereto (10)
4.10	Form of Warrant
10.7(a)	Loan Agreement, dated April 30, 2004, between GE Capital Franchise Finance Corporation and Kona Grill Las Vegas, Inc. (1)
10.7(b)	Promissory Note, dated April 30, 2004, issued by Kona Grill Las Vegas, Inc. in favor of GE Capital Franchise Finance Corporation (1)
10.8(a)	Form of Equipment Loan and Security Agreement (i) dated as of September 2, 2004, between Kona Grill Denver, Inc. and GE Capital Franchise Finance Corporation; (ii) dated as of December 31, 2004, between Kona Grill Omaha, Inc. and GE Capital Franchise Finance Corporation; and (iii) dated January 21, 2005 between Kona Grill Indiana, Inc. and GE Capital Franchise Finance Corporation (1)
10.8(b)	Form of Equipment Promissory Note, each in favor of GE Capital Franchise Finance Corporation (i) dated as of April 22, 2005, issued by Kona Grill Omaha, Inc.; and (ii) dated as of May 20, 2005, issued by Kona Grill Indiana, Inc. (1)
10.8(c)	Equipment Promissory Note, dated September 17, 2004, issued by Kona Grill Denver, Inc. in favor of GE Capital Franchise Finance Corporation (1)
10.10*	Kona Grill, Inc. 2002 Stock Plan (as of November 13, 2002) (1)
10.11*	Kona Grill, Inc. 2005 Stock Award Plan (2)
10.12*	Kona Grill, Inc. 2005 Employee Stock Purchase Plan (amended as of August 15, 2005) (4)
10.15*	Form of Stock Option Agreement (2005 Stock Award Plan) (5)
10.17	

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- Securities Purchase Agreement, dated November 1, 2007, among Kona Grill, Inc. and the investor parties thereto (7)
- 10.21 Note and Warrant Purchase Agreement, dated March 6, 2009, among Kona Grill, Inc. and the investor parties thereto (9)
- 10.24\* Employment Agreement, dated as of May 11, 2009, between the Company and Mark S. Robinow (11)
- 10.26\* Employment Agreement, dated as of November 2, 2009, between the Company and Marc A. Buehler (12)

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Exhibit

Number Exhibit

21	List of Subsidiaries
23	Consent of Independent Registered Public Accounting Firm
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.

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

- (1) Incorporated by reference to the Registrant's Registration Statement on Form S-1 (Registration No. 333-125506), as filed with the Commission on June 3, 2005.
- (2) 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.
- (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 Registration Statement on Form S-8 (Registration No. 333-127593), as filed with the Commission on August 16, 2005.
- (5) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, as filed with the Commission on May 8, 2006.
- (6) Incorporated by reference to the Registrant's Form 8-K filed on November 5, 2007.
- (7) Incorporated by reference to the Registrant's Form 8-K filed on November 6, 2007.
- (8) Incorporated by reference to the Registrant's Form 8-K filed on May 28, 2008.
- (9) Incorporated by reference to the Registrant's Form 8-K filed on March 9, 2009.
- (10) Incorporated by reference to the Registrant's Form 8-K filed on April 10, 2009.
- (11) Incorporated by reference to the Registrant's Form 8-K filed on May 14, 2009.
- (12) Incorporated by reference to the Registrant's Form 8-K filed on November 3, 2009.

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Signatures

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: March 11, 2011

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacity and on the dates indicated.

Signature	Capacity	Date
/s/ Marc A. Buehler Marc A. Buehler	President, Chief Executive Officer and Director (Principal Executive Officer)	March 11, 2011
/s/ Mark S. Robinow Mark S. Robinow	Executive Vice President, Chief Financial Officer, and Secretary (Principal Accounting and Financial Officer)	March 11, 2011
/s/ Berke Bakay Berke Bakay	Director	March 11, 2011
/s/ Richard J. Hauser Richard J. Hauser	Director	March 11, 2011
/s/ Douglas G. Hipskind Douglas G. Hipskind	Director	March 11, 2011
/s/ James R. Jundt James R. Jundt	Director	March 11, 2011
/s/ Michael Nahkunst Michael Nahkunst	Director	March 11, 2011
/s/ Anthony L. Winczewski Anthony L. Winczewski	Director	March 11, 2011

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KONA GRILL, INC.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Kona Grill, Inc.

We have audited the accompanying consolidated balance sheets of Kona Grill, Inc. as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Kona Grill, Inc. at December 31, 2010 and 2009, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Phoenix, Arizona  
March 11, 2011

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

	December 31, 2010	2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$2,555	\$2,404
Investments	174	6,282
Receivables	10	308
Other current assets	1,212	1,111
Total current assets	3,951	10,105
Other assets	650	668
Property and equipment, net	37,459	39,190
Total assets	\$42,060	\$49,963
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$2,279	\$2,922
Accrued expenses	6,046	5,753
Current portion of notes payable	504	684
Line of credit	—	5,800
Total current liabilities	8,829	15,159
Notes payable	132	636
Deferred rent	16,110	16,185
Total liabilities	25,071	31,980
Commitments and contingencies (Note 13)		
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, 9,302,995 shares issued and 9,186,795 shares outstanding at December 31, 2010 and 9,262,895 shares issued and 9,146,695 shares outstanding at December 31, 2009	93	93
Additional paid-in capital	58,232	57,649
Accumulated deficit	(40,336)	(38,759)
Treasury stock, at cost, 116,200 shares at December 31, 2010 and 2009	(1,000)	(1,000)
Total stockholders' equity	16,989	17,983
Total liabilities and stockholders' equity	\$42,060	\$49,963

See accompanying notes to the consolidated financial statements.

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

	Year Ended December 31,		
	2010	2009	2008
Restaurant sales	\$87,589	\$81,095	\$75,815
Costs and expenses:			
Cost of sales	23,850	21,058	20,730
Labor	30,652	28,517	25,396
Occupancy	7,099	6,457	5,157
Restaurant operating expenses	14,179	13,156	11,314
General and administrative	7,072	8,200	8,416
Preopening expense	567	1,685	2,073
Depreciation and amortization	5,666	7,314	6,547
Asset impairment charge	—	16,915	3,219
Total costs and expenses	89,085	103,302	82,852
Loss from operations	(1,496 )	(22,207 )	(7,037 )
Nonoperating expenses:			
Interest income and other, net	52	204	296
Interest expense	(123 )	(174 )	(51 )
Loss from continuing operations before provision for income taxes	(1,567 )	(22,177 )	(6,792 )
Provision for income taxes	10	65	205
Loss from continuing operations	(1,577 )	(22,242 )	(6,997 )
Gain (loss) from discontinued operations, net of tax	—	690	(3,504 )
Net loss	\$(1,577 )	\$(21,552 )	\$(10,501 )
Net income (loss) per share – Basic and Diluted (Note 1):			
Continuing operations	\$(0.17 )	\$(2.57 )	\$(0.87 )
Discontinued operations	—	0.08	(0.43 )
Net loss	\$(0.17 )	\$(2.49 )	\$(1.30 )
Weighted average shares outstanding (Note 1):			
Basic	9,167	8,645	8,054
Diluted	9,167	8,645	8,054

See accompanying notes to the consolidated financial statements.

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KONA GRILL, INC.  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(In thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Total
Balances at December 31, 2007	6,608	\$66	\$ 53,071	\$ (6,706 )	\$—	\$46,431
Stock-based compensation	—	—	582	—	—	582
Purchase of treasury stock	(116 )	—	—	—	(1,000 )	(1,000 )
Issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options and warrants	20	—	86	—	—	86
Net loss	—	—	—	(10,501 )	—	(10,501 )
Unrealized holding gain (loss), net	—	—	—	—	—	—
Comprehensive loss						(10,501 )
Balances at December 31, 2008	6,512	66	53,739	(17,207 )	(1,000 )	35,598
Stock-based compensation	—	—	560	—	—	560
Issuance of common stock, net of \$275 of offering expenses	2,608	26	3,219	—	—	3,245
Issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options and warrants	27	1	61	—	—	62
Warrants issued with bridge loan	—	—	70	—	—	70
Net loss	—	—	—	(21,552 )	—	(21,552 )
Unrealized holding gain (loss), net	—	—	—	—	—	—
Comprehensive loss						(21,552 )
Balances at December 31, 2009	9,147	93	57,649	(38,759 )	(1,000 )	17,983
Stock-based compensation	—	—	474	—	—	474
Issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options and warrants	40	—	109	—	—	109
Net loss	—	—	—	(1,577 )	—	(1,577 )
Unrealized holding gain (loss), net	—	—	—	—	—	—
Comprehensive loss						(1,577 )
Balances at December 31, 2010	9,187	\$93	\$ 58,232	\$ (40,336 )	\$(1,000 )	\$16,989

See accompanying notes to the consolidated financial statements.

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

	Year Ended December 31,		
	2010	2009	2008
<b>Operating activities</b>			
Net loss	\$ (1,577 )	\$ (21,552 )	\$ (10,501 )
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation and amortization	5,666	7,314	6,805
Stock-based compensation	474	560	582
Loss on disposal of assets	36	—	—
Asset impairment	—	16,915	5,377
Amortization of debt discount	—	70	—
Change in operating assets and liabilities:			
Receivables	298	672	116
Other current assets	(101 )	(173 )	455
Accounts payable	(296 )	693	(218 )
Accrued expenses	293	875	853
Deferred rent	(75 )	(33 )	3,224
Net cash provided by operating activities	4,718	5,341	6,693
<b>Investing activities</b>			
Purchase of property and equipment	(4,318 )	(12,021 )	(17,146 )
Decrease (increase) in other assets	18	126	(299 )
Net sales of investments	6,108	579	7,327
Net cash provided by (used in) investing activities	1,808	(11,316 )	(10,118 )
<b>Financing activities</b>			
Net (repayment) borrowings on line of credit	(5,800 )	3,312	2,488
Repayments of notes payable	(684 )	(717 )	(663 )
Proceeds from bridge loan	—	1,200	—
Repayment of bridge loan	—	(1,200 )	—
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	109	62	86
Purchase of treasury stock	—	—	(1,000 )
Net cash (used in) provided by financing activities	(6,375 )	5,902	911
Net increase (decrease) in cash and cash equivalents	151	(73 )	(2,514 )
Cash and cash equivalents at the beginning of the year	2,404	2,477	4,991
Cash and cash equivalents at the end of the year	\$ 2,555	\$ 2,404	\$ 2,477
<b>Supplemental disclosures of cash flow information</b>			
Cash paid for interest (net of capitalized interest)	\$ 83	\$ 104	\$ 51
Cash paid for income taxes, net of refunds	\$ 87	\$ 74	\$ 110

Noncash investing activities

(Decrease) increase in accounts payable related to property and equipment purchases	\$ (347 )	\$ (2,106 )	\$ 1,229
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See accompanying notes to the consolidated financial statements.

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010

1. The Company and Summary of Significant Accounting Policies

Description of Business

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 American favorites and award-winning sushi that are prepared fresh daily. We currently own and operate 25 restaurants in 16 states across the United States.

Basis of Presentation

The consolidated financial statements include the accounts and operations of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. Certain prior year amounts have been reclassified to conform to the current year presentation.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

We consider all highly liquid investments that are readily convertible into cash and have an original maturity of three months or less at the time of purchase to be cash equivalents. Amounts receivable from credit card processors are also considered cash equivalents because they are both short-term and highly liquid in nature and are typically converted to cash within one business day of the sales transaction.

Investments

Investments consist primarily of certificates of deposit and money market securities that are generally highly liquid in nature. We classify our investments based on the intended holding period. Available-for-sale securities are carried at estimated fair value, based on available market information, with unrealized gains and losses, if any, reported as a separate component of stockholders’ equity. Trading securities are carried at fair value with gains and losses reported in the consolidated statements of operations.

Inventory

Inventory consists of food and beverage products that are valued at the lower of cost or market using the first-in, first-out method. Inventory is included in other current assets in the accompanying consolidated balance sheets.

Fair Value of Financial Instruments

The carrying value of cash and cash equivalents, investments, accounts receivable and accounts payable approximate fair value because of their short-term nature. The fair value of long-term debt is determined using current applicable rates for similar instruments and approximates the carrying value of such obligations.

#### 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.

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

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.

Concentration of Credit Risk

Financial instruments that potentially subject us to a concentration of credit risk principally consist of cash and cash equivalents, investments and accounts receivable. Concentration of credit risk is limited by diversifying cash deposits among a variety of high credit-quality issuers. At times, cash and cash equivalent balances may be in excess of the FDIC insurance limit. Concentration of credit risk for our investments is limited by diversifying investments among a variety of high credit-quality issuers. We consider our concentration of credit risk with respect to receivables to be limited as the balance is primarily with landlords for the reimbursement of tenant improvements.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. We capitalize all direct costs on the construction of leasehold improvements and capitalize interest during the construction and development period. Leasehold improvements are amortized over the shorter of the useful life of the asset or the related lease term that includes reasonably assured lease renewals as determined on the date of acquisition of the leasehold improvement. Improvements that materially extend the life of an asset are capitalized while repair and maintenance costs are expensed as incurred.

Depreciation and amortization are recorded on a straight-line basis over the following estimated useful lives:

Furniture and fixtures	5-7 years
Equipment	7 years
Computer software and electronic equipment	3 years
Leasehold improvements	Shorter of the useful life or the lease term

We evaluate property and equipment for impairment whenever events or changes in restaurant operating results indicate that the carrying value of those assets may not be recoverable. Factors considered include, but are not limited to, significant underperformance relative to expected historical or projected future operating results; significant negative industry or economic trends; and significant changes in legal factors or in the business climate. The assessment of impairment is performed on a restaurant-by-restaurant basis. Recoverability is assessed by comparing the carrying value of the asset to the undiscounted cash flows expected to be generated by the asset. This assessment process requires the use of estimates and assumptions regarding future cash flows and estimated useful lives, which are subject to a significant degree of judgment. If indicators of impairment are present and if we determine that the carrying value of the asset exceeds the fair value of the restaurant assets, an impairment charge is recorded to reduce the carrying value of the asset to its fair value. See Note 2 for discussion of asset impairment charges recorded during



2008 and 2009.

#### Leases

We lease our restaurant locations under operating lease agreements with initial terms of approximately 10 to 20 years. Most of these agreements require minimum annual rent payments plus contingent rent payments based on a percentage of restaurant sales which exceed the minimum base rent. Contingent rent payments, to the extent they exceed minimum payments, are accrued over the periods in which the liability is incurred. Rent expense associated with these contingent payments is recorded prior to the achievement of specified sales levels if exceeding such amount is considered probable and is estimable. The lease agreements typically also require scheduled increases to minimum annual rent payments. For leases that contain rent escalations, we record the total rent payable over the initial lease term, starting on the date we gain possession of the property (including the construction period), on a straight-line basis. Any difference between minimum rent and straight-line rent is recorded as deferred rent. Deferred rent also includes tenant improvement allowances which are amortized as a reduction of rent expense on a straight-line basis over the initial term of the lease.

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

Revenue Recognition

Revenues from food, beverage, and alcohol sales are recognized when payment is tendered at the point of sale. Restaurant sales are recorded net of promotions and discounts. Revenues from gift card sales are recognized upon redemption. Prior to redemption, the outstanding balances of all gift cards are included in accrued expenses in the accompanying consolidated balance sheets.

Sales Taxes

Revenues are presented net of sales taxes. The obligation is included in accrued expenses until the taxes are remitted to the appropriate taxing authorities.

Advertising and Marketing Costs

Advertising and marketing costs are expensed as incurred. Advertising and marketing expense for 2010, 2009, and 2008 was \$1,246,000, \$1,063,000, and \$934,000, respectively, and is included in restaurant operating expenses in the accompanying consolidated statements of operations. Costs associated with the redemption of a promotion in the form of a coupon for a free or discounted product are recorded in cost of sales as the intent of the coupon is to generate additional restaurant sales through driving guest traffic. Costs associated with promotional giveaways of food and beverages to local businesses and sponsorship of events are viewed as advertising in nature and recorded in restaurant operating expenses in the accompanying consolidated statements of operations.

Preopening Expense

Costs directly related to the opening of new restaurants, including employee relocation, travel, employee payroll and related training costs, and rent expense subsequent to the date we take possession of the property through the restaurant opening, are expensed as incurred.

Stock-Based Compensation

We maintain stock award 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. 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 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. Certain stock option awards for executive officers may vest earlier in the event of a change of control or termination, as defined in the executive officer's employment agreement. We apply the Black-Scholes valuation model in determining the fair value of stock option grants. We recognize compensation cost for our stock awards using a graded vesting schedule on a straight line basis over the requisite service period.

Income Taxes

We utilize the liability method of accounting for income taxes. Under the liability method, deferred tax assets and liabilities are computed at each balance sheet date for temporary differences between the consolidated financial statements and tax basis of assets and liabilities that will result in taxable or deductible amounts in the future based on

tax rates in effect in the years in which the temporary differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts that will more likely than not be realized.

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

We recognize the impact of a tax position in our financial statements if that position more likely than not will be sustained upon examination by a tax authority. We recognize accrued interest and penalties related to uncertain tax positions as income tax expense.

## 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 year. Diluted net loss per share excludes the dilutive effect of potential stock option and warrant exercises, which are calculated using the treasury stock method, as these shares are anti-dilutive. For 2010, 2009, and 2008, there were 1,102,000, 965,000, and 1,033,000 stock options and warrants outstanding, respectively, that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive.

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

	Year Ended December 31,		
	2010	2009	2008
	(In thousands, except per share data)		
Numerator:			
Loss from continuing operations	\$ (1,577 )	\$ (22,242 )	\$ (6,997 )
Gain (loss) from discontinued operations	—	690	(3,504 )
Net loss	\$ (1,577 )	\$ (21,552 )	\$ (10,501 )
Denominator:			
Weighted average shares — basic	9,167	8,645	8,054
Effect of dilutive stock options and warrants	—	—	—
Weighted average shares — diluted	9,167	8,645	8,054
Net loss per share – Basic and Diluted:			
Continuing operations	\$ (0.17 )	\$ (2.57 )	\$ (0.87 )
Discontinued operations	—	0.08	(0.43 )
Net loss	\$ (0.17 )	\$ (2.49 )	\$ (1.30 )

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 earnings (loss) per share by an adjustment factor of 1.2309 for all periods presented prior to the completion of the rights offering.

## 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 years 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.

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

2. Asset Impairment Charges and Discontinued Operations

Asset Impairment Charges

We review the carrying value of our long-lived assets on a restaurant-by-restaurant basis. During 2009, we recorded non-cash asset impairment charges of \$16,915,000 for six underperforming restaurants based upon an assessment of each restaurant's historical operating performance combined with expected cash flows for these restaurants over the respective remaining lease term. We reduced the carrying value of these assets to their estimated fair value which was determined using a discounted cash flow model or the market value of each restaurant's assets. The six restaurants that comprise the asset impairment charge are located in the following cities: 1) Phoenix, Arizona; 2) Stamford, Connecticut; 3) West Palm Beach, Florida; 4) Oak Brook, Illinois; 5) Baton Rouge, Louisiana and 6) Sugar Land, Texas.

Additionally during 2008, we recorded non-cash charges of \$3,219,000 for the impairment of long-lived assets at our Lincolnshire, Illinois restaurant based upon the restaurant's past and present operating performance combined with our assessment of expected cash flows from this location over the remainder of the original lease term.

We continue to evaluate the future prospects for each of these restaurants on a case-by-case basis to determine the return on investment of continued operations.

Discontinued Operations

On September 13, 2008, we closed our Naples, Florida restaurant to focus our attention on the profitable locations and position our concept to generate profit from operations. As a result of the closure, we recorded non-cash asset impairment charges of \$2,158,000 as well as ongoing contractual lease obligations, restaurant-level closing costs, and employee termination benefits, net of deferred costs, of approximately \$800,000 during 2008.

Gain (loss) from discontinued operations includes both the historical results of operations as well as exit costs attributed to the Naples, Florida restaurant. 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 during 2008, we recorded a gain of \$690,000, after deducting fees and other expenses, for 2009. Gain (loss) from discontinued operations, net of tax is comprised of the following (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Restaurant sales	\$—	\$—	\$1,531
Gain (loss) from discontinued operations before income tax benefit	\$—	\$690	\$(3,579)
Income tax benefit	—	—	75
Gain (loss) from discontinued operations, net of tax	\$—	\$690	\$(3,504)

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

Balance at December 31, 2008	\$1,417
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Cash payments	(546 )
Non-cash activity	(690 )
Balance at December 31, 2009	181
Cash payments	(181 )
Balance at December 31, 2010	\$—

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

Non-cash activity reflects the revised estimate of lease termination costs based upon the settlement agreement discussed above. The lease settlement required an initial payment of \$350,000 that was paid during July 2009 and the remaining amount, including interest at a 6% annual rate, was payable in 12 equal monthly installments beginning in August 2009. The final settlement fee was paid during June 2010.

3. Investments

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

	Adjusted Cost	Gross Unrealized Losses	Estimated Fair Value
<b>December 31, 2010</b>			
Short-term investments:			
Certificates of deposit	\$ 174	\$ —	\$ 174
Total investments	\$ 174	\$ —	\$ 174
<b>December 31, 2009</b>			
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 8). Interest earned on the auction rate securities was used to reduce the outstanding balance under the line of credit.



4.

#### Fair Value Measurements

Our investment in auction rate securities were classified within Level 3 in the fair value hierarchy 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.

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

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.

Our short-term investments in certificates of deposit 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.

The following tables present information about our assets measured at fair value on a recurring basis at December 31, 2010 and 2009, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in thousands):

December 31, 2010	Level 1	Level 2	Level 3	Total
Certificates of deposit	\$174	\$—	\$—	\$174
December 31, 2009	Level 1	Level 2	Level 3	Total
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

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 December 31, 2010	\$ —	\$ —

As discussed in Note 2, we recorded asset impairment charges for long-lived assets associated with six of our restaurants for the year ended December 31, 2009. These long-lived assets had a carrying amount of \$17,444,000 and were written down to their estimated fair value of \$529,000. The fair value of each restaurant's long-lived assets was determined using either a discounted cash flow model or the market value of each restaurant's long-lived assets. The market value was determined based upon market prices for similar assets in active markets and are classified within

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Level 2. Valuations using discounted cash flows are classified within Level 3 as these valuations were determined by projecting future cash flows of each restaurant and discounting those cash flows at a rate reflective of current market conditions and factors specific to our company. The following table presents information about our assets measured at fair value on a non-recurring basis at December 31, 2009, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in thousands):

	Level 1	Level 2	Level 3	Total Losses
Property and equipment	\$—	\$427	\$102	\$(16,915 )

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

## 5. Receivables

Receivables consisted of the following (in thousands):

	December 31,	
	2010	2009
Tenant improvement allowances	\$ —	\$ 300
Other	10	8
Total receivables	\$ 10	\$ 308

No allowance for doubtful accounts has been recorded as collection of tenant improvement allowances and other receivables is considered probable.

## 6. Property and Equipment

Property and equipment consisted of the following (in thousands):

	December 31,	
	2010	2009
Leasehold improvements	\$ 47,712	\$ 44,878
Equipment	13,240	12,491
Furniture and fixtures	3,548	3,208
	64,500	60,577
Less accumulated depreciation and amortization	(27,041)	(21,525)
	37,459	39,052
Construction in progress	—	138
Total property and equipment, net	\$ 37,459	\$ 39,190

## 7. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	December 31,	
	2010	2009
Accrued payroll	\$ 2,129	\$ 1,875
Gift cards	1,140	859
Sales taxes	816	686
Business and income taxes	711	739
Accrued occupancy	233	192
Lease termination accrual	—	181
Other	1,017	1,221
Total accrued expenses	\$ 6,046	\$ 5,753



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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

## 8. Debt and Credit Agreements

## Notes Payable

As of December 31, 2010, we had four equipment term loans with a lender, each collateralized by restaurant equipment. The outstanding principal balance under these loans was \$636,000 at December 31, 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 equipment loans require us to maintain a corporate fixed charge coverage ratio of at least 1.25:1.00 determined on the last day of each fiscal year. We were in compliance with the required coverage ratio as of December 31, 2010.

Notes payable consisted of the following:

	2010	December 31, 2009 (In thousands)
\$993,544 equipment loan, collateralized by certain restaurant assets of the Company, payable in monthly installments of \$15,015 including interest at 7.04%, due June 2010	\$ —	\$ 88
\$1,000,000 equipment loan, collateralized by certain restaurant assets of the Company, payable in monthly installments of \$15,526 including interest at 7.88%, due May 2011	76	249
\$1,000,000 equipment loan, collateralized by certain restaurant assets of the Company, payable in monthly installments of \$15,521 including interest at 7.87%, due October 2011	150	317
\$600,000 equipment loan, collateralized by certain restaurant assets of the Company, payable in monthly installments of \$9,508 including interest at 8.52%, due May 2012	151	248
\$995,000 equipment loan, collateralized by certain restaurant assets of the Company, payable in monthly installments of \$15,687 including interest at 8.36%, due June 2012	259	418
Total notes payable	636	1,320
Less current portion	(504 )	(684 )
Total notes payable, net of current portion	\$ 132	\$ 636

Future maturities of notes payable at December 31, 2010 are as follows (in thousands):

2011	\$ 504
2012	132
Total notes payable	\$ 636

During 2010, 2009, and 2008, we incurred gross interest expense of \$154,000, \$312,000, and \$199,000, respectively. We capitalized \$31,000, \$138,000, and \$148,000 of interest costs during 2010, 2009, and 2008, respectively.

#### Credit Facility

In 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.

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KONA GRILL, INC.  
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## Bridge Loan

On March 6, 2009, and as amended on April 7, 2009, we entered into a Note and Warrant Purchase Agreement with certain accredited investors whereby we sold \$1,200,000 aggregate principal amount of 10% unsecured subordinated 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 generating gross proceeds to us of at least \$2,500,000. As described in Note 10 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 \$70,000 for 2009.

## 9. Income Taxes

Income tax expense from continuing operations consisted of the following (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Current:			
Federal	\$ —	\$ —	\$ 15
State	10	65	190
	10	65	205
Deferred:			
Federal	—	—	—
State	—	—	—
	—	—	—
Total	\$ 10	\$ 65	\$ 205

Income tax expense differed from amounts computed by applying the federal statutory rate to loss from continuing operations before provision for income taxes as follows (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Income tax benefit at federal statutory rate	\$ (533 )	\$ (7,540 )	\$ (2,309 )
State income taxes, net of federal benefit	(89 )	(839 )	125
Nondeductible expenses	354	362	373
Business tax credit	(911 )	(910 )	(1,028 )
Other	(209 )	(3 )	(63 )
Discontinued operations	—	235	(1,353 )
Change in valuation reserve	1,398	8,760	4,460
Total	\$ 10	\$ 65	\$ 205





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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

The temporary differences that give rise to significant portions of deferred tax assets and liabilities were as follows (in thousands):

	December 31,	
	2010	2009
Deferred tax assets (liabilities):		
Net operating loss carryforward	\$ 2,847	\$ 2,533
Deferred rent	5,957	5,971
Business tax credits	4,690	3,779
Organizational and preopening costs	145	162
Impairment of assets	5,381	5,909
Stock-based compensation	1,088	905
Accrued expenses	—	125
Property and equipment	(2,922 )	(3,206 )
Accelerated tax depreciation	1,180	792
Other	130	128
Net deferred tax assets	18,496	17,098
Valuation allowance	(18,496 )	(17,098 )
Total	\$ —	\$ —

The valuation allowance increased by approximately \$1,398,000 and \$8,760,000 at December 31, 2010 and 2009, respectively. In assessing the realization of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based on historical operating losses, we have elected to maintain a full valuation allowance until realization of deferred tax assets is more likely than not.

At December 31, 2010, we have approximately \$6,550,000 and \$14,485,000 in federal and state net operating loss carryforwards, respectively, which begin expiring in 2028 for federal income tax purposes and 2011 for state income tax purposes. We also have federal business tax credit carryforwards of approximately \$4,690,000 which begin expiring in 2021. These credits are also potentially subject to annual limitations due to ownership change rules under the Internal Revenue Code.

As of December 31, 2010, we had \$101,000 of unrecognized tax benefits. Future changes in the unrecognized tax benefits are not expected to have a material impact on the effective tax rate, nor do we expect that the amount of unrecognized tax benefits will significantly change in the next 12 months. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Beginning balance	\$ 140	\$ 158	\$ 167
Additions related to current year tax positions	—	—	—
	—	—	1

Additions related to tax positions taken during the prior period					
Reductions related to settlements with taxing authorities		—		—	—
Reductions due to lapse of statute of limitations		(39)		(18)	(10)
Ending balance	\$	101	\$	140	\$ 158

We recognize interest and penalties related to uncertain tax positions in income tax expense. For the years ended December 31, 2010, 2009, and 2008 provision for income taxes includes \$10,000, \$12,000, and \$12,000, respectively, in interest and penalties on unrecognized tax benefits. We had \$33,000 and \$36,000 accrued for the payment of interest and penalties at December 31, 2010 and 2009, respectively.

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

We are subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. The earliest tax year still subject to examination by a significant taxing jurisdiction is 2006.

10. Stockholders' Equity

Preferred Stock

We are authorized to issue 2,000,000 shares of preferred stock with a par value of \$0.01. There were no shares of preferred stock that were issued or outstanding at December 31, 2010 or 2009.

Common Stock

Rights Offering

As part of the Note and Warrant Purchase Agreement discussed in Note 8, we filed with the SEC a registration statement on Form S-3 to conduct a subscription rights offering with targeted gross proceeds to us of \$3,520,000 pursuant to which each of our stockholders 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 holders 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 holders of subscription rights granted under the rights offering. We sold 2,608,045 shares of common stock pursuant to the rights offering, including the exercise of over-subscription rights by the holders of the notes for the purchase of 482,178 shares or 18.5% of the total shares sold. We received net proceeds of \$3,245,000 after deducting \$275,000 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.

Stock Repurchase Program

During April 2008, our Board of Directors approved a stock repurchase program under which we are authorized to repurchase up to 600,000 shares of our common stock. We purchased 116,200 shares at a total cost of \$1,000,000 during 2008 under a section 10b5-1 purchase program. The shares purchased are being held in treasury until such time as they are reissued or retired, at the discretion of the Board of Directors. The authorization does not have an expiration date and it does not require us to purchase a specific number of shares. This authorization may be modified, suspended or terminated at any time. The timing and number of shares repurchased pursuant to the share repurchase authorization are subject to a number of factors, including current market conditions, legal constraints and available cash or other sources of funding.

11. Stock-Based Compensation

Stock Options

We maintain stock award 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 and the remaining available

shares for grant, including those shares related to option awards forfeited or terminated without exercise, accrue to the 2005 Stock Award Plan. We typically grant non-qualified stock options with an exercise price at or above the fair market value of the underlying common stock on the date of grant and 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 year over a one-year period. A total of 1,450,000 shares of common stock have been reserved for issuance under our plans of which 304,221 shares were available for grant as of December 31, 2010.

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KONA GRILL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

We account for stock-based compensation using the fair value recognition provisions. Compensation expense is recognized ratably over the vesting term of the option. The following table presents information related to stock-based compensation (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Stock-based compensation	\$ 474,000	\$ 560,000	\$ 582,000

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model and is affected by assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the actual and projected employee stock option exercise behavior, expected volatility, risk-free interest rate, expected dividends, and expected term. Expected volatility is based on the historical volatility of our stock. Prior to 2010, expected volatility was based upon the volatility of a peer group of companies as we did not have enough history trading as a public company to calculate our own stock price volatility. The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. We have not paid dividends in the past and do not plan to pay any dividends in the near future. Compensation expense is recognized only for those options expected to vest, with forfeitures estimated based on our historical experience and future expectations. The fair value of stock options granted was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2010		2009		2008	
Expected volatility	64.0	%	57.6	%	36.0	%
Risk-free interest rate	1.6	%	1.8	%	2.5	%
Dividend yield	0.0	%	0.0	%	0.0	%
Expected life (in years)	3.6		3.9		3.7	
Weighted average fair value per option granted	\$ 1.63		\$ 1.19		\$ 3.42	

Activity during 2010, 2009, and 2008 under our stock award plans was as follows:

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding options at December 31, 2007	655,439	12.59		
Granted	185,417	11.24		
Forfeited	(14,800 )	10.29		
Exercised	(2,000 )	6.00		
Outstanding options at December 31, 2008	824,056	12.34		
Granted	407,100	2.64		
Forfeited	(376,300 )	12.42		
Exercised	—	—		

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Outstanding options at December 31, 2009	854,856		7.67		
Granted	243,750		3.44		
Forfeited	(185,150 )		9.53		
Exercised	(28,650 )		2.38		
Outstanding options at December 31, 2010	884,806	\$	6.28	3.04 years	\$ 561,000
Exercisable at December 31, 2010	483,260	\$	7.85	2.57 years	\$ 217,000

The intrinsic value of options exercised during 2010 and 2008 was \$30,000 and \$6,000, respectively. The total fair value of shares vested during 2010, 2009, and 2008 was \$398,000, \$390,000, and \$489,000, respectively. As of December 31, 2010, there was approximately \$474,000 of unrecognized stock-based compensation expense related to unvested share-based compensation arrangements, which is expected to be recognized over a weighted average period of 2.0 years.

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Information regarding options outstanding and exercisable at December 31, 2010 is as follows:

Range of Exercise Prices	Shares	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$ 1.92 – \$ 2.10	111,800	2.80	\$ 2.02	53,075	\$ 2.06
\$ 3.21 – \$ 3.70	427,800	3.97	\$ 3.33	135,938	\$ 3.30
\$ 5.00 – \$ 8.35	148,789	2.72	\$ 6.22	146,289	\$ 6.21
\$11.72 – \$12.64	107,417	1.74	\$ 11.93	70,208	\$ 12.01
\$18.08 – \$19.49	89,000	1.00	\$ 19.07	77,750	\$ 19.06
	884,806	3.04	\$ 6.28	483,260	\$ 7.85

#### Warrants

As discussed in Note 8, we issued to the noteholders of the bridge loan three-year warrants to purchase 120,000 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. These warrants are exercisable through March 6, 2012 and 10,000 warrants were exercised during 2009 resulting in 110,000 warrants outstanding at December 31, 2010. We recorded the value of the warrant at \$70,000 and amortized this amount to interest expense during 2009.

#### 12. Employee Benefit Plans

##### Defined Contribution Plan

We maintain a voluntary defined contribution plan covering eligible employees as defined in the plan documents. Participating employees may elect to defer the receipt of a portion of their compensation, subject to applicable laws, and contribute such amount to one or more investment options. We currently match in cash a certain percentage of the employee contributions to the plan and also pay for related administrative expenses. Matching contributions made during 2010, 2009, and 2008 were \$142,000, \$142,000, and \$126,000, respectively.

##### Employee Stock Purchase Plan

During 2005, our Board of Directors and stockholders approved the 2005 Employee Stock Purchase Plan, or ESPP and reserved 425,000 shares of common stock for issuance thereunder. The ESPP permits eligible employees to purchase common stock at a discount through payroll deductions up to 15% of employees' eligible earnings during the offering period. The purchase price per share at which shares of common stock are sold in an offering under the ESPP is equal to 95% of the fair market value of common stock on the last day of the applicable offering period. During 2010, 2009, and 2008, 11,450 shares, 16,659 shares and 18,113 shares, respectively, were purchased under the ESPP.

#### 13. Commitments and Contingencies



## Leases

We lease our restaurant locations under operating leases having terms expiring from 2013 to 2029. The leases typically include renewal clauses of five years exercisable at the option of our company and rent escalation clauses stipulating specific rent increases. We record deferred rent to recognize rent evenly over the initial lease term. Certain of these leases require the payment of contingent rentals based on a percentage of gross revenues above specified minimum amounts as defined in the respective lease agreement. The leases typically require us to pay our proportionate share of common area maintenance, property tax, insurance, and other occupancy-related costs. We also lease office facilities and certain equipment under operating lease agreements.

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KONA GRILL, INC.  
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Rent expense on all operating leases was as follows (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Straight-line minimum base rent	\$ 6,638	\$ 6,018	\$ 4,900
Contingent rent	39	24	123
<b>Total rent</b>	<b>\$ 6,677</b>	<b>\$ 6,042</b>	<b>\$ 5,023</b>

As of December 31, 2010, future minimum lease payments under operating leases, excluding unexercised renewal options periods, were as follows (in thousands):

2011	\$6,777
2012	7,094
2013	7,237
2014	6,616
2015	5,745
Thereafter	22,253
<b>Total minimum lease payments</b>	<b>\$55,722</b>

#### Litigation

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 the results of operations or financial condition of our company.

#### Stockholder Derivative Action

On February 6, 2009, Samuel Beren (“Beren” or “plaintiff”), as trustee for the Samuel Beren Trust, served a demand on us pursuant to Section 220 of Delaware’s General Corporation Law (the “DGCL”), which requested that we make available for inspection certain books and records. During April 2009, Beren, as trustee for the Samuel Beren Trust, commenced a purported stockholder derivative action in the Court of Chancery of the State of Delaware. The derivative action purportedly was brought on behalf of us against our directors and the purchasers of our promissory notes issued during March 2009, for alleged breaches of fiduciary duties by our directors, and for aiding and abetting such breaches by the purchasers of our promissory notes. We also were named as a nominal defendant in the derivative action. The derivative action seeks unspecified damages, interest, reasonable attorneys’ fees, expert witness fees, and other costs.

During June 2009, the director defendants filed a motion to dismiss the derivative action. Separately, during October 2009, plaintiff served a demand on us pursuant to Section 220 of the DGCL, which requested that we make available for inspection certain books and records. During January 2010, we produced books and records in response to the October 26, 2009 demand. Two days later, plaintiff commenced a separate action against us, which sought the production of the books and records requested in plaintiff’s February 6, 2009 and October 26, 2009 demand letters. During March 2010, the court granted a stay in the derivative action until the books and records action was resolved. During July 2010, we produced books and records in response to the February 6, 2009 demand, which

production was covered by a confidentiality agreement executed between us and Beren. On February 18, 2011, the court dismissed the books and records action with prejudice.

During February 2011, the plaintiff filed an amended complaint including a claim for corporate waste. We are evaluating the amended complaint and will determine the proper response to such amended complaint. We continue to believe that the purported derivative action, as amended, is without merit, and we intend to defend vigorously this lawsuit.

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KONA GRILL, INC.  
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## 14. Selected Quarterly Financial Data (Unaudited)

Summarized quarterly unaudited financial data for 2010 and 2009 is as follows (in thousands, except per share data):

Quarter ended	2010			
	March 31	June 30	September 30	December 31
Restaurant sales	\$ 21,052	\$22,686	\$21,605	\$22,246
Net (loss) income	(907 )	262	(441 )	(491 )
Diluted net (loss) income per share				
(1)	\$ (0.10 )	\$0.03	\$(0.05 )	\$(0.05 )

Quarter ended	2009			
	March 31	June 30	September 30	December 31
Restaurant sales	\$ 19,455	\$ 21,468	\$ 20,173	\$ 19,999
Net loss	(1,096)	(214)	(1,035)	(19,207)(2)
Diluted net loss per share				
(1)	\$ (0.14)	\$ (0.03)	\$ (0.11)	\$ (2.10)

(1) Net (loss) income per share calculations for each quarter are based on the weighted average diluted shares outstanding for that quarter and may not total to the full year amount.

(2) Includes asset impairment charges of \$16.9 million for six underperforming restaurants.