

# SECURITIES AND EXCHANGE COMMISSION

## FORM 10-K/A

Annual report pursuant to section 13 and 15(d) [amend]

Filing Date: **2005-05-02** | Period of Report: **2005-01-02**  
SEC Accession No. **0001144204-05-013680**

([HTML Version](#) on [secdatabase.com](#))

### FILER

#### **SHELLS SEAFOOD RESTAURANTS INC**

CIK: **935066** | IRS No.: **650427966** | State of Incorporation: **DE** | Fiscal Year End: **1231**  
Type: **10-K/A** | Act: **34** | File No.: **000-28258** | Film No.: **05792032**  
SIC: **5812** Eating places

#### Mailing Address

*16313 NORTH DALE MABRY  
SUITE 100  
TAMPA FL 33618*

#### Business Address

*16313 N DALE MABRY HWY  
STE 100  
TAMPA FL 33618  
8139610944*

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

---

**FORM 10-K/A**

---

**Amendment No. 1**

Annual Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the fiscal year (53 weeks) ended January 2, 2005.

Or

Transition Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-28258

---

**SHELLS SEAFOOD RESTAURANTS, INC.**

(Exact name of registrant as specified in its charter)

---

**DELAWARE**

(State or other jurisdiction of incorporation or organization)

**65-0427966**

(IRS Employer Identification Number)

**16313 North Dale Mabry Highway, Tampa, Florida 33618**

(Address of principal executive offices) (Zip Code)

**(813) 961-0944**

(Registrant's telephone number, including area code)

---

**Securities registered pursuant to Section 12 (b) of the Act: None.**

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

**Common Stock, \$0.01 par value.**

(Title of Class)

---

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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 an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

The aggregate market value of the common stock held by non-affiliates of the registrant (based upon the last sales price of the common stock reported on the over-the-counter bulletin board and the assumption, for this computation only, that all directors, executive officers, and ten-percent holders of stock are affiliates of the registrant) at June 25, 2004 (the last business day of the registrant's most recently completed second fiscal quarter) was \$1,469,791.

As of April 3, 2005, the number of shares outstanding of the registrant's common stock, \$0.01 par value, was 14,630,417.

### **FORWARD LOOKING STATEMENTS**

When used in this Annual Report on Form 10-K, the words "believes", "anticipates", "expects", and similar expressions are intended to identify forward-looking statements. These statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected.

In addition to seasonal fluctuations, our quarterly and annual operating results are affected by a wide variety of other factors that could materially and adversely affect our revenues and profitability, including changes in consumer preferences, tastes and eating habits; increases in food and labor costs; promotional timings and seasonality; the availability of qualified labor; national, regional and local economic and weather conditions; demographic trends and traffic patterns; changes in travel and tourism tendencies, particularly in light of world events; competition from other restaurants and food service establishments; cash balances available for operating activities; and the timing, costs and charges relating to restaurant openings, closings and remodelings. As a result of these and other factors, we may experience material fluctuations in future operating results on a quarterly or annual basis, which could materially and adversely affect our business, financial condition, operating results, and stock price. An investment in our company involves various risks, including those which are detailed in this document and from time-to-time in our other filings with the Securities and Exchange Commission.

Any forward-looking statements included in this Annual Report speak only as of the date of this document. We are not undertaking any obligation to publicly release the results of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events.

## EXPLANATORY NOTE

This Amendment No. 1 to the Annual Report on Form 10-K of Shells Seafood Restaurants, Inc. amends the Shells' Annual Report on Form 10-K for the year ended January 2, 2005, filed with the Securities and Exchange Commission on March 11, 2005. This Amendment No. 1 is being filed to include disclosures required by Part III of Form 10-K, to move the disclosure regarding Shells' Code of Business Conduct and Ethics included in Part I of the original 10-K to Part III of this report, and to add a certification with respect to changes in internal control over financial reporting to the certifications required by Section 302 of the Sarbanes-Oxley Act of 2002. Except as described in the preceding sentence, no other changes have been made to the original Form 10-K. This Form 10-K/A does not amend, update or change the financial statements in the original Form 10-K.



## PART I

### ITEM 1. BUSINESS

Shells Seafood Restaurants, Inc. was incorporated under the laws of the State of Florida in April 1993 and was reincorporated under the laws of the State of Delaware in April 1996. Effective December 1994, Shells, Inc., a company incorporated under the laws of the State of Florida, was merged with and into our company and became our wholly owned subsidiary.

#### Concept and Strategy

Shells is a full-service, neighborhood concept, designed to appeal to a broad range of customers by providing generous portions of high-quality seafood, warm, friendly service, and a relaxed atmosphere at reasonable prices. Shells restaurants feature a wide selection of seafood items, including shrimp, oysters, clams, scallops, mussels, lobster, crab and daily fresh fish specials, cooked to order in a variety of ways: steamed, sautéed, grilled, blackened and fried. In addition, our restaurants offer a wide selection of signature pasta dishes, appetizers, salads, and desserts and full bar service. All Shells restaurants are open for dinner and 23 restaurant locations are also open for lunch.

As of January 2, 2005, our fiscal year end, we owned 20 Shells restaurants, owned a 51% ownership interest in one Shells restaurant and managed four additional Shells restaurants pursuant to contractual arrangements. In February 2005, we acquired an additional restaurant located in Clearwater Beach, Florida. This restaurant is scheduled to open for operation in March 2005. All of our restaurants are located in Florida.

Fiscal year 2004 marked a turning point in the evolution of the Shells concept. Beginning in late 2003, our senior executive team led by new President & CEO Leslie J. Christon began to strategically reposition the concept by leveraging the freshness, quality and variety of Shells food as a competitive advantage. This challenging effort to successfully improve Shells' concept appeal and reverse unfavorable long-term sales trends remained our focus throughout 2004.

We revamped the menu, improved the quality of ingredients purchased, broadened customer appeal by adding more variety, and adjusted pricing. The new menu still maintains a very strong emphasis on value through a two-tier pricing strategy, offering exceptionally high-quality, fresh seafood at reasonable prices alongside lower-priced favorites. To support the brand's quality and freshness positioning, we worked hard to elevate levels of service and overall operational execution, recruiting new operations talent into our company and enforcing higher standards. We also addressed the critical need to improve Shells' atmosphere and facilities, successfully developing a prototypical remodel package that dramatically improves Shells' appearance, comfort and consumer appeal.

Our efforts to significantly update Shells concept generally have been embraced by customers. As a result, our comparable restaurant sales turned consistently positive beginning in the late portion of the third quarter of 2004. Comparable restaurant sales have remained at strong levels through the balance of 2004.

We believe our restaurants are better positioned to capitalize on continuing increases in seafood consumption and favorable publicity about the health benefits associated with eating seafood. As our guests become more knowledgeable about quality differences and positive nutritional aspects of seafood, they are appreciating the improvements we have made. Understanding that consumer expectations are constantly rising, we continue to work on enhancing many aspect of the Shells experience.

## Restaurant Locations

Our managed and operated restaurants are located in the following Florida markets and cities/neighborhoods:

### Tampa/Sarasota

Brandon  
Clearwater Beach\*  
Holmes Beach  
Redington Shores  
St. Pete Beach  
Winter Haven  
Carrollwood  
North Tampa  
Sarasota  
South Tampa

### Orlando

Daytona Beach  
Kissimmee  
New Smyrna Beach  
Ocala  
Orlando  
Winter Park  
Melbourne

### South Florida

Coral Springs  
Davie  
Kendall  
Pembroke Pines  
Sunrise

### West Palm Beach

Stuart  
West Palm Beach

### Fort Myers

Fort Myers  
Port Charlotte

\*Scheduled to open March 2005

From 1997 to 1999, in an attempt to diversify and minimize the seasonal effect of the Florida market, we opened 18 restaurants in various Midwest markets. We sustained operating losses in these Midwest markets and completed the discontinuance of our Midwest operations in April 2001, closing the then remaining nine units. We closed one under-performing Florida restaurant in 2002, and an additional three Florida restaurants in 2004. We continuously review the performance of each restaurant unit economics and location, and regularly evaluate new real estate sites in Florida for potential expansion or relocation.

## Restaurant Operations

**Management and Employees.** We currently employ five area directors. Each area director is responsible for the management of several restaurants, including management development, recruiting, training, quality of operations and unit profitability. The staff of a typical dinner-only restaurant consists of one general manager, two or three assistant managers and approximately 45 other employees. The restaurants that are also open for lunch generally have 15 to 20 additional part-time employees. Restaurant management and area directors participate in a bonus program based upon the financial results of their particular restaurant or restaurants.

**Restaurant Reporting.** We maintain financial and accounting controls for each restaurant through a central accounting system. Our financial systems and controls allow us to access each restaurant's sales, inventory costs and other financial data on a real-time basis, enabling both store-level management and senior management to quickly react to changing sales trends, to effectively manage food, beverage and labor costs, to minimize theft, and to improve the quality and efficiency of accounting and audit procedures. Store level management performs weekly inventories and manages weekly operating results versus budget.

**Recruitment and Training.** We believe that achieving customer satisfaction by providing knowledgeable, friendly, efficient service is critical to a restaurant's long-term success. We typically recruit restaurant managers with significant experience in the restaurant industry. During a 10-week training program, restaurant managers are taught to promote our team-oriented atmosphere among restaurant employees with emphasis on preparing and serving food in accordance with strict standards and providing friendly, courteous and attentive service. The restaurant staff, through our Team Trainer program, is trained on site by restaurant managers and other staff members. During 2002 and 2003, we reduced restaurant management turnover. In 2004, restaurant management turnover increased as part of an effort to improve the level of quality in our managers. Other than our recent efforts to raise manager quality levels, we strive to reduce turnover levels.

**Purchasing.** Obtaining a reliable supply of quality seafood at competitive prices is critical to our success. We have formed long-term relationships with several seafood suppliers and purchase both fresh and frozen seafood and certain other supplies used in restaurant operations in bulk. In addition, Shells' menu has been designed to feature seafood varieties with stable sources of supply, as well as to provide flexibility to adjust to shortages and to take advantage of occasional purchasing opportunities. We believe our diverse menu selection minimizes the effect of the shortage of any seafood products. We generally have been able to anticipate and react to fluctuations in food costs through selected menu price adjustments, purchasing seafood directly from numerous suppliers and promoting certain alternative menu selections in response to availability and price of supply.

Performance Food Group of Florida, our primary distributor since October 2002, distributes our food products, comprising seafood and other commodities that make up our menu ingredients, to our restaurants. Performance Food Group purchases and takes delivery of the products that we recommend for purchase according to our specifications and subject to our inspections. Based on purchase orders initiated by our restaurants, Performance Food Group then sells the food products to us on a cost plus basis, and distributes the food products directly to the restaurants. From time-to-time, at our direction to facilitate a forward purchase opportunity, Performance Food Group acquires inventory in excess of normal recurring restaurant delivery and re-supply, which approximates 30 days supply. We pay interest on inventory holdings above 30-day supply levels, at an interest rate of 7.8% per annum. In addition, Performance Food Group procures, on our behalf, many operating supplies, other than food products, used by our restaurants and distributes and sells these products to the individual restaurants at agreed upon price mark-ups.

**Quality Control.** We maintain a continuous inspection program for all of our seafood purchases. Each shipment of frozen seafood is inspected through statistical sampling methods upon receipt at Performance Food Group's distribution center for quality and conformity to our written specifications, prior to delivery to the restaurants. Fresh fish are also inspected on a random basis by our quality control inspector. In addition, fresh fish purchased by our individual restaurants must be purchased from one of our approved suppliers and is inspected by a restaurant manager at the time of delivery. As part of our training program, restaurant employees are educated as to the correct handling and proper physical characteristics of each product.

Our area directors, general managers and assistant managers are all responsible for properly training hourly employees and ensuring that Shells restaurants are operated in accordance with strict health and quality standards. Compliance with our quality standards is monitored by on-site visits and formal inspections by the area directors. We believe that our inspection procedures and employee training practices help to maintain a high standard of quality for the food and service we provide.

### **Advertising and Marketing**

Our marketing efforts leverage the use of billboard, newspaper, radio and television advertising to raise awareness of the Shells brand and to inform new and existing customers about food-focused promotions. The fact that our restaurants are generally clustered in particular media markets helps us obtain cost effective advertising. We also stage in-store promotions and various local marketing efforts to help our restaurants partner with their communities.

Across most major markets, our broad scale marketing initiatives included network television, radio, outdoor, newspaper, concentrated internet and direct mail campaigns. The advertising messages were designed to heighten brand awareness and drive trial through food-focused promotional offerings while spotlighting fresh, quality and variety. Mid year, we introduced a focused local store marketing program, providing all of our restaurants with the resources to take advantage of an array of sales building initiatives.

In early 2004, we made significant advances in the quality and variety of our menu offerings. For example, we introduced several new flavor profiles and menu items to help drive new guest traffic and satisfy current guests. The improvements to the menu and culinary supervision have enabled us to deliver on our commitment to providing our guests with the freshest fish, shellfish and seafood pastas at fair prices.

In December 2004, we entered into a consulting agreement with Lawrence Wolf, principal of the Wolf Group. Mr. Wolf, as a consultant, assists our company in providing marketing services; including guidance toward building our creative strategy around the "Shells" brand positioning and providing support in coordinating our media production.

## **Disclosure Controls**

Consolidated subsidiaries are managed through a centralized executive office in Tampa, Florida. Material information is discussed at various weekly and monthly meetings with officers and directors. An open door policy is observed by corporate officers to facilitate communication.

## **Joint Venture and Third-Party Owned Restaurants**

The Shells restaurant system currently consists of (i) 20 restaurants that are wholly owned by us; (ii) one restaurant in Clearwater Beach, Florida acquired in February 2005, wholly owned by us, and scheduled to open for operation in March 2005; (iii) one restaurant, in Melbourne, Florida, in which we have an interest of 51%; and (iv) four restaurants that we manage and operate, but do not own. The remaining 49% interest in the Melbourne restaurant is indirectly owned by Wanda L. Hattaway, wife of William E. Hattaway, a former director and president of our company. In addition to the equity interest in this restaurant, we receive a management and licensing fee of 6% of the restaurant sales of the Melbourne restaurant.

Three of the managed restaurants are managed and operated by us pursuant to management and license agreements, originally entered into in July 1993. Pursuant to these agreements, we provide management services and license proprietary information required to operate these restaurants for a percentage of that restaurant's sales. The agreement, as amended in October 2001, provides for a 4% management fee until such time as sales return near to 1999 levels, and then returning to a 6% fee. Of the total management fee received, 2% of sales is placed in escrow and disbursed to a third party to satisfy each managed restaurants' requirement to make third party royalty payments. The management agreements grant us authority to determine the programs and policies affecting the day-to-day operations of each of these managed restaurants. Although the management agreements differ slightly, they generally have a remaining term of 19 years and provide that the third-party owners are responsible for funding all the restaurant expenses, including food and beverage costs, staffing, training, recruiting, inventory, and working capital.

We operate the fourth managed restaurant pursuant to an oral agreement requiring that the restaurant is operated in conformity with the policies and procedures established by us for Shells restaurants. In accordance with the amended management agreement for our managed restaurants, beginning in October 2001, we receive a management fee of 2% of the restaurant's sales.

In the past, the enforceability of these management and license agreements has been questioned by certain of the licensees. Although we believe the agreements are enforceable, there can be no assurance that the agreements will not be challenged in the future, and, if challenged, that the agreements will be determined to be enforceable.

## **Competition**

The restaurant industry is intensely competitive with respect to price, service, location, food quality and variety, and there are many well-established competitors with substantially greater financial and other resources than us. These competitors include national, regional and local full-service casual dining chains, many of which specialize in or offer seafood products. We also face competition from a broad range of other restaurants and foodservice establishments, including full-service, quick service and fast food restaurants, which specialize in a variety of cuisines. Some of our competitors have been in existence for substantially longer periods than we have, and may be better established in the markets where we have our restaurants. In addition, we believe that the full-service casual dining segment is likely to attract a significant number of new entrants, some offering seafood products.

## **Government Regulation**

We are subject to extensive federal, state and local government regulation by various governmental agencies, including state and local licensing, zoning, land use, construction and environmental regulations and various regulations relating to the sale of food and alcoholic beverages, sanitation, disposal of refuse and waste products, public health, safety and fire standards. Our restaurants are subject to periodic inspections by governmental agencies to ensure conformity with these regulations. Difficulties or failure in obtaining required

licensing or other regulatory approvals could delay or prevent the opening of a new restaurant, and the suspension of, or inability to renew, a license at an existing restaurant could adversely affect our operations. Restaurant operating costs are also affected by other government actions, beyond our control, including increases in the minimum hourly wage requirements, workers compensation insurance rates, health care insurance costs and unemployment and other taxes.

Approximately 12% of our revenue is attributable to the sale of alcoholic beverages. Alcoholic beverage control regulations require each of our restaurants to apply to a state authority and, in certain locations, county or municipal authorities for a license or a permit to sell alcoholic beverages on the premises. Typically, licenses must be renewed annually and may be revoked or suspended for cause at any time. Alcoholic beverage control regulations relate to numerous aspects of daily operations of our restaurants, including minimum age of patrons and employees, hours of operation, wholesale purchasing, inventory control and handling, storage and dispensing of alcoholic beverages. The failure of a restaurant to obtain or retain liquor or food service licenses would adversely affect the restaurant's operations.

We are also subject to "dram-shop" statutes, which generally provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person. We carry liquor liability coverage as part of our existing comprehensive general liability insurance.

Our restaurants are subject to federal and state minimum wage laws governing such matters as working conditions, overtime and tip credits. A significant number of our restaurant personnel are paid at rates related to the federal minimum wage and, accordingly, further increases in the minimum wage rate could increase our labor costs.

The Americans with Disabilities Act prohibits discrimination in employment and public accommodations on the basis of disability. Under the Act, including in situations where we elect to remodel a restaurant, or acquire or purchase a restaurant, we could be required to expend funds to modify our restaurants to better provide service to, or make reasonable accommodations for the employment of, disabled persons.

### **Service Marks and Proprietary Information**

We have registered the service mark "Shells" with the Secretary of the State of Florida and the "Shells" service mark and "jumping fish" logo with the United States Patent and Trademark Office. We believe that our service marks have significant value and are essential to our ability to create demand for, and awareness of, our restaurants. There can be no assurance, however, that our service marks do not or will not violate the proprietary rights of others, that they would be upheld if challenged or that we would not be prevented, in such an event, from using our service marks, any of which could have a material adverse effect on us. Although there can be no assurance that we will have the financial resources necessary to enforce or defend our service marks, we have vigorously opposed, and intend to continue to oppose vigorously, any infringement of our service marks.

We also rely on trade secrets and proprietary knowledge and employ various methods to protect our concepts and recipes. These methods may not afford complete protection and there can be no assurance that others will not independently develop similar knowledge or obtain access to our knowledge, concepts and recipes.

### **Employees**

As of January 2, 2005, we employed approximately 1,200 persons, of whom approximately 110 were management or administrative personnel employed on a salaried basis and 1,090 were employed in non-management restaurant positions on an hourly basis. Approximately 600 employees are employed on a full-time basis. We consider our employee relations to be good. No employees are covered by a collective bargaining agreement.

## Our Executive Officers

Our executive officers are:

| <u>Name</u>        | <u>Age</u> | <u>Position</u>  |
|--------------------|------------|--|
| Leslie J. Christon | 50         | President and Chief Executive Officer  |
| Guy C. Kathman     | 48         | Vice President of Operations   |
| Warren R. Nelson   | 53         | Executive Vice President of Finance, Chief Financial Officer,<br>Treasurer and Secretary |

**Leslie J. Christon** has been our President and Chief Executive Officer since joining Shells in July 2003. From 2002 to 2003, Mrs. Christon was self-employed as a management consultant in the restaurant industry. From 2000 to 2002, Mrs. Christon was employed by Sutton Place Gourmet, Inc. as its President and Chief Operating Officer. From 1996 to 2000, Mrs. Christon was employed by Brinker International, On the Border Restaurants, as its President.

**Guy C. Kathman** has been our Vice-President of Operations since joining Shells in September 2003. From 2001 to 2003, Mr. Kathman was employed by Posados Café as a General Manager. From 1997 to 2001, Mr. Kathman was employed by Brinker International, On the Border Restaurants, as a Regional Director.

**Warren R. Nelson** currently serves as our Executive Vice-President of Finance, Chief Financial Officer, Treasurer, and Secretary, positions he has held since June 1993.

Our board of directors has adopted a Code of Business Conduct and Ethics that applies to our principal executive officer and principal financial officer, as well as to the members of our board of directors and our other officers and employees. This Code of Business Conduct and Ethics is available on our web site, at [www.shellsseafood.com](http://www.shellsseafood.com). We intend to satisfy the amendment and waiver disclosure requirements under applicable securities regulations by posting any amendments of, or waivers to, the Code of Business Conduct and Ethics on our web site. A copy of our Code of Business Conduct and Ethics will be sent without charge upon request in writing addressed to us at 16313 N. Dale Mabry Hwy, Suite 100, Tampa, Florida 33618 c/o Secretary.

### Risk Factors Relating to the Business of our Company

*The risks and uncertainties described below are not the only risks we face. In addition to the following risk factors, we refer you to those risk factors described elsewhere in this Annual Report on Form 10-K and in various of our publicly reported documents. Additional risks and uncertainties not presently known to us or that we currently believe are immaterial could also impair our business operations.*

*Keep these risk factors in mind when you read “forward-looking” statements elsewhere in this Form 10-K. These are statements that relate to our expectations for future events and time periods. Generally, the words “anticipate,” “expect,” “intend” and similar expressions identify forward-looking statements. Forward-looking statements involve risks and uncertainties. Future events and circumstances could differ significantly from those associated with the forward-looking statements.*

**We have significant capital requirements and need additional financing within the first portion of fiscal year 2005.** Historically, our cash requirements have exceeded our cash flow from operations. This has been due to costs associated with developing and opening restaurants as well as the operating performance of many of our restaurants. As of January 2, 2005, our company had a working capital deficiency of \$4,639,000 and a cash balance of \$2,350,000. In 2004, we incurred a net loss of \$1,344,000 and we invested in property and equipment of \$1,292,000. In 2003, we incurred a net loss of \$1,034,000 and we invested \$755,000 in property and equipment. In addition, we have only recently experienced some success in reversing the long-term trends in declining sales and customer traffic. There are no assurances that these recent reversals will continue and that the implementation of our strategies will result in sales and customer traffic gains which are required to meet our contemplated cash flow requirements.

In December 2004, we obtained net funding of \$2,010,000 through the issuance of convertible debentures totaling \$2,375,000. The convertible debentures, which mature in April 2005, are expected to be repaid, if not converted into stock, from the proceeds of a contemplated next round of financing anticipated to occur during the first half of 2005.

In March 2005, our investors provided us with a \$1,600,000 revolving line of credit, which matures on the earlier of March 31, 2006 or the closing of a financing providing us not less than \$1,600,000 of net proceeds. We expect to use the line of credit to help repay the debentures if a cash repayment is required, to the extent we have not then consummated the contemplated next round of financing.

We cannot be assured that third party financing will be available to us when we need it or available on acceptable terms, if at all. If we cannot obtain a contemplated next round of financing or other financing when we need it, this could materially adversely affect our results of operations. Conversely, if we raise additional capital, our existing stockholders could be substantially diluted.

***We may be unable to repay certain of our debts when they mature.*** As noted, convertible debentures totaling \$2,375,000 mature in April 2005. In addition, in August 2004, we extended the maturity dates on notes totaling \$2,000,000 from January 31, 2005 to January 31, 2007, at which time payment will be due in full, along with deferred interest through the due date of \$535,000. The \$2,000,000 principal amount notes are held by entities owned by or associated with various of our directors and largest shareholders. In March 2005, warrants to purchase 1,000,000 shares of common stock, which were issued on August 4, 2004 pursuant to the extension of the \$2,000,000 related-party financing, were exercised at \$0.50 per share by certain of our investors. The proceeds of \$500,000 were used to pay down the principal amount of the notes to these investors. Additionally, in March 2005, the \$1,000,000 note held by Frederick R. Adler was modified to allow Shells to defer entirely the monthly interest payment on \$500,000 of principal amount of the note until the maturity date of January 31, 2007, resulting in the deferral of \$72,000 of cash payments until the maturity date. We anticipate that prior to maturity, funds will be available to pay off the remainder of this debt or alternative outside financing will be available to replace these obligations. There are no assurances that adequate financing options will be available to our company when necessary.

We have two promissory notes outstanding through Colonial Bank, for the financing of two restaurant locations, Melbourne and Winter Haven. As of January 2, 2005, we owed collectively \$1,099,000 on the principal balances of these notes. We are required to meet a financial covenant relating to debt coverage. We were in compliance in meeting this loan covenant as of January 2, 2005. However, in the past, we were not in compliance with meeting the loan covenant for which a covenant waiver was provided by the bank.

The two bank notes and the remaining \$1,500,000 principal amount of the notes held by entities owned or associated with insiders are secured by various of our assets. Our failure to pay these notes as they mature will allow the holders of these notes to seize and sell various of our assets to satisfy amounts owed.

***Our business plan is contingent on additional future financing.*** Integral to our business plan and subject to our ability to secure a contemplated next round of financing, we presently have plans to continue our renovation and remodeling of existing restaurants in 2005. In addition, we will continue to explore restaurant locations for new growth and relocations. If we do not secure the contemplated next round of financing and achieve our operating cash flow requirements, our plans to renovate and remodel will be adversely affected.

***History of losses.*** We have experienced operating and net losses during the majority of our recent prior years. In 2004, we had losses of \$1,344,000. In 2003, we had losses of \$1,034,000. Excluding non-recurring items, our losses were \$734,000 and \$765,000 in 2004 and 2003, respectively.

***Substantial dilution to our stockholders is possible.*** During January 2002, we completed a \$2,000,000 financing transaction pursuant to which, among other things, we issued warrants to purchase 8,908,030 shares of our common stock, at an exercise price of \$0.16 per share. As of January 31, 2005, these warrants were exercised, some in accordance with a cashless exercise provision; whereby 8,462,630 shares of common stock were issued to the respective warrant holders.

In August 2004, we agreed with the holders of the \$2,000,000 of promissory notes to an extension of the term of the notes from their original expiration date of January 31, 2005 to January 31, 2007. In connection with this extension, we issued warrants to purchase 2,000,000 shares of common stock. In March 2005, we issued 1,000,000 shares of common stock upon the exercise of one-half of these warrants.

In December 2004, we completed a \$2,375,000 private placement of convertible debentures. The debentures mature on the earliest to occur of certain events, but in any event, not later than April 5, 2005. In conjunction with this private placement, we issued warrants to purchase 1,971,250 shares of common stock to the debenture holders and the placement agent. Until the maturity of these debentures, the placement agent has the right to place up to an additional \$125,000 aggregate principal amount of debentures, which in turn would cause us to issue up to 62,500 additional warrants.

As of February 7, 2005, there were 13,628,417 shares of common stock outstanding, and warrants, options or other convertible securities outstanding to purchase an additional 5,291,125 shares of common stock at an average exercise price of \$0.58 per share. By written consent, our board of directors and the holders of a majority of our outstanding shares of common stock have authorized an amendment to our certificate of incorporation that will increase the total number of authorized shares of our common stock from 20,000,000 shares to 40,000,000 shares. We are contemplating pursuing a significant round of additional equity financing which is expected to be used, among other things, for additional remodels and potential new locations or relocations for existing restaurants. We anticipate using the additional authorized shares of common stock, among other things, to finance the repayment of the debentures to the extent they are not converted in to common stock and in other future capital raising transactions.

***Control by Management and Certain Individuals.*** Frederick R. Adler, and Bruce Galloway, both significant shareholders, together with members of our board of directors and executive management team, are beneficial owners of record, in the aggregate, of approximately 58% of our outstanding common stock as of February 7, 2005. In addition, as part of our \$2,000,000 financing transaction in January 2002, we entered into an Investor Rights Agreement with the investor groups and certain other stockholders. Pursuant to the Investor Rights Agreement, our board of directors is to consist of seven members and the investor groups are entitled to nominate six individuals to serve on our board. These rights are presently held by three unrelated investor groups consisting of Frederick R. Adler (3 nominees), Trinad Capital, LP and Galloway Capital Management, LLC (collectively, 3 nominees). The investor groups, among others, have agreed to vote their respective shares of our common stock for the election to our board of the slated nominees. As a result, these persons, acting together, currently are able to control the business and affairs of our company, including the election of our directors and decisions regarding any proposed dissolution, merger or sale of our assets.

***We depend on key personnel.*** Our success is largely dependent upon our executive management and other key personnel. The loss of the services of one of our executives or other key personnel could materially adversely affect us. Our success may also depend on our ability to attract and retain qualified management restaurant industry personnel.

***Operating results may require the closure of additional restaurants.*** If we experience prolonged periods of unfavorable operating results at any existing restaurants, view the prospects for a restaurant to be less than satisfactory or elect not to renew a restaurant lease due to its operating results, we may elect to close or relocate restaurants. The lack of success or closing of any of our restaurants could have an adverse effect upon our financial condition and results of operations. We closed 16 restaurants during 2001, of which 14 were located in the Midwest and two were located in Florida. We closed one restaurant in 2002 and three restaurants in 2004. We are continuing to monitor the operations and financial performance with respect to certain of our other existing restaurants.

***Our operating results fluctuate seasonally because of our geographic concentration.*** We experience significant fluctuations in our quarter-to-quarter operating results because of factors including:

- the seasonal nature of our business; and
- weather conditions in Florida, which may be severe from time-to-time.

Our restaurants are all located in Florida and can be affected by the health of Florida's economy in general, and of the tourism industry in particular, which can further be affected by anticipated world events, as well as economic trends. In addition, while the majority of our restaurants are located primarily in residential areas in Florida, many of our restaurants are located in seasonal tourist areas.

Our restaurant sales generally increase from January through April and June through August, the peaks of the Florida tourism season, and generally decrease from September through mid-December. In addition, because of

our present geographic concentration, adverse publicity relating to our restaurants or adverse weather conditions could have a more pronounced adverse effect on our operating results than if our restaurants were more geographically dispersed. Adverse weather conditions or a decline in tourism in Florida, or in general economic conditions, which would likely affect the Florida economy or tourism industry, particularly during the time of peak sales, could materially adversely affect our operations and prospects. During the third and fourth quarters of 2004, we incurred substantial business and property losses as a result of four hurricanes that struck Florida. Because of the seasonality of our business, our results for any quarter are not necessarily indicative of the results that may be achieved for a full year.

***The supply and quality of our seafood may fluctuate.*** In recent years, the availability of certain types of seafood has fluctuated. This has resulted in a corresponding fluctuation in prices. We maintain short-term contracts with several of our suppliers. In addition, we purchase products through Performance Food Group in the ordinary course of business. Performance Food Group distributes and warehouses the majority of our seafood supply and procures, distributes and stores other supplies for us. We believe that our relationships with our suppliers and Performance Food Group are satisfactory and that alternative sources are readily available. However, the loss of some suppliers or of our relationship with Performance Food Group could materially adversely affect us.

Some species of seafood have become subject to adverse publicity because of claims of contamination by lead, mercury or other chemicals that may exist in the ocean or in an aquaculture environment. This can adversely affect both market demand and supply for these food products. Customer demand may also be negatively impacted by reports of medical or other risks resulting from eating seafood. We maintain a continuous inspection program for our seafood purchases. However, we cannot assure you that seafood contamination or consumer perception of inadequate seafood quality, in the industry in general or as to us specifically, will not have a material adverse effect on us. Our failure to obtain adequate supplies of seafood or problems or difficulties resulting from the contamination of seafood, in general, or at any of our restaurants in particular, will have a material adverse effect on our operations and profitability .

***Our expenses for food and other costs fluctuate.*** Our profitability depends on our ability to anticipate and to react to increases in food, labor, employee benefits, and similar costs. We have limited control over these costs. Specifically, our dependence on frequent deliveries of seafood, produce, dairy and other products means we are at greater risk of shortages or interruptions in supply because of adverse weather or other conditions. This could adversely affect the availability and cost of these items. Also, substantial price increases imposed by our suppliers in the absence of alternative sources of supply in a timely manner, could have a material adverse effect on us. We have been able to anticipate and react to fluctuations in food costs by:

- adjusting selected menu prices;
- purchasing seafood directly from numerous suppliers; and
- promoting alternative menu selections in response to price and availability of supply.

However, we cannot assure you that we will be able to continue to anticipate and respond to supply and price fluctuations or that we will not be subject to significantly increased costs. A shortage of available seafood could cause our cost of sales to increase. Because of our value oriented pricing structure, this could materially adversely affect our operations and profitability. In addition, seafood suppliers and processors are subject to a program of inspection by the Food and Drug Administration. This program may increase our seafood costs because seafood suppliers' and processors' costs in complying with this program may increase.

***Our industry is highly competitive.*** The restaurant industry, particularly the full-service casual dining segment, is highly competitive. We compete in the areas of:

- price;
- service;
- food quality, including taste, freshness, healthfulness and nutritional value; and
- location.

We have numerous well-established competitors, some of which dominate the industry. These competitors possess substantially greater financial, marketing, personnel and other resources than we do. Many of our

competitors have achieved significant brand name and product recognition. They also engage in extensive advertising and promotional programs, both generally and in response to efforts by additional competitors to enter new markets or introduce new products. Our competitors include national, regional and local full-service casual dining chains, many of which specialize in or offer seafood products.

We believe that the full-service casual dining segment is likely to attract a significant number of new entrants, some offering seafood products. We also expect to face competition from a broad range of other restaurants and food service establishments. These include full-service, quick-service and fast food restaurants, which specialize in a variety of menu offerings. In addition, the full-service restaurant industry is characterized by the frequent introduction of new food products, which are accompanied by substantial promotional campaigns. In recent years, numerous companies in the full-service restaurant industry have introduced products, including seafood, intended to capitalize on growing consumer preference for food products that are, or are perceived to be, healthful, nutritious, and low in calories, carbohydrates or fat content. You can expect that we will be subject to increasing competition from companies whose products or marketing strategies address these consumer preferences. While we believe that we offer a broad variety of quality seafood products, we cannot assure you that:

- consumers will be able to distinguish our products from competitive products;
- substantially equivalent food products will not be introduced by our competitors; or
- we will be able to compete successfully.

**Many factors affect our industry.** We must respond to various factors affecting the restaurant industry including:

- changes in consumer preferences, tastes and eating habits;
- demographic trends and traffic patterns;
- increases in food and labor costs;
- inflation; and
- national, regional and local economic conditions and the effect of world events, in general, and the tourism industry in particular:

**We face risks associated with government regulation.** We are subject to extensive state and local government regulation by various agencies, including:

- state and local licensing, zoning, land use, construction and environmental regulations;
- various regulations relating to the sale of food and alcoholic beverages;
- regulations relating to sanitation, disposal of refuse and waste products;
- regulations relating to public health; and
- safety and fire standards.

Our restaurants are inspected periodically by governmental agencies to ensure conformity with these regulations. The suspension of, or inability to renew a license at an existing restaurant would adversely affect our operations. A significant percentage of our revenue comes from sales of alcoholic beverages. State and local regulation of the sale of alcoholic beverages require us to obtain a license or permit for each of our restaurants. The failure of a restaurant to obtain or retain a license to serve liquor would materially adversely affect our operations. In addition, our failure or difficulty in obtaining required licensing or other regulatory approvals could delay or prevent new restaurant openings.

Restaurant operating costs are also affected by other government actions, which are beyond our control, including increases in:

- the minimum hourly wage requirements;
- workers compensation insurance rates;

- health care insurance costs;
- other insurance costs, including general liability and property; and
- unemployment and other taxes.

In May 2005, the minimum wage rate in Florida will increase by \$1.00 per hour. Tipped employees will also be receiving the \$1.00 per hour wage increase under this new law. Each year thereafter, the minimum wage will increase according to the U.S. Department of Labor, Bureau of Labor Statistics cost of living index. Such payroll cost increases will have a significantly adverse affect to our company. Menu price increases and other actions will be required to negate the effect of these wage increases. There can be no assurances that such measures expected to be taken by our company will be successful to adequately offset these additional payroll costs, or will be accepted without adverse reaction by our customers.

Furthermore, the Americans with Disabilities Act may require us to make certain modifications to certain of our restaurants to meet specified access and use requirements. These and other initiatives could adversely affect our results of operations.

***We may have liability for sales of alcoholic beverages.*** We are also subject to “dram-shop” statutes. These statutes generally provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person. In certain states, statutes also provide that a vendor of alcoholic beverages may be held liable in a civil cause of action for injury or damage caused by or resulting from the intoxication of a minor under certain conditions. In addition, significant national attention is currently focused on the problem of drunk driving, which could result in the adoption of additional legislation. This could increase our potential liability for damage or injury caused by our customers.

***We may not be able to protect our service marks and proprietary information.*** We own two United States registrations for the service marks that we use, including the name “Shells.” We believe that our service marks have significant value and are essential to our ability to create demand for and awareness of our restaurants. We cannot assure you, however, that our service marks:

- do not or will not violate the proprietary rights of others;
- would be upheld if challenged; or
- that we would not be prevented from using our service marks.

Any of these occurrences could materially adversely affect us. In addition, we cannot assure you that we will have the financial resources necessary to enforce or defend our service marks. We believe that we own all of our intellectual property and that the management and license agreements to which we are a party are enforceable. In the past, the enforceability of these management and license agreements has been questioned by certain of the licensees. Although we believe the agreements are enforceable, there can be no assurance that the agreements will not be challenged in the future, and, if challenged, that the agreements will be determined to be enforceable and the managed restaurants will be restricted from using the Shells service marks independent of us.

We also rely on trade secrets and proprietary knowledge. We employ various methods to protect our concepts and recipes. However, these methods may not completely protect us. We cannot assure you that others will not independently develop similar knowledge or obtain access to our knowledge, concepts and recipes. Although we generally enter into confidentiality agreements with our executives and managers, we cannot assure you that these agreements will adequately protect our trade secrets.

***Our insurance coverage may not be adequate.*** We maintain insurance, including insurance relating to personal injury, in amounts, which we currently consider adequate. Nevertheless, a partially or completely uninsured claim against us, if successful, could materially adversely affect us.

***Absence of Dividends.*** We have never paid cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. In addition, our debt financings prohibit the payment of cash dividends and any future financing agreements may also prohibit the payment of cash dividends.



**Provisions with Potential Anti-Takeover Effect.** Our certificate of incorporation provides that we may issue up to 2,000,000 shares of preferred stock from time-to-time in one or more series. The board of directors is authorized to determine the rights, preferences, privileges and restrictions granted to and imposed upon any wholly unissued series of preferred stock. The board is authorized to fix the number of shares of any series of preferred stock and the designation of any such series, without any vote or action by our stockholders. The board may authorize and issue preferred stock with voting, dividend, liquidation, conversion or other rights that could adversely affect the voting power or other rights of the holders of our common stock. In addition, the potential issuance of preferred stock may have the effect of delaying, deferring or preventing a change in control, may discourage bids for our common stock at a premium over the market price of the common stock and may adversely affect the market price of the common stock.

On October 24, 2001, we issued 66,862 shares of Series A 5% Convertible Preferred Stock, par value \$0.01 per share, pursuant to an exemption from registration under Section 4(6) of the Securities Act of 1933, as amended, in consideration for the cancellation of \$669,000 of trade indebtedness by trade creditors of our company. As of January 2, 2005, we have 35,275 shares of preferred stock outstanding. We have no present intention to issue any additional shares of our preferred stock. However, we cannot assure you that we will not do so in the future.

On February 7, 2005, we obtained written consents from our board of directors and the holders of a majority of our outstanding shares of common stock, to increase the number of authorized shares of common stock from 20,000,000 shares to 40,000,000 shares. One of the effects of the amendment to our certificate of incorporation may be to enable the board to render more difficult or to discourage an attempt to obtain control of our company, since the issuance of these additional shares of common stock could be used to dilute the stock ownership of persons seeking to obtain control or otherwise increase the cost of obtaining control of our company.

## **ITEM 2. PROPERTIES**

We lease 4,500 square feet of space in Tampa, Florida for our executive offices. The annual rent payable under the lease, which expires October 31, 2006, is approximately \$66,000.

All but three of our existing restaurants in operation are leased properties. In the future, we intend to lease most of our properties but may from time-to-time acquire restaurant locations based on individual site evaluation. Each of our leases provides for a minimum annual rent and certain of these leases require additional rental payments to the extent sales volumes exceed specified amounts. Generally, we are required to pay the cost of insurance, taxes and a portion of the landlord's operating costs to maintain common areas. Restaurant leases have initial terms averaging 13 years and renewal options averaging 16 years, and rents averaging \$15.00 per square foot.

## **ITEM 3. LEGAL PROCEEDINGS**

On June 21, 2002 we brought legal action against The Lark Group LLC, Best Que LLC, and Michael Sloane, II, in the United States District Court, Middle District of Florida, Tampa Division, relating to their purchase of assets and leasehold rights for two Midwest locations. Our complaint sought relief for breaches of contract against each of the defendants. Defendants consented to a final judgment in the amount of \$188,201, which was filed with the Court on January 22, 2003. The parties reached a settlement which was finalized with a \$100,000 lump sum payment to Shells in December 2004.

In the ordinary course of business, Shells is and may be a party to various legal proceedings, the outcome of which, singly or in the aggregate, is not expected to be material to our financial position, results of operations or cash flows.

## **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SHAREHOLDERS**

None.

**PART II**

**ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS**

Our common stock is traded on the over-the-counter bulletin board under the symbol "SHLL". The following table sets forth the high and low per share price of our common stock as reported by the OTC bulletin board.

These over-the-counter market quotations reflect inter-dealer prices, without retail markup, mark-down or commission and may not necessarily represent actual transactions.

| Fiscal 2003    | High   | Low    |
|----------------|--------|--------|
| First quarter  | \$0.75 | \$0.35 |
| Second quarter | \$0.70 | \$0.40 |
| Third quarter  | \$0.70 | \$0.51 |
| Fourth quarter | \$0.95 | \$0.42 |
| Fiscal 2004    |        |        |
| First quarter  | \$0.75 | \$0.34 |
| Second quarter | \$0.65 | \$0.27 |
| Third quarter  | \$0.80 | \$0.47 |
| Fourth quarter | \$0.88 | \$0.47 |

The number of stockholders of record of our common stock on January 31, 2005 was approximately 250. Our stock price as of January 31, 2005 was \$0.75.

Our authorized capital stock consists of 20,000,000 shares of common stock, par value \$0.01 per share, and 2,000,000 shares of preferred stock, par value \$0.01 per share. In February 2005, our board of directors and the holders of a majority of our outstanding shares of common stock authorized, by written consent, an amendment to our certificate of incorporation that will increase the total number of authorized shares of our common stock from 20,000,000 shares to 40,000,000 shares. Subsequently, an Information Statement was mailed to our stockholders of record at that time, pursuant to Section 14(C) of the Securities Exchange Act of 1934, regarding these actions by written consents. The additionally authorized shares are expected to be available for issuance commencing in March 2005.

**Dividend Policy**

We have never declared or paid any cash dividends on our common stock. All future earnings will be retained by us for the development of our business. Accordingly, we do not anticipate paying cash dividends on the common stock in the foreseeable future. We are subject to loan covenants containing certain provisions prohibiting our ability to pay dividends.

**Equity Compensation Plans**

Securities authorized for issuance under equity compensation plans as of January 2, 2005 were as follows:

| Plan category  | Number of securities to be issued upon exercise of outstanding options, warrants, and rights<br>[a] | Weighted-average exercise price of outstanding options, warrants and rights<br>[b] | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column [a])<br>[c] |
|--|---|--|--|
| Equity compensation plans approved by security holders     | 1,143,500   | \$1.00   | 1,583,043  |
| Equity compensation plans not approved by security holders | 9,129,280   | \$0.30   | —  |
| Total  | 10,272,780  |  | 1,583,043  |



Equity compensation plans not approved by security holders consist of (i) warrants to purchase 5,158,030 shares of common stock, issued on January 31, 2002, in connection with a \$2,000,000 private financing transaction; warrants were exercised at \$0.16 per share on January 31, 2005, the expiration date, resulting in the issuance of 4,712,630 shares of common stock, which provided proceeds of \$754,000 to us; warrants to purchase 445,400 shares of common stock were also exercised by a “cashless exercise” on January 31, 2005 resulting in the issuance of 350,381 shares of common stock; (ii) warrants to purchase 2,000,000 shares of common stock, issued on August 4, 2004, in connection with the extension of the maturity date of the \$2,000,000 private financing transaction to January 31, 2007; warrants to purchase 1,000,000 shares were exercised in March 2005 at the exercise price of \$0.50 per share by certain of our investors, the proceeds of which were used to pay down the principal amount of the notes to these investors; and (iii) warrants to purchase 1,971,250 shares of common stock, exercisable through December 7, 2010, issued on December 7, 2004 in connection with the \$2,375,000 debenture offering; the exercise price will be determined at a future date upon the completion of an anticipated financing transaction, however, the exercise price will not be less than \$0.45 nor greater than \$0.80 per share.

The number of securities and type of plans available for future issuance of stock options as of January 2, 2005 was:

| <u>Plan Name</u>                             | <u>Options and Warrants for Common Shares</u> |                  |                    |                  |
|--|---|------------------|--------------------|------------------|
|  | <u>Authorized</u>                             | <u>Exercised</u> | <u>Outstanding</u> | <u>Available</u> |
| Stock Option Plan for Non-Employee Directors | 150,000                                       | 0                | 32,000             | 118,000          |
| 1995 Employee Stock Option Plan              | 840,000                                       | 0                | 173,750            | 666,250          |
| 1996 Employee Stock Option Plan              | 101,000                                       | 11,001           | 31,992             | 58,007           |
|  | 1,850,000                                     |                  |                    |                  |
| 2002 Equity Incentive Plan                   |   |                  | 905,758            |                  |
|  |   | <u>203,456</u>   |                    | <u>740,786</u>   |
|  |   |                  |                    | 1,583,043        |
| Total stock options                          | <u>2,941,000</u>                              | <u>214,457</u>   | <u>1,143,500</u>   |                  |

Stock options exercised consist of (i) 42,666 shares of common stock issued from options exercised in 2004 by employees, (ii) 160,790 shares of common stock issued in 2003 to key employees pursuant to our fiscal year 2002 management bonus plan, and (iii) 11,001 shares of common stock issued from options exercised by employees in prior years.

## ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following table sets forth selected historical consolidated financial data for Shells. The historical consolidated financial data is for the fiscal years (53 weeks) ended January 2, 2005 (our fiscal year 2004), and the (52 weeks) ended December 28, 2003 (our fiscal year 2003), December 29, 2002 (our fiscal year 2002), December 30, 2001 (our fiscal year 2001), and December 31, 2000 (our fiscal year 2000). This consolidated financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and Notes thereto included elsewhere in this Form 10-K. (The amounts are presented in thousands, except earnings per share, shares outstanding, number of restaurants data, and percentage information).

|  | Year              |                       |               |                |                   |
|--|-------------------|-----------------------|---------------|----------------|-------------------|
|  | (53 Weeks)        | Year (52 Weeks) Ended |               |                |                   |
|  | Ended             | December 28,          | December 29,  | December 30,   | December 31,      |
|  | January 2,        | 2003                  | 2002          | 2001           | 2000              |
|  | 2005              |                       |               |                |                   |
| <b>Statement of Operations Data:</b>   |                   |                       |               |                |                   |
| Revenues   |                   |                       |               |                |                   |
| Restaurant sales   | \$ 41,393         | \$ 43,881             | \$ 47,065     | \$ 57,258      | \$ 90,023         |
| Management fees  | 171               | 165                   | 163           | 271            | 419               |
| Total revenues   | <u>41,564</u>     | <u>44,046</u>         | <u>47,228</u> | <u>57,529</u>  | <u>90,442</u>     |
| Costs and expenses   |                   |                       |               |                |                   |
| Cost of sales  | 14,051            | 14,467                | 15,778        | 21,239         | 33,984            |
| Labor and other related expenses   | 12,935            | 13,845                | 14,585        | 17,628         | 28,028            |
| Other restaurant operating expenses  | 10,123            | 11,117                | 10,774        | 12,047         | 19,635            |
| General and administrative expenses  | 3,249             | 3,387                 | 3,565         | 4,751          | 7,212             |
| Depreciation and amortization  | 1,058             | 1,077                 | 1,102         | 1,702          | 2,703             |
| Provision for impairment of assets   | 105               | 360                   | 110           | 2,259          | 3,978             |
| Provision for impairment of goodwill   | —                 | —                     | 206           | —              | —                 |
| Provision for store closings   | —                 | —                     | —             | 1,333          | 1,027             |
| Income (loss) from operations  | 43                | (207)                 | 1,108         | (3,430)        | (6,125)           |
| Interest expense, net  | (1,154)           | (463)                 | (534)         | (481)          | (789)             |
| Other income (expense)   |                   |                       |               |                |                   |
| Other income (expense), net  | 33                | (100)                 | (3)           | (476)          | 145               |
| Gain on preferred stock conversion   | —                 | —                     | —             | 588            | —                 |
| (Loss) income before elimination of minority partner interest and income taxes | (1,078)           | (770)                 | 571           | (3,799)        | (6,769)           |
| Elimination of minority partner interest                                       | (266)             | (264)                 | (221)         | (221)          | (259)             |
| (Loss) income before benefit (provision) for income taxes                      | (1,344)           | (1,034)               | 350           | (4,020)        | (7,028)           |
| Income tax benefit (provision) (1)   | —                 | —                     | 327           | 1,001          | (2,304)           |
| Net (loss) income  | <u>\$ (1,344)</u> | <u>\$ (1,034)</u>     | <u>\$ 677</u> | <u>(3,019)</u> | <u>\$ (9,332)</u> |

|  | Fiscal Years Ended |                      |                      |
|--|--------------------|----------------------|----------------------|
|  | January 2,<br>2005 | December 28,<br>2003 | December 29,<br>2002 |
| <b>Earnings per Share Data:</b>  |                    |                      |                      |
| Basic net (loss) income per share  | \$ (0.26)          | \$ (0.23)            | \$ 0.15              |
| Diluted net (loss) income per share  | \$ (0.26)          | \$ (0.23)            | \$ 0.07              |
| <b>Shares Outstanding Data:</b>  |                    |                      |                      |
| Basic weighted average   | 5,261,981          | 4,577,470            | 4,454,015            |
| Diluted weighted average   | 5,261,981          | 4,577,470            | 10,259,188           |
| <b>Operating Data:</b>   |                    |                      |                      |
| System-wide sales:   |                    |                      |                      |
| Company-owned restaurants (2)(3)   | \$ 41,393          | \$ 43,881            | \$ 47,065            |
| Licensed restaurants   | 7,883              | 7,167                | 8,147                |
|  | <u>\$ 49,276</u>   | <u>\$ 51,048</u>     | <u>\$ 55,212</u>     |
| Number of restaurants (at end of period):  |                    |                      |                      |
| Company-owned restaurants (2)  | 21                 | 24                   | 24                   |
| Licensed restaurants   | 4                  | 4                    | 4                    |
|  | <u>25</u>          | <u>28</u>            | <u>28</u>            |
| Average annual sales per Company-owned and joint venture restaurant open for full period (4) | \$ 1,896           | \$ 1,828             | \$ 1,924             |
| Decrease in Company-owned and joint venture restaurant same store sales (4)                  | -1.6%              | -5.1%                | -7.2%                |

|                              | January 2,<br>2005 | December 28,<br>2003 | December 29,<br>2002 | December 30,<br>2001 | December 31,<br>2000 |
|------------------------------|--------------------|----------------------|----------------------|----------------------|----------------------|
| <b>Balance Sheet Data:</b>   |                    |                      |                      |                      |                      |
| Working capital (deficiency) | \$ (4,639)         | \$ (3,606)           | \$ (3,116)           | \$ (7,580)           | \$ (7,500)           |
| Total assets                 | 13,519             | 11,616               | 13,858               | 14,847               | 21,461               |
| Long-term debt               | 3,734              | 3,826                | 3,883                | 1,633                | 5,700                |
| Minority partner interest    | 442                | 466                  | 428                  | 428                  | 449                  |
| Preferred stock              | —                  | 1                    | 1                    | 1                    | —                    |
| Stockholders' equity         | 502                | 1,183                | 2,152                | 1,475                | 4,414                |

- (1) The effective tax rates for fiscal years 2004, 2003, 2002, 2001 and 2000 include the effect of recognizing valuation allowance adjustments relating to tax benefits. There was no benefit or provision for income taxes in 2004 or 2003. Income tax benefit (provision) of 93.3%, 24.9% and (32.8)% for the fiscal years ended 2002, 2001 and 2000, respectively, differ from the amounts computed by applying the effective federal income tax rate of 34% as a result of adjusting the valuation allowance, primarily related to net operating loss carryforwards from prior years. The valuation allowance in 2004 was increased by \$210,000, reserving for all tax assets that were deemed non-realizable. The valuation allowance in 2003 was increased by \$596,000, reserving for all tax assets that were deemed non-realizable. The valuation allowance in 2002 was increased by \$1,403,000, reserving for all tax assets that were deemed non-realizable. The valuation allowance in 2001 was decreased by \$706,000, reserving for all tax assets except those subject to recovery through carrybacks resulting from the March 9, 2002 Economic Stimulus Package.
- (2) Includes one joint venture restaurant in which we own a 51% equity interest.
- (3) Includes three locations that were closed in 2004.
- (4) Includes only restaurants open during the full fiscal year shown and open for a full comparable fiscal year and at least the full six months prior thereto. Same store sales are calculated on a comparable calendar period basis.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### General

Fiscal year 2004 was a year of significant variability for Shells. The first half of the year marked a continued focus on repositioning the Shells concept to leverage the competitive strengths of freshness, quality and variety at reasonable prices. We worked to elevate service and operations levels, recruiting new operations talent to replace underperforming restaurant managers. A comprehensive service program was rolled out, including certifying all servers, bartenders, hostesses and service assistants, in the new procedures. We also addressed improving our atmosphere and facilities, testing and completing a remodel package to dramatically enhance the appearance and appeal of its restaurants. Shells "new look" was unveiled at three restaurants during the year and met with enthusiastic guest acceptance.

Just as Shells was beginning to experience positive sales momentum from the various changes to improve the concept, four major hurricanes struck Florida, the state where all of our restaurants are located. The hurricanes significantly disrupted our business, with evacuations and storm-related damage closing several restaurants for extended periods of time. Many of the lost sales days occurred on weekends, the period where the majority of the week's sales are typically generated. The impact also hampered Florida tourism for several weeks, particularly affecting our restaurants located in coastal areas. Cash flow from operations and same store sales are among the most significant drivers in our business and the combined impact of the Florida hurricanes seriously diminished our cash position and dealt us a significant financial setback.

However, Shells regained sales momentum after the storms, and as our restaurants reopened, sales rebounded very well. Beginning late in the third quarter, our comparable store sales turned positive and were consistently strong for the remainder of the year, with same store sales up 5.7% during the fourth quarter.

Management continues to focus on its strategy to improve and strengthen the concept's customer appeal, striving to attract new and former Shells customers as well as core customers. A major part of this ongoing effort is remodeling and modernizing the restaurants. The new look introduced at three remodeled restaurants during 2004 has been very successful in generating excellent guest feedback and strong sales increases.

We received funding during the fourth quarter of 2004, which we are utilizing to remodel additional restaurants. We anticipate closing a contemplated next round of financing in the first half of 2005 which, if completed, should allow us to remodel most of our remaining restaurants. We may also use funds from any contemplated financing to strategically open new restaurants or relocate existing restaurants.

The fourth quarter 2004 net funding of \$2,010,000 was achieved by the sale of \$2,375,000 principal amount of convertible debentures, which are due in April 2005. In March 2005, our investors provided us with a \$1,600,000 revolving line of credit. We expect to use the line of credit to help repay the debentures if a cash repayment is required, to the extent we have not then consummated the contemplated next round of financing.

There are no assurances that the implementation of our strategies will result in sales and customer traffic gains which are required to meet our contemplated cash flow requirements. In addition, there are no assurances that financing options will be available to us or that our business plan will not be significantly hampered by cash availability.

The following table sets forth, for the periods indicated, the percentages that the items in our Consolidated Statements of Operations bear to total revenues, or where indicated, restaurant sales.

|   | Fiscal Years Ended |                      |                      |
|---|--------------------|----------------------|----------------------|
|   | January 2,<br>2005 | December 28,<br>2003 | December 29,<br>2002 |
| Revenues                                      |                    |                      |                      |
| Restaurant sales                              | 99.6%              | 99.6%                | 99.7%                |
| Management fees                               | 0.4%               | 0.4%                 | 0.3%                 |
|   | <u>100%</u>        | <u>100%</u>          | <u>100%</u>          |
| Cost and expenses                             |                    |                      |                      |
| Cost of sales (1)                             | 33.9%              | 33.0%                | 33.5%                |
| Labor and other related expenses (1)          | 31.2%              | 31.6%                | 31.0%                |
| Other restaurant operating expenses (1)       | 24.5%              | 25.3%                | 22.9%                |
| Total restaurant costs and expenses (1)       | <u>89.6%</u>       | <u>89.9%</u>         | <u>87.4%</u>         |
| General and administrative expenses           | 7.8%               | 7.7%                 | 7.5%                 |
| Depreciation and amortization                 | 2.5%               | 2.4%                 | 2.3%                 |
| Provision for impairment of assets            | 0.3%               | 0.8%                 | 0.2%                 |
| Provision for impairment of goodwill          | 0.0%               | 0.0%                 | 0.4%                 |
| Income (loss) from operations                 | 0.1%               | -0.5%                | 2.3%                 |
| Interest expense, net                         | -2.8%              | -1.1%                | -1.1%                |
| Other income (expense), net                   | 0.1%               | -0.2%                | 0.0%                 |
| Elimination of minority partner interest      | -0.6%              | -0.6%                | -0.5%                |
| (Loss) income before benefit for income taxes | <u>-3.2%</u>       | <u>-2.4%</u>         | <u>0.7%</u>          |
| Income tax benefit                            | 0.0%               | 0.0%                 | 0.7%                 |
| Net (loss) income                             | <u>-3.2%</u>       | <u>-2.4%</u>         | <u>1.4%</u>          |

(1) As a percentage of restaurant sales.

## Results of Operations

### *Fiscal Year 2004 versus Fiscal Year 2003*

Total revenues for the 53-week fiscal year 2004 were \$41,564,000 as compared to \$44,046,000 for the 52-week fiscal year 2003. The \$2,482,000 or 5.6% decrease in revenues was primarily due to a reduction in the number of restaurants open for operation in 2004. We operated 25 restaurants as of the end of 2004 compared to 28 restaurants at the end of 2003. However, revenues in 2004 contained an additional operating week compared to 2003, as our fiscal year is the 52 or 53 weeks ending the Sunday nearest to December 31st. Our revenues consisted of restaurant sales of our company-owned restaurants and management and licensing fees on sales at the managed restaurants. Our food sales and liquor sales accounted for 88% and 12% of revenues, respectively, for 2004 compared to 89% and 11%, respectively, for 2003. Liquor sales, relative to food sales, increased year-to-year as a result of a new beverage program initiated in the first quarter of 2004. Same store sales in 2004 decreased 1.6% when compared to 2003. The decline in same store sales was the result of a 10.5% decline in customer traffic, offset in part by a 10.0% increase in average customer check. In 2004, we incurred estimated sales losses of \$930,000 due to hurricane-related business interruption. Adjusting for estimated hurricane-related sales losses, same store sales would have increased by 0.2% above the prior year. Comparisons of same store sales include only stores, which were operating during the equivalent calendar periods being compared and, due to the time needed for a restaurant to become established and fully operational, at least six months prior to the beginning of that period.

The cost of restaurant sales as a percentage of restaurant sales increased to 33.9% for 2004 from 33.0% for 2003. This increase primarily was due to a 0.6% of sales increase in commodity costs and 0.4% increase relating to menu mix changes including promotional items which affected customer preferences. Fiscal year 2004 and 2003 cost of sales included a non-recurring inventory write down of \$22,000 and \$36,000, respectively. Exclusive of these non-recurring items, cost of restaurant sales was 33.9% and 32.9% of restaurant sales for 2004 and 2003, respectively. The cost of restaurant sales generally consists of the cost of food, beverages, freight, and paper and plastic goods used in food preparation and carry-out orders.



Labor and other related expenses as a percentage of restaurant sales decreased to 31.2% in 2004 as compared to 31.6% for 2003. This decrease was mostly due to a reduction in workers' compensation insurance costs of 0.2% of sales and a reduction in key hourly labor of 0.2% of sales. Fiscal year 2004 and 2003 included a non-recurring reduction in expenses of \$161,000 and \$196,000, respectively, relating to a refund and corresponding reserve adjustment for prior years workers' compensation experience. Exclusive of these non-recurring items, labor and other related expenses was 31.6% and 32.0% of restaurant sales for 2004 and 2003, respectively. Labor and other related expenses generally consist of restaurant hourly and management payroll, benefits, taxes and workers' compensation insurance.

Other restaurant operating expenses as a percentage of restaurant sales decreased to 24.5% for 2004 as compared with 25.3% for 2003. This decrease was primarily due to a 0.9% decrease in restaurant repairs and maintenance costs, partially offset by a loss of sales leverage caused by lower unit sales volumes. Other restaurant operating expenses generally consist of advertising, costs associated with area directors, supplies, repairs and maintenance, rent and other occupancy costs and utilities.

General and administrative expenses were \$3,249,000 or 7.8% of revenues and \$3,387,000 or 7.7% of revenues in 2004 and 2003, respectively. The \$138,000 expense reduction was mostly due to a general downsizing in corporate office staff, which occurred in June 2004. Non-recurring expense in 2004 and 2003 each included a one-time charge for severance expense of \$39,000 and \$70,000, respectively. Exclusive of these non-recurring charges, general and administrative expense was 7.7% and 7.5% of revenues in 2004 and 2003, respectively. General and administrative expenses relate to the operations of all Shells restaurants owned by us and management services that we provide to the managed restaurants.

Depreciation and amortization expenses as a percentage of revenues were 2.5% for 2004 and 2.4% for 2003. The 0.1% of revenues increase was mostly due to increasing the fixed asset basis as a result of restaurant remodeling and hurricane-related reconstruction.

The provision for impaired assets was \$105,000 or 0.3% of revenues for 2004 as compared to \$360,000 or 0.8% of revenues for 2003. In 2004 and 2003, we recorded a pre-tax charge relating to the write-down of impaired assets to their estimated fair value in accordance with Financial Accounting Standards Board Statement No. 144. The asset impairment charge in 2004 related to one restaurant compared to three restaurants in 2003. The respective write-downs were necessitated by the then current period operating losses and the projected cash flows of the restaurants, many of which were negative.

Goodwill was evaluated for impairment in each of 2004 and 2003 in accordance with FASB Statement No. 142. As a result of the evaluation, we did not recognize goodwill impairment in either year.

Net interest expense was \$1,154,000 in 2004 compared to \$463,000 in 2003. In 2004, we recorded one-time charges of \$446,000 in the third quarter, relating to warrants to purchase 2,000,000 shares of common stock issued in connection with the extension of the maturity dates on the \$2,000,000 promissory notes; and \$265,000 in the fourth quarter, relating to warrants to purchase 1,187,500 shares of common stock issued to debenture holders in conjunction with the \$2,375,000 financing transaction. Exclusive of these non-recurring charges, net interest expense was \$443,000 in 2004. The \$20,000 decrease in net interest expense in 2004 from 2003, excluding the non-recurring charges, was generally due to the pay down of outstanding debt, partially offset by a \$9,000 reduction in interest income resulting from lower balances of cash in 2004 compared to 2003.

Other income in 2004 was \$33,000, compared to other expense of \$100,000 in 2003. In 2004, we recognized non-recurring gains for hurricane-related insurance settlements of \$597,000 and the disposition of assets of \$89,000. In 2004, we also recognized non-recurring charges for financing costs of \$539,000 relating to the \$2,375,000 financing transaction and a loss on the disposal of assets of \$41,000 relating to our restaurant renovations. Exclusive of these non-recurring items, other expense in 2004 was \$139,000.

No benefit or provision for income taxes was recognized in either 2004 or 2003.

As a result of the factors discussed above, the income from operations for 2004 was \$43,000 compared to a loss from operations for 2003 of \$207,000. Exclusive of non-recurring items, our loss from operations was \$57,000 for 2004 compared to net income of \$63,000 for 2003. Net loss for 2004 was \$1,344,000 compared to \$1,034,000 for 2003. Exclusive of non-recurring items, the net loss in 2004 was \$733,000 compared to \$764,000 for 2003.

## *Fiscal Year 2003 versus Fiscal Year 2002*

Total revenues for 2003 were \$44,046,000 as compared to \$47,228,000 for 2002. The \$3,182,000 or 6.7% decrease in revenues was primarily due to a 5.1% decrease in same store sales and, to a lesser extent, due to operating one less restaurant during and after the third quarter of 2002. The decline in same store sales was the result of a decline in customer traffic, offset in part by an increase in average customer check. Our food sales and liquor sales accounted for 89% and 11% of revenues, respectively, for the fiscal year ended December 28, 2003.

The cost of restaurant sales as a percentage of restaurant sales decreased to 33.0% for 2003 from 33.5% for 2002. This decrease primarily was due to favorable food costs and lower distribution costs, partially offset by a non-recurring write-down of inventory of \$36,000. Exclusive of the non-recurring item, cost of restaurant sales was 32.9% for 2003.

Labor and other related expenses as a percentage of restaurant sales increased to 31.6% during 2003 as compared to 31.0% for 2002. This percentage increase was due to a loss of sales leverage caused by lower unit sales volumes, along with increases in health insurance and workers' compensation insurance; partially offset by a non-recurring reduction in expenses of \$196,000 relating to a reserve adjustment for prior years workers' compensation experience. Exclusive of the non-recurring item, labor and other related expenses was 32.0% of restaurant sales for 2003.

Other restaurant operating expenses as a percentage of restaurant sales increased to 25.3% for 2003 as compared with 22.9% for 2002. This percentage increase was primarily due to a loss of sales leverage caused by lower unit sales volumes, along with increases in restaurant maintenance; utilities, particularly electricity and gas; insurance and real estate taxes.

General and administrative expenses were \$3,387,000 or 7.7% of revenues and \$3,565,000 or 7.5% of revenues in 2003 and 2002, respectively. Non-recurring expense in 2003 included a one-time charge for severance expense of \$70,000. Exclusive of the non-recurring charge, general and administrative expense was 7.5% in 2003.

Depreciation and amortization expenses as a percentage of revenues were 2.4% for 2003 and 2.3% for 2002.

The provision for impaired assets was \$360,000 or 0.8% of revenues for 2003 as compared to \$110,000 or 0.2% of revenues for 2002. In 2003 and 2002, we recorded a pre-tax charge relating to the write-down of impaired assets to their estimated fair value in accordance with Financial Accounting Standards Board Statement No. 144. The asset impairment charge in 2003 related to three restaurants, two of which were previously not written down and a third that was partially written down in 2002. The asset impairment charge in 2002 related to three restaurants that were previously not written down.

Goodwill was evaluated for impairment in 2003 and 2002 in accordance with FASB Statement No. 142 which we adopted in 2002. As a result of the evaluation we did not recognize goodwill impairment in 2003. The provision for impairment of goodwill was \$206,000 or 0.4% of revenues in 2002.

Net interest expense was \$463,000 in 2003 compared to \$534,000 in 2002. We recorded a one-time charge of \$106,000 in the first quarter of 2002 relating to the previously reported \$2,000,000 financing transaction. Exclusive of this non-recurring charge, net interest expense was \$428,000 in 2002. The increase in net interest expense in 2003 over 2002, excluding the non-recurring charge was primarily due to a \$23,000 reduction in interest income, resulting from lower balances of cash in 2003 compared to 2002.

Other expense in 2003 was \$100,000, compared to \$3,000 in 2002. The increase primarily related to a net change in the reserve adjustment for gift certificates.

A benefit from income taxes of \$327,000 was recognized in 2002. No benefit or provision was recognized in 2003. The benefit in 2002 related to a refund application to recover tax payments of \$1,176,000 from prior years, resulting from the Economic Stimulus Package signed into law in March 2002. The refund was received in July 2002.

As a result of the factors discussed above, loss from operations for 2003 was \$207,000 compared to income from operations for 2002 of \$1,108,000. Exclusive of non-recurring items, our income from operations was \$63,000 for 2003 compared to \$1,218,000 for 2002. Our net loss for 2003 was \$1,034,000 compared to net income of \$677,000 for 2002. Exclusive of non-recurring items, net loss in 2003 was \$764,000 compared to net income in 2002 of \$575,000.

## Liquidity and Capital Resources

We attained a marginally positive income from operations in 2004, after incurring significant business losses as a result of successive hurricanes in 2004. Subsequent to the four hurricanes which occurred in the third quarter of 2004, we began to experience a resurgence in sales growth, with a 5.7% improvement in fourth quarter 2004 same store sales. In August 2004, the maturity dates on the \$2,000,000 principal amount promissory notes were extended from January 31, 2005 to January 31, 2007. We attained cash infusions of \$600,000 in November 2004 and \$754,000 January and February 2005 from the exercise and conversion of noteholder warrants to shares of our common stock. We also obtained a \$500,000 interim line of credit from our bank to assist in the hurricane-related reconstruction of our restaurants of which \$295,000 was utilized and subsequently repaid from insurance proceeds.

In December 2004, we raised additional net funds of \$2,010,000 for the remodeling of many of our restaurants through an offering of \$2,375,000 in convertible debentures. The debentures mature on the earliest to occur of certain events, but in any event, not later than April 5, 2005. In addition, we contemplate that an additional round of financing will be sought in the first half of 2005. In March 2005, our investors provided us a \$1,600,000 revolving line of credit, which matures on the earlier of March 31, 2006 or the closing of a financing providing us not less than \$1,600,000 of net proceeds. Amounts drawn under the line of credit bear interest at the rate of 15% per annum, payable 8% monthly in arrears and 7% deferred until the maturity date. The investors received a fee of \$80,000 for extending the credit line to Shells.

Proceeds of \$600,000 from the issuance of common stock received in November 2004 and \$295,000 obtained from an interim bank line of credit were used to remodel three restaurants in 2004. In addition, approximately one-half of the net \$2,010,000 funds received through the \$2,375,000 offering of convertible debentures, is currently being used to complete the remodeling of six additional restaurants. We have experienced favorable sales trends as a result of our restaurant remodeling, to-date. Subsequent to the August and September hurricanes, aggregate sales for the three remodeled stores which were remodeled in 2004 have increased 13.3% above the prior year period in comparison to an increase of 4.4% for the non-remodeled restaurants over the comparable period. While we believe that our restaurants will experience sales improvements from remodeling, there are no assurances that future restaurant remodels will achieve similar, if any, increases in same store sales or that the restaurants remodeled to-date or any of these future restaurant remodels will be able to sustain continuing sales improvements. There are also no assurances that the remodeling costs of any new remodels will be at levels comparable to remodeling expenditures incurred to-date.

In addition to repaying the debentures, we anticipate that the contemplated additional round of financing will be utilized to complete our restaurant remodeling and position our company for growth. There can be no assurances that such financing or any other financing will be available to us, or at terms acceptable to us. We believe that with funds from the contemplated additional financing or the revolving credit line, we will have sufficient capital to satisfy the debt service requirements of the convertible debentures.

Proceeds of \$754,000 from the issuance of common stock received in January and February 2005 relating to the warrant exercise, and \$600,000 for a lease termination fee received in February 2005 on a restaurant location are being used to acquire, renovate and prepare to open our new Clearwater Beach restaurant.

The following table presents a summary of our cash flows for the last three fiscal years (in thousands):

|   | <u>2004</u>     | <u>2003</u>       | <u>2002</u>     |
|---|-----------------|-------------------|-----------------|
| Net cash (used in) provided by operating activities | \$ (128)        | \$ (490)          | \$ 444          |
| Net cash (used in) provided by investing activities | 1,292           | (755)             | 325             |
| Net cash provided by (used in) financing activities | 3,046           | (500)             | 730             |
| Net increase (decrease) in cash                     | <u>\$ 1,626</u> | <u>\$ (1,745)</u> | <u>\$ 1,499</u> |

As of January 2, 2005, our current liabilities of \$7,992,000 exceeded our current assets of \$3,353,000, resulting in a working capital deficiency of \$4,639,000. In comparison, as of December 28, 2003, our working capital deficiency was \$3,606,000. Our operating leverage decreased mostly due to the deployment of interim financing toward restaurant remodeling and reconstruction from hurricane-related property losses. We may still encounter operating pressures from declining sales, increasing food, labor or other operating costs or additional restaurant restoration or disposition costs. Historically, we have generally operated with negative working capital as a result of the investing of current assets into non-current property and equipment, as well as the turnover of restaurant inventory relative to more favorable vendor terms in accounts payable.

During 2004, our cash position increased by \$1,626,000, from \$724,000 as of December 28, 2003 to \$2,350,000 as of January 2, 2005. The increase in cash was almost exclusively provided by financing activities of \$3,046,000, representing proceeds from the issuance of debt of \$2,832,000 and common stock of \$618,000, partially offset by \$404,000 in debt repayment. The net cash used in investing activities was \$1,292,000, generally reflecting capital expenditures related to restaurant remodeling and hurricane-related reconstruction. Net cash used in operating activities totaled \$128,000.

In connection with the \$2,000,000 financing dated January 31, 2002, we issued to each of Shells Investment Partners and Banyon (i) a \$1,000,000 secured promissory note due January 31, 2005 (extended to January 31, 2007) which bears interest at 15% per annum, of which 8% is payable monthly in arrears and 7% is deferred and payable when the principal is paid in full and (ii) a warrant to purchase 4,454,015 shares of our common stock, at an exercise price of \$0.16 per share. On April 12, 2004, Banyon sold their interest in the \$1,000,000 note to Frederick R. Adler, a more than 10% shareholder. On June 23, 2004, Shells Investment Partners sold their interest in the \$1,000,000 note along with 90% of their warrants to Trinad Capital, LP (\$600,000) and GCM Shells Seafood Partners, LLC (\$400,000). Subsequently, on September 30, 2004, GCM Shells Seafood Partners sold their interest in their \$400,000 note to Bruce Galloway, IRA R/O. These warrants to purchase an aggregate of 8,908,030 shares of our common stock were exercised from November 2004 through January 31, 2005, resulting in net proceeds to us of \$600,000 in 2004 and \$754,000 in 2005.

On August 4, 2004, the \$2,000,000 aggregate principal amount of secured promissory notes set to mature on January 31, 2005 were extended to be due on January 31, 2007, under the same terms as the original notes. As an inducement to extend the maturity date of the notes, warrants to purchase 2,000,000 shares of common stock at an exercise price of \$0.50 per share were issued to the note holders in proportion to the value of their respective notes. Warrants to purchase 1,000,000 shares of common stock were exercised in March 2005 by certain of our investors, and the proceeds of \$500,000 were used to pay down the principal amount of the notes to these investors. Additionally, in March 2005, the \$1,000,000 note held by Frederick R. Adler was modified to allow Shells to defer entirely the monthly interest payment on \$500,000 of principal amount of the note until the maturity date of January 31, 2007, resulting in the deferral of \$72,000 of cash payments until the maturity date.

On December 7, 2004, we sold \$2,375,000 principal amount of debentures and warrants to purchase 1,187,500 shares of our common stock. We received net proceeds of \$2,010,000 from the sale. The debentures bear interest at 12%, and mature on the earlier of: (i) April 5, 2005, (ii) the closing of an additional round of financing of no less than \$1,500,000, or (iii) upon the occurrence of an event of default. In the event that we, on or prior to the maturity date, consummate the sale of shares of capital stock (other than a sale of capital stock to our officers, directors, employees or consultants in connection with their provision of services to us) resulting in net proceeds to us of at least \$250,000, then the outstanding principal amount of the debentures and all accrued and unpaid interest, at the sole option of the holder of the debenture, will convert in whole or in part, into shares of the common stock sold in such future financing. The warrants are exercisable until December 7, 2007. The warrants have an exercise price equal to 80% of the price per share or unit in our contemplated next round of equity financing resulting in net proceeds to us of at least \$250,000, provided that the exercise price cannot exceed \$0.80 per share or be less than \$0.45 per share. In the event that such financing is not completed on or before September 4, 2005, the warrants will automatically be assigned an exercise price equal to 65% of the closing price of our common stock on September 4, 2005, but in no event greater than \$0.80 or less than \$0.45 per share. The exercise price of the warrants and the number of underlying shares of common stock is subject to adjustment under certain circumstances. As compensation for their services as placement agent in the debenture offering and future consulting services to us, the placement agent received cash fees and warrants with terms substantially identical to those received by the investors.

In October 2002, we refinanced through Colonial Bank two of our restaurant locations, Melbourne and Winter Haven, with notes of \$635,000 and \$667,000, respectively. The loans, which bear interest at the bank's base rate, are for terms of five years with required monthly principal payments based on a 15 year amortization schedule, and a balloon payment at the end of the five years. The principal balances owed on these two notes as of January 2, 2005 were \$532,000 and \$567,000, respectively. Relative to these two promissory notes, we are required to meet a financial covenant relating to debt coverage. We were in compliance in meeting this loan covenant as of January 2, 2005. However, in the past, we were not in compliance with meeting the loan covenant for which a covenant waiver was provided by the bank.

We believe that our cash balance, coupled with the \$1,600,000 revolving credit line provided to Shells in March 2005, along with our operating cash flow will be sufficient to satisfy our contemplated cash requirements through the end of 2005. There are no assurances that the implementation of our strategies will result in sales and customer traffic gains which are required to meet our contemplated cash flow requirements.

We have, from time-to-time utilized, and to the extent applicable may utilize sale-leaseback transactions, real estate mortgage and restaurant equipment financing with various banks or financing institutions as necessary. In the event that our plans change, assumptions prove to be inaccurate, or due to unanticipated expenses, and in the event projected cash flow or third party financing otherwise prove to be insufficient to fund operations, we could be required to seek additional financing from sources not currently anticipated. There can be no assurance that third party financing will be available to us when needed, on acceptable terms, or at all.

### ***Contractual Obligations***

As of January 2, 2005, our contractual obligations were:

|  | Payments due by period |                    |                    |                    |                    |
|--|------------------------|--------------------|--------------------|--------------------|--------------------|
|  | Total                  | < 1 yr             | 1 - 3 yrs          | 3 - 5 yrs          | > 5 yrs            |
| Long-term debt (1)   | \$ 2,010,609           | \$ 515,761         | \$1,254,504        | \$ 240,344         | \$ —               |
| Capital lease obligations  | —                      | —                  | —                  | —                  | —                  |
| Operating lease obligations (2)  | 15,086,000             | 1,968,000          | 3,475,000          | 3,112,000          | 6,531,000          |
| Purchase obligations   | —                      | —                  | —                  | —                  | —                  |
| Other debt obligations reflected on the company's balance sheet under GAAP (3) | 4,634,242              | 2,395,301          | 2,238,941          | —                  | —                  |
| Total  | <u>\$21,730,851</u>    | <u>\$4,879,062</u> | <u>\$6,968,445</u> | <u>\$3,352,344</u> | <u>\$6,531,000</u> |

Note 1 – consists of long-term debt as reported in footnote 6 of the financial statements.

Note 2 – consists of operating leases primarily for real estate.

Note 3 – consists of convertible debentures due in 2005 and related party debt due in 2007.

### **Quarterly Fluctuation of Financial Results**

The restaurant industry in general is seasonal, depending on restaurant location and the type of food served. We have experienced fluctuations in our quarter-to-quarter operating results due, in large measure, to our full concentration of restaurants in Florida. Business in Florida is influenced by seasonality due to various factors, which include but are not limited to weather conditions in Florida relative to other areas of the U.S. and the health of Florida's economy and the effect of world events in general and the tourism industry in particular. Our restaurant sales are generally highest from January through April and June through August, the peaks of the Florida tourism season, and generally lower from September through mid-December. Many of our restaurant locations are in coastal cities, where sales are significantly dependent on tourism and its seasonality patterns.

In addition, quarterly results have been substantially affected by the timing of restaurant closings or openings or remodelings. Because of the seasonality of our business and the impact of restaurant closings, openings or remodelings, results for any quarter are not generally indicative of the results that may be achieved for a full fiscal year on an annualized basis and cannot be used to indicate financial performance for the entire year.

### **Impact of Inflation and Price Changes**

We have not operated in a highly inflationary period and management does not believe that inflation has had a material effect on sales or expenses. As expenses increase, we expect to recover increased costs by increasing prices, to the extent permitted by competition, or by modifying our menu and promoting other less cost sensitive products. Many food products purchased by us are affected by commodity pricing and are, therefore, subject to unpredictable price volatility. Extreme changes in commodity prices and/or long-term changes could affect us adversely. From time-to-time, competitive circumstances could limit menu price flexibility, and in those cases margins would be negatively impacted by increased commodity prices. Due to the fact that our business is somewhat dependent on tourism in Florida, any significant decrease in tourism due to inflation would likely have a material adverse effect on revenues and profitability.

In May 2005, the minimum wage rate in Florida will increase by \$1.00 per hour. Tipped employees will also be receiving the \$1.00 per hour wage increase under this new law. Each year thereafter, the minimum wage will increase according to the U.S. Department of Labor, Bureau of Labor Statistics cost of living index. Such payroll cost increases could have a significant adverse affect to our company. Menu price increases and other actions will be



required to negate the effect of these wage increases. There can be no assurances that such measures expected to be taken by our company will be successful to adequately offset these additional payroll costs, or will be accepted without adverse reaction by our customers.

## **New Accounting Pronouncements**

In April 2003, the FASB issued Statement No. 149, “Amendment of Statement 133 on Derivative Instruments and Hedging Activities.” This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. This Statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, all provisions of this Statement should be applied prospectively. Adoption of FASB Statement 149 did not materially impact our consolidated financial statements.

In May 2003, the FASB issued Statement No. 150, “Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.” This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. Many of those instruments were previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of FASB Statement No. 150 did not materially impact our consolidated financial statements.

In December 2003, the FASB issued a pronouncement, Financial Interpretation Number 46R (“FIN 46R”), “Consolidation of Variable Interest Entities.” This FIN deals with Off-Balance Sheet Assets, Liabilities, and Obligations and gives guidance for determining which entities should consolidate the respective assets and liabilities associated with the obligations. We must fully consolidate assets and liabilities covered by FIN 46R in our financial statements in the first fiscal year or interim period beginning after March 15, 2004. Full disclosure, as well as consolidation, if applicable, of any newly created agreements after January 31, 2003 must begin immediately. Adoption of FIN 46R did not materially impact our consolidated financial statements.

In December 2003, the FASB revised Statement No. 132, “Employers’ Disclosures about Pensions and Other Postretirement Benefits” which amended FASB Statements No. 87, 88, and 106. Statement No. 132 requires additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit post-retirement plans. The required information is to be provided separately for pension plans and for other post-retirement benefit plans. Adoption of revised FASB Statement No. 132 did not materially impact our consolidated financial statements.

In November 2004, the FASB issued FASB Statement No. 151, “Inventory Costs” which amended ARB No. 43, Chapter 4. The amendments made by FASB Statement No. 151 will improve financial reporting by clarifying that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 23, 2004. The provisions of FASB Statement No. 151 are to be applied prospectively. Adoption of FASB Statement No. 151 is not expected to materially impact our consolidated financial statements.

In December 2004, the FASB revised Statement No. 123, “Accounting for Stock-Based Compensation.” This Statement supersedes APB Opinion No. 25, “Accounting for Stock Issued to Employees,” and its related implementation guidance. This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity’s equity instruments or that may be settled by the issuance of those equity instruments. Revised Statement No. 123 focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. This Statement does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and EITF Issue No. 96-18, “Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services,” nor address the accounting for employee share ownership plans, which are subject to AICPA Statement

of Position 93-6, "Employers' Accounting for Employee Stock Ownership Plans." Revised Statement No. 123 is effective for Shells as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. Adoption of revised FASB Statement No. 123 is not expected to materially impact our consolidated financial statements.

In December 2004, the FASB issued Statement No. 153, "Exchanges of Non-monetary Assets" which amended APB Opinion No. 29, "Accounting for Non-monetary Transactions." The amendments made by FASB Statement No. 153 are based on the principle that exchanges of non-monetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for non-monetary exchanges of similar productive assets and replace it with a broader exception for exchanges of non-monetary assets that do not have commercial substance. Previously, Opinion 29 required that the accounting for an exchange of a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset should be based on the recorded amount of the asset relinquished. The Statement is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for non-monetary asset exchanges occurring in fiscal periods beginning after the date of issuance. The provisions of this Statement are to be applied prospectively. Adoption of FASB Statement No. 153 is not expected to materially impact our consolidated financial statements.

#### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risk from changes in interest rates on debt and changes in commodity prices. Our exposure to interest rate risk relates to the \$1,099,000 in outstanding debt with banks that is based on variable rates. Borrowings under the loan agreements bear interest at the rate equal to the applicable bank's base rate.

**ITEM 8. FINANCIAL STATEMENTS**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

|   |     |
|---|-----|
| Independent Auditors' Report                    | F-2 |
| Consolidated Balance Sheets                     | F-3 |
| Consolidated Statements of Operations           | F-4 |
| Consolidated Statements of Stockholders' Equity | F-5 |
| Consolidated Statements of Cash Flows           | F-6 |
| Notes to Consolidated Financial Statements      | F-8 |

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders  
Shells Seafood Restaurants, Inc. and Subsidiaries  
Tampa, Florida

We have audited the accompanying consolidated balance sheets of Shells Seafood Restaurants, Inc. and Subsidiaries (the "company") as of January 2, 2005 and December 28, 2003 and the related consolidated statements of operations, stockholders' equity and cash flows for the fiscal years ended January 2, 2005 (53 weeks), December 28, 2003 (52 weeks) and December 29, 2002 (52 weeks). These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements referred to above present fairly, in all material respects, the financial position of the company at January 2, 2005 and December 28, 2003 and the results of its operations and cash flows for the fiscal years ended January 2, 2005 (53 weeks), December 28, 2003 (52 weeks) and December 29, 2002 (52 weeks) in conformity with accounting principles generally accepted in the United States of America.

KIRKLAND, RUSS, MURPHY & TAPP P.A.

Clearwater, Florida  
February 4, 2005, except as to Note 19,  
which date is March 10, 2005

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

|  | <u>January 2,</u><br><u>2005</u> | <u>December 28,</u><br><u>2003</u> |
|--|----------------------------------|------------------------------------|
| <b>ASSETS</b>  |                                  |                                    |
| Cash   | \$ 2,349,519                     | \$ 723,939                         |
| Inventories  | 396,823                          | 382,549                            |
| Other current assets   | 497,178                          | 265,891                            |
| Receivables from related parties   | <u>109,477</u>                   | <u>110,147</u>                     |
| Total current assets   | 3,352,997                        | 1,482,526                          |
| Property and equipment, net  | 7,095,922                        | 6,996,095                          |
| Goodwill   | 2,474,407                        | 2,474,407                          |
| Other assets   | <u>595,332</u>                   | <u>663,189</u>                     |
| TOTAL ASSETS   | <u>\$ 13,518,658</u>             | <u>\$ 11,616,217</u>               |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                  |                                    |
| Accounts payable   | \$ 2,311,584                     | \$ 2,390,685                       |
| Accrued expenses   | 2,567,026                        | 2,295,290                          |
| Sales tax payable  | 202,666                          | 168,385                            |
| Convertible debentures and interest payable  | 2,395,301                        | —                                  |
| Current portion of long-term debt  | <u>515,764</u>                   | <u>234,247</u>                     |
| Total current liabilities  | 7,992,341                        | 5,088,607                          |
| Notes and deferred interest payable to related parties   | 2,238,941                        | 2,267,416                          |
| Long-term debt, less current portion   | 1,494,845                        | 1,558,245                          |
| Deferred rent  | <u>849,287</u>                   | <u>1,053,531</u>                   |
| Total liabilities  | 12,575,414                       | 9,967,799                          |
| Minority partner interest  | 441,618                          | 465,836                            |
| <b>STOCKHOLDERS' EQUITY:</b>   |                                  |                                    |
| Preferred stock, \$0.01 par value; authorized 2,000,000 shares;<br>35,275 and 63,548 shares issued and outstanding     | 353                              | 635                                |
| Common stock, \$0.01 par value; authorized 20,000,000 shares;<br>8,565,406 and 4,631,375 shares issued and outstanding | 85,654                           | 46,314                             |
| Additional paid-in-capital   | 14,926,627                       | 14,303,151                         |
| Accumulated deficit  | <u>(14,511,008)</u>              | <u>(13,167,518)</u>                |
| Total stockholders' equity   | <u>501,626</u>                   | <u>1,182,582</u>                   |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY   | <u>\$ 13,518,658</u>             | <u>\$ 11,616,217</u>               |

See notes to consolidated financial statements and independent auditors' report.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

|  | Fiscal Years Ended |                      |                      |
|--|--------------------|----------------------|----------------------|
|  | January 2,<br>2005 | December 28,<br>2003 | December 29,<br>2002 |
| REVENUES   | \$ 41,564,138      | \$ 44,046,055        | \$ 47,227,747        |
| COST AND EXPENSES:   |                    |                      |                      |
| Cost of sales  | 14,050,690         | 14,466,578           | 15,777,572           |
| Labor and other related expenses   | 12,935,204         | 13,845,271           | 14,585,378           |
| Other restaurant operating expenses  | 10,123,584         | 11,117,396           | 10,773,494           |
| General and administrative expenses  | 3,248,657          | 3,387,470            | 3,564,828            |
| Depreciation and amortization  | 1,057,841          | 1,076,511            | 1,102,221            |
| Provision for impairment of assets   | 105,000            | 360,000              | 110,000              |
| Provision for impairment of goodwill   | —                  | —                    | 206,196              |
|  | 41,520,976         | 44,253,226           | 46,119,689           |
| INCOME (LOSS) FROM OPERATIONS  | 43,162             | (207,171)            | 1,108,058            |
| INTEREST EXPENSE, net  | (1,153,340)        | (462,246)            | (533,870)            |
| OTHER INCOME (EXPENSE), net  | 32,641             | (100,352)            | (2,743)              |
| (LOSS) INCOME BEFORE ELIMINATION OF<br>MINORITY PARTNER INTEREST AND<br>INCOME TAXES | (1,077,537)        | (769,769)            | 571,445              |
| ELIMINATION OF MINORITY<br>PARTNER INTEREST  | (265,953)          | (263,964)            | (221,319)            |
| (LOSS) INCOME BEFORE BENEFIT FOR<br>INCOME TAXES                                     | (1,343,490)        | (1,033,733)          | 350,126              |
| BENEFIT FOR INCOME TAXES   | —                  | —                    | 326,715              |
| NET (LOSS) INCOME  | \$ (1,343,490)     | \$ (1,033,733)       | \$ 676,841           |
| NET (LOSS) INCOME PER SHARE OF<br>COMMON STOCK:                                      |                    |                      |                      |
| Basic  | \$ (0.26)          | \$ (0.23)            | \$ 0.15              |
| Diluted  | \$ (0.26)          | \$ (0.23)            | \$ 0.07              |
| WEIGHTED AVERAGE NUMBER OF<br>SHARES OF COMMON STOCK<br>OUTSTANDING:                 |                    |                      |                      |
| Basic  | 5,261,981          | 4,577,470            | 4,454,015            |
| Diluted  | 5,261,981          | 4,577,470            | 10,259,188           |

See notes to consolidated financial statements and independent auditors' report.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

|                                      | <u>Preferred Stock</u> |               | <u>Common Stock</u> |                 | <u>Additional<br/>Paid-In<br/>Capital</u> | <u>Accumulated<br/>Deficit</u> | <u>Total</u>      |
|--------------------------------------|------------------------|---------------|---------------------|-----------------|---|--------------------------------|-------------------|
|                                      | <u>Shares</u>          | <u>Amount</u> | <u>Shares</u>       | <u>Amount</u>   |   |                                |                   |
| Balance at December 30,<br>2001      | 66,862                 | \$ 669        | 4,454,015           | \$44,540        | \$ 14,240,576                             | \$(12,810,626)                 | \$ 1,475,159      |
| Net income                           |                        |               |                     |                 | <<br>/TD>                                 | 676,841                        | 676,841           |
| Balance at December 29,<br>2002      | 66,862                 | 669           | 4,454,015           | 44,540          | 14,240,576                                | (12,133,785)                   | 2,152,000         |
| Net loss                             |                        |               |                     |                 |   | (1,033,733)                    | (1,033,733)       |
| Conversion of preferred<br>to common | (3,314)                | (34)          | 16,570              | 166             | (132)                                     |                                | —                 |
| Issuance of common<br>stock          |                        |               | <u>160,790</u>      | <u>1,608</u>    | <u>62,707</u>                             |                                | <u>64,315</u>     |
| Balance at December 28,<br>2003      | 63,548                 | 635           | 4,631,375           | 46,314          | 14,303,151                                | (13,167,518)                   | 1,182,582         |
| Net loss                             |                        |               |                     |                 |   | (1,343,490)                    | (1,343,490)       |
| Conversion of preferred<br>to common | (28,273)               | (282)         | 141,365             | 1,413           | (1,131)                                   |                                | —                 |
| Issuance of common<br>stock          |                        |               | <u>3,792,666</u>    | <u>37,927</u>   | <u>624,607</u>                            |                                | <u>662,534</u>    |
| Balance at January 2,<br>2005        | <u>35,275</u>          | <u>\$ 353</u> | <u>8,565,406</u>    | <u>\$85,654</u> | <u>\$ 14,926,627</u>                      | <u>\$(14,511,008)</u>          | <u>\$ 501,626</u> |

See notes to consolidated financial statements and independent auditors' report.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | Fiscal Years Ended         |                          |                            |
|--|----------------------------|--------------------------|----------------------------|
|  | January 2,<br>2005         | December 28,<br>2003     | December 29,<br>2002       |
| <b>OPERATING ACTIVITIES:</b>   |                            |                          |                            |
| Net (loss) income  | \$(1,343,490)              | \$(1,033,733)            | \$ 676,841                 |
| Adjustments to reconcile net<br>(loss) income to net cash (used in)<br>provided by operating activities: |                            |                          |                            |
| Depreciation and amortization  | 1,057,841                  | 1,076,511                | 1,102,765                  |
| Interest expense on warrants issued  | 711,000                    | —                        | —                          |
| Financing costs on warrants issued   | 175,000                    | —                        | —                          |
| Provision for impairment of goodwill   | —                          | —                        | 206,196                    |
| Provision for impairment of assets   | 201,000                    | 360,000                  | 110,000                    |
| Gain from hurricane-related insurance<br>recoveries  | (499,795)                  | —                        | —                          |
| (Gain) loss on sale of assets  | (48,204)                   | 2,874                    | 6,956                      |
| Loss on sale of assets applied<br>against reserves   | 63,554                     | 49,356                   | 144,153                    |
| Minority partner interest  | (24,218)                   | 37,984                   | 210                        |
| Changes in operating assets and liabilities:   |                            |                          |                            |
| Increase in current assets and liabilities   | (483,201)                  | (891,690)                | (1,759,505)                |
| Changes in other assets and liabilities:   |                            |                          |                            |
| Decrease (increase) in other assets  | 20,691                     | (205,826)                | (6,577)                    |
| Increase in accrued interest to<br>related parties   | 136,840                    | 144,081                  | 123,335                    |
| Decrease in deferred rent  | <u>(95,356)</u>            | <u>(29,230)</u>          | <u>(160,296)</u>           |
| Total adjustments  | <u>1,215,152</u>           | <u>544,060</u>           | <u>(232,763)</u>           |
| Net cash (used in) provided by<br>operating activities   | <u>(128,338)</u>           | <u>(489,673)</u>         | <u>444,078</u>             |
| <b>INVESTING ACTIVITIES:</b>   |                            |                          |                            |
| Proceed from hurricane-related insurance<br>recoveries   | 139,935                    | —                        | —                          |
| Proceeds from sale of assets   | 92,776                     | 500                      | 1,091,324                  |
| Purchase of property and equipment   | <u>(1,524,515)</u>         | <u>(755,278)</u>         | <u>(766,772)</u>           |
| Net cash (used in) provided by<br>investing activities   | <u>(1,291,804)</u>         | <u>(754,778)</u>         | <u>324,552</u>             |
| <b>FINANCING ACTIVITIES:</b>   |                            |                          |                            |
| Proceeds from debt financing   | 2,832,298                  | 578,585                  | 3,043,817                  |
| Repayment of debt  | (404,496)                  | (1,079,004)              | (2,313,318)                |
| Proceeds from the issuance of<br>common stock  | <u>617,920</u>             | <u>—</u>                 | <u>—</u>                   |
| Net cash provided by (used in)<br>financing activities   | <u>3,045,722</u>           | <u>(500,419)</u>         | <u>730,499</u>             |
| Net increase (decrease) in cash  | 1,625,580                  | (1,744,870)              | 1,499,129                  |
| CASH AT BEGINNING OF PERIOD  | <u>723,939</u>             | <u>2,468,809</u>         | <u>969,680</u>             |
| CASH AT END OF PERIOD  | <u><u>\$ 2,349,519</u></u> | <u><u>\$ 723,939</u></u> | <u><u>\$ 2,468,809</u></u> |

See notes to consolidated financial statements and independent auditors' report.



**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**

|   | <b>Fiscal Years Ended</b>  |                              |                              |
|---|----------------------------|------------------------------|------------------------------|
|   | <u>January 2,<br/>2005</u> | <u>December 28,<br/>2003</u> | <u>December 29,<br/>2002</u> |
| Cash (outflows) flows from changes in current assets and liabilities: |                            |                              |                              |
| Inventories   | \$ (14,274)                | \$ (26,115)                  | \$ 101,176                   |
| Receivables from related parties                                      | 670                        | (4,794)                      | (27,216)                     |
| Tax refunds receivable  | —                          | —                            | 898,338                      |
| Other current assets  | 128,573                    | 337                          | (81,763)                     |
| Accounts payable  | (79,101)                   | (164,169)                    | (1,524,542)                  |
| Accrued expenses  | (553,350)                  | (673,481)                    | (1,109,438)                  |
| Sales tax payable   | 34,281                     | (23,468)                     | (16,060)                     |
| Change in current assets and liabilities                              | <u>\$ (483,201)</u>        | <u>\$ (891,690)</u>          | <u>\$ (1,759,505)</u>        |
| Supplemental disclosure of cash flow information:                     |                            |                              |                              |
| Cash paid for interest  | \$ 309,006                 | \$ 338,883                   | \$ 445,793                   |
| Cash paid (received) for income taxes, net                            | \$ 634                     | \$ 3,300                     | \$ (1,216,438)               |
| Cash received from the 2002 sales of assets                           | \$ 100,000                 | \$ —                         | \$ —                         |

Non-cash operating and investing activities:

Accounts receivable of \$359,860, as of January 2, 2005, for hurricane-related insurance recoveries was applied to reduce the \$499,795 gain from hurricane-related insurance recoveries, resulting in \$139,935 proceeds from hurricane-related insurance recoveries.

Accrued interest to related parties of \$165,315 was refinanced through a second mortgage in June 2004 and classified as long-term debt.

Provision for impairment of assets of \$201,000 consists of a \$96,000 charge, which was applied to accrued expenses in June 2004, and \$105,000 which was expensed in fiscal year 2004.

Loss on sale of assets applied against reserves totaled \$63,554 consisting of (i) \$24,776 reduced net book value of property and equipment by \$19,062 and deferred rent by \$5,714 in June 2004; and (ii) \$38,778 reduced net book value of property and equipment in December 2004.

Asset impairment charges of \$158,335 were applied to reduce the basis of fixed assets damaged by a fire in September 2004.

During 2004, Shells relieved \$383,695 of the FAS 144 allowance for impaired assets relating to disposed restaurants.

Deferred rent of \$114,602 was applied to gain on sale of restaurant in April 2004.

Asset impairment charges of \$110,000 were applied against gain on sale of restaurant in April 2004.

Warrant valuation reserves of \$44,613 relating to warrants exercised in November 2004 was applied to paid in capital.

Bonuses of \$64,315 were paid in common stock during 2003.

Losses on disposals of assets of \$49,356 were applied against reserves in 2003.

During 2002, Shells relieved \$3,789,595 of the FAS 144 Allowance relating to disposed restaurants.

Gains, net of losses, on disposals of assets of \$144,153 were applied against reserves for store closings in 2002.

Notes receivable of \$100,000 were received on the sale of assets during 2002.

Shells transferred \$43,794 from other assets into property and equipment for assets placed in service during 2002.

Property held for sale of \$1,022,060 on December 30, 2001 was sold during 2002.

See notes to consolidated financial statements and independent auditors' report.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation** – At January 2, 2005, Shells Seafood Restaurants, Inc. and subsidiaries managed and operated 25 full-service, casual dining seafood restaurants in Florida under the name “Shells”.

Shells was incorporated on April 29, 1993 and began operations in August 1993 when it purchased from Shells, Inc. the service mark “Shells” as well as all other intangible and tangible assets necessary to operate a restaurant chain under the name “Shells”. Shells subsequently acquired Shells, Inc. effective December 29, 1994.

**Principles of Consolidation** – The consolidated financial statements include the accounts and operations of Shells and its wholly owned subsidiaries as well as a joint venture partnership in which Shells is a general partner owning a 51% equity interest. All material intercompany balances and transactions between the consolidated entities have been eliminated in consolidation.

**Fiscal Year** – Our fiscal year is the 52 or 53 weeks ending the Sunday nearest to December 31. Our fiscal year ended January 2, 2005 (“fiscal year 2004”) was 53 weeks, and each of the fiscal years ended December 28, 2003 (“fiscal year 2003”) and December 29, 2002 (“fiscal year 2002”) were 52 weeks.

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

**Inventories** – Inventories consist of food (primarily seafood), beverages and supplies and are recorded at the lower of cost or market. Cost is determined using the first-in, first-out (FIFO) method. Shells utilizes a third party to hold and distribute certain products. The inventory is not recorded by Shells nor is the risk of ownership transferred to Shells until its individual restaurants receive the product.

**Property and Equipment** – Property and equipment are stated at cost less the provision for impairment and are depreciated using the straight-line method over the estimated useful lives of the assets. Leasehold improvements and buildings are depreciated over the shorter of the lease term or the estimated useful life and range from five to 30 years. Useful lives for equipment, furniture and fixtures, and signs range from three to 10 years.

**Goodwill** – The excess of the cost over the fair value of the net assets resulting from the acquisition of Shells, Inc. was recognized as goodwill. Prior to 2002, goodwill was amortized on the straight-line basis over 20 years; the use of a 20-year estimated life was based on the upper and lower limits considering among other factors the lease terms of restaurants acquired and the cash flow projections of the restaurants. During 2002, we adopted Financial Accounting Standards Board (“FASB”) Statement No. 142 whereby goodwill is evaluated periodically for possible impairment and written-down to fair value if impaired.

**Impairment of Long-lived Assets** – Property and equipment, goodwill and other intangible assets are reviewed annually or whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable by the estimated future undiscounted cash flows. The impairment write-down is the difference between the carrying amounts and the fair value of those assets. If the total of future undiscounted cash flows is less than the carrying amount of goodwill or property and equipment, the carrying amount is written down to the fair value, and a loss resulting from value impairment is recognized by a charge to earnings. The undiscounted cash flow for each restaurant is calculated through the end of the real estate rental period, plus extensions, if applicable, by estimating future cash flows based on actual historical results of operations and the 2005 budget for each restaurant.

**Income Taxes** – Shells uses the asset and liability method which recognizes the amount of current and deferred income taxes payable or refundable at the date of the financial statements as a result of all events that have been recognized in the financial statements and as measured by the provisions of enacted tax laws. On March 9, 2002, the Economic Stimulus Package was signed into law. This program allows for, among other initiatives, the lengthening of the carry back period allowed for net operating losses from two years to five years. Shells recognized

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

an estimate of the income tax benefit and receivable in 2001 and an additional income tax benefit was recognized in 2002 when the refund was received, relating to the recovery of taxes paid in 1996 and 1997.

**Net income (loss) per share of common stock** – Net income (loss) per common share is computed in accordance with FASB No. 128 “Earnings Per Share”, which requires companies to present basic earnings per share and diluted earnings per share. The basic net income (loss) per share of common stock is computed by dividing net income (loss) applicable to common stock by the weighted average number of shares of common stock outstanding. Diluted net income per share of common stock is computed by dividing net income applicable to common stock by the weighted average number of shares of common stock and common stock equivalents outstanding. The diluted net loss per common share is computed by dividing net loss by the weighted average common shares outstanding excluding common stock equivalents, which are anti-dilutive.

**Fair Value of Financial Instruments** – The estimated fair value of amounts reported in the consolidated financial statements have been determined by using available market information and appropriate valuation methodologies. The carrying value of all current assets and current liabilities approximates fair value because of their short-term nature. The carrying value of long-term debt approximates fair value based upon quoted market information as available. As judgment is involved, the estimates are not necessarily indicative of the amounts that could be realized in a current market exchange.

In April 2002, the FASB issued Statement No. 145, “Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections.” The Statement updates, clarifies and simplifies existing accounting pronouncements. Statement No. 145 rescinds Statement No. 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in Opinion 30 will now be used to classify those gains and losses. Statement No. 64 amended Statement No. 4, and is no longer necessary because Statement No. 4 has been rescinded. Statement No. 44 was issued to establish accounting requirements for the effects of transition to the provisions of the Motor Carrier Act of 1980. Because the transition has been completed, Statement No. 44 is no longer necessary. Statement No. 145 also amends Statement No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This amendment is consistent with the FASB’s goal of requiring similar accounting treatment for transactions that have similar economic effects. Statement No. 145 also makes technical corrections to existing pronouncements. The adoption of Statement No. 145 did not have a material affect our consolidated financial statements.

In June 2002, the FASB issued Statement No. 146, “Accounting for Costs Associated with Exit or Disposal Activities.” The Statement addresses costs that are a result of exiting an activity, such as termination benefits, costs to terminate a contract that is not a capital lease, and costs to consolidate facilities or relocate employees. Under the Statement, a company may recognize costs related to a restructuring only when the liability is incurred. Under previous accounting principles generally accepted in the United States of America, a liability for such costs was recognized on the date when a company committed to an exit plan. The provisions of this statement are effective for exits and disposal activities that are initiated after December 31, 2002. Based on our actual results for 2004 and our business plan for 2005, the adoption of Statement No. 146 did not have a material affect on our consolidated financial statements during 2004 and is not expected to have a material affect on our consolidated financial statements in 2005.

In November 2002, the FASB issued Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others.” Interpretation No. 45 supersedes Interpretation No. 34, “Disclosure of Indirect Guarantees of Indebtedness of Others,” and provides guidance on the recognition and disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees. The initial recognition and measurement provisions of Interpretation No. 45 are effective for guarantees issued or modified after December 31, 2002, and are to be applied prospectively. The disclosure requirements are effective for financial statements for interim or annual periods ending after December 15, 2002. The adoption of Interpretation No. 45 did not have a material affect on our consolidated financial statements.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

In November 2002, the FASB's Emerging Issues Task Force (EITF) discussed Issue No. 02-16, "Accounting by a Reseller for Cash Consideration Received from a Vendor." Issue No. 02-16 provides guidance on the recognition of cash consideration received by a customer from a vendor. The consensus reached by the EITF in November 2002 is effective for fiscal periods beginning after December 15, 2002. Income statements for prior periods are required to be reclassified to comply with the consensus. Adoption of the consensus reached in November 2002 related to Issue No. 02-16 did not have a material affect on our consolidated financial statements.

In December 2002, we adopted FASB Statement No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." Statement No. 148 amends Statement No. 123, "Accounting for Stock-Based Compensation," and provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. Statement No. 148 also amends the disclosure requirements of Statement No. 123 to require more prominent and frequent disclosures in financial statements about the effects of stock-based compensation. The transition guidance and annual disclosure provisions of Statement No. 148 are effective for financial statements issued for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. See Note 14 for required disclosures under Statement No. 148.

In April 2003, the FASB issued Statement No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. This Statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, all provisions of this Statement should be applied prospectively. Adoption of FASB Statement No. 149 did not have a material affect on our consolidated financial statements.

In May 2003, the FASB issued Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. Many of those instruments were previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of FASB Statement No. 150 did not have a material affect on our consolidated financial statements.

In December 2003, the FASB issued a pronouncement, Financial Interpretation No. 46R ("FIN 46R"), "Consolidation of Variable Interest Entities." FIN 46R deals with Off-Balance Sheet Assets, Liabilities, and Obligations and gives guidance for determining which entities should consolidate the respective assets and liabilities associated with the obligations. Corporations must fully consolidate assets and liabilities covered by FIN 46R in their financial statements in the first fiscal year or interim period beginning after March 15, 2004. Full disclosure, as well as consolidation, if applicable, of any newly created entities after January 31, 2003 must begin immediately. Adoption of FIN 46R did not have a material affect on our consolidated financial statements.

In December 2003, the FASB revised Statement No. 132 Employers' Disclosures about Pensions and Other Postretirement Benefits which amended FASB Statements No. 87, 88, and 106. Statement No. 132 requires additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. The required information is to be provided separately for pension plans and for other postretirement benefit plans. Adoption of revised FASB Statement No. 132 did not have a material affect on our consolidated financial statements.

In November 2004, the FASB issued FASB Statement No. 151, "Inventory Costs" which amended ARB No. 43, Chapter 4. The amendments made by FASB Statement No. 151 will improve financial reporting by clarifying that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 23, 2004. The provisions of FASB Statement No. 151

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

are to be applied prospectively. Adoption of FASB Statement No. 151 is not expected to materially impact our consolidated financial statements.

In December 2004, the FASB revised Statement No. 123, "Accounting for Stock-Based Compensation." This Statement supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. This Statement does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." This Statement does not address the accounting for employee share ownership plans, which are subject to AICPA Statement of Position 93-6, "Employers' Accounting for Employee Stock Ownership Plans." This Statement is effective for Shells as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. Adoption of revised FASB Statement No. 123 is not expected to materially impact our consolidated financial statements.

In December 2004, the FASB issued Statement No. 153, "Exchanges of Non-monetary Assets" which amended APB Opinion No. 29, "Accounting for Non-monetary Transactions." The amendments made by FASB Statement No. 153 are based on the principle that exchanges of non-monetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for non-monetary exchanges of similar productive assets and replace it with a broader exception for exchanges of non-monetary assets that do not have commercial substance. Previously, Opinion 29 required that the accounting for an exchange of a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset should be based on the recorded amount of the asset relinquished. The Statement is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for non-monetary asset exchanges occurring in fiscal periods beginning after the date of issuance. The provisions of this Statement are to be applied prospectively. Adoption of FASB Statement No. 153 is not expected to materially impact our consolidated financial statements.

**Reclassifications** – Certain reclassifications of prior year balances have been made to conform to the current presentation.

## **NOTE 2. LIQUIDITY**

Our company's working capital deficit increased from \$3,606,000 in 2003 to \$4,639,000 in 2004, however, our cash position at January 2, 2005 improved to \$2,349,000 from \$724,000 at December 28, 2003. In August 2004, the maturity dates on the \$2,000,000 principal amount promissory notes were extended from January 31, 2005 to January 31, 2007. Shells obtained cash infusions of \$600,000 in November 2004 from the exercise and conversion of noteholder warrants to shares of our common stock. Shells also obtained a \$500,000 interim line of credit from our bank to assist in the hurricane-related reconstruction of our restaurants of which \$295,000 was utilized and subsequently repaid from insurance proceeds.

In December 2004, Shells raised additional funds, which are being utilized for the remodeling of several restaurants, through an offering of \$2,375,000 in convertible debentures. The debentures mature on the earliest to occur of certain events, but in any event, not later than April 5, 2005.

Additional information about our liquidity is discussed in Note 19, Subsequent Events.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

**NOTE 3. OTHER CURRENT ASSETS**

Other current assets consist of the following:

|                               | <u>January 2,<br/>2005</u> | <u>December 28,<br/>2003</u> |
|-------------------------------|----------------------------|------------------------------|
| Prepaid expenses              | \$ 97,176                  | \$ 139,893                   |
| Insurance proceeds receivable | 359,860                    | —                            |
| Note receivable               | —                          | 100,000                      |
| Other current assets          | 40,142                     | 25,998                       |
|                               | <u>\$ 497,178</u>          | <u>\$ 265,891</u>            |

**NOTE 4. PROPERTY AND EQUIPMENT**

Property and equipment consist of the following:

|   | <u>January 2,<br/>2005</u> | <u>December 28,<br/>2003</u> |
|---|----------------------------|------------------------------|
| Leasehold improvements                            | \$ 5,694,911               | \$ 4,632,847                 |
| Equipment   | 3,321,306                  | 5,292,188                    |
| Furniture and fixtures                            | 3,150,959                  | 2,995,371                    |
| Land and buildings                                | 2,541,397                  | 2,291,546                    |
| Signage   | 451,832                    | 488,715                      |
|   | <u>15,160,405</u>          | <u>15,700,667</u>            |
| Less accumulated depreciation<br>and amortization | <u>(8,064,483)</u>         | <u>(8,704,572)</u>           |
|   | <u>\$ 7,095,922</u>        | <u>\$ 6,996,095</u>          |

**NOTE 5. ACCRUED EXPENSES**

Accrued expenses consist of the following:

|                             | <u>January 2,<br/>2005</u> | <u>December 28,<br/>2003</u> |
|-----------------------------|----------------------------|------------------------------|
| Accrued payroll             | \$ 776,652                 | \$ 801,548                   |
| Accrued insurance           | 26,382                     | 237,098                      |
| Restaurant closing expenses | 216,677                    | 396,537                      |
| Warrant valuation reserve   | 947,364                    | 105,977                      |
| Other                       | 348,453                    | 473,982                      |
| Unearned gift card revenue  | 251,498                    | 280,148                      |
|                             | <u>\$ 2,567,026</u>        | <u>\$ 2,295,290</u>          |

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

**NOTE 6. LONG-TERM DEBT**

Long-term debt consists of the following:

|   | <u>January 2,<br/>2005</u> | <u>December 28,<br/>2003</u> |
|---|----------------------------|------------------------------|
| \$667,500 promissory note with a bank collateralized by real property owned by Shells. Interest is payable monthly based on the Colonial Bank Base Rate. Principal is payable \$3,709 monthly with all unpaid principal due in September 2007. The interest rate was 5.25% at January 2, 2005.                      | \$ 567,357                 | \$ 611,865                   |
| \$635,000 promissory note with a bank collateralized by real property owned by the 51% owned joint venture. Interest is payable monthly based on the Colonial Bank Base Rate. Principal is payable \$3,900 monthly with all unpaid principal due in September 2007. The interest rate was 5.25% at January 2, 2005. | 531,871                    | 578,671                      |
| \$655,000 promissory note collateralized by real property owned by Shells. Payments are \$8,000 monthly with unpaid principal due June 2009. The interest rate is fixed at 10.0%.   | 425,518                    | 483,934                      |
| Line of credit with bank to finance construction from fire loss, interest payable monthly at bank base rate plus 1%; interest rate was 6.25% at January 2, 2005; principal payable by April 18, 2005.   | 295,000                    | —                            |
| \$165,315 promissory note collateralized by real estate owned by Shells. Payable at \$6,888 monthly starting June 2005 through June 2007.   | 165,315                    | —                            |
| Capitalized lease agreement, collateralized by equipment, payable monthly at \$2,132 through November 2005.   | 21,083                     | 40,850                       |
| Finance agreement, collateralized by insurance policy, principal and interest due monthly through January 2005, at 5.0% fixed interest rate.  | 4,465                      | 8,137                        |
| \$540,000 non-interest bearing note, principal was payable in variable monthly installments through December 2004. The balance was net of imputed interest of \$3,927 at December 28, 2003 at 11%. The note was collateralized by a leasehold interest in certain property and fixed assets of Shells.              | —                          | 57,436                       |
| Finance agreements were collateralized by equipment, principal and interest was paid monthly through January 2004, interest rates ranged from 6.8% - 8.0%   | —                          | 11,599                       |
|   | <u>2,010,609</u>           | <u>1,792,492</u>             |
| Less current portion  | <u>(515,764)</u>           | <u>(234,247)</u>             |
|   | <u>\$ 1,494,845</u>        | <u>\$ 1,558,245</u>          |

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

The annual maturities of debt as of January 2, 2005 are as follows:

|            |  |              |
|------------|--|--------------|
| 2005       |  | \$ 515,764   |
| 2006       |  | 235,485      |
| 2007       |  | 1,019,019    |
| 2008       |  | 75,080       |
| 2009       |  | 165,261      |
| Thereafter |  | —            |
|            |  | \$ 2,010,609 |

Relative to the two promissory notes provided by Colonial Bank, we are required to meet a financial covenant relating to debt coverage. We were in compliance in meeting this loan covenant as of January 2, 2005. However, in the past, we were not in compliance with meeting the loan covenant for which a covenant waiver was provided by the bank.

**NOTE 7. RELATED PARTY DEBT**

On January 31, 2002, we raised \$2,000,000 in a private financing transaction, consisting of secured promissory notes and warrants to purchase shares of our common stock. The two investors in this financing were Shells Investment Partners, LLC (“SIP”) and Banyon Investment, LLC, each for \$1,000,000 principal amount. Shells Investment Partners is an entity comprised of members previously unaffiliated with our company. Banyon is an entity associated with Philip R. Chapman, Chairman of the Board, and certain family members of Frederick R. Adler, a greater than 10% stockholder. The proceeds of the financing were used for working capital.

In April 2004, Banyon Investment, LLC sold its interest in the \$1,000,000 promissory note to Frederick R. Adler. In June 2004, SIP sold to GCM Shells Seafood Partners, LLC (“GCM”) and Trinad Capital, L.P. (“Trinad”) the \$1,000,000 promissory note issued to SIP. GCM and Trinad purchased the note in the amount of \$400,000 and \$600,000, respectively. We refinanced deferred interest of \$165,315 on the \$1,000,000 note, previously scheduled to be payable to SIP in full on January 31, 2005, through a note which calls for 24 equal monthly payments beginning June 1, 2005. This deferred interest note is secured by a second mortgage on certain real estate owned by us. In September 2004, GCM sold its interest in the \$400,000 note to Bruce Galloway, IRA R/O.

Notes and deferred interest payable to these related parties were:

|   | January 2,<br>2005 | December 28,<br>2003 |
|---|--------------------|----------------------|
| Secured promissory notes due January 31, 2007 bearing interest at 15%, of which 8% is payable monthly in arrears and 7% is deferred and payable when the principal is paid in full, owned by: |                    |                      |
| Frederick R. Adler  | \$ 1,000,000       | \$ —                 |
| Bruce Galloway, IRA R/O   | 400,000            | —                    |
| Trinad Capital, L.P.  | 600,000            | —                    |
| Banyon Investment, LLC  | —                  | 1,000,000            |
| Shells Investment Partners, LLC   | —                  | 1,000,000            |
| Aggregate deferred interest due on January 31, 2007   | 238,941            | 267,416              |
|   | \$ 2,238,941       | \$ 2,267,416         |

The deferred interest due at maturity, January 31, 2007, will be \$535,000.

See Note 19, Subsequent Events, for discussion of pay down of the principal amount of the loans and deferral of cash payments for interest now due at maturity.

**NOTE 8. COMMITMENTS AND CONTINGENCIES**

Prior to January 1, 1995, Shells agreed to pay \$540,000 over a 10 year period as inducement to obtain a lease for a certain restaurant site. This amount, net of interest imputed at 11% was recorded as prepaid rent and was amortized over the term of the lease. The \$540,000 note expired in December 2004.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

With the exception of three operating restaurants, Shells conducts all of its operations and maintains its administrative offices in leased facilities. Certain leases provide for Shells to pay for common area maintenance charges, insurance, and its proportionate share of real estate taxes. In addition, certain leases have escalation clauses and/or require additional rent based upon a percentage of the restaurant's sales in excess of stipulated amounts. Total rent expense under all leases was \$2,712,000, \$2,571,000 and \$2,568,000, for 2004, 2003 and 2002, respectively, which included contingent rent of \$108,000, \$143,000 and \$100,000, respectively. The approximate future minimum aggregate rental payments under such operating leases as of January 2, 2005 are as follows:

|            |                      |
|------------|----------------------|
| 2005       | \$ 1,968,000         |
| 2006       | 1,842,000            |
| 2007       | 1,633,000            |
| 2008       | 1,566,000            |
| 2009       | 1,546,000            |
| Thereafter | <u>6,531,000</u>     |
|            | <u>\$ 15,086,000</u> |

These leases expire at various dates through the year 2016 and generally have renewal options for additional periods.

During 2003, Shells entered into an employment agreement with Leslie J. Christon, President and Chief Executive Officer, that included a salary of \$275,000 per year. The term of the employment agreement is two years, and thereafter renews automatically for successive one-year periods unless either party provides notice of intent not to renew. The agreement also provided for the grant of employee options to purchase 297,374 shares of common stock, which vest over a two year period on an annual basis.

Warren R. Nelson, our Chief Financial Officer, holds a letter agreement from the board of directors clarifying his severance arrangement, if applicable.

During 1996, Shells entered into an agreement to purchase the leasehold interest in six sites, as well as the leasehold improvements, fixtures and equipment, from Islands Florida, LP, a Delaware limited partnership, in exchange for \$500,000 plus, in general, an aggregate amount equal to 1% of the gross sales, as defined ("royalty"), of each of the restaurants opened and continuing to be operated by Shells at each of the six sites through the end of the initial terms of the respective leases. Of the six sites originally leased, four sites continue to be leased. The base terms expire at various dates through 2015 one of which expired in 2003. The royalty expense related to these restaurants was \$56,000, \$95,000 and \$99,000 for 2004, 2003 and 2002, respectively. During 2004, this agreement was terminated through a \$100,000 settlement, paid in installment payments throughout the year.

Shells is subject to legal proceedings, claims and liabilities that arose in the ordinary course of business. In the opinion of management, the amount of the ultimate liability with respect to these actions will not materially affect our financial position, results of operations or cash flows.

**NOTE 9. MINORITY PARTNER INTEREST**

Shells has a 51% equity interest in a joint venture partnership that owns and operates the Shells restaurant located in Melbourne, Florida. Shells entered into the joint venture partnership in March 1994 with WLH Investments, Inc., a corporation owned by the wife of our then President, who was a Director of Shells until February 2002. We have a 51% equity interest and WLH Investments has the remaining 49%. As a condition of the joint venture partnership, WLH Investments contributed \$400,000 in capital on March 1, 1994. The profits, as defined in the joint venture agreement, of the joint venture partnership are allocated as follows: (i) 100% of the first \$60,000 annually is allocated to WLH Investments, (ii) 100% of the next \$60,000 is allocated to Shells, if available, and (iii) any excess over the \$120,000 is allocated 51% to Shells and 49% to WLH Investments. All losses are allocated in accordance with the owners' percentages.

Our share of the joint venture partnership profits was \$296,000 (inclusive of a \$10,000 prior period adjustment), \$272,000 and \$235,000 during 2004, 2003 and 2002, respectively. In addition, the joint venture partnership paid us \$181,000, \$177,000 and \$180,000 in 2004, 2003 and 2002, respectively, for management and

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

license fees. The WLH Investments' share of the joint venture partnership profits was \$266,000, \$264,000 and \$221,000 in 2004, 2003 and 2002, respectively. The joint venture agreement and management agreement outline the respective joint venture partner's responsibility for funding all restaurant expenses, including food and beverage costs, staffing, training, recruiting, inventories, working capital, capital expenditures and principal and interest payments on loans and mortgages. The joint ventures cash balance was \$130,000 as of January 2, 2005.

The joint venture agreement, which was effective March 1994, as amended March 1995, contains a purchase option for Shells to purchase the WLH Investments interest in the joint venture partnership, or conversely, for WLH Investments to put their interest in the joint venture partnership to Shells, for a purchase price of \$750,000 payable by the issuance of our common stock having a value of \$750,000. The option is exercisable at any time following the date our common stock equals or exceeds \$20 per share for a period of 20 consecutive trading days. The option has not been exercisable through January 2, 2005.

**NOTE 10. STOCKHOLDERS' EQUITY AND CONVERTIBLE DEBENTURES**

In connection with the \$2,000,000 financing dated January 31, 2002, we issued to each of Shells Investment Partners and Banyon (i) a \$1,000,000 secured promissory note due January 31, 2005 (extended to January 31, 2007) which bears interest at 15% per annum, of which 8% is payable monthly in arrears and 7% is deferred and payable when the principal is paid in full and (ii) a warrant to purchase 4,454,015 shares of our common stock, at an exercise price of \$0.16 per share. The warrants were exercisable through January 31, 2005.

On April 12, 2004, Banyon sold their interest in the \$1,000,000 note to Frederick R. Adler, a more than 10% shareholder. On June 23, 2004, Shells Investment Partners sold their interest in the \$1,000,000 secured promissory note along with 90% of their warrants to Trinad Capital, LP (\$600,000) and GCM Shells Seafood Partners, LLC (\$400,000). Subsequently, on September 30, 2004, GCM Shells Seafood Partners sold their interest in their \$400,000 note to Bruce Galloway, IRA R/O.

On August 4, 2004, our \$2,000,000 aggregate principal amount of secured promissory notes set to mature on January 31, 2005 were extended to be due on January 31, 2007, under the same terms as the original notes. As an inducement to extend the maturity date of the notes, warrants to purchase 2,000,000 shares of our common stock at an exercise price of \$0.50 per share were issued to the note holders in proportion to the value of their respective notes. These newly issued warrants are exercisable from January 31, 2005 through January 31, 2007. We recognized a one-time, non-cash charge of \$446,000 relating to this transaction.

In November 2004, a portion of the warrants issued as part of the \$2,000,000 January 2002 financing were exercised, resulting in the issuance of 3,750,000 shares of common stock.

On December 7, 2004, we sold \$2,375,000 principal amount of debentures and warrants to purchase 1,187,500 shares of our common stock. We received net proceeds of \$2,010,000 from the sale. The debentures bear interest at 12%, and mature on the earlier of: (i) April 5, 2005, (ii) the closing of an additional round of financing of no less than \$1,500,000, or (iii) upon the occurrence of an event of default. In the event that we, on or prior to the maturity date, consummate the sale of shares of capital stock (other than a sale of capital stock to our officers, directors, employees or consultants in connection with their provision of services to us) resulting in net proceeds to us of at least \$250,000, then the outstanding principal amount of the debentures and all accrued and unpaid interest, at the sole option of the holder of the debenture, will convert in whole or in part, into shares of the common stock sold in such future financing. The warrants are exercisable until December 7, 2007. The warrants have an exercise price equal to 80% of the price per share or unit in our next round of equity financing resulting in net proceeds to us of at least \$250,000, provided that the exercise price cannot exceed \$0.80 per share or be less than \$0.45 per share. In the event that such financing is not completed on or before September 4, 2005, the warrants will automatically be assigned an exercise price equal to 65% of the closing price of our common stock on September 4, 2005, but in no event greater than \$0.80 or less than \$0.45 per share. The exercise price of the warrants and the number of underlying shares of common stock is subject to adjustment under certain circumstances. As compensation for their services as placement agent in the debenture offering and future consulting services to us, the placement agent received cash fees and warrants with terms substantially identical to those received by the investors.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

To date, no dividends have been declared or paid on our common stock. In addition, our debt financings prohibit the payment of cash dividends and any future financing agreements may also prohibit the payment of cash dividends.

**NOTE 11. CONVERTIBLE PREFERRED STOCK**

On October 24, 2001, Shells issued 66,862 shares of Series A 5% Convertible Preferred Stock, par value \$0.01 per share (the "Series A Preferred Stock"), pursuant to an exemption from registration under Section 4(6) of the Securities Act of 1933, as amended, in consideration for the cancellation of \$669,000 of trade indebtedness by trade creditors of Shells. The shares were issued exclusively to "accredited investors" as defined in Rule 501(a) under the Securities Act. Shells did not receive any cash proceeds in connection with the issuance of the Series A Preferred Stock.

Each share of Series A Preferred Stock is convertible by the holder into five shares of our common stock. The Series A Preferred Stock has a liquidation preference equal to \$10.00 per share, plus any declared but unpaid dividends. Dividends on the Series A Preferred Stock, payable in cash at the rate of 5% of the Liquidation Value (\$10.00) per annum, are payable annually, when, as and if declared by the board of directors of Shells out of funds legally available for the payment of dividends. Dividends on the Series A Preferred Stock are not cumulative. To date, no dividends have been declared or paid on the Series A Preferred Stock.

During May 2004, investors converted 28,273 shares of Series A Preferred Stock into 141,365 shares of our common stock. During January 2003, investors converted 3,314 shares of Series A Preferred Stock into 16,570 shares of our common stock.

**NOTE 12. INCOME TAXES**

The components of the provision (benefit) for income taxes for the years ended January 2, 2005, December 28, 2003 and December 29, 2002 are as follows:

|                               | <u>Fiscal Years Ended</u>  |                              |                              |
|-------------------------------|----------------------------|------------------------------|------------------------------|
|                               | <u>January 2,<br/>2005</u> | <u>December 28,<br/>2003</u> | <u>December 29,<br/>2002</u> |
| Federal                       |                            |                              |                              |
| Current                       | \$ —                       | \$ —                         | \$ (326,715)                 |
| Deferred                      | —                          | —                            | —                            |
|                               | <u>—</u>                   | <u>—</u>                     | <u>(326,715)</u>             |
| State                         |                            |                              |                              |
| Current                       | —                          | —                            | —                            |
| Deferred                      | —                          | —                            | —                            |
|                               | <u>—</u>                   | <u>—</u>                     | <u>—</u>                     |
| Tax asset valuation allowance | —                          | —                            | —                            |
| Income tax benefit            | <u>\$ —</u>                | <u>\$ —</u>                  | <u>\$ (326,715)</u>          |

Our effective tax rate is composed of the following for the years ended January 2, 2005, December 28, 2003 and December 29, 2002, respectively:

|  | <u>Fiscal Years Ended</u>  |                              |                              |
|--|----------------------------|------------------------------|------------------------------|
|  | <u>January 2,<br/>2005</u> | <u>December 28,<br/>2003</u> | <u>December 29,<br/>2002</u> |
| Federal statutory rate                   | (34.0)%                    | (34.0)%                      | 34.0%                        |
| State income tax, net of federal benefit | (0.4)                      | (3.5)                        | 3.5                          |
| FICA tip credits                         | (15.8)                     | (19.3)                       | (64.3)                       |
| Warrant grants                           | 22.4                       | —                            | —                            |
| Valuation allowance and other adjustment | 15.6                       | 56.8                         | (125.4)                      |
| Revalue certain deferred tax assets      | 8.4                        | —                            | —                            |
| Other                                    | 3.8                        | —                            | —                            |
| Goodwill impairment write-down           | —                          | —                            | 58.9                         |
| Effective income tax benefit             | <u>—%</u>                  | <u>—%</u>                    | <u>(93.3)%</u>               |



**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

requirement to make third party royalty payments. The management agreements were amended in October 2001, reducing the management fee to 4% of restaurant sales until such time that cash flow for three consecutive months is at least 80% of the cash flow for the same respective periods in 1999. The management fee then becomes 5% of sales. The management fee increases to, and is maintained at, 6% of sales when cash flow for three consecutive months is at least 90% of cash flow for the same respective periods in 1999. The management agreements outline the respective owners' ("licensees") responsibility for funding all restaurant expenses, including food and beverage costs, staffing, training, recruiting, inventories, working capital and capital expenditures. A fourth restaurant is operated by Shells, pursuant to an oral agreement requiring the restaurant to be operated in conformance with the policies and procedures established by management for Shells restaurants. Our management fee was originally set at 4% of the restaurant's sales, and later was modified to 2% in October 2001. The aggregate management fees earned under these agreements was approximately \$172,000, \$165,000 and \$163,000 for 2004, 2003 and 2002, respectively.

Shells also has entered into option agreements with three of the licensees, effective July 1993, which were amended in August 1995 and October 2001, documenting the terms by which, Shells can acquire the restaurant's assets in exchange for a purchase price of six times the restaurants cash flow, less any liabilities assumed. The purchase price is to be paid in the form of shares of our common stock at the prevailing market price. The option is exercisable by either party upon Shells averaging a market capitalization, as defined, of \$100,000,000 for 20 consecutive trading dates. The option has not been exercisable through January 2, 2005.

Effective January 31, 2002, Shells raised \$2,000,000 in a private financing transaction, consisting of secured promissory notes and warrants to purchase shares of our common stock. The two investors in the financing were Shells Investment Partners, LLC and Banyon Investment, LLC. Shells Investment Partners is an entity comprised of members previously unaffiliated with Shells. Banyon is an entity associated with Philip R. Chapman, Chairman of our board of directors, and certain family members of Frederick R. Adler. The proceeds of the financing were used for working capital requirements. During 2004, Banyon sold their interest in the note to Frederick R. Adler and Shells Investment Partners sold their interest in their note along with 90% of their warrants to Trinad Capital, LP (\$600,000) and GCM Shells Seafood Partners, LLC (\$400,000). GCM has sold their interest in the note to the Bruce Galloway, IRA R/O. See Note 7 – Related Party Debt.

In connection with this financing, we issued to each of Shells Investment Partners and Banyon a \$1,000,000 secured promissory note due January 31, 2005 (extended to January 31, 2007) which bears interest at 15% per annum, of which 8% is payable monthly in arrears and 7% is deferred and payable when the principal is paid in full, and a warrant to purchase 4,454,015 shares of our common stock, at an exercise price of \$0.16 per share. The warrants were exercisable through January 31, 2005. During November 2004, warrant holders exercised warrants and acquired 3,750,000 shares of common stock for \$600,000 in proceeds to Shells.

Furthermore, as part of this financing, we entered into an Investor Rights Agreement, with the two investor groups and certain other stockholders. Pursuant to this agreement, the composition of our board of directors is fixed at seven members and each of Banyon and Shells Investment Partners (now Trinad Capital and GCM Shells Seafood Partners) are entitled to nominate three individuals to serve on our board. This right will terminate with respect to each of Banyon and Shells Investment Partners (now Trinad Capital and GCM Shells Seafood Partners) on the earlier of the date that such entity, or any legal successors thereto, ceases to own at least 13% of our issued and outstanding stock on a fully diluted basis, or the date that all amounts due and payable under such entity's \$1,000,000 promissory note have been paid in full. Additionally, each of these investor groups and Frederick R. Adler and Philip R. Chapman, among others, have agreed to vote their shares, to cause these slated nominees to be elected to our board of directors.

Banyon initially appointed Philip R. Chapman, Richard A. Mandell and Christopher D. Illick, all of whom were then serving as directors of our company, as Banyon's nominees for election to the board. Shells Investment Partners initially nominated Thomas R. Newkirk, J. Stephen Gardner and John N. Giordano as its nominees for election to the board. Messrs. Newkirk, Gardner and Giordano were appointed directors of our company, to fill the vacancies existing on the board. Mr. Mandell resigned from the board on March 12, 2002. Effective April 2, 2002, Michael R. Golding filled the vacancy on the board as Banyon's nominee. On June 23, 2004, the three members from Shells Investment Partners resigned from the board when their interests were acquired by Trinad Capital

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

and GCM Shells Seafood Partners. Trinad and GCM appointed Jay A. Wolf, Robert Ellin and Gary Herman as its nominees, all of whom were appointed directors to fill the vacancies on the board.

On December 28, 2004, we entered into a consulting agreement with Lawrence Wolf, the father of Jay Wolf who is a member of our board of directors. The consulting agreement has a one year term, where Mr. Lawrence Wolf is to assist Shells in providing marketing services; including guidance toward building our creative strategy around the “Shells” brand positioning and providing support in coordinating our media production. As compensation, Mr. Lawrence Wolf received options, pursuant to our 2002 Equity Incentive Plan, to purchase 130,000 shares of common stock at an exercise price of \$0.83, the market price on the date of grant. The options fully vest on the first anniversary of the grant date.

**NOTE 14. STOCK COMPENSATION PLAN**

At January 2, 2005, we have four stock-based employee compensation plans, which are described more fully below. We account for these plans under the recognition and measurement principles of Accounting Principles Board Opinion 25, “Accounting for Stock Issued to Employees,” and related interpretations. Stock-based compensation costs are not reflected in net income, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Had compensation cost for our stock option plans been determined based on the fair value at the grant dates consistent with recognition provisions of FASB Statement No. 123, “Accounting for Stock-Based Compensation,” the effect on net income (loss) and earnings per share on a pro forma basis would have been immaterial.

On September 11, 1995, our board of directors approved two employee stock option plans. The options generally vest over three years, one third annually on the anniversary date of the grant and, under both plans, have a maximum term of 10 years. The 1995 Employee Stock Option Plan, as amended, provides for the issuance of options to purchase up to a total of 840,000 shares. The 1996 Employee Stock Option Plan provides for the issuance of options to purchase a total of 101,000 shares. As of January 2, 2005, options to purchase an aggregate of 205,742 shares were outstanding under the plans of which all were exercisable. There were 11,001 shares purchased through the exercise of these options through 2004. The exercise prices of the outstanding options range from \$0.45 to \$5.75. The weighted average remaining contractual life for the options outstanding at January 2, 2005 for both plans is approximately five years.

On May 20, 1997, the stockholders approved the Stock Option Plan for Non-employee Directors. The plan, as amended, authorized a total of 150,000 shares to be reserved for issuance under this director’s compensation plan. Shells did not grant any options under this plan during 2004, 2003 or 2002. Shells granted options to purchase 20,000 shares during each of 2001 and 2000, at the market price on the date of grant. As of January 2, 2005, options to purchase 32,000 shares were outstanding and exercisable.

On May 21, 2002, the stockholders approved the 2002 Equity Incentive Plan allowing for grants of options to purchase up to 1,850,000 shares of common stock. The options generally vest over three years, one third annually on the anniversary date of the grant and have a maximum term of 10 years. As of January 2, 2005, options to purchase 905,758 shares were outstanding, 620,286 of which were exercisable. The weighted average remaining contractual life for the options outstanding at January 2, 2005 is approximately seven years. During 2004, 201,900 options were granted at prices ranging between \$0.36 and \$0.83 per share, the fair market value on the date of the grant. During April 2003, officers and corporate management were issued 160,790 shares of common stock at \$0.40 per share, pursuant to a 2002 management bonus plan.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

Option activity is summarized below:

|                                  | <u>Number of<br/>Shares</u> | <u>Option Price</u> | <u>Weighted<br/>Average<br/>Price</u> |
|----------------------------------|-----------------------------|---------------------|---------------------------------------|
| Outstanding at December 30, 2001 | 864,025                     | \$0.20 - \$11.00    | \$ 1.36                               |
| Granted                          | 1,332,484                   | 0.35 - 0.65         | 0.42                                  |
| Cancelled                        | <u>(163,300)</u>            | 0.22 - 9.50         | 1.53                                  |
| Outstanding at December 29, 2002 | 2,033,209                   | 0.20 - 9.50         | 0.73                                  |
| Granted                          | 571,704                     | 0.37 - 0.90         | 0.55                                  |
| Exercised                        | (160,790)                   | 0.40                | 0.40                                  |
| Cancelled                        | <u>(1,235,056)</u>          | 0.37 - 5.75         | 0.48                                  |
| Outstanding at December 28, 2003 | 1,209,067                   | 0.20 - 9.50         | 0.95                                  |
| Granted                          | 201,900                     | 0.36 - 0.83         | 0.77                                  |
| Exercised                        | (42,666)                    | 0.42                | 0.42                                  |
| Cancelled                        | <u>(224,801)</u>            | 0.20 - 5.75         | 0.61                                  |
| Outstanding at January 2, 2005   | <u><u>1,143,500</u></u>     | \$0.24 - \$9.50     | \$ 1.00                               |

**NOTE 15. EARNINGS (LOSS) PER SHARE**

The following table represents the computation of basic and diluted earnings (loss) per share of common stock as required by FASB Statement No. 128:

|   | <u>Fiscal Years Ended</u>  |                              |                              |
|---|----------------------------|------------------------------|------------------------------|
|   | <u>January 2,<br/>2005</u> | <u>December 28,<br/>2003</u> | <u>December 29,<br/>2002</u> |
| Net (loss) income                                   | \$ (1,343,490)             | \$ (1,033,733)               | \$ 676,841                   |
| Weighted common shares outstanding                  | 5,261,981                  | 4,577,470                    | 4,454,015                    |
| Basic net (loss) income per share of common stock   | \$ (0.26)                  | \$ (0.23)                    | \$ 0.15                      |
| Effect of dilutive securities:                      |                            |                              |                              |
| Warrants  | —                          | —                            | 5,575,916                    |
| Stock options                                       | —                          | —                            | <u>229,257</u>               |
| Diluted weighted common shares outstanding          | <u>5,261,981</u>           | <u>4,577,470</u>             | <u>10,259,188</u>            |
| Diluted net (loss) income per share of common stock | <u><u>\$ (0.26)</u></u>    | <u><u>\$ (0.23)</u></u>      | <u><u>\$ 0.07</u></u>        |

Diluted net loss per common share excludes anti-dilutive stock options and warrants of 6,305,000 and 6,909,000 during 2004 and 2003, respectively.

See Note 19, Subsequent Events, for information about common stock issued in 2005.

**NOTE 16. PROVISION FOR IMPAIRMENT OF ASSETS**

In accordance with FASB Statement No. 144, which superseded FASB Statement No. 121, Shells identified certain long-lived assets as impaired. The impairment was recognized when the future undiscounted cash flows of certain assets were estimated to be less than the assets' related carrying value. As such, the carrying values were written down to our estimates of fair value based on the best information available making whatever estimates, judgments and projections were deemed necessary.

Shells recognized write-downs of \$201,000 (of which \$96,000 was applied against reserves), \$360,000 and \$110,000 during 2004, 2003 and 2002, respectively. We have seven restaurants that are deemed to be impaired as of January 2, 2005. The write-down in 2004 related to one Florida restaurant which had not previously been written

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

down. The write-down in 2003 related to three Florida restaurants, two of which have not previously been written down. The write-down in 2002 related to three Florida restaurants, which were not previously written down. The write-downs were necessitated by the current period operating losses as well as the projected cash flows of the restaurants.

**NOTE 17. DEFINED CONTRIBUTION PLAN**

Shells has a defined contribution plan which meets the requirements of Section 401(k) of the Internal Revenue Code. All salaried employees of Shells with more than 90 days of service who are at least 21 years of age, and who are not considered highly compensated, are eligible to participate in the plan. The plan allows for a discretionary matching contribution from Shells. Shells, which pays the plan expenses, has contributed \$12,000 in discretionary contributions to date.

**NOTE 18. ADVERTISING AND MARKETING**

Shells has incurred the following costs for television, radio, billboards and local store marketing:

|                                    | Fiscal Years Ended |                      |                      |
|------------------------------------|--------------------|----------------------|----------------------|
|                                    | January 2,<br>2005 | December 28,<br>2003 | December 29,<br>2002 |
| Advertising and marketing expenses | \$ 1,467,000       | \$ 1,501,000         | \$ 1,545,000         |
| As a percentage of revenues        | 3.5%               | 3.4%                 | 3.3%                 |

**NOTE 19. SUBSEQUENT EVENTS**

In January and February 2005, the remaining warrants issued as part of the \$2,000,000 financing in January 2002 were exercised, whereby warrant holders acquired 4,712,630 shares of common stock for \$754,000 in proceeds to Shells. Additionally, Shells Investment Partners converted their retained warrants into common stock under the cashless exercise provisions of the warrant agreement, resulting in the issuance of 350,381 shares of common stock.

In January 2005, we entered into an agreement with our landlord in St. Pete Beach, Florida, whereby on February 22, 2005, the landlord paid \$600,000 to Shells for an option to buy-out the lease. Any time after 12 months beyond the payment date, the landlord can provide notice of lease termination to Shells. Thereafter, we have 60 days to wind down business and vacate the premises.

In February 2005, we agreed to acquire for \$843,000 the leasehold rights and personal property of a restaurant located in Clearwater Beach, Florida from Gold Coast Restaurants, Inc. (d/b/a Leverock's), out of bankruptcy proceedings. We expect the restaurant to reopen as a "Shells" in March 2005, once remodeling and staff training are completed.

In February 2005, we mailed notice to stockholders of record on February 7, 2005 an Information Statement advising that our board of directors and the holders of a majority of our outstanding shares of common stock have delivered written consents authorizing an amendment to our certificate of incorporation that will increase the number of authorized shares of our common stock, \$0.01 par value per share, from 20,000,000 shares to 40,000,000 shares. This increase to our capitalization is expected to become effective in March 2005.

In March 2005, our investors provided us with a \$1,600,000 revolving line of credit, which matures on the earlier of March 31, 2006 or the closing of a financing providing us not less than \$1,600,000 of net proceeds. Amounts drawn under the line of credit bear interest at the rate of 15% per annum, payable 8% monthly in arrears and 7% deferred until the maturity date. The investors received a fee of \$80,000 for extending the credit line to Shells.

In March 2005, warrants to purchase a total of 1,000,000 shares of common stock, which were issued on August 4, 2004 pursuant to the extension of the \$2,000,000 related-party financing, were exercised at \$0.50 per share by Trinad Capital, L.P. and Bruce Galloway, IRA R/O. The proceeds of \$500,000 were used to pay down the principal amount of the notes to these investors. Additionally, in March 2005, the \$1,000,000 note held by Frederick R. Adler was modified to allow Shells to defer entirely the monthly interest payment on \$500,000 of principal amount of the note until the maturity date of January 31, 2007, resulting in the deferral of \$72,000 of cash payments until the maturity date. The remaining principal balance of \$1,500,000 matures on January 31, 2007 along with deferred interest payable at maturity of \$535,000.

**SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (continued)**

We contemplate that an additional round of financing will be sought by us in the first half of 2005. In addition to repaying the debentures (as discussed in Note 10, Stockholders' Equity and Convertible Debentures), we anticipate that the contemplated additional round of financing will be utilized to complete our restaurant remodeling and position our company for growth. There can be no assurance that this contemplated financing will be available to us when needed, on acceptable terms, or at all.



## ITEM 9A. CONTROLS AND PROCEDURES

We maintain "disclosure controls and procedures," as such term is defined under Securities Exchange Act Rule 13a-15(e), that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in 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 disclosures. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. As required by SEC Rule 13a-15(b), we have carried out an evaluation, as of the end of the period covered by this report, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon their evaluation and subject to the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in ensuring that material information relating to Shells is made known to the Chief Executive Officer and Chief Financial Officer by others within our company during the period in which this report was being prepared.

There were no changes in our internal controls over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART III

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

#### Board Structure

The Board of Directors of Shells is comprised of seven members. Directors are elected for a term of one year which expires at the next annual meeting of stockholders or at such other time as his or her successor is duly elected and qualified.

As part of our financing transaction in January 2002 (described in Item 7 "Management's Discussion and Analysis of Financial Condition Results of Operation - Liquidity and Capital Resources"), we entered into an Investor Rights Agreement with SIP, Banyon and certain other stockholders. SIP's rights under the Investor Rights Agreement were transferred to GCM and Trinad in connection with the purchase by GCM Shells Seafood Partners, LLC, a Delaware limited liability company ("GCM") and Trinad Capital, L.P., a Delaware limited partnership ("Trinad") of the \$1,000,000 promissory note on June 23, 2004. The Investor Rights Agreement, among other things, fixed the composition of our board of directors at seven members, subject to certain requirements, and provided each of SIP and Banyon with the right to nominate three individuals to serve on the board. Banyon, SIP (now GCM and Trinad) and certain other stockholders that are parties to the Investor Rights Agreement agreed to vote their respective shares for the election as directors of the other's nominees. As part of the transfer by SIP of the \$1,000,000 promissory note to GCM and Trinad in June 2004, we accepted the resignation of J. Stephen Gardner, John N. Giordano and Thomas R. Newkirk (who were SIP's designees) as members of our board of directors and elected Robert S. Ellin, Jay A. Wolf and Gary Herman (the board nominees of GCM and Trinad) to our board to fill these three vacancies. In accordance with the terms of the Investors Rights Agreement, the right to nominate individuals for election to our Board terminated upon the repayment in full of the \$2,000,000 promissory notes.

In April 2005, the Nominating Committee, consisting of Messrs. Herman and Illick and Dr. Golding was formed. The Nominating Committee nominated Philip R. Chapman, Leslie J. Christon, Robert S. Ellin, Michael R. Golding, Gary Herman, Christopher D. Illick and Jay A. Wolf to stand for re-election as members of our Board of Directors at the 2005 Annual Meeting of Stockholders.

#### Directors

The members of our Board of Directors (each of whom has been nominated for re-election at the 2005 Annual Meeting of Stockholders), their ages, the year in which each first became a director and their principal occupations or employment during the past five years are summarized below:



| <b>Director</b>    | <b>Age</b> | <b>Year First Became Director</b> | <b>Principal Occupation During the Past Five Years</b>  |
|--------------------|------------|-----------------------------------|---|
| Philip R. Chapman  | 44         | 1997                              | Mr. Chapman has served on our Board of Directors since May 1977 and as Chairman since April 2002. Since 1993, Mr. Chapman has been President of Adler & Company, a corporation which provides administrative services for financial and venture capital investing, including certain entities controlled by Frederick R. Adler, a greater than 10% stockholder. Mr. Chapman is a director of Regeneration Technologies, Inc., a company which produces allografts for surgical use, and various private companies. He is also a General Partner in Euro-America II, L.P., a private venture capital fund, and a managing partner of Alpha Beta Capital Management, a private hedge fund. Mr. Chapman is the son-in-law of Fredrick R. Adler.                                  |
| Leslie J. Christon | 50         | 2004                              | Mrs. Christon has served as the President and Chief Executive Officer of Shells since joining our company in July 2003. From 2002 to 2003, Mrs. Christon was self-employed as a management consultant in the restaurant industry. From 2000 to 2002, Mrs. Christon was employed by Sutton Place Gourmet, Inc. as its President and Chief Operating Officer. From 1996 to 2000, Mrs. Christon was employed by Brinker International, On the Border Restaurants, as its President.  |
| Robert S. Ellin    | 40         | 2004                              | Mr. Ellin has served on our Board of Directors since June 2004. In 2003, Mr. Ellin founded Trinad Capital, LP and has served as a managing member of Trinad Advisors GP, LLC which is the general partner of Trinad Capital, LP, since inception. In 1990, Mr. Ellin founded and served as President of Atlantis Equities Inc., a private investment company. From 1996 to 1998, he served as President of S&S Industries, Inc. Prior to founding Atlantis Equities, Mr. Ellin worked in Institutional Sales at LF Rothschild and was the Manager of Retail Operations at Lombard Securities.   |
| Michael R. Golding | 71         | 2002                              | Dr. Golding has been a professor of surgery at the State University of New York Health Science Center in Brooklyn, New York since 1963, where he is currently an Emeritus Clinical Professor of Surgery. From 1977 to 1989, Dr. Golding served as Director of Surgery at Lutheran Medical Center in Brooklyn, New York. From 1984 to 1989, Dr. Golding was President of the Tri-Boro Association of Directors of Surgery. Dr. Golding is a Fellow of the American College of Surgeons, a Fellow of the American College of Chest Physicians, and a Fellow of the American College of Angiology. Dr. Golding is a Member of the Board of Directors of the United Hospital Fund. Dr. Golding also serves on the boards of numerous professional entities and private companies. |

|                       |    |      |   |
|-----------------------|----|------|---|
| Gary Herman           | 40 | 2004 | Mr. Herman has been the Chairman and Secretary of Digital Creative Development Corporation, an investment holding company, since 2001. He has been a member of the Board of Directors of DataMetrics Corporation, a military defense company, since 2000. In addition, Mr. Herman has been a member of Galloway Capital Management, LLC, an affiliate of a greater than 10% stockholder, since 2002. Mr. Herman has also been a member of the Board of Directors of NYC Industrial Development Agency since 1997.   |
| Christopher D. Illick | 66 | 1998 | Mr. Illick has been the President of iQ Venture Partners, Inc., an investment bank, since 2001 and a General Partner of Illick Brothers, a real estate and management concern, since 1965. From 1997 to 2001, Mr. Illick was a senior officer of the investment bank of Brean Murray & Co., Inc. Mr. Illick is a Member of the Board of Directors of Analytical Surveys, Inc.   |
| Jay A. Wolf           | 32 | 2004 | Mr. Wolf has served on our Board of Directors since June 2004 and as Audit Committee Chairman since 2004. Since February 2004, Mr. Wolf has served as a Managing Director of Trinad Capital, LP. From 1999 to 2003, Mr. Wolf served as Vice President of Corporate Development for Wolf Group Integrated Communications Ltd. where he was responsible for the company's acquisition program. From 1996 to 1999, Mr. Wolf was employed by Canadian Corporate Funding, Ltd., a Toronto-based merchant bank in the senior debt department and, subsequently by Trillium Growth Capital, the firm's venture capital Fund. Mr. Wolf currently sits on the board of Amalgamated Technologies Inc. |

During fiscal year 2004, our Board of Directors held 17 meetings, acted by unanimous written consent 3 times and acted by committee action 6 times. During fiscal 2004, each director currently nominated for re-election to the Board at the 2005 Annual Meeting attended at least 75% of the aggregate number of meetings of the Board of Directors and all committees of the Board on which he or she served, during the time period in which he or she served.

We have a general policy of expecting our directors to attend our annual meetings of stockholders. All of our directors were in attendance at last year's annual meeting of stockholders.

### **Board Committees**

The Board of Directors has standing Executive, Audit, and Stock Option and Compensation Committees and, since April 2005, a Nominating Committee.

The Executive Committee possesses all the powers and authority of the Board in the management of the business and affairs of our company, except for certain powers which are specifically reserved by Delaware law to the entire Board or the stockholders. Messrs. Chapman and Herman are the current members of the Executive Committee. The Executive Committee did not meet in fiscal 2004.

The Audit Committee's responsibilities, which include reviewing our internal accounting procedures and consulting with and reviewing the services provided by the independent auditors, are described in the Audit Committee Charter. Messrs. Illick and Wolf and Dr. Golding are the current members of the Audit Committee. Mr. Illick and Dr. Golding are independent directors as that term is defined by Rule 4200(a)(15) of the Nasdaq Listing Standards. Mr. Wolf may not be an independent director pursuant to that definition. Messrs. Illick and Wolf are audit committee financial experts, as that term is defined in Item 401(h)(2) of Regulation S-K. The Audit Committee met 4 times in fiscal 2004.

The Stock Option and Compensation Committee is charged with reviewing compensation policies and practices, recommending compensation for executives and key employees and administering our stock option plans. The Stock Option and Compensation Committee Report appears under Item 11 of this annual report and is titled "Executive Compensation - Stock Option and Compensation Committee Report to Stockholders Regarding Executive Compensation." Messrs. Chapman and Ellin are the current members of the Stock Option and Compensation Committee. During fiscal 2004, the Stock Option and Compensation Committee met 2 times.

In April 2005, the Board of Directors established a Nominating Committee to assist the Board in its selection of individuals (i) as nominees for election to the Board of Directors and (ii) to fill any vacancies or newly created directorships on the Board. The members of the Nominating Committee are Messrs. Herman and Illick and Dr. Golding.

It is the policy of the Nominating Committee to consider candidates for Board membership suggested by Nominating Committee members and other Board members, management, our stockholders, third-party search firms and any other appropriate sources. As a stockholder, you may recommend any person for consideration as a nominee for director by writing to the Nominating Committee of the Board of Directors, 16313 N. Dale Mabry Highway, Suite 100, Tampa, Florida 33618. Recommendations must be received by January 18, 2006 to be considered for the 2006 Annual Meeting of Stockholders. Recommendations must include the name and address of the stockholder making the recommendation, a representation setting forth the number of shares of Common Stock beneficially owned by the recommending stockholder, a statement that the recommended nominee has expressed his or her intent to serve on the Board if elected, biographical information about the recommended nominee, any other information the stockholder believes would be helpful to the Nominating Committee in evaluating the recommended nominee and a description of all arrangements or understandings between the recommending stockholder and each nominee and any other person concerning the nomination.

In evaluating candidates, the Nominating Committee will consider the following criteria: personal integrity, sound business judgment, business and professional skills and experience, independence, potential conflicts of interest, the extent to which a candidate would fill a present need, and concern for the long term interests of stockholders. In any particular situation, the Nominating Committee may focus on persons possessing a particular background, experience or qualifications which the Committee believes would be important to enhance the effectiveness of the Board. The evaluation process for stockholder recommendations is the same as for candidates recommended from any other source.

### **AUDIT COMMITTEE REPORT**

*This report of the Audit Committee shall not be deemed incorporated by reference by any general statement incorporating by reference this annual report into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that Shells specifically incorporates the information by reference, and shall not otherwise be deemed filed under such Acts.*

Management has the primary responsibility for the financial statements and the reporting process, including the systems of internal control. On behalf of the Board, the Audit Committee, among other things, reviews and monitors the financial reporting process, the systems of internal control, the audit process, the independence and performance of the independent accountants and the process for monitoring compliance with laws and regulations. The members of the Audit Committee are Dr. Michael R. Golding and Messrs. Christopher Illick and Jay A. Wolf.

The Audit Committee reviewed our financial statements with management and the Board of Directors and discussed with Kirkland Russ Murphy & Tapp P.A., or Kirkland Russ, our independent auditors for fiscal 2004, the matters required to be discussed by Statement of Auditing Standard No. 61. The Audit Committee received from Kirkland Russ the written disclosures and the letter required by Independence Standards Board Standard No. 1 and discussed with Kirkland Russ its independence. The Audit Committee has reviewed the audit fees of Kirkland Russ and any non-audit services and fees, to assure compliance with Shells' and the Committee's policies restricting the independent accountants from performing services that might impair their independence.

After reviewing and discussing the financial statements, and in reliance on the matters reviewed and discussed above, and without other independent verification, the Audit Committee recommended that the audited consolidated financial statements of Shells be included in our Annual Report on Form 10-K for our fiscal 2004.

Audit Committee  
Jay A. Wolf, Chairman  
Christopher D. Illick  
Michael R. Golding

## ITEM 11. EXECUTIVE COMPENSATION

The following table shows all the cash compensation, as well as other compensation, we paid during the fiscal years indicated to (i) our Chief Executive Officer and (ii) each other executive officer whose total annual salary and bonus exceeded \$100,000 for our fiscal year 2004.

**SUMMARY COMPENSATION TABLE**

| Name and Principal Position   | Fiscal Year | Annual Compensation |          |           | Long-Term Compensation |         |
|---|-------------|---------------------|----------|-----------|------------------------|---------|
|   |             | Salary              | Bonus    | Other     | Awards                 | Options |
| Leslie J. Christon,<br>Chief Executive Officer and President <sup>(1)</sup>   | 2004        | \$ 285,577          | 1,164    | \$ 8,120  | -                      | -       |
|   | 2003        | \$ 121,635          | -        | \$ 31,403 | -                      | 297,374 |
| Warren R. Nelson,<br>Executive Vice President of Finance,<br>Chief Financial Officer, Secretary and<br>Treasurer <sup>(2)</sup> | 2004        | \$ 162,000          | \$       | \$ 530    | -                      | -       |
|   | 2003        | \$ 155,769          | \$ 1,164 | 605       | -                      | -       |
|   | 2002        | \$ 142,225          | 36,334   | -         | -                      | 157,984 |
| Guy C. Kathman,<br>Vice President of Operations <sup>(3)</sup>  | 2004        | \$ 124,615          | \$ 1,164 | \$ 12,768 | -                      | -       |
|   | 2003        | \$ 27,692           | -        | -         | -                      | 50,000  |

- (1) Mrs. Christon joined Shells in July 2003. Compensation for 2003 reflects payments made pursuant to her employment agreement for the portion of 2003 during which she was employed by us. The amount of other compensation for 2004 includes: (i) \$7,500 paid by Shells for Mrs. Christon's automobile allowance, and (ii) \$620 paid by Shells for life insurance premiums. The amount of other compensation for 2003 includes: (i) \$1,403 paid by Shells for Mrs. Christon's automobile allowance, and (ii) \$30,000 paid by Shells for relocation costs of Mrs. Christon.
- (2) Mr. Nelson's other compensation consists of \$530 and \$605 for 2004 and 2003, respectively, paid by Shells for life insurance premiums. The fiscal 2003 bonus consisted of \$18,167 in cash and \$18,167 in Common Stock grants, which after adjusting for payroll tax withholdings, comprised 28,318 shares of unrestricted Common Stock at \$0.40 per share, issued and paid pursuant to the 2002 management incentive plan relating to 2002 results.
- (3) Mr. Kathman joined Shells in September 2003. Compensation for 2003 reflects payments made for the portion of 2003 during which he was employed by us. The amount of other compensation for 2004 includes: (i) \$12,451 paid by Shells for relocation costs of Mr. Kathman, and (ii) \$317 paid by Shells for life insurance premiums.

### AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR END OPTION VALUES

The following table sets forth information with respect to (i) options exercised during fiscal 2004 by the persons named in the Summary Compensation Table and (ii) unexercised options held by these individuals at January 2, 2005 (our fiscal year end).

| Name               | Shares<br>Acquired<br>on<br>Exercise<br>(#) | Value<br>Realized | Number of Securities<br>Underlying Unexercised<br>Option Held<br>at Fiscal Year End |               | Value of Unexercised,<br>In-the-Money Option at<br>Fiscal Year End <sup>(1)</sup> |               |
|--------------------|---|-------------------|---|---------------|---|---------------|
|                    |   |                   | Exercisable   | Unexercisable | Exercisable   | Unexercisable |
| Leslie J. Christon | -   | -                 | 148,687   | 148,687       | \$29,737  | \$29,737      |
| Warren R. Nelson   | -   | -                 | 173,783   | 63,193        | 45,316  | 25,277        |
| Guy C. Kathman     | -   | -                 | 16,667  | 33,333        | 3,000   | 6,000         |

(1) Based on the closing market price of the Common Stock of \$0.82 on Thursday, December 30, 2004, the last day of fiscal 2004 on which our Common Stock was traded.

### Employment Agreements

On July 1, 2003, we entered into a two-year employment agreement with Leslie J. Christon, pursuant to which she serves as our President and Chief Executive Officer. The employment agreement provided for an annual base salary of \$275,000 during fiscal 2004, along with discretionary bonuses, as determined by the Stock Option and Compensation Committee of the Board. In fiscal 2003, pursuant to her employment agreement, Mrs. Christon was granted an option to purchase 297,374 shares of Common Stock. The option vests annually over two years. Mrs. Christon's employment agreement automatically renews for consecutive one-year terms unless either she or Shells gives notice to the other of an intention not to renew.

We currently do not have employment agreements with Messrs. Nelson and Kathman. However, Mr. Nelson has a letter agreement with the Board stating that in the event Mr. Nelson's employment is terminated without cause, Mr. Nelson will be entitled to receive severance payments for a period of 12 months following the termination in an amount equal to his then current salary as of such date.

## STOCK OPTION AND COMPENSATION COMMITTEE REPORT TO STOCKHOLDERS REGARDING EXECUTIVE COMPENSATION

*The report of the Stock Option and Compensation Committee shall not be deemed incorporated by reference by any general statement incorporating by reference this annual report into any filing under the Securities Act of 1933, as amended, or under the Securities Exchange Act of 1934, as amended, except to the extent Shells specifically incorporates this information by reference, and shall not otherwise be deemed filed under such Acts.*

### Executive Compensation Philosophy

Shells manages and operates full service, mid-priced, casual dining seafood restaurants. One of our central goals is to ensure that our remuneration policy enables us to attract, retain and reward capable employees who can contribute, both short and longer-term, to the success of Shells. Equity participation and a strong alignment to stockholders' interests are key elements of our compensation philosophy.

Our executive compensation program consists of three parts: base salary, bonus and stock options. In awarding salary increases and bonuses, we considered whether the compensation package as a whole adequately compensated each executive for Shells' performance during fiscal 2004 and that executive's contribution to this performance.

### **Base Salaries of Executive Officers**

Base salary represents the fixed component of the executive compensation program. Our practice generally is to maintain base salaries at approximately competitive industry averages. Determinations of base salary levels are established on an annual review of marketplace competitiveness with similar restaurant companies. Periodic increases in base salary relate to individual contributions to Shells' overall performance and relative marketplace competitiveness.

### **Bonus**

Bonuses represent the variable component of the executive compensation program that is tied to our performance and individual achievement. To the extent deemed appropriate, our policy is to grant bonuses as a portion of the compensation paid to Shells' management personnel. In determining bonuses, we consider factors such as the performance of Shells during the year and the individual's contribution to that performance. During fiscal 2002, we adopted an executive and management bonus program specifying criteria relating to our financial performance as well as individual contributions to Shells.

### **Stock Options**

We believe that an important goal of the executive compensation program should be to provide executives and key employees who have significant responsibility for the management, growth and future success of Shells with an opportunity to increase their ownership in Shells and the potential for financial gain from increases in our stock price. This approach ensures that the interests of the stockholders, executives and employees will be closely aligned. Therefore, executive officers and other key employees of Shells are granted stock options which give them a right to purchase shares of Common Stock at a specified price in the future. The grant of options is based primarily on an employee's potential contribution to Shells' growth and financial results. In determining the size of option grants, we also consider the number of options owned by such officer, the number and exercise price of options previously granted and currently outstanding, and the aggregate size of the current option grants. Options generally are granted at the prevailing market value of the Common Stock and will only have value if our stock price increases. Generally, grants of options vest over time, and the individual must be employed by Shells for the options to vest.

## Compensation of Shells' President

On July 1, 2003, Shells entered into a two-year employment agreement with Leslie J. Christon, pursuant to which she serves as President and Chief Executive Officer. The employment agreement provided for an annual base compensation of \$275,000 during fiscal 2004 and supplemental discretionary bonuses, as determined by the Stock Option Committee. In determining Mrs. Christon's compensation, we considered the pay practices of other companies in the restaurant industry as well as her potential contribution to our future performance. A more complete description of Mrs. Christon's employment agreement is set out earlier in the annual report statement under the heading "Executive Compensation - Employment Agreements."

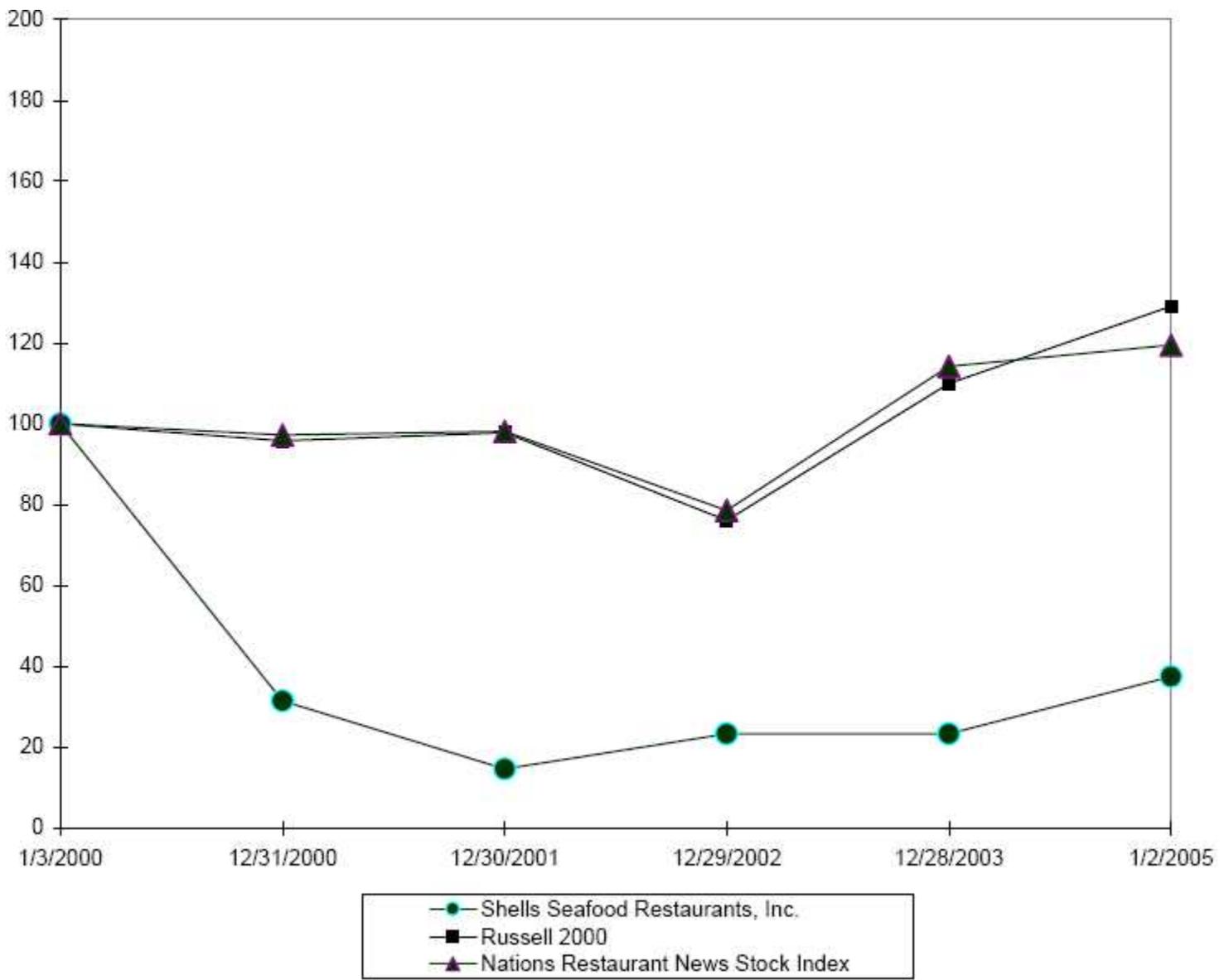
Stock Option and Compensation Committee  
Philip R. Chapman, Chairman  
Robert Ellin

## OUR STOCK PRICE PERFORMANCE

*The following Stock Price Performance Graph shall not be deemed incorporated by reference by any general statement incorporating by reference this annual report into any filing under the Securities Act of 1933 or under the Securities Exchange Act of 1934, except to the extent Shells specifically incorporates this information by reference, and shall not otherwise be deemed filed under such Acts.*

The following graph compares cumulative total return of our Common Stock with the cumulative total return of (i) the Russell 2000 Index and (ii) the Nations Restaurant News Stock Index (the "Peer Index"). The graph assumes (a) \$100 was invested on January 3, 2000 (the first day of our fiscal 2000) in each of our Common Stock, the stocks comprising the Russell 2000 Index and the stocks comprising the Peer Index, and (b) the reinvestment of dividends, if any.

## COMPARISON OF CUMULATIVE TOTAL RETURN AMONG SHELLS SEAFOOD RESTAURANTS, INC., RUSSELL 2000 INDEX, AND NATIONS RESTAURANT NEWS STOCK INDEX



## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

### INFORMATION ABOUT OWNERSHIP OF OUR COMMON STOCK

The following table sets forth certain information as of April 3, 2005 regarding the beneficial ownership of our Common Stock by (i) each person known by us to own beneficially more than 5% of the outstanding Common Stock; (ii) each current director (all of whom are standing for re-election); (iii) each executive officer named in the Summary Compensation Table appearing in Item 11 "Executive Compensation - Summary Compensation Table" in this annual report; and (iv) all of our directors and executive officers as a group. Except as otherwise specified, the named beneficial owner has the sole voting and investment power over the shares listed, and has an address c/o Shells Seafood Restaurants, Inc., 16313 N. Dale Mabry Highway, Suite 100, Tampa, FL 33618. For purposes of this table, beneficial ownership is determined according to the rules of the Securities and Exchange Commission, which generally attributes beneficial ownership of securities to persons who possess sole or shared voting power and/or investment power with respect to those securities. Common stock options and warrants which are presently exercisable or which become exercisable within 60 days of April 3, 2005 are considered beneficially owned shares of Common Stock.

| <b>Name and Address of Beneficial Owner</b>  | <b>Beneficial<br/>Ownership<br/>Amount</b> | <b>Percent of Class</b> |   |
|--|--|-------------------------|---|
| Philip R. Chapman<br>750 Lexington Avenue, 18th Floor<br>New York, NY 10022 (1)  | 4,526,682                                  | 30.8                    | % |
| Leslie J. Christon (2)   | 163,687                                    | 1.1                     | % |
| Robert Ellin<br>c/o Trinad Capital, L.P.<br>2121 Avenue of the Stars, Suite 1650<br>Los Angeles, CA 90067 (3)                | 2,878,215                                  | 19.7                    | % |
| Michael R. Golding<br>439 Newman Springs Road<br>Lincroft, NJ 07738 (4)  | 16,667                                     | *                       |   |
| Gary Herman<br>Galloway Capital Management, LLC<br>1325 Avenue of Americas, 26 <sup>th</sup> floor<br>New York, NY 10019 (5) | 492,607                                    | 3.4                     | % |

|   |           |      |   |
|---|-----------|------|---|
| Christopher D. Illick<br>154 Mercer Street<br>Princeton, NJ 08540 (6)   | 40,667    | *    |   |
| Jay Wolf<br>c/o Trinad Capital, L.P.<br>2121 Avenue of the Stars, Suite 1650<br>Los Angeles, CA 90067 (7)                       | 6,667     | *    |   |
| Guy C. Kathman (8)  | 16,667    | *    |   |
| Warren R. Nelson (9)  | 241,684   | 1.6  | % |
| Catherine R. Adler<br>1520 South Ocean Blvd.<br>Palm Beach, FL 33480 (10)   | 4,454,015 | 30.4 | % |
| Frederick R. Adler<br>1520 South Ocean Blvd.<br>Palm Beach, FL 33480 (11)   | 2,204,426 | 14.1 | % |
| Bruce Galloway<br>Galloway Capital Management LLC<br>1325 Avenue of Americas, 26 <sup>th</sup> floor<br>New York, NY 10019 (12) | 2,294,566 | 15.7 | % |
| Banyon Investment, LLC<br>750 Lexington Avenue, 18 <sup>th</sup> Floor<br>New York, NY 10022                                    | 4,454,015 | 30.4 | % |
| Galloway Capital Management, LLC<br>1325 Avenue of Americans, 26 <sup>th</sup> floor<br>New York, NY 10019                      | 387,502   | 2.7  | % |
| Trinad Advisors GP, LLC<br>153 East 53 <sup>rd</sup> Street, 48 <sup>th</sup> floor<br>New York, NY 10022 (13)                  | 2,871,548 | 19.6 | % |
| Trinad Capital, L.P.<br>153 East 53 <sup>rd</sup> Street, 48 <sup>th</sup> floor<br>New York, NY 10022                          | 2,871,548 | 19.6 | % |
| All directors and executive officers as a group (9 persons)(14)   | 8,383,541 | 55.5 | % |

\* less than 1%

- (1) Includes (i) 4,454,015 shares of Common Stock owned by Banyon Investment, LLC, and (ii) 42,667 shares of Common Stock which may be acquired through the exercise of options held by Mr. Chapman. Does not include options to purchase 13,333 shares of Common Stock which are not exercisable within 60 days of April 3, 2005. Mr. Chapman and Catherine R. Adler are co-managing members of Banyon Investment, LLC and share voting and investment powers.

- (2) Includes 148,687 shares of Common Stock which may be acquired through the exercise of options. Does not include options to purchase 148,687 shares of Common Stock which are not exercisable within 60 days of April 3, 2005.
- (3) Consists of: (i) 2,871,548 shares of Common Stock owned by Trinad Capital, LP, and (ii) 6,667 shares of Common Stock which may be acquired through the exercise of options. Does not include options to purchase 13,333 shares of Common Stock which are not exercisable within 60 days of April 3, 2005. Mr. Ellin is a managing member of Trinad Advisors GP, LLC which is the general partner of Trinad Capital, LP.
- (4) Consists of 16,667 shares of Common Stock which may be acquired through the exercise of options. Does not include options to purchase 13,333 shares of Common Stock which are not exercisable within 60 days of April 3, 2005.
- (5) Includes: (i) 387,502 shares of Common Stock owned by Galloway Capital Management, LLC; (ii) 6,667 shares of Common Stock which may be acquired through the exercise of options; and (iii) 4,688 shares of Common Stock owned by a trust for the benefit of Mr. Herman's children. Does not include options to purchase 13,333 shares of Common Stock which are not exercisable within 60 days of April 3, 2005. Mr. Herman is a managing member of Galloway Capital Management, LLC and GCM Shells Seafood Partners, LLC, and the trustee of the aforementioned trust.
- (6) Consists of 40,667 shares of Common Stock which may be acquired through the exercise of options. Does not include options to purchase 13,333 shares of Common Stock which are not exercisable within 60 days of April 3, 2005.
- (7) Consists of 6,667 shares of Common Stock which may be acquired through the exercise of options. Does not include options to purchase 13,333 shares of Common Stock which are not exercisable within 60 days of April 3, 2005.
- (8) Consists of 16,667 shares of Common Stock which may be acquired through the exercise of options. Does not include options to purchase 158,333 shares of Common Stock which are not exercisable within 60 days of April 3, 2005.
- (9) Includes 176,416 shares of Common Stock which may be acquired through the exercise of options. Does not include options to purchase 185,560 shares of Common Stock which are not exercisable within 60 days of April 3, 2005.
- (10) Consists of 4,454,015 shares of Common Stock owned by Banyon Investment, LLC. Mrs. Adler and Mr. Chapman are co-managing members of Banyon Investment, LLC and share voting and investment powers. Does not include any shares held by Mr. Adler.
- (11) Includes a warrant to purchase 1,000,000 shares of Common Stock and 10,100 shares of Common Stock held by 1520 Partners LP. Mr. Adler is the General Partner of 1520 Partners LP. Does not include 4,454,015 shares of Common Stock owned by Banyon Investment, LLC. Mr. Adler's wife is a co-managing member of Banyon Investment, LLC.
- (12) Includes: (i) 387,502 shares of Common Stock owned by Galloway Capital Management, LLC; (ii) 1,749,964 shares of Common Stock owned by the Bruce Galloway, IRA R/O; (iii) 93,100 shares of Common Stock owned by Jacombs Trading, Inc.; and (iv) 64,000 shares of Common Stock owned by trusts for the benefit of Mr. Galloway's children. Mr. Galloway is a managing member of Galloway Capital Management, LLC and GCM Shells Seafood Partners, LLC, the beneficiary and manager of the Bruce Galloway, IRA R/O, a majority shareholder of Jacombs Trading, Inc., and trustee of the aforementioned trust.

- (13) Consists of 2,871,548 shares of Common Stock owned by Trinad Capital, LP. Trinad Advisors GP, LLC is the general partner of Trinad Capital, LP.
- (14) Includes 461,770 shares of Common Stock which may be acquired through the exercise of options. Does not include options to purchase an aggregate of 1,022,580 shares of Common Stock which are not exercisable within 60 days of April 3, 2005.

*Certain information in the table and its footnotes is derived from filings made with the Securities and Exchange Commission or supplemental information received from various of the entities named in this table.*

### **The 2002 Financing Transaction**

In January 2002, we raised \$2,000,000 in a private financing transaction, consisting of secured promissory notes and warrants to purchase Common Stock. The two investors in the financing transaction were Shells Investment Partners, L.L.C. ("SIP") and Banyon Investment, LLC ("Banyon"). SIP is an entity comprised of Messrs. J. Stephen Gardner, John N. Giordano and Thomas R. Newkirk, each of whom served as a member of our board of directors until his resignation in June 2004. At the time of the transactions, none of Messrs. Gardner, Giordano or Newkirk were affiliated with us. Banyon is an entity associated with Philip R. Chapman, Chairman of our Board of Directors, and certain family members of Frederick R. Adler, who was at the time a greater than 10% stockholder. The proceeds of the financing transaction were used for working capital requirements.

In the financing, we issued to each of SIP and Banyon (i) a \$1,000,000 secured promissory note initially due January 31, 2005 (subsequently extended to January 31, 2007) which bears interest at 15% per annum, of which initially 8% was payable monthly in arrears and 7% was deferred and payable when the principal was payable in full (subsequently amended to provide for the deferral of the entire 15% per annum interest until maturity) and (ii) a warrant to purchase 4,454,015 shares of Common Stock at an exercise price of \$0.16 per share. The warrants automatically converted into shares of Common Stock on January 31, 2005 (unless the warrants were exercised prior to that date) pursuant to a mandatory cashless exercise provision in the warrant agreements.

### **Change of Control**

On June 23, 2004, SIP sold to GCM Shells Seafood Partners, LLC, a Delaware limited liability company ("GCM"), and Trinad Capital, L.P., a Delaware limited partnership ("Trinad"), the \$1,000,000 promissory note issued by us to SIP on January 31, 2002 as part of our \$2,000,000 private financing transaction. GCM and Trinad purchased the note with working capital in the amount of \$400,000 and \$600,000, respectively.

As part of the June 23, 2004 sale of the \$1,000,000 promissory note by SIP to GCM and Trinad, warrants to purchase an aggregate of 4,008,615 shares of our Common Stock were transferred to Galloway Capital Management, LLC (668,103 shares), GCM (1,068,964 shares), Trinad (1,603,445 shares) and Atlantis Equities, Inc. (668,103 shares)(collectively, the "GCM Entities"). Galloway Capital Management, LLC and Atlantis Equities, Inc. are affiliates of GCM. The remaining warrants to purchase 445,400 shares of our Common Stock were retained by SIP. Banyon exercised its warrant to purchase 4,454,015 shares of Common Stock, and the GCM Entities exercised their warrants to purchase an aggregate of 4,008,615 shares of Common Stock, all by the payment in cash of the exercise price. The warrants retained by SIP were automatically exercised pursuant to the mandatory cashless exercise provision, whereby an aggregate of 350,381 shares of Common Stock were issued to the individual members of SIP.

In August 2004, we agreed with the holders of the \$2,000,000 of promissory notes to an extension of the term of the notes from their original expiration date of January 31, 2005 to January 31, 2007. In connection with this extension, we issued warrants to purchase 400,000, 600,000 and 1,000,000 shares of Common Stock, respectively, to GCM, Trinad and Frederick R. Adler, at the time a greater than 10% stockholder, who is not affiliated with GCM or Trinad.

In March 2005, GCM and Trinad exercised these warrants in full. We used a portion of the proceeds from this exercise to repay an aggregate of \$500,000 principal amount of promissory notes held by GCM and Trinad. At the same time, the \$1,000,000 note held by Frederick R. Adler was modified to allow Shells to defer entirely the monthly interest payment on \$500,000 of principal amount of the note until the maturity date of January 31, 2007, resulting in the deferral of \$72,000 of cash payments until the maturity date.

In May 2005, we anticipate completing an offering of our securities (Common Stock and warrants to purchase Common Stock), which would provide us with net proceeds of approximately \$10,000,000. We contemplate using a portion of these proceeds to repay in full the remaining \$1,500,000 principal amount of the promissory notes from the 2002 financing and all accrued but unpaid interest on these notes.

For information regarding the approximate number of shares and percentage of Common Stock beneficially owned by Frederick R. Adler, GCM, Trinad and other persons and entities affiliated with them, we refer you to the information set forth in the beneficial ownership table in this Item 12 under the heading "Information About Ownership of Our Common Stock". Certain information contained in this annual report regarding these beneficial owners has been obtained from the filings made by such entities with the Securities and Exchange Commission.

### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information set forth below briefly describes certain transactions between our Company and certain parties who or which may be deemed to be affiliated with us.

On March 1, 1994, our wholly-owned subsidiary, Shells of Melbourne, Inc. entered into a joint venture agreement with WLH Investments, Inc., a corporation wholly-owned by Wanda L. Hattaway, wife of William E. Hattaway, our then president. The joint venture owns and operates the Shells restaurant located in Melbourne, Florida. The Joint Venture Agreement provides that WLH Investments receives a cumulative annual preferred return of 15% on the \$400,000 of capital contributed to the joint venture by WLH Investments. Shells of Melbourne will then be allocated an equal amount to this preferred return. The remaining net income of the joint venture will be allocated 51% to Shells of Melbourne and 49% to WLH Investments. Based upon these allocations, we paid \$60,000 to WLH Investments for its fiscal 2004 preferred return, and \$268,737 in net income allocations to WLH Investments during 2004. Capital contributions in 2004 by WLH Investments were \$104,393. Distributions in 2004 exceeded life-to-date income allocations resulting in a net capital increase in 2004 of \$62,775.

In January 2002, we raised \$2,000,000 in the financing transaction described more fully in Item 12 "Security Ownership of Certain Beneficial Owners and Management - Information about Ownership of Our Common Stock - The 2002 Financing Transaction." Both of the investment entities which participated in the financing transaction, SIP and Banyon, had members who were nominated for election to the Board of Directors. On June 23, 2004, SIP sold to GCM and Trinad the \$1,000,000 promissory note issued to SIP, and GCM and Trinad acquired the rights to nominate individuals to serve as Board members under the Investor Rights Agreement. Robert S. Ellin, Jay A. Wolf and Gary Herman, the individuals nominated by GCM and Trinad to serve as Board members, are members of GCM and Trinad. Philip R. Chapman, our Chairman of the Board, and Catherine Adler, the spouse of Frederick R. Adler, one of our principal stockholders, are co-managing members of Banyon. Certain other family members of Frederick R. Adler also are members of Banyon. The financing transaction was approved by a special committee of the Board, comprised of the then disinterested members of the Board. Although we believe that the transaction was on terms no less favorable than would have been available from unaffiliated third parties in arm's length transactions, there can be no assurance that this is the case. Pursuant to the Investor Rights Agreement described in Item 10 "Directors and Executive Officers of the Registrant - Board Composition" in this annual report, each of GCM, Trinad and Banyon have nominated individuals (Messrs. Ellin, Herman and Wolf in the case of GCM and Trinad, and Messrs. Chapman and Illick and Dr. Golding in the case of Banyon) to serve as members of our Board of Directors.

In August 2004, we agreed with the holders of the \$2,000,000 of promissory notes to an extension of the term of the notes from their original expiration date of January 31, 2005 to January 31, 2007. In connection with this extension, we issued warrants to purchase 400,000, 600,000 and 1,000,000 shares of Common Stock, respectively, to GCM, Trinad and Frederick R. Adler, at the time a greater than 10% stockholder, who is not affiliated with GCM or Trinad.

During October 2002, we refinanced through Colonial Bank two of our restaurant properties, Melbourne and Winter Haven, with notes of \$635,000 and \$667,000, respectively. The loans, which bear interest at the bank's then base rate, are for terms of five years with required annual principal payments based on a 15 year amortization schedule, and a balloon payment of all then outstanding amounts due at the end of the five years. The principal balances owed on these two notes as of January 2, 2005, were \$532,000 and \$567,000, respectively.

On December 28, 2004, we entered into a consulting agreement with Lawrence Wolf, the father of Jay A. Wolf, a member of our Board of Directors. The consulting agreement has a one year term, and under it, Mr. Lawrence Wolf is to assist Shells in providing marketing services, including guidance toward building our creative strategy around the "Shells" brand positioning and providing support in coordinating our media production. As compensation, Mr. Lawrence Wolf received options, pursuant to our 2002 Equity Incentive Plan, to purchase 130,000 shares of Common Stock at an exercise price of \$0.83, the market price of the Common Stock on the date of grant. The options fully vest on the first anniversary of the grant date.

## **Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our executive officers and directors, and persons who beneficially own more than 10% of our Common Stock, to file initial reports of ownership and reports of changes in ownership with the SEC. Executive officers, directors and greater than 10% stockholders are required by the SEC to furnish us with copies of all Section 16(a) forms they file.

Based upon a review of the copies of the forms furnished to us and written representations from our executive officers and directors, we believe that during fiscal 2004, all Section 16(a) filing requirements applicable to our executive officers, directors and greater than 10% beneficial owners were complied with on a timely basis, except for (i) Philip Chapman, Catherine Adler and Banyon Investment, LLC each failed to timely file a Form 4 reporting the exercise of a warrant by Banyon, (ii) Galloway Capital Management, LLC and GCM Shells Seafood Partners, LLC each failed to timely file a Form 3 with respect to their becoming greater than 10% stockholders, and (iii) Warren R. Nelson failed to timely file a Form 4 to report a stock bonus awarded in 2003. Each of the forms listed above was subsequently filed with the Securities and Exchange Commission.

### **Code of Ethics**

Our board of directors has adopted a Code of Business Conduct and Ethics that applies to our principal executive officer and principal financial officer, as well as to the members of our board of directors and our other officers and employees. This Code of Business Conduct and Ethics is available on our web site, at [www.shellsseafood.com](http://www.shellsseafood.com). We intend to satisfy the amendment and waiver disclosure requirements under applicable securities regulations by posting any amendments of, or waivers to, the Code of Business Conduct and Ethics on our web site. A copy of our Code of Business Conduct and Ethics will be sent without charge upon request in writing addressed to us at 16313 N. Dale Mabry Hwy, Suite 100, Tampa, Florida 33618 c/o Secretary.

## **ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

### **Independent Auditors**

The firm of Kirkland, Russ, Murphy & Tapp, P.A. audited and issued a report on our financial statements for fiscal 2004 and has been selected by the Audit Committee to issue a report on our financial statements for the fiscal year ending January 1, 2006.

### **Audit fees for fiscal 2004 and 2003.**

For fiscal 2004 and 2003, fees for professional services performed by Kirkland Russ were as follows:

|                               | <u>Fiscal 2004</u> | <u>Fiscal 2003</u> |
|-------------------------------|--------------------|--------------------|
| Audit Fees                    | \$62,321           | \$51,550           |
| Audit Related Fees            | 0                  | 0                  |
| Tax Fees                      | 23,000             | 22,800             |
| All Other Fees - tax planning | 5,250              | 0                  |
| <b>Total</b>                  | <u>\$90,571</u>    | <u>\$74,350</u>    |

The Audit Committee of the Board of Directors has considered whether the performance and services related to "Tax Fees" is compatible with maintaining the independence of Kirkland Russ.

We have a policy that discourages the retention of our independent auditors for non-audit services. We will not retain our independent auditors for non-audit work unless: (a) the approvals of the Chair of the Audit Committee and the Chief Financial Officer are obtained prior to the retention; and (b) the retention will not affect the status of the auditors as "independent accountants" under applicable rules of the Securities and Exchange Commission and the Independence Standards Board.

The details regarding any engagement of the independent auditors for non-audit services are provided promptly to the full Audit Committee. During fiscal 2004 and 2003, all of the services provided by Kirkland Russ for the services described above under Tax Fees were pre-approved using the above procedures.



## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

## (a) Financial Statements

(1) and (2) See "Index to Financial Statements" at Item 8 of this Annual Report on Form 10-K.

(3) Exhibits - Exhibits Nos. 10.1, 10.2, 10.4, 10.5, 10.30, 10.31, 10.53, 10.54, 10.55 and 10.57 are management contracts, compensatory plans or arrangements.

| <b>Exhibits</b> | <b>Description (everything filed which is currently active)</b>   |
|-----------------|---|
| 3.1             | Certificate of Incorporation*   |
| 3.2             | Agreement and Plan of Merger, dated March 31, 1996, by and between Shells Seafood Restaurants, Inc., a Delaware Corporation, and Shells Seafood Restaurant, Inc., a Florida Corporation. *  |
| 3.3             | By-laws. *  |
| 3.4             | Certificate of Designation. **  |
| 4.1             | Specimen common stock certificate. *  |
| 10.1            | 1996 Employee Stock Option Plan. *  |
| 10.2            | 1995 Employee Stock Option Plan. *  |
| 10.3            | Agreement for Purchase and Sale of Assets, dated May 14, 1993, between Shells Seafood Restaurants, Inc. and Shells, Inc.*   |
| 10.4            | 1996 Stock Option Plan for Non-Employee Directors **  |
| 10.5            | 2002 Equity Incentive Plan **   |
| 10.6            | First Amendment of Agreement and Plan of Merger, dated December 13, 1995, by and among Shells Seafood Restaurants, Inc., Shells Seafood Acquisition, Inc. and Shells, Inc. *  |
| 10.7            | Joint Venture Agreement, dated March 1, 1994, between Shells of Melbourne, Inc. and WLH Investments, Inc. *   |
| 10.8            | First Amendment to Joint Venture Agreement, effective as of March 31, 1995 between Shells of Melbourne, Inc. and WLH Investments, Inc. *  |
| 10.9            | Management and License Agreement, dated March 1, 1994, between Shells of Melbourne Joint Venture and Shells Seafood Restaurants, Inc. *   |
| 10.10           | Management and License Agreement dated July 29, 1993, between Shells of Carrollwood Village, Inc. and Shells Seafood Restaurants, Inc., as amended. *   |
| 10.11           | Management and License Agreement, dated July 28, 1993, between Shells of North Tampa, Inc. and Shells Seafood Restaurants, Inc., as amended. *  |
| 10.12           | Management and License Agreement, dated July 29, 1993, between Shells of Sarasota South, Inc. and Shells Seafood Restaurants, Inc., as amended. *   |
| 10.13           | Amended Option Agreement dated August 10, 1995 between Shells Seafood Restaurants, Inc. and Shells of Carrollwood Village, Inc.*  |
| 10.14           | Amended Option Agreement, dated August 11, 1995 between Shells Seafood Restaurants, Inc. and Shells of North Tampa, Inc. *  |
| 10.15           | Amended Option Agreement, dated August 16, 1995 by and between Shells Seafood Restaurants, Inc. and Shells of Sarasota South, Inc. *  |
| 10.16           | Agreement for Consulting and Management Services and Licensing of Service Marks, dated October 4, 1989 by and between Ursula Collaud and Shells of Daytona Beach, Inc., as amended by the Stipulation of Settlement dated December 2, 1994. * |
| 10.17           | Asset Purchase Agreement, dated September 30, 1994 between Shells of St. Petersburg Beach, Inc. and the Bleckley Corporation. *   |
| 10.18           | Assignment Agreement, dated September 30, 1994 between Shells of St. Pete Beach, Inc. and the Bleckley Corporation. *   |
| 10.19           | Promissory Note in the initial principal amount of \$540,000, dated September 30, 1994 by Shells of St. Pete Beach, Inc. for the benefit of the Bleckley Corporation (retired in 2004 with satisfaction of debt). *                           |
| 10.20           | Continuing and Unconditional Guaranty by Shells Seafood Restaurants, Inc. for the benefit of the Bleckley Corporation. *  |
| 10.21           | Security Agreement, dated September 30, 1995 between Shells of St. Pete Beach, Inc. and the Bleckley Corporation. *   |

**Exhibits****Description (everything filed which is currently active)**

- 10.24 Form of Directors Indemnification Agreement. \*
- 10.26 Agreement for the purchase and sale of leases, leasehold improvements, restaurant assets, assigned contracts and restaurant licenses by Shells Seafood Restaurants, Inc. for the benefit of Islands Florida LP \*\*
- 10.28 Loan agreement, dated January 15, 1998, between Shells Seafood Restaurants, Inc. and Manufacturers Bank of Florida, in the initial principal amount of \$850,000. \*\*
- 10.30 Letter from board of directors, dated January 19, 2000, clarifying severance arrangement for Warren R. Nelson \*\*
- 10.31 Employment Agreement, dated April 2, 2001, between David W. Head and Shells Seafood Restaurants, Inc. (employment terminated June 6, 2003) \*\*
- 10.33 Secured Promissory Note, dated January 18, 2002, between Shells Seafood Restaurants, Inc., and Best Que, LLC (funded in 2004) \*\*
- 10.36 Assignment and Assumption of Lease, dated January 21, 2002 between Shells Seafood Restaurants, Inc. and Famous Dave's Ribs, Inc. with landlord consent \*\*
- 10.39 Second Amendment to Management and License Agreement, dated October 4, 2001, between Shells Seafood Restaurants, Inc. and Shells of Sarasota South, Inc. \*\*
- 10.40 Second Amendment to Management and License Agreement, dated October 4, 2001, between Shells Seafood Restaurants, Inc. and Shells of North Tampa, Inc. \*\*
- 10.41 Second Amendment to Management and License Agreement, dated October 4, 2001, between Shells Seafood Restaurants, Inc. and Shells of Carrollwood Village, Inc. \*\*
- 10.42 Securities Purchase Agreement, dated as of January 31, 2002, by and among Shells Seafood Restaurants, Inc., its subsidiaries listed on the signature pages thereto, Shells Investment Partners, LLC and Banyon Investment, LLC \*\*\*
- 10.43 Security Agreement, dated as of January 31, 2002, by and among Shells Seafood Restaurants, Inc., its subsidiaries listed in the signature pages thereto, Shells Investment Partners, LLC and Banyon Investment, LLC \*\*\*
- 10.44 Investor Rights Agreement, dated as of January 31, 2002, among Shells Seafood Restaurants, Inc., Shells Investment Partners, LLC, Banyon Investment, LLC and the shareholders listed on Schedule I thereto; \*\*\* amended June 23, 2004, whereby Shells Investment Partners assigned their rights collectively to Trinad Capital, LP and Galloway Capital Management, LLC
- 10.45 Secured Senior Note in the aggregate principal amount of \$1,000,000 issued to Banyon Investment, LLC, and sold to Frederick R. Adler on April 12, 2004 \*\*\*
- 10.46 Secured Senior Note in the aggregate principal amount of \$1,000,000 issued to Shells Investment Partners, LLC, and sold to Trinad Capital, LP (\$600,000) and GCM Shells Seafood Partners, LLC (\$400,000) on June 23, 2004; GCM sold their \$400,000 note to Bruce Galloway, IRA R/O on October 1, 2004. \*\*\* (and 2004 transactions \*\*\*\*\*)
- 10.47 Warrant to purchase 4,454,015 shares of Common Stock of Shells Seafood Restaurants, Inc., issued to Banyon Investment, LLC \*\*\*
- 10.48 Warrant to purchase 4,454,015 shares of Common Stock of Shells Seafood Restaurants, Inc., issued to Shells Investment Partners, LLC; transferred to Trinad Capital, LP and GCM Shells Seafood Partners, LLC on June 23, 2004 except for 445,400 warrants which were retained. \*\*\* (and 2004 transactions \*\*\*\*\*)
- 10.49 Loan agreement, dated October 8, 2002, between Shells Seafood Restaurants, Inc. and Colonial Bank (previously known as Manufacturers Bank of Florida), in the initial principal amount of \$667,500. \*\*
- 10.50 Loan agreement, dated October 25, 2002, between Shells of Melbourne, Joint Venture and Colonial Bank (previously known as Manufacturers Bank of Florida), in the renewal principal amount of \$635,506. \*\*
- 10.51 Settlement Agreement and Release, dated February 27, 2003, between Shells Seafood Restaurants, Inc. and The Lark Group, L.L.C., Best Que, L.L.C, and Michael L Sloane, II in the amount of \$188,201 (fully settled in 2004) \*\*
- 10.52 Distribution Agreement, dated August 28, 2002, between Shells Seafood Restaurants, Inc. and Performance Food Group, LLC. \*\*
- 10.53 Consulting Agreement, dated March 21, 2003, between Shells Seafood Restaurants, Inc. and George Heaton; terminated August 28, 2003. \*\*
- 10.54 Amendment to the Non-Employee Director Stock Option Plan, as approved October 23, 2001 \*\*
- 10.55 Amendment to the 1995 Employee Stock Option Plan, as approved October 23, 2001 \*\*

**Exhibits**      **Description (everything filed which is currently active)**

- 10.56      Equipment lease agreement between Colonial Pacific Leasing Corporate dba GE Capital Colonial Pacific Leasing and Shells Seafood Restaurants, Inc. dated November 8, 2002 and funded in 2003. \*\*
- 10.57      Employment Agreement, dated July 1, 2003, between Leslie J. Christon and Shells Seafood Restaurants, Inc. \*\*\*\*
- 10.58      Code of Ethics. \*\*
- 10.59      Form of Securities and Debenture Purchase Agreement, dated December 7, 2004. \*\*\*\*\*
- 10.60      Form of Stock Purchase Warrant, dated December 7, 2004, in the aggregate of 1,971,250 warrants to purchase shares of common stock. \*\*\*\*\*
- 10.61      Form of 12% Convertible Debenture, dated December 7, 2004, in the aggregate amount of \$2,375,000. \*\*\*\*\*
- 10.62      Promissory Note in the aggregate principal amount of \$165,315.07 issued to Shells Investment Partners, L.L.C. +
- 10.63      Mortgage and Security Agreement in the aggregate principal amount of \$165,315.07 issued to Shells Investment Partners, L.L.C. +
- 21      Subsidiaries of the Registrant. \*
- 31.1      Certification of Chief Executive Officer under Rule 13a-14(a) (filed March 11, 2005 on Form 10-K)
- 31.1.1      Amended Certification of Chief Executive Officer under Rule 13a-14(a)
- 31.2      Certification of Chief Financial Officer under Rule 13a-14(a) (filed March 11, 2005 on Form 10-K)
- 31.2.1      Amended Certification of Chief Financial Officer under Rule 13a-14(a)
- 32      Certification of Chief Executive Officer and Chief Financial Officer under Section 906 (filed March 11, 2005 on Form 10-K)
- 32.1      Amended Certification of Chief Executive Officer and Chief Financial Officer under Section 906

- 
- \*      Previously filed with the Securities and Exchange Commission as Exhibits to, and incorporated herein by reference from our Registration Statement on Form S-1 (File No. 333-1600).
  - \*\*      Previously filed with the Securities and Exchange Commission as Exhibits to, and incorporated herein by reference from our Form 10-K or 10-KA for the fiscal year ended December 28, 2003.
  - \*\*\*      Previously filed with the Securities and Exchange Commission as Exhibits to, and incorporated herein by reference from our Form 8-K dated February 11, 2002.
  - \*\*\*\*      Previously filed with the Securities and Exchange Commission as an Exhibit to, and incorporated herein by reference from our Form 10-Q for the quarter ended June 29, 2003.
  - \*\*\*\*\*      Previously filed with the Securities and Exchange Commission as Exhibits to, and incorporated herein by reference from our Form 8-K dated December 9, 2004.
  - +      Previously filed with the Securities and Exchange Commission as Exhibits to, and incorporated herein by reference from our Form 8-K dated June 25, 2004.

(b) Exhibits (currently being filed or not previously filed)

- 31.1      Certification of Chief Executive Officer under Rule 13a-14(a) (filed March 11, 2005 on Form 10-K)
- 31.1.1      Amended Certification of Chief Executive Officer under Rule 13a-14(a)
- 31.2      Certification of Chief Financial Officer under Rule 13a-14(a) (filed March 11, 2005 on Form 10-K)
- 31.2.1      Amended Certification of Chief Financial Officer under Rule 13a-14(a)
- 32      Certification of Chief Executive Officer and Chief Financial Officer under Section 906 (filed March 11, 2005 on Form 10-K)
- 32.1      Amended Certification of Chief Executive Officer and Chief Financial Officer under Section 906

(c) Financial statement schedules

None

**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.

**SHELLS SEAFOOD RESTAURANTS, INC.**

Dated: May 2, 2005

By: /s/ WARREN R. NELSON

---

Warren R. Nelson  
Executive Vice President of Finance,  
Chief Financial Officer, Treasurer and Secretary



**CERTIFICATION**

I, Leslie J. Christon, certify that:

1. I have reviewed this Amendment No. 1 to the annual report on Form 10-K/A of Shells Seafood Restaurants, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this annual report based on such evaluation; and
  - (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:

May 2, 2005

/s/ LESLIE J. CHRISTON

Leslie J. Christon

President and Chief Executive Officer

**CERTIFICATION**

I, Warren R. Nelson, certify that:

1. I have reviewed this Amendment No. 1 to the annual report on Form 10-K/A of Shells Seafood Restaurants, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this annual report based on such evaluation; and
  - (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:

May 2, 2005

/s/ WARREN R. NELSON

Warren R. Nelson

Executive Vice President and Chief Financial Officer

**Certification of Chief Executive Officer and Chief Financial Officer  
pursuant to 18 U.S.C. Section 1350, as adopted pursuant to  
Section 906 of the Sarbanes-Oxley Act of 2002**

Securities and Exchange Commission  
Washington, DC

The undersigned Chief Executive Officer and Chief Financial Officer of Shells Seafood Restaurants, Inc. do hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that Amendment No. 1 to the Annual Report of Shells Seafood Restaurants, Inc. on Form 10-K/A for the fiscal year ended January 2, 2005 fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and the information contained in such Amendment No. 1 to the Annual Report on Form 10-K/A fairly presents, in all material respects, the financial condition and results of operations of Shells Seafood Restaurants, Inc.

A signed original of this written statement required by Section 906 has been provided to Shells Seafood Restaurants, Inc. and will be retained by Shells Seafood Restaurants, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

/s/ LESLIE J. CHRISTON

President and Chief Executive Officer

May 2, 2005

/s/ WARREN R. NELSON

Executive Vice President and Chief Financial Officer

May 2, 2005