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SHELLS SEAFOOD RESTAURANTS INC
Form 10-Q
August 13, 2003

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

FORM 10-Q

- x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Quarterly Period Ended June 29, 2003
- Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Transition Period from _____ to _____

Commission File No. 0-28258

SHELLS SEAFOOD RESTAURANTS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

65-0427966

(State or other jurisdiction of incorporation or organization)

(IRS) Employer Identification Number

16313 North Dale Mabry Highway, Suite 100, Tampa, FL 33618

(Address of principal executive offices) (zip code)

(813) 961-0944

(Registrant's telephone number, including area code)

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 [x] No []

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [] No [X]

Class	Outstanding at July 30, 2003
Common stock, \$0.01 par value	4,631,375

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

	(Unaudited) June 29, 2003	December 29, 2002
	-----	-----
ASSETS		
Cash	\$ 2,253,446	\$ 2,468,809
Inventories	397,244	356,434
Other current assets	921,375	266,228
Receivables from related parties	104,378	105,353
	-----	-----
Total current assets	3,676,443	3,196,824
Property and equipment, net	7,573,221	7,682,892
Goodwill	2,474,407	2,474,407
Other assets	482,087	504,529
	-----	-----
TOTAL ASSETS	\$ 14,206,158	\$ 13,858,652
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	\$ 2,094,756	\$ 2,554,854
Accrued expenses	2,668,826	3,033,086
Sales tax payable	237,916	191,853
Current portion of long-term debt	578,253	532,857
	-----	-----
Total current liabilities	5,579,751	6,312,650
Notes and deferred interest payable		

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to related parties	2,194,333	2,123,335
Long-term debt, less current portion	1,666,627	1,760,054
Deferred rent	1,061,370	1,082,761
	-----	-----
Total liabilities	10,502,081	11,278,800
Minority partner interest	459,499	427,852
	-----	-----
STOCKHOLDERS' EQUITY:		
Preferred stock, \$0.01 par value; authorized 2,000,000 shares; 63,548 and 66,862 shares issued and outstanding, respectively	635	669
Common stock, \$0.01 par value; authorized 20,000,000 shares; 4,631,375 and 4,454,015 shares issued and outstanding, respectively	46,313	44,540
Additional paid-in-capital	14,303,152	14,240,576
Retained earnings (deficit)	(11,105,522)	(12,133,785)
	-----	-----
Total stockholders' equity	3,244,578	2,152,000
	-----	-----
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 14,206,158	\$ 13,858,652
	=====	=====

See accompanying notes to consolidated financial statements.

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SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	13 Weeks Ended	
	June 29, 2003	June 30, 2002
	-----	-----
REVENUES	\$ 11,901,337	\$ 12,508,630
	-----	-----
COST AND EXPENSES:		
Cost of revenues	3,926,727	4,244,906
Labor and other related expenses	3,496,061	3,743,467
Other restaurant operating expenses	2,880,211	2,682,438
General and administrative expenses	874,015	962,831
Depreciation and amortization	263,293	279,166
Provision for impairment of goodwill	-	51,549
	-----	-----
	11,440,307	11,964,357
	-----	-----
INCOME FROM OPERATIONS	461,030	544,273
	-----	-----
OTHER INCOME (EXPENSE):		

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Interest expense	(118,843)	(127,936)
Interest income	3,531	10,290
Other expense, net	(31,585)	(28,082)
	-----	-----
	(146,897)	(145,728)
	-----	-----
INCOME BEFORE ELIMINATION OF MINORITY PARTNER INTEREST AND INCOME TAXES	314,133	398,545
ELIMINATION OF MINORITY PARTNER INTEREST	(69,953)	(57,532)
	-----	-----
INCOME BEFORE PROVISION FOR INCOME TAXES	244,180	341,013
BENEFIT FROM INCOME TAXES	-	318,377
	-----	-----
NET INCOME	\$ 244,180	\$ 659,390
	=====	=====
NET INCOME PER SHARE OF COMMON STOCK:		
Basic	\$ 0.05	\$ 0.15
	=====	=====
Diluted	\$ 0.02	\$ 0.06
	=====	=====
AVERAGE WEIGHTED NUMBER OF COMMON SHARES OUTSTANDING:		
Basic	4,561,797	4,454,015
	=====	=====
Diluted	11,466,292	11,194,642
	=====	=====

See accompanying notes to consolidated financial statements.

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SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	26 Weeks Ended	
	June 29, 2003	June 30, 2002
	-----	-----
REVENUES	\$ 24,913,322	\$ 26,637,499
	-----	-----
COST AND EXPENSES:		
Cost of revenues	8,149,567	8,914,683
Labor and other related expenses	7,352,669	7,838,885
Other restaurant operating expenses	5,709,736	5,715,263
General and administrative expenses	1,713,754	1,787,634
Depreciation and amortization	524,086	554,406
Provision for impairment of goodwill	-	103,098
	-----	-----
	23,449,812	24,913,969
	-----	-----
INCOME FROM OPERATIONS	1,463,510	1,723,530

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OTHER INCOME (EXPENSE):		
Interest expense	(245,665)	(323,778)
Interest income	8,145	16,110
Other expense, net	(53,370)	(27,282)
	(290,890)	(334,950)
INCOME BEFORE ELIMINATION OF MINORITY PARTNER INTEREST AND INCOME TAXES	1,172,620	1,388,580
ELIMINATION OF MINORITY PARTNER INTEREST	(144,357)	(121,896)
INCOME BEFORE PROVISION FOR INCOME TAXES	1,028,263	1,266,684
BENEFIT FROM INCOME TAXES	-	318,377
NET INCOME	\$ 1,028,263	\$ 1,585,061
NET INCOME PER SHARE OF COMMON STOCK:		
Basic	\$ 0.23	\$ 0.36
Diluted	\$ 0.09	\$ 0.16
AVERAGE WEIGHTED NUMBER OF COMMON SHARES OUTSTANDING:		
Basic	4,507,906	4,454,015
Diluted	11,413,529	9,789,563

See accompanying notes to consolidated financial statements.

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

	26 Weeks Ended	
	June 29, 2003	June 30, 2002
OPERATING ACTIVITIES:		
Net income	\$ 1,028,263	\$ 1,585,061
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Loss on disposal of assets	2,352	2,616
Depreciation and amortization	524,086	554,405
Provision for impairment of goodwill	-	103,098
Minority partner interest	31,647	12,937

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Changes in assets and liabilities:		
Increase in inventories	(40,810)	(45,874)
Decrease in receivables from related parties	975	30,013
Increase in other assets	(667,031)	(249,849)
Decrease in prepaid rent	14,044	25,200
Decrease in income tax refunds receivable	(3,300)	(279,073)
Decrease in deferred tax asset	-	-
Decrease in accounts payable	(460,098)	(1,639,773)
Decrease in accrued expenses	(228,952)	(264,984)
Increase in sales tax payable	46,063	46,121
Decrease in deferred rent	(21,391)	(14,127)
	-----	-----
Total adjustments	(802,415)	(1,719,290)
	-----	-----
Net cash provided by (used in) operating activities	225,848	(134,229)
	-----	-----
INVESTING ACTIVITIES:		
Proceeds from the sale of assets	-	1,091,324
Purchase of property and equipment	(393,180)	(252,151)
	-----	-----
Net cash (used in) provided by investing activities	(393,180)	839,173
	-----	-----
FINANCING ACTIVITIES:		
Proceeds from debt financing	578,585	2,304,317
Repayment of debt	(626,616)	(1,351,399)
	-----	-----
Net cash (used in) provided by financing activities	(48,031)	952,918
	-----	-----
Net (decrease) increase in cash	(215,363)	1,657,862
	-----	-----
CASH AT BEGINNING OF PERIOD	2,468,809	969,680
	-----	-----
CASH AT END OF PERIOD	\$ 2,253,446	\$ 2,627,542
	=====	=====
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 179,964	\$ 289,692
Bonus paid in common stock	\$ 64,315	\$ -
Cash paid (refunds received) for income taxes	\$ 3,300	\$ (40,000)
Note receivable on sale of assets	\$ -	\$ 100,000

See accompanying notes to consolidated financial statements.

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SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (Unaudited)

	PREFERRED STOCK		COMMON STOCK		ADDITIONAL	RETAINED
	Shares	Amount	Shares	Amount	PAID-IN	EARNING
	-----	-----	-----	-----	CAPITAL	(DEFICI
Balance at						
December 29, 2002	66,862	\$ 669	4,454,015	\$ 44,540	14,240,576	\$ (12,133,

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Net income							1,028,
Preferred stock converted to common stock	(3,314)	(34)	16,570	166	(132)		
Common stock issued			160,790	1,607	62,708		
Balance at June 29, 2003	63,548	\$ 635	4,631,375	\$ 46,313	\$ 14,303,152		\$(11,105,

See accompanying notes to consolidated financial statements.

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SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED)

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and, therefore, these statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all material adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

The consolidated financial statements of Shells Seafood Restaurants, Inc. (the "Company") should be read in conjunction with the audited consolidated financial statements and notes thereto contained in the Form 10-K for the year ended December 29, 2002 filed with the United States Securities and Exchange Commission. Company management believes that the disclosures are sufficient for interim financial reporting purposes. Certain prior year amounts have been reclassified in the accompanying condensed consolidated financial statements to conform with the current year presentation.

NOTE 2. EARNINGS PER SHARE

The following table represents the computation of basic and diluted earnings per share of common stock as required by Financial Accounting Standards Board ("FASB") Statement No. 128, "Earnings Per Share":

For the 13 weeks Ended	June 29, 2003	June 30, 2002
Net income applicable to common stock	\$ 244,180	\$ 659,390

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Weighted common shares outstanding	4,561,797	4,454,015
Basic net income per share of common stock	\$ 0.05	\$ 0.15
Effect of dilutive securities:		
Warrants	6,450,642	6,344,568
Stock options	453,853	396,059
	-----	-----
Diluted weighted common shares outstanding	11,466,292	11,194,642
	-----	-----
Diluted net income per share of common stock	\$ 0.02	\$ 0.06
	=====	=====

For the 26 weeks ended	June 29, 2003	June 30, 2002
	-----	-----
Net income applicable to common stock	\$ 1,028,263	\$ 1,585,061
	=====	=====

Weighted common shares outstanding	4,507,906	4,454,015
Basic net income per share of common stock	\$ 0.23	\$ 0.36
Effect of dilutive securities:		
Warrants	6,450,642	5,110,959
Stock options	454,981	224,589
	-----	-----
Diluted weighted common shares outstanding	11,413,529	9,789,563
	-----	-----
Diluted net income per share of common stock	\$ 0.09	\$ 0.16

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The earnings per share calculations excluded warrants and options to purchase an aggregate of 545,588 and 310,827 shares of common stock during the 13 weeks ended June 29, 2003 and June 30, 2002, respectively, and warrants and options to purchase an aggregate of 541,172 and 2,193,248 shares of common stock during the 26 weeks ended June 29, 2003 and June 30, 2002, respectively, as the exercise price of the warrants and options were greater than the average market price of the common shares.

NOTE 3. STOCK COMPENSATION PLANS

Currently, we have four stock-based employee compensation plans. 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. No stock-based compensation cost is 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 and earnings per share on a pro forma basis would have been immaterial.

NOTE 4. COMMON STOCK

On April 28, 2003, the Company awarded 160,790 shares

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of common stock to key management personnel under a management incentive plan relating to fiscal 2002 performance pursuant to the 2002 Equity Incentive Plan. Compensation expense of \$104,000 was recognized in fiscal 2002 by the Company for this stock award.

NOTE 5. NEW ACCOUNTING PRONOUNCEMENTS

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 materially affect our consolidated financial statements.

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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, in general, a company may recognize costs related to a restructuring only when the liability is incurred. Under previous US GAAP, 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. The adoption of Statement No. 146 did not materially affect our consolidated financial statements.

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

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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 materially affect our consolidated financial statements.

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 materially affect our consolidated financial statements.

In December 2002, the Company 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 3 for disclosure under Statement No. 148.

In January 2003, the FASB issued a pronouncement, Financial Interpretation Number 46 ("FIN 46"), "Consolidation of Variable Interest Entities." FIN 46 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 46 in their financial statements in the first fiscal year or interim period beginning after June 15, 2003. Full disclosure, as well as consolidation, if applicable, of any newly created agreements after January 31, 2003 must begin immediately. Adoption of FIN 46 is not expected to materially impact our consolidated financial statements.

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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.

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Adoption of FASB Statement 149 is not expected to materially impact our consolidated financial statements.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis of Financial Condition and Results of Operations contains certain pro forma financial information. In all instances, management believes that use of such pro forma information is useful to investors assessing the financial condition and results of operations of the Company's core business operations because it excludes results which management believes are atypical and unlikely to occur with regularity in the future.

The following table sets forth, for the periods indicated, the percentages which the items in the Company's Consolidated Statements of Income bear to total revenues.

	13 Weeks Ended		26 Weeks Ended	
	June 29, 2003	June 30, 2002	June 29, 2003	June 30, 2002
REVENUES	100.0%	100.0%	100.0%	100.0%
COST AND EXPENSES:				
Cost of revenues	33.0%	33.9%	32.7%	32.7%
Labor and other related expenses	29.4%	29.9%	29.5%	29.5%
Other restaurant operating expenses	24.2%	21.4%	22.9%	22.9%
	86.6%	85.3%	85.1%	85.1%
General and administrative expenses	7.3%	7.7%	6.9%	6.9%
Depreciation and amortization	2.2%	2.2%	2.1%	2.1%
Provision for impairment of goodwill	0.0%	0.4%	0.0%	0.0%
Income from operations	3.9%	4.4%	5.9%	5.9%
Interest expense, net	-1.0%	-0.9%	-1.0%	-1.0%
Other expense, net	-0.3%	-0.2%	-0.2%	-0.2%
Elimination of minority partner interest	-0.6%	-0.5%	-0.6%	-0.6%
Income before provision for taxes	2.1%	2.7%	4.1%	4.1%
Benefit from income taxes	0.0%	2.5%	0.0%	0.0%
Net income	2.1%	5.3%	4.1%	4.1%

RESULTS OF OPERATIONS

13 weeks ended June 29, 2003 and June 30, 2002

Revenues. Total revenues for the second quarter of 2003 were \$11,901,000 as compared to \$12,509,000 for the second quarter of 2002. The \$608,000, or 4.9% decrease in revenues was primarily due to a 2.3% decrease in comparable store sales, and to a lesser extent the closing of one restaurant during the third quarter of 2002. Comparisons of same store sales include only stores which were open during the entire 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.

Cost of revenues. The cost of revenues as a percentage of revenues decreased to 33.0% for the second quarter of 2003 from 33.9% for the second quarter of 2002. This decrease primarily was due to favorable food costs, operational improvements and lower distribution costs partially offset by a non-recurring write-down of inventory of \$36,000 in the second quarter of 2003. Exclusive of the non-recurring item, cost of revenues was 32.7% for the second quarter of 2003. The Company is continually attempting to anticipate and reacting to fluctuations in food costs by purchasing seafood directly from numerous suppliers, promoting certain alternative menu selections in response to price and availability of supply and adjusting its menu prices accordingly to help control the cost of revenues.

Labor and other related expenses. Labor and other related expenses as a percentage of revenues decreased to 29.4% during the second quarter of 2003 as compared to 29.9% for the second quarter of 2002. This decrease was primarily due to a second quarter 2003 non-recurring reduction in benefits and taxes relating to a reduction in the workers compensation insurance reserve (and refund) of \$197,000, of which \$182,000 was allocated to restaurant labor costs. Exclusive of the non-recurring item, labor as a percentage of revenues was 30.9% for the second quarter of 2003.

Other restaurant operating expenses. Other restaurant operating expenses as a percentage of revenues increased to 24.2% for the second quarter of 2003 as compared with 21.4% for the second quarter of 2002. The increase primarily was due to increases in general liability and property insurance costs, natural gas, electricity and contract services along with a reduction in operating leverage caused by lower sales volumes.

General and administrative expenses. General and administrative expenses of \$874,000 or 7.3% of revenues for the second quarter of 2003 decreased from \$963,000 or 7.7% of revenues for the second quarter of 2002, primarily due to decreases in administrative salaries partially offset by increases in consulting fees.

Depreciation and amortization. Depreciation and amortization

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expense as a percentage of revenues was 2.2% for the second quarter of 2003 and 2002.

Provision for impairment of goodwill. There was no provision for impairment of goodwill in the second quarter of 2003. The provision for impairment of goodwill was \$52,000 or 0.4% of revenues during the second quarter of 2002; goodwill was evaluated for impairment and written down in accordance with FASB Statement No. 142 which the Company adopted in 2002.

Interest expense, net. Interest expense was \$115,000 in the second quarter of 2003 compared to \$118,000 in the second quarter of 2002. The decrease was primarily related to the reduction of loan balances outstanding.

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Benefit from income taxes. No benefit or provision for income taxes was recognized for the second quarter of 2003 based on annual projected taxable income for 2003, as adjusted for net operating loss carry forwards. A tax benefit of \$318,000 was recognized in the second quarter of 2002 relating to the applicable portion of a refund 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.

Income from operations and net income. As a result of the factors discussed above, the Company had income from operations of \$461,000 for the second quarter of 2003 compared to \$544,000 for the second quarter of 2002. Exclusive of non-recurring items, income from operations was \$300,000 for the second quarter of 2003. Non-recurring items consisted of a benefit of \$197,000 from workers compensation reserve adjustments, partially offset by an inventory write-down of \$36,000. The Company had net income of \$244,000 for the second quarter of 2003 compared to \$659,000 for the second quarter of 2002. Exclusive of nonrecurring charges, net income was \$83,000 in the second quarter of 2003 and \$341,000 for the second quarter of 2002. The non-recurring charge for the second quarter of 2002 related to \$318,000 in income tax benefits.

26 weeks ended June 29, 2003 and June 30, 2002

Revenues. Total revenues for the 26 weeks ended June 29, 2003 were \$24,913,000 as compared to \$26,637,000 for the 26 weeks ended June 30, 2002. The \$1,724,000 or 6.5% decrease primarily was due to a reduction in same store sales of 4.0% in addition to the closing of one unit in August of 2002.

Cost of revenues. The cost of revenues as a percentage of revenues decreased to 32.7% for the 26 weeks ended June 29, 2003 from 33.5% for the comparable period in 2002. This decrease primarily relates to favorable food costs, operational improvements and lower distribution costs partially offset by a non-recurring write-down of inventory of \$36,000 in 2003. Exclusive of the non-recurring item cost of revenues was 32.6% for the 26 weeks ended June 29, 2003.

Labor and other related expenses. Labor and other related

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expenses increased to 29.5% as a percentage of revenues for the 26 weeks ended June 29, 2003 as compared to 29.4% for the same period in 2002. This increase was primarily attributable to an increase in management labor partially offset by a 2003 non-recurring decrease in benefits and taxes relating to a reduction in the workers compensation insurance reserve (and refund) of \$197,000, of which \$182,000 was allocated to restaurant labor costs. Exclusive of the non-recurring item, labor and other related expenses was 30.2% for the 26 weeks ending June 29, 2003.

Other restaurant operating expenses. Other restaurant operating expenses increased to 22.9% as a percentage of revenues for the 26 weeks ended June 29, 2003 as compared with 21.5% for the same period in 2002. The increase primarily was due to a reduction in operating leverage caused by lower sales volumes and increases in general liability and property insurance costs, natural gas, and electricity costs.

General and administrative expenses. General and administrative expenses increased to 6.9% as a percentage of revenues for the 26 weeks ended June 29, 2003 as compared with 6.7% for the same period in 2002. This increase was primarily attributable to increases in consulting fees partially offset by reductions in administrative salaries.

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Depreciation and amortization. Depreciation and amortization expenses as a percentage of revenues was 2.1% for the 26 weeks ended June 29, 2003 and June 30, 2002.

Provision for impairment of goodwill. There was no provision for impairment of goodwill in the 26 weeks ending June 29, 2003. The provision for impairment of goodwill was \$103,000 or 0.4% of revenues during the 26 weeks ended June 30, 2002; goodwill was evaluated for impairment and written down in accordance with FASB Statement No. 142 which the Company adopted in 2002.

Interest expense, net. Interest expense was \$238,000 in the 26 weeks ending June 29, 2003 compared to \$308,000 in the same period of 2002. The Company recorded a non-recurring charge of \$106,000 in the 26 weeks ending June 30, 2002 relating to the issuance of warrants on January 31, 2002 as part of the previously reported \$2,000,000 financing transaction. Exclusive of the non-recurring charge, net interest expense was \$202,000 for the 26 weeks ending June 30, 2002.

Benefit from income taxes. No benefit or provision for income taxes was recognized for the 26 weeks ending June 29, 2003 compared to a tax benefit of \$318,000 in the same period in 2002, relating to the applicable portion of a refund 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.

Income from operations and net income. As a result of the factors discussed above, the Company's income from operations was \$1,464,000 for the 26 weeks ended June 29, 2003 compared to \$1,724,000 for the same period in 2002. Exclusive of non-recurring items, the Company's income from operations was \$1,303,000 for the 26 weeks ended June 29, 2003. Non-recurring items consisted of a benefit of \$197,000 from workers

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compensation reserve adjustments partially offset by an inventory write-down of \$36,000 for the 26 weeks ended June 29, 2003. The Company's net income for the 26 weeks ended June 29, 2003 was \$1,028,000 compared to \$1,585,000 in the same period in 2002. Exclusive of non-recurring items, the Company's net income was \$867,000 for the 26 weeks ended June 29, 2003 compared to \$1,373,000 for the comparable period in 2002. Non-recurring items for the 26 weeks ended June 30, 2002 consisted of \$318,000 in income tax benefits, offset by \$106,000 in imputed interest expense.

LIQUIDITY AND CAPITAL RESOURCES

As of June 29, 2003, the Company's current liabilities of \$5,580,000 exceeded its current assets of \$3,676,000, resulting in a working capital deficiency of \$1,904,000. In comparison, the December 29, 2002 working capital deficiency was \$3,116,000. The improvement in the working capital deficiency was primarily related to an increase in other assets consisting of prepaid insurance of \$329,000 and the receivable for the \$197,000 insurance refund, coupled with reductions in accounts payable of \$460,000 and accrued expenses of \$229,000.

The Company was negatively impacted in fiscal 2002 by the ongoing costs of divestiture of its Midwest locations. Such divestiture costs had an adverse affect on the Company's cash position. Historically, the Company has generally operated with minimal or negative working capital as a result of the investment 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.

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Cash provided by operating activities for the 26 weeks ended June 29, 2003 was \$226,000 compared to cash used in operating activities of \$134,000 for the comparable period in 2002. The net improvement of \$360,000 was primarily related to reductions in accounts payable and accrued expenses, partially offset by a reduction in net income and increases in accounts receivable and prepaid expenses.

The cash used in investing activities was \$393,000 for the 26 weeks ended June 29, 2003 compared to cash provided by investing activities of \$839,000 for the comparable period in 2002. We had a net increase of \$141,000 in expenditures for capital improvements for 2003 compared to 2002. In 2002, we received proceeds from the sale of a Midwest property of \$1,091,000.

The cash used in financing activities was \$48,000 for the 26 weeks ended June 29, 2003 compared to cash provided by financing activities of \$953,000 for the comparable period in 2002. In 2002, we completed a \$2 million private financing transaction, consisting of secured promissory notes and warrants to purchase shares of our Common Stock. Also, in 2002, we repayed existing debt of \$893,000 relating to the sale of the Midwest property.

SEASONALITY

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The restaurant industry in general is seasonal, depending on restaurant location and the type of food served. The Company has experienced fluctuations in its quarter-to-quarter operating results due primarily to its high 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., the health of Florida's economy and the effect of world events in general and on the tourism industry in particular. The Company's 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. In many cases, locations are in coastal cities, where sales are significantly dependent on tourism and its seasonality patterns.

In addition, quarterly results have been, and in the future could be, affected by the timing and conditions under which restaurants are closed. Because of the seasonality of the Company's business and the impact of restaurant closures and openings, if applicable, 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.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from changes in interest rates on debt and changes in commodity prices. Our exposure to interest rate risk relates to the \$1,240,000 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 4. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, the Company's management, including its President and Chief Executive Officer and Executive Vice President and Chief Financial Officer, carried out an evaluation, of the effectiveness of the design and operation of the Company's

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disclosure controls and procedures pursuant to Exchange Act Rule 13a-15 or 15d-15. Based upon that evaluation, the Company's President and Chief Executive Officer and Executive Vice President and Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective in alerting them to material information, on a timely basis, required to be included in the Company's periodic SEC filings. There have been no changes in the Company's internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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Part II. OTHER INFORMATION

Item 1. Legal Proceedings

On May 29, 2001, a lawsuit was filed in the Court of Common Pleas of Clermont County, Ohio by Cin-Beech, LLC, the landlord of a closed restaurant located in Cincinnati. This restaurant was closed in April 2001. In July 2001, the Company entered into a lease termination agreement with the landlord. Pursuant to the lease termination agreement, we paid \$50,000 in termination fees and \$39,000 for rents and real estate taxes owed; and were obligated to pay an additional \$50,000 within 30 days in exchange for a simultaneous written release from the landlord. The landlord refused to provide the written release as required and, therefore, Shells did not pay the additional \$50,000 for which it was prepared to pay. The landlord has since demanded \$236,000, which was later reduced to \$150,000. The landlord sold the property in October 2002 to an unrelated third party. We believe the demand for additional damages is inappropriate and we intend to vigorously defend our position. The court has ordered the parties to attempt settlement through mediation, which process will begin in late August 2003.

Item 2. Changes in Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

At the Company's Annual Meeting of Stockholders held on June 3, 2003, the following directors were elected by the votes indicated:

Philip R. Chapman: 3,573,847 For, 3,000 Against or Withheld, 0 Abstaining
J. Stephen Gardner: 3,574,197 For, 2,650 Against or Withheld, 0 Abstaining
John N. Giordano: 3,574,197 For, 2,650 Against or Withheld, 0 Abstaining
Michael R. Golding: 3,574,197 For, 3,150 Against or Withheld, 0 Abstaining
David W. Head: 3,008,471 For, 568,376 Against or Withheld, 0 Abstaining
Christopher D. Illick: 3,574,197 For, 2,650 Against or Withheld, 0 Abstaining
Thomas R. Newkirk: 3,574,197 For, 2,650 Against or Withheld, 0 Abstaining

Item 5. Other Information

Effective July 7, 2003, casual dining veteran Leslie Christon joined the company as CEO and President. Christon is the former President and COO of Sutton Place Gourmet, Inc., the food market and restaurant owner of Hay Day Markets, Balducci's and Sutton Place Gourmet. Before that she served as President of On the Border Restaurants, a Brinker International casual dining chain, from 1996-2000. Before heading On the Border Restaurants, Christon served as Senior Vice President of Operations for Red Lobster Restaurants, where she oversaw 127 restaurants with revenues of more than \$400 million for two years. Previously she headed operations at Dallas-based El Chico, a 100-unit Mexican restaurant chain. Christon, no relation to Shells' founder John Christen, got her start in the

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restaurant business with Steak & Ale Restaurants, holding a variety of management positions at that company during the '70s and early '80s.

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Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.56 Employment Agreement, dated July 1, 2003, between Leslie J. Christon and Shells Seafood Restaurants, Inc.

31.1 Certification of Leslie J. Christon, President and Chief Executive Officer of Shells Seafood Restaurants, Inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, in connection with Shells Seafood Restaurants Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 29, 2003.

31.2 Certification of Warren R. Nelson, Executive Vice President and Chief Financial Officer of Shells Seafood Restaurants, Inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, in connection with Shells Seafood Restaurants Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 29, 2003.

32.1 Certifications by Leslie J. Christon and Warren R. Nelson, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, in connection with Shells Seafood Restaurants, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 29, 2003.

(b) Reports on Form 8-K filed during the current quarter

The Company filed a current report on Form 8-K, Item 5, regarding a press release on June 2, 2003 announcing that CEO and President David Head has voluntarily resigned to take another position.

The Company filed a current report on Form 8-K, Item 5, regarding a press release on July 1, 2003 announcing that casual dining veteran Leslie Christon will join the company as President and CEO effective July 7, 2003.

The Company filed a current report on Form 8-K, Item 12, regarding a press release on July 25, 2003 announcing operating results for the quarter ended June 29, 2003.

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SIGNATURES

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

SHELLS SEAFOOD RESTAURANTS, INC
(Registrant)

Date: August 13, 2003 /s/ Leslie J. Christon
President and Chief Executive Officer
(On behalf of the registrant.)

Date: August 13, 2003 /s/ Warren R. Nelson
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)

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SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
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