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Annual Reports
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S K I P P E R' S, I N C.

1986 Annual Report

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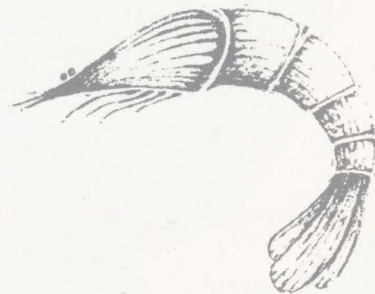
FROM OUR FOUNDING IN 1969, SKIPPER'S HAS SOUGHT TO provide good value for our customers' money. We focus on preparing high-quality foods served quickly and efficiently by our friendly employees. Our menu is basic – fried fish and seafood, chicken, clam chowder, salads and assorted beverages. All orders are taken centrally at the restaurant's cash register. While customers are given an opportunity to sit and relax for a few minutes, their meals are then prepared individually and hand carried by Skipper's employees directly to the customers' tables.

Our aim is to provide a pleasant, inexpensive, quick-service dining experience at Skipper's. Our restaurants follow a nautical theme, with a decor that establishes a casual atmosphere.

From our founding in 1969, Skipper's has sought to provide good value for our customers' money. We focus on preparing high-quality foods served quickly and efficiently by our friendly employees.

At year-end 1986, the company operated and franchised 206 Skipper's Seafood 'n Chowder House restaurants. They are located in Alaska, Arizona, British Columbia, California, Colorado, Hawaii, Idaho, Minnesota, Montana, Nevada, New Mexico, North Dakota, Oregon, Utah and Washington.

The company's stock (SKIP) is traded over-the-counter on the NASDAQ system.



TO OUR SHAREHOLDERS: SKIPPER'S, INC. ENCOUNTERED MANY difficulties in 1986, resulting in the company's first annual loss since 1971. We experienced negative real sales and higher costs for payroll taxes, insurance and real estate. Difficulties are not new to Skipper's – or to this industry which in recent years has found itself facing the dilemma of a 9% increase in the number of restaurants with only a 1% increase in new business.

Of course, we are disappointed in our 1986 financial results. Revenues increased to \$78.8 million from \$72.3 million in 1985. The net loss was \$1.5 million, compared with a net income of \$863,000 the previous year. Real sales decreased nearly 5%. A detailed explanation of our results can be found in our Management Discussion and Analysis beginning on page 9 of this report.

The dynamic changes in the foodservice industry during the past few years have had a direct effect on Skipper's. These industry conditions have spotlighted the need for the back-to-the-basics approach which made this company successful in the first place.

But, Skipper's has dealt successfully with troubles before. The solutions have come from finding the opportunities in these situations, and culling from them the wisdom and the experience needed to move forward...with renewed confidence in our abilities to improve the future of Skipper's.

The dynamic changes in the foodservice industry during the past few years have had a direct effect on Skipper's. These industry conditions have spotlighted the need for the back-to-the-basics approach which made this company successful in the first place.

To reverse the company's decline in real sales and profits, we are now concentrating on several areas. One of them has been to purge distractions which diverted management's attention in recent years. Consequently, we provided for the closure of 13 unprofitable Skipper's and three Zackly's restaurants in Florida. A \$3.9 million provision for the disposition of 16 restaurants in total led to the company's net loss.

The company also will concentrate on solidifying our position in existing markets in 1987 – avoiding any possible loss of corporate energies to developing new markets. Plans for 1987 indicate 15-20 new Skipper's restaurants with an emphasis on development in Minnesota and Colorado. The company has also begun a major remodeling program to update and revitalize our restaurants' decor.

Instrumental to improving Skipper's future sales and profits are programs enhancing productivity – while still maintaining our founding objectives for good product values and customer satisfaction. In response to these needs, we implemented a number of innovative and cost-effective solutions in 1986. And additional programs are being evaluated company-wide. Here are some of the notable achievements of 1986:

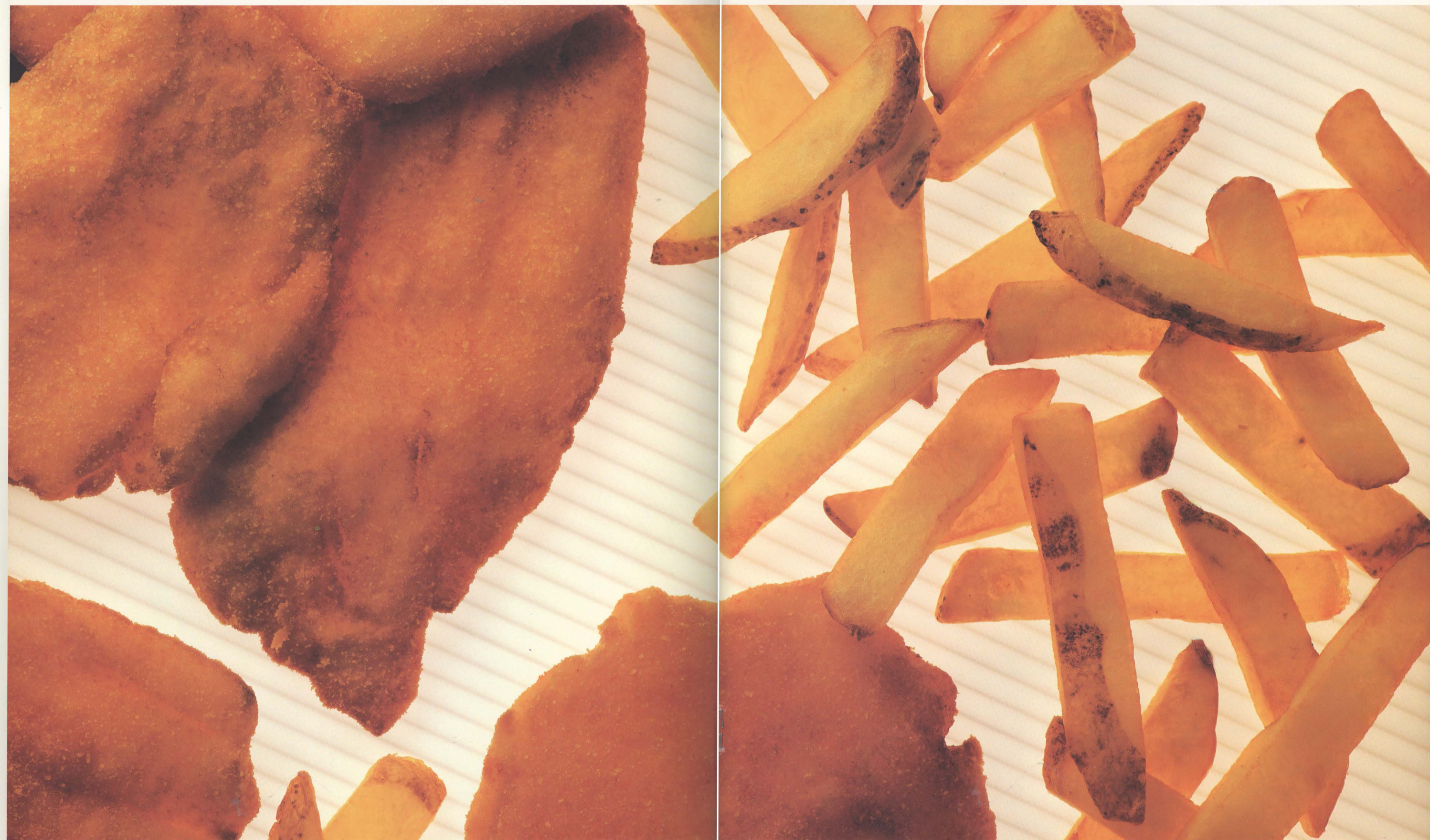
A number of economic conditions affecting the profitability of our restaurant operations prescribed the design of a smaller Skipper's restaurant. While maximizing space utilization in the kitchen and the dining areas, this smaller restaurant reduces our investment and operating expenses for land and construction – and brings a new restaurant online in less time. The new design also enhances opportunities for sites in high-traffic locations.

Our long-range marketing research also indicated changing consumer preferences with regard

to our restaurants' decor. So in 1986, we updated the look in new Skipper's restaurants and those being remodeled. The new, brightly colored nautical decor, as shown on these pages, is a lighter, refreshing change from the previous dark

woods and earth tones introduced in the mid-'70s. Customers have reacted favorably to the updating, and most Skipper's Seafood 'n Chowder House restaurants should sport the new interiors within a few years.

The hiring of a new advertising agency became one of the key elements of a restructured advertising program last year. The new agency assisted us in developing an unusual, intrusive yet



creative ad campaign that raised customer awareness of Skipper's. We also revised our media strategies to maximize our advertising awareness levels during active promotional time periods. All of these changes should optimize the effectiveness of our advertising budgets through 1987.

Good product is one of the basics that continues to make Skipper's successful – fish being the strength of our customer appeal. We hand cut every fillet in our kitchen, and use only 100 percent vegetable shortening in the preparation of all our fried food. Last year, the supply and price instability of true cod prompted a search for an acceptable alternative. After thoroughly testing another cod species, we introduced it in all our restaurants by year-end 1986.

Two important sales opportunities are lunch and take-out business. New operational packaging and products are currently being researched. For example, the product-services team has been developing entree salads, targeting a two-fold objective: meet customer demands for salads while eliminating the high food and labor expenses of our existing salad bars.

Further cost savings and improved information handling have resulted from two computerized systems now fully installed in Skipper's restaurants. Our point-of-sale cash register system provides up-to-the-minute data on sales, customer spending patterns, inventory and food costs. This information allows our restaurant managers to control expenses better on a daily basis. A sales- and labor-forecasting program will be tested in 1987. A computerized energy-management program has considerably reduced our energy expenses. In addition, the Washington State Energy Office and the Bonneville Power Administration honored Skipper's with an Energy Edge award for designing and constructing a restaurant with even greater energy efficiency than our current operations. This technology is now being added to all newly constructed restaurants.



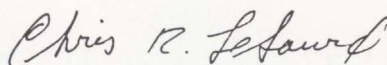
Another important change has involved streamlining of corporate spending, including restructuring programs and staffing in innovative but more cost-effective ways. At the core of our operational efforts to improve sales are the basics of good product, fast, friendly service, clean restaurants and affordable prices. And, with consumers eager for good service and convenience, we intensified our efforts to provide them, attending particularly to improving our speed of service.

Our goal is to work more productively in every business aspect to return Skipper's to consistent profitability. In addition, we have acknowledged our mistakes and successes, learned from them and are moving forward...committed to achieving improved operating results during 1987.

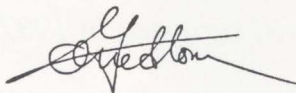
As we look at Skipper's past, present and future, we see a company with the resources and the determination to be a competitive force in each of the communities we serve. Our capable management team is committed to excellence. And we consider our 2,800 employees the company's strongest assets for achieving our objectives in the years to come.

At the core of our operational efforts to improve sales are the basics of good product, fast, friendly service, clean restaurants and affordable prices. And, with consumers eager for good service and convenience, we intensified our efforts to provide them, attending particularly to improving our speed of service.

We are certain you will share this same confidence as you continue to read more about 1986's noteworthy programs. These efforts coupled with our enthusiasm have already paid off successfully with our first-quarter results showing a net profit of \$412,000 or an increase of 70 percent over first quarter 1986.



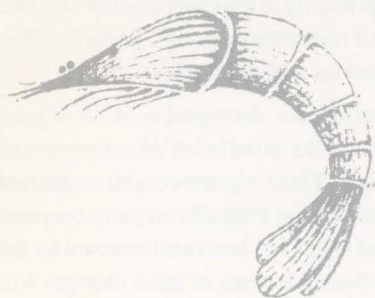
Chris R. LeSourd
President-Chief Operating Officer



Gene Stone
Chairman-Chief Executive Officer

April 6, 1987

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Results of Operations Systemwide sales, which include franchise restaurant sales, increased 8.6% to \$94,624,000 in 1986 from \$87,101,000 in 1985. Company sales increased 9.3% to \$77,894,000 from \$71,244,000. Such sales include equipment sales to franchisees which in 1986 amounted to \$273,000 as compared to \$1,233,000 in 1985. Discussions of percentage relationships for the balance of this item are based exclusively on company-operated restaurant sales.

The company recorded a net loss in 1986 of \$1,496,000 compared to net income of \$863,000 in 1985. In 1984 the company's net income was \$2,532,000. As is discussed more fully below, the loss in 1986 is primarily attributable to thirteen non-performing Skipper's restaurants which have either now been closed or will be closed, the cost of operating and then disposing of the company's three Zackly's restaurants which were located in Florida, and increased general and administrative expenses. In 1985, net income was adversely affected by a provision for loan loss on the termination of a merger and loan agreement with CulCon Systems, Inc.

Sales for company-operated restaurants increased 10.9% in 1986, 12% in 1985, and 25% in 1984. In 1986, the increase reflects a combination of new restaurant openings, the effect of restaurants opened during 1985 and the cumulative effect of a small menu price increase, offset by a decrease in real sales. Increases in 1985 and 1984 sales were due to similar reasons with the exception that real sales increases were experienced in those years. Real sales (total sales minus menu price increases and new restaurant openings) decreased by 4.6% in 1986 as compared to increases in real sales of 1.1% in 1985 and 6.3% in 1984. The company believes that the industrywide sales slowdown that began in the fourth quarter of 1984 has continued through 1985 and 1986. In addition, the thirteen non-performing Skipper's restaurants discussed below contributed to this decrease in real sales. The company instituted a 3.8% menu price increase in April, 1986 which increased sales for the year 1986 by 2.6%. During 1985 and 1986 the company had total menu price increases of 3.2% and 3.1% respectively.

During 1986, nineteen company-operated restaurants, including Zackly's, were opened as compared to fifteen units opened in each of 1985 and 1984. The new restaurants opened in 1986, net of restaurant closures, contributed 6.9% to the sales increase. Restaurants open for only a part of 1985 but for all of 1986 contributed 6.0% to the sales increase. As is discussed more fully below, during 1986, the company commenced action to close sixteen non-performing restaurants. By December 28, 1986, the company had actually closed ten of these units and subsequent to that date closed an additional four. The company expects to close the remaining two units in 1987. During 1986, the company recorded sales of \$3,634,000 from these sixteen units. In 1984 the company closed two restaurants. None were closed during 1985.

Franchise restaurant sales were \$16,730,000 in 1986, \$15,857,000 in 1985, and \$11,545,000 in 1984. In 1986, four franchise restaurants opened as compared to fourteen units in 1985 and nine in 1984. Four franchise restaurants were closed during 1986 as compared to five in 1985. Franchise revenues to the company were \$950,000 in 1986,

\$1,048,000 in 1985, and \$761,000 in 1984. Such revenue is comprised primarily of initial franchise fees recognized after preopening obligations have been satisfied and restaurants are opened, and royalties based on a percentage of gross sales. The decrease in revenue from franchise operations from 1985 to 1986 is due primarily to the lower amount of initial franchise fees recognized due to a reduced number of restaurant openings, partially offset by an increase in franchise royalties which are based on restaurant sales.

Food cost, which is the primary component of cost of sales, decreased to 34.4% of sales from 35.2% in 1985. Contributing to the decrease was the installation of computerized point-of-sale cash registers in all Skipper's restaurants. These registers enable restaurant managers to control food cost more effectively. Also, during 1986 all company-operated restaurants began using a lower priced species of cod which has been well received by the customer. The company believes that the full year benefit of both of these changes will contribute to lower food costs as a percentage of sales in 1987. In 1984 the company's food cost was 34.7% of sales which reflected an improvement over the preceding year following the negotiation of favorable distribution agreements.

Restaurant labor costs increased slightly in 1986 to 23.7% of sales from 23.4% in 1985. This increase resulted primarily from increased worker's compensation and health and accident insurance premiums, offset partially by the company's continuing emphasis on maintaining labor guidelines to improve labor efficiency. In addition, the non-performing restaurants referred to above operated at a 31.4% labor cost, substantially in excess of the average 23.6% labor cost experienced at other company-operated restaurants.

Other restaurant expenses, which are comprised primarily of restaurant occupancy costs and insurance, increased to 22.0% of sales from 20.6% in 1985. This increase is due primarily to relatively higher rentals for new restaurants as the overall cost of real estate increases and as newer restaurants comprise a larger percentage of total restaurants. The company has recently established a policy that would limit the maximum amount of real estate costs for new locations. In addition, the non-performing restaurants referred to above experienced restaurant operating costs which compared unfavorably to the average cost level experienced at other company-operated restaurants.

General and administrative expenses in 1986 totaled \$15,400,000, consisting of salaries and benefits of \$5,140,000, advertising of \$4,647,000, corporate office expenses of \$1,765,000, net interest expense of \$1,200,000 and other amounts totaling \$2,648,000. General and administration expenses increased in 1986 by \$2,720,000 or 21.5% over 1985. The increase in general and administrative expenses from 1985 is due primarily to normal compensation increases for employees, the retirement of cash registers with a net book value of \$221,000 that were replaced by a computerized point-of-sale cash register system, consulting fees of \$220,000 relating to the development of new design and decor packages for future restaurants, and an increase in interest expense of \$552,000 which resulted from continued expansion. Advertising cost increases of \$370,000 were commensurate with the increase in sales. The company has instituted a more strict corporate spending policy including staff reductions and expects this area of corporate spending to decline as a percentage of sales in 1987.

On June 19, 1985 the company and CulCon Systems, Inc. (CulCon) entered into merger and loan agreements whereby the company received an option to acquire CulCon under certain conditions and agreed to extend financial accommodations to CulCon of up to \$8,000,000, through direct loans or guarantees of CulCon obligations. CulCon is a holding company that owns Zackly's Restaurant Systems, Inc. and Uno's Restaurant Systems, Inc. both of which operate restaurants. On March 2, 1986 the company and CulCon agreed to terminate the merger and loan agreements and as part of the settlement the company received three Zackly's restaurants in western Florida. The company recognized a provision for loan loss of \$2,400,000 in 1985 as its estimate of the loss on the settlement. This provision related primarily to the excess of the advances and guarantees extended to CulCon over the estimated value of the restaurants received.

During 1986 the company closed seven Skipper's restaurants and adopted a plan to close an additional six restaurants that were not achieving satisfactory operating results. As a result, the company provided \$2,975,000 for the estimated costs of disposing of the restaurants. The provision for the loss includes unrecoverable costs of real estate, leasehold improvements and equipment of \$1,265,000, costs related to the settlement of lease commitments of \$1,468,000, and anticipated operating and holding period losses of \$242,000.

During 1986 the company also discontinued the operations of the three Zackly's restaurants received in the CulCon settlement and provided \$917,000 for the estimated costs of disposing of the restaurants. The provision includes unrecoverable costs of leasehold improvements and equipment of \$680,000 and other costs, including the settlement of lease commitments, of \$237,000.

As a result of the aforementioned provisions for the restaurant closures in 1986, which totaled \$3,892,000, the operating losses incurred on these same restaurants during 1986 of approximately \$409,000, and the impact of other operating matters described above, the company recorded a loss before tax in 1986 of \$2,961,000 as compared to income before taxes in 1985 and 1984 of \$633,000 and \$3,731,000, respectively. This loss before tax in 1986 can be utilized to partially reduce deferred tax liabilities provided in previous years and generate a tax refund on federal income taxes previously paid. This utilization resulted in a net benefit from income taxes in 1986 of \$1,465,000. In 1985, the company recorded a net benefit from income taxes of \$230,000 primarily through the utilization of significant investment tax credits.

During 1986, the Financial Accounting Standards Board issued an exposure draft relating to the accounting for income taxes which, if adopted, would change the procedure for calculating income tax provisions in the future. In addition, the Tax Reform Act of 1986 (the "Act") contained several changes, the more significant of which to the company being the reduction of the corporate tax rate and the elimination of investment tax credit. The company does not believe that these matters will have a material effect on currently recorded balances. Further, the company believes that the effective tax rate in future periods for both financial statement and tax reporting will not be substantially different under the Act as compared to prior tax rules.

Liquidity Due to costs of expansion and because restaurant businesses generally do not require significant investment in accounts receivable or inventory but often receive trade credit in purchasing food and supplies, many companies in this industry operate with

working capital deficits, where current liabilities exceed current assets. The working capital deficits were \$4,493,000 and \$2,462,000 in 1986 and 1985, respectively. As an indication of the company's ability to operate with working capital deficits, during 1986, 1985 and 1984 the company generated working capital from operations of \$3,927,000, \$5,102,000 and \$5,833,000, respectively. The company anticipates similar amounts of working capital to be generated from operations in 1987.

Through December 28, 1986 the company utilized a revolving credit line of \$10,000,000 with stipulated interest at prime. Borrowings under this bank agreement at December 28, 1986 were \$997,000. At December 28, 1986 the company was in default under certain covenants of the agreement. By agreement dated February 25, 1987 the bank and the company agreed to certain conditions on the loan until March 31, 1987 and have verbally agreed to amended terms for the loan through August 31, 1987. The company is currently renegotiating the agreement and exploring alternative sources of credit.

Capital Resources Of the total \$31,858,000 capital additions to property and equipment for the three years ended December 28, 1986, \$19,920,000 represents capital expenditures for the 46 restaurants opened during the period. Additionally, 51 restaurants were remodeled for a total expenditure of \$3,052,000. An additional \$8,886,000 was expended for other capital additions, including energy management equipment, current equipment replacements, and point-of-sale cash registers. The major portion of these expenditures was internally financed through the use of working capital, the proceeds from a public stock offering in 1983 and obligations under capital leases totaling \$9,844,000.

The company expects to continue the opening of new restaurants beyond 1986. During 1987, the company expects to open 12 new restaurants for a total commitment of \$4,500,000 and to remodel 14 restaurants for \$980,000. Funding of the new restaurants and remodels will come from a variety of sources including the revolving line of credit, sale and leaseback transactions, and internally generated funding from operations.

During January 1985 and June 1985, the company entered into agreements with two limited partnerships under which it agreed to sell and then lease back certain restaurants. During 1986, fifteen restaurants were sold under these agreements for proceeds of \$6,092,000.

Inflation Because of the absence of receivables and inventory in the restaurant business, it is difficult to compute and evaluate the effects of inflation and changing prices upon the operations of the company. During 1986, 1985 and 1984, the company did experience modest increases in the cost of food, labor and other products. In addition, a significant portion of the company's restaurant labor cost is based on the federal minimum wage. Any change in the minimum wage could have a material effect on the company labor cost. In the past, rising costs have been generally offset by menu price increases.

Management partially controls inflation in occupancy costs either by owning the properties or by entering long-term fixed rate leases. However, most leases require Skipper's to pay taxes, maintenance, insurance, repairs and utility costs, all of which are subject to inflationary pressures.

(Dollar amounts in thousands, except
earnings, dividends and book value per share)

	1986	1985	1984	1983	1982
<i>Operating Results</i>					
Company sales	\$ 77,894	\$ 71,244	\$ 62,306	\$ 49,956	\$ 37,704
Franchised restaurant sales	16,730	15,857	11,545	8,686	5,649
Systemwide sales	94,624	87,101	73,851	58,642	43,353
Company sales	77,894	71,244	62,306	49,956	37,704
Franchise revenues	950	1,048	761	503	363
Total revenues	78,844	72,292	63,067	50,459	38,067
Income before income taxes	(2,961)	633	3,731	2,956	1,443
Income tax (benefit) provision	(1,465)	(230)	1,199	936	396
Net (loss) income	(1,496)	863	2,532	2,020	1,047
Weighted average common shares outstanding	2,729,351	2,723,424	2,722,695	2,508,043	2,174,312
Earnings per common share	(.55)	.32	.93	.81	.48
Cash dividends declared per common share	.08	.07	.06	.057	.053
Depreciation and amortization expense	4,542	3,732	2,872	2,231	1,788
Capital expenditures	15,224	14,522	11,956	7,760	5,428
<i>Financial Position (End of Year)</i>					
Total assets	43,237	41,909	34,349	27,565	18,800
Working capital	(4,493)	(2,462)	(1,934)	1,057	(1,884)
Long-term debt	14,929	11,040	7,469	4,956	4,899
Stockholders' equity	18,792	20,462	19,734	17,401	9,695
<i>Ratio Analysis</i>					
Net (loss) income as a percentage of revenues	(1.89)	1.19	4.01	4.00	2.75
Percent return on average equity during the year	(7.62)	4.29	13.64	14.91	11.33
Current ratio	.53	.70	.66	1.24	.50
Total liabilities to equity ratio	1.30	1.04	.74	.58	.94
Book value per outstanding common share	6.87	7.50	7.26	6.40	4.47
<i>Restaurants</i>					
Number open (end of year)					
Company-operated	171	162	147	133	118
Franchised	35	35	26	18	15
Total restaurants	206	197	173	151	133
Average annual systemwide sales	459	468	460	420	361
<i>Company Employment</i>					
Number of employees (average)	2,608	2,419	2,216	1,864	1,487

(Unaudited)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<i>For the Year Ended</i>				
<i>December 28, 1986</i>				
	(Dollar amounts in thousands, except earnings per share)			
Systemwide sales	\$ 21,924	\$ 22,348	\$ 21,711	\$ 28,641
Company sales and franchise revenue	18,193	18,529	18,100	24,022
Gross profit	3,577	3,768	3,889	5,097
Net income (loss)	242	(502)	403	(1,639)
Earnings (loss) per common share	.09	(.18)	.14	(.60)
Weighted average common shares outstanding	2,727,097	2,729,596	2,731,612	2,730,640
<i>For the Year Ended</i>				
<i>December 29, 1985</i>				
Systemwide sales	\$ 18,416	\$ 19,341	\$ 21,194	\$ 28,150
Company sales and franchise revenue	15,563	16,224	17,434	23,071
Gross profit	3,404	3,749	3,916	4,644
Net income (loss)	452	650	594	(833)
Earnings (loss) per common share	.17	.24	.21	(.30)
Weighted average common shares outstanding	2,721,382	2,722,547	2,724,204	2,725,033
	1986		1985	

*Annual Dividend Per Share-Paid
in April and October*

\$.08

\$.07

*Quarterly Low & High Bid Prices
for the Fiscal Year*

First Quarter	\$ 9.00 - \$10.63	\$10.00 - \$12.50
Second Quarter	9.25 - 11.25	9.50 - 11.50
Third Quarter	7.63 - 10.38	8.75 - 11.25
Fourth Quarter	7.50 - 9.38	9.13 - 12.13

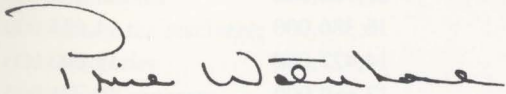
(OTC market; NASDAQ Symbol: SKIP)

*Shareholders and Shares
at Fiscal Year End*

Approximate shareholders of record	2,500	2,500
Shares outstanding	2,730,640	2,725,033

To the Board of Directors and Shareholders of Skipper's, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and of changes in financial position present fairly the financial position of Skipper's, Inc. and its subsidiaries at December 28, 1986 and December 29, 1985, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 28, 1986, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

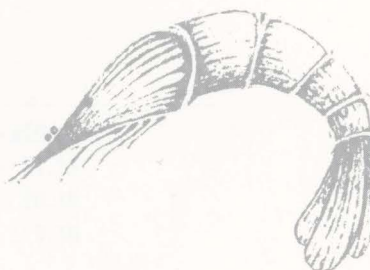


Seattle, Washington

March 5, 1987

	For the Year Ended		
	December 28, 1986	December 29, 1985	December 30, 1984
Sales	\$77,894,000	\$71,244,000	\$62,306,000
Franchise revenues	950,000	1,048,000	761,000
	78,844,000	72,292,000	63,067,000
Cost of sales	26,948,000	25,766,000	21,630,000
Salaries, wages and benefits	18,422,000	16,386,000	14,885,000
Other restaurant expenses	17,143,000	14,427,000	12,090,000
General and administrative expenses	15,400,000	12,680,000	10,731,000
Provision for restaurant closures	3,892,000		
Provision for loan loss		2,400,000	
	81,805,000	71,659,000	59,336,000
Income (loss) before income taxes	(2,961,000)	633,000	3,731,000
Income tax provision (benefit)	(1,465,000)	(230,000)	1,199,000
Net income (loss)	\$(1,496,000)	\$ 863,000	\$ 2,532,000
Earnings (loss) per common share	\$ (.55)	\$.32	\$.93

See accompanying notes to consolidated financial statements



	December 28, 1986	December 29, 1985
ASSETS		
<i>Current Assets</i>		
Cash	\$ 1,284,000	\$ 977,000
Marketable securities	932,000	1,048,000
Receivables	343,000	1,207,000
Income tax receivable	1,359,000	1,194,000
Inventories	791,000	807,000
Prepaid expenses	314,000	527,000
Total current assets	5,023,000	5,760,000
<i>Property and Equipment</i>	37,481,000	35,320,000
<i>Intangibles and Other Assets</i>	733,000	829,000
	\$43,237,000	\$41,909,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
<i>Current Liabilities</i>		
Trade accounts payable	\$ 3,393,000	\$ 3,492,000
Accrued liabilities	2,498,000	1,345,000
Salaries, wages and payroll taxes payable	1,692,000	1,851,000
Current portion of long-term debt and capital leases	913,000	528,000
Accrued contingent rents	618,000	577,000
Accrued sales tax	402,000	429,000
Total current liabilities	9,516,000	8,222,000
<i>Noncurrent Obligations</i>		
Obligations under capital leases	12,513,000	8,148,000
Long-term debt	1,032,000	2,892,000
Deferred federal income taxes	448,000	1,685,000
Other	936,000	500,000
Total noncurrent obligations	14,929,000	13,225,000
	24,445,000	21,447,000
<i>Stockholders' Equity</i>		
Preferred stock — 1,000,000 shares authorized; none issued		
Common stock — 10,000,000 shares authorized; 2,730,640 in 1986 and 2,725,033 in 1985 issued and outstanding	10,292,000	10,248,000
Retained earnings	8,500,000	10,214,000
	18,792,000	20,462,000
<i>Commitments and Contingent Liabilities</i>		
	\$43,237,000	\$41,909,000

See accompanying notes to consolidated financial statements

	For the Year Ended		
	December 28, 1986	December 29, 1985	December 30, 1984
Financial resources were provided by:			
Net income (loss)	\$(1,496,000)	\$ 863,000	\$ 2,532,000
Add (deduct) income charges (credits)			
not affecting working capital in the period –			
Depreciation and amortization	4,542,000	3,732,000	2,872,000
Deferred income taxes	(1,237,000)	488,000	526,000
Loss on disposition of property and equipment	2,238,000	82,000	49,000
Deferred compensation	51,000	163,000	
Revenue from initial franchise fees	(61,000)	(226,000)	(146,000)
Revenue from deferred guarantee fees	(110,000)		
Working capital provided by operations	3,927,000	5,102,000	5,833,000
Proceeds from sale of property and equipment	7,052,000	5,590,000	1,092,000
Long-term obligations arising from capitalization of leases	5,827,000	3,132,000	820,000
Proceeds from long-term debt		1,048,000	1,963,000
Long term liabilities arising from guarantees of lease payments	542,000	63,000	
Proceeds from initial franchise fees	14,000	276,000	149,000
Other	44,000	56,000	23,000
Total financial resources provided	17,406,000	15,267,000	9,880,000
Financial resources were used for:			
Additions to property and equipment	9,397,000	11,390,000	11,071,000
Additions to property under capital leases	5,827,000	3,132,000	885,000
Additions to intangibles	673,000	419,000	429,000
Current maturities and payments of long-term debt and capital lease obligations	3,322,000	610,000	233,000
Payment of dividends	218,000	190,000	163,000
Other		54,000	89,000
Total financial resources used	19,437,000	15,795,000	12,870,000
Increase (decrease) in working capital	\$(2,031,000)	\$ (528,000)	\$(2,990,000)

See accompanying notes to consolidated financial statements

(CONTINUED)

	For the Year Ended		
	December 28, 1986	December 29, 1985	December 30, 1984
<i>Analysis Of Changes In Components Of Working Capital</i>			
Increase (decrease) in current assets:			
Cash	\$ 307,000	\$ 14,000	\$(1,970,000)
Marketable securities	(116,000)	(230,000)	262,000
Receivables	(864,000)	709,000	2,000
Income tax receivable	165,000	1,194,000	
Inventories	(16,000)	170,000	16,000
Prepaid expenses	(213,000)	112,000	109,000
	(737,000)	1,969,000	(1,581,000)
Increase (decrease) in current liabilities:			
Trade accounts payable	(99,000)	1,433,000	763,000
Accrued liabilities	1,153,000	671,000	187,000
Salaries, wages and payroll taxes payable	(159,000)	135,000	169,000
Current portion of long-term debt and capital leases	385,000	231,000	53,000
Accrued contingent rents	41,000	18,000	148,000
Accrued sales tax	(27,000)	9,000	89,000
	1,294,000	2,497,000	1,409,000
Increase (decrease) in working capital	\$(2,031,000)	\$ (528,000)	\$(2,990,000)

See accompanying notes to consolidated financial statements

NOTE 1 – ACCOUNTING POLICIES

Principles of Consolidation The company operates and franchises Skipper's Seafood 'n Chowder House Restaurants. The consolidated financial statements include the accounts of the company and its subsidiaries. Significant intercompany transactions have been eliminated from the consolidated financial statements.

The company operates on a 52 or 53 week year with three quarters of 12 weeks and a final quarter of 16 or 17 weeks ending on the Sunday closest to December 31.

Marketable Securities Marketable securities are stated at cost, which approximates market value. Investment income earned on such instruments was \$203,000, \$294,000 and \$143,000 in 1986, 1985 and 1984 respectively.

Inventories Inventories consist primarily of food and beverages and are valued at the lower of cost or market. Cost is determined using the first in, first out method.

Property and Equipment Property and equipment are stated at cost and are depreciated on a straight-line basis over the estimated useful lives of properties and equipment owned by the company or over the terms of leases capitalized. Estimated lives are generally 20 to 35 years for buildings and 7 to 10 years for equipment.

Restaurant Preopening Costs The company capitalizes costs incurred in preparation of opening new restaurants and amortizes such costs on a straight-line basis over a three-year period.

Franchise Operations The company grants franchise rights for a term of 20 years to private operators in exchange for an initial franchise fee which is not recognized as income until the preopening obligations are satisfied and restaurants are opened. Royalties based on a percentage of gross sales are recognized on the accrual basis.

Deferred Compensation The company has a deferred compensation agreement with corporate officers based on certain performance criteria. The agreement has a five year vesting period and compensation expense is recognized over the same period. During 1985 the company entered into a retirement agreement with a former officer providing for deferred compensation to be paid in five equal payments beginning January 1, 1994.

Earnings Per Common Share Earnings per common share are calculated using the weighted average number of common shares outstanding during each year. Average shares were 2,729,351, 2,723,424, and 2,722,695 in 1986, 1985 and 1984 respectively.

NOTE 2 – LOANS TO CULCON SYSTEMS, INC.

On June 19, 1985 the company and CulCon Systems, Inc. (CulCon) entered into merger and loan agreements whereby the company received an option to acquire CulCon under certain conditions and agreed to extend financial accommodations to CulCon of up to \$8,000,000, through direct loans or guarantees of CulCon obligations. CulCon is a holding company that owns Zackly's Restaurant Systems, Inc. and Uno's Restaurant Systems, Inc. both of which operate restaurants. One of the principal shareholders of CulCon was a member of the company's Board of Directors through 1985. On March 2, 1986 the company and CulCon agreed to terminate the merger and loan agreements and as part of the settlement the company received three Zackly's restaurants in western Florida. The company provided \$2,400,000 in 1985 as its estimate of the loss on the settlement. This provision related primarily to the excess of the advances and guarantees extended to CulCon over the estimated value of the restaurants received.

NOTE 3 – RESTAURANT CLOSURES

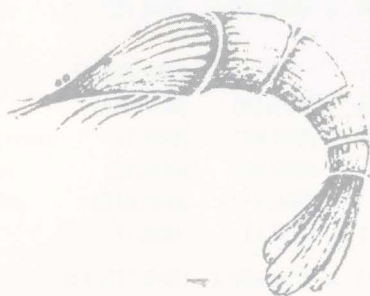
During 1986 the company closed seven restaurants and adopted a plan to close an additional six restaurants that were not achieving satisfactory operating results. As a result, the company provided \$2,975,000 for the estimated costs of disposing of the restaurants. The provision for the loss includes unrecoverable costs of real estate, leasehold improvements and equipment of \$1,265,000, costs related to the settlement of lease commitments of \$1,468,000, and anticipated operating and holding period losses of \$242,000.

During 1986 the company also discontinued the operations of the three Zackly's restaurants received in the CulCon settlement and provided \$917,000 for the estimated costs of disposing of the restaurants. The provision includes unrecoverable costs of leasehold improvements and equipment of \$680,000 and other costs, including the settlement of lease commitments, of \$237,000.

NOTE 4 – PROPERTY AND EQUIPMENT

The company had property and equipment as follows:

	December 28, 1986	December 29, 1985
Buildings and leasehold improvements	\$13,651,000	\$14,647,000
Equipment	20,816,000	20,248,000
	34,467,000	34,895,000
Less-accumulated depreciation and amortization	(12,909,000)	(11,116,000)
	21,558,000	23,779,000
Land	4,196,000	4,250,000
	25,754,000	28,029,000
Leased property under capital leases:		
Buildings and leasehold improvements	14,163,000	9,782,000
Equipment	1,172,000	563,000
	15,335,000	10,345,000
Less-accumulated amortization	(3,956,000)	(3,195,000)
	11,379,000	7,150,000
Real estate held for sale	348,000	141,000
	\$37,481,000	\$35,320,000



NOTE 5 – LEASES

The company leases a majority of its restaurant facilities and its administrative offices. Certain leases require the company to pay property taxes and insurance and others require additional rental payments contingent upon sales exceeding specified amounts. The leases are generally for 20-year periods and frequently provide options to renew for up to three five-year periods.

Total minimum commitments under noncancelable leases in force at December 28, 1986 are as follows:

Fiscal Year	Capital Leases	Operating Leases	Total
1987	\$ 1,870,000	\$ 2,350,000	\$ 4,220,000
1988	1,872,000	2,354,000	4,226,000
1989	1,873,000	2,350,000	4,223,000
1990	1,857,000	2,308,000	4,165,000
1991	1,823,000	2,094,000	3,917,000
Thereafter	17,102,000	25,710,000	42,812,000

Total minimum lease commitments	26,397,000	\$37,166,000	\$63,563,000
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Less-amounts representing implicit interest	(13,340,000)
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Present value of net minimum lease commitments	13,057,000
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Less-current portion	(544,000)
	\$12,513,000

Total rent expense under operating leases was \$2,923,000, \$2,375,000, and \$2,062,000 during 1986, 1985 and 1984, respectively, which included contingent rent expense of \$631,000, \$588,000, and \$571,000, respectively.

Total interest costs incurred, which primarily relate to capital leases, were \$1,469,000, \$962,000 and \$723,000 during 1986, 1985 and 1984, respectively. Interest costs capitalized in 1986, 1985 and 1984 amounted to \$66,000, \$103,000 and \$99,000 respectively.

NOTE 6 – INTANGIBLES AND OTHER ASSETS

Intangibles and other assets are as follows:

	December 28, 1986	December 29, 1985
Restaurant preopening costs	\$ 843,000	\$1,035,000
Trademark and goodwill	259,000	370,000
Other	91,000	137,000
	1,193,000	1,542,000
Less-accumulated amortization	(460,000)	(713,000)
	\$ 733,000	\$ 829,000

NOTE 7 – LONG-TERM DEBT

Long-term debt consists of the following:

	December 28, 1986	December 29, 1985
Payable to bank under revolving credit and term loan agreement	\$ 997,000	\$2,487,000
Contracts associated with purchase of equipment payable in monthly installments at interest rates ranging from 11% to 13% through August, 1994	344,000	488,000
Mortgage payable to bank in monthly installments at interest rate of 10% through 1995	60,000	62,000
	1,401,000	3,037,000
Less-current maturities	(369,000)	(145,000)
	\$1,032,000	\$2,892,000

In 1984 the company entered into an unsecured bank loan agreement, bearing interest at the prime lending rate which at December 28, 1986 was 7.5%. Under the terms of the agreement, the company could borrow on a revolving line of credit basis up to \$10,000,000. The borrowings outstanding at December 28, 1986 have been refinanced through sale-leaseback arrangements subsequent to December 28, 1986 and therefore are included in the schedule of annual principal payments based upon the terms of the new agreements. At December 28, 1986 the company was in default under certain covenants of the agreement and is currently renegotiating the agreement.

Annual principal payments required on long-term debt are as follows:

Fiscal Year	
1987	\$ 369,000
1988	118,000
1989	113,000
1990	103,000
1991	101,000
Thereafter	597,000
	\$1,401,000

In addition the company has issued standby letters of credit in the amount of \$330,000 in connection with worker's compensation and general liability insurance policies.

NOTE 8 – INCOME TAXES

The company files consolidated federal and state income tax returns. For 1986 and 1985 the company recorded a benefit for income taxes. All losses were carried back against the prior years earnings. The components of the income tax (benefit) provision were:

	1986	1985	1984
Current (benefit) provision	\$ (228,000)	\$ (718,000)	\$ 673,000
Deferred (benefit) provision	(1,237,000)	488,000	526,000
	<u>\$ (1,465,000)</u>	<u>\$ (230,000)</u>	<u>\$ 1,199,000</u>

The difference between taxes calculated at the statutory rate of 46% and the company's effective rate is as follows:

	1986	1985	1984
Federal income tax (benefit)			
provision at 46%	\$ (1,362,000)	\$ 291,000	\$ 1,716,000
Investment tax credits, net of recapture	(13,000)	(413,000)	(500,000)
Targeted jobs tax credit	(108,000)	(145,000)	(30,000)
Other, net	18,000	37,000	13,000
	<u>\$ (1,465,000)</u>	<u>\$ (230,000)</u>	<u>\$ 1,199,000</u>

State taxes were \$10,000, \$10,000 and \$94,000 in 1986, 1985 and 1984 respectively. Investment tax credits are recognized when the assets are placed in service under the flow-through method of accounting.

Deferred tax (benefit) provision was attributable to the following:

	1986	1985	1984
Excess tax depreciation	\$ 521,000	\$ 864,000	\$ 508,000
Reserve for restaurant closures	(1,366,000)		
Capitalized leases	(160,000)	(82,000)	(60,000)
Restaurant preopening costs	(3,000)	(35,000)	94,000
Deferred compensation	(23,000)	(69,000)	
Gain on sale-leasebacks	(218,000)	(178,000)	
Other	12,000	(12,000)	(16,000)
	<u>\$ (1,237,000)</u>	<u>\$ 488,000</u>	<u>\$ 526,000</u>

NOTE 9 – EQUITY TRANSACTIONS

Cash dividends amounting to \$218,000, \$190,000 and \$163,000 were paid in 1986, 1985 and 1984, respectively. During 1984, the company purchased and retired 5,000 shares of its common stock at a cost of \$47,000.

Under a nonqualified stock option plan adopted in 1977, the Board of Directors made available for grants to employees options to purchase up to 20,000 shares of the company's common stock at the market price as of the date of the grants. The plan terminates on June 30, 1987. Options are exercisable in five equal annual amounts commencing one year from the date of grant and expire ten years from the date they are granted to the employee. At December 28, 1986 there were unexercised options to purchase 4,766 shares at prices ranging from \$3.00 to \$3.50, and options to purchase 940 shares were available for future grants. No options were granted or canceled during the year ended December 28, 1986 and options to purchase 1,540 shares were exercised at prices from \$3.00 to \$3.50. During 1985 and 1984 options to purchase 100 and 3,453 shares were exercised resulting in proceeds to the company of \$300 and \$11,383, respectively.

Under a qualified employee incentive stock option plan adopted in 1984 the Board of Directors made available for grants to employees options to purchase up to 135,000 shares of the company's common stock at the market price as of the date of the grants. The plan terminates on March 16, 1994. Options are exercisable in three annual amounts commencing one year from the date of grant and expire ten years after the date they are granted to the employee. At December 28, 1986 there were unexercised options to purchase 116,170 shares at prices ranging from \$9.75 to \$10.50, and options to purchase 17,690 shares were available for future grants. No options were granted or exercised during the year ended December 28, 1986 and options to purchase 15,090 shares were canceled. During the year ended December 29, 1985 options to purchase 1,140 shares were exercised resulting in proceeds to the company of \$11,115.

Under an employee stock purchase plan adopted in 1984 the Board of Directors made available 80,000 shares of common stock for purchase by employees at 95% of the lower of the beginning or ending market price during each successive six month period. The difference between the market price at the date of issuance and the price charged to employees is recorded as compensation expense. On January 2, 1986 2,064 shares were sold to employees for \$9.50 per share and on June 30, 1986 2,003 shares were sold to employees for \$9.61 per share. On January 2, 1985 2,235 shares were sold to employees for \$9.26 per share and on June 30, 1985 2,486 shares were sold to employees for \$9.50 per share. At December 29, 1986 71,212 shares were available for sale to employees; on January 2, 1987 2,395 shares were issued.

NOTE 10 – RELATED PARTY TRANSACTIONS

The company leases its administrative offices in a building in which a director has an ownership interest. Additionally, the company leases five of its restaurants from stockholders and two are leased from a company which is owned by a principal stockholder of Skipper's. The remaining terms of these eight leases range from 5 to 13 years and will continue to require minimum annual payments of approximately \$344,000.

Subsequent to December 28, 1986, the company entered into an agreement with a general partnership, the managing partner of which is a member of the company's Board of Directors, under which it sold and then leased back four restaurants. The restaurants had a book value of \$1,448,000 and were sold for \$1,500,000; the gain on sale has been deferred and will be recognized in income over the terms of the leases. The leases have terms of 20 years with three optional five year renewal periods; lease payments in connection with the four restaurants aggregate \$173,000 annually. Lease obligations capitalized under this agreement amounted to \$831,000 as of the inception of the leases; ground leases are classified as operating leases and are not included in the amounts capitalized.

NOTE 11 – SALE-LEASEBACK TRANSACTIONS

During 1986 the company entered into an agreement with a limited partnership under which it sold and then leased back fifteen restaurants and equipment in five restaurants. The assets had a book value of \$5,964,000 and were sold for \$6,092,000; the gain on the sale has been deferred and will be recognized in income over the terms of the leases. The leases have terms of 20 years with three optional five-year renewal periods for restaurants and 10 years for equipment; lease payments aggregate \$745,000 annually. Lease obligations capitalized under this agreement amounted to \$4,442,000 as of the inception of the leases; ground leases are classified as operating leases and are not included in the amounts capitalized.

During 1985 the company entered into agreements with limited partnerships under which it sold and then leased back ten restaurants. The restaurants had a book value of \$4,969,000 and were sold for \$5,175,000; the gain on the sale has been deferred and will

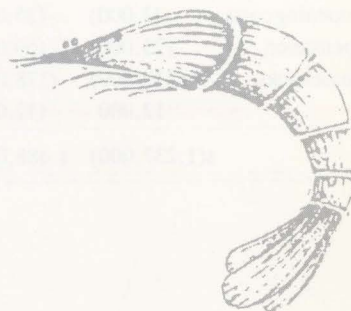
be recognized in income over the terms of the leases. The leases have terms of 20 years with three optional five-year renewal periods; lease payments in connection with the five restaurants aggregate \$652,000 annually. Lease obligations capitalized under this agreement amounted to \$3,084,000 as of the inception of the leases; ground leases are classified as operating leases and are not included in the amounts capitalized.

During 1985 one of the partnerships entered into similar agreements with certain of the company's franchise holders. The company agreed to guarantee 90% of the lease payments to be made by franchise holders. At December 28, 1986 the company was contingently liable under these guarantee arrangements in the amount of \$1,381,000. The fees received by the company in connection with these guarantees are recognized in income over the terms of the leases.

NOTE 12 – LITIGATION

On June 5, 1986 a franchisee filed claims against the company seeking approximately \$7,000,000 for several causes of action including misrepresentation in the sale of the franchise, breach of fiduciary duty, breach of contract, and violation of Hawaii franchise and unfair trade practice acts. The action is in the preliminary stages of discovery and settlement discussions are in process. In the opinion of management, the ultimate resolution of these claims will not have a significant effect on the financial position of the company.

The company is subject to other legal proceedings and claims arising in the ordinary course of its business. In the opinion of management, the amount of ultimate liability with respect to these actions will not materially affect the financial position of the company.



Officers

Douglas C. Bamford
Vice President Marketing

Chris R. LeSourd
President
Chief Operating Officer

Carol L. Nolan
Vice President Controller

M. Eugene Stone
Chairman
Chief Executive Officer

Jay W. Switzer
Vice President – Finance
Secretary – Treasurer

Directors

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Executive Vice President
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Vice President – Treasurer
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Safeco Plaza
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Chief Operating Officer
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Chairman/Chief Executive Officer
Skipper's, Inc.

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Seattle, Washington 98104

Independent Accountants

Price Waterhouse
The Financial Center
Seattle, Washington 98161

Transfer Agent

First Interstate Bank of California
Corporate Trust Division
P.O. Box 21927
Seattle, Washington 98111

Annual Meeting

The 1987 annual meeting of stockholders will be held on Wednesday, May 27, 1987 at 2:00 p.m. in the Safeco Auditorium, 4333 Brooklyn Avenue Northeast, Seattle, WA 98105. Corner of Brooklyn Avenue NE and 45th Street NE in the University District. Parking available in nearby lots.

For a copy of the Skipper's, Inc. Annual Report on Form 10-K write:

Jay W. Switzer
Vice President Finance
Secretary/Treasurer
Skipper's, Inc.
14450 N.E. 29th Place
Suite 200
Bellevue, Washington 98007

A copy will be provided at no charge.

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