ZALE CORP
Form 10-Q
June 07, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended April 30, 2012

Commission File Number 1-04129

Zale Corporation

A Delaware Corporation

IRS Employer Identification No. 75-0675400

901 W. Walnut Hill Lane

Irving, Texas 75038-1003

(972) 580-4000

Zale Corporation (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Zale Corporation has submitted electronically and posted on the Company s website every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T.

Zale Corporation is an accelerated filer.

Zale Corporation is not a shell company.

As of June 4, 2012, 32,219,702 shares of Zale Corporation s Common Stock, par value $0.01 per share, were outstanding.

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ZALE CORPORATION AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ZALE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended April 30, 2012	Three Months Ended April 30, 2011	Nine Months Ended April 30, 2012	Nine Months Ended April 30, 2011
Revenues	$ 445,170	$ 411,843	$ 1,459,915	$ 1,365,296
Cost of sales	216,977	205,424	708,535	678,677
Gross margin	228,193	206,419	751,380	686,619
Selling, general and administrative	213,088	202,347	694,740	655,635
Depreciation and amortization	9,275	9,773	28,456	31,052
Other (gains) charges	(375)	(265)	1,274	3,715
Operating earnings (loss)	6,205	(5,436)	26,910	(3,783)
Interest expense	9,777	8,653	30,135	73,433
Loss before income taxes	(3,572)	(14,089)	(3,225)	(77,216)
Income tax expense (benefit)	868	(4,161)	4,006	2,124
Loss from continuing operations	(4,440)	(9,928)	(7,231)	(79,340)
(Loss) earnings from discontinued operations, net of taxes	(87)	935	(332)	(324)
Net loss	$ (4,527)	$ (8,993)	$ (7,563)	$ (79,664)
Basic and diluted net loss per common share:				
Loss from continuing operations	$ (0.14)	$ (0.31)	$ (0.22)	$ (2.47)
(Loss) earnings from discontinued operations		0.03	(0.01)	(0.01)
Net loss per share	$ (0.14)	$ (0.28)	$ (0.23)	$ (2.48)
Weighted average number of common shares outstanding:				
Basic	32,213	32,135	32,189	32,122
Diluted	32,213	32,135	32,189	32,122

See notes to consolidated financial statements.

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ZALE CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	April 30, 2012	July 31, 2011	April 30, 2011
ASSETS			
Current assets:			
Cash and cash equivalents	$ 37,291	$ 35,125	$ 36,875
Merchandise inventories	778,705	720,782	756,439
Other current assets	41,500	49,811	37,635
Total current assets	857,496	805,718	830,949
Property and equipment	700,505	704,813	704,131
Less accumulated depreciation and amortization	(572,998)	(563,062)	(555,046)
Net property and equipment	127,507	141,751	149,085
Goodwill	102,041	104,620	105,336
Other assets	40,540	44,843	44,145
Deferred tax asset	93,746	92,967	77,287
Total assets	$ 1,221,330	$ 1,189,899	$ 1,206,802
LIABILITIES AND STOCKHOLDERS INVESTMENT			
Current liabilities:			
Accounts payable and accrued liabilities	$ 229,034	$ 219,256	$ 238,655
Deferred revenue	87,798	94,188	96,136
Deferred tax liability	93,281	92,721	72,225
Total current liabilities	410,113	406,165	407,016
Long-term debt	445,505	395,454	375,454
Deferred revenue long-term	130,029	137,992	139,356
Other liabilities	33,547	37,461	38,941
Commitments and contingencies			
Stockholders investment:			
Common stock	488	488	488
Additional paid-in capital	162,208	161,575	160,915
Accumulated other comprehensive income	58,166	63,385	65,128
Accumulated earnings	444,141	451,704	484,346
	665,003	677,152	710,877
Treasury stock	(462,867)	(464,325)	(464,842)
Total stockholders investment	202,136	212,827	246,035
Total liabilities and stockholders investment	$ 1,221,330	$ 1,189,899	$ 1,206,802

See notes to consolidated financial statements.

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ZALE CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended April 30, 2012	Nine Months Ended April 30, 2011
Cash Flows From Operating Activities:		
Net loss	$ (7,563)	$ (79,664)
Adjustments to reconcile net loss to net cash used in operating activities:		
Non-cash interest	2,742	33,659
Depreciation and amortization	28,456	31,052
Deferred taxes	(220)	(523)
Loss on disposition of property and equipment	1,506	514
Impairment of property and equipment	1,009	3,664
Stock-based compensation	2,114	1,772
Loss from discontinued operations	332	324
Changes in operating assets and liabilities:		
Merchandise inventories	(61,851)	(42,532)
Other current assets	8,160	4,712
Other assets	383	(1,742)
Accounts payable and accrued liabilities	11,370	2,180
Deferred revenue	(13,419)	13,019
Other liabilities	(3,829)	(44)
Net cash used in operating activities	(30,810)	(33,609)
Cash Flows From Investing Activities:		
Payments for property and equipment	(14,221)	(8,109)
Purchase of available-for-sale investments	(6,833)	(7,232)
Proceeds from sales of available-for-sale investments	8,375	5,082
Net cash used in investing activities	(12,679)	(10,259)
Cash Flows From Financing Activities:		
Borrowings under revolving credit agreement	3,309,600	2,740,300
Payments on revolving credit agreement	(3,262,800)	(2,670,300)
Payments on senior secured term loan		(11,250)
Payments on capital lease obligations	(309)	
Net cash provided by financing activities	46,491	58,750
Cash Flows Used in Discontinued Operations:		
Net cash used in operating activities of discontinued operations	(789)	(5,054)
Effect of exchange rate changes on cash	(47)	812
Net change in cash and cash equivalents	2,166	10,640
Cash and cash equivalents at beginning of period	35,125	26,235
Cash and cash equivalents at end of period	$ 37,291	$ 36,875

See notes to consolidated financial statements.

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ZALE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

References to the Company, we, us, and our in this Form 10-Q are references to Zale Corporation and its subsidiaries. We are, through our wholly owned subsidiaries, a leading specialty retailer of fine jewelry in North America. At April 30, 2012, we operated 1,134 specialty retail jewelry stores and 658 kiosks located mainly in shopping malls throughout the United States of America, Canada and Puerto Rico.

We report our operations under three segments: Fine Jewelry, Kiosk Jewelry and All Other. Fine Jewelry is comprised of five brands, predominantly focused on the value-oriented consumer as our core customer target. Each brand specializes in fine jewelry and watches, with merchandise and marketing emphasis focused on diamond products. Zales Jewelers® is our national brand in the U.S. providing moderately priced jewelry to a broad range of customers. Zales Outlet® operates in outlet malls and neighborhood power centers and capitalizes on Zale Jewelers ® national advertising and brand recognition. Gordon s Jewelers® is a value-oriented regional jeweler. Peoples Jewellers®, Canada s largest fine jewelry retailer, provides customers with an affordable assortment and an accessible shopping experience. Mappins Jewellers® offers Canadian customers a broad selection of merchandise from engagement rings to fashionable and contemporary fine jewelry. Certain brands in Fine Jewelry have expanded their presence in the retail market through their e-commerce sites, *www.zales.com, www.zalesoutlet.com, www.gordonsjewelers.com* and *www.peoplesjewellers.com*.

Kiosk Jewelry operates under the brand names Piercing Pagoda®, Plumb Gold , and Silver and Gold Connection® through mall-based kiosks and is focused on the opening price point customer. Kiosk Jewelry specializes in gold, silver and non-precious metal products that capitalize on the latest fashion trends. We expanded our presence in Kiosk Jewelry through our e-commerce site, *www.pagoda.com*.

All Other includes our insurance and reinsurance operations, which offer insurance coverage primarily to our private label credit card customers.

We consolidate substantially all of our U.S. operations into Zale Delaware, Inc. (ZDel), a wholly owned subsidiary of Zale Corporation. ZDel is the parent company for several subsidiaries, including four that are engaged primarily in providing credit insurance to our credit customers. We consolidate our Canadian retail operations into Zale International, Inc., which is a wholly owned subsidiary of Zale Corporation. All significant intercompany transactions have been eliminated. The consolidated financial statements are unaudited and have been prepared by the Company in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In management s opinion, all material adjustments (consisting of normal recurring accruals and adjustments) and disclosures necessary for a fair presentation have been made. Because of the seasonal nature of the retail business, operating results for interim periods are not necessarily indicative of the results that may be expected for the full year. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended July 31, 2011 filed with Securities and Exchange Commission on September 20, 2011.

Reclassification. Certain prior year amounts have been reclassified in the accompanying consolidated balance sheets to conform to our fiscal year 2012 presentation, including valuation reserves associated with deferred taxes.

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2. FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. In determining fair value, Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*, establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair values. These tiers include:

Level 1	Quoted prices for *identical* instruments in active markets;
Level 2	Quoted prices for *similar* instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose significant inputs are observable; and
Level 3	Instruments whose significant inputs are *unobservable.*

Assets and Liabilities that are Measured at Fair Value on a Recurring Basis

The following tables include our assets and liabilities that are measured at fair value on a recurring basis (in thousands):

	Fair Value as of April 30, 2012		
	Level 1	**Level 2**	**Level 3**
Assets			
U.S. Treasury securities	$ 20,933	$	$
U.S. government agency securities		3,048	
Corporate bonds and notes		1,342	
Corporate equity securities	4,104		
	$ 25,037	$ 4,390	$
Liabilities			
Lease reserves	$	$	$ 1,064

	Fair Value as of April 30, 2011		
	Level 1	**Level 2**	**Level 3**
Assets			
U.S. Treasury securities	$ 18,932	$	$
U.S. government agency securities		3,926	
Corporate bonds and notes		2,001	
Corporate equity securities	4,206		
	$ 23,138	$ 5,927	$
Liabilities			
Lease reserves	$	$	$ 2,098

Investments in U.S. Treasury securities and corporate equity securities are based on quoted market prices for identical instruments in active markets, and therefore were classified as a Level 1 measurement in the fair value hierarchy. Investments in U.S. government agency securities and corporate bonds and notes are based on quoted prices for similar instruments in active markets, and therefore were classified as a Level 2 measurement in the fair value hierarchy (see Note 3 for additional information related to our investments).

Lease reserves associated with closed stores are calculated using significant unobservable inputs including the present value of the remaining lease rentals using a weighted-average cost of capital and estimated sublease rentals, and therefore were classified as a Level 3 measurement in the fair value hierarchy. The weighted-average cost of capital was estimated using information from comparable companies and management s judgment related to the risk associated with the

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operations of the stores. The sublease rentals were estimated using comparable rentals in the same or similar markets in which the closed stores operated.

Assets that are Measured at Fair Value on a Nonrecurring Basis

The following table includes our store-level property and equipment that were measured at fair value, using Level 3 inputs, on a nonrecurring basis (in thousands):

	Fair Value for the the Nine Months Ended April 30, 2012	2011
Store-level property and equipment	$ 256	$ 900

Potential impairment losses related to store-level property and equipment are calculated using significant unobservable inputs including the present value of future cash flows expected to be generated using a weighted-average cost of capital and updated financial projections, and therefore are classified as a Level 3 measurement in the fair value hierarchy. For the nine months ended April 30, 2012, store-level property and equipment of $1.3 million were written down to their fair value of $0.3 million, resulting in an impairment charge of $1.0 million. For the nine months ended April 30, 2011, store-level property and equipment of $4.6 million were written down to their fair value of $0.9 million, resulting in an impairment charge of $3.7 million.

At the end of the second quarter of fiscal year 2012, we completed our annual impairment testing of goodwill pursuant to ASC 350, *Intangible-Goodwill and Other*. Based on the test results, we concluded that no impairment was necessary for the $82.7 million of goodwill related to the Peoples Jewellers acquisition and the $19.3 million of goodwill related to the Piercing Pagoda acquisition. As of the date of the test, the fair value of the Peoples Jewellers and Piercing Pagoda reporting units would have to decline by more than 22 percent and 52 percent, respectively, to be considered for potential impairment. We calculate the estimated fair value of our reporting units using Level 3 inputs, including: (1) cash flow projections for five years assuming positive comparable store sales growth; (2) terminal year growth rates of two percent based on estimates of long-term inflation expectations; and (3) discount rates of 13.75 percent to 15.25 percent based on a weighted average cost of capital that reflects current market conditions. While we believe we have made reasonable estimates and assumptions to calculate the fair value of the reporting units, it is possible a material change could occur. If our actual results are not consistent with estimates and assumptions used to calculate fair value, we may be required to recognize goodwill impairments.

Other Financial Instruments

As cash and short-term cash investments, trade payables and certain other short-term financial instruments are all short-term in nature, their carrying amount approximates fair value. The outstanding principal of our revolving credit agreement and Senior Secured Term Loan approximates fair value as of April 30, 2012. The fair values of the revolving credit agreement and the Senior Secured Term Loan were based on estimates of current interest rates for similar debt, a Level 3 input.

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3. INVESTMENTS

Investments in debt and equity securities held by our insurance subsidiaries are reported in other assets in the accompanying consolidated balance sheets. Investments are recorded at fair value based on quoted market prices. All investments are classified as available-for-sale. All long-term debt securities outstanding at April 30, 2012 will contractually mature within 1 to 20 years. Our investments consist of the following (in thousands):

	April 30, 2012		April 30, 2011	
	Cost	Fair Value	Cost	Fair Value
U.S. Treasury securities	$ 19,428	$ 20,933	$ 18,187	$ 18,932
U.S. government agency securities	2,782	3,048	3,632	3,926
Corporate bonds and notes	1,223	1,342	1,866	2,001
Corporate equity securities	3,501	4,104	3,501	4,206
	$ 26,934	$ 29,427	$ 27,186	$ 29,065

At April 30, 2012 and 2011, the carrying value of investments included a net unrealized gain of $2.5 million and $1.9 million, respectively, which are included in accumulated other comprehensive income. Realized gains and losses on investments are determined on the specific identification basis. There were no material net realized gains or losses during the three and nine months ended April 30, 2012 and 2011.

4. LONG-TERM DEBT

Long-term debt consists of the following (in thousands):

	April 30,	
	2012	2011
Revolving credit agreement	$ 301,800	$ 235,000
Senior Secured Term Loan	140,454	140,454
Capital lease obligations	3,251	
	$ 445,505	$ 375,454

Amended and Restated Revolving Credit Agreement

On May 10, 2010, we entered into an agreement to amend and restate various terms of the revolving credit agreement with Bank of America, N.A. and certain other lenders. The Amended and Restated Revolving Credit Agreement (the Revolving Credit Agreement) consisted of two tranches: (a) an extended tranche totaling $530 million, including seasonal borrowings of $88 million, maturing on April 30, 2014 and (b) a non-extending tranche totaling $120 million, including seasonal borrowings of $20 million, maturing on August 11, 2011. The commitments under the agreement from both tranches total $650 million, including seasonal borrowings of $108 million. On April 21, 2011, the $120 million non-extending tranche was assigned to other lenders and the maturity date was extended to April 30, 2014, the maturity date for the remainder of the credit facility. Borrowings under the Revolving Credit Agreement are capped at the lesser of: (1) 73 percent of the cost of eligible inventory during October through December and 69 percent for the remainder of the year (less certain reserves that may be established under the agreement), plus 85 percent of eligible credit card receivables or (2) 87.5 percent of the appraised liquidation value of eligible inventory (less certain reserves that may be established under the agreement), plus 85 percent of eligible credit card receivables. The Revolving Credit Agreement also contains an accordion feature that allows us to permanently increase commitments up to an additional $100 million, subject to approval by our lenders and certain other requirements. The Revolving Credit Agreement is secured by a first priority security interest and lien on merchandise inventory, credit card receivables and certain other assets and a second priority security interest and lien on all other assets.

The monthly borrowing rates calculated from the cost of eligible inventory range from 64 to 68 percent for the period of April through September 2012, 73 percent for the period of October through December 2012, and 66 to 69 percent for the period of January through April 2013.

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Borrowings under the Revolving Credit Agreement bear interest at either: (i) LIBOR plus the applicable margin (ranging from 350 to 400 basis points) or (ii) the base rate (as defined in the Revolving Credit Agreement) plus the applicable margin (ranging from 250 to 300 basis points). We are required to pay a quarterly unused commitment fee of 50 basis points based on the preceding quarter s unused commitment.

Borrowing availability cannot be less than $40 million during the term of the agreement and less than $50 million on one occasion for three consecutive business days in each four-month period, except for the period from September 1 through November 30, when borrowing availability can be less than $50 million on two occasions, but in no event can borrowing availability be less than $50 million more than four times during any 12 consecutive months. The Revolving Credit Agreement contains various other covenants including restrictions on the incurrence of certain indebtedness, liens, investments, acquisitions and asset sales. As of April 30, 2012, we were in compliance with all covenants under the Revolving Credit Agreement.

Borrowing availability under the terms of the Revolving Credit Agreement was approximately $206 million as of April 30, 2012, or $156 million excluding the $50 million minimum availability requirement. As a result of the minimum liquidity requirement under the Senior Secured Term Loan (see below), the amount available under the Revolving Credit Agreement at April 30, 2012 was approximately $109 million.

We incurred debt issuance costs associated with the Revolving Credit Agreement totaling $14.1 million, including $1.1 million associated with the April 21, 2011 extension of the $120 million portion of the credit facility. The debt issuance costs are included in other assets in the accompanying consolidated balance sheets and are amortized to interest expense on a straight-line basis over the four-year life of the Revolving Credit Agreement.

On September 24, 2010, we received a waiver and consent from the lenders under the Amended and Restated Revolving Credit Agreement permitting the amendments to our Senior Secured Term Loan and the related payments to Z Investment Holdings, LLC (see below for additional details).

Senior Secured Term Loan

On May 10, 2010, we entered into a $150 million Senior Secured Term Loan (the Term Loan) and a Warrant and Registration Rights Agreement (as discussed below) with Z Investment Holdings, LLC, an affiliate of Golden Gate Capital. The Term Loan matures on May 10, 2015 and is secured by a first priority security interest in substantially all current and future intangible assets not secured under the Revolving Credit Agreement and a second priority security interest on merchandise inventory, credit card receivables and certain other assets. The proceeds received were used to pay down amounts outstanding under the Revolving Credit Agreement after payment of debt issuance costs incurred pursuant to the Revolving Credit Agreement and the Term Loan. Debt issuance costs associated with the Term Loan totaled approximately $13.0 million, $1.7 million of which was attributable to the warrants issued in connection with the Term Loan (see more details below under *Warrant and Registration Rights Agreement*) and expensed on the date of issuance.

On September 24, 2010, we amended the Term Loan with Z Investment Holdings, LLC. The amendment eliminated the Minimum Consolidated EBITDA covenant and our option to pay a portion of future interest payments in kind subsequent to July 31, 2010. As a result, all future interest payments will be made in cash. In consideration for the amendment, we paid Z Investment Holdings, LLC an aggregate of $25.0 million, of which $11.3 million was used to pay down the outstanding principal balance of the Term Loan, $1.2 million was a prepayment premium and

$12.5 million was an amendment fee. The outstanding balance of the Term Loan after the amendment totaled $140.5 million. In accordance with ASC 470-50, *Debt Modifications and Extinguishments*, the amendment was considered a significant modification, which required us to account for the Term Loan and related unamortized costs as an extinguishment and record the amended Term Loan at fair value. As a result, we recorded a charge to interest expense totaling $45.8 million in the first quarter of fiscal year 2011. The charge consists of $20.3 million related to the unamortized discount associated with the warrants issued in connection with the Term Loan, the $12.5 million amendment fee, $10.3 million related to the unamortized debt issuance costs associated with the Term Loan and $2.7 million related to the prepayment premium and other costs associated with the amendment.

The Term Loan bears interest at 15 percent payable on a quarterly basis. We may repay all or any portion of the Term Loan with the following penalty prior to maturity: (i) 10 percent during the first year; (ii) 7.5 percent during the second year; (iii) 5.0 percent during the third year; (iv) 2.5 percent during the fourth year and (v) no penalty in the fifth year. Our

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ability to repay the Term Loan prior to maturity is restricted by certain conditions under the Revolving Credit Agreement. As of April 30, 2012, we are not restricted by any conditions governing repayment of the Term Loan prior to maturity.

The Term Loan contains various covenants, as defined in the agreement, including maintaining minimum store contribution thresholds for Piercing Pagoda and Zale Canada, as defined, and restrictions on the incurrence of certain indebtedness, liens, investments, acquisitions and asset sales. The Piercing Pagoda and Zale Canada minimum store contribution threshold for the twelve-month period ended April 30, 2012 is $24 million and CAD $34 million, respectively. As of April 30, 2012, store contribution for Piercing Pagoda and Zale Canada would have to decline by more than 27 percent and 26 percent, respectively, to breach these covenants. The Piercing Pagoda minimum store contribution thresholds for the next twelve months range from $26 million to $31 million. The Zale Canada minimum store contribution thresholds for the next twelve months range from CAD $36 million to CAD $41 million. Liquidity (as defined in the Term Loan) was $244.0 million as of April 30, 2012, which exceeded the $135 million minimum liquidity requirement under the Term Loan by approximately $109 million. As of April 30, 2012, we were in compliance with all covenants under the Term Loan.

On May 10, 2010, we acknowledged the terms of an intercreditor agreement (the Intercreditor Agreement) between Bank of America N.A, as agent under the Revolving Credit Agreement, and Z Investment Holdings, LLC, as agent under the Term Loan. Under the Intercreditor Agreement, Z Investment Holdings, LLC, may request Bank of America N.A. to establish a reserve equal to two and one-half percent of the borrowing base, as defined in the Revolving Credit Agreement, if the borrowing availability is less than $75 million at any time, thereby reducing the amount we can borrow under the Revolving Credit Agreement. In addition, the Intercreditor Agreement restricts changes that can be made to certain terms and covenants under the Term Loan.

Warrant and Registration Rights Agreement

In connection with the execution of the Term Loan in May 2010, we entered into a Warrant and Registration Rights Agreement (the Warrant Agreement) with Z Investment Holdings, LLC. Under the terms of the Warrant Agreement, we issued 6.4 million A-Warrants and 4.7 million B-Warrants (collectively, the Warrants) to purchase shares of our common stock, on a one-for-one basis, for an exercise price of $2.00 per share. The Warrants, which are currently exercisable and expire seven years after issuance, represented 25 percent of our common stock on a fully diluted basis (including the shares issuable upon exercise of the Warrants and excluding certain out-of-the-money stock options) as of the date of the issuance. The A-Warrants were exercisable immediately; however, the B-Warrants were not exercisable until the shares of common stock to be issued upon exercise of the B-Warrants were approved by our stockholders, which occurred on July 23, 2010. The number of shares and exercise price are subject to customary antidilution protection. The Warrant Agreement also entitles the holder to designate two, and in certain circumstances three, directors to our board. The holders of the Warrants may, at their option, request that we register for resale all or part of the common stock issuable under the Warrant Agreement.

The fair value of the Warrants totaled $21.3 million as of the date of issuance and was recorded as a long-term liability, with a corresponding discount to the carrying value of the Term Loan. On July 23, 2010, the stockholders approved the shares of common stock to be issued upon exercise of the B-Warrants. The long-term liability associated with the Warrants was marked-to-market as of the date of the stockholder approval resulting in an $8.3 million gain during the fourth quarter of fiscal year 2010. The remaining amount of $13.0 million was reclassified to stockholders investment and is included in additional paid-in capital in the accompanying consolidated balance sheets. Issuance costs attributable to the Warrants totaling $1.7 million were expensed on the date of issuance. As indicated above, the remaining unamortized discount as of September 24, 2010 totaling $20.3 million associated with the Warrants was charged to interest expense during the first quarter of fiscal year 2011.

Capital Lease Obligations

In fiscal year 2012, we entered into capital leases related to vehicles for our field management. The vehicles are included in property and equipment in the accompanying consolidated balance sheet and are depreciated over a five-year life. The amount capitalized during the nine months ended April 30, 2012 totaled $3.5 million; such amount is a non-cash item and therefore excluded from the consolidated statement of cash flows.

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5. OTHER (GAINS) CHARGES

Other (gains) charges consist of the following (in thousands):

	Three Months Ended April 30, 2012	Three Months Ended April 30, 2011	Nine Months Ended April 30, 2012	Nine Months Ended April 30, 2011
Store impairments	$	$	$ 1,009	$ 3,664
Store closure adjustments	(375)	(265)	265	51
	$ (375)	$ (265)	$ 1,274	$ 3,715

During the second quarter of fiscal years 2012 and 2011, we recorded charges related to the impairment of long-lived assets for underperforming stores in Fine Jewelry totaling $1.0 million and $3.7 million, respectively. The impairment of long-lived assets is based on the amount that the carrying value exceeds the estimated fair value of the assets. The fair value is based on future cash flow projections over the remaining lease term using a discount rate that we believe is commensurate with the risk inherent in our current business model. If actual results are not consistent with our cash flow projections, we may be required to record additional impairments. If operating earnings over the remaining lease term for each store included in our impairment test as of January 31, 2012 were to decline by 40 percent, we would be required to record additional impairments of approximately $0.7 million.

We have recorded lease termination charges related to certain store closures, primarily in Fine Jewelry. The lease termination charges for leases where the Company has finalized settlement negotiations with the landlords are based on the amounts agreed upon in the termination agreement. If a settlement has not been reached for a lease, the charges are based on the present value of the remaining lease rentals, including common area maintenance and other charges, reduced by estimated sublease rentals that could reasonably be obtained. While we believe we have made reasonable estimates and assumptions to record these charges, it is possible a material change could occur and we may be required to record additional charges. During the three months ended April 30, 2012 and 2011, we recorded gains totaling $0.4 million and $0.3 million, respectively, as a result of adjustments to our lease reserves related to store closures. During the nine months ended April 30, 2012 and 2011, we recorded charges related to the store closures totaling $0.3 million and $0.1 million, respectively. As of April 30, 2012, the remaining lease reserve associated with the store closures totaled $0.4 million.

6. LOSS PER COMMON SHARE

Basic loss per common share is computed by dividing net loss by the weighted average number of common shares outstanding for the reporting period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted earnings per share, the basic weighted average number of shares is increased by the dilutive effect of stock options, restricted share awards and warrants issued in connection with the Term Loan determined using the Treasury Stock method. There were antidilutive stock options totaling 3.6 million and 3.1 million for the three months ended April 30, 2012 and 2011, respectively, and 3.6 million and 3.0 million for the nine months ended April 30, 2012 and 2011, respectively. There were antidilutive warrants totaling 11.1 million for the three and nine months ended April 30, 2012 and 2011.

During the three months ended April 30, 2012 and 2011, we incurred a net loss of $4.5 million and $9.0 million, respectively. During the nine months ended April 30, 2012 and 2011, we incurred a net loss of $7.6 million and $79.7 million, respectively. A net loss causes all outstanding stock options, restricted share awards and warrants to be antidilutive. As a result, the basic and dilutive losses per common share are the same for the three and nine month periods presented.

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7. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) represents the change in equity during a period from transactions and other events, except those resulting from investments by and distributions to stockholders. The following table gives further detail regarding the components of comprehensive income (loss) (in thousands):

	Three Months Ended April 30, 2012	Three Months Ended April 30, 2011	Nine Months Ended April 30, 2012	Nine Months Ended April 30, 2011
Net loss	$ (4,527)	$ (8,993)	$ (7,563)	$ (79,664)
Foreign currency translation adjustment	3,954	10,945	(5,550)	16,215
Unrealized (loss) gain on securities, net	(217)	283	331	473
Comprehensive (loss) income	$ (790)	$ 2,235	$ (12,782)	$ (62,976)

The following table gives further detail regarding changes in the composition of accumulated other comprehensive income (in thousands):

	Three Months Ended April 30, 2012	Three Months Ended April 30, 2011	Nine Months Ended April 30, 2012	Nine Months Ended April 30, 2011
Beginning of period	$ 54,429	$ 53,900	$ 63,385	$ 48,440
Foreign currency translation adjustment	3,954	10,945	(5,550)	16,215
Unrealized (loss) gain on securities, net	(217)	283	331	473
End of period	$ 58,166	$ 65,128	$ 58,166	$ 65,128

8. INCOME TAXES

Due to uncertainties surrounding the utilization of net operating loss carryforwards generated in our U.S. and Puerto Rico subsidiaries, valuation allowances totaling $0.6 million were recorded during the nine months ended April 30, 2012 to offset the tax benefit associated with the operating losses. The valuation allowance as of April 30, 2012 totaled $97.2 million.

9. DISPOSITION OF BAILEY BANKS & BIDDLE

In connection with the sale of the Bailey Banks & Biddle brand in November 2007, we assigned the applicable store operating leases to the buyer, Finlay Fine Jewelry Corporation (Finlay). As a condition of this assignment, we remained contingently liable for the leases for the remainder of the respective lease terms, which generally ranged from fiscal year 2009 through fiscal year 2017. On August 5, 2009, Finlay filed for Chapter 11 bankruptcy protection and subsequently decided to liquidate. The lease reserve associated with the one remaining lease totaled \$0.7 million at April 30, 2012. Adjustments to the lease reserve are recorded in discontinued operations in the accompanying statements of operations. There is no tax impact associated with discontinued operations due to the uncertainty of our ability to utilize net operating loss carryforwards in the future.

10. SEGMENTS

We report our operations under three business segments: Fine Jewelry, Kiosk Jewelry, and All Other. Fine Jewelry consists of five brands, Zales Jewelers®, Zales Outlet®, Gordon s Jewelers®, Peoples Jewellers® and Mappins Jewellers®, and is predominantly focused on the value-oriented customer as our core customer target. Each brand specializes in fine jewelry and watches, with merchandise and marketing emphasis focused on diamond products. These five brands have been aggregated into one reportable segment. Kiosk Jewelry operates under the brand names Piercing Pagoda®, Plumb Gold , and Silver and Gold Connection® through mall-based kiosks and is focused on the opening price point customer. Kiosk Jewelry specializes in gold, silver and non-precious metal products that capitalize on the latest

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fashion trends. All Other includes our insurance and reinsurance operations, which offer insurance coverage primarily to our private label credit card customers. Management s expectation is that overall economics of each of our major brands within each reportable segment will be similar over time.

We use earnings before unallocated corporate overhead, interest and taxes but include an internal charge for inventory carrying cost to evaluate segment profitability. Unallocated costs before income taxes include corporate employee-related costs, administrative costs, information technology costs, corporate facilities costs and depreciation and amortization.

Income tax information by segment is not included as taxes are calculated at a company-wide level and not allocated to each segment.

Selected Financial Data by Segment	**Three Months Ended April 30,**				**Nine Months Ended April 30,**			
		2012		**2011**		**2012**		**2011**
	(amounts in thousands)							
Revenues:								
Fine Jewelry (a)	$	381,123	$	347,802	$	1,266,721	$	1,170,172
Kiosk		61,128		61,426		185,339		187,593
All Other		2,919		2,615		7,855		7,531
Total revenues	$	445,170	$	411,843	$	1,459,915	$	1,365,296
Depreciation and amortization:								
Fine Jewelry	$	5,883	$	6,847	$	17,943	$	21,344
Kiosk		810		832		2,391		2,563
All Other								
Unallocated		2,582		2,094		8,122		7,145
Total depreciation and amortization	$	9,275	$	9,773	$	28,456	$	31,052
Operating earnings (loss):								
Fine Jewelry (b)	$	4,833	$	(6,400)	$	31,464	$	(907)
Kiosk		6,372		6,619		14,031		15,507
All Other		1,127		1,259		3,339		4,065
Unallocated (c)		(6,127)		(6,914)		(21,924)		(22,448)
Total operating earnings (loss)	$	6,205	$	(5,436)	$	26,910	$	(3,783)

(a) Includes $65.3 million and $62.0 million for the three months ended April 30, 2012 and 2011, respectively, and $244.3 million and $231.0 million for the nine months ended April 30, 2012 and 2011, respectively, related to foreign operations.

(b) Includes gains totaling $0.4 million and $0.3 million related to leases associated with store closures for the three months ended April 30, 2012 and 2011, respectively. Includes $1.3 million and $3.7 million related to lease charges for store closures and store impairments for the nine months ended April 30, 2012 and 2011, respectively.

(c) Includes $14.8 million and $13.5 million for the three months ended April 30, 2012 and 2011, respectively, and $44.7 million and $36.9 million for the nine months ended April 30, 2012 and 2011, respectively, to offset internal carrying costs charged to the segments.

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11. CONTINGENCIES

In November 2009, the Company and four former officers, Neal L. Goldberg, Rodney Carter, Mary E. Burton and Cynthia T. Gordon, were named as defendants in two purported class-action lawsuits filed in the United States District Court for the Northern District of Texas. On August 9, 2010, the two lawsuits were consolidated into one consolidated lawsuit, which alleged various violations of securities laws arising from the financial statement errors that led to the restatement completed by the Company as part of its Annual Report on Form 10-K for the fiscal year ended July 31, 2009. The lawsuit requests unspecified damages and costs. On August 1, 2011, the Court dismissed the lawsuit with prejudice. The plaintiffs have appealed the decision. We intend to vigorously defend the dismissal. The Company cannot predict the outcome of the lawsuit and cannot estimate the damages, if any, that the Company may incur in connection with this matter.

In December 2009, the directors of the Company and four former officers, Neal L. Goldberg, Rodney Carter, Mary E. Burton and Cynthia T. Gordon, were named as defendants in a derivative action lawsuit brought on behalf of the Company by a shareholder in the County Court of Dallas County, Texas. The suit alleged various breaches of fiduciary and other duties by the defendants that generally were related to the financial statement errors described above. In addition, the Board of Directors received demands from two shareholders requesting that the Board of Directors take action against each of the individuals named in the derivative lawsuit to recover damages for the alleged breaches. The lawsuit requested unspecified damages and costs. The Board of Directors also received a demand from two other shareholders that the Company take legal action against Rebecca Higgins as a result of her purported role in the financial statement errors. On September 29, 2011, the Court dismissed the derivative action lawsuit without prejudice.

On April 21, 2011, the Securities and Exchange Commission concluded its investigation of the Company with respect to the matters underlying the lawsuits and demands described above and did not recommend any enforcement action against the Company. No penalties or fines were assessed to the Company.

We are involved in legal and governmental proceedings as part of the normal course of our business. Reserves have been established based on management s best estimates of our potential liability in these matters. These estimates have been developed in consultation with internal and external counsel and are based on a combination of litigation and settlement strategies. Management believes that such litigation and claims will be resolved without material effect on our financial position or results of operations.

12. DEFERRED REVENUE

We offer our Fine Jewelry customers lifetime warranties on certain products that cover sizing and breakage with an option to purchase theft protection for a two-year period. ASC 605-20, *Revenue Recognition-Services*, requires recognition of warranty revenue on a straight-line basis until sufficient cost history exists. Once sufficient cost history is obtained, revenue is required to be recognized in proportion to when costs are expected to be incurred. Prior to fiscal year 2012, the Company recognized revenue from lifetime warranties on a straight-line basis over a five-year period because sufficient evidence of the pattern of costs incurred was not available. During the first quarter of fiscal year 2012, we began recognizing revenue related to lifetime warranty sales in proportion to when the expected costs will be incurred, which we estimate will be over an eight-year period. The deferred revenue balance as of July 31, 2011 related to lifetime warranties is recognized prospectively, in proportion to the remaining estimated warranty costs. The change in estimate related to the pattern of revenue recognition and the life of the warranties is the result of accumulating additional historical evidence over the five-year period that we have been selling the lifetime warranties. The change in estimate increased revenues by $8.5 million and $27.4 million during the three and nine months ended April 30, 2012, respectively. Net loss improved by $8.0 million and $25.8 million during the three and nine months ended April 30, 2012, respectively. In addition, basic and dilutive net loss per share improved by $0.25 per share and $0.80 per share during the three and nine months ended April 30, 2012, respectively.

Revenues related to the optional theft protection are recognized over the two-year contract period on a straight-line basis. We also offer our Fine Jewelry customers a two-year watch warranty and our Fine Jewelry and Kiosk Jewelry customers a one-year warranty that covers breakage. The revenue from these warranties is recognized on a straight-line basis over their respective contract terms.

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The change in deferred revenue associated with the sale of warranties is as follows (in thousands):

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2012	**2011**	**2012**	**2011**
Deferred revenue, beginning of period	$ 222,422	$ 232,093	$ 232,525	$ 219,251
Warranties sold (a)	31,973	27,972	95,864	84,822
Revenue recognized	(36,568)	(24,573)	(110,562)	(68,581)
Deferred revenue, end of period	$ 217,827	$ 235,492	$ 217,827	$ 235,492

(a) Warranty sales for the three months ended April 30, 2012 include approximately $0.7 million related to the appreciation in the Canadian currency rate on the beginning of the period deferred revenue balance. Warranty sales for the nine months ended April 30, 2012 include approximately $1.2 million related to the depreciation in the Canadian currency rate on the beginning of the period deferred revenue balance. Warranty sales for the three and nine months ended April 30, 2011 include approximately $2.2 million and $3.2 million, respectively, related primarily to the appreciation in the Canadian currency rate on the beginning of the period deferred revenue balance.

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

This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements of the Company (and the related notes thereto), and the audited consolidated financial statements of the Company (and the related notes thereto) and Management s Discussion and Analysis of Financial Condition and Results of Operations in the Company s Annual Report on Form 10-K for the fiscal year ended July 31, 2011.

Overview

We are a leading specialty retailer of fine jewelry in North America. At April 30, 2012, we operated 1,134 fine jewelry stores and 658 kiosk locations primarily in shopping malls throughout the United States of America, Canada and Puerto Rico.

We report our business under three operating segments: Fine Jewelry, Kiosk Jewelry and All Other. Fine Jewelry is comprised of five brands, Zales Jewelers®, Zales Outlet®, Gordon s Jewelers®, Peoples Jewellers® and Mappins Jewellers®, and is predominantly focused on the value-oriented consumer. Each brand specializes in fine jewelry and watches, with merchandise and marketing emphasis focused on diamond products. These five brands have been aggregated into one reportable segment. Kiosk Jewelry operates under the brand names Piercing Pagoda®, Plumb Gold , and Silver and Gold Connection® through mall-based kiosks and is focused on the opening price point customer. Kiosk Jewelry specializes in gold, silver and non-precious metal products that capitalize on the latest fashion trends. All Other includes our insurance and reinsurance operations, which offer insurance coverage primarily to our private label credit card customers.

Comparable store sales increased by 8.0 percent during the third quarter of fiscal year 2012. At constant exchange rates, which excludes the effect of translating Canadian currency denominated sales into U.S. dollars, comparable store sales increased by 8.3 percent for the quarter. Gross margin increased by 120 basis points to 51.3 percent during the third quarter of fiscal year 2012. Gross margin compared to the same period in the prior year was impacted by a 100 basis point improvement resulting from a change in warranty revenue recognition and a 50 basis point last-in, first-out (LIFO) inventory charge. Excluding these items, gross margin improved by 70 basis points as a result of an increase in retail prices, lower merchandise discounts and an improvement in inventory reserves, partially offset by an increase in the cost of merchandise. Operating earnings for the quarter were $6.2 million compared to an operating loss of $5.4 million in the same period in the prior year, an increase of $11.6 million. Operating earnings as a percent of revenue increased by 270 basis points to 1.4 percent compared to an operating loss of 1.3 percent in the same period in the prior year. The increase in operating earnings as a percent of revenue is primarily the result of an increase in gross margin and greater operating leverage.

Net earnings associated with warranties totaled $91.5 million for the nine months ended April 30, 2012, compared to $53.6 million for the same period in the prior year. The increase is primarily the result of improved sales and a $27.4 million increase resulting from a change in revenue recognition related to lifetime warranties. Accounting Standards Codification 605-20, *Revenue Recognition-Services*, requires recognition of warranty revenue on a straight-line basis until sufficient cost history exists. Once sufficient cost history is obtained, revenue is required to be recognized in proportion to when costs are expected to be incurred. Prior to fiscal year 2012, the Company recognized revenue from lifetime warranties on a straight-line basis over a five-year period because sufficient evidence of the pattern of costs incurred was not available. During the first quarter of fiscal year 2012, we began recognizing revenue in proportion to when the expected costs will be incurred, which we estimate will be over an eight-year period. The deferred revenue balance as of July 31, 2011 related to lifetime warranties is recognized prospectively in proportion to the remaining estimated warranty costs. The change in estimate related to the pattern of revenue recognition and the life of the warranties is the result of accumulating additional historical evidence over the five-year period that we have been selling the lifetime warranties.

During the nine months ended April 30, 2012 and 2011, the average Canadian currency rate depreciated by approximately one percent and appreciated by approximately five percent, respectively, relative to the U.S. dollar as compared to the prior year period. The depreciation in the Canadian currency rate for the nine months ended April 30, 2012 resulted in a $1.4 million decrease in reported revenues, offset by an decrease in reported cost of sales and selling, general and administrative expenses of $0.6 million and $0.5 million, respectively. The appreciation in the Canadian currency rate for the nine months ended April 30, 2011 resulted in a $10.8 million increase in reported revenues, offset by an increase in reported cost of sales and selling, general and administrative expenses of $5.2 million and $4.3 million,

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respectively. In addition, as a result of fluctuations in the Canadian dollar, we recorded a loss totaling $1.5 million and a gain totaling $1.2 million primarily associated with the settlement of Canadian accounts payable during the nine months ended April 30, 2012 and 2011, respectively.

Substantially all U.S. inventories represent finished goods, which are valued using the LIFO retail inventory method. We are required to determine the LIFO cost on an interim basis by estimating annual inflation trends, annual purchases and ending inventory. Actual annual inflation rates and inventory balances as of the end of any fiscal year may differ from interim estimates. The inflation rates pertaining to merchandise inventories, especially as they relate to diamond, gold, and silver costs, are primary components in determining our LIFO inventory. As a result of commodity cost increases, we have recorded LIFO charges in cost of sales totaling $7.8 million and $5.4 million during the three months ended April 30, 2012 and 2011, respectively. We also recorded LIFO charges totaling $16.2 million and $9.1 million during the nine months ended April 30, 2012 and 2011, respectively. The LIFO inventory reserve included in the consolidated balance sheets as of April 30, 2012 and 2011 totaled $52.1 million and $28.1 million, respectively.

Comparable store sales include internet sales and repair sales but exclude revenue recognized from warranties and insurance premiums related to credit insurance policies sold to customers who purchase merchandise under our proprietary credit programs. The sales results of new stores are included beginning with their thirteenth full month of operation. The results of stores that have been relocated, renovated or refurbished are included in the calculation of comparable store sales on the same basis as other stores. However, stores closed for more than 90 days due to unforeseen events (e.g., hurricanes, etc.) are excluded from the calculation of comparable store sales.

Non-GAAP Financial Measure

We report our consolidated financial statements in accordance with U.S. generally accepted accounting principles (GAAP). However, the non-GAAP performance measure of EBITDA (defined as earnings before interest, income taxes and depreciation and amortization) is presented to enhance investors ability to analyze trends in our business and evaluate our performance relative to other companies. We use the non-GAAP performance measure to assist us in explaining underlying performance trends in our business.

EBITDA is a non-GAAP financial measure and should not be considered in isolation of, or as a substitute for, net loss or other GAAP measures as an indicator of operating performance. In addition, EBITDA should not be considered as an alternative to operating earnings (loss) or net loss as a measure of operating performance. Our calculation of EBITDA may differ from others in our industry and is not necessarily comparable with similar titles used by other companies.

The following table reconciles EBITDA to loss from continuing operations as presented in our consolidated statements of operations:

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2012	**2011**	**2012**	**2011**
Loss from continuing operations	$ (4,440)	$ (9,928)	$ (7,231)	$ (79,340)
Depreciation and amortization	9,275	9,773	28,456	31,052
Interest expense	9,777	8,653	30,135	73,433
Income tax expense (benefit)	868	(4,161)	4,006	2,124
EBITDA	$ 15,480	$ 4,337	$ 55,366	$ 27,269

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Results of Operations

The following table sets forth certain financial information from our unaudited consolidated statements of operations expressed as a percentage of total revenues:

Revenues	100.0%	100.0%	100.0%	100.0%
Cost of sales	48.7	49.9	48.5	49.7
Gross margin	51.3	50.1	51.5	50.3
Selling, general and administrative	47.9	49.1	47.6	48.0
Depreciation and amortization	2.1	2.4	1.9	2.3
Other (gains) charges	(0.1)	(0.1)	0.1	0.3
Operating earnings (loss)	1.4	(1.3)	1.8	(0.3)
Interest expense	2.2	2.1	2.1	5.4
Loss before income taxes	(0.8)	(3.4)	(0.2)	(5.7)
Income tax expense (benefit)	0.2	(1.0)	0.3	0.2
Loss from continuing operations	(1.0)	(2.4)	(0.5)	(5.8)
(Loss) earnings from discontinued operations, net of taxes		0.2		
Net loss	(1.0)%	(2.2)%	(0.5)%	(5.8)%

Three Months Ended April 30, 2012 Compared to Three Months Ended April 30, 2011

Revenues. Revenues for the quarter ended April 30, 2012 were $445.2 million, an increase of 8.1 percent compared to revenues of $411.8 million for the same period in the prior year. Comparable store sales increased 8.0 percent as compared to the same period in the prior year. The increase in comparable store sales was attributable to a 7.8 percent increase in the number of units sold in our fine jewelry stores and a 1.5 percent increase in the average price per unit sold. The change in the number of units sold and the average price per unit sold includes the impact of an increase in sales related to our bead product lines, which are sold at a lower price point, partially offset by an increase in retail prices. The increase in revenue was also due to an $11.7 million increase in revenues related to warranties, of which $8.5 million is the result of a change in revenue recognition related to lifetime warranties. The increase was partially offset by a decrease in revenues related to 54 stores closed (net of store openings) since April 30, 2011.

Fine Jewelry contributed $381.1 million of revenues in the quarter ended April 30, 2012, an increase of 9.6 percent compared to $347.8 million for the same period in the prior year.

Kiosk Jewelry contributed $61.1 million of revenues for the quarter ended April 30, 2012 as compared to $61.4 million in the prior year, representing a decrease of 0.5 percent. The decrease in revenues is due to a 4.6 percent decrease in the number of units sold, partially offset by a 3.7 percent increase in the average price per unit.

All Other contributed $2.9 million in revenues for the quarter ended April 30, 2012, an increase of 11.6 percent compared to $2.6 million for the same period in prior year.

During the quarter ended April 30, 2012, we converted one Gordon s store to the Zales nameplate in Fine Jewelry. In addition, we closed 17 stores in Fine Jewelry and one location in Kiosk Jewelry.

Gross Margin. Gross margin represents net sales less cost of sales. Cost of sales includes cost related to merchandise sold, receiving and distribution, customer repairs and repairs associated with warranties. Gross margin increased by 120 basis points to 51.3 percent during the third quarter of fiscal year 2012. Gross margin compared to the same period in the prior year was impacted by a 100 basis point improvement resulting from a change in warranty revenue recognition and a 50 basis point LIFO inventory charge. Excluding these items, gross margin improved by 70 basis points as a result of an increase in retail prices, lower merchandise discounts and an improvement in inventory reserves, partially offset by an increase in the cost of merchandise.

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Selling, General and Administrative. Included in selling, general and administrative expenses (SG&A) are store operating, advertising, buying, cost of insurance operations and general corporate overhead expenses. SG&A was 47.9 percent of revenues for the quarter ended April 30, 2012, compared to 49.1 percent for the same period in the prior year. SG&A increased by $10.7 million to $213.1 million for the quarter ended April 30, 2012. The increase is primarily the result of a $5.3 million increase in labor costs to support increased sales, a $3.8 million increase in proprietary credit fees and a $1.7 million increase in promotional costs. The increase was partially offset by a $1.3 million decrease in occupancy costs primarily related to 54 stores closed (net of store openings) since April 30, 2011.

Depreciation and Amortization. Depreciation and amortization as a percentage of revenues for the quarter ended April 30, 2012 and 2011 was 2.1 percent and 2.4 percent, respectively. The decrease is primarily the result of store closures and impairment charges recorded during fiscal year 2011.

Other (Gains) Charges. Other (gains) charges for the quarter ended April 30, 2012 and 2011 includes a gain of $0.4 million and $0.3 million, respectively, related to adjustments to the lease reserves associated with store closures.

Interest Expense. Interest expense as a percentage of revenues for the quarters ended April 30, 2012 and 2011 was 2.2 percent and 2.1 percent, respectively. Interest expense increased by $1.1 million to $9.8 million for the three months ended April 30, 2012. The increase is primarily due to an increase in the weighted average effective interest rate associated with the revolving credit agreement to 4.1 percent as compared to 3.7 percent for the same period in the prior year and an increase in the average borrowings compared to the same period in the prior year.

Income Tax Expense. Income tax expense totaled $0.9 million for the three months ended April 30, 2012, as compared to a $4.2 million income tax benefit for the same period in the prior year. The income tax expense for the three months ended April 30, 2012 was primarily associated with operating earnings related to our Canadian subsidiaries. The income tax benefit for the three months ended April 30, 2011 was primarily the result of the recognition of a $4.6 million tax refund associated with the Worker, Homeownership and Business Assistance Act of 2009 (the WHBA), partially offset by tax expense primarily associated with our Canadian subsidiaries.

Nine Months Ended April 30, 2012 Compared to Nine Months Ended April 30, 2011

Revenues. Revenues for the nine months ended April 30, 2012 were $1,459.9 million, an increase of 6.9 percent compared to revenues of $1,365.3 million for the same period in the prior year. Comparable store sales increased 6.5 percent as compared to the same period in the prior year. The increase in comparable store sales was attributable to a 5.5 percent increase in the number of units sold and a 1.9 percent increase in the average price per unit sold in our fine jewelry stores. The change in the number of units sold and the average price per unit sold includes the impact of an increase in sales related to our bead product lines, which are sold at a lower price point, partially offset by an increase in retail prices. The increase in revenue was also due to a $41.2 million increase in revenues related to warranties, of which $27.4 million is the result of a change in revenue recognition related to lifetime warranties. The increase was partially offset by a decrease in revenues related to 54 stores closed (net of store openings) since April 30, 2011.

Fine Jewelry contributed $1,266.7 million of revenues in the nine months ended April 30, 2012, an increase of 8.3 percent compared to $1,170.2 million for the same period in the prior year.

Kiosk Jewelry contributed $185.3 million of revenues for the nine months ended April 30, 2012 as compared to $187.6 million in the prior year, representing a decrease of 1.2 percent. The decrease in revenues is due to a 6.9 percent decrease in the number of units sold, partially offset by a 5.2 percent increase in the average price per unit.

All Other contributed $7.9 million in revenues for the nine months ended April 30, 2012, an increase of 4.3 percent compared to $7.5 million for the same period in prior year.

During the nine months ended April 30, 2012, we converted three Gordon s stores to the Zales nameplate in Fine Jewelry. In addition, we closed 29 stores in Fine Jewelry and 10 locations in Kiosk Jewelry.

Gross Margin. Gross margin represents net sales less cost of sales. Cost of sales includes cost related to merchandise sold, receiving and distribution, customer repairs and repairs associated with warranties. Gross margin increased by 120 basis points to 51.5 percent during the nine months ended April 30, 2012. Gross margin compared to the same period in the prior year was impacted by a 100 basis point improvement resulting from a change in warranty revenue recognition and a 50 basis point LIFO inventory charge. Excluding these items, gross margin improved by 70 basis points as a result of an increase in retail prices and lower merchandise discounts, partially offset by an increase in the cost of merchandise.

Selling, General and Administrative. Included in selling, general and administrative expenses (SG&A) are store operating, advertising, buying, cost of insurance operations and general corporate overhead expenses. SG&A was 47.6 percent of revenues for the nine months ended April 30, 2012, compared to 48.0 percent for the same period in the prior year. SG&A increased by $39.1 million to $694.7 million for the nine months ended April 30, 2012. The increase is primarily the result of a $17.8 million increase in promotional costs, including production costs and marketing for the launch of proprietary products during the second quarter, an $8.3 million increase in labor costs to support increased sales and an $8.9 million increase in proprietary credit fees. The increase was partially offset by a $3.0 million decrease in occupancy costs primarily related to 54 stores closed (net of store openings) since April 30, 2011.

Depreciation and Amortization. Depreciation and amortization as a percentage of revenues for the nine months ended April 30, 2012 and 2011 was 1.9 percent and 2.3 percent, respectively. The decrease is primarily the result of store closures and impairment charges recorded during fiscal year 2011.

Other (Gains) Charges. Other (gains) charges for the nine months ended April 30, 2012 and 2011 includes lease charges related to closed stores and store impairments totaling $1.3 million and $3.7 million, respectively.

Interest Expense. Interest expense as a percentage of revenues for the nine months ended April 30, 2012 and 2011 was 2.1 percent and 5.4 percent, respectively. Interest expense decreased by $43.3 million to $30.1 million for the nine months ended April 30, 2012. The decrease is the result of a $45.8 million charge recorded in the first quarter of fiscal year 2011 associated with the first amendment to our Senior Secured Term Loan (Term Loan) on September 24, 2010. Excluding the $45.8 million charge, interest expense increased by $2.5 million primarily due to an increase in the weighted average effective interest rate associated with the revolving credit agreement to 4.0 percent as compared to 3.6 percent for the same period in the prior year and an increase in the average borrowings compared to the same period in the prior year.

Income Tax Expense. Income tax expense totaled $4.0 million for the nine months ended April 30, 2012, as compared to $2.1 million for the same period in the prior year. The income tax expense for the nine months ended April 30, 2012 was primarily associated with earnings of our Canadian subsidiaries. The income tax expense for the nine months ended April 30, 2011 was primarily associated with earnings of our Canadian subsidiaries, partially offset by the recognition of a $4.6 million tax refund associated with the WHBA.

Liquidity and Capital Resources

Our cash requirements consist primarily of funding ongoing operations, including merchandise inventory requirements, capital expenditures for new stores, renovation of existing stores, upgrades to our information technology systems and distribution facilities, and debt service. Through April 30, 2012, our cash requirements were funded through cash flows from operations and our revolving credit agreement with a syndicate of lenders led by Bank of America, N.A. We manage availability under the revolving credit agreement by monitoring the timing of merchandise purchases and vendor payments. The average vendor payment terms during the nine months ended April 30, 2012 and 2011 were approximately 50 days and 45 days, respectively. As of April 30, 2012, we had cash and cash equivalents totaling $37.3 million. We believe that our operating cash flows and available credit facility are sufficient to finance our cash requirements for at least the next twelve months.

Net cash used in operating activities improved from $33.6 million for the nine months ended April 30, 2011 to $30.8 million for the nine months ended April 30, 2012. The $2.8 million improvement in the deficit is primarily the result of an increase in operating earnings compared to the same period in the prior year, a $15.2 million payment in the prior year related to the Term Loan amendment and the timing of vendor payments, partially offset by an increase in inventory.

Our business is highly seasonal, with a disproportionate amount of sales (approximately 30 to 40 percent) occurring in November and December of each year, the Holiday season. Other important periods include Valentine s Day and Mother s Day. We purchase inventory in anticipation of these periods and, as a result, have higher inventory and inventory financing needs immediately prior to these periods. Owned inventory at April 30, 2012 was $778.7 million, an increase of $22.3 million compared to inventory levels at April 30, 2011. The increase is primarily the result of additional merchandise purchased as a result of increased sales and higher merchandise cost.

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Amended and Restated Revolving Credit Agreement

On May 10, 2010, we entered into an agreement to amend and restate various terms of the revolving credit agreement with Bank of America, N.A. and certain other lenders. The Amended and Restated Revolving Credit Agreement (the   Revolving Credit Agreement) consisted of two tranches: (a) an extended tranche totaling $530 million, including seasonal borrowings of $88 million, maturing on April 30, 2014 and (b) a non-extending tranche totaling $120 million, including seasonal borrowings of $20 million, maturing on August 11, 2011. The commitments under the agreement from both tranches total $650 million, including seasonal borrowings of $108 million. On April 21, 2011, the $120 million non-extending tranche was assigned to other lenders and the maturity date was extended to April 30, 2014, the maturity date for the remainder of the credit facility. Borrowings under the Revolving Credit Agreement are capped at the lesser of: (1) 73 percent of the cost of eligible inventory during October through December and 69 percent for the remainder of the year (less certain reserves that may be established under the agreement), plus 85 percent of eligible credit card receivables or (2) 87.5 percent of the appraised liquidation value of eligible inventory (less certain reserves that may be established under the agreement), plus 85 percent of eligible credit card receivables. The Revolving Credit Agreement also contains an accordion feature that allows us to permanently increase commitments up to an additional $100 million, subject to approval by our lenders and certain other requirements. The Revolving Credit Agreement is secured by a first priority security interest and lien on merchandise inventory, credit card receivables and certain other assets and a second priority security interest and lien on all other assets.

The monthly borrowing rates calculated from the cost of eligible inventory range from 64 to 68 percent for the period of April through September 2012, 73 percent for the period of October through December 2012, and 66 to 69 percent for the period of January through April 2013.

Borrowings under the Revolving Credit Agreement bear interest at either: (i) LIBOR plus the applicable margin (ranging from 350 to 400 basis points) or (ii) the base rate (as defined in the Revolving Credit Agreement) plus the applicable margin (ranging from 250 to 300 basis points). We are required to pay a quarterly unused commitment fee of 50 basis points based on the preceding quarter s unused commitment.

Borrowing availability cannot be less than $40 million during the term of the agreement and less than $50 million on one occasion for three consecutive business days in each four-month period, except for the period from September 1 through November 30, when borrowing availability can be less than $50 million on two occasions, but in no event can borrowing availability be less than $50 million more than four times during any 12 consecutive months. The Revolving Credit Agreement contains various other covenants including restrictions on the incurrence of certain indebtedness, liens, investments, acquisitions and asset sales. As of April 30, 2012, we were in compliance with all covenants under the Revolving Credit Agreement.

Borrowing availability under the terms of the Revolving Credit Agreement was approximately $206 million as of April 30, 2012, or $156 million excluding the $50 million minimum availability requirement. As a result of the minimum liquidity requirement under the Senior Secured Term Loan (see below), the amount available under the Revolving Credit Agreement at April 30, 2012 was approximately $109 million.

We incurred debt issuance costs associated with the Revolving Credit Agreement totaling $14.1 million, including $1.1 million associated with the April 21, 2011 extension of the $120 million portion of the credit facility. The debt issuance costs are included in other assets in the accompanying consolidated balance sheets and are amortized to interest expense on a straight-line basis over the four-year life of the Revolving Credit Agreement.

Senior Secured Term Loan

On May 10, 2010, we entered into a $150 million Senior Secured Term Loan (the Term Loan) and a Warrant and Registration Rights Agreement (as discussed below) with Z Investment Holdings, LLC, an affiliate of Golden Gate Capital. The Term Loan matures on May 10, 2015 and is secured by a first priority security interest in substantially all current and future intangible assets not secured under the Revolving Credit Agreement and a second priority security interest on merchandise inventory, credit card receivables and certain other assets. The proceeds received were used to pay down amounts outstanding under the Revolving Credit Agreement after payment of debt issuance costs incurred pursuant to the Revolving Credit Agreement and the Term Loan. Debt issuance costs associated with the Term Loan totaled approximately $13.0 million, $1.7 million of which was attributable to the warrants issued in connection with the

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Term Loan (see more details below under *Warrant and Registration Rights Agreement*) and expensed on the date of issuance.

On September 24, 2010, we amended the Term Loan with Z Investment Holdings, LLC. The amendment eliminated the Minimum Consolidated EBITDA covenant and our option to pay a portion of future interest payments in kind subsequent to July 31, 2010. As a result, all future interest payments will be made in cash. In consideration for the amendment, we paid Z Investment Holdings, LLC an aggregate of $25.0 million, of which $11.3 million was used to pay down the outstanding principal balance of the Term Loan, $1.2 million was a prepayment premium and $12.5 million was an amendment fee. The outstanding balance of the Term Loan after the amendment totaled $140.5 million. In accordance with Accounting Standards Codification (ASC) 470-50, *Debt Modifications and Extinguishments*, the amendment was considered a significant modification, which required us to account for the Term Loan and related unamortized costs as an extinguishment and record the amended Term Loan at fair value. As a result, we recorded a charge to interest expense totaling $45.8 million in the first quarter of fiscal year 2011. The charge consists of $20.3 million related to the unamortized discount associated with the warrants issued in connection with the Term Loan, the $12.5 million amendment fee, $10.3 million related to the unamortized debt issuance costs associated with the Term Loan and $2.7 million related to the prepayment premium and other costs associated with the amendment.

The Term Loan bears interest at 15 percent payable on a quarterly basis. We may repay all or any portion of the Term Loan with the following penalty prior to maturity: (i) 10 percent during the first year; (ii) 7.5 percent during the second year; (iii) 5.0 percent during the third year; (iv) 2.5 percent during the fourth year and (v) no penalty in the fifth year. Our ability to repay the Term Loan prior to maturity is restricted by certain conditions under the Revolving Credit Agreement. As of April 30, 2012, we are not restricted by any conditions governing repayment of the Term Loan prior to maturity.

The Term Loan contains various covenants, as defined in the agreement, including maintaining minimum store contribution thresholds for Piercing Pagoda and Zale Canada, as defined, and restrictions on the incurrence of certain indebtedness, liens, investments, acquisitions and asset sales. The Piercing Pagoda and Zale Canada minimum store contribution threshold for the twelve-month period ended April 30, 2012 is $24 million and CAD $34 million, respectively. As of April 30, 2012, store contribution for Piercing Pagoda and Zale Canada would have to decline by more than 27 percent and 26 percent, respectively, to breach these covenants. The Piercing Pagoda minimum store contribution thresholds for the next twelve months range from $26 million to $31 million. The Zale Canada minimum store contribution thresholds for the next twelve months range from CAD $36 million to CAD $41 million. Liquidity (as defined in the Term Loan) was $244.0 million as of April 30, 2012, which exceeded the $135 million minimum liquidity requirement under the Term Loan by approximately $109 million. As of April 30, 2012, we were in compliance with all covenants under the Term Loan.

Warrant and Registration Rights Agreement

In connection with the execution of the Term Loan in May 2010, we entered into a Warrant and Registration Rights Agreement (the Warrant Agreement) with Z Investment Holdings, LLC. Under the terms of the Warrant Agreement, we issued 6.4 million A-Warrants and 4.7 million B-Warrants (collectively, the Warrants) to purchase shares of our common stock, on a one-for-one basis, for an exercise price of $2.00 per share. The Warrants, which are currently exercisable and expire seven years after issuance, represented 25 percent of our common stock on a fully diluted basis (including the shares issuable upon exercise of the Warrants and excluding certain out-of-the-money stock options) as of the date of the issuance. The A-Warrants were exercisable immediately; however, the B-Warrants were not exercisable until the shares of common stock to be issued upon exercise of the B-Warrants were approved by our stockholders, which occurred on July 23, 2010. The number of shares and exercise price are subject to customary antidilution protection. The Warrant Agreement also entitles the holder to designate two, and in certain circumstances three, directors to our board. The holders of the Warrants may, at their option, request that we register for resale all or part of the common stock issuable under the Warrant Agreement.

The fair value of the Warrants totaled $21.3 million as of the date of issuance and was recorded as a long-term liability, with a corresponding discount to the carrying value of the Term Loan. On July 23, 2010, the stockholders approved the shares of common stock to be issued upon exercise of the B-Warrants. The long-term liability associated with the Warrants was marked-to-market as of the date of the stockholder approval resulting in an $8.3 million gain during the fourth quarter of fiscal year 2010. The remaining amount of $13.0 million was reclassified to stockholders investment and is included in additional paid-in capital in the accompanying consolidated balance sheets. Issuance costs attributable to the Warrants totaling $1.7 million were expensed on the date of issuance. As indicated above, the remaining

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unamortized discount as of September 24, 2010 totaling $20.3 million associated with the Warrants was charged to interest expense during the first quarter of fiscal year 2011.

Capital Lease Obligations

In fiscal year 2012, we entered into capital leases related to vehicles for our field management. The vehicles are included in property and equipment in the accompanying consolidated balance sheet and are depreciated over a five-year life. The amount capitalized during the nine months ended April 30, 2012 totaled $3.5 million; such amount is a non-cash item and therefore excluded from the consolidated statement of cash flows.

Private Label Credit Card Programs

On May 7, 2010, we entered into a five year Private Label Credit Card Program Agreement (the TD Agreement) with TD Financing Services Inc. (TDFS) to provide financing for our Canadian customers to purchase merchandise through private label credit cards beginning July 1, 2010. In addition, TDFS provides credit insurance for our customers and receives 40 percent of the net profits, as defined, and the remaining 60 percent is paid to us. The TD Agreement replaced the agreement with Citi Cards Canada Inc., which expired on June 30, 2010. The TD Agreement will automatically renew for successive one-year periods, unless either party notifies the other in writing of its intent not to renew. The agreement may be terminated at any time during the 90-day period following the end of a program year in the event that credit sales are less than $50 million in the immediately preceding year. If TDFS terminates the agreement as a result of a breach by us, we will be required to pay a termination fee of $1.0 million in the first year, $0.7 million in the second year or $0.3 million in the third year. As of April 30, 2012, we expect to exceed the $50 million threshold for the program year ending June 30, 2012. Our customers use our private label credit card to pay for approximately 19 percent of purchases in Canada.

On September 23, 2010, we entered into a five year agreement to amend and restate various terms of the Merchant Services Agreement (MSA) with Citibank (South Dakota), N.A. (Citibank), to provide financing for our U.S. customers to purchase merchandise through private label credit cards beginning October 1, 2010. The MSA will automatically renew for successive two-year periods, unless either party notifies the other in writing of its intent not to renew. In addition, the MSA can be terminated by either party upon certain breaches by the other party and also can be terminated by Citibank if our net credit card sales during any twelve-month period are less than $315 million or if net card sales during a twelve-month period decrease by 20 percent or more from the prior twelve-month period. We may be obligated to purchase the credit card portfolio upon termination with Citibank as a result of insolvency, material breaches of the MSA and violations of applicable law related to the credit card program. As of April 30, 2012, we were in compliance with all covenants under the MSA. As of April 30, 2012, we expect to exceed the $315 million threshold for the program year ending September 30, 2012. Our customers use our private label credit card to pay for approximately 36 percent of purchases in the U.S.

We also have agreements with certain other credit providers to offer alternative financing options to our U.S. customers who have been declined by Citibank.

Capital Expenditures

During the nine months ended April 30, 2012, we invested $9.7 million to remodel, relocate and refurbish 32 stores in Fine Jewelry and to complete store enhancement projects. We invested $0.4 million in capital expenditures to convert three Gordon s stores to the Zales nameplate in Fine Jewelry and to open two stores in Kiosk Jewelry. We also invested $4.1 million in infrastructure, primarily related to our information technology. We anticipate investing approximately $9 million in capital expenditures for the remainder of fiscal year 2012, including $6 million in existing store refurbishments, approximately $2 million in capital investments related to information technology infrastructure and support operations and $1 million to convert seven Gordon s stores to the Zales or Zales Outlet nameplate.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04). ASU 2011-04 amends ASC 820, *Fair Value Measurements and Disclosures,* to improve comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and

International Financial Reporting Standards. The amendment is effective during interim and annual periods beginning after December 15, 2011. We adopted this standard effective February 1, 2012. There was not a material impact from the adoption of this guidance on our consolidated financial statements.

In June 2011, the FASB issued Accounting Standards Update 2011-05, *Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 eliminates the option to present components of other comprehensive income as part of the statement of changes in stockholders equity. The amendment will instead require that all nonowner changes in stockholders equity be presented either in a single continuous statement, referred to as the statement of comprehensive income, or in two separate but consecutive statements. The amendment is effective for fiscal years beginning after December 15, 2011. We do not expect a material impact from the adoption of this guidance on our consolidated financial statements.

In August 2011, the FASB issued Accounting Standards Update 2011-08, *Intangibles Goodwill and Other* (ASU 2011-08), which will simplify the rules for testing goodwill for impairment. ASU 2011-08 will allow entities to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether a company should perform the two-step impairment test as required under ASC 350, *Intangibles Goodwill and Other*. The amendment is effective for goodwill impairment tests performed for fiscal years beginning after December 15, 2011. We do not expect a material impact from the adoption of this guidance on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Risk. We are not subject to significant gains or losses as a result of currency fluctuations because most of our purchases are U.S. dollar-denominated. However, our Canadian operations expose us to market risk from currency rate exposures, which may adversely affect our results of operations. During the nine months ended April 30, 2012 and 2011, the average Canadian currency rate depreciated by approximately one percent and appreciated by approximately five percent, respectively, relative to the U.S. dollar as compared to the prior year period. The depreciation in the Canadian currency rate for the nine months ended April 30, 2012 resulted in a $1.4 million decrease in reported revenues, offset by an decrease in reported cost of sales and selling, general and administrative expenses of $0.6 million and $0.5 million, respectively. The appreciation in the Canadian currency rate for the nine months ended April 30, 2011 resulted in a $10.8 million increase in reported revenues, offset by an increase in reported cost of sales and selling, general and administrative expenses of $5.2 million and $4.3 million, respectively. In addition, as a result of fluctuations in the Canadian dollar, we recorded a loss totaling $1.5 million and a gain totaling $1.2 million primarily associated with the settlement of Canadian accounts payable during the nine months ended April 30, 2012 and 2011, respectively.

Inflation. Substantially all U.S. inventories represent finished goods, which are valued using the last-in, first-out (LIFO) retail inventory method. We are required to determine the LIFO cost on an interim basis by estimating annual inflation trends, annual purchases and ending inventory. The inflation rates pertaining to merchandise inventories, especially as they relate to diamond, gold and silver costs, are primary components in determining our LIFO inventory. As a result of commodity cost increases, we have recorded LIFO charges in cost of sales totaling $7.8 million and $5.4 million during the three months ended April 30, 2012 and 2011, respectively. We also recorded LIFO charges totaling $16.2 million and $9.1 million during the nine months ended April 30, 2012 and 2011, respectively. The LIFO inventory reserve included in the consolidated balance sheets as of April 30, 2012 and 2011 totaled $52.1 million and $28.1 million, respectively. It is likely that the increase in commodity prices will continue to result in higher merchandise costs, which could materially affect us in the future.

At April 30, 2012, there were no other material changes in any of the market risk information disclosed by us in our Annual Report on Form 10-K for the fiscal year ended July 31, 2011. More detailed information concerning market risk can be found under the sub-caption Item 7A, Quantitative and Qualitative Disclosures about Market Risk of the caption Management s Discussion and Analysis of Financial Condition and Results of Operations on page 33 of our Annual Report on Form 10-K for the fiscal year ended July 31, 2011.

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ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective in enabling us to record, process, summarize and report information required to be included in the Company s periodic SEC filings within the required time period, and that such information is accumulated and communicated to the Company s management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting during the quarter ended April 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II. Other Information

ITEM 1. LEGAL PROCEEDINGS

Information regarding legal proceedings is incorporated by reference from Note 11 to our consolidated financial statements set forth, under the heading, Contingencies, in Part I of this report.

ITEM 1A. RISK FACTORS

We make forward-looking statements in this Quarterly Report on Form 10-Q and in other reports we file with the Securities and Exchange Commission (SEC). In addition, members of our senior management make forward-looking statements orally in presentations to analysts, investors, the media and others. Forward-looking statements include statements regarding our objectives and expectations with respect to our financial plan, sales and earnings, merchandising and marketing strategies, acquisitions and dispositions, share repurchases, store openings, renovations, remodeling and expansion, inventory management and performance, liquidity and cash flows, capital structure, capital expenditures, development of our information technology and telecommunications plans and related management information systems, e-commerce initiatives, human resource initiatives and other statements regarding our plans and objectives. In addition, the words plans to, anticipate, estimate, project, intend, expect, believe, forecast, can, could, should, will, may, or similar expressions may statements, but some of these statements may use other phrasing. These forward-looking statements are intended to relay our expectations about the future, and speak only as of the date they are made. We disclaim any obligation to update or revise publicly or otherwise any forward-looking statements to reflect subsequent events, new information or future circumstances.

Forward-looking statements are not guarantees of future performance and a variety of factors could cause our actual results to differ materially from the anticipated or expected results expressed in or suggested by these forward-looking statements.

If the general economy performs poorly, discretionary spending on goods that are, or are perceived to be, luxuries may not grow and may decrease.

Jewelry purchases are discretionary and may be affected by adverse trends in the general economy (and consumer perceptions of those trends). In addition, a number of other factors affecting consumers such as employment, wages and salaries, business conditions, energy costs, credit availability and taxation policies, for the economy as a whole and in regional and local markets where we operate, can impact sales and earnings. The economic downturn that began in 2008 has significantly impacted our sales and the continuation of this downturn, and particularly its worsening, would have a material adverse impact on our business and financial condition.

The concentration of a substantial portion of our sales in three relatively brief selling periods means that our performance is more susceptible to disruptions.

A substantial portion of our sales are derived from three selling periods Holiday (Christmas), Valentine s Day and Mother s Day. Because of the briefness of these three selling periods, the opportunity for sales to recover in the event of a disruption or other difficulty is limited, and the impact of disruptions and difficulties can be significant. For instance, adverse weather (such as a blizzard or hurricane), a significant interruption in the receipt of products (whether because of vendor or other product problems), or a sharp decline in mall traffic occurring during one of these selling periods could materially impact sales for the affected period and, because of the importance of each of these selling periods, commensurately impact overall sales and earnings.

Any disruption in the supply of finished goods from our largest merchandise vendors could adversely impact our sales.

We purchase substantial amounts of finished goods from our five largest merchandise vendors. If our supply with these top vendors was disrupted, particularly at certain critical times of the year, our sales could be adversely affected in the short-term until alternative supply arrangements could be established.

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Most of our sales are of products that include diamonds, precious metals and other commodities. A substantial portion of our purchases and sales occur outside the United States. Fluctuations in the availability and pricing of commodities or exchange rates could impact our ability to obtain, produce and sell products at favorable prices.

The supply and price of diamonds in the principal world market are significantly influenced by a single entity, which has traditionally controlled the marketing of a substantial majority of the world s supply of diamonds and sells rough diamonds to worldwide diamond cutters at prices determined in its sole discretion. The availability of diamonds also is somewhat dependent on the political conditions in diamond-producing countries and on the continuing supply of raw diamonds. Any sustained interruption in this supply could have an adverse affect on our business.

We also are affected by fluctuations in the price of diamonds, gold and other commodities. A significant change in prices of key commodities could adversely affect our business by reducing operating margins or decreasing consumer demand if retail prices are increased significantly. Our vendors have experienced significant increases in commodity costs, especially diamond, gold and silver costs. It is likely that the increase in commodity prices will result in higher merchandise costs, which could materially affect us in the future. In addition, foreign currency exchange rates and fluctuations impact costs and cash flows associated with our Canadian operations and the acquisition of inventory from international vendors.

A substantial portion of our raw materials and finished goods are sourced in countries generally described as having developing economies. Any instability in these economies could result in an interruption of our supplies, increases in costs, legal challenges and other difficulties.

The U.S. Dodd-Frank Act requires the SEC to issue rules, which are still being prepared, for the disclosure and reporting on the use of certain minerals, including gold, which come from the conflict zones of the Democratic Republic of Congo and adjoining countries. The supply chain for gold and other minerals is complex and it is estimated that the rules will likely add to the Company s costs, but this increase is not expected to be material.

Our sales are dependent upon mall traffic.

Our stores and kiosks are located primarily in shopping malls throughout the U.S., Canada and Puerto Rico. Our success is in part dependent upon the continued popularity of malls as a shopping destination and the ability of malls, their tenants and other mall attractions to generate customer traffic. Accordingly, a significant decline in this popularity, especially if it is sustained, would substantially harm our sales and earnings. In addition, even assuming this popularity continues, mall traffic can be negatively impacted by weather, gas prices and similar factors.

We operate in a highly competitive and fragmented industry.

The retail jewelry business is highly competitive and fragmented, and we compete with nationally recognized jewelry chains as well as a large number of independent regional and local jewelry retailers and other types of retailers who sell jewelry and gift items, such as department stores and mass merchandisers. We also compete with internet sellers of jewelry. Because of the breadth and depth of this competition, we are constantly under competitive pressure that both constrains pricing and requires extensive merchandising efforts in order for us to remain competitive.

Any failure by us to manage our inventory effectively will negatively impact our financial condition, sales and earnings.

We purchase much of our inventory well in advance of each selling period. In the event we misjudge consumer preferences or demand, we will experience lower sales than expected and will have excessive inventory that may need to be written down in value or sold at prices that are less than expected, which could have a material adverse impact on our business and financial condition.

Any failure of our pricing and promotional strategies to be as effective as desired will negatively impact our sales and earnings.

We set the prices for our products and establish product specific and store-wide promotions in order to generate store traffic and sales. While these decisions are intended to maximize our sales and earnings, in some instances they do not. For instance, promotions, which can require substantial lead time, may not be as effective as desired or may prove

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unnecessary in certain economic circumstances. Where we have implemented a pricing or promotional strategy that does not work as expected, our sales and earnings will be adversely impacted.

Because of our dependence upon a small concentrated number of landlords for a substantial number of our locations, any significant erosion of our relationships with those landlords or their financial condition would negatively impact our ability to obtain and retain store locations.

We are significantly dependent on our ability to operate stores in desirable locations with capital investment and lease costs that allow us to earn a reasonable return on our locations. We depend on the leasing market and our landlords to determine supply, demand, lease cost and operating costs and conditions. We cannot be certain as to when or whether desirable store locations will become or remain available to us at reasonable lease and operating costs. Several large landlords dominate the ownership of prime malls, and we are dependent upon maintaining good relations with those landlords in order to obtain and retain store locations on optimal terms. From time to time, we do have disagreements with our landlords and a significant disagreement, if not resolved, could have an adverse impact on our business. In addition, any financial weakness on the part of our landlords could adversely impact us in a number of ways, including decreased marketing by the landlords and the loss of other tenants that generate mall traffic.

Any disruption in, or changes to, our private label credit card arrangements may adversely affect our ability to provide consumer credit and write credit insurance.

We rely on third party credit providers to provide financing for our customers to purchase merchandise and credit insurance through private label credit cards. Any disruption in, or changes to, our credit card agreements would adversely affect our sales and earnings.

Significant restrictions in the amount of credit available to our customers could negatively impact our business and financial condition.

Our customers rely heavily on financing provided by credit card companies to purchase our merchandise. The availability of credit to our customers is impacted by numerous factors, including general economic conditions and regulatory requirements relating to the extension of credit. Numerous federal and state laws impose disclosure and other requirements upon the origination, servicing and enforcement of credit accounts and limitations on the maximum amount of finance charges that may be charged by a credit provider. Regulations implementing the Credit Card Accountability Responsibility and Disclosure Act of 2009 imposed new restrictions on credit card pricing, finance charges and fees, customer billing practices and payment application that have negatively impacted the availability of credit to our customers. Future regulations or changes in the application of current laws could further impact the availability of credit to our customers. If the amount of available credit provided to our customers is significantly restricted, our sales and earnings would be negatively impacted.

We are dependent upon our revolving credit agreement, senior secured term loan and other third party financing arrangements for our liquidity needs.

We have a revolving credit agreement and a senior secured term loan that contain various financial and other covenants. Should we be unable to fulfill the covenants contained in these loans, we would be in default, all outstanding amounts will be immediately due, and we would be unable to fund our operations without a significant restructuring of our business.

If the credit markets deteriorate, our ability to obtain the financing needed to operate our business could be adversely impacted.

We utilize a revolving credit agreement to finance our working capital requirements, including the purchase of inventory, among other things. If our ability to obtain the financing needed to meet these requirements was adversely impacted as a result of continued deterioration in the credit markets, our business could be significantly impacted. In addition, the amount of available borrowings under our revolving credit agreement is based, in part, on the appraised liquidation value of our inventory. Any declines in the appraised value of our inventory could impact our ability to obtain the financing necessary to operate our business.

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Any security breach with respect to our information technology systems could result in legal or financial liabilities, damage to our reputation and a loss of customer confidence.

During the course of our business, we regularly obtain and transmit through our information technology systems customer credit and other data. If our information technology systems are breached due to the actions of outside parties, or otherwise, an unauthorized third party may obtain access to confidential customer information. Any breach of our systems that results in unauthorized access to customer information could cause us to incur significant legal and financial liabilities, damage to our reputation and a loss of customer confidence. In each case, these impacts could have an adverse effect on our business and results of operations.

Acquisitions and dispositions involve special risk, including the risk that we may not be able to complete proposed acquisitions or dispositions or that such transactions may not be beneficial to us.

We have made significant acquisitions and dispositions in the past and may in the future make additional acquisitions and dispositions. Difficulty integrating an acquisition into our existing infrastructure and operations may cause us to fail to realize expected return on investment through revenue increases, cost savings, increases in geographic or product presence and customer reach, and/or other projected benefits from the acquisition. In addition, we may not achieve anticipated cost savings or may be unable to find attractive investment opportunities for funds received in connection with a disposition. Additionally, attractive acquisition or disposition opportunities may not be available at the time or pursuant to terms acceptable to us and we may be unable to complete acquisitions or dispositions.

Ineffective internal controls can have adverse impacts on the Company.

Under Federal law, we are required to maintain an effective system of internal controls over financial reporting. Should we not maintain an effective system, it would result in a violation of those laws and could impair our ability to produce accurate and timely financial statements. In turn, this could result in increased audit costs, a loss of investor confidence, difficulties in accessing the capital markets, and regulatory and other actions against us. Any of these outcomes could be costly to both our shareholders and us.

Changes in estimates, assumptions and judgments made by management related to our evaluation of goodwill and other long-lived assets for impairment could significantly affect our financial results.

Evaluating goodwill and other long-lived assets for impairment is highly complex and involves many subjective estimates, assumptions and judgments by our management. For instance, management makes estimates and assumptions with respect to future cash flow projections, terminal growth rates, discount rates and long-term business plans. If our actual results are not consistent with our estimates, assumptions and judgments made by management, we may be required to recognize impairments.

Additional factors may adversely affect our financial performance.

Increases in expenses that are beyond our control including items such as increases in interest rates, inflation, fluctuations in foreign currency rates, higher tax rates and changes in laws and regulations, may negatively impact our operating results.

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ITEM 6. EXHIBITS

The following exhibits are filed as part of, or incorporated by reference into, this Quarterly Report on Form 10-Q.

Exhibit Number	Description of Exhibit
31.1*	Rule 13a-14(a) Certification of Principal Executive Officer
31.2*	Rule 13a-14(a) Certification of Chief Administrative Officer
31.3*	Rule 13a-14(a) Certification of Principal Financial Officer
32.1*	Section 1350 Certification of Principal Executive Officer
32.2*	Section 1350 Certification of Chief Administrative Officer
32.3*	Section 1350 Certification of Principal Financial Officer
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase
101.DEF**	XBRL Taxonomy Extension Definition Linkbase
101.LAB**	XBRL Taxonomy Extension Label Linkbase
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase

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* Filed herewith.

** These exhibits are furnished herewith. In accordance with Rule 406T of Regulation S-T, these exhibits are not deemed to be filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are not deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.

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SIGNATURE

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.

ZALE CORPORATION
(Registrant)

Date: June 7, 2012	By:	/s/ THOMAS A. HAUBENSTRICKER Thomas A. Haubenstricker Senior Vice President, Chief Financial Officer (principal financial officer of the registrant)