

WILLIAMS SONOMA INC  
Form 10-Q  
June 11, 2008  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended May 4, 2008.

or

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

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

Commission File Number: 001-14077

**WILLIAMS-SONOMA, INC.**

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(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of incorporation or organization)

94-2203880  
(I.R.S. Employer Identification No.)

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3250 Van Ness Avenue, San Francisco, CA  
(Address of principal executive offices)

94109  
(Zip Code)

Registrant's telephone number, including area code: (415) 421-7900

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company)

Accelerated filer   
Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes

No

As of June 1, 2008, 105,561,812 shares of the registrant's Common Stock were outstanding.

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**WILLIAMS-SONOMA, INC.**  
**REPORT ON FORM 10-Q**  
**FOR THE QUARTER ENDED MAY 4, 2008**

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**Table of Contents****ITEM 1. FINANCIAL STATEMENTS****WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited)

| <i>Dollars and shares in thousands, except per share amounts</i>  | May 4,<br>2008 | February 3,<br>2008 | April 29,<br>2007 |
|---|----------------|---------------------|-------------------|
| <b>ASSETS</b>   |                |                     |                   |
| Current assets  |                |                     |                   |
| Cash and cash equivalents   | \$ 26,838      | \$ 118,950          | \$ 117,363        |
| Accounts receivable   | 60,413         | 48,052              | 43,630            |
| Merchandise inventories net   | 713,691        | 693,661             | 639,350           |
| Prepaid catalog expenses  | 54,268         | 54,907              | 60,333            |
| Prepaid expenses  | 42,720         | 32,276              | 37,450            |
| Deferred income taxes   | 91,816         | 91,843              | 70,903            |
| Other assets  | 8,404          | 10,086              | 7,126             |
| Total current assets  | 998,150        | 1,049,775           | 976,155           |
| Property and equipment net  | 995,734        | 981,075             | 910,965           |
| Non-current deferred income taxes   | 47,032         | 44,997              | 33,837            |
| Other assets  | 18,626         | 18,007              | 16,369            |
| Total assets  | \$ 2,059,542   | \$ 2,093,854        | \$ 1,937,326      |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                |                     |                   |
| Current liabilities   |                |                     |                   |
| Accounts payable  | \$ 177,341     | \$ 197,561          | \$ 156,088        |
| Accrued salaries, benefits and other  | 82,505         | 95,383              | 83,254            |
| Customer deposits   | 192,403        | 201,743             | 192,070           |
| Income taxes payable  | 16,648         | 83,984              | 5,654             |
| Current portion of long-term debt   | 14,734         | 14,734              | 15,772            |
| Borrowings under line of credit   | 61,000         | -                   | -                 |
| Other liabilities   | 16,642         | 18,129              | 17,538            |
| Total current liabilities   | 561,273        | 611,534             | 470,376           |
| Deferred rent and lease incentives  | 259,874        | 247,836             | 234,608           |
| Long-term debt  | 11,238         | 11,238              | 12,822            |
| Other long-term obligations   | 56,436         | 57,523              | 54,296            |
| Total liabilities   | 888,821        | 928,131             | 772,102           |
| Commitments and contingencies   |                |                     |                   |
| Shareholders equity   |                |                     |                   |
| Preferred stock, \$.01 par value, 7,500 shares authorized, none issued  | -              | -                   | -                 |
| Common stock, \$.01 par value, 253,125 shares authorized, issued and outstanding: 105,546, 105,349 and 110,604 shares at May 4, 2008, February 3, 2008 and April 29, 2007, respectively | 1,055          | 1,054               | 1,106             |
| Additional paid-in capital  | 411,278        | 403,217             | 384,566           |
| Retained earnings   | 743,903        | 746,201             | 768,982           |
| Accumulated other comprehensive income  | 14,485         | 15,251              | 10,570            |
| Total shareholders equity   | 1,170,721      | 1,165,723           | 1,165,224         |
| Total liabilities and shareholders equity   | \$ 2,059,542   | \$ 2,093,854        | \$ 1,937,326      |

*See Notes to Condensed Consolidated Financial Statements.*



**Table of Contents****WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

(Unaudited)

|  | Thirteen Weeks Ended |            |
|--|----------------------|------------|
|  | May 4,               | April      |
|  | 2008                 | 2007       |
| <i>Dollars and shares in thousands, except per share amounts</i> |                      |            |
| Net revenues   | \$ 781,784           | \$ 816,051 |
| Cost of goods sold   | 505,565              | 514,081    |
| Gross margin   | 276,219              | 301,970    |
| Selling, general and administrative expenses                     | 259,336              | 273,528    |
| Interest income  | (577)                | (2,470)    |
| Interest expense   | 398                  | 531        |
| Earnings before income taxes                                     | 17,062               | 30,381     |
| Income taxes   | 6,615                | 12,231     |
| Net earnings   | \$ 10,447            | \$ 18,150  |
| Basic earnings per share   | \$ 0.10              | \$ 0.16    |
| Diluted earnings per share                                       | \$ 0.10              | \$ 0.16    |
| Shares used in calculation of earnings per share:                |                      |            |
| Basic  | 105,400              | 110,036    |
| Diluted  | 107,114              | 112,355    |

*See Notes to Condensed Consolidated Financial Statements.*

**Table of Contents****WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

|   | Thirteen Weeks Ended |            |
|---|----------------------|------------|
|   | May 4,               | April 29,  |
| <i>Dollars in thousands</i>   | 2008                 | 2007       |
| Cash flows from operating activities:   |                      |            |
| Net earnings  | \$ 10,447            | \$ 18,150  |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: |                      |            |
| Depreciation and amortization   | 37,132               | 34,425     |
| Loss on disposal/impairment of assets   | 1,413                | 1,547      |
| Amortization of deferred lease incentives   | (7,852)              | (6,837)    |
| Deferred income taxes   | (2,113)              | (15,141)   |
| Tax benefit from exercise of stock options  | 875                  | 2,871      |
| Stock-based compensation expense  | 6,556                | 6,009      |
| Other   | (416)                | -          |
| Changes in:   |                      |            |
| Accounts receivable   | (13,039)             | 5,643      |
| Merchandise inventories   | (20,203)             | (28,271)   |
| Prepaid catalog expenses  | 639                  | (723)      |
| Prepaid expenses and other assets   | (9,180)              | (8,175)    |
| Accounts payable  | (20,546)             | (61,917)   |
| Accrued salaries, benefits and other current and long-term liabilities                        | (15,451)             | 26,640     |
| Customer deposits   | (9,266)              | 4,264      |
| Deferred rent and lease incentives  | 19,996               | 4,454      |
| Income taxes payable  | (67,334)             | (107,674)  |
| Net cash used in operating activities   | (88,342)             | (124,735)  |
| Cash flows from investing activities:   |                      |            |
| Purchases of property and equipment   | (53,481)             | (31,860)   |
| Proceeds from insurance reimbursement   | 632                  | -          |
| Other   | (152)                | (357)      |
| Net cash used in investing activities   | (53,001)             | (32,217)   |
| Cash flows from financing activities:   |                      |            |
| Repayments of long-term obligations   | -                    | (81)       |
| Net borrowings under line of credit   | 61,000               | -          |
| Net proceeds from exercise of stock options   | (203)                | 13,633     |
| Excess tax benefit from exercise of stock options   | 908                  | 4,599      |
| Payment of dividends  | (12,210)             | (11,072)   |
| Repurchase of common stock  | -                    | (9,764)    |
| Net cash provided by (used in) financing activities   | 49,495               | (2,685)    |
| Effect of exchange rates on cash and cash equivalents   | (264)                | 1,571      |
| Net decrease in cash and cash equivalents   | (92,112)             | (158,066)  |
| Cash and cash equivalents at beginning of period  | 118,950              | 275,429    |
| Cash and cash equivalents at end of period  | \$ 26,838            | \$ 117,363 |

See Notes to Condensed Consolidated Financial Statements.

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**WILLIAMS-SONOMA, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Thirteen Weeks Ended May 4, 2008 and April 29, 2007

(Unaudited)

**NOTE A. FINANCIAL STATEMENTS - BASIS OF PRESENTATION**

These financial statements include Williams-Sonoma, Inc. and its wholly owned subsidiaries ( we, us or our ). The condensed consolidated balance sheets as of May 4, 2008 and April 29, 2007, the condensed consolidated statements of earnings and cash flows for the thirteen weeks ended May 4, 2008 ( first quarter of fiscal 2008 ) and April 29, 2007 ( first quarter of fiscal 2007 ) have been prepared by us, without audit. In our opinion, the financial statements include all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position at the balance sheet dates and the results of operations for the thirteen weeks then ended. Significant intercompany transactions and accounts have been eliminated. The balance sheet as of February 3, 2008, presented herein, has been derived from our audited balance sheet included in our Annual Report on Form 10-K for the fiscal year ended February 3, 2008.

The results of operations for the first quarter of fiscal 2008 are not necessarily indicative of the operating results of the full year.

Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended February 3, 2008.

**NOTE B. ACCOUNTING POLICIES**

*Recent Accounting Pronouncements*

On February 4, 2008, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements*, for all financial assets and liabilities. SFAS No. 157 establishes a standard definition for fair value, provides a framework under generally accepted accounting principles for measuring fair value and expands disclosure requirements for fair value measurements. In December 2007, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position ( FSP ) No. 157-b, *Effective Date of FASB No. 157*, which delayed the effective date of SFAS No. 157 for all nonfinancial assets and liabilities (except those recognized or disclosed at fair value in the financial statements on a recurring basis) to annual reporting periods beginning after November 15, 2008. We do not have significant financial assets and liabilities or nonfinancial assets and liabilities recognized or disclosed at fair value on a recurring basis and, as such, the adoption of SFAS No. 157 did not have a material impact on our consolidated financial position, results of operations or cash flows.

On February 4, 2008, we adopted the provisions of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified



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election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The adoption of SFAS No. 159 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* ( SFAS 141(R) ), which will change the accounting for business combinations. Under SFAS 141(R), an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition date fair

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value with limited exceptions. SFAS 141(R) will change the accounting treatment for certain specific acquisition-related items, including expensing acquisition-related costs as incurred, valuing non-controlling interests (minority interests) at fair value at the acquisition date, and expensing restructuring costs associated with an acquired business. SFAS 141(R) applies prospectively, with limited exceptions, to business combinations for which the acquisition date is on or after the first fiscal period beginning on or after December 15, 2008. Early adoption is not permitted. Generally, the effect of SFAS 141(R) will depend on future acquisitions and, as such, we do not currently expect the adoption of this Statement to have a material impact on our consolidated financial position, results of operations or cash flows.

## **NOTE C. STOCK-BASED AND OTHER LONG-TERM INCENTIVE COMPENSATION**

We provide long-term compensation to our employees through various equity and cash award programs.

### *Equity Award Programs*

Our Amended and Restated 2001 Long-Term Incentive Plan (the *Plan*) provides for grants of incentive stock options, nonqualified stock options, stock-settled stock appreciation rights (collectively, *option awards*), restricted stock awards, restricted stock units, deferred stock awards (collectively, *stock awards*) and dividend equivalents up to an aggregate of 15,959,903 shares. As of May 4, 2008, there were approximately 5,286,000 shares available for future grant. Awards may be granted under the Plan to officers, employees and non-employee Board members of the company or any parent or subsidiary. Annual grants are limited to 1,000,000 shares covered by option awards and 400,000 shares covered by stock awards on a per person basis. All grants of option awards made under the Plan have a maximum term of ten years, except incentive stock options that may be issued to 10% shareholders, which have a maximum term of five years. The exercise price of these option awards is not less than 100% of the closing price of our stock on the date prior to the grant date or not less than 110% of such closing price for an incentive stock option granted to a 10% shareholder. Option awards granted to employees generally vest over five years. Stock awards granted to employees generally vest over a period of three to five years for service based awards, and four and five years for performance based awards. Certain option and stock awards contain vesting acceleration clauses in the event of a merger or similar corporate event. Option and stock awards granted to non-employee Board members generally vest in one year. Non-employee Board members automatically receive stock awards on the date of their initial election to the Board and annually thereafter on the date of the annual meeting of shareholders (so long as they continue to serve as a non-employee Board member). Shares issued as a result of option award exercises and the vesting of stock awards will be funded with the issuance of new shares.

### *Stock-Based Compensation Expense*

We account for stock-based compensation arrangements in accordance with SFAS No. 123R, *Share-Based Payment*, which requires us to measure and record compensation expense in our consolidated financial statements for all employee stock-based awards using a fair value method.

**Table of Contents***Stock Options*

The following table summarizes our stock option activity during the thirteen weeks ended May 4, 2008:

|   | Shares    |
|---|-----------|
| Balance at February 3, 2008                 | 6,631,149 |
| Granted <sup>1</sup>                        | -         |
| Exercised                                   | (394,892) |
| Canceled                                    | (91,409)  |
| Balance at May 4, 2008                      | 6,144,848 |
| Vested at May 4, 2008                       | 5,204,178 |
| Vested plus expected to vest at May 4, 2008 | 6,033,368 |

<sup>1</sup> In fiscal 2006, we began issuing stock-settled stock appreciation rights in lieu of stock option grants. Therefore, no stock options have been granted during the thirteen weeks ended May 4, 2008. See the stock-settled stock appreciation rights table below.

*Stock-Settled Stock Appreciation Rights*

The following table summarizes our stock-settled stock appreciation right activity during the thirteen weeks ended May 4, 2008:

|   | Shares    |
|---|-----------|
| Balance at February 3, 2008                     | 3,286,470 |
| Granted (weighted average fair value of \$8.63) | 17,000    |
| Converted                                       | -         |
| Canceled  | (80,540)  |
| Balance at May 4, 2008                          | 3,222,930 |
| Vested at May 4, 2008                           | 683,498   |
| Vested plus expected to vest at May 4, 2008     | 2,716,881 |

The weighted-average assumptions associated with option awards issued during the thirteen weeks ended May 4, 2008 and April 29, 2007 are as follows:

|                         | Thirteen Weeks Ended |                   |
|-------------------------|----------------------|-------------------|
|                         | May 4,<br>2008       | April 29,<br>2007 |
| Expected term (years)   | 5.1                  | 5.0               |
| Expected volatility     | 41.5%                | 33.2%             |
| Risk-free interest rate | 2.9%                 | 4.5%              |
| Dividend yield          | 1.5%                 | 1.0%              |

**Table of Contents***Restricted Stock Units*

The following table summarizes restricted stock unit activity during the thirteen weeks ended May 4, 2008:

|                                 | Shares    |
|---------------------------------|-----------|
| Balance at February 3, 2008     | 831,800   |
| Granted                         | 385,261   |
| Vested                          | -         |
| Canceled                        | (40,000)  |
| Balance at May 4, 2008          | 1,177,061 |
| Vested at May 4, 2008           | -         |
| Expected to vest at May 4, 2008 | 1,028,702 |

*Other Long-Term Incentive Awards*

Beginning in fiscal 2008, we began issuing long-term cash-based awards to certain employees, in lieu of option awards. The cash award allows the recipient to receive a fixed cash payment upon vesting, which typically occurs at the end of a four-year service period. Compensation expense for these cash awards is recorded on a straight-line basis over the term of the award based on the fixed value of the award, adjusted for the percentage of the awards expected to be issued on the vest date. On May 2, 2008, we issued cash awards with a fair value of \$4,182,000 to employees with a four-year cliff vesting schedule. No cash awards were issued during fiscal 2007.

*Total Stock-Based and Other Long-Term Incentive Compensation Expense*

During the thirteen weeks ended May 4, 2008, we recognized total stock-based and other long-term incentive compensation expense, as a component of selling, general and administrative expenses, of \$6,560,000 (\$5,015,000 for option awards, \$1,541,000 for stock awards, and \$4,000 for other long-term incentive awards). During the thirteen weeks ended April 29, 2007, we recognized total stock-based compensation expense of \$5,995,000.

**NOTE D. BORROWING ARRANGEMENTS***Credit Facility*

As of May 4, 2008, we have a credit facility that provides for a \$300,000,000 unsecured revolving line of credit that may be used for loans or letters of credit and contains certain financial covenants, including a maximum leverage ratio (funded debt adjusted for lease and rent expense to EBITDAR), and covenants limiting our ability to dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens and make investments. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the credit facility of up to \$200,000,000, to provide for a total of \$500,000,000 of unsecured revolving credit. The credit facility contains events of default that include, among others, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, bankruptcy and insolvency events, material judgments, cross defaults to certain other indebtedness and events constituting a change of control. The occurrence of an event

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of default will increase the applicable rate of interest by 2.0% and could result in the acceleration of our obligations under the credit facility and an obligation of any or all of our U.S. subsidiaries to pay the full amount of our obligations under the credit facility. The credit facility matures on October 4, 2011, at which time all outstanding borrowings must be repaid and all outstanding letters of credit must be cash collateralized.

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We may elect interest rates calculated at Bank of America's prime rate (or, if greater, the average rate on overnight federal funds plus one-half of one percent) or LIBOR plus a margin based on our leverage ratio. As of May 4, 2008, an aggregate of \$61,000,000 (at a weighted average interest rate of 3.2%) was outstanding under our credit facility and is recorded within current liabilities as it is our intention to repay this amount within the next twelve months. Additionally, as of May 4, 2008, \$36,229,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. The standby letters of credit were issued to secure the liabilities associated with workers' compensation, other insurance programs and certain debt transactions. As of May 4, 2008, we were in compliance with our financial covenants under the credit facility.

*Letter of Credit Facilities*

On September 8, 2007, we amended our five unsecured commercial letter of credit reimbursement facilities, each of which expires on September 7, 2008, to increase the aggregate credit available under all letter of credit facilities to \$175,000,000. The letter of credit facilities contain substantially similar covenants and provide for substantially similar events of default as the credit facility. Interest on amounts outstanding under the letter of credit facilities accrues at the lender's prime rate (or if greater, the average rate on overnight federal funds plus one-half of one percent). As of May 4, 2008, an aggregate of \$86,518,000 was outstanding under the letter of credit facilities. Such letters of credit represent only a future commitment to fund inventory purchases to which we had not taken legal title as of May 4, 2008. The latest expiration possible for any future letters of credit issued under the facilities is February 4, 2009.

**NOTE E. COMPREHENSIVE INCOME**

Comprehensive income for the thirteen weeks ended May 4, 2008 and April 29, 2007 was as follows:

|   | Thirteen Weeks Ended |           |
|---|----------------------|-----------|
|   | May 4,               | April 29, |
| <i>Dollars in thousands</i>             | 2008                 | 2007      |
| Net earnings                            | \$ 10,447            | \$ 18,150 |
| Other comprehensive income -            |                      |           |
| Foreign currency translation adjustment | (762)                | 2,795     |
| Net unrealized loss on investment       | (3)                  | (9)       |
| Comprehensive income                    | \$ 9,682             | \$ 20,936 |

**NOTE F. EARNINGS PER SHARE**

Basic earnings per share is computed as net earnings divided by the weighted average number of common shares outstanding for the period. Diluted earnings per share is computed as net earnings divided by the weighted average number of common shares outstanding for the period plus common stock equivalents consisting of shares subject to stock-based awards with exercise prices less than or equal to the average market price of our common stock for the period, to the extent their inclusion would be dilutive.

The following is a reconciliation of net earnings and the number of shares used in the basic and diluted earnings per share computations:



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| <i>Dollars and amounts in thousands, except per share amounts</i> | Net<br>Earnings | Weighted<br>Average Shares | Per Share<br>Amount |
|---|-----------------|----------------------------|---------------------|
| <b>Thirteen weeks ended May 4, 2008</b>                           |                 |                            |                     |
| Basic   | \$ 10,447       | 105,400                    | \$ 0.10             |
| Effect of dilutive stock-based awards                             |                 | 1,714                      |                     |
| Diluted   | \$ 10,447       | 107,114                    | \$ 0.10             |
| <b>Thirteen weeks ended April 29, 2007</b>                        |                 |                            |                     |
| Basic   | \$ 18,150       | 110,036                    | \$ 0.16             |
| Effect of dilutive stock-based awards                             |                 | 2,319                      |                     |
| Diluted   | \$ 18,150       | 112,355                    | \$ 0.16             |

Stock-based awards of 6,219,000 and 4,908,000 for the first quarter of fiscal 2008 and the first quarter of fiscal 2007, respectively, were not included in the computation of diluted earnings per share, as their inclusion would be anti-dilutive.

**NOTE G. LEGAL PROCEEDINGS**

We are involved in lawsuits, claims and proceedings incident to the ordinary course of our business. These disputes, which are not currently material, are increasing in number as our business expands and our company grows larger. Litigation is inherently unpredictable. Any claims against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources. The results of these lawsuits, claims and proceedings cannot be predicted with certainty. However, we believe that the ultimate resolution of these current matters will not have a material adverse effect on our consolidated financial statements taken as a whole.

**NOTE H. SEGMENT REPORTING**

We have two reportable segments, retail and direct-to-customer. The retail segment has five merchandising concepts which sell products for the home (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, West Elm and Williams-Sonoma Home). The five retail merchandising concepts are operating segments, which have been aggregated into one reportable segment, retail. The direct-to-customer segment has six merchandising concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, PBteen, West Elm and Williams-Sonoma Home) and sells similar products through our seven direct mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed and Bath, PBteen, West Elm and Williams-Sonoma Home) and six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and wshome.com). Management's expectation is that the overall economics of each of our major concepts within each reportable segment will be similar over time.

These reportable segments are strategic business units that offer similar home-centered products. They are managed separately because the business units utilize two distinct distribution and marketing strategies. It is not practicable for us to report revenue by product group.

We use earnings before unallocated corporate overhead, interest and taxes to evaluate segment profitability. Unallocated costs before income taxes include corporate employee-related costs, occupancy expenses (including depreciation expense), administrative costs and third-party service costs, primarily in our corporate systems, corporate facilities and other administrative departments. Unallocated assets include the net book value of corporate facilities and related information systems, deferred income taxes, other corporate long-lived assets and corporate cash and cash equivalents.



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

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| <i>Dollars in thousands</i>                      | Direct-to- |            |             | Total      |
|--|------------|------------|-------------|------------|
|  | Retail     | Customer   | Unallocated |            |
| <b>Thirteen weeks ended May 4, 2008</b>          |            |            |             |            |
| Net revenues <sup>1</sup>                        | \$ 433,551 | \$ 348,233 | -           | \$ 781,784 |
| Depreciation and amortization expense            | 25,419     | 4,982      | \$ 6,731    | 37,132     |
| Earnings (loss) before income taxes <sup>2</sup> | 17,969     | 49,604     | (50,511)    | 17,062     |
| <b>Assets<sup>3</sup></b>                        |            |            |             |            |
| Capital expenditures                             | 1,183,464  | 369,786    | 506,292     | 2,059,542  |
| <b>Thirteen weeks ended April 29, 2007</b>       |            |            |             |            |
| Net revenues <sup>1</sup>                        | \$ 453,375 | \$ 362,676 | -           | \$ 816,051 |
| Depreciation and amortization expense            | 23,211     | 5,035      | \$ 6,179    | 34,425     |
| Earnings (loss) before income taxes              | 23,690     | 56,135     | (49,444)    | 30,381     |
| <b>Assets<sup>3</sup></b>                        |            |            |             |            |
| Capital expenditures                             | 1,085,916  | 341,631    | 509,779     | 1,937,326  |

<sup>1</sup> Includes revenues in the retail channel of \$18.0 million and \$16.2 million in the first quarter of fiscal 2008 and the first quarter of fiscal 2007, respectively, related to our foreign operations.

<sup>2</sup> Includes a benefit in the retail channel of approximately \$9.4 million related to an incentive payment received from a landlord to compensate us for terminating a store lease prior to its expiration, partially offset by accelerated depreciation of \$1.1 million related to the early termination of this lease.

<sup>3</sup> Includes \$30.0 million and \$23.7 million of long-term assets as of May 4, 2008 and April 29, 2007, respectively, related to our foreign operations.

**NOTE I. SUBSEQUENT EVENTS**

On May 16, 2008, we completed two transactions relating to our corporate aircraft. First, we were able to take advantage of a robust corporate aircraft market and sold our Bombardier Global Express airplane for approximately \$46,800,000 in cash (a net after-tax cash benefit of approximately \$29,000,000) to an unrelated third party. This will result in a gain on sale of asset of approximately \$16,000,000, or \$0.09 per diluted share, in the second quarter of 2008. Second, in order to address our ongoing aircraft needs, we entered into an Aircraft Lease Agreement (the Lease Agreement) with a limited liability company (the LLC) owned by W. Howard Lester, our Chief Executive Officer, Chairman of the Board of Directors and a significant shareholder, for use of a Bombardier Global 5000 owned by the LLC. These transactions were approved by our Board of Directors.

Under the terms of the Lease Agreement, in exchange for use of the aircraft, we will pay the LLC \$375,000 for each of the thirty-six months of the lease term through May 15, 2011. We are also responsible for all use-related costs associated with the aircraft, including fixed costs such as crew salaries and benefits, insurance and hangar costs, and all direct operating costs. Closing costs associated with the Lease Agreement will be divided evenly between us and the LLC, and each party will pay its own attorney and advisor fees. The Lease Agreement is subject to early termination by either party, with 90 days prior written notice, if Mr. Lester retires or otherwise withdraws from active management of the company.

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

**FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they do not fully materialize or prove incorrect, could cause our business and results

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of operations to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include projections of earnings, revenues or financial items, including the impact of accounting changes and our expected effective tax rate, statements of the plans, strategies and objectives of management for future operations, statements related to the future performance of our brands, statements related to our returns, replacements and damages reductions initiative, statements related to our catalog circulation, catalog versioning and paid search strategies, statements related to driving future growth, optimizing asset efficiency and reducing costs, statements related to our plans to open new retail stores and expand or remodel other retail stores, statements related to intensifying our e-commerce marketing initiatives, statements related to upgrading our websites, statements related to our Pottery Barn brand revitalization initiatives, statements related to improving the productivity of advertising costs, statements related to vendor management, quality control and logistics initiatives, statements related to reducing corporate overhead costs, statements related to distribution and facility infrastructure projects, statements related to the adequacy and use of our available cash, including the payment of a dividend, statements related to our projected capital expenditures, statements related to systems development projects, statements related to our stock repurchase program, and statements of belief and statements of assumptions underlying any of the foregoing. You can identify these and other forward-looking statements by the use of words such as may, should, expects, plans, anticipates, believes, estimates, predicts, intends, potential, continue, or the negative of such terms, or terminology.

The risks, uncertainties and assumptions referred to above that could cause our results to differ materially from the results expressed or implied by such forward-looking statements include those discussed under the heading Risk Factors in this document and the risks, uncertainties and assumptions discussed from time to time in our other public filings and public announcements. All forward-looking statements included in this document are based on information available to us as of the date hereof, and we assume no obligation to update these forward-looking statements.

## **OVERVIEW**

We are a specialty retailer of products for the home. The retail segment of our business sells our products through our five retail store concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, West Elm and Williams-Sonoma Home). The direct-to-customer segment of our business sells similar products through our seven direct mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed and Bath, PBteen, West Elm and Williams-Sonoma Home) and six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and wshome.com). Based on net revenues in fiscal 2007, retail net revenues accounted for 57.8% of our business and direct-to-customer net revenues accounted for 42.2% of our business. Based on their contribution to our net revenues in fiscal 2007, the core brands in both the retail and direct-to-customer channels are: Pottery Barn, which sells casual home furnishings; Williams-Sonoma, which sells cooking and entertaining essentials; and Pottery Barn Kids, which sells stylish children's furnishings.

The following discussion and analysis of financial condition, results of operations, and liquidity and capital resources should be read in conjunction with our condensed consolidated financial statements and the notes thereto.

### *First Quarter of Fiscal 2008 Financial Results*

In the first quarter of fiscal 2008, net revenues decreased 4.2% to \$781,784,000 from \$816,051,000 in the first quarter of fiscal 2007. The home furnishings environment continued to be very challenging and industry growth rates continued to decline. This net revenue decline was primarily driven by decreases in the Pottery Barn, Pottery Barn Kids and Williams-Sonoma brands, partially offset by increases in the PBteen, West Elm and Williams-Sonoma Home brands.



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Including a \$0.05 per diluted share net benefit related to an incentive payment from a landlord to compensate us for terminating a store lease prior to its expiration, diluted earnings per share for the first quarter of fiscal 2008 decreased 37.5% to \$0.10 per diluted share compared to \$0.16 per diluted share in the first quarter of fiscal 2007.

Retail net revenues in the first quarter of fiscal 2008 decreased \$19,824,000, or 4.4%, compared to the first quarter of fiscal 2007. This decrease was driven by a 9.0% reduction in comparable store sales, partially offset by a 6.9% year-over-year increase in retail leased square footage (including 19 net new store openings). West Elm and Williams-Sonoma Home were the only brands in the retail segment generating year-over-year growth in net revenues.

Direct-to-customer net revenues in the first quarter of fiscal 2008 decreased \$14,443,000, or 4.0%, compared to the first quarter of fiscal 2007. This decrease was primarily driven by declining net revenues in all brands except PBteen and West Elm. Revenues generated in our Internet business, which continued to be our fastest growing shopping channel, increased 8.7% to \$251,522,000 in the first quarter of fiscal 2008 compared to \$231,464,000 in the first quarter of fiscal 2007.

In our core brands, net revenues in the first quarter of fiscal 2008 decreased 7.0%, with negative growth in all brands. In the Pottery Barn brand, first quarter net revenues decreased 7.9% compared to last year as the benefits of our revitalization strategy were more than offset by continued weakness in the macroeconomic environment. Retail was particularly challenging with comparable store sales decreasing 10.5%. Despite this, we did see new product introductions outperform all other categories and, from an operational perspective, we saw substantial results in our returns, replacements and damages, as well as in our catalog circulation optimization initiatives. In the Pottery Barn Kids brand, net revenues in the first quarter decreased 11.1% compared to last year, including a comparable store sales decrease of 10.9%. We continue to believe that Pottery Barn Kids has been more impacted by the macroeconomic environment than any of our other brands due to its significant dependence on discretionary categories like textiles and decorative accessories. In the Williams-Sonoma brand, first quarter net revenues decreased 1.7% compared to last year due to ongoing softness in retail traffic and a comparable store sales decrease of 4.8%, partially offset by incremental revenues from new and expanded stores and positive e-commerce growth.

In our emerging brands (West Elm, PBteen and Williams-Sonoma Home), net revenues increased 16.3%, primarily driven by a strong performance across all brands. In the West Elm brand, despite the negative pressures of the macroeconomic environment, we saw positive net revenue growth, primarily driven by incremental sales from new stores and strength in e-commerce. We opened two new stores during the first quarter in Puerto Rico and Ohio and ended the quarter with 29 stores. In the PBteen brand, all key merchandising categories saw strong growth during the quarter. Highly targeted marketing, new innovative products, and a strong in-stock position contributed to these results. In the Williams-Sonoma Home brand, we continued to make significant progress on the brand-building initiatives we set for ourselves at the beginning of the year.

*First Quarter of Fiscal 2008 Operational Results*

In our supply chain, we continued to roll out the next phase of our returns, replacements and damages reduction initiative. This has been a key area of focus and investment for us, and we are beginning to see meaningful results. We are driving accountability back to our agents and vendors and expect to make substantial progress in this area in 2008.

In direct marketing, we continued to move forward with our catalog circulation optimization strategy with favorable results. These results are a direct benefit of the proprietary direct marketing systems that we have implemented over the past two years, and we are optimistic that we will be able to expand this strategy over the next several quarters.



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As we look forward to the second quarter and balance of the year, we are increasingly concerned by the downward trends in consumer confidence and in the growth of the home furnishings category. In light of these trends, we will be operating more cautiously. While we are committed to driving future growth across all channels, we are equally committed to optimizing asset efficiency, including inventory turns, and aggressively reducing costs to the extent that these actions do not affect service levels to our customers.

To support future growth and expand the reach of our brands in 2008, we expect to open 27 net new retail stores (29 new stores in addition to 22 remodeled stores, partially offset by 4 permanently closed stores and 20 stores closed temporarily due to remodeling). These new store openings include 10 stores in the West Elm brand. We also expect to intensify the marketing behind our fastest growing channel, e-commerce, in addition to upgrading our websites in the Pottery Barn, Pottery Barn Kids, PBteen, and Williams-Sonoma Home brands. We will also continue to roll out the next phase of our Pottery Barn revitalization initiatives.

In our efforts to improve asset efficiency, we are continuing to aggressively manage inventory levels across all brands and channels. In addition, in early May, we took advantage of a robust corporate aircraft market and replaced an owned aircraft with a leased aircraft. This will result in a gain on sale of asset of approximately \$16,000,000, or \$0.09 per diluted share, in the second quarter of fiscal 2008.

From a cost perspective, we plan to optimize catalog circulation, catalog versioning and paid search to improve the overall productivity of advertising costs; to reduce returns, replacements and damages by implementing effective vendor management, quality control and logistics initiatives; and to reduce corporate overhead costs.

**NET REVENUES**

Net revenues consist of retail sales, direct-to-customer sales and shipping fees. Retail sales include sales of merchandise to customers at our retail stores. Direct-to-customer sales include sales of merchandise to customers through our catalogs and the Internet. Shipping fees consist of revenue received from customers for delivery of merchandise. Revenues are net of sales returns and other discounts.

The following table summarizes our net revenues for the thirteen weeks ended May 4, 2008 ( first quarter of fiscal 2008 ) and the thirteen weeks ended April 29, 2007 ( first quarter of fiscal 2007 ):

| <i>Dollars in thousands</i> | Thirteen Weeks Ended |         |                   |         |
|-----------------------------|----------------------|---------|-------------------|---------|
|                             | May 4,<br>2008       | % Total | April 29,<br>2007 | % Total |
| Retail revenues             | \$ 433,551           | 55.5%   | \$ 453,375        | 55.6%   |
| Direct-to-customer revenues | 348,233              | 44.5%   | 362,676           | 44.4%   |
| Net revenues                | \$ 781,784           | 100.0%  | \$ 816,051        | 100.0%  |

Net revenues for the first quarter of fiscal 2008 decreased by \$34,267,000, or 4.2%, compared to the first quarter of fiscal 2007 due to decreases in the Pottery Barn, Pottery Barn Kids and Williams-Sonoma brands, partially offset by increases in the PBteen, West Elm and



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Williams-Sonoma Home brands. These decreases were primarily driven by a 9.0% reduction in comparable store sales, partially offset by a 6.9% year-over-year increase in retail leased square footage resulting from 19 net new stores (28 new store openings and the permanent closure of 9 stores) and the remodeling or expansion of an additional 27 stores.

**Table of Contents****RETAIL REVENUES AND OTHER DATA**

| <i>Dollars in thousands</i>                            | Thirteen Weeks Ended |                   |
|--|----------------------|-------------------|
|  | May 4,<br>2008       | April 29,<br>2007 |
| Retail revenues  | \$ 433,551           | \$ 453,375        |
| Percent (decrease) increase in retail revenues         | (4.4%)               | 4.5%              |
| Percent decrease in comparable store sales             | (9.0%)               | (0.8%)            |
| Number of stores - beginning of period                 | 600                  | 588               |
| Number of new stores                                   | 7                    | 2                 |
| Number of new stores due to remodeling <sup>1</sup>    | 2                    | 1                 |
| Number of closed stores due to remodeling <sup>1</sup> | (5)                  | (1)               |
| Number of permanently closed stores                    | (1)                  | (6)               |
| Number of stores - end of period                       | 603                  | 584               |
| Store selling square footage at period-end             | 3,624,000            | 3,376,000         |
| Store leased square footage ( LSF ) at period-end      | 5,808,000            | 5,433,000         |

<sup>1</sup> *Remodeled stores are defined as those stores temporarily closed and subsequently reopened during the period due to square footage expansion, store modification or relocation.*

|                      | Store Count |          |          | Store Count |           | Avg. LSF  | Avg. LSF  |
|----------------------|-------------|----------|----------|-------------|-----------|-----------|-----------|
|                      | February 3, |          |          | May 4,      | April 29, | Per Store | Per Store |
|                      | 2008        | Openings | Closings | 2008        | 2007      | May 4,    | April 29, |
| Williams-Sonoma      | 256         | 4        | (4)      | 256         | 250       | 6,200     | 6,000     |
| Pottery Barn         | 198         | 2        | (2)      | 198         | 195       | 12,600    | 12,200    |
| Pottery Barn Kids    | 94          | -        | -        | 94          | 93        | 7,900     | 7,900     |
| West Elm             | 27          | 2        | -        | 29          | 22        | 17,800    | 17,400    |
| Williams-Sonoma Home | 9           | -        | -        | 9           | 8         | 14,300    | 14,200    |
| Outlets              | 16          | 1        | -        | 17          | 16        | 20,900    | 20,200    |
| Total                | 600         | 9        | (6)      | 603         | 584       | 9,600     | 9,300     |

Retail revenues in the first quarter of fiscal 2008 decreased \$19,824,000, or 4.4%, compared to the first quarter of fiscal 2007. This decrease was driven by a 9.0% reduction in comparable store sales partially offset by a 6.9% year-over-year increase in retail leased square footage resulting from 19 net new stores (28 new store openings and the permanent closure of 9 stores) and the remodeling or expansion of an additional 27 stores. West Elm and Williams-Sonoma Home were the only brands in the retail segment generating year-over-year growth in net revenues.

*Comparable Store Sales*

Comparable stores are defined as those stores in which gross square footage did not change by more than 20% in the previous 12 months and which have been open for at least 12 consecutive months without closure for seven or more consecutive days. By measuring the year-over-year sales of merchandise in the stores that have a history of being open for a full comparable 12 months or more, we can better gauge how the core store base is performing since it excludes new store openings, store remodelings, expansions and closings. Comparable stores exclude new retail concepts until such time as we believe that comparable store results in those concepts are meaningful to evaluating the performance of the retail strategy. In both the first quarters of fiscal year 2008 and fiscal year 2007, we excluded West Elm and Williams-Sonoma Home.



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Percentages represent changes in comparable store sales compared to the same period in the prior year.

| <i>Percent (decrease) increase in comparable store sales</i> | Thirteen Weeks Ended |                   |
|--|----------------------|-------------------|
|  | May 4,<br>2008       | April 29,<br>2007 |
| Williams-Sonoma  | (4.8%)               | (0.6%)            |
| Pottery Barn   | (10.5%)              | (1.2%)            |
| Pottery Barn Kids  | (10.9%)              | (3.8%)            |
| Outlets  | (13.0%)              | 9.3%              |
| Total  | (9.0%)               | (0.8%)            |

Various factors affect comparable store sales, including the number, size and location of stores we open, close, remodel or expand in any period, the general retail sales environment, consumer preferences and buying trends, changes in sales mix between distribution channels, our ability to efficiently source and distribute products, changes in our merchandise mix, competition (including competitive promotional activity), current local and global economic conditions, the timing of our releases of new merchandise and promotional events, the success of marketing programs, the cannibalization of existing store sales by our new stores, changes in our catalog circulation strategies, continued strength in our Internet business and fluctuation in foreign exchange rates. Among other things, weather conditions can affect comparable store sales because inclement weather can alter consumer behavior or require us to close certain stores temporarily and thus reduce store traffic. Even if stores are not closed, many customers may decide to avoid going to stores in bad weather. These factors have caused our comparable store sales to fluctuate significantly in the past on an annual, quarterly and monthly basis and, as a result, we expect that comparable store sales will continue to fluctuate in the future.

**DIRECT-TO-CUSTOMER REVENUES**

| <i>Dollars in thousands</i>                                | Thirteen Weeks Ended |                   |
|--|----------------------|-------------------|
|  | May 4,<br>2008       | April 29,<br>2007 |
| Catalog revenues <sup>1</sup>                              | \$ 96,711            | \$ 131,212        |
| Internet revenues <sup>1</sup>                             | 251,522              | 231,464           |
| Total direct-to-customer revenues <sup>1</sup>             | \$ 348,233           | \$ 362,676        |
| Percent (decrease) increase in direct-to-customer revenues | (4.0%)               | 0.6%              |
| Percent decrease in number of catalogs circulated          | (16.3%)              | (3.0%)            |
| Percent (decrease) increase in number of pages circulated  | (25.2%)              | 5.7%              |

<sup>1</sup>Approximately 60% of our company-wide non-gift registry Internet revenues are driven by customers who recently received a catalog and approximately 40% are incremental to the direct-to-customer channel.

Direct-to-customer revenues in the first quarter of fiscal 2008 decreased \$14,443,000, or 4.0%, compared to the first quarter of fiscal 2007. This decrease was primarily driven by declining net revenues in all brands except PBteen and West Elm. Revenues generated in our Internet business, which continued to be our fastest growing shopping channel, increased 8.7% to \$251,522,000 in the first quarter of fiscal 2008 compared to \$231,464,000 in the first quarter of fiscal 2007.

**COST OF GOODS SOLD**

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| <i>Dollars in thousands</i> | Thirteen Weeks Ended |                   |                   |                   |
|-----------------------------|----------------------|-------------------|-------------------|-------------------|
|                             | May 4,<br>2008       | % Net<br>Revenues | April 29,<br>2007 | % Net<br>Revenues |
| Cost of goods sold          | \$ 505,565           | 64.7%             | \$ 514,081        | 63.0%             |

Cost of goods sold includes cost of goods, occupancy expenses and shipping costs. Cost of goods consists of cost of merchandise, inbound freight expenses, freight-to-store expenses and other inventory related costs such as shrinkage, damages and replacements. Occupancy expenses consist of rent, depreciation and other occupancy

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costs, including common area maintenance and utilities. Shipping costs consist of third party delivery services and shipping materials.

Our classification of expenses in cost of goods sold may not be comparable to other public companies, as we do not include non-occupancy related costs associated with our distribution network in cost of goods sold. These costs, which include distribution network employment, third party warehouse management, and other distribution-related administrative expenses, are recorded in selling, general and administrative expenses.

Within our reportable segments, the direct-to-customer channel does not incur freight-to-store or store occupancy expenses, and typically operates with lower markdowns and inventory shrinkage than the retail channel. However, the direct-to-customer channel incurs higher customer shipping, damage and replacement costs than the retail channel.

*First Quarter of Fiscal 2008 vs. First Quarter of Fiscal 2007*

Cost of goods sold decreased by \$8,516,000, or 1.7%, in the first quarter of fiscal 2008 compared to the first quarter of fiscal 2007. Cost of goods sold as a percentage of net revenues increased to 64.7% in the first quarter of 2008 from 63.0% in the first quarter of 2007. This increase as a percentage of net revenues was primarily due to the deleveraging of fixed occupancy expenses from declining sales, an increase in cost of merchandise sold and the impact of accelerated depreciation associated with terminating a store lease prior to its expiration, partially offset by reductions in replacements and damages.

In the retail channel, cost of goods sold as a percentage of net revenues increased 280 basis points in the first quarter of fiscal 2008 compared to the first quarter of fiscal 2007. This increase as a percentage of net revenues primarily resulted from the deleveraging of fixed occupancy expenses from declining sales, an increase in cost of merchandise sold and the impact of accelerated depreciation associated with terminating a store lease prior to its expiration.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues increased 20 basis points in the first quarter of fiscal 2008 compared to the first quarter of fiscal 2007. This increase as a percentage of net revenues primarily resulted from the deleveraging of fixed occupancy expenses from declining sales and an increase in cost of merchandise sold, partially offset by a reduction in customer shipping costs and replacements and damages.

**SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

| <i>Dollars in thousands</i>                  | May 4,<br>2008 | Thirteen Weeks Ended |                   | % Net<br>Revenues |
|--|----------------|----------------------|-------------------|-------------------|
|  |                | % Net<br>Revenues    | April 29,<br>2007 |                   |
| Selling, general and administrative expenses | \$ 259,336     | 33.2%                | \$ 273,528        | 33.5%             |

Selling, general and administrative expenses consist of non-occupancy related costs associated with our retail stores, distribution warehouses, customer care centers, supply chain operations (buying, receiving and inspection), and corporate administrative functions. These costs include employment, advertising, third party credit card processing, and other general expenses.

Due to their distinct distribution and marketing strategies, we experience differing employment and advertising costs as a percentage of net revenues within the retail and direct-to-customer channels. Store employment costs represent a greater percentage of retail net revenues than employment costs as a percentage of net revenues within the direct-to-customer channel. However, catalog advertising expenses are greater within the

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direct-to-customer channel than the retail channel.

### *First Quarter of Fiscal 2008 vs. First Quarter of Fiscal 2007*

Selling, general and administrative expenses decreased by \$14,192,000, or 5.2%, in the first quarter of fiscal 2008 compared to the first quarter of fiscal 2007. Selling, general and administrative expenses as a percentage of net revenues decreased to 33.2% in the first quarter of fiscal 2008 from 33.5% in the first quarter of fiscal 2007. This decrease was primarily driven by a benefit of approximately \$9,350,000 related to an incentive payment received from a landlord to compensate us for terminating a store lease prior to its expiration, partially offset by the deleverage of our employment and advertising costs due to declining sales.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues decreased 180 basis points in the first quarter of fiscal 2008 compared to the first quarter of fiscal 2007. This decrease was primarily due to the benefit related to an incentive payment received from a landlord to compensate us for terminating a store lease prior to its expiration and a reduction in catalog advertising expenses, partially offset by the deleverage of our employment costs due to declining sales.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues increased 110 basis points in the first quarter of fiscal 2008 compared to the first quarter of fiscal 2007. This increase was primarily due to the deleverage of our advertising and employment costs resulting from declining sales.

## **INTEREST INCOME**

Interest income was \$577,000 in the first quarter of fiscal 2008, compared to \$2,470,000 in the first quarter of fiscal 2007, and is comprised primarily of income from short-term investments classified as cash and cash equivalents. This \$1,893,000 decrease resulted from lower average cash balances during the first quarter of fiscal 2008 compared to the first quarter of fiscal 2007 after returning over \$230,000,000 to our shareholders through shares repurchases and dividends over the past twelve months.

## **INCOME TAXES**

Our effective tax rate was 38.8% and 40.3% for the first quarter of fiscal 2008 and the first quarter of fiscal 2007, respectively. This decrease in the effective quarterly income tax rate was primarily driven by certain favorable income tax resolutions during the first quarter of fiscal 2008. We expect our effective tax rate to be in the range of 38.1% to 38.5% in fiscal 2008. Throughout the year, we expect that there could be ongoing variability in our quarterly tax rates as taxable events occur and exposures are re-evaluated.

## **LIQUIDITY AND CAPITAL RESOURCES**



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As of May 4, 2008, we held \$26,838,000 in cash and cash equivalent funds. As is consistent with our industry, our cash balances are seasonal in nature, with the fourth quarter representing a significantly higher level of cash than other periods.

Throughout the fiscal year, we utilize our cash balances to build our inventory levels in preparation for our fourth quarter holiday sales. In fiscal 2008, we plan to utilize our cash resources to fund our inventory and inventory related purchases, catalog advertising and marketing initiatives, purchases of property and equipment and dividend payments. In addition to the current cash balances on-hand, we have a \$300,000,000 credit facility available as of May 4, 2008 that may be used for loans or letters of credit. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the credit facility of up to \$200,000,000, to provide for a total of \$500,000,000 of unsecured revolving credit. As of May 4, 2008, an aggregate of \$61,000,000 (at a weighted average interest rate of 3.2%) was outstanding under our credit facility and is recorded within current liabilities as it is our intention to repay this amount within the next twelve months.

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No amounts were borrowed under the credit facility during the first quarter of fiscal 2007. Additionally, as of May 4, 2008, \$36,229,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. We believe our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations and growth opportunities over the next 12 months.

For the first quarter of fiscal 2008, net cash used in operating activities was \$88,342,000 compared to net cash used in operating activities of \$124,735,000 for the first quarter of fiscal 2007. Net cash used in operating activities for the first quarter of fiscal 2008 was primarily attributable to the payment of income taxes during the quarter, a decrease in accounts payable due to the timing of payments and an increase in merchandise inventories to support our new and remodeled stores and the increase in sales in our emerging brands, partially offset by an increase in deferred lease incentives.

For the first quarter of fiscal 2008, net cash used in investing activities was \$53,001,000 compared to net cash used in investing activities of \$32,217,000 for the first quarter of fiscal 2007. For the first quarter of fiscal 2008, purchases of property and equipment were \$53,481,000, comprised of \$39,067,000 for stores, \$11,058,000 for systems development projects (including e-commerce websites) and \$3,356,000 for distribution, facility infrastructure and other projects.

In fiscal 2008, we anticipate investing \$215,000,000 to \$235,000,000 in the purchase of property and equipment, primarily for the construction of 29 new stores and 22 remodeled or expanded stores, systems development projects (including e-commerce websites), and distribution, facility infrastructure and other projects.

For the first quarter of fiscal 2008, net cash provided by financing activities was \$49,495,000 compared to net cash used in financing activities of \$2,685,000 for the first quarter of fiscal 2007. Net cash provided by financing activities for the first quarter of fiscal 2008 was primarily due to net borrowings under our line of credit facility, partially offset by the payment of dividends.

### *Related Party Transaction*

On May 16, 2008, we completed two transactions relating to our corporate aircraft. First, we were able to take advantage of a robust corporate aircraft market and sold our Bombardier Global Express airplane for approximately \$46,800,000 in cash (a net after-tax cash benefit of approximately \$29,000,000) to an unrelated third party. This will result in a gain on sale of asset of approximately \$16,000,000, or \$0.09 per diluted share, in the second quarter of fiscal 2008. Second, in order to address our ongoing aircraft needs, we entered into an Aircraft Lease Agreement (the Lease Agreement ) with a limited liability company (the LLC ) owned by W. Howard Lester, our Chief Executive Officer, Chairman of the Board of Directors and a significant shareholder, for use of a Bombardier Global 5000 owned by the LLC. These transactions were approved by our Board of Directors.

Under the terms of the Lease Agreement, in exchange for use of the aircraft, we will pay the LLC \$375,000 for each of the thirty-six months of the lease term through May 15, 2011. We are also responsible for all use-related costs associated with the aircraft, including fixed costs such as crew salaries and benefits, insurance and hangar costs, and all direct operating costs. Closing costs associated with the Lease Agreement will be divided evenly between us and the LLC, and each party will pay its own attorney and advisor fees. The Lease Agreement is subject to early termination by either party, with 90 days prior written notice, if Mr. Lester retires or otherwise withdraws from active management of the company.

*Stock Repurchase Program*

In January 2008, the Board of Directors authorized the repurchase of up to \$150,000,000 of our common stock through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including

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price, corporate and regulatory requirements, capital availability, and other market conditions. The stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

During the first quarter of fiscal 2008, no shares of our common stock were repurchased and \$150,000,000 of our common stock remains available for repurchase.

### *Dividend Policy*

In March 2008, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.115 to \$0.12 per common share which was paid on May 23, 2008 to shareholders of record as of the close of business on April 25, 2008. The indicated annual cash dividend, subject to capital availability, is \$0.48 per common share or approximately \$51,000,000 in fiscal 2008. Our quarterly cash dividend could be reduced or discontinued at any time.

### *Critical Accounting Policies*

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. The estimates and assumptions are evaluated on an ongoing basis and are based on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results may differ significantly from these estimates. There have been no significant changes to the policies as discussed in our Annual Report on Form 10-K for the year ended February 3, 2008.

### *Impact of Inflation*

The impact of inflation on results of operations was not significant for the first quarter of fiscal 2008 or the first quarter of fiscal 2007.

### *Seasonality*

Our business is subject to substantial seasonal variations in demand. Historically, a significant portion of our revenues and net earnings have been realized during the period from October through December, and levels of net revenues and net earnings have generally been significantly lower during the period from January through September. We believe this is the general pattern associated with the retail and direct-to-customer industries. In anticipation of our peak season, we hire a substantial number of additional temporary employees in our retail stores, call centers and distribution centers, and incur significant fixed catalog production and mailing costs.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risks, which include changes in U.S. interest rates, foreign currency exchange rates, including the devaluation of the U.S. dollar and the effects of rising prices in the foreign countries in which we do business. We do not engage in financial transactions for trading or speculative purposes.

*Interest Rate Risk*

As of May 4, 2008, we have three debt instruments with variable interest rates which subject us to risks associated with changes in interest rates (the interest payable on our credit facility, our Mississippi industrial development bond and the bond-related debt associated with one of our Memphis-based distribution facilities).

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As of May 4, 2008, the total outstanding principal balance on these instruments was \$75,079,000 (with a weighted average interest rate of approximately 3.1%). If interest rates on these existing variable rate debt instruments rose 31 basis points (an approximate 10% increase in the associated variable rates as of May 4, 2008), our results from operations and cash flows would not be materially affected.

In addition, we have fixed and variable income investments consisting of short-term investments classified as cash and cash equivalents, which are also affected by changes in market interest rates. As of May 4, 2008, our investments, made solely in money market funds, are stated at cost and approximate their fair values. An increase in interest rates of 10% would have an immaterial effect on the value of these investments. Declines in interest rates would, however, decrease the income derived from these investments.

### *Foreign Currency Risks*

We purchase a significant amount of inventory from vendors outside of the U.S. in transactions that are denominated in U.S. dollars. Approximately 5% of our international purchase transactions are in currencies other than the U.S. dollar, primarily the euro. Any currency risks related to these international purchase transactions were not significant to us during the first quarter of fiscal 2008 and fiscal 2007. However, since we pay for the majority of our international purchases in U.S. dollars, a decline in the U.S. dollar relative to other foreign currencies would subject us to risks associated with increased purchasing costs from our vendors in their effort to offset any lost profits associated with any currency devaluation. We cannot predict with certainty the effect these increased costs may have on our financial statements or results of operations.

In addition, as of May 4, 2008, we have 15 retail stores in Canada and limited operations in both Europe and Asia, each of which expose us to market risk associated with foreign currency exchange rate fluctuations. Although these exchange rate fluctuations have not been material to us in the past, we may enter into foreign currency contracts in the future to minimize any currency remeasurement risk associated with the intercompany assets and liabilities of our subsidiaries. We did not enter into any foreign currency contracts during the first quarter of fiscal 2008 or the first quarter of fiscal 2007.

## **ITEM 4. CONTROLS AND PROCEDURES**

### *Evaluation of Disclosure Controls and Procedures*

As of May 4, 2008, an evaluation was performed by management, with the participation of our Chief Executive Officer ( CEO ) and our Executive Vice President, Chief Operating and Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow timely discussions regarding required disclosures, and that such information is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

### *Changes in Internal Control Over Financial Reporting*

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There was no change in our internal control over financial reporting that occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

Information required by this Item is contained in Note G to our Consolidated Financial Statements within Part I of this Form 10-Q.

**ITEM 1A. RISK FACTORS**

A description of the risks and uncertainties associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risks and uncertainties associated with our business previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended February 3, 2008. You should carefully consider such risks and uncertainties, together with the other information contained in this report, our Annual Report on Form 10-K for the fiscal year ended February 3, 2008 and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.

*We must successfully identify and analyze factors affecting our business, anticipate changing consumer preferences and buying trends, and manage our inventory commensurate with customer demand.*

Our success depends, in large part, upon our ability to identify and analyze factors affecting our business and to anticipate and respond in a timely manner to changing merchandise trends and customer demands. Consumer preferences cannot be predicted with certainty and may change between selling seasons. Changes in customer preferences and buying trends may also affect our brands differently. If we misjudge either the market for our merchandise or our customers' purchasing habits, our sales may decline significantly, and we may be required to mark down certain products to sell the resulting excess inventory or to sell such inventory through our outlet stores or other liquidation channels at prices which are significantly lower than our retail prices, either of which would negatively impact our business and operating results.

In addition, we must manage our inventory effectively and commensurate with customer demand. Much of our inventory is sourced from vendors located outside the United States. Thus, we usually must order merchandise, and enter into contracts for the purchase and manufacture of such merchandise, up to twelve months in advance of the applicable selling season and frequently before trends are known. The extended lead times for many of our purchases may make it difficult for us to respond rapidly to new or changing trends. Our vendors may also not have the capacity to handle our demands. In addition, the seasonal nature of the specialty home products business requires us to carry a significant amount of inventory prior to peak selling season. As a result, we are vulnerable to demand and pricing shifts and to misjudgments in the selection and timing of merchandise purchases. If we do not accurately predict our customers' preferences and acceptance levels of our products, our inventory levels will not be appropriate, and our business and operating results may be negatively impacted.

*Our business depends, in part, on factors affecting consumer spending that are out of our control.*



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Our business depends on consumer demand for our products and, consequently, is sensitive to a number of factors that influence consumer spending, including general economic conditions, disposable consumer income, fuel prices, recession and fears of recession, war and fears of war, inclement weather, consumer debt, conditions in the housing market, interest rates, sales tax rates and rate increases, inflation, foreign currency exchange rate

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fluctuations, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. These factors may also affect our various brands and channels differently. Adverse changes in factors affecting discretionary consumer spending could reduce consumer demand for our products, thus reducing our sales and harming our business and operating results. For example, our business has been impacted by the current downturn in the housing market and declining consumer confidence, as well as other macro-economic factors.

*We face intense competition from companies with brands or products similar to ours.*

The specialty retail and direct-to-customer business is highly competitive. Our specialty retail stores, direct mail catalogs and e-commerce websites compete with other retail stores, other direct mail catalogs and other e-commerce websites that market lines of merchandise similar to ours. We compete with national, regional and local businesses utilizing a similar retail store strategy, as well as traditional furniture stores, department stores and specialty stores. The substantial sales growth in the direct-to-customer industry within the last decade has encouraged the entry of many new competitors and an increase in competition from established companies.

The competitive challenges facing us include:

- anticipating and quickly responding to changing consumer demands or preferences better than our competitors;
- maintaining favorable brand recognition and achieving customer perception of value;
- effectively marketing and competitively pricing our products to consumers in several diverse market segments;
- developing innovative, high-quality products in colors and styles that appeal to consumers of varying age groups and tastes, and in ways that favorably distinguish us from our competitors; and
- effectively managing our supply chain and distribution strategies in order to provide our products to our consumers on a timely basis and minimize returns, replacements, and damaged products.

In light of the many competitive challenges facing us, we may not be able to compete successfully. Increased competition could reduce our sales and harm our operating results and business.

*We depend on key domestic and foreign agents and vendors for timely and effective sourcing of our merchandise, and we are subject to various risks and uncertainties that might affect our vendors' ability to produce quality merchandise.*

Our performance depends, in part, on our ability to purchase our merchandise in sufficient quantities at competitive prices. We purchase our merchandise from numerous foreign and domestic manufacturers and importers. We have no contractual assurances of continued supply, pricing or access to new products, and any vendor could change the terms upon which they sell to us, or discontinue selling to us, at any time. We may not be able to acquire desired merchandise in sufficient quantities on terms acceptable to us in the future. Better than expected sales demand may also lead to customer backorders and lower in-stock positions of our merchandise.

Any inability to acquire suitable merchandise on acceptable terms or the loss of one or more of our key agents or vendors could have a negative effect on our business and operating results because we would be missing products that we felt were important to our assortment, unless and until alternative supply arrangements are secured. We may not be able to develop relationships with new agents or vendors, and products from alternative sources, if any, may be of a lesser quality and/or more expensive than those we currently purchase.

In addition, we are subject to certain risks, including availability of raw materials, labor disputes, union organizing activities, vendor financial liquidity, inclement weather, natural disasters, and general economic and political conditions, that could limit our vendors' ability to provide us with quality merchandise on a timely basis.

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and at a price that is commercially acceptable. For these or other reasons, one or more of our vendors might not adhere to our quality control standards, and we might not identify the deficiency before merchandise ships to our stores or customers. In addition, our vendors may have difficulty adjusting to our changing demands and growing business. Our vendors' failure to manufacture or import quality merchandise in a timely and effective manner could damage our reputation and brands, and could lead to an increase in customer litigation against us and an attendant increase in our routine litigation costs. Further, any merchandise that does not meet our quality standards could become subject to a recall, which would damage our reputation and brands, and harm our business.

*Our dependence on foreign vendors and our overseas operations subject us to a variety of risks and uncertainties.*

In fiscal 2007, we sourced our products from vendors in 43 countries outside of the United States. Approximately 60% of our merchandise purchases were foreign-sourced, primarily from Asia and Europe. Our dependence on foreign vendors means that we may be affected by declines in the relative value of the U.S. dollar to other foreign currencies. For example, any upward valuation in the Chinese yuan, the euro, or any other foreign currency against the U.S. dollar may result in higher costs to us for those goods. Although approximately 95% of our foreign purchases of merchandise are negotiated and paid for in U.S. dollars, declines in foreign currencies and currency exchange rates might negatively affect the profitability and business prospects of one or more of our foreign vendors. This, in turn, might cause such foreign vendors to demand higher prices for merchandise, delay merchandise shipments to us, or discontinue selling to us, any of which could ultimately reduce our sales or increase our costs.

We are also subject to other risks and uncertainties associated with changing economic and political conditions in foreign countries. These risks and uncertainties include import duties and quotas, concerns over anti-dumping, work stoppages, economic uncertainties (including inflation), foreign government regulations, employment matters, wars and fears of war, political unrest, natural disasters and other trade restrictions. We cannot predict whether any of the countries in which our products are currently manufactured or may be manufactured in the future will be subject to trade restrictions imposed by the U.S. or foreign governments or the likelihood, type or effect of any such restrictions. Any event causing a disruption or delay of imports from foreign vendors, including the imposition of additional import restrictions, restrictions on the transfer of funds and/or increased tariffs or quotas, or both, could increase the cost or reduce the supply of merchandise available to us and adversely affect our business, financial condition and operating results. Furthermore, some or all of our foreign vendors' operations may be adversely affected by political and financial instability resulting in the disruption of trade from exporting countries, restrictions on the transfer of funds and/or other trade disruptions. Our overseas operations in Europe and Asia could also be affected by changing economic and political conditions in foreign countries, which could have a negative effect on our business, financial condition and operating results.

In addition, although we continue to improve our global compliance program, there remains a risk that one or more of our foreign vendors will not adhere to our global compliance standards such as fair labor standards and the prohibition on child labor. Non-governmental organizations might attempt to create an unfavorable impression of our sourcing practices or the practices of some of our vendors that could harm our image. If either of these occurs, we could lose customer goodwill and favorable brand recognition, which could negatively affect our business and operating results.

Our overseas operations are subject to certain U.S. laws applicable to us, including the Foreign Corrupt Practices Act. We must ensure that the employees in our overseas operations comply with these laws. If any of our overseas operations, or our employees or agents, violates such U.S. laws, we could become subject to sanctions, which could negatively affect our business and operating results.

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*The growth of our sales and profits depends, in large part, on our ability to successfully open new stores.*

In each of the past three fiscal years, the majority of our net revenues have been generated by our retail stores. Our ability to open additional stores successfully will depend upon a number of factors, including:

- our identification and availability of suitable store locations;
- our success in negotiating leases on acceptable terms;
- our ability to secure required governmental permits and approvals;
- our hiring and training of skilled store operating personnel, especially management;
- our timely development of new stores, including the availability of construction materials and labor and the absence of significant construction and other delays in store openings based on weather or other events;
- the availability of financing on acceptable terms, if at all; and
- general economic conditions.

Many of these factors are beyond our control. For example, for the purpose of identifying suitable store locations, we rely, in part, on demographic surveys regarding location of consumers in our target market segments. While we believe that the surveys and other relevant information are helpful indicators of suitable store locations, we recognize that the information sources cannot predict future consumer preferences and buying trends with complete accuracy. In addition, changes in demographics, in the types of merchandise that we sell and in the pricing of our products may reduce the number of suitable store locations. Further, time frames for lease negotiations and store development vary from location to location and can be subject to unforeseen delays. Construction and other delays in store openings could have a negative impact on our business and operating results. We may not be able to open new stores or, if opened, operate those stores profitably.

*We must timely and effectively deliver merchandise to our stores and customers.*

We cannot control all of the various factors that might affect our fulfillment rates in direct-to-customer sales and timely and effective merchandise delivery to our stores. We rely upon third party carriers for our merchandise shipments and reliable data regarding the timing of those shipments, including shipments to our customers and to and from all of our stores. In addition, we are heavily dependent upon two carriers for the delivery of our merchandise to our customers. Accordingly, we are subject to the risks, including labor disputes, union organizing activity, inclement weather, natural disasters and possible acts of terrorism associated with such carriers' ability to provide delivery services to meet our shipping needs. Failure to deliver merchandise in a timely and effective manner could damage our reputation and brands. In addition, fuel costs have increased substantially and airline and other transportation companies struggle to operate profitably, which could lead to increased fulfillment expenses. The increased fulfillment costs could negatively affect our business and operating results by increasing our transportation costs and decreasing the efficiency of our shipments.

*Our failure to successfully manage our order-taking and fulfillment operations could have a negative impact on our business.*

Our direct-to-customer business depends on our ability to maintain efficient and uninterrupted order-taking and fulfillment operations and our e-commerce websites. Disruptions or slowdowns in these areas could result from disruptions in telephone service or power outages, inadequate system capacity, system issues, computer viruses, security breaches, human error, changes in programming, union organizing activity, disruptions in our third party labor contracts, natural disasters or adverse weather conditions. These problems could result in a reduction in sales as well as increased selling, general and administrative expenses.

In addition, we face the risk that we cannot hire enough qualified employees, or that there will be a disruption in the labor we hire from our third party providers, especially during our peak season, to support our

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direct-to-customer operations, due to circumstances that reduce the relevant workforce. The need to operate with fewer employees could negatively impact our customer service levels and our operations.

*Our facilities and systems, as well as those of our vendors, are vulnerable to natural disasters and other unexpected events, any of which could result in an interruption in our business.*

Our retail stores, corporate offices, distribution centers, infrastructure projects and direct-to-customer operations, as well as the operations of vendors from which we receive goods and services, are vulnerable to damage from earthquakes, tornadoes, hurricanes, fires, floods, power losses, telecommunications failures, hardware and software failures, computer viruses and similar events. If any of these events result in damage to our facilities or systems, or those of our vendors, we may experience interruptions in our business until the damage is repaired, resulting in the potential loss of customers and revenues. In addition, we may incur costs in repairing any damage beyond our applicable insurance coverage.

*We experience fluctuations in our comparable store sales.*

Our success depends, in part, upon our ability to increase sales at our existing stores. Various factors affect comparable store sales, including the number, size and location of stores we open, close, remodel or expand in any period, the general retail sales environment, consumer preferences and buying trends, changes in sales mix among distribution channels, our ability to efficiently source and distribute products, changes in our merchandise mix, competition (including competitive promotional activity), current local and global economic conditions, the timing of our releases of new merchandise and promotional events, the success of marketing programs, the cannibalization of existing store sales by our new stores, changes in our catalog circulation strategies, continued strength in our Internet business and fluctuation in foreign exchange rates. Among other things, weather conditions can affect comparable store sales because inclement weather can alter consumer behavior or require us to close certain stores temporarily and thus reduce store traffic. Even if stores are not closed, many customers may decide to avoid going to stores in bad weather. These factors have caused and may continue to cause our comparable store sales results to differ materially from prior periods and from earnings guidance we have provided.

Our comparable store sales have fluctuated significantly in the past on an annual, quarterly and monthly basis, and we expect that comparable store sales will continue to fluctuate in the future. Past comparable store sales are no indication of future results, and comparable store sales may decrease in the future. Our ability to maintain and improve our comparable store sales results depends, in large part, on maintaining and improving our forecasting of customer demand and buying trends, selecting effective marketing techniques, providing an appropriate mix of merchandise for our broad and diverse customer base and using effective pricing strategies. Any failure to meet the comparable store sales expectations of investors and securities analysts in one or more future periods could significantly reduce the market price of our common stock.

*Our failure to successfully manage the costs and performance of our catalog mailings might have a negative impact on our business.*

Postal rate increases, paper costs, printing costs and other catalog distribution costs affect the cost of our catalog mailings. We rely on discounts from the basic postal rate structure, which could be changed or discontinued at any time. Our cost of paper has fluctuated significantly during the past three fiscal years, and our paper costs are expected to increase in the future. Future increases in postal rates, paper costs or printing costs would have a negative impact on our operating results to the extent that we are unable to offset such increases by raising prices or by implementing more efficient printing, mailing, delivery and order fulfillment systems.

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We have historically experienced fluctuations in customer response to our catalogs. Customer response to our catalogs is substantially dependent on merchandise assortment, merchandise availability and creative presentation, as well as the selection of customers to whom the catalogs are mailed, changes in mailing strategies, and the sizing and timing of delivery of the catalogs. For example, we are currently implementing initiatives to optimize catalog circulation, catalog versioning and paid search, which are resulting in the circulation of fewer catalogs and fewer catalog pages. We may not be able to accurately predict the impact of these initiatives on our direct-to-consumer and retail store revenues.



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In addition, environmental organizations and other consumer advocacy groups may attempt to create an unfavorable impression of our paper use in catalogs and our distribution of catalogs generally. In addition, we depend upon external vendors to print our catalogs. The failure to effectively produce or distribute our catalogs could affect the timing of catalog delivery. The timing of catalog delivery has been and can be affected by postal service delays. Any delays in the timing of catalog delivery could cause customers to forego or defer purchases.

*We must successfully manage our Internet business.*

The success of our Internet business depends, in part, on factors over which we have limited control. We must successfully respond to changing consumer preferences and buying trends relating to Internet usage. We are also vulnerable to certain additional risks and uncertainties associated with the Internet, including changes in required technology interfaces, website downtime and other technical failures, costs and technical issues as we upgrade our website software, computer viruses, changes in applicable federal and state regulation, security breaches and consumer privacy concerns. In addition, we must keep up to date with competitive technology trends, including the use of improved technology, creative user interfaces and other Internet marketing tools, which may increase costs and which may not succeed in increasing sales or attracting customers. Our failure to successfully respond to these risks and uncertainties might adversely affect the sales in our Internet business, as well as damage our reputation and brands.

*Our failure to successfully anticipate merchandise returns might have a negative impact on our business.*

We record a reserve for merchandise returns based on historical return trends together with current product sales performance in each reporting period. If actual returns are greater than those projected by management, additional sales returns might be recorded in the future. Actual merchandise returns may exceed our reserves. In addition, to the extent that returned merchandise is damaged, we often do not receive full retail value from the resale or liquidation of the merchandise. Further, the introduction of new merchandise, changes in merchandise mix, changes in consumer confidence, or other competitive and general economic conditions may cause actual returns to exceed merchandise return reserves. Any significant increase in merchandise returns that exceeds our reserves could harm our business and operating results.

*We must successfully manage the complexities associated with a multi-channel and multi-brand business.*

During the past few years, with the launch and expansion of our Internet business, new brands and brand extensions, our overall business has become substantially more complex. The changes in our business have forced us to develop new expertise and face new challenges, risks and uncertainties. For example, we face the risk that our Internet business might cannibalize a significant portion of our retail and catalog businesses, and we face the risk of increased catalog circulation cannibalizing our retail sales. While we recognize that our Internet sales cannot be entirely incremental to sales through our retail and catalog channels, we seek to attract as many new customers as possible to our e-commerce websites. We continually analyze the business results of our three channels and the relationships among the channels, in an effort to find opportunities to build incremental sales.

*We may not be able to introduce new brands and brand extensions, or to reposition existing brands, to improve our business.*

We have in the past and may in the future introduce new brands and brand extensions, or reposition existing brands. Our newest brands West Elm, PBteen and Williams-Sonoma Home and any other new brands, however, may not be successful growth vehicles. Further, if we devote time and resources to new brands, brand extensions or brand repositioning, and those businesses are not as successful as we planned, then we risk

damaging our overall business results. Alternatively, if our new brands, brand extensions or repositioned brands

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prove to be very successful, we risk hurting our other existing brands through the potential migration of existing brand customers to the new businesses. In addition, we may not be able to introduce new brands and brand extensions, or to reposition brands in a manner that improves our overall business and operating results.

*Our inability to obtain commercial insurance at acceptable prices or our failure to adequately reserve for self-insured exposures might have a negative impact on our business.*

We believe that commercial insurance coverage is prudent for risk management. Insurance costs may increase substantially in the future and may be affected by natural catastrophes, fear of terrorism and financial irregularities and other fraud at publicly traded companies. In addition, for certain types or levels of risk, such as risks associated with earthquakes, hurricanes or terrorist attacks, we may determine that we cannot obtain commercial insurance at acceptable prices, if at all. Therefore, we may choose to forego or limit our purchase of relevant commercial insurance, choosing instead to self-insure one or more types or levels of risks. We are primarily self-insured for workers' compensation, employee health benefits and product and general liability claims. If we suffer a substantial loss that is not covered by commercial insurance or our self-insurance reserves, the loss and attendant expenses could harm our business and operating results. In addition, exposures exist for which no insurance may be available and for which we have not reserved.

*Our inability or failure to protect our intellectual property would have a negative impact on our business.*

Our trademarks, service marks, copyrights, patents, trade dress rights, trade secrets, domain names and other intellectual property are valuable assets that are critical to our success. The unauthorized reproduction or other misappropriation of our intellectual property could diminish the value of our brands or goodwill and cause a decline in our sales. We may not be able to adequately protect our intellectual property. In addition, the costs of defending our intellectual property may adversely affect our operating results.

*We may be subject to legal proceedings that could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources.*

We are involved in lawsuits, claims and proceedings incident to the ordinary course of our business. Litigation is inherently unpredictable. Any claims against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources. There are an increasing number of cases being filed against companies generally, including a growing number of business method patent infringement lawsuits. The plaintiff in each case claims to hold a patent that covers certain technology or methodologies, which are allegedly infringed by the operation of the defendants' business. We are currently a defendant in such patent infringement cases and may be named in others in the future, as part of an industry-wide trend. There has also been a rise in lawsuits against companies like us that collect personal information from customers. The cost of defending such claims or the ultimate resolution of such claims may harm our business and operating results.

*We need to successfully manage our employment, occupancy and other operating costs.*

To be successful, we need to manage our operating costs and continue to look for opportunities to reduce costs. We recognize that we may need to increase the number of our employees, especially in peak sales seasons, and incur other expenses to support new brands and brand extensions, as well as the opening of new stores and direct-to-customer growth of our existing brands. From time to time, we may also experience union

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organizing activity in currently non-union facilities. Union organizing activity may result in work slowdowns or stoppages and higher labor costs. In addition, there appears to be a growing number of wage-and-hour lawsuits against retail companies, especially in California.

We contract with various agencies to provide us with qualified personnel for our workforce. Any negative publicity regarding these agencies, such as in connection with immigration issues or employment practices, could

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damage our reputation, disrupt our ability to obtain needed labor or result in financial harm to our business, including the potential loss of business-related financial incentives in the jurisdictions where we operate.

Although we strive to secure long-term contracts with our service providers and other vendors and to otherwise limit our financial commitment to them, we may not be able to avoid unexpected operating cost increases in the future. Further, we incur substantial costs to warehouse and distribute our inventory. Significant increases in our inventory levels may result in increased warehousing and distribution costs in addition to potential increases in costs associated with inventory that is lost, damaged or aged. Higher than expected costs, particularly if coupled with lower than expected sales, would negatively impact our business and operating results.

*We are undertaking certain systems changes that might disrupt our business operations.*

Our success depends, in part, on our ability to source and distribute merchandise efficiently through appropriate systems and procedures. We are in the process of substantially modifying our information technology systems, including design, sourcing, merchandise planning and forecasting, purchase order and inventory management, customer order management, and pricing and promotions management. Modifications will involve updating or replacing legacy systems with successor systems during the course of several years. There are inherent risks associated with replacing our core systems, including supply chain and merchandising systems disruptions that affect our ability to get the correct products into the appropriate stores and delivered to customers. We may not successfully launch these new systems, or the launch of such systems may result in disruptions to our business operations. In addition, changes to any of our software implementation strategies could result in the impairment of software-related assets. We are also subject to the risks associated with the ability of our vendors to provide information technology solutions to meet our needs. Any disruptions could negatively impact our business and operating results.

*We outsource certain aspects of our business to third party vendors that subject us to risks, including disruptions in our business and increased costs.*

We outsource certain aspects of our business to third party vendors that subject us to risks of disruptions in our business as well as increased costs. For example, we have engaged IBM to host and manage certain aspects of our data center information technology infrastructure. Accordingly, we are subject to the risks associated with IBM's ability to provide information technology services to meet our needs. Our operations will depend significantly upon our ability to make our servers, software applications and websites available and to protect our data from damage or interruption from human error, computer viruses, intentional acts of vandalism, labor disputes, natural disasters and similar events. If the cost of IBM hosting and managing certain aspects of our data center information technology infrastructure is more than expected, or if IBM or we are unable to adequately protect our data and information is lost or our ability to deliver our services is interrupted, then our business and operating results may be negatively impacted.

*Our operating and financial performance in any given period might not meet the extensive guidance that we have provided to the public.*

We provide extensive public guidance on our expected operating and financial results for future periods. Although we believe that this guidance provides investors and analysts with a better understanding of management's expectations for the future and is useful to our shareholders and potential shareholders, such guidance is comprised of forward-looking statements subject to the risks and uncertainties described in this report and in our other public filings and public statements. Our guidance may not always be accurate. If, in the future, our operating or financial results for a particular period do not meet our guidance or the expectations of investment analysts or if we reduce our guidance for future periods, the market price of our common stock could significantly decline.



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*Our quarterly operating results might fluctuate due to a variety of factors, including seasonality.*

Our quarterly results have fluctuated in the past and may fluctuate in the future, depending upon a variety of factors, including shifts in the timing of holiday selling seasons, including Valentine's Day, Easter, Halloween, Thanksgiving and Christmas. A significant portion of our revenues and net earnings has been realized during the period from October through December. In anticipation of increased holiday sales activity, we incur certain significant incremental expenses, including fixed catalog production and mailing costs and the costs associated with hiring a substantial number of temporary employees to supplement our existing workforce. If, for any reason, we were to realize significantly lower-than-expected revenues or net earnings during the October through December selling season, our business and operating results would be harmed.

*We may require external funding sources for operating funds.*

We regularly review and evaluate our liquidity and capital needs. We currently believe that our available cash, cash equivalents, cash flow from operations and cash available under our existing credit facilities will be sufficient to finance our operations and expected capital requirements for at least the next 12 months. However, as we continue to grow, we might experience peak periods for our cash needs during the course of our fiscal year, and we might need additional external funding to support our operations. Although we believe we would have access to additional debt and/or capital market funding if needed, such funds may not be available to us on acceptable terms. If the cost of such funds is greater than expected, it could adversely affect our expenses and our operating results.

*We will require a significant amount of cash to pay quarterly dividends at intended levels and for our stock repurchase programs.*

In January 2008, the Board of Directors authorized the repurchase of up to \$150,000,000 of the company's common stock. In March 2008, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.115 to \$0.12 per common share. The share repurchase and dividend programs require the use of a significant portion of our cash earnings. As a result, we may not retain a sufficient amount of cash to finance growth opportunities, new product development initiatives and unanticipated capital expenditures or to fund our operations. Our Board of Directors may, at its discretion, decrease the intended level of dividends or entirely discontinue the payment of dividends at any time. The stock repurchase program does not have an expiration date and may be limited or terminated at any time. Our ability to pay dividends and repurchase shares will depend on our ability to generate sufficient cash flows from operations in the future. This ability may be subject to certain economic, financial, competitive and other factors that are beyond our control. Any failure to pay dividends or repurchase shares after we have announced our intention to do so may negatively impact our reputation and investor confidence in us and negatively impact our stock price.

*We are exposed to potential risks from legislation requiring companies to evaluate controls under Section 404 of the Sarbanes-Oxley Act of 2002.*

We have evaluated and tested our internal controls in order to allow management to report on, and our registered independent public accounting firm to attest to, our internal controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002. We have incurred, and expect to continue to incur, significant expenses and a diversion of management's time to meet the ongoing requirements of Section 404. If we are not able to continue to meet the requirements of Section 404 in a timely manner or with adequate compliance, we would be required to disclose material weaknesses if they develop or are uncovered and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission or the New York Stock Exchange. Any such action could negatively impact the perception of us in the financial market and our business. In addition, our internal controls may not prevent or detect all errors and fraud. A control system, no matter how well





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designed and operated, is based upon certain assumptions and can provide only reasonable assurance that the objectives of the control system will be met.

*Changes to accounting rules or regulations may adversely affect our operating results.*

Changes to existing accounting rules or regulations may impact our future operating results. For example, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. ( FIN ) 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which we adopted on January 29, 2007. The adoption of FIN 48 resulted in the recognition of an \$11,684,000 increase in the liability for tax contingencies, which was accounted for as a reduction to retained earnings, and had an approximate net 40 basis point negative impact on our effective tax rate in fiscal 2007. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective. Other new accounting rules or regulations and varying interpretations of existing accounting rules or regulations have occurred and may occur in the future. Future changes to accounting rules or regulations or the questioning of current accounting practices may adversely affect our operating results.

*Changes to estimates related to our property and equipment, or operating results that are lower than our current estimates at certain store locations, may cause us to incur impairment charges.*

We make certain estimates and projections in connection with impairment analyses for certain of our store locations and other property and equipment in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. For example, we review for impairment all stores for which current cash flows from operations are either negative or nominal, or the construction costs are significantly in excess of the amount originally expected. An impairment charge is required when the carrying value of the asset exceeds the undiscounted future cash flows over the life of the lease. These calculations require us to make a number of estimates and projections of future results, often up to 20 years into the future. If these estimates or projections change or prove incorrect, we may be, and have been, required to record impairment charges on certain store locations and other property and equipment. If these impairment charges are significant, our operating results would be adversely affected.

*We must properly account for our unredeemed gift certificates, gift cards and merchandise credits.*

We maintain a liability for unredeemed gift certificates, gift cards and merchandise credits until the earlier of redemption, escheatment or four years. After four years, the remaining unredeemed gift certificate, gift card or merchandise credit liability is relieved and recorded within selling, general and administrative expenses. In the event that a state or states were to require that the unredeemed amounts should have been escheated to that state or states, our business and operating results would be harmed. Further, in the event that our historical redemption patterns change in the future, our operating results would be affected.

*We may experience fluctuations in our tax obligations and effective tax rate.*

We are subject to income taxes in many U.S. and certain foreign jurisdictions. We record tax expense based on our estimates of future payments, which include reserves for estimates of probable settlements of foreign and domestic tax audits. At any one time, many tax years are subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. As a result, we expect that throughout the year there could be on-going variability in our quarterly tax rates as taxable events occur

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and exposures are evaluated. Further, our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings or by changes to existing accounting rules or regulations. For example, the adoption of FIN 48 had an approximate net 40 basis point negative impact on our effective tax rate in fiscal 2007.

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*We rely on the services of key personnel, whose knowledge of our business and expertise would be difficult to replace.*

Our future success depends to a significant degree on the skills, experience and efforts of key personnel in our senior management, whose vision for our company, knowledge of our business and expertise would be difficult to replace. If any of our key employees leaves, is seriously injured or is unable to work, and we are unable to find a qualified replacement, we may be unable to execute our business strategy.

In addition, our main offices are located in the San Francisco Bay Area, where competition for personnel with retail and technology skills is intense. If we fail to identify, attract, retain and motivate these skilled personnel, our business may be harmed. Further, in the event we need to hire additional personnel, we may experience difficulties due to significant competition for highly skilled personnel in our market.

*We may be exposed to risks and costs associated with credit card fraud and identity theft that could cause us to incur unexpected expenditures and loss of revenue.*

A significant portion of our customer orders are placed through our website or through our customer care centers. In order for our direct-to-customer channel to function and develop successfully, we and other parties involved in processing customer transactions must be able to transmit confidential information, including credit card information, securely over public networks. Third parties may have the technology or knowledge to breach the security of customer transaction data. Although we take the security of our systems and the privacy of our customers confidential information seriously, we cannot guarantee that our security measures will effectively prohibit others from obtaining unauthorized access to our information and our customers' information. Any person who circumvents our security measures could destroy or steal valuable information or disrupt our operations. Any security breach could cause customers to lose confidence in the security of our website and choose not to purchase from us. Any security breach could also expose us to risks of data loss, litigation and liability and could seriously disrupt our operations and harm our reputation, any of which could harm our business.

In addition, states and the federal government are increasingly enacting laws and regulations to protect consumers against identity theft. We collect personal information from consumers in the course of doing business. These laws will likely increase the costs of doing business and, if we fail to implement appropriate safeguards or to detect and provide prompt notice of unauthorized access as required by some of these new laws, we could be subject to potential claims for damages and other remedies, which could harm our business.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Information required by this Item is contained in the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the heading "Stock Repurchase Program" within Part I of this Form 10-Q.

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## (a) Exhibits

| Exhibit |  |
|---------|--|
| Number  | Exhibit Description  |
| 10.1    | Form of Williams-Sonoma, Inc. 2001 Long-Term Incentive Plan Restricted Stock Unit Award Agreement for Employee Grants                              |
| 10.2    | 2001 Incentive Bonus Plan, as amended and restated   |
| 31.1    | Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended                 |
| 31.2    | Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended                 |
| 32.1    | Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2    | Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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**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.

WILLIAMS-SONOMA, INC.

By: /s/ Sharon L. McCollam  
Sharon L. McCollam  
Executive Vice President,  
Chief Operating and Chief Financial Officer

Date: June 11, 2008