

WILLIAMS SONOMA INC  
Form 10-Q  
September 09, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**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 July 31, 2011.

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.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

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

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

## Edgar Filing: WILLIAMS SONOMA INC - Form 10-Q

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 ☒

Accelerated filer ☐

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

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 August 28, 2011, 103,678,962 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 JULY 31, 2011**

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

(Unaudited)

|                                                                                                                                                                                           | July 31,<br>2011 | January 30,<br>2011 | August 1,<br>2010 |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|---------------------|-------------------|
| <i>Dollars and shares in thousands, except per share amounts</i>                                                                                                                          |                  |                     |                   |
| <b>ASSETS</b>                                                                                                                                                                             |                  |                     |                   |
| Current assets                                                                                                                                                                            |                  |                     |                   |
| Cash and cash equivalents                                                                                                                                                                 | \$ 424,634       | \$ 628,403          | \$ 404,037        |
| Restricted cash                                                                                                                                                                           | 14,721           | 12,512              | 12,502            |
| Accounts receivable, net                                                                                                                                                                  | 51,406           | 41,565              | 37,888            |
| Merchandise inventories, net                                                                                                                                                              | 556,628          | 513,381             | 518,623           |
| Prepaid catalog expenses                                                                                                                                                                  | 41,663           | 36,825              | 41,798            |
| Prepaid expenses                                                                                                                                                                          | 39,697           | 21,120              | 42,165            |
| Deferred income taxes                                                                                                                                                                     | 85,690           | 85,612              | 92,241            |
| Other assets                                                                                                                                                                              | 7,626            | 8,176               | 7,718             |
| Total current assets                                                                                                                                                                      | 1,222,065        | 1,347,594           | 1,156,972         |
| Property and equipment, net                                                                                                                                                               | 735,129          | 730,556             | 771,635           |
| Non-current deferred income taxes                                                                                                                                                         | 32,381           | 32,646              | 52,129            |
| Other assets, net                                                                                                                                                                         | 20,549           | 20,966              | 14,757            |
| Total assets                                                                                                                                                                              | \$ 2,010,124     | \$ 2,131,762        | \$ 1,995,493      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                                                                                                                               |                  |                     |                   |
| Current liabilities                                                                                                                                                                       |                  |                     |                   |
| Accounts payable                                                                                                                                                                          | \$ 196,843       | \$ 227,963          | \$ 184,135        |
| Accrued salaries, benefits and other                                                                                                                                                      | 78,488           | 122,440             | 83,188            |
| Customer deposits                                                                                                                                                                         | 191,889          | 192,450             | 190,347           |
| Income taxes payable                                                                                                                                                                      | 13,190           | 41,997              | 17,507            |
| Current portion of long-term debt                                                                                                                                                         | 1,542            | 1,542               | 1,714             |
| Other liabilities                                                                                                                                                                         | 25,731           | 25,324              | 25,279            |
| Total current liabilities                                                                                                                                                                 | 507,683          | 611,716             | 502,170           |
| Deferred rent and lease incentives                                                                                                                                                        | 195,691          | 202,135             | 221,086           |
| Long-term debt                                                                                                                                                                            | 7,064            | 7,130               | 7,197             |
| Other long-term obligations                                                                                                                                                               | 49,499           | 51,918              | 58,383            |
| Total liabilities                                                                                                                                                                         | 759,937          | 872,899             | 788,836           |
| Commitments and contingencies                                                                                                                                                             |                  |                     |                   |
| Shareholders' equity                                                                                                                                                                      |                  |                     |                   |
| Preferred stock, \$.01 par value, 7,500 shares authorized, none issued                                                                                                                    | 0                | 0                   | 0                 |
| Common stock, \$.01 par value, 253,125 shares authorized, issued and outstanding: 103,992, 104,888 and 106,483 shares at July 31, 2011, January 30, 2011 and August 1, 2010, respectively | 1,040            | 1,049               | 1,065             |
| Additional paid-in capital                                                                                                                                                                | 478,024          | 466,885             | 462,106           |
| Retained earnings                                                                                                                                                                         | 755,672          | 777,939             | 732,290           |
| Accumulated other comprehensive income                                                                                                                                                    | 15,451           | 12,990              | 11,196            |
| Total shareholders' equity                                                                                                                                                                | 1,250,187        | 1,258,863           | 1,206,657         |
| Total liabilities and shareholders' equity                                                                                                                                                | \$ 2,010,124     | \$ 2,131,762        | \$ 1,995,493      |

*See Notes to Condensed Consolidated Financial Statements.*

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

(Unaudited)

|                                                                  | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|------------------------------------------------------------------|----------------------|-------------------|------------------------|-------------------|
|                                                                  | July 31,<br>2011     | August 1,<br>2010 | July 31,<br>2011       | August 1,<br>2010 |
| <i>Dollars and shares in thousands, except per share amounts</i> |                      |                   |                        |                   |
| Net revenues                                                     | \$ 814,750           | \$ 775,554        | \$ 1,585,575           | \$ 1,493,191      |
| Cost of goods sold                                               | 506,029              | 488,827           | 980,971                | 935,906           |
| Gross margin                                                     | 308,721              | 286,727           | 604,604                | 557,285           |
| Selling, general and administrative expenses                     | 244,636              | 235,530           | 488,819                | 473,627           |
| Interest expense, net                                            | 69                   | 123               | 70                     | 251               |
| Earnings before income taxes                                     | 64,016               | 51,074            | 115,715                | 83,407            |
| Income tax expense                                               | 24,707               | 20,315            | 44,791                 | 33,110            |
| Net earnings                                                     | \$ 39,309            | \$ 30,759         | \$ 70,924              | \$ 50,297         |
| Basic earnings per share                                         | \$ 0.38              | \$ 0.29           | \$ 0.68                | \$ 0.47           |
| Diluted earnings per share                                       | \$ 0.37              | \$ 0.28           | \$ 0.66                | \$ 0.46           |
| Shares used in calculation of earnings per share:                |                      |                   |                        |                   |
| Basic                                                            | 104,467              | 107,668           | 104,795                | 107,370           |
| Diluted                                                          | 106,766              | 110,224           | 107,071                | 109,895           |

*See Notes to Condensed Consolidated Financial Statements.*

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

(Unaudited)

|                                                                                               | Twenty-Six Weeks Ended |            |
|-----------------------------------------------------------------------------------------------|------------------------|------------|
|                                                                                               | July 31,               | August 1,  |
|                                                                                               | 2011                   | 2010       |
| <i>Dollars in thousands</i>                                                                   |                        |            |
| Cash flows from operating activities:                                                         |                        |            |
| Net earnings                                                                                  | \$ 70,924              | \$ 50,297  |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: |                        |            |
| Depreciation and amortization                                                                 | 65,899                 | 73,882     |
| (Gain)/loss on sale/disposal of assets                                                        | 646                    | (2,033)    |
| Impairment of assets                                                                          | 172                    | 2,032      |
| Amortization of deferred lease incentives                                                     | (13,999)               | (19,709)   |
| Deferred income taxes                                                                         | (4,830)                | (6,327)    |
| Tax benefit from exercise of stock-based awards                                               | 5,865                  | 8,011      |
| Stock-based compensation expense                                                              | 12,256                 | 15,269     |
| Changes in:                                                                                   |                        |            |
| Accounts receivable                                                                           | (9,048)                | 6,345      |
| Merchandise inventories                                                                       | (42,669)               | (52,160)   |
| Prepaid catalog expenses                                                                      | (4,839)                | (9,021)    |
| Prepaid expenses and other assets                                                             | (17,262)               | (17,952)   |
| Accounts payable                                                                              | (42,240)               | (2,561)    |
| Accrued salaries, benefits and other current and long-term liabilities                        | (46,523)               | (18,710)   |
| Customer deposits                                                                             | (846)                  | (4,991)    |
| Deferred rent and lease incentives                                                            | 7,648                  | (743)      |
| Income taxes payable                                                                          | (28,885)               | (30,740)   |
| Net cash used in operating activities                                                         | (47,731)               | (9,111)    |
| Cash flows from investing activities:                                                         |                        |            |
| Purchases of property and equipment                                                           | (62,525)               | (30,889)   |
| Restricted cash deposits                                                                      | (2,209)                | (12,502)   |
| Proceeds from sale of assets                                                                  | 41                     | 10,715     |
| Other                                                                                         | (200)                  | 0          |
| Net cash used in investing activities                                                         | (64,893)               | (32,676)   |
| Cash flows from financing activities:                                                         |                        |            |
| Repayments of long-term obligations                                                           | (66)                   | (1,348)    |
| Net proceeds from exercise of stock-based awards                                              | 7,412                  | 9,573      |
| Tax withholdings related to stock-based awards                                                | (8,181)                | (11,024)   |
| Excess tax benefit from exercise of stock-based awards                                        | 4,821                  | 5,992      |
| Payment of dividends                                                                          | (33,617)               | (27,023)   |
| Repurchase of common stock                                                                    | (62,496)               | (44,306)   |
| Other                                                                                         | (20)                   | 0          |
| Net cash used in financing activities                                                         | (92,147)               | (68,136)   |
| Effect of exchange rates on cash and cash equivalents                                         | 1,002                  | 17         |
| Net decrease in cash and cash equivalents                                                     | (203,769)              | (109,906)  |
| Cash and cash equivalents at beginning of period                                              | 628,403                | 513,943    |
| Cash and cash equivalents at end of period                                                    | \$ 424,634             | \$ 404,037 |

*See Notes to Condensed Consolidated Financial Statements.*

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**WILLIAMS-SONOMA, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Twenty-Six Weeks Ended July 31, 2011 and August 1, 2010

(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 July 31, 2011 and August 1, 2010, the condensed consolidated statements of earnings for the thirteen and twenty-six weeks then ended and the condensed consolidated statements of cash flows for the twenty-six weeks then ended 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 and twenty-six weeks then ended. Significant intercompany transactions and accounts have been eliminated. The balance sheet as of January 30, 2011, presented herein, has been derived from our audited balance sheet included in our Annual Report on Form 10-K for the fiscal year ended January 30, 2011.

The results of operations for the thirteen and twenty-six weeks ended July 31, 2011 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 January 30, 2011.

**NOTE B. BORROWING ARRANGEMENTS**

*Credit Facility*

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. Prior to March 23, 2015, 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 certain financial covenants, including a maximum leverage ratio (funded debt adjusted for lease and rent expense to earnings before interest, income tax, depreciation, amortization and rent expense EBITDAR ), and covenants limiting our ability to dispose of assets, make acquisitions, be acquired (if a default would result from the acquisition), incur indebtedness, grant liens and make investments. 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 material indebtedness and events constituting a change of control. The occurrence of an event 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 that have guaranteed the credit facility to pay the full amount of our obligations under the credit facility. As of July 31, 2011, we were in compliance with our financial covenants under the credit facility and, based on current projections, we expect to be in compliance throughout fiscal 2011. The credit facility matures on September 23, 2015, at which time all outstanding borrowings must be repaid and all outstanding letters of credit must be cash collateralized.

We may elect interest rates calculated at (i) Bank of America's prime rate (or, if greater, the average rate on overnight federal funds plus one-half of one percent, or a rate based on LIBOR plus one percent) plus a margin based on our leverage ratio or (ii) LIBOR plus a margin based on our leverage ratio. During the thirteen and twenty-six weeks ended July 31, 2011 and August 1, 2010, we had no borrowings under the credit facility, and no amounts were outstanding as of July 31, 2011 or August 1, 2010. Additionally, as of July 31, 2011, \$9,420,000 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 and other insurance programs.

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### *Letter of Credit Facilities*

As of July 31, 2011, we had three unsecured letter of credit reimbursement facilities for a total of \$90,000,000. On September 2, 2011, we renewed the three unsecured commercial letter of credit reimbursement facilities, each of which matures on August 31, 2012. The letter of credit facilities contain covenants and provide for events of default that are consistent with our unsecured revolving line of credit. Interest on unreimbursed amounts 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) plus 2.0%. As of July 31, 2011, an aggregate of \$30,184,000 was outstanding under the letter of credit facilities, which represent only a future commitment to fund inventory purchases to which we had not taken legal title. The latest expiration possible for any future letters of credit issued under the facilities is now January 28, 2013.

### *Long-Term Debt*

As of July 31, 2011, we had \$8,606,000 of long-term debt obligations, consisting primarily of the bond-related debt associated with one of our Memphis-based distribution facilities, which accrues interest based on a variable rate. As of July 31, 2011, the carrying value of our long-term debt approximates fair value.

## **NOTE C. STOCK-BASED COMPENSATION**

### *Equity Award Programs*

On May 25, 2011, our shareholders approved an amendment and restatement of our Amended and Restated 2001 Long-Term Incentive Plan (the Plan) to, among other things, increase the shares issuable by 7,300,000 shares and extend the term to 2021. 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 25,759,903 shares. As of July 31, 2011, there were 9,112,108 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 seven years. Incentive stock options that may be issued to 10% shareholders, however, 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 day 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 a period of four to five years. Stock awards granted to employees generally vest over a period of three to five years for service based awards. Certain option awards, stock awards and other agreements contain vesting acceleration clauses resulting from events including, but not limited to, retirement, merger or a 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 award exercises will be funded with the issuance of new shares.

### *Stock-Based Compensation Expense*

We measure and record stock-based compensation expense in our consolidated financial statements for all employee stock-based awards using a fair value method. During the thirteen and twenty-six weeks ended July 31, 2011, we recognized total stock-based compensation expense, as a component of selling, general and administrative expenses, of \$7,029,000 and \$12,256,000, respectively. During the thirteen and twenty-six weeks ended August 1, 2010, we recognized total stock-based compensation expense of \$6,513,000 and \$15,269,000, respectively (including stock-based compensation expense of approximately \$815,000 and \$4,042,000, respectively, associated with the retirement of our former Chairman and Chief Executive Officer).

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### Stock Options

The following table summarizes our stock option activity during the twenty-six weeks ended July 31, 2011:

|                                        | Shares    |
|----------------------------------------|-----------|
| Balance at January 30, 2011            | 1,367,629 |
| Granted                                | 0         |
| Exercised                              | (336,158) |
| Canceled                               | (700)     |
| Balance at July 31, 2011 (100% vested) | 1,030,771 |

### Stock-Settled Stock Appreciation Rights

The following table summarizes our stock-settled stock appreciation right activity during the twenty-six weeks ended July 31, 2011:

|                                               | Shares    |
|-----------------------------------------------|-----------|
| Balance at January 30, 2011                   | 3,429,200 |
| Granted                                       | 1,387,460 |
| Converted                                     | (372,365) |
| Canceled                                      | (155,705) |
| Balance at July 31, 2011                      | 4,288,590 |
| Vested at July 31, 2011                       | 1,004,079 |
| Vested plus expected to vest at July 31, 2011 | 3,780,800 |

### Restricted Stock Units

The following table summarizes our restricted stock unit activity during the twenty-six weeks ended July 31, 2011:

|                                               | Shares    |
|-----------------------------------------------|-----------|
| Balance at January 30, 2011                   | 2,050,898 |
| Granted                                       | 589,933   |
| Released                                      | (266,096) |
| Canceled                                      | (81,741)  |
| Balance at July 31, 2011                      | 2,292,994 |
| Vested plus expected to vest at July 31, 2011 | 1,904,731 |

### NOTE D. COMPREHENSIVE INCOME

Comprehensive income for the thirteen and twenty-six weeks ended July 31, 2011 and August 1, 2010 was as follows:

|                                         | Thirteen Weeks Ended<br>July 31, |                   | Twenty-Six Weeks Ended<br>July 31, |                   |
|-----------------------------------------|----------------------------------|-------------------|------------------------------------|-------------------|
|                                         | 2011                             | August 1,<br>2010 | 2011                               | August 1,<br>2010 |
| <i>Dollars in thousands</i>             |                                  |                   |                                    |                   |
| Net earnings                            | \$ 39,309                        | \$ 30,759         | \$ 70,924                          | \$ 50,297         |
| Other comprehensive income              |                                  |                   |                                    |                   |
| Foreign currency translation adjustment | 73                               | (885)             | 2,460                              | 807               |
| Comprehensive income                    | \$ 39,382                        | \$ 29,874         | \$ 73,384                          | \$ 51,104         |



**Table of Contents****NOTE E. 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:

| <i>Dollars and amounts in thousands, except per share amounts</i> | Net Earnings | Weighted<br>Average Shares | Earnings<br>Per Share |
|-------------------------------------------------------------------|--------------|----------------------------|-----------------------|
| <b>Thirteen weeks ended July 31, 2011</b>                         |              |                            |                       |
| Basic                                                             | \$ 39,309    | 104,467                    | \$ 0.38               |
| Effect of dilutive stock-based awards                             |              | 2,299                      |                       |
| Diluted                                                           | \$ 39,309    | 106,766                    | \$ 0.37               |
| <b>Thirteen weeks ended August 1, 2010</b>                        |              |                            |                       |
| Basic                                                             | \$ 30,759    | 107,668                    | \$ 0.29               |
| Effect of dilutive stock-based awards                             |              | 2,556                      |                       |
| Diluted                                                           | \$ 30,759    | 110,224                    | \$ 0.28               |
| <b>Twenty-six weeks ended July 31, 2011</b>                       |              |                            |                       |
| Basic                                                             | \$ 70,924    | 104,795                    | \$ 0.68               |
| Effect of dilutive stock-based awards                             |              | 2,276                      |                       |
| Diluted                                                           | \$ 70,924    | 107,071                    | \$ 0.66               |
| <b>Twenty-six weeks ended August 1, 2010</b>                      |              |                            |                       |
| Basic                                                             | \$ 50,297    | 107,370                    | \$ 0.47               |
| Effect of dilutive stock-based awards                             |              | 2,525                      |                       |
| Diluted                                                           | \$ 50,297    | 109,895                    | \$ 0.46               |

Stock-based awards of 1,530,000 and 1,995,000 for the thirteen weeks ended and 1,697,000 and 2,008,000 for the twenty-six weeks ended July 31, 2011 and August 1, 2010, respectively, were not included in the computation of diluted earnings per share, as their inclusion would be anti-dilutive.

**NOTE F. ASSET IMPAIRMENT AND LEASE TERMINATION CHARGES**

We review the carrying value of all long-lived assets for impairment, primarily at a store level, whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. We review for impairment all stores for which current or projected cash flows from operations are not sufficient to recover the carrying value of the assets. Impairment results when the carrying value of the assets exceeds the estimated undiscounted future cash flows over the remaining life of the lease. Our estimate of undiscounted future cash flows over the store lease term (generally 5 to 22 years) is based upon our experience, historical operations of the stores and estimates of future store profitability and economic conditions. The future estimates of store profitability and economic conditions require estimating such factors as sales growth, gross margin, employment rates, lease escalations, inflation on operating expenses and the overall economics of the retail industry, and are therefore subject to variability and difficult to predict. If a long-lived asset is found to be impaired, the amount recognized for impairment is equal to the difference between the net carrying value and the asset's fair value. Long-lived assets are measured at fair value on a nonrecurring basis using Level 3 inputs as defined in the fair value hierarchy. The fair value is estimated based upon future cash flows (discounted at a rate that is commensurate with the risk and approximates our weighted average cost of capital).

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For any store or facility closure where a lease obligation still exists, we record the estimated future liability associated with the rental obligation on the cease use date.

During the thirteen and twenty-six weeks ended July 31, 2011, we recorded expense of approximately \$787,000 (of which \$518,000 is recorded within selling, general and administrative expenses and the remainder within cost of goods sold) and \$2,309,000 (of which \$2,040,000 is recorded within selling, general and administrative expenses and the remainder within cost of goods sold), respectively, associated with asset impairment and early lease termination charges for underperforming retail stores.

During the thirteen and twenty-six weeks ended August 1, 2010, we recorded expense of approximately \$4,280,000 (of which \$4,110,000 is recorded within selling, general and administrative expenses and the remainder within cost of goods sold) and \$10,317,000 (of which \$9,689,000 is recorded within selling, general and administrative expenses and the remainder within cost of goods sold), respectively, associated with asset impairment and early lease termination charges for underperforming retail stores. We also recorded a net benefit in selling, general and administrative expenses of \$403,000 during the thirteen and twenty-six weeks ended August 1, 2010 related to the exit of excess distribution capacity.

## **NOTE G. SEGMENT REPORTING**

We have two reportable segments, direct-to-customer and 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 our products through our six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and wshome.com) and six direct mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed and Bath, PBteen and West Elm). The retail segment has four merchandising concepts which sell products for the home (Williams-Sonoma, Pottery Barn, Pottery Barn Kids and West Elm). The four retail merchandising concepts are operating segments, which have been aggregated into one reportable segment, retail. Management's expectation is that the overall economic characteristics of each of our major concepts within each reportable segment will be similar over time based on management's judgment that the operating segments have had similar historical economic characteristics and are expected to have similar long-term financial performance in the future.

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. Based on management's best estimate, our operating segments include allocations of certain expenses, including advertising and employment costs, to the extent they have been determined to benefit both channels. These operating segments are aggregated at the channel level for reporting purposes due to the fact that our brands are interdependent for economies of scale and we do not maintain fully allocated income statements at the brand level. As a result, material financial decisions related to the brands are made at the channel level. Furthermore, 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-Customer | Retail     | Unallocated | Total        |
|------------------------------------------------------|--------------------|------------|-------------|--------------|
| <b>Thirteen weeks ended July 31, 2011</b>            |                    |            |             |              |
| Net revenues <sup>1</sup>                            | \$ 368,041         | \$ 446,709 | \$ 0        | \$ 814,750   |
| Depreciation and amortization expense                | 4,951              | 19,791     | 8,279       | 33,021       |
| Earnings (loss) before income taxes <sup>2</sup>     | 83,348             | 38,275     | (57,607)    | 64,016       |
| Capital expenditures                                 | 8,873              | 13,860     | 17,556      | 40,289       |
| <b>Thirteen weeks ended August 1, 2010</b>           |                    |            |             |              |
| Net revenues <sup>1</sup>                            | \$ 325,678         | \$ 449,876 | \$ 0        | \$ 775,554   |
| Depreciation and amortization expense                | 5,313              | 21,870     | 7,697       | 34,880       |
| Earnings (loss) before income taxes <sup>2,3,4</sup> | 68,344             | 34,446     | (51,716)    | 51,074       |
| Capital expenditures                                 | 3,065              | 5,718      | 4,675       | 13,458       |
| <b>Twenty-six weeks ended July 31, 2011</b>          |                    |            |             |              |
| Net revenues <sup>1</sup>                            | \$ 712,162         | \$ 873,413 | \$ 0        | \$ 1,585,575 |
| Depreciation and amortization expense                | 10,063             | 39,401     | 16,435      | 65,899       |
| Earnings (loss) before income taxes <sup>2</sup>     | 158,262            | 68,754     | (111,301)   | 115,715      |
| Assets <sup>5</sup>                                  | 315,176            | 882,388    | 812,560     | 2,010,124    |
| Capital expenditures                                 | 13,227             | 20,723     | 28,575      | 62,525       |
| <b>Twenty-six weeks ended August 1, 2010</b>         |                    |            |             |              |
| Net revenues <sup>1</sup>                            | \$ 631,535         | \$ 861,656 | \$ 0        | \$ 1,493,191 |
| Depreciation and amortization expense                | 10,697             | 47,942     | 15,243      | 73,882       |
| Earnings (loss) before income taxes <sup>2,3,4</sup> | 136,955            | 57,026     | (110,574)   | 83,407       |
| Assets <sup>5</sup>                                  | 282,213            | 896,831    | 816,449     | 1,995,493    |
| Capital expenditures                                 | 6,821              | 13,652     | 10,416      | 30,889       |

<sup>1</sup> Includes net revenues in the retail channel of approximately \$30.3 million and \$25.2 million for the thirteen weeks ended July 31, 2011 and August 1, 2010, respectively, and \$56.6 million and \$45.6 million for the twenty-six weeks ended July 31, 2011 and August 1, 2010, respectively, related to our foreign operations.

<sup>2</sup> Includes expenses in the retail channel of approximately \$0.8 million and \$4.3 million for the thirteen weeks ended July 31, 2011 and August 1, 2010, respectively, and \$2.3 million and \$10.3 million for the twenty-six weeks ended July 31, 2011 and August 1, 2010, respectively, related to asset impairment and early lease termination charges for underperforming retail stores.

<sup>3</sup> Unallocated costs before income taxes include \$1.0 million and \$4.3 million for the thirteen and twenty-six weeks ended August 1, 2010, respectively, related to the retirement of our former Chairman of the Board and Chief Executive Officer.

<sup>4</sup> Unallocated costs before income taxes include a net benefit of \$0.4 million for the thirteen and twenty-six weeks ended August 1, 2010 related to the exit of excess distribution capacity.

<sup>5</sup> Includes \$26.0 million and \$28.1 million of long-term assets as of July 31, 2011 and August 1, 2010, respectively, related to our foreign operations.

**NOTE H. MEMPHIS-BASED DISTRIBUTION FACILITY**

Our Memphis-based distribution facilities include an operating lease entered into in July 1983 for a distribution facility in Memphis, Tennessee. The lessor is a general partnership ( Partnership 1 ) comprised of the estate of W. Howard Lester ( Mr. Lester ), our former Chairman of the Board of Directors and Chief Executive Officer, and the estate of James A. McMahan, a former Director Emeritus and significant shareholder. Partnership 1 does not have operations separate from the leasing of this distribution facility and does not have lease agreements with any unrelated third parties. The terms of the lease automatically renewed until the bonds were fully repaid in December 2010. We are currently operating the distribution center on a month-to-month lease.

Our other Memphis-based distribution facility includes an operating lease entered into in August 1990 for another distribution facility that is adjoined to the Partnership 1 facility in Memphis, Tennessee. The lessor is a general partnership ( Partnership 2 ) comprised of the estate of Mr. Lester, the estate of James A. McMahan and two unrelated parties. Partnership 2 does not have operations separate from the leasing of this distribution facility and does not have lease agreements with any unrelated third parties. The term of the lease automatically renews on an annual basis until these bonds are fully repaid in August 2015.



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Prior to December 2010, the two partnerships described above qualified as variable interest entities and were consolidated by us due to their related party relationship and our obligation to renew the leases until the bonds were fully repaid. As of December 2010, however, the bonds on the distribution center leased from Partnership 1 were fully repaid and, accordingly, this facility is no longer consolidated by us. As such, as of July 31, 2011, our consolidated balance sheet includes \$12,195,000 in assets (primarily buildings), \$8,338,000 in debt and \$3,857,000 in other long-term liabilities related solely to the consolidation of the Partnership 2 distribution facility.

### **NOTE I. RELATED PARTY TRANSACTION**

On May 16, 2008, we entered into an Aircraft Lease Agreement (the "Lease Agreement") with a limited liability company (the "LLC") owned by Mr. Lester for use of a Bombardier Global 5000 aircraft owned by the LLC. Under the terms of the Lease Agreement, in exchange for use of the aircraft, we were required to pay the LLC \$375,000 for each of the 36 months of the lease term through May 2011. We were 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.

In conjunction with a retirement and consulting agreement entered into between us and Mr. Lester on January 25, 2010, Mr. Lester agreed to give us an option to purchase this aircraft at the end of the lease term for its then estimated fair value of \$32,000,000. On January 3, 2011, we provided the LLC with notice under the agreement of our intent to exercise our option to purchase the aircraft at the end of the lease term. Immediately prior to the end of the lease term, we assigned our rights to purchase the aircraft to Wells Fargo Equipment Finance, Inc. ("Wells Fargo"). We then entered into a Master Lease Agreement (the "Master Lease") with Wells Fargo to lease the aircraft. The Master Lease commenced on May 16, 2011, has a term of 10 years and is classified as an operating lease.

### **NOTE J. COMMITMENTS AND CONTINGENCIES**

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 K. STOCK REPURCHASE PROGRAM**

In January 2011, our Board of Directors authorized a stock repurchase program to purchase up to \$125,000,000 of our common stock through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. During the thirteen weeks ended July 31, 2011, we repurchased 806,282 shares under this program at a weighted average cost of \$38.75 per share and a total cost of approximately \$31,246,000. During the twenty-six weeks ended July 31, 2011, we repurchased 1,566,508 shares under this program at a weighted average cost of \$39.90 per share and a total cost of approximately \$62,496,000. There remains an aggregate of approximately \$62,504,000 available for repurchases under this stock repurchase program.

The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. This stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

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### **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 are proven incorrect, could cause our business and results of operations to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include statements related to: our expectations regarding the overall economic characteristics of each of our major concepts within each reportable segment; our beliefs regarding the resolution of current lawsuits, claims and proceedings; the expansion of our international business, including expectations regarding the opening of additional franchised locations; our expectations regarding our international e-commerce sites; our expectations regarding demand for our products; our plans to gain market share and improve profitability; our plans to leverage our multi-channel business model and grow our direct-to-customer business; our planned investment in the next phase of growth for e-commerce; our plans to explore new geographies for global expansion and find white space in the marketplace; our plans and strategies for attracting new customers to our brands; our plans to implement new efficiencies in our worldwide supply chain; our plans to drive increased traffic and higher sales per square foot in our retail stores; our plans to expand e-commerce; our expectations regarding our cash flow; our ability to return excess capital to shareholders; our plans to use our cash resources to fund our inventory and inventory-related purchases, advertising and marketing initiatives, purchases of property and equipment, stock repurchases and dividend payments; our projected earnings, revenues and sales; our stock repurchase program; the future payment of dividends; our expected effective tax rate and the variability in our quarterly tax rates; our plans for using our cash resources; our compliance with our bank covenants; our belief that our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations over the next 12 months; our planned investments and purchases; our planned investments for the purchase of property and equipment; our estimates and assumptions in preparing our condensed consolidated financial statements; our beliefs regarding seasonal patterns associated with the retail and direct-to-customer industries; our plans to enter into foreign currency contracts; the fluctuation of comparable store sales; and the implementation of certain new processes that may subject us to additional regulations and laws, as well as 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 other comparable 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 direct-to-customer segment of our business sells our products through our six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and wshome.com) and six direct-mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed and Bath, PBteen and West Elm). The retail segment of our business sells similar products through our four retail store concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids and West Elm). Based on their contribution to our net revenues, the core brands in both the direct-to-customer and retail 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.

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The following discussion and analysis of financial condition, results of operations, and liquidity and capital resources for the thirteen weeks ended July 31, 2011 ( second quarter of fiscal 2011 ), as compared to the thirteen weeks ended August 1, 2010 ( second quarter of fiscal 2010 ) and the twenty-six weeks ended July 31, 2011 ( year-to-date 2011 ), as compared to the twenty-six weeks ended August 1, 2010 ( year-to-date 2010 ), should be read in conjunction with our condensed consolidated financial statements and the notes thereto. All explanations of changes in operational results are discussed in order of their magnitude.

### *Second Quarter of Fiscal 2011 Financial Results*

The second quarter was another strong quarter. Net revenues increased 5.1% to \$814,750,000 and diluted earnings per share increased 32.1% to \$0.37 per share. Comparable brand revenues increased 6.5% as innovative merchandising, targeted marketing and a quality customer experience continued to attract customers to our brands.

Direct-to-customer net revenues in the second quarter of fiscal 2011 increased \$42,363,000, or 13.0%, compared to the second quarter of fiscal 2010. This increase was driven by growth across all brands. In e-commerce, net revenues increased 18.4% to \$316,715,000 in the second quarter of fiscal 2011, compared to \$267,470,000 in the second quarter of fiscal 2010, and now represent 86.1% of direct-to-customer net revenues as compared to 82.1% in the second quarter of fiscal 2010.

Retail net revenues in the second quarter of fiscal 2011 decreased \$3,167,000, or 0.7%, compared to the second quarter of fiscal 2010. This decrease was primarily driven by a 4.6% decline in retail leased square footage, including the closure of our Williams-Sonoma Home stores at the end of fiscal 2010. This decrease was partially offset by net revenue growth in the West Elm brand and international franchise operations, as well as comparable store sales growth of 1.4%.

In our core brands, comparable brand revenues increased 3.5%. Pottery Barn Kids saw the greatest increase, followed by Pottery Barn and Williams-Sonoma. In Pottery Barn Kids, comparable brand revenues increased 8.0% with particular strength in e-commerce. This increase was driven by strong growth across all key categories. In Pottery Barn, comparable brand revenues increased 3.6%. An innovative merchandise assortment, a strong value proposition and a strategic promotional calendar in our top performing categories drove these results. In Williams-Sonoma, planned traffic-generating promotions helped drive a comparable brand revenue increase of 0.7%.

In our emerging brands, West Elm and PBteen, comparable brand revenues increased 25.3%. In West Elm, comparable brand revenues increased 28.6%, resulting from new product introductions, an enhanced value proposition and new targeted multi-channel marketing strategies in our key merchandising categories. In PBteen, comparable brand revenues increased 20.4%. Planned promotions, expanded assortments, and successful e-marketing initiatives drove growth across all key categories.

### *Second Quarter of Fiscal 2011 Operational Results*

Throughout the second quarter of fiscal 2011, we continued to invest in our key growth initiatives, including increasing our penetration in e-commerce, expanding the reach of the West Elm brand, and extending our international presence.

In e-commerce, net revenues increased 18.4% to 38.9% of total company revenues. Several key initiatives drove these strong results, including the ongoing optimization of natural search, increased paid search, and improved relevance of event-triggered marketing.

In international, we completed the launch of our new international shipping websites across all brands, which now allow us to ship from the U.S. to customers in over 75 countries around the world. We also continued to aggressively explore profitable opportunities for retail expansion in other regions of the world, as our eight

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franchised stores in Dubai, Kuwait, and Saudi Arabia continue to introduce new customers to our brands. In the back half of the year, we expect to add five additional franchised locations in Saudi Arabia, including two Pottery Barn and three Pottery Barn Kids stores.

In our supply chain, we are continuing to see ongoing customer service and cost reduction benefits from our distribution, transportation, and packaging initiatives. These initiatives include: optimizing our inbound and outbound packaging costs; further in-sourcing our home furniture delivery operations; and expanding our company-managed Asian sourcing operations. We also significantly expanded our North Carolina upholstered furniture operations into a new facility as the demand for our exclusive assortments continues to grow.

*Fiscal 2011*

For the remainder of fiscal 2011, our focus remains on gaining market share and further improving profitability.

To achieve this, we will continue to leverage our multi-channel business model and grow our direct-to-customer business as a percentage of our mix. At the same time, we will invest in the next phase of growth for e-commerce, explore new geographies for global expansion and find white space in the marketplace that a new brand or small acquisition could fill.

To gain market share, we will continue to attract new customers to our brands through: creative, innovative and relevant product offerings, including exclusive e-commerce assortments; increased investment in e-commerce; highly targeted multi-channel marketing, including the expansion of our in-store clienteling services; and the expansion of our brands into new categories.

To further improve profitability in fiscal 2011, we plan to implement new efficiencies in our worldwide supply chain; drive increased traffic and higher sales per square foot in our retail stores by reinventing the customer experience; and continue to expand e-commerce.

**Results of Operations****NET REVENUES**

Net revenues consist of direct-to-customer revenues and retail revenues. Direct-to-customer revenues include sales of merchandise to customers through our e-commerce websites and our catalogs, as well as shipping fees. Retail revenues include sales of merchandise to customers at our retail stores, as well as shipping fees on any retail products shipped to our customers' homes. Shipping fees consist of revenue received from customers for delivery of merchandise to their homes. Revenues are presented net of sales returns and other discounts.

The following table summarizes our net revenues for the second quarter of fiscal 2011 and fiscal 2010, and year-to-date 2011 and 2010:

| <i>Dollars in thousands</i>     | Thirteen Weeks Ended |         |                   |         | Twenty-Six Weeks Ended |         |                   |         |
|---------------------------------|----------------------|---------|-------------------|---------|------------------------|---------|-------------------|---------|
|                                 | July 31,<br>2011     | % Total | August 1,<br>2010 | % Total | July 31,<br>2011       | % Total | August 1,<br>2010 | % Total |
| Direct-to-customer net revenues | \$ 368,041           | 45.2%   | \$ 325,678        | 42.0%   | \$ 712,162             | 44.9%   | \$ 631,535        | 42.3%   |
| Retail net revenues             | 446,709              | 54.8%   | 449,876           | 58.0%   | 873,413                | 55.1%   | 861,656           | 57.7%   |
| Net revenues                    | \$ 814,750           | 100.0%  | \$ 775,554        | 100.0%  | \$ 1,585,575           | 100.0%  | \$ 1,493,191      | 100.0%  |

Net revenues in the second quarter of fiscal 2011 increased by \$39,196,000, or 5.1%, compared to the second quarter of fiscal 2010. This increase was driven by growth in the West Elm, Pottery Barn Kids, PBteen and Pottery Barn brands. Comparable brand revenue increased 6.5% in the second quarter of fiscal 2011, including growth of 18.4% in our e-commerce net revenues (primarily driven by increased Internet advertising) and a 1.4%

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increase in our comparable store sales. This increase was partially offset by a 4.6% year-over-year reduction in retail leased square footage, including 23 net fewer stores.

Net revenues for year-to date 2011 increased by \$92,384,000, or 6.2%, compared to year-to-date 2010. This increase was driven by growth in the West Elm, Pottery Barn and Pottery Barn Kids brands. Comparable brand revenue increased 7.7% for year-to-date 2011, including growth of 19.5% in our e-commerce net revenues (primarily driven by increased Internet advertising) and a 4.0% increase in our comparable store sales. This increase was partially offset by a 4.6% year-over-year reduction in retail leased square footage, including 23 net fewer stores.

*Comparable Brand Revenue Growth*

Comparable brand revenue includes retail comparable store sales and direct-to-customer sales, as well as shipping fees, sales returns and other discounts associated with current period sales. Outlet comparable store net revenues are also included in their respective brands. Sales related to our international franchisee stores have been excluded as these stores are not operated by us.

Comparable stores are defined as permanent 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.

Percentages represent growth in comparable brand revenue compared to the same period in the prior year.

|                                        | Thirteen Weeks Ended |           | Twenty-Six Weeks Ended |           |
|----------------------------------------|----------------------|-----------|------------------------|-----------|
|                                        | July 31,             | August 1, | July 31,               | August 1, |
|                                        | 2011                 | 2010      | 2011                   | 2010      |
| <i>Comparable brand revenue growth</i> |                      |           |                        |           |
| Pottery Barn                           | 3.6%                 | 19.1%     | 5.7%                   | 21.2%     |
| Williams-Sonoma                        | 0.7%                 | 6.6%      | 1.8%                   | 6.8%      |
| Pottery Barn Kids                      | 8.0%                 | 24.9%     | 9.5%                   | 24.6%     |
| West Elm                               | 28.6%                | 19.0%     | 29.8%                  | 14.7%     |
| PBteen                                 | 20.4%                | 22.0%     | 14.3%                  | 21.8%     |
| Total                                  | 6.5%                 | 16.5%     | 7.7%                   | 17.3%     |

**DIRECT-TO-CUSTOMER NET REVENUES**

|                                                                     | Thirteen Weeks Ended |            | Twenty-Six Weeks Ended |            |
|---------------------------------------------------------------------|----------------------|------------|------------------------|------------|
|                                                                     | July 31,             | August 1,  | July 31,               | August 1,  |
|                                                                     | 2011                 | 2010       | 2011                   | 2010       |
| <i>Dollars in thousands</i>                                         |                      |            |                        |            |
| Direct-to-customer net revenues                                     | \$ 368,041           | \$ 325,678 | \$ 712,162             | \$ 631,535 |
| Direct-to-customer net revenue growth                               | 13.0%                | 19.8%      | 12.8%                  | 20.0%      |
| E-commerce revenue growth                                           | 18.4%                | 27.6%      | 19.5%                  | 25.7%      |
| E-commerce revenues as a percent of direct-to-customer net revenues | 86.1%                | 82.1%      | 85.2%                  | 80.4%      |
| Percent increase (decrease) in number of catalogs circulated        | (1.2%)               | 1.2%       | (1.5%)                 | (0.9%)     |
| Percent decrease in number of pages circulated                      | (3.7%)               | (0.9%)     | (1.2%)                 | (2.5%)     |

Direct-to-customer net revenues in the second quarter of fiscal 2011 increased \$42,363,000, or 13.0%, compared to the second quarter of fiscal 2010. This increase was driven by growth across all brands. In e-commerce, net revenues increased 18.4% to \$316,715,000 in the second quarter of fiscal 2011, compared to \$267,470,000 in the second quarter of fiscal 2010, and now represent 86.1% of direct-to-customer net revenues as compared to 82.1% in the second quarter of fiscal 2010.

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Direct-to-customer net revenues for year-to-date 2011 increased \$80,627,000, or 12.8%, compared to year-to-date 2010 driven by growth in the Pottery Barn, Pottery Barn Kids and West Elm brands. E-commerce net revenues for year-to-date 2011 increased 19.5% to \$606,523,000 versus \$507,459,000 for year-to-date 2010.

**RETAIL NET REVENUES AND OTHER DATA**

|                                                        | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|--------------------------------------------------------|----------------------|-------------------|------------------------|-------------------|
|                                                        | July 31,<br>2011     | August 1,<br>2010 | July 31,<br>2011       | August 1,<br>2010 |
| <i>Dollars in thousands</i>                            |                      |                   |                        |                   |
| Retail net revenues                                    | \$ 446,709           | \$ 449,876        | \$ 873,413             | \$ 861,656        |
| Retail net revenue growth (decline)                    | (0.7%)               | 12.4%             | 1.4%                   | 13.7%             |
| Comparable store sales growth                          | 1.4%                 | 13.6%             | 4.0%                   | 15.2%             |
| Number of stores - beginning of period                 | 589                  | 610               | 592                    | 610               |
| Number of new stores                                   | 3                    | -                 | 3                      | 3                 |
| Number of new stores due to remodeling <sup>1</sup>    | 3                    | 1                 | 8                      | 5                 |
| Number of closed stores due to remodeling <sup>1</sup> | (4)                  | (1)               | (7)                    | (3)               |
| Number of permanently closed stores                    | (5)                  | (1)               | (10)                   | (6)               |
| Number of stores - end of period                       | 586                  | 609               | 586                    | 609               |
| Store selling square footage at period-end             | 3,558,000            | 3,742,000         | 3,558,000              | 3,742,000         |
| Store leased square footage ( LSF ) at period-end      | 5,767,000            | 6,047,000         | 5,767,000              | 6,047,000         |

<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 |                   |           | Avg. LSF |                        |
|-----------------------|-------------|-------------------|-----------|----------|------------------------|
|                       | May 1,      | July 31,          | August 1, | July 31, | August 1,              |
|                       | 2011        | Openings Closings | 2011      | 2010     | 2011 <sup>1</sup> 2010 |
| Williams-Sonoma       | 268         | 1 (1)             | 268       | 260      | 6,500 6,300            |
| Pottery Barn          | 201         | 4 (5)             | 200       | 197      | 13,700 13,000          |
| Pottery Barn Kids     | 85          | 1 (3)             | 83        | 85       | 8,200 8,100            |
| West Elm <sup>2</sup> | 35          | - -               | 35        | 37       | 17,200 17,000          |
| Williams-Sonoma Home  | -           | - -               | -         | 11       | - 13,200               |
| Outlets <sup>1</sup>  | -           | - -               | -         | 19       | - 19,100               |
| Total                 | 589         | 6 (9)             | 586       | 609      | 9,800 9,900            |

<sup>1</sup> Beginning in fiscal 2011, Outlet stores and their leased square footage have been reclassified into their respective brands.

<sup>2</sup> Short-term pop-up stores, whose lease terms are typically less than one year, are not included in the totals above as they are not considered permanent stores.

Retail net revenues in the second quarter of fiscal 2011 decreased \$3,167,000, or 0.7%, compared to the second quarter of fiscal 2010. This decrease was primarily driven by a 4.6% decline in retail leased square footage, including the closure of our Williams-Sonoma Home stores at the end of fiscal 2010. This decrease was partially offset by net revenue growth in the West Elm brand and international franchise operations, as well as comparable store sales growth of 1.4%.

Retail net revenues for year-to-date 2011 increased \$11,757,000, or 1.4%, compared to year-to-date 2010. This increase was primarily driven by growth in the West Elm brand, comparable store sales growth of 4.0% and international franchise operations, partially offset by a 4.6% decrease in retail leased square footage, including the closure of our Williams-Sonoma Home stores at the end of fiscal 2010.



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| <i>Dollars in thousands</i>     | Thirteen Weeks Ended |                   |                   |                   | Twenty-Six Weeks Ended |                   |                   |                   |
|---------------------------------|----------------------|-------------------|-------------------|-------------------|------------------------|-------------------|-------------------|-------------------|
|                                 | July 31,<br>2011     | % Net<br>Revenues | August 1,<br>2010 | % Net<br>Revenues | July 31,<br>2011       | % Net<br>Revenues | August 1,<br>2010 | % Net<br>Revenues |
| Cost of goods sold <sup>1</sup> | \$ 506,029           | 62.1%             | \$ 488,827        | 63.0%             | \$ 980,971             | 61.9%             | \$ 935,906        | 62.7%             |

<sup>1</sup> Includes total occupancy expenses of \$123,193,000 and \$124,947,000 for the second quarter of fiscal 2011 and fiscal 2010, respectively, and \$247,829,000 and \$250,087,000 for year-to-date 2011 and year-to-date 2010, respectively.

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 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.

*Second Quarter of Fiscal 2011 vs. Second Quarter of Fiscal 2010*

Cost of goods sold increased by \$17,202,000, or 3.5%, in the second quarter of fiscal 2011 compared to the second quarter of fiscal 2010. Cost of goods sold as a percentage of net revenues decreased to 62.1% in the second quarter of fiscal 2011 from 63.0% in the second quarter of fiscal 2010. This decrease was primarily driven by the leverage of fixed occupancy expenses due to increasing net revenues, a decrease in occupancy expense dollars and higher selling margins, partially offset by the cost of goods sold impact of international franchise operations.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues decreased 10 basis points in the second quarter of fiscal 2011 compared to the second quarter of fiscal 2010. This decrease as a percentage of net revenues was primarily driven by the leverage of fixed occupancy expenses due to increasing net revenues and ongoing benefits from supply chain, partially offset by higher promotional activity compared to last year.

In the retail channel, cost of goods sold as a percentage of net revenues decreased 60 basis points in the second quarter of fiscal 2011 compared to the second quarter of fiscal 2010. This decrease as a percentage of net revenues was primarily driven by a decrease in occupancy expense dollars and higher selling margins, partially offset by the cost of goods sold impact of international franchise operations.

*Year-to-Date 2011 vs. Year-to-Date 2010*

Cost of goods sold for year-to-date 2011 increased by \$45,065,000, or 4.8%, compared to year-to-date 2010. Cost of goods sold as a percentage of net revenues decreased to 61.9% for year-to-date 2011 from 62.7% for year-to-date 2010. This decrease was primarily driven by the leverage of fixed occupancy expenses due to increasing net revenues and a decrease in occupancy expense dollars, partially offset by higher promotional activity, including shipping fees, compared to last year, and the cost of goods sold impact of international franchise operations.

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In the direct-to-customer channel, cost of goods sold as a percentage of net revenues increased 20 basis points for year-to-date 2011 compared to year-to-date 2010. This increase as a percentage of net revenues was primarily driven by higher promotional activity, including shipping fees, compared to last year, partially offset by the leverage of fixed occupancy expenses due to increasing net revenues and ongoing benefits from supply chain.

In the retail channel, cost of goods sold as a percentage of net revenues decreased 80 basis points for year-to-date 2011 compared to year-to-date 2010. This decrease as a percentage of net revenues was primarily driven by a decrease in occupancy expense dollars, the leverage of fixed occupancy expenses due to increasing net revenues and higher selling margins, partially offset by the cost of goods sold impact of international franchise operations.

**SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

| <i>Dollars in thousands</i>                  | Thirteen Weeks Ended |                   |                   |                   | Twenty-Six Weeks Ended |                   |                   |                   |
|----------------------------------------------|----------------------|-------------------|-------------------|-------------------|------------------------|-------------------|-------------------|-------------------|
|                                              | July 31,<br>2011     | % Net<br>Revenues | August 1,<br>2010 | % Net<br>Revenues | July 31,<br>2011       | % Net<br>Revenues | August 1,<br>2010 | % Net<br>Revenues |
| Selling, general and administrative expenses | \$ 244,636           | 30.0%             | \$ 235,530        | 30.4%             | \$ 488,819             | 30.8%             | \$ 473,627        | 31.7%             |

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.

We experience differing employment and advertising costs as a percentage of net revenues within the retail and direct-to-customer channels due to their distinct distribution and marketing strategies. 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, advertising expenses are higher within the direct-to-customer channel than in the retail channel.

*Second Quarter of Fiscal 2011 vs. Second Quarter of Fiscal 2010*

Selling, general and administrative expenses increased by \$9,106,000, or 3.9%, in the second quarter of fiscal 2011 compared to the second quarter of fiscal 2010. Including expense of approximately \$518,000 from early lease termination charges for underperforming retail stores, selling, general and administrative expenses as a percentage of net revenues decreased to 30.0% in the second quarter of fiscal 2011 from 30.4% in the second quarter of fiscal 2010 (which included \$4,110,000 from asset impairment and early lease termination charges for underperforming retail stores and \$972,000 associated with the retirement of our former Chairman and Chief Executive Officer). This decrease as a percentage of net revenues was primarily driven by a reduction in year-over-year asset impairment and early lease termination charges for underperforming retail stores, a decrease in advertising costs, leverage from international franchise operations, and fiscal 2010 expenses associated with the retirement of our former Chairman and Chief Executive Officer that did not recur in fiscal 2011. This decrease was partially offset by higher employment expenses, reflective of our planned incremental investment to support our e-commerce, international and business development growth strategies, as well as a gain on the sale of assets in the second quarter of 2010 that did not recur in the second quarter of 2011.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased 150 basis points in the second quarter of fiscal 2011 compared to the second quarter of fiscal 2010. This decrease was primarily driven by increased productivity on our advertising spend, partially offset by higher employment expenses.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues decreased 30 basis points in the second quarter of fiscal 2011 compared to the second quarter of fiscal 2010. This decrease was

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primarily driven by a reduction in asset impairment and early lease termination charges for underperforming retail stores and leverage from international franchise operations, partially offset by higher employment expenses.

### *Year-to-Date 2011 vs. Year-to-Date 2010*

Selling, general and administrative expenses for year-to-date 2011 increased by \$15,192,000, or 3.2%, compared to year-to-date 2010. Including expense of approximately \$2,040,000 from early lease termination charges for underperforming retail stores, selling, general and administrative expenses as a percentage of net revenues decreased to 30.8% for year-to-date 2011 from 31.7% for year-to-date 2010 (which included \$9,689,000 from asset impairment and early lease termination charges for underperforming retail stores and \$4,319,000 associated with the retirement of our former Chairman and Chief Executive Officer). This decrease as a percentage of net revenues was primarily driven by a reduction in year-over-year asset impairment and early lease termination charges for underperforming retail stores, lower incentive compensation costs, fiscal 2010 expenses associated with the retirement of our former Chairman and Chief Executive Officer that did not recur in fiscal 2011 and leverage from international franchise operations. This decrease was partially offset by higher employment expenses, reflective of our planned incremental investment to support our e-commerce, international and business development growth strategies, as well as a gain on the sale of assets in the second quarter of 2010 that did not recur in the second quarter of 2011.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased 70 basis points for year-to-date 2011 compared to year-to-date 2010. This decrease was primarily driven by increased productivity on our advertising spend, partially offset by higher employment expenses.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues decreased 50 basis points for year-to-date 2011 compared to year-to-date 2010. This decrease was primarily driven by a reduction in asset impairment and early lease termination charges for underperforming retail stores and leverage from international franchise operations, partially offset by higher employment expenses.

## **INCOME TAXES**

The effective rate was 38.7% for year-to-date 2011 and 39.7% for year-to-date 2010.

We expect the effective tax rate to be in the range of 37% to 39% in fiscal 2011. Throughout the year, we expect that there could be ongoing variability in our quarterly tax rates due to volatility in earnings in addition to taxable events that occur and tax exposures that are re-evaluated.

## **LIQUIDITY AND CAPITAL RESOURCES**

As of July 31, 2011, we held \$424,634,000 in cash and cash equivalent funds, the majority of which are held in money market funds and highly liquid U.S. Treasury bills. As is consistent within our industry, our cash balances are seasonal in nature, with the fourth quarter historically 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 2011, we plan to use our cash resources to fund our inventory and inventory-related purchases, advertising and marketing initiatives, purchases of property and equipment, stock repurchases and dividend payments. In addition to the current cash balances on hand, 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. Prior to March 23, 2015, 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. During the thirteen and twenty-six weeks ended July 31, 2011 and August 1, 2010, we had no borrowings under the credit facility, and no amounts were outstanding as of July 31, 2011 or August 1, 2010. However, as of July 31, 2011, \$9,420,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. Additionally, as of July 31, 2011, we

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had three unsecured letter of credit reimbursement facilities for a total of \$90,000,000, of which an aggregate of \$30,184,000 was outstanding. On September 2, 2011, we renewed all three of our letter of credit facilities for the same amount and for an additional one year term. These letter of credit facilities represent only a future commitment to fund inventory purchases to which we had not taken legal title. We are currently in compliance with all of our bank covenants and, based on our current projections, we expect to remain in compliance throughout fiscal 2011. We believe our cash on hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations over the next 12 months.

For year-to-date 2011, net cash used in operating activities was \$47,731,000 compared to net cash used in operating activities of \$9,111,000 for year-to-date 2010. For year-to-date 2011, net cash used in operating activities was primarily attributable to a decrease in accrued salaries, benefits and other expenses and accounts payable due to the timing of expenditures, as well as an increase in merchandise inventories. This represents an increase compared to year-to-date 2010 primarily due to a decrease in accounts payable and accrued salaries, benefits and other expenses.

For year-to-date 2011, net cash used in investing activities was \$64,893,000 compared to net cash used in investing activities of \$32,676,000 for year-to-date 2010. For year-to-date 2011, net cash used in investing activities was primarily attributable to purchases of property and equipment of \$62,525,000, comprised of \$26,703,000 for systems development projects (including e-commerce websites), \$18,755,000 for distribution, facility infrastructure and other projects and \$17,067,000 for stores. This represents an increase compared to year-to-date 2010 primarily due to an increase in the purchase of property and equipment.

For fiscal 2011, we anticipate investing \$150,000,000 in the purchase of property and equipment, primarily for the construction of 7 new stores and 8 remodeled or expanded stores, systems development projects (including e-commerce websites) and distribution, facility infrastructure and other projects.

For year-to-date 2011, net cash used in financing activities was \$92,147,000 compared to net cash used in financing activities of \$68,136,000 for year-to-date 2010. Net cash used in financing activities for year-to-date 2011 and compared to year-to-date 2010 was primarily attributable to the repurchase of common stock and the payment of dividends.

### *Stock Repurchase Program*

In January 2011, our Board of Directors authorized a stock repurchase program to purchase up to \$125,000,000 of our common stock through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. During the second quarter of fiscal 2011, we repurchased 806,282 shares under this program at a weighted average cost of \$38.75 per share and a total cost of approximately \$31,246,000. During year-to-date 2011, we repurchased 1,566,508 shares under this program at a weighted average cost of \$39.90 per share and a total cost of approximately \$62,496,000. There remains an aggregate of approximately \$62,504,000 available for repurchases under this stock repurchase program.

The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. This stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

### *Dividend Policy*

Our quarterly cash dividend is \$0.17 per common share. The indicated annual cash dividend, subject to capital availability, is \$0.68 per common share, or approximately \$71,000,000. Our quarterly cash dividend may be limited or terminated at any time.

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### *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. During the second quarter of fiscal 2011, there have been no significant changes to the critical accounting policies discussed in our Annual Report on Form 10-K for the year ended January 30, 2011.

### *Impact of Inflation*

The impact of inflation on results of operations was not significant for year-to-date 2011 or year-to-date 2010.

### *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, customer care 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 significant deterioration of the U.S. and foreign markets, changes in U.S. interest rates, foreign currency exchange rates, including the devaluation of the U.S. dollar, and the effects of uncertain economic forces which may affect the prices we pay our vendors 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 July 31, 2011, our line of credit facility was the only instrument we held with a variable interest rate which could, if drawn upon, subject us to risks associated with changes in that interest rate. As of July 31, 2011, there were no amounts outstanding under our credit facility. If the interest rate on this existing variable rate debt instrument rose 10%, 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 short-term cash and cash equivalents, which are also affected by changes in market interest rates. As of July 31, 2011, our investments, made primarily in money market funds and highly liquid U.S. Treasury bills, are stated at cost and approximate their fair values.

### *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, however, only approximately 3% 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 year-to-date 2011 and year-to-date 2010. Since we pay for the majority of our international purchases in U.S. dollars, however, 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

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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 July 31, 2011, we have 14 retail stores in Canada and limited operations in Europe and Asia, each of which exposes 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 year-to-date 2011 or year-to-date 2010.

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

### *Evaluation of Disclosure Controls and Procedures*

As of July 31, 2011, 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*

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.

## **PART II - OTHER INFORMATION**

## **ITEM 1. LEGAL PROCEEDINGS**

Information required by this Item is contained in Note J to our Condensed 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. You should carefully consider such risks and uncertainties, together with the other information contained in this report 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.

*The changes in general economic conditions over the past few years, and the resulting impact on consumer confidence and consumer spending, could adversely impact our results of operations.*

Our financial performance is subject to changes in general economic conditions and the impact of such economic conditions on levels of consumer confidence and consumer spending. Consumer confidence and consumer spending may deteriorate significantly, and could remain depressed for an extended period of time. Consumer

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purchases of discretionary items, including our merchandise, generally decline during periods when disposable income is adversely affected, unemployment rates increase or there is economic uncertainty. The recent uncertain economic environment could cause our vendors to go out of business or our banks to discontinue lending to us or our vendors, or it could cause us to undergo additional restructurings, any of which would adversely impact our business and operating results.

*We are unable to control many of the factors affecting consumer spending, and declines in consumer spending on home furnishings in general could reduce demand for our products.*

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, consumer disposable income, fuel prices, recession and fears of recession, unemployment, war and fears of war, inclement weather, availability of consumer credit, consumer debt levels, conditions in the housing market, interest rates, sales tax rates and rate increases, inflation, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. In particular, the recent economic downturn has led to decreased discretionary spending, which has adversely impacted our business in the past. In addition, a decrease in home purchases has led and may continue to lead to decreased consumer spending on home products. These factors have affected our various brands and channels differently. Adverse changes in factors affecting discretionary consumer spending have reduced and may continue to further reduce consumer demand for our products, thus reducing our sales and harming our business and operating results.

*If we are unable to identify and analyze factors affecting our business, anticipate changing consumer preferences and buying trends, and manage our inventory commensurate with customer demand, our sales levels and profit margin may decline.*

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. For example, in the specialty home products business, style and color trends are constantly evolving. 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. We must be able to stay current with preferences and trends in our brands and address the customer tastes for each of our target customer demographics. We must also be able to identify and adjust the customer offerings in our brands to cater to customer demands. For example, a change in customer preferences for children's room furnishings may not correlate to a similar change in buying trends for other home furnishings. 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 of 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 also may not have the capacity to handle our demands or may go out of business in times of economic crisis. 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.

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*Our sales may be negatively impacted by increasing competition from companies with brands or products similar to ours.*

The specialty direct-to-customer and retail business is highly competitive. Our e-commerce websites, direct mail catalogs and specialty retail stores compete with other e-commerce websites, other direct mail catalogs and other retail stores 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. In addition, the decline in the global economic environment has led to increased competition from discount retailers selling similar products at reduced prices. 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 may not be able to acquire products in sufficient quantities and at acceptable prices to meet our needs, which would impact our operations and financial results.*

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 it sells to us, discontinue selling to us, or go out of business 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, which could negatively affect our business and operating results.

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 risks related to the availability of raw materials, labor disputes, union organizing activities, vendor financial liquidity, inclement weather, natural disasters, general economic and political conditions and regulations to address climate change that could limit our vendors' ability to provide us with quality merchandise on a timely basis and at prices that are 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 increase in our routine litigation costs. Further, any merchandise that we receive, even if it meets our quality standards, could become subject to a recall, which could



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damage our reputation and brands, and harm our business. Recently enacted legislation has given the U.S. Consumer Product Safety Commission increased regulatory and enforcement power, particularly with regard to children's safety, among other areas. As a result, companies like ours may be subject to more product recalls and incur higher recall-related expenses. Any recalls or other safety issues could harm our brands' images and negatively affect our business and operating results.

*Our dependence on foreign vendors and our increased overseas operations subject us to a variety of risks and uncertainties that could impact our operations and financial results.*

In fiscal 2010, we sourced our products from vendors in 44 countries outside of the United States. Approximately 60% of our merchandise purchases were foreign-sourced, predominantly from Asia. Our dependence on foreign vendors means that we may be affected by changes in the value of the U.S. dollar relative 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 97% 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 in their effort to offset any lost profits associated with any currency devaluation, delay merchandise shipments to us, or discontinue selling to us, any of which could ultimately reduce our sales or increase our costs. In addition, an increase in the cost of living in the foreign countries in which our vendors operate may result in an increase in our costs or in our vendors going out of business.

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, compliance with anti-dumping regulations, work stoppages, economic uncertainties and adverse economic conditions (including inflation and recession), foreign government regulations, employment matters, wars and fears of war, political unrest, natural disasters, regulations to address climate change and other trade restrictions. We cannot predict whether any of the countries in which our raw materials are sourced from, or 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. In addition, an economic downturn in or failure of foreign markets may result in financial instabilities for our foreign vendors, which may cause our foreign vendors to decrease production, discontinue selling to us, or cease operations altogether. Our overseas operations in Europe and Asia could also be affected by changing economic and political conditions in foreign countries, any of which could have a negative effect on our business, financial condition and operating results.

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 events occurs, we could lose customer goodwill and favorable brand recognition, which could negatively affect our business and operating results.

In addition, as we continue to expand our overseas operations, we are subject to certain U.S. laws, including the Foreign Corrupt Practices Act, in addition to the laws of the foreign countries in which we operate. We must ensure that our employees comply with these laws. If any of our overseas operations, or our employees or agents, violates such laws, we could become subject to sanctions or other penalties that could negatively affect our reputation, business and operating results.

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*A number of factors that affect our ability to successfully open new stores or close existing stores are beyond our control, and these factors may harm our ability to expand or contract our retail operations and harm our ability to increase our sales and profits.*

Historically, the majority of our net revenues have been generated by our retail stores. Our ability to open additional stores or close existing stores successfully will depend upon a number of factors, including:

general economic conditions;

our identification of, and the availability of, suitable store locations;

our success in negotiating new leases and amending or terminating existing leases on acceptable terms;

the success of other retail stores in and around our retail locations;

our ability to secure required governmental permits and approvals;

our hiring and training of skilled store operating personnel, especially management;

the availability of financing on acceptable terms, if at all; and

the financial stability of our landlords and potential landlords.

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 the 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 these 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. We may not be able to open new stores or, if opened, operate those stores profitably. Construction and other delays in store openings could have a negative impact on our business and operating results. Additionally, in these economic times, we may not be able to renegotiate the terms of our current leases or close our underperforming stores, either of which could negatively impact our operating results.

*Our business and operating results may be harmed if we are unable to timely and effectively deliver merchandise to our stores and customers.*

The success of our business depends, in part, on our ability to 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 risks, including labor disputes, union organizing activity, inclement weather, natural disasters, the closure of such carriers' offices or a reduction in operational hours due to an economic slowdown, possible acts of terrorism associated with such carriers' ability to provide delivery services to meet our shipping needs and disruptions or increased fuel costs associated with any regulations to address climate change. Failure to deliver merchandise in a timely and effective manner could damage our reputation and brands. In addition, fuel costs have been volatile and airline and other transportation companies continue to struggle to operate profitably, which could lead to increased fulfillment expenses. Any rise in fulfillment costs could negatively affect our business and operating results by increasing our transportation costs and decreasing the efficiency of our shipments.

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

Our direct-to-customer business depends, in part, on our ability to maintain efficient and uninterrupted order-taking and fulfillment operations in our customer care centers and on 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

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organizing activity, disruptions in our third party labor contracts, natural disasters or adverse weather conditions. Industries that are particularly seasonal, such as the home furnishings business, face a higher risk of harm from operational disruptions during peak sales seasons. 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 to support our direct-to-customer operations, or that there will be a disruption in the labor we hire from our third party providers, especially during our peak season. 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 and harm our operating results.*

Our retail stores, corporate offices, distribution centers, infrastructure projects and direct-to-customer operations, as well as the operations of our 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.

*If we are unable to effectively manage our e-commerce business, our reputation and operating results may be harmed.*

E-commerce has been our fastest growing business over the last several years and continues to be a significant part of our sales success. The success of our e-commerce 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 e-commerce usage. We are also vulnerable to certain additional risks and uncertainties associated with our e-commerce websites, 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 regulations; 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 such as paid search, which may increase our 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 e-commerce business, as well as damage our reputation and brands.

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

Catalog mailings are an important component of 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. Paper costs have fluctuated significantly during the past and may continue to fluctuate 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; by implementing more efficient printing, mailing, delivery and order fulfillment systems; or through the use of alternative direct-mail formats. In addition, if the performance of our catalogs declines, if we misjudge the correlation between our catalog circulation and net sales, or if our catalog circulation optimization strategy overall does not continue to be successful, our results of operations could be negatively impacted.

We have historically experienced fluctuations in our customers' 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,

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the size of our mailings, timing of delivery of our mailings, as well as the general retail sales environment and current domestic and global economic conditions. 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, which may have a negative effect on our sales and our reputation. 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, negatively impacting our business and operating results.

*Declines in our comparable brand revenue may harm our operating results and cause a decline in the market price of our common stock.*

Various factors affect comparable store sales within our comparable brand revenue metric, including the number, size and location of stores we open, close, remodel or expand in any period, the overall economic and 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 and discount retailers), 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 catalog circulation and in our direct-to-customer business and fluctuations 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. For example, the overall economic and general retail sales environment, as well as local and global economic conditions, has caused a significant decline in our comparable store sales results in the recent past.

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. However, past comparable store sales are not necessarily an indication of future results and comparable store sales may decrease in the future. Our ability to 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, effectively driving traffic to our stores through marketing and various promotional events, 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 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 and reserved for by management, additional sales returns might be recorded in the future. 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. In particular, the recent adverse economic conditions resulted and may result in increased merchandise returns. Any significant increase in merchandise returns that exceeds our reserves could harm our business and operating results.

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*If we are unable to manage successfully the complexities associated with a multi-channel and multi-brand business, we may suffer declines in our existing business and our ability to attract new business.*

With the expansion of our e-commerce 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 e-commerce business might cannibalize a significant portion of our retail and catalog businesses, and we face the risk of catalog circulation cannibalizing our retail sales. While we recognize that our e-commerce 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.

*If we are unable to introduce new brands and brand extensions successfully, or to reposition or close existing brands, our business and operating results may be negatively impacted.*

We have in the past and may in the future introduce new brands and brand extensions, or reposition or close existing brands. Our newest brands West Elm and PBteen and any other new brands, may not grow as we project and plan for. 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 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 and may therefore be forced to close the brands.

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

We believe that commercial insurance coverage is prudent in certain areas of our business for risk management. Insurance costs may increase substantially in the future and may be affected by natural catastrophes, fear of terrorism, financial irregularities and other fraud at publicly-traded companies, intervention by the government and a decrease in the number of insurance carriers. In addition, the carriers with which we hold our policies may go out of business, or may be otherwise unable to fulfill their contractual obligations. 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 rates, 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 related 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 brands, goodwill and operating results.*

We may not be able to adequately protect our intellectual property. Our trademarks, service marks, copyrights, 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. Protection of our intellectual property and maintenance of distinct branding are particularly important as they distinguish our products and services from our competitors who may sell similar products and services. In addition, the costs of defending our intellectual property may adversely affect our operating results.

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*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 have been a growing number of e-commerce-related patent infringement lawsuits in recent years. There has also been a rise in lawsuits against companies that gather information in order to market to consumers, online or through the mail. In addition, there has been an increase in employment-related lawsuits. From time to time, we have been subject to these types of lawsuits. The cost of defending claims against us or the ultimate resolution of such claims may harm our business and operating results. In addition, the increasingly regulated business environment may result in a greater number of enforcement actions and private litigation. This could subject us to increased exposure to shareholder lawsuits.

*Our operating results may be harmed by unsuccessful management of our employment, occupancy and other operating costs, and the operation and growth of our business may be harmed if we are unable to attract qualified personnel.*

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 during peak sales seasons, and incur other expenses to support new brands and brand extensions, as well as the opening of new stores and the direct-to-customer growth of our existing brands. Alternatively, if we are unable to make substantial adjustments to our cost structure during times of uncertainty, such as the recent economic environment, we may incur unnecessary expenses, we may have too few resources to properly run our business, or our business and operating results may be negatively impacted. From time to time, we may also experience union 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 and other employment-related 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 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 on favorable terms with our service providers and other vendors, 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. In addition, in times of economic uncertainty, these long-term contracts may make it difficult to quickly reduce our fixed operating costs, which could 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, which involves updating or replacing legacy systems with successor systems over the course of several years. There are inherent risks associated with replacing our core systems, including supply chain and merchandising systems disruptions, that could 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

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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 and are in the process of insourcing certain business functions from third party vendors, both of which 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 utilize outside vendors for such things as payroll processing and various distribution center services. Accordingly, we are subject to the risks associated with their ability to successfully provide the necessary services to meet our needs. If our vendors are unable to adequately protect our data and information is lost, our ability to deliver our services is interrupted, or our vendors' fees are higher than expected, then our business and operating results may be negatively impacted.

In addition, we are in the process of insourcing certain aspects of our business, including the management of certain infrastructure technology, furniture manufacturing, furniture delivery to our customers and the management of our international vendors, each of which were previously outsourced to third party providers. This may cause disruptions in our business and result in increased cost to us. In addition, if we are unable to perform these functions better than, or at least as well as, our third party providers, our business may be harmed.

*Our efforts to expand internationally through franchising and other arrangements may not be successful and could negatively impact the value of our brands.*

We are currently evaluating several opportunities to grow our business through international expansion. In fiscal 2009, we entered into a franchise agreement with the M.H. Alshaya Company ( "M.H. Alshaya" ), an unaffiliated franchisee to operate stores in the Middle East. Under this agreement, M.H. Alshaya operates stores that sell goods purchased from us under our brand names. We had no prior experience operating through these types of third party arrangements, and this arrangement may not be successful. The administration of this relationship may divert management attention and require more resources than we expect. While this relationship has to date been a small part of our business, we plan to continue to increase the number of stores and countries in which these franchises operate as part of our efforts to expand internationally. The effect of these arrangements on our business and results of operations is uncertain and will depend upon various factors, including the demand for our products in new markets internationally. In addition, certain aspects of these arrangements are not directly within our control, such as the ability of M.H. Alshaya to meet its projections regarding store openings and sales. Moreover, while the agreement we have entered into may provide us with certain termination rights, to the extent that M.H. Alshaya does not operate its stores in a manner consistent with our requirements regarding our brand identities and customer experience standards, the value of our brands could be impaired. In addition, in connection with this franchise agreement, we have and will continue to implement certain new processes that may subject us to additional regulations and laws, such as U.S. export regulations. Failure to comply with any applicable laws or regulations could have an adverse effect on our results of operations.

*If our operating and financial performance in any given period does not meet the extensive guidance that we have provided to the public, our stock price may decline.*

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 actual results may not always be in line with or exceed the guidance we have provided, especially in times of economic uncertainty. In the past, when we have reduced our previously provided guidance, the market price of our common stock has declined. If, in the future, our operating or financial results for a particular period do not meet our guidance or the expectations of investment

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analysts or if we reduce our guidance for future periods, the market price of our common stock may decline as well.

*A variety of factors, including seasonality and the economic environment, may cause our quarterly operating results to fluctuate, leading to volatility in our stock price.*

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, as well as changes in economic conditions. A significant portion of our revenues and net earnings has typically been realized during the period from October through December each year. In anticipation of increased holiday sales activity, we incur certain significant incremental expenses prior to and during peak selling seasons, particularly October through December, including fixed catalog production and mailing costs and the costs associated with hiring a substantial number of temporary employees to supplement our existing workforce.

*We may require external funding sources for operating funds, which may cost more than we expect, or not be available at the levels we require and, as a consequence, our expenses and operating results could be negatively affected.*

We regularly review and evaluate our liquidity and capital needs. We currently believe that our available cash, cash equivalents and cash flow from operations will be sufficient to finance our operations and expected capital requirements for at least the next 12 months. However, we might experience periods during which we encounter additional cash needs and we might need additional external funding to support our operations. Although we were able to amend our line of credit facility during fiscal 2010 on acceptable terms, in the event we require additional liquidity from our lenders, such funds may not be available to us or may not be available to us on acceptable terms in the future. For example, in the event we were to breach any of our financial covenants, our banks would not be required to provide us with additional funding, or they may require us to renegotiate our existing credit facility on less favorable terms. In addition, we may not be able to renew our letters of credit that we use to help pay our suppliers on terms that are acceptable to us, or at all, as the availability of letter of credit facilities may continue to be limited. Further, the providers of such credit may reallocate the available credit to other borrowers. If we are unable to access credit at the levels we require, or the cost of credit is greater than expected, it could adversely affect our operating results.

*Disruptions in the financial markets may adversely affect our liquidity and capital resources and our business.*

Disruptions in the global financial markets and banking systems have made credit and capital markets more difficult for companies to access, even for some companies with established revolving or other credit facilities. We have access to capital through our revolving line of credit facility. Each financial institution, which is part of the syndicate for our revolving line of credit facility, is responsible for providing a portion of the loans to be made under the facility. If any participant, or group of participants, with a significant portion of the commitments in our revolving line of credit facility fails to satisfy its obligations to extend credit under the facility and we are unable to find a replacement for such participant or group of participants on a timely basis (if at all), our liquidity and our business may be materially adversely affected.

*If we are unable to pay quarterly dividends or repurchase our stock at intended levels, our reputation and stock price may be harmed.*

In January 2011, our Board of Directors authorized the repurchase of up to \$125,000,000 of our common stock. In addition, in March 2011, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.15 to \$0.17 per common share. The indicated annual cash dividend, subject to capital availability, is approximately \$71,000,000. The dividend and stock repurchase program may require the use of a significant portion of our cash earnings. As a result, we may not retain a sufficient amount of cash to fund

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our operations or finance future growth opportunities, new product development initiatives and unanticipated capital expenditures. Further, 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 at any time. Our ability to pay dividends and repurchase stock 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 stock after we have announced our intention to do so may negatively impact our reputation and investor confidence in us and may negatively impact our stock price.

*If we fail to maintain proper and effective internal controls, our ability to produce accurate and timely financial statements could be impaired and our investors' views of us could be harmed.*

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. 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. In addition, our internal controls may not prevent or detect all errors and fraud. A control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable assurance that the objectives of the control system will be met. If any of the above were to occur, our business and the perception of us in the financial markets could be negatively impacted.

*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. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective. The introduction of 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, including information technology systems, or operating results that are lower than our current estimates at certain store locations, may cause us to incur impairment charges.*

We make estimates and projections in connection with impairment analyses for certain of our store locations and other property and equipment, including information technology systems. These impairment analyses require that we review for impairment all stores for which current or projected cash flows from operations are not sufficient to recover the carrying value of the asset. An impairment charge is required when the carrying value of the asset exceeds the undiscounted future cash flows over the remaining life of the lease. These calculations require us to make a number of estimates and projections of future results. 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, including information technology systems. These impairment charges have been significant in the past and may be in the future and, as a result of these charges, our operating results have been and may, in the future, be adversely affected.

*If we do not properly account for our unredeemed gift certificates, gift cards and merchandise credits, our operating results will be harmed.*

We maintain a liability for unredeemed gift cards, gift certificates and merchandise credits until the earlier of redemption, escheatment or four years. After four years, the remaining unredeemed gift cards, gift certificate or merchandise credit liability is relieved and recorded as a benefit within selling, general and administrative expenses. In the event that our historical redemption patterns change in the future, we might change the minimum time period for maintaining a liability for unredeemed gift certificates on our balance sheets, which would affect

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our financial position or operating results. Further, in the event that a state or states were to require that the unredeemed amounts be escheated to that state or states, our business and operating results would be harmed.

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

A significant portion of our customer orders are placed through our e-commerce websites or through our customer care centers. In addition, a significant portion of sales made through our retail channel require the collection of certain customer data, such as credit card information. In order for our sales 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 prevent 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 consumers to lose confidence in the security of our website or stores 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.

*Fluctuations in our tax obligations and effective tax rate may result in volatility of our operating results and stock price.*

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 ongoing variability in our quarterly tax rates as taxable events occur and exposures are evaluated. In addition, 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. Further, there is proposed tax legislation that may be enacted in the future, which could negatively impact our current or future tax structure and effective tax rates.

*If we fail to attract and retain key personnel, our business and operating results may be harmed.*

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 can be intense. If we fail to identify, attract, retain and motivate these skilled personnel, especially in this challenging economic environment, our business may be harmed. Further, in the event we need to hire additional personnel, we may experience difficulties in attracting and successfully hiring such individuals due to competition for highly skilled personnel, as well as the significantly higher cost of living expenses in our market.

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The following table provides information as of July 31, 2011 with respect to shares of common stock we repurchased during the second quarter of fiscal 2011.

| Fiscal period                  | Total<br>Number of<br>Shares<br>Purchased | Average Price<br>Paid per<br>Share | Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced<br>Program | Maximum Dollar<br>Value of Shares that<br>May Yet be<br>Purchased Under the<br>Program |
|--------------------------------|-------------------------------------------|------------------------------------|------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------|
| May 2, 2011 to May 29, 2011    | 235,701                                   | \$ 42.09                           | 235,701                                                                            | \$ 83,829,000                                                                          |
| May 30, 2011 to June 26, 2011  | 254,159                                   | \$ 37.08                           | 254,159                                                                            | \$ 74,405,000                                                                          |
| June 27, 2011 to July 31, 2011 | 316,422                                   | \$ 37.61                           | 316,422                                                                            | \$ 62,504,000                                                                          |
| Total                          | 806,282                                   | \$ 38.75                           | 806,282                                                                            | \$ 62,504,000                                                                          |

**Table of Contents****ITEM 6. EXHIBITS**

## (a) Exhibits

| Exhibit  | Exhibit                                                                                                                                                                                                        |
|----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Number   | Description                                                                                                                                                                                                    |
| 2.1      | Agreement and Plan of Merger of Williams-Sonoma, Inc., a Delaware corporation (incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on May 25, 2011, File No. 001-14077) |
| 3.1      | Williams-Sonoma, Inc. Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on May 25, 2011, File No. 001-14077)       |
| 3.2      | Amended and Restated Bylaws of Williams-Sonoma, Inc. (incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K filed on May 25, 2011, File No. 001-14077)                          |
| 10.1     | Form of Williams-Sonoma, Inc. Indemnification Agreement                                                                                                                                                        |
| 10.2+    | Williams-Sonoma, Inc. 2001 Long-Term Incentive Plan, as amended (incorporated by reference to Exhibit D to the definitive proxy statement on Schedule 14A as filed on April 7, 2011, File No. 001-14077)       |
| 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                                                             |
| 101.INS* | XBRL Instance Document                                                                                                                                                                                         |
| 101.SCH* | XBRL Taxonomy Extension Schema Document                                                                                                                                                                        |
| 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase Document                                                                                                                                                          |
| 101.DEF* | XBRL Taxonomy Extension Definition Linkbase Document                                                                                                                                                           |
| 101.LAB* | XBRL Taxonomy Extension Label Linkbase Document                                                                                                                                                                |
| 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase Document                                                                                                                                                         |

+ Indicates a management contract or compensatory plan or arrangement.

\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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**SIGNATURE**

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

WILLIAMS-SONOMA, INC.

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

Date: September 9, 2011