

WILLIAMS SONOMA INC  
Form 10-Q  
September 07, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended July 29, 2007.

or

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

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

Commission File Number: 001-14077

**WILLIAMS-SONOMA, INC.**

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(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of incorporation or organization)

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

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

94109  
(Zip Code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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 26, 2007, 108,544,038 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 29, 2007**

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(Unaudited)

| <i>Dollars and shares in thousands, except per share amounts</i>   | July 29,<br>2007 | January 28,<br>2007 | July 30,<br>2006 |
|--|------------------|---------------------|------------------|
| <b>ASSETS</b>  |                  |                     |                  |
| Current assets   |                  |                     |                  |
| Cash and cash equivalents  | \$ 58,039        | \$ 275,429          | \$ 187,377       |
| Accounts receivable net  | 63,847           | 48,821              | 74,527           |
| Merchandise inventories net  | 651,262          | 610,599             | 565,691          |
| Prepaid catalog expenses   | 69,488           | 59,610              | 64,059           |
| Prepaid expenses   | 46,361           | 28,570              | 35,440           |
| Deferred income taxes  | 70,986           | 70,837              | 57,279           |
| Other assets   | 6,708            | 7,097               | 6,710            |
| Total current assets   | 966,691          | 1,100,963           | 991,083          |
| Property and equipment net   | 948,415          | 912,582             | 900,565          |
| Non-current deferred income taxes  | 35,087           | 18,670              | -                |
| Other assets net   | 17,195           | 16,116              | 18,563           |
| Total assets   | \$ 1,967,388     | \$ 2,048,331        | \$ 1,910,211     |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                  |                     |                  |
| Current liabilities  |                  |                     |                  |
| Accounts payable   | \$ 205,546       | \$ 214,771          | \$ 188,331       |
| Accrued salaries, benefits and other   | 87,568           | 85,148              | 82,908           |
| Customer deposits  | 200,560          | 187,625             | 174,710          |
| Income taxes payable   | 2,786            | 101,638             | 10,183           |
| Current portion of long-term debt  | 15,690           | 15,853              | 16,186           |
| Other liabilities  | 20,541           | 22,699              | 23,915           |
| Total current liabilities  | 532,691          | 627,734             | 496,233          |
| Deferred rent and lease incentives   | 250,946          | 236,604             | 241,819          |
| Long-term debt   | 12,548           | 12,822              | 14,037           |
| Deferred income tax liabilities  | -                | -                   | 12,371           |
| Other long-term obligations  | 55,402           | 19,740              | 15,958           |
| Total liabilities  | 851,587          | 896,900             | 780,418          |
| Commitments and contingencies  |                  |                     |                  |
| Shareholders equity  |                  |                     |                  |
| Preferred stock, \$.01 par value, 7,500 shares authorized, none issued   | -                | -                   | -                |
| Common stock, \$.01 par value, 253,125 shares authorized, issued and outstanding:<br>108,536, 109,868 and 113,451 shares at July 29, 2007, January 28, 2007 and July 30, 2006,<br>respectively | 1,085            | 1,099               | 1,135            |
| Additional paid-in capital   | 397,132          | 358,223             | 352,896          |
| Retained earnings  | 704,034          | 784,325             | 766,641          |
| Accumulated other comprehensive income   | 13,550           | 7,784               | 9,121            |
| Total shareholders equity  | 1,115,801        | 1,151,431           | 1,129,793        |
| Total liabilities and shareholders equity  | \$ 1,967,388     | \$ 2,048,331        | \$ 1,910,211     |

*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 29,<br>2007     | July 30,<br>2006 | July 29,<br>2007       | July 30,<br>2006 |
| <i>Dollars and shares in thousands, except per share amounts</i> |                      |                  |                        |                  |
| Net revenues   | \$ 859,396           | \$ 825,536       | \$ 1,675,447           | \$ 1,619,822     |
| Cost of goods sold   | 539,301              | 510,976          | 1,053,382              | 999,841          |
| Gross margin   | 320,095              | 314,560          | 622,065                | 619,981          |
| Selling, general and administrative expenses                     | 277,227              | 260,312          | 550,755                | 531,043          |
| Interest income  | (1,031)              | (4,056)          | (3,501)                | (7,378)          |
| Interest expense   | 505                  | 542              | 1,036                  | 1,069            |
| Earnings before income taxes                                     | 43,394               | 57,762           | 73,775                 | 95,247           |
| Income taxes   | 17,428               | 22,199           | 29,659                 | 36,585           |
| Net earnings   | \$ 25,966            | \$ 35,563        | \$ 44,116              | \$ 58,662        |
| Basic earnings per share   | \$ 0.24              | \$ 0.31          | \$ 0.40                | \$ 0.51          |
| Diluted earnings per share                                       | \$ 0.23              | \$ 0.30          | \$ 0.39                | \$ 0.50          |
| Shares used in calculation of earnings per share:                |                      |                  |                        |                  |
| Basic  | 109,884              | 115,026          | 110,081                | 114,672          |
| Diluted  | 112,022              | 117,724          | 112,339                | 117,515          |

*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 29,<br>2007       | July 30,<br>2006 |
| <i>Dollars in thousands</i>   |                        |                  |
| Cash flows from operating activities:   |                        |                  |
| Net earnings  | \$ 44,116              | \$ 58,662        |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: |                        |                  |
| Depreciation and amortization   | 68,758                 | 65,830           |
| Loss on disposal/impairment of assets   | 2,748                  | 2,127            |
| Amortization of deferred lease incentives   | (13,904)               | (14,286)         |
| Deferred income taxes   | (2,741)                | (6,079)          |
| Tax benefit from exercise of stock options  | 3,114                  | 3,872            |
| Stock-based compensation expense  | 12,741                 | 16,886           |
| Changes in:   |                        |                  |
| Accounts receivable   | (14,488)               | (23,491)         |
| Merchandise inventories   | (39,622)               | (45,327)         |
| Prepaid catalog expenses  | (9,878)                | (10,134)         |
| Prepaid expenses and other assets   | (17,145)               | (3,003)          |
| Accounts payable  | (25,680)               | (22,510)         |
| Accrued salaries, benefits and other current and long term liabilities <sup>1</sup>           | 998                    | (11,048)         |
| Customer deposits   | 12,515                 | 1,900            |
| Deferred rent and lease incentives  | 27,453                 | 37,763           |
| Income taxes payable  | (90,213)               | (73,443)         |
| Net cash used in operating activities   | (41,228)               | (22,281)         |
| Cash flows from investing activities:   |                        |                  |
| Purchases of property and equipment   | (90,368)               | (84,481)         |
| Proceeds from the disposal of assets  | 285                    | -                |
| Other   | (605)                  | -                |
| Net cash used in investing activities   | (90,688)               | (84,481)         |
| Cash flows from financing activities:   |                        |                  |
| Repayments of long-term obligations   | (437)                  | (3,130)          |
| Net proceeds from exercise of stock options   | 26,358                 | 9,581            |
| Excess tax benefit from exercise of stock options   | 4,949                  | 2,541            |
| Repurchase of common stock  | (95,468)               | (65,430)         |
| Payment of dividends  | (23,881)               | (11,591)         |
| Net cash used in financing activities   | (88,479)               | (68,029)         |
| Effect of exchange rates on cash and cash equivalents   | 3,005                  | 1,186            |
| Net decrease in cash and cash equivalents   | (217,390)              | (173,605)        |
| Cash and cash equivalents at beginning of period  | 275,429                | 360,982          |
| Cash and cash equivalents at end of period  | \$ 58,039              | \$ 187,377       |

<sup>1</sup> Includes the impact from the implementation of Financial Accounting Standards Board ( FASB ) Interpretation Number ( FIN ) 48. See Note B.

See Notes to Condensed Consolidated Financial Statements.





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**WILLIAMS-SONOMA, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Thirteen and Twenty-Six Weeks Ended July 29, 2007 and July 30, 2006

(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 29, 2007 and July 30, 2006, the condensed consolidated statements of earnings for the thirteen and twenty-six weeks ended July 29, 2007 and July 30, 2006 and the condensed consolidated statements of cash flows for the twenty-six weeks ended July 29, 2007 and July 30, 2006 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 28, 2007, 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 28, 2007.

The results of operations for the thirteen and twenty-six weeks ended July 29, 2007 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 28, 2007.

**NOTE B. ACCOUNTING POLICIES**

*Recent Accounting Pronouncements*

We adopted the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. ( FIN ) 48, Accounting for Uncertainty in Income Taxes, on January 29, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. As a result of the implementation of FIN 48, we recognized an \$11,684,000 increase in the liability for tax contingencies, which was accounted for as a reduction to the January 29, 2007 balance of retained earnings. After the date of adoption, we had \$30,981,000 of liabilities for unrecognized tax benefits, of which \$19,661,000 (net of tax benefit) would, if recognized, affect the effective tax rate. We recognize interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of January 29, 2007, our accruals for the payment of interest and penalties totaled \$5,983,000, all of which relates to interest.

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It is reasonably possible that current income tax examinations involving uncertain tax positions could be resolved within the next 12 months through administrative adjudicative procedures or settlement. An estimate of the potential impact cannot be made at this time.

The Internal Revenue Service (IRS) has concluded its examination of our U.S. federal income tax returns for years prior to 2004 without any significant adjustments. Substantially all material state, local and foreign income tax examinations have been concluded for years through 1999.

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In September 2006, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value Measures, which establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair value measurements. SFAS No. 157 only applies to fair value measurements that are already required or permitted by other accounting standards, except for measurements of share-based payments, and measurements that are similar to, but not intended to be, fair value. This Statement is effective for fiscal years beginning after November 15, 2007 and will require additional disclosures in our financial statements. We do not expect the adoption of SFAS No. 157 to have a material impact on our consolidated financial position, results of operations or cash flows.

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

We maintain the Amended and Restated 2001 Long-Term Incentive Plan (the Plan ) to award stock options and stock-settled stock appreciation rights (collectively, option awards ) and other forms of equity compensation, including restricted stock awards, restricted stock units, deferred stock awards, and dividend equivalents (collectively, stock awards ) to officers, employees and Board members of the company or any parent or subsidiary up to an aggregate of 15,959,903 shares. As of July 29, 2007, there were approximately 5,615,000 shares available for future grant.

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

In accordance with the provisions of SFAS No. 123R, our compensation expense recognized is based on the following:

- q Stock Options Compensation expense related to the remaining unvested portion of all stock options granted prior to the adoption of SFAS No. 123R based on the grant date fair value (using the market value of our stock on the date prior to the grant date), estimated in accordance with the provisions of SFAS No. 123, as amended by SFAS No. 148. Compensation expense related to all stock options granted subsequent to the SFAS No. 123R adoption date, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R.
  
- q Stock-Settled Stock Appreciation Rights Compensation expense related to all stock-settled stock appreciation rights granted based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R.
  
- q Restricted Stock Units For performance-based restricted stock units, compensation expense based on the grant date fair value and the probability that the performance metrics will be achieved. For non-performance-based restricted stock units, compensation expense based on the grant date fair value.

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The following table summarizes our stock option activity during the twenty-six weeks ended July 29, 2007:

|   | Shares      | Weighted<br>Average<br>Exercise<br>Price | Weighted Average<br>Contractual<br>Term Remaining<br>(In Years) | Intrinsic<br>Value <sup>1</sup> |
|---|-------------|--|---|---------------------------------|
| Balance at January 28, 2007                   | 9,026,289   | \$ 23.04                                 | 5.17  | \$ 109,551,000                  |
| Granted <sup>2</sup>                          | -           | -  | -   | -                               |
| Exercised                                     | (1,856,657) | 19.66                                    | -   | 26,766,000                      |
| Canceled                                      | (298,029)   | 36.72                                    | -   | -                               |
| Balance at July 29, 2007                      | 6,871,603   | \$ 23.36                                 | 4.84  | \$ 64,817,000                   |
| Vested at July 29, 2007                       | 5,522,581   | \$ 20.39                                 | 4.24  | \$ 63,624,000                   |
| Vested plus expected to vest at July 29, 2007 | 6,634,792   | \$ 22.88                                 | 4.75  | \$ 64,715,000                   |

<sup>1</sup> Intrinsic value, for activities other than exercises, is defined as the difference between the grant price and the market value on the last business day of the quarter. For exercises, intrinsic value is defined as the difference between the grant price and the market value on the date of exercise.

<sup>2</sup> In fiscal 2006, we began issuing stock-settled stock appreciation rights in lieu of stock option grants. Therefore, no stock options have been granted during the twenty-six weeks ended July 29, 2007. See the stock-settled stock appreciation rights table below.

*Stock-Settled Stock Appreciation Rights*

A stock-settled stock appreciation right is an award that allows the recipient to receive common stock equal to the appreciation in the fair market value of our common stock between the date the award was granted and the conversion date for the number of shares vested.

The following table summarizes our stock-settled stock appreciation rights activity during the twenty-six weeks ended July 29, 2007:

|  | Shares    | Weighted<br>Average<br>Conversion<br>Price <sup>1</sup> | Weighted Average<br>Contractual<br>Term Remaining<br>(In Years) | Intrinsic<br>Value <sup>2</sup> |
|--|-----------|---|---|---------------------------------|
| Balance at January 28, 2007                      | 1,978,850 | \$ 36.01  | 9.47  | \$ 2,211,000                    |
| Granted (weighted average fair value of \$11.62) | 1,435,950 | 34.77   | -   | -                               |
| Converted  | -         | -   | -   | -                               |
| Canceled   | (112,750) | 36.14   | -   | -                               |

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|   |           |          |      |            |
|---|-----------|----------|------|------------|
| Balance at July 29, 2007                      | 3,302,050 | \$ 35.47 | 9.27 | \$ 200,000 |
| Vested at July 29, 2007                       | 177,270   | \$ 40.29 | 8.64 | -          |
| Vested plus expected to vest at July 29, 2007 | 2,588,698 | \$ 35.53 | 9.26 | \$ 153,000 |

<sup>1</sup> Conversion price is defined as the price from which stock-settled stock appreciation rights are measured and is equal to the market value on the date of issuance.

<sup>2</sup> Intrinsic value, for activities other than conversions, is defined as the difference between the grant price and the market value on the last business day of the quarter for those stock-settled stock appreciation rights where the market value is greater than the conversion price. For conversions, intrinsic value is defined as the difference between the grant price and the market value on the date of conversion.

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The fair value for both stock options and stock-settled stock appreciation rights was estimated on the date of the grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

- q *Expected term* The expected term of the option awards represents the period of time between the grant date of the option awards and the date the option awards are either exercised or canceled including an estimate for those option awards still outstanding.
- q *Expected volatility* The expected volatility is based on an average of the historical volatility of our stock price, for a period approximating our expected term, and the implied volatility of externally traded options of our stock that were entered into during the period.
- q *Risk-free interest rate* The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and with a maturity that approximates our expected term.
- q *Dividend yield* The dividend yield is based on our quarterly cash dividend and its anticipated dividend payout over our expected term of the option award.

The weighted-average assumptions for the thirteen and twenty-six weeks ended July 29, 2007 and July 30, 2006 are as follows:

|                         | Thirteen Weeks Ended |                  | Twenty-Six Weeks Ended |                  |
|-------------------------|----------------------|------------------|------------------------|------------------|
|                         | July 29,<br>2007     | July 30,<br>2006 | July 29,<br>2007       | July 30,<br>2006 |
| Expected term (years)   | 5.0                  | 5.0              | 5.0                    | 5.0              |
| Expected volatility     | 33.3%                | 33.2%            | 33.2%                  | 34.5%            |
| Risk-free interest rate | 4.6%                 | 4.9%             | 4.5%                   | 4.7%             |
| Dividend yield          | 1%                   | 1%               | 1%                     | 1%               |

*Restricted Stock Units*

The following table summarizes restricted stock unit activity during the twenty-six weeks ended July 29, 2007:

|                                      | Shares   | Weighted Average<br>Grant Date Fair<br>Value | Intrinsic<br>Value <sup>1</sup> |
|--------------------------------------|----------|--|---------------------------------|
| Unvested balance at January 28, 2007 | 850,000  | \$ 41.20                                     | \$ 29,104,000                   |
| Granted                              | 21,650   | 33.35  | -                               |
| Vested                               | -        | -  | -                               |
| Canceled                             | (70,000) | 42.18  | -                               |
| Unvested balance at July 29, 2007    | 801,650  | \$ 40.91                                     | \$ 24,635,000                   |
| Expected to vest at July 29, 2007    | 736,335  | \$ 40.90                                     | \$ 22,628,000                   |

<sup>1</sup> *Intrinsic value for restricted stock units is defined as the market value on the last business day of the quarter.*

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### *Total Stock-Based Compensation Expense*

During the thirteen and twenty-six weeks ended July 29, 2007, we recognized total stock-based compensation expense, as a component of selling, general and administrative expense, of \$6,731,000 and \$12,741,000, respectively. During the thirteen and twenty-six weeks ended July 30, 2006, we recognized total stock-based compensation expense, as a component of selling, general and administrative expense, of \$8,939,000 and \$16,860,000, respectively. As of July 29, 2007, there was a remaining unamortized expense balance of \$62,216,000 (net of estimated forfeitures), which we expect to be recognized on a straight-line basis over an average remaining service period of approximately 3.5 years.

### *Tax Effect*

We present tax benefits resulting from the exercise of stock-based awards as operating cash flows, and tax deductions in excess of the cumulative compensation cost recognized for stock-based compensation awards exercised as financing cash flows in the Condensed Consolidated Statements of Cash Flows. For the thirteen and twenty-six weeks ended July 29, 2007, cash received from stock-based awards exercised was \$12,725,000 and \$26,358,000 and the tax benefit associated with such exercises totaled \$1,955,000 and \$10,199,000, respectively.

## **NOTE D. BORROWING ARRANGEMENTS**

### *Credit Facility*

As of July 29, 2007, we have a credit facility that provides for a \$300,000,000 unsecured revolving line of credit that may be used for loans or letters of credit and contains certain financial covenants, including a maximum leverage ratio (funded debt adjusted for lease and rent expense to EBITDAR). Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the new credit facility of up to \$200,000,000, to provide for a total of \$500,000,000 of unsecured revolving credit. The credit facility contains events of default that include, among others, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, bankruptcy and insolvency events, material judgments, cross defaults to certain other indebtedness and events constituting a change of control. The occurrence of an event of default will increase the applicable rate of interest by 2.0% and could result in the acceleration of our obligations under the credit facility and an obligation of any or all of our U.S. subsidiaries to pay the full amount of our obligations under the credit facility. The credit facility matures on October 4, 2011, at which time all outstanding borrowings must be repaid and all outstanding letters of credit must be cash collateralized.

We may elect interest rates calculated at Bank of America's prime rate (or, if greater, the average rate on overnight federal funds plus one-half of one percent) or LIBOR plus a margin based on our leverage ratio. No amounts were borrowed under the credit facility during the twenty-six weeks ended July 29, 2007 and July 30, 2006. However, as of July 29, 2007, \$37,398,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. The standby letters of credit were issued to secure the liabilities associated with workers' compensation, other insurance programs and certain debt transactions. As of July 29, 2007, we were in compliance with our financial covenants under the credit facility.

### *Letter of Credit Facilities*



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We have five unsecured commercial letter of credit reimbursement facilities for an aggregate of \$165,000,000, each of which expires on September 8, 2007. As of July 29, 2007, an aggregate of \$137,172,000 was outstanding under the letter of credit facilities. Such letters of credit represent only a future commitment to fund inventory purchases to which we had not taken legal title as of July 29, 2007. The latest expiration possible for any future letters of credit issued under the facilities is February 5, 2008. We intend to renew our letter of credit reimbursement agreement to increase our facility to \$175,000,000.

**Table of Contents****NOTE E. COMMITMENTS AND CONTINGENCIES**

On September 30, 2004, we entered into a five-year service agreement with IBM to host and manage certain aspects of our data center information technology infrastructure. On July 10, 2007, we amended our service agreement with IBM and as a result, we will assume responsibility for the operation of portions of our data center information technology infrastructure. Under the terms of the agreement, we are required to continue to pay both fixed and variable charges over the life of the agreement. The variable charges are primarily based on CPU hours, storage capacity and support services that are expected to fluctuate throughout the term of the agreement. We also remain subject to a minimum charge over the term of the agreement based on both a fixed and variable component calculated as a percentage of the total estimated service charges over the five-year term of the agreement. As of July 29, 2007, we estimate the remaining minimum charge to be approximately \$5,992,000. The agreement can be terminated at any time for cause or convenience. In the event the agreement is terminated for convenience, a graduated termination fee will be assessed based on the time period remaining in the contract term. As of July 29, 2007, this termination fee was approximately \$1,410,000.

**NOTE F. COMPREHENSIVE INCOME**

Comprehensive income for the thirteen and twenty-six weeks ended July 29, 2007 and July 30, 2006 was as follows:

|   | Thirteen Weeks Ended |                  | Twenty-Six Weeks Ended |                  |
|---|----------------------|------------------|------------------------|------------------|
|   | July 29,<br>2007     | July 30,<br>2006 | July 29,<br>2007       | July 30,<br>2006 |
| <i>Dollars in thousands</i>             |                      |                  |                        |                  |
| Net earnings                            | \$ 25,966            | \$ 35,563        | \$ 44,116              | \$ 58,662        |
| Other comprehensive (loss) income -     |                      |                  |                        |                  |
| Foreign currency translation adjustment | 2,983                | (443)            | 5,778                  | 1,426            |
| Net unrealized loss on investment       | (3)                  | -                | (12)                   | -                |
| Comprehensive income                    | \$ 28,946            | \$ 35,120        | \$ 49,882              | \$ 60,088        |

**NOTE G. 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 the average market price of our common stock for the period, to the extent their inclusion would be dilutive.

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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 Average Shares | Per Share Amount |
|---|--------------|-------------------------|------------------|
| <b>Thirteen weeks ended July 29, 2007</b>                         |              |                         |                  |
| Basic   | \$ 25,966    | 109,884                 | \$ 0.24          |
| Effect of dilutive stock-based awards                             | -            | 2,138                   |                  |
| Diluted   | \$ 25,966    | 112,022                 | \$ 0.23          |
| <b>Thirteen weeks ended July 30, 2006</b>                         |              |                         |                  |
| Basic   | \$ 35,563    | 115,026                 | \$ 0.31          |
| Effect of dilutive stock-based awards                             | -            | 2,698                   |                  |
| Diluted   | \$ 35,563    | 117,724                 | \$ 0.30          |
| <b>Twenty-six weeks ended July 29, 2007</b>                       |              |                         |                  |
| Basic   | \$ 44,116    | 110,081                 | \$ 0.40          |
| Effect of dilutive stock-based awards                             | -            | 2,258                   |                  |
| Diluted   | \$ 44,116    | 112,339                 | \$ 0.39          |
| <b>Twenty-six weeks ended July 30, 2006</b>                       |              |                         |                  |
| Basic   | \$ 58,662    | 114,672                 | \$ 0.51          |
| Effect of dilutive stock-based awards                             | -            | 2,843                   |                  |
| Diluted   | \$ 58,662    | 117,515                 | \$ 0.50          |

Stock-based awards of 4,957,000 and 2,588,000 for the thirteen weeks ended and 4,922,000 and 2,538,000 for the twenty-six weeks ended July 29, 2007 and July 30, 2006, respectively, were not included in the computation of diluted earnings per share, as their inclusion would be anti-dilutive.

**NOTE H. LEGAL PROCEEDINGS**

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

**NOTE I. SEGMENT REPORTING**

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



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

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

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.

**Segment Information**

| <i>Dollars in thousands</i>                      | Retail <sup>1</sup> | Direct-to-Customer | Unallocated | Total        |
|--|---------------------|--------------------|-------------|--------------|
| <b>Thirteen weeks ended July 29, 2007</b>        |                     |                    |             |              |
| Net revenues                                     | \$ 486,976          | \$ 372,420         | -           | \$ 859,396   |
| Depreciation and amortization expense            | 23,351              | 4,727              | \$ 6,255    | 34,333       |
| Earnings (loss) before income taxes              | 37,412              | 57,889             | (51,907)    | 43,394       |
| Capital expenditures                             | 35,397              | 7,165              | 15,946      | 58,508       |
| <b>Thirteen weeks ended July 30, 2006</b>        |                     |                    |             |              |
| Net revenues                                     | \$ 463,372          | \$ 362,164         | -           | \$ 825,536   |
| Depreciation and amortization expense            | 22,210              | 4,910              | \$ 5,757    | 32,877       |
| Earnings (loss) before income taxes <sup>2</sup> | 41,086              | 51,551             | (34,875)    | 57,762       |
| Capital expenditures                             | 29,523              | 7,013              | 8,930       | 45,466       |
| <b>Twenty-six weeks ended July 29, 2007</b>      |                     |                    |             |              |
| Net revenues                                     | \$ 940,352          | \$ 735,095         | -           | \$ 1,675,447 |
| Depreciation and amortization expense            | 46,562              | 9,762              | \$ 12,434   | 68,758       |
| Earnings (loss) before income taxes              | 61,102              | 114,024            | (101,351)   | 73,775       |
| Assets <sup>3</sup>                              | 1,103,600           | 361,657            | 502,131     | 1,967,388    |
| Capital expenditures                             | 56,356              | 8,416              | 25,596      | 90,368       |
| <b>Twenty-six weeks ended July 30, 2006</b>      |                     |                    |             |              |
| Net revenues                                     | \$ 897,281          | \$ 722,541         | -           | \$ 1,619,822 |
| Depreciation and amortization expense            | 45,147              | 9,464              | \$ 11,219   | 65,830       |
| Earnings (loss) before income taxes <sup>2</sup> | 75,756              | 103,207            | (83,716)    | 95,247       |
| Assets <sup>3</sup>                              | 1,055,754           | 329,322            | 525,135     | 1,910,211    |
| Capital expenditures                             | 53,738              | 14,941             | 15,802      | 84,481       |

<sup>1</sup> Includes revenues of \$17.7 million and \$17.0 million for the thirteen weeks ended July 29, 2007 and July 30, 2006, respectively, and \$33.9 million and \$32.1 million for the twenty-six weeks ended July 29, 2007 and July 30, 2006, respectively, related to our foreign operations.

<sup>2</sup> Includes \$0.5 million and \$0.4 million in the retail and direct-to-customer segments, respectively, for the thirteen weeks ended July 30, 2006 and \$2.2 million, \$1.6 million and \$0.3 million in the retail, direct-to-customer and corporate unallocated segments, respectively, for the twenty-six weeks ended July 30, 2006, related to the transitioning of the merchandising strategies of our Hold Everything brand into our other existing brands.

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<sup>3</sup> Includes \$25.2 million and \$25.3 million of long-term assets as of July 29, 2007 and July 30, 2006, respectively, related to our foreign operations.

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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 prove 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 projections of earnings, revenues or financial items, including the impact of accounting changes and our expected effective tax rate, statements of the plans, strategies and objectives of management for future operations, statements related to the future performance of our brands, statements related to the revitalization of the Pottery Barn brand, statements related to refining our merchandising strategies including expanding merchandise assortments and improving product quality, statements related to expanding catalog circulation, statements related to increasing electronic direct marketing, statements related to implementing supply chain initiatives, statements related to our in-sourced furniture delivery program, statements related to implementing new marketing initiatives and expanding on-line and electronic direct marketing initiatives including a website redesign, statements related to our plans to open new retail stores and expand or remodel existing retail stores, statements related to innovations and expansions in our brands, statements related to distribution and facility infrastructure projects, statements related to new product launches, statements related to the launch of a new private label credit card, statements related to the adequacy and use of our available cash, including the payment of a dividend, statements related to our projected capital expenditures, statements relating to renewing our existing letter of credit facilities, statements related to systems development projects, statements related to our stock repurchase program, and statements of belief and statements of assumptions underlying any of the foregoing. You can identify these and other forward-looking statements by the use of words such as may, should, expects, plans, anticipates, believes, estimates, predicts, intends, potential, continue, or the negative of such terms, or other comparable terms.

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

**OVERVIEW**

We are a specialty retailer of products for the home. The retail segment of our business sells our products through our five retail store concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, West Elm and Williams-Sonoma Home). The direct-to-customer segment of our business sells similar products through our seven direct-mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed and Bath, PBteen, West Elm and Williams-Sonoma Home) and six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and wshome.com). Based on net revenues in fiscal 2006, retail net revenues accounted for 57.8% of our business and direct-to-customer net revenues accounted for 42.2% of our business. Based on their contribution to our net revenues in fiscal 2006, the core brands in both retail and direct-to-customer are: Pottery Barn, which sells casual home furnishings; Williams-Sonoma, which sells cooking and entertaining essentials; and Pottery Barn Kids, which sells stylish children's furnishings.

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

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*Second Quarter of Fiscal 2007 Financial Results*

During the second quarter of fiscal 2007, net revenues increased 4.1% over the second quarter of fiscal 2006. Including the less than \$0.006 per diluted share impact from an increase in our effective tax rate as a result of applying Financial Accounting Standards Board ( FASB ) Interpretation Number ( FIN ) 48, Accounting for Uncertainty in Income Taxes in the second quarter of fiscal 2007 and the \$0.048 per diluted share net benefit associated with unusual business events (unredeemed gift certificate income due to a change in estimate, litigation settlement income, the expense associated with the departure of our Chief Executive Officer and the expense associated with the Hold Everything transition) in the second quarter of fiscal 2006, diluted earnings per share for the second quarter of fiscal 2007 were \$0.23 versus \$0.30 per diluted share for the second quarter of fiscal 2006.

In our retail channel, net revenues in the second quarter of fiscal 2007 increased by \$23,604,000, or 5.1%, over the second quarter of fiscal 2006. The increase was driven by a year-over-year increase in store leased square footage of 4.1%, including 7 net new stores, and a comparable store sales increase of 1.2%. Net revenues generated in the West Elm, Williams-Sonoma Home and Pottery Barn brands were the primary contributors to the year-over-year revenue increase, partially offset by reduced revenues in the Pottery Barn Kids brand.

In our direct-to-customer channel, net revenues increased by \$10,256,000, or 2.8%, during the second quarter of fiscal 2007 versus the second quarter of fiscal 2006. The increase was primarily driven by net revenues generated in the West Elm, PBteen, Williams-Sonoma and Williams-Sonoma Home brands due to an overall increase in catalog and page circulation of 8.6% and 9.2%, respectively, and continued strength in our Internet business primarily resulting from our catalog advertising, expanded efforts associated with our electronic direct marketing initiatives and strategic e-commerce partnerships. This increase was partially offset by lost revenues in the Hold Everything brand and reduced revenues in the Pottery Barn Kids and Pottery Barn brands.

In our core brands, which include Williams-Sonoma, Pottery Barn, and Pottery Barn Kids, net revenues in the second quarter of fiscal 2007 increased 1.0% over the second quarter of fiscal 2006.

In Williams-Sonoma, second quarter of fiscal 2007 net revenues increased 2.2% versus the second quarter of fiscal 2006. In the retail channel, we had a positive 1.1% comparable store sales increase, and we continue to be pleased with the performance of our re-merchandised small and mid-size stores. In the direct-to-customer channel, we saw a strong consumer response to our seasonal merchandising strategies, continuing momentum in our e-commerce performance, both in traffic and conversion, and ongoing success with our versioned catalogs. Higher response rates from paid search and electronic direct marketing also contributed to these results.

In Pottery Barn, net revenue increased 1.0% in the second quarter of fiscal 2007 versus the second quarter of fiscal 2006. In the retail channel, comparable store sales increased 1.8%; however, in the direct-to-customer channel, growth was negatively impacted by higher backorders and lower shipping revenue. From an operational perspective, we continued to focus on the revitalization strategy for the brand and are pleased with our progress on our initiatives to date.

In Pottery Barn Kids, net revenues decreased 3.2% in the second quarter of fiscal 2007 versus a 16.8% increase in the second quarter of fiscal 2006. Ongoing macro pressure and challenging year-over-year comparisons negatively impacted revenue growth in both channels. In the retail channel, comparable store sales decreased 3.8% versus an 8.1% increase in the second quarter of 2006 and in the direct-to-customer channel, growth was negatively impacted by higher backorders and lower shipping revenue.



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In our emerging brands, which include West Elm, Williams-Sonoma Home, and PBteen, revenues increased 39.4% in the second quarter of fiscal 2007 versus the second quarter of fiscal 2006, with strong growth across all brands and channels. Like the core brands, increased backorders in addition to higher customer orders in-transit negatively impacted second quarter growth.

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In West Elm, retail revenue growth was primarily driven by incremental sales from new stores and a significantly expanded retail assortment across all stores. In the direct-to-customer channel, year-over-year revenue growth was driven by higher conversion rates and increased catalog circulation.

In Williams-Sonoma Home, we continued to broaden our merchandise assortment, rationalize our catalog circulation strategy, leverage our e-commerce website, and accelerate our year-over-year growth in both the retail and direct-to-customer channels. All of these initiatives resulted in an improvement in the brand's overall performance versus the prior year. In the retail channel, growth was primarily driven by incremental sales from new stores and an expanded retail merchandise assortment. In the direct-to-customer channel, we continued to drive brand awareness through paid search and build upon the momentum driven by last year's catalog redesign and the e-commerce website launch in Fall of 2006.

In PBteen, net revenues increased 17.7% in the second quarter of fiscal 2007 versus the second quarter of fiscal 2006. We saw a positive consumer response to both our summer and fall merchandise assortments. Increased newness and a relevant, on-brand presentation drove these results, and continued to attract new customers to the brand.

### *Second Quarter of Fiscal 2007 Operational Results*

During the quarter, we continued to make strategic advancements in our supply chain infrastructure. From a systems perspective, we rolled out our new retail inventory management system to our West Elm and Williams-Sonoma Home brands. In the supply chain organization, we consolidated our returns-processing operations into one dedicated location. This initiative is expected to result in the more rapid identification of return-related trends, in addition to lower operating costs. We also expanded our west coast distribution center, which facilitated the in-sourcing of our west coast furniture-hub operations.

### *Fiscal 2007*

As we look forward to the third quarter and balance of the year, we are continuing to focus on the execution of two of our most important strategic initiatives, driving top-line revenue growth across all of our brands and optimizing our pre-tax operating margin through operational advancements and cost containment initiatives. Within these initiatives, our top priority continues to be the revitalization of the Pottery Barn brand.

Consistent with our strategic initiative to drive profitable top-line revenue growth, we are investing in the growth opportunities that we believe will provide the greatest returns in both our core and emerging brands.

In the retail channel throughout fiscal 2007, we are expecting to add 11 net new retail locations, seven of which are in our emerging brands, expand the square footage of 20 of our existing stores and remodel 3 additional existing stores.

In the direct-to-customer channel, we will continue to leverage the rollout of our Pottery Barn Outdoor catalog into the third quarter of fiscal 2007 in addition to launching our website redesign in the Williams-Sonoma brand in the fourth quarter of fiscal 2007. We also expect to increase

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catalog page circulation in both our core and emerging brands, as well as increase the marketing behind our fastest growing channel, e-commerce.

In addition, in the Williams-Sonoma brand, we plan to leverage our key vendor partnerships to introduce unique and exclusive product at a broad range of price points, launch the first phase of our website redesign, and introduce new tabletop and entertaining assortments to drive increased sales per square foot and an improved bridal experience.

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In Pottery Barn, we will be introducing a significant number of new product introductions and will continue to focus on the rollout of our revitalization initiatives, recognizing that these initiatives are going to take several quarters to fully implement, and additional time to analyze.

In Pottery Barn Kids, we plan to roll out merchandising strategies in the back half of the year, including a significantly expanded assortment in back-to-school, holiday and gift giving. In addition, we plan to test versioning of our catalog beginning in the third quarter of fiscal 2007, which we believe could drive increased sales and higher catalog productivity, in addition to allowing us to identify new customers for the brand.

In West Elm, we will continue to focus on a number of brand-building initiatives, including launching the private label credit card in the retail channel in the third quarter, followed by the direct-to-customer channel later in the year; rolling-out a new marketing campaign centered around people, design, and style; and introducing new merchandise line extensions and expanded holiday gift-giving strategies. We also opened our first flagship store in Washington D.C. in August 2007.

In Williams-Sonoma Home, we plan to open one additional store, increase brand exposure through leveraging the namesake Williams-Sonoma brand, expand our merchandise assortment to drive greater sales productivity, and enhance the holiday gift-giving assortment, including a broader range of price points and an improved visual presentation.

To support all of these growth initiatives, we are continuing to invest in our supply chain infrastructure, including the expansion of our west coast distribution and furniture hub operations, the consolidation of our returns-processing facility, and the integration of our recently acquired European sourcing company. We are also intensifying our sourcing and quality control operations in Asia and leveraging our in-sourced domestic furniture operations as part of our ongoing effort to reduce furniture returns, replacements, and damages. We believe these will allow for our continued ability to drive greater efficiencies in our supply chain operations and overhead cost structure.

**NET REVENUES**

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

The following table summarizes our net revenues for the thirteen weeks ended July 29, 2007 ( second quarter of fiscal 2007 ) and July 30, 2006 ( second quarter of fiscal 2006 ), and the twenty-six weeks ended July 29, 2007 ( year-to-date 2007 ) and July 30, 2006 ( year-to-date 2006 ):

|                             | Thirteen Weeks Ended |         |                  |         | Twenty-Six Weeks Ended |         |                  |         |
|-----------------------------|----------------------|---------|------------------|---------|------------------------|---------|------------------|---------|
|                             | July 29,<br>2007     | % Total | July 30,<br>2006 | % Total | July 29,<br>2007       | % Total | July 30,<br>2006 | % Total |
| <i>Dollars in thousands</i> |                      |         |                  |         |                        |         |                  |         |
| Retail revenues             | \$ 486,976           | 56.7%   | \$ 463,372       | 56.1%   | \$ 940,352             | 56.1%   | \$ 897,281       | 55.4%   |
| Direct-to-customer revenues | 372,420              | 43.3%   | 362,164          | 43.9%   | 735,095                | 43.9%   | 722,541          | 44.6%   |
| Net revenues                | \$ 859,396           | 100.0%  | \$ 825,536       | 100.0%  | \$ 1,675,447           | 100.0%  | \$ 1,619,822     | 100.0%  |

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Net revenues in the second quarter of fiscal 2007 increased by \$33,860,000, or 4.1%, over the second quarter of fiscal 2006. The increase was primarily driven by a year-over-year increase in store leased square footage of 4.1% (including 23 new store openings and the remodeling or expansion of an additional 22 stores) and a comparable stores sales increase of 1.2%. The increase was further driven by increased catalog and page

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circulation of 8.6% and 9.2%, respectively, and continued strength in our Internet business primarily resulting from our catalog advertising, expanded efforts associated with our electronic direct marketing initiatives and strategic e-commerce partnerships. This increase was partially offset by lost revenues in the Hold Everything brand, which was transitioned into our other existing brands throughout the first and second quarters of fiscal 2006, and the temporary closure of 29 stores and the permanent closure of 9 stores, for a net of 7 new store openings.

Net revenues for year-to-date 2007 increased by \$55,625,000, or 3.4%, over year-to-date 2006. The increase was primarily driven by a year-over-year increase in store leased square footage of 4.1% (including 23 new store openings and the remodeling or expansion of an additional 22 stores). The increase was further driven by increased catalog and page circulation of 2.4% and 7.4%, respectively, and continued strength in our Internet business primarily resulting from our catalog advertising, expanded efforts associated with our electronic direct marketing initiatives and strategic e-commerce partnerships. This increase was partially offset by lost revenues in the Hold Everything brand, which was transitioned into our other existing brands throughout the first and second quarters of fiscal 2006, and the temporary closure of 29 stores and the permanent closure of 9 stores, for a net of 7 new store openings.

**RETAIL REVENUES AND OTHER DATA**

|  | Thirteen Weeks Ended |               | Twenty-Six Weeks Ended |               |
|--|----------------------|---------------|------------------------|---------------|
|  | July 29, 2007        | July 30, 2006 | July 29, 2007          | July 30, 2006 |
| <i>Dollars in thousands</i>                            |                      |               |                        |               |
| Retail revenues  | \$ 486,976           | \$ 463,372    | \$ 940,352             | \$ 897,281    |
| Percent growth in retail revenues                      | 5.1%                 | 6.7%          | 4.8%                   | 7.9%          |
| Percent increase in comparable store sales             | 1.2%                 | 1.2%          | 0.2%                   | 1.3%          |
| Number of stores - beginning of period                 | 584                  | 569           | 588                    | 570           |
| Number of new stores                                   | 2                    | 2             | 4                      | 9             |
| Number of new stores due to remodeling <sup>1</sup>    | 8                    | 10            | 9                      | 15            |
| Number of closed stores due to remodeling <sup>1</sup> | (12)                 | (8)           | (18)                   | (13)          |
| Number of permanently closed stores                    | (2)                  | -             | (3)                    | (8)           |
| Number of stores - end of period                       | 580                  | 573           | 580                    | 573           |
| Store selling square footage at period-end             | 3,343,000            | 3,204,000     | 3,343,000              | 3,204,000     |
| Store leased square footage ( LSF ) at period-end      | 5,370,000            | 5,159,000     | 5,370,000              | 5,159,000     |

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

|                      | Store Count    |          |          | Store Count   |               | Avg. LSF      |               |
|----------------------|----------------|----------|----------|---------------|---------------|---------------|---------------|
|                      | April 29, 2007 | Openings | Closings | July 29, 2007 | July 30, 2006 | July 29, 2007 | July 30, 2006 |
| Williams-Sonoma      | 250            | 6        | (4)      | 252           | 256           | 6,000         | 5,800         |
| Pottery Barn         | 195            | 1        | (6)      | 190           | 191           | 12,100        | 12,200        |
| Pottery Barn Kids    | 93             | 1        | (3)      | 91            | 91            | 7,900         | 7,800         |
| West Elm             | 22             | 1        | -        | 23            | 14            | 17,500        | 16,100        |
| Williams-Sonoma Home | 8              | -        | -        | 8             | 5             | 14,200        | 14,700        |
| Outlets              | 16             | 1        | (1)      | 16            | 16            | 20,500        | 20,400        |
| Total                | 584            | 10       | (14)     | 580           | 573           | 9,300         | 9,000         |

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Retail revenues in the second quarter of fiscal 2007 increased by \$23,604,000, or 5.1%, over the second quarter of fiscal 2006. The increase was driven by a year-over-year increase in store leased square footage of 4.1% (including 23 new store openings and the remodeling or expansion of an additional 22 stores) and a comparable stores sales increase of 1.2%, partially offset by the temporary closure of 29 stores and the permanent

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closure of 9 stores, for a net of 7 new store openings. Net revenues generated in the West Elm, Williams-Sonoma Home and Pottery Barn brands were the primary contributors to the year-over-year revenue increase, partially offset by reduced revenues in the Pottery Barn Kids brand.

Retail revenues for year-to-date 2007 increased by \$43,071,000, or 4.8%, over year-to-date 2006. The increase was driven by a year-over-year increase in store leased square footage of 4.1% (including 23 new store openings and the remodeling or expansion of an additional 22 stores), partially offset by the temporary closure of 29 stores and the permanent closure of 9 stores, for a net of 7 new store openings. Net revenues generated in the West Elm, Williams-Sonoma Home and Pottery Barn brands were the primary contributors to the year-over-year revenue increase, partially offset by lost revenues in the Hold Everything brand, which was transitioned into our other existing brands throughout the first and second quarters of fiscal 2006, in addition to reduced revenues in the Pottery Barn Kids brand. All of our Hold Everything stores were closed during late fiscal 2005 and the first quarter of fiscal 2006.

*Comparable Store Sales*

Comparable stores are defined as those stores in which gross square footage did not change by more than 20% in the previous 12 months and which have been open for at least 12 consecutive months without closure for seven or more consecutive days. By measuring the year-over-year sales of merchandise in the stores that have a history of being open for a full comparable 12 months or more, we can better gauge how the core store base is performing since it excludes store remodelings, expansions and closings. Comparable stores exclude new retail concepts until such time as we believe that comparable store results in those concepts are meaningful to evaluating the performance of the retail strategy. In the second quarter of fiscal 2007, we have excluded West Elm and Williams-Sonoma Home. In the second quarter of fiscal 2006, we have excluded only West Elm as there were no Williams-Sonoma Home stores that were open for at least 12 months.

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

|  | Thirteen Weeks Ended |                  | Twenty-Six Weeks Ended |                  |
|--|----------------------|------------------|------------------------|------------------|
|  | July 29,<br>2007     | July 30,<br>2006 | July 29,<br>2007       | July 30,<br>2006 |
| <i>Percent increase (decrease) in comparable store sales</i> |                      |                  |                        |                  |
| Williams-Sonoma  | 1.1%                 | 2.3%             | 0.3%                   | 2.1%             |
| Pottery Barn   | 1.8%                 | (0.2%)           | 0.3%                   | 0.4%             |
| Pottery Barn Kids  | (3.8%)               | 8.1%             | (3.8%)                 | 5.7%             |
| Outlets  | 9.0%                 | (8.6%)           | 9.2%                   | (6.4%)           |
| Total  | 1.2%                 | 1.2%             | 0.2%                   | 1.3%             |

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





**Table of Contents****DIRECT-TO-CUSTOMER REVENUES**

|  | Thirteen Weeks Ended |                  | Twenty-Six Weeks Ended |                  |
|--|----------------------|------------------|------------------------|------------------|
|  | July 29,<br>2007     | July 30,<br>2006 | July 29,<br>2007       | July 30,<br>2006 |
| <i>Dollars in thousands</i>                                  |                      |                  |                        |                  |
| Catalog revenues <sup>1</sup>                                | \$ 135,041           | \$ 148,409       | \$ 266,252             | \$ 307,761       |
| Internet revenues <sup>1</sup>                               | 237,379              | 213,755          | 468,843                | 414,780          |
| Total direct-to-customer revenues <sup>1</sup>               | \$ 372,420           | \$ 362,164       | \$ 735,095             | \$ 722,541       |
| Percent growth in direct-to-customer revenues                | 2.8%                 | 5.9%             | 1.7%                   | 8.6%             |
| Percent increase (decrease) in number of catalogs circulated | 8.6%                 | (3.4%)           | 2.4%                   | (0.6%)           |
| Percent growth in number of pages circulated                 | 9.2%                 | 4.2%             | 7.4%                   | 5.8%             |

<sup>1</sup> Approximately 55% of our company-wide non-gift registry Internet revenues are driven by customers who recently received a catalog and approximately 45% are incremental to the direct-to-customer channel.

Direct-to-customer revenues in the second quarter of fiscal 2007 increased by \$10,256,000, or 2.8%, over the second quarter of fiscal 2006. The increase was primarily driven by net revenues generated in the West Elm, PBteen, Williams-Sonoma and Williams-Sonoma Home brands due to an overall increase in catalog and page circulation of 8.6% and 9.2%, respectively, and continued strength in our Internet business primarily resulting from our catalog advertising, expanded efforts associated with our electronic direct marketing initiatives and strategic e-commerce partnerships. This increase was partially offset by lost revenues in the Hold Everything brand, which was transitioned into our other existing brands throughout the first and second quarters of fiscal 2006, and reduced revenues in the Pottery Barn Kids and Pottery Barn brands.

Direct-to-customer revenues for year-to-date 2007 increased \$12,554,000, or 1.7%, over year-to-date 2006. The increase was primarily driven by net revenues generated in the West Elm, PBteen, Williams-Sonoma and Williams-Sonoma Home brands, primarily due to an overall increase in catalog and page circulation of 2.4% and 7.4%, respectively, and continued strength in our Internet business primarily resulting from our catalog advertising, expanded efforts associated with our electronic direct marketing initiatives and strategic e-commerce partnerships. This increase was partially offset by lost revenues in the Hold Everything brand, which was transitioned into our other existing brands throughout the first and second quarters of fiscal 2006. All of the brands in the direct-to-customer channel delivered positive growth for year-to-date 2007.

**COST OF GOODS SOLD**

|                             | Thirteen Weeks Ended |                   |                  |                   | Twenty-Six Weeks Ended |                   |                  |                   |
|-----------------------------|----------------------|-------------------|------------------|-------------------|------------------------|-------------------|------------------|-------------------|
|                             | July 29,<br>2007     | % Net<br>Revenues | July 30,<br>2006 | % Net<br>Revenues | July 29,<br>2007       | % Net<br>Revenues | July 30,<br>2006 | % Net<br>Revenues |
| <i>Dollars in thousands</i> |                      |                   |                  |                   |                        |                   |                  |                   |
| Cost of goods sold          | \$ 539,301           | 62.8%             | \$ 510,976       | 61.9%             | \$ 1,053,382           | 62.9%             | \$ 999,841       | 61.7%             |

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.

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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.

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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 2007 vs. Second Quarter of Fiscal 2006*

Cost of goods sold increased by \$28,325,000, or 5.5%, in the second quarter of fiscal 2007 compared to the second quarter of fiscal 2006. Cost of goods sold as a percentage of net revenues increased 90 basis points in the second quarter of fiscal 2007 from the second quarter of fiscal 2006. This increase was primarily driven by increased markdowns and higher cost of merchandise in our Pottery Barn and Pottery Barn Kids brands and increased occupancy costs. The increase in occupancy costs as a percentage of net revenues was primarily driven by the retail rollout of the emerging brands. These costs were partially offset, however, by the elimination of costs of goods sold associated with the Hold Everything brand.

In the retail channel, cost of goods sold as a percentage of retail net revenues increased 130 basis points in the second quarter of fiscal 2007 compared to the second quarter of fiscal 2006. This increase was primarily driven by increased markdowns and higher cost of merchandise in our Pottery Barn and Pottery Barn Kids brands and increased occupancy costs. The increase in occupancy costs as a percentage of net revenues was primarily driven by the retail rollout of the emerging brands, partially offset by the elimination of costs of goods sold associated with the Hold Everything brand. All of our Hold Everything stores were closed during late fiscal 2005 and the first quarter of fiscal 2006.

In the direct-to-customer channel, cost of goods sold as a percentage of direct-to-customer net revenues decreased 40 basis points in the second quarter of fiscal 2007 compared to the second quarter of fiscal 2006. This decrease was primarily driven by a reduction in occupancy expenses and the elimination of costs of goods sold associated with the Hold Everything brand, which was transitioned into our other existing brands throughout the first and second quarters of fiscal 2006, partially offset by increased markdowns and higher cost of merchandise in our Pottery Barn and Pottery Barn Kids brands.

### *Year-to-Date 2007 vs. Year-to-Date 2006*

Cost of goods sold for year-to-date 2007 increased by \$53,541,000, or 5.4%, over year-to-date 2006. Cost of goods sold as a percentage of net revenues increased 120 basis points for year-to-date 2007 compared to year-to-date 2006. This increase was primarily driven by increased markdowns and higher cost of merchandise in our Pottery Barn and Pottery Barn Kids brands, increased liquidation activity in our Outlet stores and increased occupancy costs. The increase in occupancy costs as a percentage of net revenues was primarily driven by the retail rollout of the emerging brands and increased distribution capacity. These costs were partially offset, however, by the elimination of costs of goods sold associated with the Hold Everything brand.

In the retail channel, cost of goods sold as a percentage of retail net revenues increased 190 basis points for year-to-date 2007 compared to year-to-date 2006 resulting from increased markdowns and higher cost of merchandise in our Pottery Barn and Pottery Barn Kids brands, increased liquidation activity in our Outlet stores and increased occupancy costs driven by the retail rollout of the emerging brands. This increase was partially offset by the elimination of costs of goods sold associated with the Hold Everything brand, including expense associated with the Hold Everything transition. All of our Hold Everything stores were closed during late 2005 and the first quarter of fiscal 2006.

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In the direct-to-customer channel, cost of goods sold as a percentage of direct-to-customer net revenues decreased 40 basis points for year-to-date 2007 compared to year-to-date 2006 due to the elimination of costs of goods sold associated with the Hold Everything brand, which was transitioned into our other existing brands throughout the first and second quarters of fiscal 2006.

**Table of Contents****SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

|  | Thirteen Weeks Ended |                   |                  |                   | Twenty-Six Weeks Ended |                   |                  |                   |
|--|----------------------|-------------------|------------------|-------------------|------------------------|-------------------|------------------|-------------------|
|  | July 29,<br>2007     | % Net<br>Revenues | July 30,<br>2006 | % Net<br>Revenues | July 29,<br>2007       | % Net<br>Revenues | July 30,<br>2006 | % Net<br>Revenues |
| <i>Dollars in thousands</i>                  |                      |                   |                  |                   |                        |                   |                  |                   |
| Selling, general and administrative expenses | \$ 277,227           | 32.3%             | \$ 260,312       | 31.5%             | \$ 550,755             | 32.9%             | \$ 531,043       | 32.8%             |

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

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

*Second Quarter of Fiscal 2007 vs. Second Quarter of Fiscal 2006*

Selling, general and administrative expenses increased by \$16,915,000, or 6.5%, in the second quarter of fiscal 2007 compared to the second quarter of fiscal 2006. Selling, general and administrative expenses as a percentage of net revenues increased 80 basis points in the second quarter of fiscal 2007 from the second quarter of fiscal 2006. This increase was primarily due to a net benefit in the second quarter of fiscal 2006 of approximately \$10,000,000 associated with unusual business events (unredeemed gift certificate income due to a change in estimate, litigation settlement income, the expense associated with the departure of our Chief Executive Officer and the expense associated with the Hold Everything transition) and increased costs in the second quarter of 2007 associated with the growth of the emerging brands, partially offset by lower advertising expenses as a percentage of net revenues, primarily in the Pottery Barn and PBteen brands, reductions in other general expenses, and the elimination of all selling, general and administrative expenses associated with the Hold Everything brand.

In the retail channel, selling, general and administrative expenses as a percentage of retail net revenues decreased 20 basis points in the second quarter of fiscal 2007 compared to the second quarter of fiscal 2006 primarily due to reduced advertising expenses, partially offset by increased costs associated with the growth of the emerging brands.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of direct-to-customer net revenues decreased 90 basis points in the second quarter of fiscal 2007 compared to the second quarter of fiscal 2006 due to lower advertising expenses as a percentage of net revenues and reductions in other general expenses.

*Year-to-Date 2007 vs. Year-to-Date 2006*

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Selling, general and administrative expenses for year-to-date 2007 increased by \$19,712,000, or 3.7%, over year-to-date 2006. Selling, general and administrative expenses as a percentage of net revenues increased 10 basis points for year-to-date 2007 compared to year-to-date 2006. This increase was primarily due to a net benefit for year-to-date 2006 of approximately \$8,500,000 associated with unusual business events (unredeemed gift certificate income due to a change in estimate, litigation settlement income, the expense associated with the departure of our Chief Executive Officer and the expense associated with the Hold Everything transition) and increased costs associated with the growth of the emerging brands, partially offset by reduced stock-based

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compensation, reductions in other general expenses, increased income from unredeemed gift certificates, reduced advertising expenses as a percentage of net revenues and the elimination of all selling, general and administrative expenses associated with the Hold Everything brand.

In the retail channel, selling, general and administrative expenses as a percentage of retail net revenues increased 10 basis points for year-to-date 2007 compared to year-to-date 2006 due to increased costs associated with the growth of the emerging brands, partially offset by increased income from unredeemed gift certificates.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of direct-to-customer net revenues decreased 80 basis points for year-to-date 2007 compared to year-to-date 2006 due to reductions in advertising and other general expenses.

## **INTEREST INCOME**

Interest income was \$1,031,000 in the second quarter of fiscal 2007, compared to \$4,056,000 in the second quarter of fiscal 2006, comprised primarily of income from short-term investments classified as cash and cash equivalents. For year-to-date 2007, interest income was \$3,501,000 compared to \$7,378,000 for year-to-date 2006. The decrease in interest income during the second quarter of fiscal 2007 and year-to-date 2007 compared to the second quarter of fiscal 2006 and year-to-date 2006 resulted from lower cash and investment balances during 2007 compared to 2006, partially offset by an increase in the interest rates associated with these balances.

## **INCOME TAXES**

Our effective tax rate was 40.2% for both the second quarter of fiscal 2007 and year-to-date 2007 and 38.4% for the second quarter of fiscal 2006 and year-to-date 2006. Our second quarter of fiscal 2007 and year-to-date 2007 tax rate increased primarily due to the impact of applying FIN 48, which we adopted on January 29, 2007. We expect our effective tax rate to be in the range of 39.3% to 39.6% in fiscal 2007, which includes an approximate 100 basis point impact due to applying FIN 48 throughout fiscal 2007. Throughout the year, we expect that there could be ongoing variability in our quarterly tax rates as taxable events occur and exposures are evaluated.

## **LIQUIDITY AND CAPITAL RESOURCES**

As of July 29, 2007, we held \$58,039,000 in cash and cash equivalent funds. As is consistent with our industry, our cash balances are seasonal in nature, with the fourth quarter representing a significantly higher level of cash than other periods.

Throughout the fiscal year, we utilize our cash balances to build our inventory levels in preparation for our fourth quarter holiday sales. In fiscal 2007, we plan to utilize our cash resources to fund our inventory and inventory related purchases, catalog advertising and marketing initiatives, purchases of property and equipment, share repurchases and dividends. In addition to the current cash balances on-hand, we have a \$300,000,000 credit facility available as of July 29, 2007 that may be used for loans or letters of credit. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the new credit facility of up to \$200,000,000, to provide for a total of \$500,000,000 of unsecured revolving credit. No amounts were borrowed under the credit facility during the twenty-six weeks ended July 29, 2007 and July 30, 2006.



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However, as of July 29, 2007, \$37,398,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. We believe our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations and growth opportunities over the next 12 month period.

For year-to-date 2007, net cash used in operating activities was \$41,228,000 compared to net cash used in operating activities of \$22,281,000 for the year-to-date 2006. Net cash used in operating activities for year-to-date 2007 was primarily attributable to the payment of income taxes, the purchase of merchandise inventories to

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support the increase in sales in our core and emerging brands and a decrease in accounts payable due to the timing of payments.

For year-to-date 2007, net cash used in investing activities was \$90,688,000 compared to net cash used in investing activities of \$84,481,000 for year-to-date 2006. For year-to-date 2007, net cash used in investing activities was primarily due to purchases of property and equipment of \$90,368,000, comprised of \$47,686,000 for stores, \$34,608,000 for systems development projects (including e-commerce websites) and \$8,074,000 for distribution and facility infrastructure projects.

In fiscal 2007, we anticipate investing \$220,000,000 to \$240,000,000 in the purchase of property and equipment, primarily for the construction of 21 new stores and 26 remodeled or expanded stores, systems development projects (including e-commerce websites), and distribution, facility infrastructure and other projects.

For the year-to-date 2007, net cash used in financing activities was \$88,479,000 compared to net cash used in financing activities of \$68,029,000 for year-to-date 2006. Net cash used in financing activities for year-to-date 2007 was primarily due to the repurchase of common stock and the payment of dividends, partially offset by the net proceeds and related excess tax benefit from the exercise of stock options.

*Stock Repurchase Program*

In March 2007, our Board of Directors authorized a stock repurchase program to acquire up to an additional 5,000,000 shares of our common stock through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. The stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

During the second quarter of fiscal 2007, we repurchased and retired 2,604,760 shares of our common stock at a weighted average cost of \$32.90 per share and a total cost of approximately \$85,704,000. An aggregate of 3,309,395 shares remain available for repurchase under all previously authorized stock repurchase programs.

The following table summarizes our repurchases of shares of our common stock during the second quarter of fiscal 2007 under our repurchase programs:

| Period         |               | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of a Publicly Announced Repurchase Plan | Maximum Number of Shares that May Yet be Purchased Under Any Plan |
|----------------|---------------|----------------------------------|------------------------------|--|---|
| April 30, 2007 | May 27, 2007  | -                                | -                            | -  | 5,914,155   |
| May 28, 2007   | June 24, 2007 | 2,439,060                        | \$ 33.00                     | 2,439,060  | 3,475,095   |
| June 25, 2007  | July 29, 2007 | 165,700                          | \$ 31.54                     | 165,700  | 3,309,395   |

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|       |           |          |           |           |
|-------|-----------|----------|-----------|-----------|
| Total | 2,604,760 | \$ 32.90 | 2,604,760 | 3,309,395 |
|-------|-----------|----------|-----------|-----------|

### *Dividend Policy*

In March 2007, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.10 to \$0.115 per common share. The indicated annual cash dividend, subject to capital availability, is \$0.46 per common share or approximately \$50,000,000 in fiscal 2007. Our quarterly cash dividend could be reduced or discontinued 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 on-going basis and are based on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results may differ significantly from these estimates. There have been no significant changes to the policies as discussed in our Annual Report on Form 10-K for the year ended January 28, 2007, other than the adoption of FIN 48 as discussed in Note B to our condensed consolidated financial statements.

### *Contractual Obligations*

There have been no significant changes to our contractual obligations and commitments table as discussed in our Annual Report on Form 10-K for the year ended January 28, 2007, except for the changes related to our adoption of FIN 48 as discussed in Note B to our condensed consolidated financial statements and the amendment to our service agreement with IBM as discussed in Note E to our condensed consolidated financial statements. The short-term and long-term liabilities for uncertain tax positions under FIN 48, excluding interest, are \$1,988,000 and \$30,008,000, respectively, as of July 29, 2007. We are not able to reasonably estimate when cash payments of the long-term liability for uncertain tax positions will occur.

Under our service agreement with IBM, we are subject to a minimum remaining charge of \$5,992,000 and in the event the agreement is terminated for convenience, a graduated termination fee will be assessed based on the time period remaining in the contract term. As of July 29, 2007, this termination fee was approximately \$1,410,000. For the fiscal year ended January 29, 2007, we had included in our purchase obligations table within the contractual obligations section of our annual report \$5,800,000 relating to our service agreement with IBM.

### *Impact of Inflation*

The impact of inflation on results of operations was not significant for year-to-date 2007 or year-to-date 2006.

### *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, and we expect this to continue going forward. In anticipation of our peak season, we hire a substantial number of additional employees in our retail stores and direct-to-customer processing and distribution areas, and incur significant fixed catalog production and mailing costs.

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

We are exposed to market risks, which include changes in U.S. interest rates and foreign exchange rates. We do not engage in financial transactions for trading or speculative purposes.

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### *Interest Rate Risk*

The interest payable on our credit facility, Mississippi industrial development bond and the bond-related debt associated with our Memphis-based distribution facility is based on variable interest rates and is therefore affected by changes in market interest rates. If interest rates on existing variable rate debt rose 53 basis points (an approximate 10% increase in the associated variable rates as of July 29, 2007), our results from operations and cash flows would not be materially affected.

In addition, we have fixed and variable income investments consisting of short-term investments classified as cash and cash equivalents, which are also affected by changes in market interest rates. An increase in interest rates of 10% would have an immaterial effect on the value of these investments. Declines in interest rates would, however, decrease the income derived from these investments.

### *Foreign Currency Risks*

We purchase a significant amount of inventory from vendors outside of the U.S. in transactions that are denominated in U.S. dollars. Approximately 5% of our international purchase transactions are in currencies other than the U.S. dollar, primarily the euro. As of July 29, 2007, any currency risks related to these transactions were not significant to us. A decline in the relative value of the U.S. dollar to other foreign currencies could, however, lead to increased purchasing costs.

As of July 29, 2007, we have 14 retail stores in Canada (three of which were temporarily closed at period end), which expose us to market risk associated with foreign currency exchange rate fluctuations. As necessary, we may enter into 30-day foreign currency contracts to minimize any currency remeasurement risk associated with intercompany assets and liabilities of our Canadian subsidiary. We did not enter into any foreign currency contracts during year-to-date 2007 and year-to-date 2006, and there were no such contracts outstanding as of July 29, 2007 or July 30, 2006. Any gain or loss associated with these types of contracts in prior years was not material to us.

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

### *Evaluation of Disclosure Controls and Procedures*

As of July 29, 2007, 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.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

A description of the risks and uncertainties associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risks and uncertainties associated with our business previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended January 28, 2007. You should carefully consider such risks and uncertainties, together with the other information contained in this report, our Annual Report on Form 10-K for the fiscal year ended January 28, 2007 and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.

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

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

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

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



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Our business depends on consumer demand for our products and, consequently, is sensitive to a number of factors that influence consumer spending, including general economic conditions, disposable consumer income, fuel prices, recession and fears of recession, war and fears of war, inclement weather, consumer debt, conditions in the housing market, interest rates, sales tax rates and rate increases, inflation, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. These factors may also affect our various brands and channels differently. Adverse changes in factors affecting

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discretionary consumer spending could reduce consumer demand for our products, thus reducing our sales and harming our business and operating results.

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

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

The competitive challenges facing us include:

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

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

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

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

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

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In addition, we are subject to certain risks, including availability of raw materials, labor disputes, union organizing activities, vendor financial liquidity, inclement weather, natural disasters, and general economic and political conditions, that could limit our vendors' ability to provide us with quality merchandise on a timely basis and at a price that is commercially acceptable. For these or other reasons, one or more of our vendors might not adhere to our quality control standards, and we might not identify the deficiency before merchandise ships to our stores or customers. In addition, our vendors may have difficulty adjusting to our changing demands and growing business. Our vendors' failure to manufacture or import quality merchandise in a timely and effective manner

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could damage our reputation and brands, and could lead to an increase in customer litigation against us and an attendant increase in our routine litigation costs. Further, any merchandise that does not meet our quality standards could become subject to a recall, which would damage our reputation and brands, and harm our business.

*Our dependence on foreign vendors subjects us to a variety of risks and uncertainties.*

In fiscal 2006, we sourced our products from manufacturers in 39 countries outside of the United States. Approximately 62% of our merchandise purchases were foreign-sourced, primarily from Asia and Europe. Our dependence on foreign vendors means that we may be affected by declines in the relative value of the U.S. dollar to other foreign currencies. For example, any upward valuation in the Chinese yuan against the U.S. dollar may result in higher costs to us for those goods that we source from mainland China. Although approximately 95% of our foreign purchases of merchandise are negotiated and paid for in U.S. dollars, declines in foreign currencies and currency exchange rates might negatively affect the profitability and business prospects of one or more of our foreign vendors. This, in turn, might cause such foreign vendors to demand higher prices for merchandise, delay merchandise shipments to us, or discontinue selling to us, any of which could ultimately reduce our sales or increase our costs.

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

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

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

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

- our identification and availability of suitable store locations;
- our success in negotiating leases on acceptable terms;
- our ability to secure required governmental permits and approvals;
- our hiring and training of skilled store operating personnel, especially management;

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our timely development of new stores, including the availability of construction materials and labor and the absence of significant construction and other delays in store openings based on weather or other events;  
the availability of financing on acceptable terms, if at all; and  
general economic conditions.

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

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

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

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

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

In addition, we face the risk that we cannot hire enough qualified employees, or that there will be a disruption in the labor we hire from our third party providers, especially during our peak season, to support our direct-to-customer operations, due to circumstances that reduce the relevant workforce. The need to operate with fewer employees could negatively impact our customer service levels and our operations.

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

Our retail stores, corporate offices, distribution centers, infrastructure projects and direct-to-customer operations, as well as the operations of vendors from which we receive goods and services, are vulnerable to damage from earthquakes, 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.



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*We experience fluctuations in our comparable store sales.*

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

Our comparable store sales have fluctuated significantly in the past on an annual, quarterly and monthly basis, and we expect that comparable store sales will continue to fluctuate in the future. Our comparable store sales increases for fiscal 2006, fiscal 2005 and fiscal 2004 were 0.3%, 4.9% and 3.5%, respectively. Past comparable store sales are no indication of future results, and comparable store sales may decrease in the future. Our ability to maintain and improve our comparable store sales results depends, in large part, on maintaining and improving our forecasting of customer demand and buying trends, selecting effective marketing techniques, providing an appropriate mix of merchandise for our broad and diverse customer base and using effective pricing strategies. Any failure to meet the comparable store sales expectations of investors and securities analysts in one or more future periods could significantly reduce the market price of our common stock.

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

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

We have historically experienced fluctuations in customer response to our catalogs. Customer response to our catalogs is substantially dependent on merchandise assortment, merchandise availability and creative presentation, as well as the selection of customers to whom the catalogs are mailed, changes in mailing strategies, and the sizing and timing of delivery of the catalogs. In addition, environmental organizations may attempt to create an unfavorable impression of our paper use in 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. For example, the August 2005 natural disaster caused by Hurricane Katrina created domestic ground and rail transportation capacity constraints that resulted in late catalog delivery. Any delays in the timing of catalog delivery could cause customers to forego or defer purchases.

*We must successfully manage our Internet business.*

The success of our Internet business depends, in part, on factors over which we have limited control. In addition to changing consumer preferences and buying trends relating to Internet usage, we are vulnerable to certain additional risks and uncertainties associated with the Internet, including changes in required technology interfaces, website downtime and other technical failures, costs and technical issues as we upgrade our website





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software, computer viruses, changes in applicable federal and state regulation, security breaches and consumer privacy concerns. Our failure to successfully respond to these risks and uncertainties might adversely affect the sales in our Internet business, as well as damage our reputation and brands.

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

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

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

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

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

We have recently introduced three new brands – West Elm, PBteen and Williams-Sonoma Home – and may introduce new brands and brand extensions, or reposition existing brands, in the future. All of these brands, however, may not be successful growth vehicles. For example, in January 2006, we announced our decision to transition the merchandising strategies of our Hold Everything brand into our other existing brands by the end of fiscal 2006. 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.

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

We believe that commercial insurance coverage is prudent for risk management. Insurance costs may increase substantially in the future and may be affected by natural catastrophes, fear of terrorism and financial irregularities and other fraud at publicly traded companies. In addition, for certain types or levels of risk, such as risks associated with earthquakes, hurricanes or terrorist attacks, we may determine that we cannot

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obtain commercial insurance at acceptable prices, if at all. Therefore, we may choose to forego or limit our purchase of relevant commercial insurance, choosing instead to self-insure one or more types or levels of risks. We are primarily self-insured for workers' compensation, employee health benefits and product and general liability claims. If we suffer a substantial loss that is not covered by commercial insurance or our self-insurance reserves,

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the loss and attendant expenses could harm our business and operating results. In addition, exposures exist for which no insurance may be available and for which we have not reserved.

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

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

*We have been sued and may be named in additional lawsuits in a growing number of industry-wide business method patent litigation cases relating to our business operations.*

There appears to be a growing number of business method patent infringement lawsuits instituted against companies such as ours. The plaintiff in each case claims to hold a patent that covers certain technology or methodologies, which are allegedly infringed by the operation of the defendants' business. We are currently a defendant in such patent infringement cases and may be named in others in the future, as part of an industry-wide trend. Even in cases where a plaintiff's claim lacks merit, the defense costs in a patent infringement case can be high. Additional patent infringement claims may be brought against us and the cost of defending such claims or the ultimate resolution of such claims may harm our business and operating results.

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

To be successful, we need to manage our operating costs and continue to look for opportunities to reduce costs. We recognize that we may need to increase the number of our employees, especially in peak sales seasons, and incur other expenses to support new brands and brand extensions, as well as the opening of new stores and direct-to-customer growth of our existing brands. From time to time, we may also experience union organizing activity in currently non-union facilities. Union organizing activity may result in work slowdowns or stoppages and higher labor costs. In addition, there appears to be a growing number of wage-and-hour lawsuits against retail companies, especially in California. We are currently a defendant in one such case and may be named in others in the future.

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

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

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

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

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

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

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

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

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

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

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



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

In March 2007, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.10 to \$0.115 per common share. In March 2007, our Board of Directors also authorized the repurchase of an additional 5,000,000 shares of our common stock. The dividend and the share repurchase programs require the use of a significant portion of our cash earnings. As a result, we may not retain a sufficient amount of cash to finance growth opportunities, new product development initiatives and unanticipated capital expenditures or to fund our operations. Our Board of Directors may, at its discretion, decrease the intended level of dividends or entirely discontinue the payment of dividends at any time. The stock repurchase program does not have an expiration date and may be limited or terminated at any time. Our ability to pay dividends and repurchase shares will depend on our ability to generate cash flows from operations in the future. This ability may be subject to certain economic, financial, competitive and other factors that are beyond our control. Any failure to pay dividends or repurchase shares after we have announced our intention to do so may negatively impact our reputation and investor confidence in us and negatively impact our stock price. In addition, we may be subject to lawsuits regarding the use of our cash for dividends or share repurchases.

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

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

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

Changes to existing accounting rules or regulations may impact our future results of operations. For example, on December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 123R, Share Based Payment, which requires us to measure compensation costs for all stock-based compensation at fair value and record compensation expense equal to that value over the requisite service period. Share-based compensation resulted in a negative impact of approximately \$0.14 on our fiscal 2006 diluted earnings per share. In addition, in June 2006, the FASB issued FIN 48, which we adopted in the first quarter of fiscal 2007. The adoption of FIN 48 resulted in the recognition of an \$11,684,000 increase in the liability for tax contingencies, which was accounted for as a reduction to retained earnings, and is expected to have an approximate 100 basis point impact on our fiscal 2007 effective tax rate. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective. Other new accounting rules or regulations and varying interpretations of existing accounting rules or regulations have occurred and may occur in the future. Future changes to accounting rules or regulations or the questioning of current accounting practices may adversely affect our results of operations.



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

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

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

We maintain a liability for unredeemed gift certificates and merchandise credits until the earlier of redemption, escheatment or four years. After four years, the remaining unredeemed gift certificate or merchandise credit liability is relieved and recorded within selling, general and administrative expenses. In the event that a state or states were to require that these unredeemed certificates and credits be escheated to that state or states, then our business and operating results would be harmed.

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

We are subject to income taxes in many U.S. and foreign jurisdictions. We record tax expense based on our estimates of future payments, which include reserves for estimates of probable settlements of foreign and domestic tax audits. At any one time, many tax years are subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. As a result, we expect that throughout the year there could be on-going variability in our quarterly tax rates as taxable events occur and exposures are evaluated. Further, our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings or by changes to existing accounting rules or regulations. For example, we adopted FIN 48 in the first quarter of fiscal 2007, which resulted in the recognition of an \$11,684,000 increase in the liability for tax contingencies, which was accounted for as a reduction to retained earnings. We expect our effective tax rate to be in the range of 39.3% to 39.6% in fiscal 2007, which includes an approximate 100 basis point impact due to applying FIN 48 throughout fiscal 2007.

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

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

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



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

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

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Our Annual Meeting of Shareholders was held on May 16, 2007. At this meeting, the shareholders took the following actions:

(I) The shareholders elected each of the following persons by the vote indicated to serve as a member of our Board of Directors until the next Annual Meeting of Shareholders or until his or her successor is elected and qualified:

| Name                 | For         | Withheld   |
|----------------------|-------------|------------|
| Adrian D.P. Bellamy  | 66,745,852  | 34,721,248 |
| Patrick J. Connolly  | 100,906,293 | 560,807    |
| Adrian T. Dillon     | 100,903,694 | 563,406    |
| Anthony A. Greener   | 100,890,955 | 576,145    |
| W. Howard Lester     | 100,673,760 | 793,340    |
| Michael R. Lynch     | 100,808,593 | 658,507    |
| Richard T. Robertson | 100,903,398 | 563,702    |
| David B. Zenoff      | 100,876,067 | 591,033    |

(II) The shareholders ratified, by the vote indicated, the selection of Deloitte & Touche LLP as our independent registered public accounting firm for the fiscal year ending February 3, 2008:

| For         | Against | Abstain | Broker Non-Vote |
|-------------|---------|---------|-----------------|
| 101,198,302 | 253,307 | 15,491  | 0               |

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## (a) Exhibits

| Exhibit |   |
|---------|---|
| Number  | Exhibit Description   |
| 3.1     | Amended and Restated Bylaws of Registrant (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed with the Commission on May 22, 2007, File No. 001-14077) |
| 10.1    | Amended and Restated Williams-Sonoma, Inc. 2001 Long-Term Incentive Plan  |
| 10.2    | Williams-Sonoma, Inc. 2001 Long-Term Incentive Plan Restricted Stock Unit Award Term Sheet  |
| 10.3    | Williams-Sonoma, Inc. 2001 Long-Term Incentive Plan Stock-Settled Stock Appreciation Right Award Agreement  |
| 31.1    | Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended  |
| 31.2    | Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended  |
| 32.1    | Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2    | Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

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**SIGNATURE**

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

WILLIAMS-SONOMA, INC.

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

Date: September 7, 2007