

GART SPORTS CO  
Form 10-Q  
September 17, 2002

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## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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### FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934

For the Quarterly Period Ended: August 3, 2002

Commission File Number: 000-23515

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### GART SPORTS COMPANY

(Exact name of registrant as specified in its charter)

**Delaware** **84-1242802**  
(State or other jurisdiction of incorporation (I.R.S. Employer Identification No.)  
or organization)

**1050 West Hampden Avenue, Englewood, Colorado 80110**  
(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (303) 200-5050

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Indicate by check mark whether the registrant 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 shorter period that the registrant was required to file such reports). Yes  No

Indicate by check mark whether the registrant has been subject to such filing requirements for the past 90 days. Yes  No

As of September 10, 2002, there were outstanding 12,191,336 shares of the registrant's common stock, \$.01 par value, and the aggregate market value of the shares (based upon the closing price on that date of the shares on the NASDAQ National Market) held by non-affiliates was approximately \$171,674,000.

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**GART SPORTS COMPANY**  
**QUARTERLY PERIOD ENDED AUGUST 3, 2002**  
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**PART I FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**GART SPORTS COMPANY  
AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS  
(Dollars in Thousands, Except Share and Per Share Amounts)**

|  | <u>August 3,<br/>2002</u> | <u>February 2,<br/>2002</u> |
|--|---------------------------|-----------------------------|
|  | (Unaudited)               |                             |
| <b>ASSETS</b>  |                           |                             |
| Current assets:  |                           |                             |
| Cash and cash equivalents  | \$ 14,293                 | \$ 11,536                   |
| Accounts receivable, net of allowance for doubtful accounts of \$1,164 and \$1,116 | 10,912                    | 11,831                      |
| Inventories  | 349,310                   | 326,543                     |
| Prepaid expenses and other assets  | 11,856                    | 9,796                       |
| Deferred income taxes  | 14,925                    | 12,471                      |
|  | <u>401,296</u>            | <u>372,177</u>              |
| Property and equipment, net  | 84,233                    | 87,615                      |
| Favorable leases, net of accumulated amortization of \$2,111 and \$1,196           | 11,380                    | 12,295                      |
| Deferred income taxes  | 10,677                    | 14,015                      |
| Goodwill, net of accumulated amortization of \$734                                 | 44,938                    | 41,663                      |
| Other assets, net of accumulated amortization of \$6,852 and \$5,227               | 8,028                     | 8,417                       |
|  | <u>800,272</u>            | <u>777,523</u>              |

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|   | August 3,<br>2002 | February 2,<br>2002 |
|---|-------------------|---------------------|
| Total assets  | \$ 560,552        | \$ 536,182          |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                   |                     |
| Current liabilities:  |                   |                     |
| Accounts payable  | \$ 151,037        | \$ 171,888          |
| Current portion of capital lease obligations  | 668               | 634                 |
| Accrued expenses and other current liabilities  | 55,163            | 57,161              |
| Total current liabilities   | 206,868           | 229,683             |
| Long-term debt  | 146,702           | 158,474             |
| Capital lease obligations, less current portion   | 1,472             | 1,821               |
| Deferred rent and other long-term liabilities   | 12,850            | 10,695              |
| Total liabilities   | 367,892           | 400,673             |
| Commitments and contingencies   |                   |                     |
| Stockholders' equity:   |                   |                     |
| Preferred stock, \$.01 par value. 3,000,000 shares authorized; none issued  |                   |                     |
| Common stock, \$.01 par value. 22,000,000 shares authorized; 13,415,894 and 11,340,341 shares issued and 12,344,540 and 10,728,986 shares outstanding | 134               | 113                 |
| Additional paid-in capital  | 156,863           | 99,355              |
| Unamortized restricted stock compensation   | (2,322)           | (2,743)             |
| Accumulated other comprehensive loss  | (805)             | (448)               |
| Retained earnings   | 53,679            | 44,755              |
|   | 207,549           | 141,032             |
| Treasury stock, 1,071,354 and 611,355 common shares, at cost  | (14,889)          | (5,523)             |
| Total stockholders' equity  | 192,660           | 135,509             |
| Total liabilities and stockholders' equity  | \$ 560,552        | \$ 536,182          |

See accompanying notes to consolidated financial statements.

**GART SPORTS COMPANY**  
**AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited, Dollars in Thousands, Except Share and Per Share Amounts)

|           | Thirteen weeks ended |                   | Twenty-six weeks ended |                   |
|-----------|----------------------|-------------------|------------------------|-------------------|
|           | August 3,<br>2002    | August 4,<br>2001 | August 3,<br>2002      | August 4,<br>2001 |
| Net sales | \$ 261,705           | \$ 237,938        | \$ 506,682             | \$ 400,580        |

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|  | Thirteen weeks ended |            | Twenty-six weeks ended |           |
|--|----------------------|------------|------------------------|-----------|
| Cost of goods sold, buying, distribution and occupancy | 193,646              | 178,616    | 377,169                | 301,932   |
| Gross profit   | 68,059               | 59,322     | 129,513                | 98,648    |
| Operating expenses                                     | 55,510               | 50,550     | 110,277                | 86,667    |
| Merger integration costs                               |                      | 3,477      |                        | 3,477     |
| Operating income                                       | 12,549               | 5,295      | 19,236                 | 8,504     |
| Non operating income (expense):                        |                      |            |                        |           |
| Interest expense, net                                  | (2,432)              | (2,656)    | (5,116)                | (4,932)   |
| Other income   | 231                  | 467        | 439                    | 526       |
| Income before income taxes                             | 10,348               | 3,106      | 14,559                 | 4,098     |
| Income tax expense                                     | (4,014)              | (1,211)    | (5,635)                | (1,598)   |
| Net income   | \$ 6,334             | \$ 1,895   | \$ 8,924               | \$ 2,500  |
| Earnings per share:                                    |                      |            |                        |           |
| Basic  | \$ 0.52              | \$ 0.20    | \$ 0.77                | \$ 0.30   |
| Diluted  | \$ 0.48              | \$ 0.18    | \$ 0.72                | \$ 0.27   |
| Weighted average shares of common stock outstanding:   |                      |            |                        |           |
| Basic  | 12,282,536           | 9,529,185  | 11,562,880             | 8,447,488 |
| Diluted  | 13,128,400           | 10,268,375 | 12,459,681             | 9,102,633 |

See accompanying notes to consolidated financial statements.

**GART SPORTS COMPANY**  
**AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
(Unaudited, Dollars in Thousands)

|  | Common stock | Additional paid-in capital | Unamortized restricted stock compensation | Accumulated other comprehensive loss | Retained earnings | Comprehensive income | Treasury stock | Total Stockholders' equity |
|--|--------------|----------------------------|---|--------------------------------------|-------------------|----------------------|----------------|----------------------------|
| BALANCES AT FEBRUARY 2, 2002                     | \$ 113       | \$ 99,355                  | \$ (2,743)                                | \$ (448)                             | \$ 44,755         | \$                   | \$ (5,523)     | \$ 135,509                 |
| Net income                                       |              |                            |   |                                      | 8,924             | 8,924                |                | 8,924                      |
| Unrealized loss on equity securities, net of tax |              |                            |   | (127)                                |                   | (127)                |                | (127)                      |
| Unrealized loss on interest rate swap, net of    |              |                            |   | (230)                                |                   | (230)                |                | (230)                      |

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|                                   | Common stock  | Additional paid-in capital | Unamortized restricted stock compensation | Accumulated other comprehensive loss | Retained earnings | Comprehensive income | Treasury stock     | Total Stockholders' equity |
|-----------------------------------|---------------|----------------------------|---|--------------------------------------|-------------------|----------------------|--------------------|----------------------------|
| tax                               |               |                            |   |                                      |                   |                      |                    |                            |
| Comprehensive income              |               |                            |   |                                      |                   | \$ 8,567             |                    |                            |
| Issuance of common stock          |               | 25                         |   |                                      |                   |                      |                    | 25                         |
| Exercise of stock options         | 3             | 5,356                      |   |                                      |                   |                      |                    | 5,359                      |
| Proceeds from stock offering      | 18            | 52,127                     |   |                                      |                   |                      |                    | 52,145                     |
| Purchase of treasury stock        |               |                            |   |                                      |                   |                      | (9,366)            | (9,366)                    |
| Amortization of restricted stock  |               |                            | 421                                       |                                      |                   |                      |                    | 421                        |
| <b>BALANCES AT AUGUST 3, 2002</b> | <b>\$ 134</b> | <b>\$ 156,863</b>          | <b>\$ (2,322)</b>                         | <b>\$ (805)</b>                      | <b>\$ 53,679</b>  |                      | <b>\$ (14,889)</b> | <b>\$ 192,660</b>          |

See accompanying notes to consolidated financial statements.

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**GART SPORTS COMPANY**  
**AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited, Dollars in Thousands)

|   | Twenty-six weeks ended |                |
|---|------------------------|----------------|
|   | August 3, 2002         | August 4, 2001 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                        |                |
| Net income  | \$ 8,924               | \$ 2,500       |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                        |                |
| Depreciation and amortization   | 11,616                 | 8,889          |
| Deferred income taxes   | 5,635                  | (41)           |
| Loss on disposition of assets   | 125                    | 1,598          |
| Increase in deferred rent   | 1,406                  | 849            |
| Deferred compensation   | 25                     | 69             |
| Changes in operating assets and liabilities:  |                        |                |
| Accounts receivable, net  | 919                    | (2,008)        |
| Inventories   | (22,767)               | (12,624)       |
| Prepaid expenses and other assets   | (2,263)                | (1,028)        |
| Other assets  | (85)                   | (2,413)        |
| Accounts payable  | (20,963)               | 13,805         |
| Accrued expenses and other current liabilities  | (1,568)                | (7,287)        |

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|   | Twenty-six weeks ended |           |
|---|------------------------|-----------|
| Net cash provided by (used in) operating activities       | (18,996)               | 2,309     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>              |                        |           |
| Purchases of property and equipment                       | (11,585)               | (12,027)  |
| Proceeds from sale of property and equipment              |                        | 7,834     |
| Receipts (payment) of notes receivable                    | 24                     | (211)     |
| Acquisition of Oshman's, net of cash acquired             |                        | (46,848)  |
| Net cash used in investing activities                     | (11,561)               | (51,252)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>              |                        |           |
| Proceeds from long-term debt                              | 172,234                | 184,114   |
| Principal payments on long-term debt                      | (184,006)              | (124,929) |
| Principal payments on capital lease obligations           | (315)                  | (144)     |
| Proceeds from stock offering, net of offering costs       | 52,145                 |           |
| Purchase of treasury stock                                | (9,366)                |           |
| Proceeds from the sale of common stock under option plans | 2,622                  | 1,667     |
| Net cash provided by financing activities                 | 33,314                 | 60,708    |
| Increase in cash and cash equivalents                     | 2,757                  | 11,765    |
| Cash and cash equivalents at beginning of period          | 11,536                 | 8,107     |
| Cash and cash equivalents at end of period                | \$ 14,293              | \$ 19,872 |
| Supplemental disclosures of cash flow information:        |                        |           |
| Cash paid during the period for interest, net             | \$ 4,093               | \$ 4,593  |
| Cash paid during the period for income taxes              | \$ 18                  | \$        |

See accompanying notes to consolidated financial statements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements do not include all information and footnotes necessary for the annual presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America, and should be read in conjunction with the 2001 Annual Report on Form 10-K. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the statement of financial position and the results of operations for the interim periods have been included. The results for the thirteen and twenty-six week periods ended August 3, 2002 are not necessarily indicative of the results to be expected for the full year.

*Reclassifications*

Certain prior period amounts have been reclassified to conform to the current period presentation.

**2. ACQUISITION**

On June 7, 2001, Gart Sports Company completed its acquisition of Oshman's Sporting Goods, Inc. ("Oshman's"). The consideration consisted of approximately 3.4 million shares of Gart Sports Company common stock valued at approximately \$37.8 million and approximately \$50.2 million in cash. Oshman's operates as a wholly owned subsidiary of the Company. At the time of the acquisition, Oshman's operated 58 sporting goods specialty stores, including 43 SuperSports USA stores and 15 traditional stores. The acquisition was accounted for under the purchase method of accounting, and accordingly, the statement of operations includes the results of Oshman's since the date of the acquisition.

The total cost of the acquisition has been allocated to the tangible and intangible assets acquired and liabilities assumed based on their respective fair values. The Company's initial recording of the purchase price has been adjusted to give effect to the market value of the Company stock at the time of the announcement of the merger and for changes in estimates made at the time of the initial recording. In compliance with Financial Accounting Standards Board ("FASB") Statement No. 142, the Company no longer amortizes goodwill. The final adjusted allocation of the purchase price is as follows:

|   |           |
|---|-----------|
| Inventory   | \$ 67,336 |
| Other current assets  | 19,415    |
| Property and equipment, net                                     | 22,833    |
| Favorable leases and other long term assets, excluding goodwill | 13,364    |
| Goodwill  | 45,672    |
| Current liabilities   | (67,232)  |
| Long term debt  | (12,128)  |
| Other long term liabilities                                     | (1,236)   |
|   | <hr/>     |
| Book value of net assets acquired, including intangibles        | \$ 88,024 |
|   | <hr/>     |

The following unaudited pro forma combined financial information presents the combined consolidated results of operations of Gart Sports Company and Oshman's as if the acquisition had occurred as of the beginning of fiscal 2001, after giving effect to certain adjustments, including amortization of favorable leases and goodwill, interest expense, depreciation expense, and related income tax effects. No adjustments have been made to the pro forma statement of operations to

conform accounting policies and practices or to recognize anticipated cost savings and synergies. The pro forma combined consolidated financial information does not necessarily reflect the results of operations that would have occurred had Gart Sports Company and Oshman's constituted a single entity during such periods.

|                                 | Thirteen<br>weeks ended<br>August 4,<br>2001          | Twenty-six<br>weeks ended<br>August 4,<br>2001 |
|---------------------------------|---|--|
|                                 | <hr/>   | <hr/>  |
|                                 | (Unaudited, in thousands except<br>per share amounts) |  |
| Net Sales                       | 264,757   | 502,053  |
|                                 | <hr/>   | <hr/>  |
| Net Income (loss)               | 569(1)  | (3,858)(1)(2)                                  |
|                                 | <hr/>   | <hr/>  |
| Basic earnings (loss) per share | 0.06(1)   | (0.46)(1)(2)                                   |
|                                 | <hr/>   | <hr/>  |
| Diluted earnings per share      | 0.06(1)   |  |
|                                 | <hr/>   |  |

(1)

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Includes \$3.5 million, before taxes, of integration costs, due to the acquisition of Oshman's.

(2)

Includes \$5.2 million, before taxes, of severance expense accrued by Oshman's as part of the acquisition.

### 3. NEW ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations consummated after June 30, 2001 and establishes criteria for recognizing intangible assets separately from goodwill.

SFAS No. 142 requires that upon adoption, amortization of goodwill and intangible assets deemed to have indefinite lives will cease and instead, the carrying value of goodwill and these intangibles will be evaluated for impairment on an annual basis. In addition, a transitional impairment test is required as of the date of adoption. Other intangible assets will continue to be amortized over their useful lives and periodically reviewed for impairment. The Company adopted SFAS No. 142 for the period commencing February 3, 2002, the beginning of its fiscal 2002. The Company completed its initial impairment analysis of its existing goodwill in the first quarter of fiscal 2002, and determined that no impairment was indicated.

The adoption of SFAS No. 142 did not have a material impact on the Company's consolidated financial position, results of operations, or cash flows in regard to the impairment provisions of the statement while the application of the non-amortization provisions of the statement will result in the cessation of amortization of approximately \$1.1 million per year.

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Net income and earnings per share for the thirteen and twenty-six weeks ended August 4, 2001 adjusted to exclude amortization expense (net of income taxes) is as follows (in thousands, except per share data):

|  | <b>13 weeks<br/>ended<br/>August 4,<br/>2001</b> | <b>26 weeks<br/>ended<br/>August 4,<br/>2001</b> |
|--|--|--|
|  | <b>_____</b>                                     | <b>_____</b>                                     |
| Reported net income                        | \$ 1,895   | \$ 2,500   |
| Add back goodwill amortization, net of tax | 153  | 153  |
|  | <b>_____</b>                                     | <b>_____</b>                                     |
| Adjusted net income                        | <b>\$ 2,048</b>                                  | <b>\$ 2,653</b>                                  |
|  | <b>_____</b>                                     | <b>_____</b>                                     |
| Basic earnings per share:                  |  |  |
| Reported net income                        | \$ 0.20  | \$ 0.30  |
| Add back goodwill amortization, net of tax | 0.01   | 0.01   |
|  | <b>_____</b>                                     | <b>_____</b>                                     |
| Adjusted net income                        | <b>\$ 0.21</b>                                   | <b>\$ 0.31</b>                                   |
|  | <b>_____</b>                                     | <b>_____</b>                                     |
| Diluted earnings per share:                |  |  |
| Reported net income                        | \$ 0.18  | \$ 0.27  |
| Add back goodwill amortization, net of tax | 0.02   | 0.02   |
|  | <b>_____</b>                                     | <b>_____</b>                                     |
| Adjusted net income                        | <b>\$ 0.20</b>                                   | <b>\$ 0.29</b>                                   |
|  | <b>_____</b>                                     | <b>_____</b>                                     |

The carrying amount of intangible assets is as follows (in thousands):

As of August 3, 2002



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|                         | Gross Carrying<br>Amount | Accumulated<br>Amortization |
|-------------------------|--------------------------|-----------------------------|
| Goodwill                | \$ 45,672                | \$ (734)                    |
| Favorable leases        | 13,491                   | (2,111)                     |
| Loan origination fees   | 4,043                    | (1,929)                     |
| Lease acquisition costs | 3,100                    | (561)                       |
| <b>Total</b>            | <b>\$ 66,306</b>         | <b>\$ (5,335)</b>           |

The Company recorded an additional \$1,021,000 of goodwill in the 13 weeks ended August 3, 2002 as a result of certain adjustments related to the purchase accounting for the acquisition of Oshman's. During the three months ended August 3, 2002, amortization of intangible assets expense was \$756,000. The estimated amortization of intangible assets for each of the five fiscal years ending in fiscal 2006 is as follows (in thousands):

| Fiscal Year | Amortization<br>Expense |
|-------------|-------------------------|
| 2002        | \$ 3,176                |
| 2003        | \$ 2,734                |
| 2004        | \$ 2,302                |
| 2005        | \$ 1,572                |
| 2006        | \$ 1,099                |

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses certain implementation issues related to SFAS No. 121,

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"Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" and establishes a single accounting model, based on the framework established in SFAS No. 121, for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. The Company adopted this statement on February 3, 2002 and there was not a material impact on results of operations or financial position.

In May 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, 64, Amendment of SFAS No. 13, and Technical Corrections." SFAS No. 145 rescinds FASB No. 4, "Reporting Gains and Losses from Extinguishment of Debt," and an amendment of that statement, SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." As a result, gains and losses from extinguishment of debt will no longer be aggregated and classified as an extraordinary item, net of related income tax effect, on the statement of earnings. SFAS No. 145 is effective for fiscal years beginning after May 15, 2002, with earlier application encouraged.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS 146 requires that a liability for a cost associated with an exit or disposal activity is recognized at fair value when the liability is incurred rather than at the date of a commitment to an exit or disposal plan. This statement is effective for exit or disposal activities initiated after December 31, 2002.

#### 4. SHARE REPURCHASE PROGRAM

The Company repurchased 459,999 common shares totaling approximately \$9.4 million during the quarter ended August 3, 2002 under a common share repurchase program approved by the Board of Directors. As of August 8, 2002, the Company has authorization from its Board of Directors to repurchase up to an additional \$15.1 million of shares.

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#### 5. EARNINGS PER SHARE

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The following table sets forth the computations of basic and diluted earnings per share (in thousands, except share and per share amounts):

|   | Thirteen weeks ended |                   | Twenty-six weeks ended |                   |
|---|----------------------|-------------------|------------------------|-------------------|
|   | August 3,<br>2002    | August 4,<br>2001 | August 3,<br>2002      | August 4,<br>2001 |
| Net income  | \$ 6,334             | \$ 1,895          | \$ 8,924               | \$ 2,500          |
| Weighted average shares of common stock outstanding basic       | 12,282,536           | 9,529,185         | 11,562,880             | 8,447,488         |
| Basic earnings per share  | \$ 0.52              | \$ 0.20           | \$ 0.77                | \$ 0.30           |
| Number of shares used for diluted earnings per share:           |                      |                   |                        |                   |
| Weighted average shares of common stock outstanding basic       | 12,282,536           | 9,529,185         | 11,562,880             | 8,447,488         |
| Dilutive securities stock options and unvested restricted stock | 845,864              | 739,190           | 896,801                | 655,145           |
| Weighted average shares of common stock outstanding diluted     | 13,128,400           | 10,268,375        | 12,459,681             | 9,102,633         |
| Diluted earnings per share                                      | \$ 0.48              | \$ 0.18           | \$ 0.72                | \$ 0.27           |

### 6. CONTINGENCIES

#### *Tax Contingency*

Under the terms of the Company's tax sharing agreement with its former parent, the Company is responsible for its share, on a separate return basis, of any tax payments associated with proposed deficiencies or adjustments, and related interest and penalties charged to the controlled group which may arise as a result of an assessment by the IRS.

On July 24, 1997, the IRS proposed adjustments to the Company's and its former parent's (now Thrifty Payless Holdings, Inc., a subsidiary of RiteAid Corporation) 1992 and 1993 federal income tax returns in conjunction with the former parent's Internal Revenue Service examination. The proposed adjustments related to the manner in which LIFO inventories were characterized on such returns. The Company has taken the position that the inventory acquired in connection with the acquisition of the Company's former parent was appropriately allocated to its inventory pools. The Internal Revenue Service has asserted the inventory was acquired at a bargain purchase price and should be allocated to a separate pool and liquidated as inventory turns. The Internal Revenue Service has asserted that this basis difference should have been reflected in taxable income in 1992 and 1993. Based on management's discussions with the Company's former parent, the Company believes the potential accelerated tax liability, which could have a negative effect on liquidity in the near term, ranges from approximately \$0 to \$9.7 million. The Company recorded approximately \$9.7 million as a long-term net deferred tax liability for the tax effect of the LIFO inventory basis difference. In addition, the loss from possible assessed interest charges resulting from the proposed adjustments ranges from approximately \$0 to \$3.3 million. The Company has accrued approximately \$1.2 million for potential interest charges in its consolidated financial statements. The Company does not expect that any penalties will be assessed relating to this matter although the Company cannot be certain that penalties will not be

assessed. Any accelerated tax liability, including interest charges and penalties, may have a material impact on the Company's liquidity.

The Company has reviewed the various matters that are under consideration and believes that it has adequately provided for any liability that may result from this matter. In the opinion of management, any additional liability beyond the amounts recorded that may arise as a result of the IRS examination will not have a material adverse effect on the Company's consolidated financial condition, results of operations, or liquidity.

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In addition, the Company is currently under examination for the fiscal tax years ended September 1997 and 1998. No adjustments have been proposed at this time.

### *Legal Proceedings*

The Company is, from time to time, involved in various legal proceedings and claims arising in the ordinary course of business. Management believes that the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial condition, results of operations or liquidity.

In June 2000, a former employee of Sportmart brought two class action complaints in California against the Company, alleging certain wage and hour claims in violation of the California Labor Code, California Business and Professional Code section 17200 and other related matters. One complaint alleges that the Company classified certain managers in its California stores as exempt from overtime pay when they would have been classified as non-exempt and paid overtime. The second complaint alleges that the Company failed to pay hourly employees in its California stores for all hours worked. In March 2001, a third class action complaint was filed in the same court in California alleging the same wage and hour violations regarding classification of certain managers as exempt from overtime pay. In July 2001, a fourth complaint was filed alleging that store managers should also not be classified as employees exempt from overtime pay. All the complaints seek compensatory damages, punitive damages and penalties. The amount of damages sought is unspecified. Although the court denied motions to dismiss the first two complaints, the Company intends to vigorously defend these matters and at this time, the Company has not ascertained the future liability, if any, as a result of these complaints. The Company has not accrued any reserves related to these claims.

## **7. FINANCIAL INSTRUMENTS**

### *Interest Rate Swap*

The Company entered into an interest rate swap agreement on June 28, 2001, which expires on June 30, 2004, to minimize the risks and costs associated with its financing activities. Under the swap agreement, the Company pays fixed rate interest and receives variable LIBOR interest rate payments periodically over the life of the instrument. The notional interest rate swap amount is \$20.0 million and is used to measure interest to be paid or received and does not represent the exposure due to credit loss.

The Company's interest rate swap is designated as a cash flow hedge, qualifies for the short cut method of assessing effectiveness and is considered highly effective, as defined by FASB Statement No. 133. Under the short cut method there is no need to measure effectiveness of the hedge and there is no charge to earnings for changes in the fair value of the swap agreement. Payments or receipts on the swap agreement are recorded as interest expense. At August 3, 2002 the fair value of the swap was

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a loss of \$747,000, net of the related tax benefit. The unrealized loss from this interest rate swap is included in other comprehensive income and is shown as a component of stockholders' equity.

## **8. E-COMMERCE AGREEMENT**

On June 28, 2001, the Company entered into a long-term agreement with Global Sports Interactive, Inc. ("Global"). Under the terms of the agreement, Global developed and is currently operating three online sporting goods stores at [www.gartsports.com](http://www.gartsports.com), [www.sportmart.com](http://www.sportmart.com), and [www.oshmans.com](http://www.oshmans.com). The Company receives royalty payments from Global based on a certain percent of sales from these sites, which are recorded as a component of Net Sales in the statement of operations. In connection with the e-commerce agreement, Global granted the Company a warrant to purchase 60,000 shares of common stock of Global. A similar warrant for 30,000 Global shares was acquired from Oshman's at the time of the acquisition. The Company sold 60,000 of these warrants in October 2001, and recognized a gain of \$195,000. The remaining warrant to purchase 30,000 shares was exercised on November 2, 2001, and the shares acquired upon exercise of the warrant are classified as available-for-sale marketable equity securities and have an aggregate fair value of \$106,000 at August 3, 2002.

## **9. STOCK OFFERING**

On May 29, 2002, the Company completed a stock offering for 3.5 million shares of common stock. This offering resulted in net proceeds of approximately \$53 million from the sale of 1.75 million new shares by the Company. The Company used the net proceeds to repay certain borrowings under the revolving line of credit agreement with CIT Group/Business Credit, Inc. The balance of the shares were sold by selling stockholders, including Green Equity Investors, L.P. The Company did not receive any proceeds from the sale of shares by selling stockholders.

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

The following discussion and analysis should be read in conjunction with the Company's consolidated financial statements and notes thereto included elsewhere within this report and the 2001 Annual Report on Form 10-K.

The Company is a leading retailer of sporting goods in the Midwest and western United States. Given the economic characteristics of the store formats, the similar nature of the products sold, the type of customer and method of distribution, the operations of the Company are aggregated in one reportable segment.

The Company uses a 52-53 week fiscal reporting year ending on the Saturday closest to the end of January, which for fiscal year 2002 will be February 1, 2003. The results for the thirteen and twenty-six weeks ended August 4, 2001 include the results of Oshman's from the acquisition date through the end of the quarter.

**RESULTS OF OPERATIONS**

The following table sets forth the Company's consolidated statement of operations data as a percentage of net sales and the number of stores open at the end of each period for the periods indicated (dollars rounded to millions):

|  | Thirteen weeks ended |        |                |        | Twenty-six weeks ended |        |                |        |
|--|----------------------|--------|----------------|--------|------------------------|--------|----------------|--------|
|  | August 3, 2002       |        | August 4, 2001 |        | August 3, 2002         |        | August 4, 2001 |        |
|  | Dollars              | %      | Dollars        | %      | Dollars                | %      | Dollars        | %      |
| Net sales  | \$ 261.7             | 100.0% | \$ 237.9       | 100.0% | \$ 506.7               | 100.0% | \$ 400.6       | 100.0% |
| Cost of goods sold, buying, distribution and occupancy | (193.7)              | (74.0) | (178.6)        | (75.1) | (377.2)                | (74.4) | (301.9)        | (75.4) |
| Gross profit   | 68.0                 | 26.0   | 59.3           | 24.9   | 129.5                  | 25.6   | 98.7           | 24.6   |
| Operating expenses                                     | (55.5)               | (21.2) | (50.5)         | (21.2) | (110.3)                | (21.8) | (86.7)         | (21.6) |
| Merger integration costs                               | 0.0                  | 0.0    | (3.5)          | (1.5)  | 0.0                    | 0.0    | (3.5)          | (0.9)  |
| Operating income                                       | 12.5                 | 4.8    | 5.3            | 2.2    | 19.2                   | 3.8    | 8.5            | 2.1    |
| Interest expense, net                                  | (2.4)                | (0.9)  | (2.7)          | (1.1)  | (5.1)                  | (1.0)  | (4.9)          | (1.2)  |
| Other income   | 0.2                  | 0.0    | 0.5            | 0.2    | 0.4                    | 0.1    | 0.5            | 0.1    |
| Income before income taxes                             | 10.3                 | 3.9    | 3.1            | 1.3    | 14.5                   | 2.9    | 4.1            | 1.0    |
| Income tax expense                                     | (4.0)                | (1.5)  | (1.2)          | (0.5)  | (5.6)                  | (1.1)  | (1.6)          | (0.4)  |
| Net income   | \$ 6.3               | 2.4%   | \$ 1.9         | 0.8%   | \$ 8.9                 | 1.8%   | \$ 2.5         | 0.6%   |
| Number of stores at end of period                      | 179                  |        | 177            |        | 179                    |        | 177            |        |

**Pro-forma FY 2001 results excluding the effect of the one time integration costs associated with the acquisition of Oshman's:**

|  |    |       |       |    |       |       |
|--|----|-------|-------|----|-------|-------|
| Income before income taxes as reported | \$ | 3.1   | 1.3   | \$ | 4.1   | 1.0   |
| Integration costs                      |    | 3.5   | 1.5   |    | 3.5   | 0.9   |
| Pro-forma income before income taxes   |    | 6.6   | 2.8   |    | 7.6   | 1.9   |
| Income tax expense                     |    | (2.6) | (1.1) |    | (3.0) | (0.8) |

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|   | Thirteen weeks ended |     | Twenty-six weeks ended |     |
|---|----------------------|-----|------------------------|-----|
|   | \$                   |     | \$                     |     |
| Pro-forma net income                        | 4.0                  | 1.7 | 4.6                    | 1.1 |
| <b>Earnings per share:</b>                  |                      |     |                        |     |
| Basic                                       | 0.42                 |     | 0.55                   |     |
| Diluted                                     | 0.39                 |     | 0.51                   |     |
| Basic weighted average shares outstanding   | 9,529,185            |     | 8,447,488              |     |
| Diluted weighted average shares outstanding | 10,268,375           |     | 9,102,633              |     |
|   | 12                   |     |                        |     |

Newly opened stores enter the comparable store sales base at the beginning of their 14<sup>th</sup> full month of operation. The Sportmart stores acquired on January 9, 1998, that met the criteria above, were included in the comparable store sales base from the date of acquisition. The Oshman's stores will be included in the comparable store sales base beginning August 4, 2002, the beginning of the 14<sup>th</sup> full month of operations since the date of acquisition by the Company.

Inventories are stated at the lower of LIFO cost or market. The Company considers cost of goods sold to include the direct cost of merchandise, plus certain costs associated with procurement, warehousing, handling and distribution. In addition to the full cost of inventory, cost of goods sold includes related occupancy costs and amortization and depreciation of leasehold improvements and rental equipment. Operating expenses include controllable and non-controllable store expenses (except occupancy), non-store expenses and depreciation and amortization not associated with cost of goods sold.

### CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis discusses the results of operations and financial condition as reflected in the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its estimates and judgments, including those related to inventory valuation, the recoverability of long-lived assets including intangible assets, the store closing reserve, and the estimates used to record purchase accounting related to acquisitions. Management bases its estimates and judgments on its substantial historical experience and other relevant factors, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

#### *Valuation of Inventory*

The Company values its inventory at the lower of cost or market. Cost is determined using the average cost of items purchased and applying the dollar value last-in, first-out ("LIFO") inventory method. The Company's dollar value LIFO pools are computed using the Inventory Price Index Computation ("IPIC") method. Historically, we have rarely experienced significant occurrences of obsolescence or slow moving inventory. However, future changes, such as changes in customer merchandise preferences or unseasonable weather patterns could cause the Company's inventory to be exposed to obsolescence or slow moving merchandise.

Shrink is accrued as a percentage of merchandise sales based on historical shrink trends. We perform physical inventories at our stores and distribution centers throughout the year. The reserve for shrink represents an estimate for shrink for each of our locations since the last physical inventory date through the reporting date. These estimates are impacted by internal and external factors and may vary from actual results.

#### *Vendor allowances*

We receive certain allowances from our vendors which include rebates and cooperative advertising funds. These amounts are determined in advance for each year and are, at times, dependent on projected purchase volumes and advertising plans. The amounts are subject to changes in

market conditions or marketing strategies of our vendors, and changes in our product purchases. We record an

estimate of earned allowances based on the latest information available with respect to purchase volumes, advertising plans and status of our negotiations with vendors.

#### *Impairment of Assets*

The Company reviews long-lived tangible and intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Future events could cause management to conclude that impairment indicators exist and that the value of long-lived tangible and intangible assets is impaired.

#### *Store Closing Reserve*

The Company currently records a provision for store closing when the decision to close a store is made. The provision consists of the incremental costs which are expected to be incurred after the store closing, including settlement of future net lease obligations, utilities and property taxes, and other expenses directly related to the store closing. The company will comply with the recently issued SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities", which requires that a liability for costs associated with exit or disposal activities, initiated after December 31, 2002, are recognized at fair value when a liability is incurred rather than when the decision to close a store is made. This will change the timing of recognition for certain exit costs, so that certain exit costs will be recognized over the period in which the exit activities occur.

#### *Acquisitions Accounting*

The Company's acquisitions are accounted for under the purchase method of accounting. Accordingly, the total costs of the acquisitions are allocated to the tangible and intangible assets acquired and liabilities assumed based on their respective fair values. The determination of fair values involves the use of estimates and assumptions which could require adjustment in the future.

While the Company believes that the historical experience and other factors considered provide a meaningful basis for the accounting policies applied in the preparation of the consolidated financial statements, the Company cannot guarantee that its estimates and assumptions will be accurate, which could require the Company to make adjustments to these estimates in future periods.

### **THIRTEEN WEEKS ENDED AUGUST 3, 2002 COMPARED TO THIRTEEN WEEKS ENDED AUGUST 4, 2001**

*Net Sales.* Net sales for the thirteen weeks ended August 3, 2002 were \$261.7 million compared to \$237.9 million for the thirteen weeks ended August 4, 2001. Last year's sales for the thirteen week period only include Oshman's results after the June 7, 2001 acquisition date. Comparable store sales, excluding Oshman's, during the quarter decreased by 1.2% versus the prior year's comparable quarter. This comparable sales performance was primarily due to a challenging sales environment, due in part to unseasonably cool and wet weather in the Midwest earlier in the quarter, record drought and significant forest fire activity in the Rocky Mountain region for much of the quarter, and finally, an overall weak retail environment. The weather and forest fire activity negatively impacted sales in several product departments, including fishing, hunting, skates and footwear. In addition, licensed apparel sales decreased primarily due to the Colorado Avalanche not repeating as Stanley Cup Champions.

*Gross Profit.* Gross profit for the thirteen weeks ended August 3, 2002 was \$68.0 million, or 26.0% of net sales, as compared to \$59.3 million, or 24.9% of net sales, for the thirteen weeks ended August 4, 2001. The increase as a percent of sales is due to a number of factors including: a less promotional strategy taken during the quarter on footwear, skates, and other departments; synergies being realized from the Oshman's acquisition; favorable shrink results from physical inventories taken during the period; continued systems improvements, allowing the Company to better manage in-stock positions; and the addition of key personnel in our buying organization, particularly in the softlines department.

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*Operating Expenses.* Operating expenses for the thirteen weeks ended August 3, 2002 were \$55.5 million, or 21.2% of net sales, compared to \$50.5 million, or 21.2% of net sales, for the period ended August 4, 2001. Operating expense dollars increased due to the Oshman's acquisition versus the year ago period. As a percentage of sales, operating expenses remained flat compared to the prior year quarter due to a continued focus on controlling costs.

*Merger Integration Costs.* Merger integration costs for the thirteen weeks ended August 3, 2002 were \$0 compared to \$3.5 million, or 1.5% of net sales, for the period ended August 4, 2001. The Company has not recorded any merger integration costs since the fourth quarter of fiscal 2001.

*Operating Income.* As a result of the factors described above, the Company recorded operating income for the thirteen weeks ended August 3, 2002 of \$12.5 million compared to operating income of \$5.3 million for the thirteen weeks ended August 4, 2001.

*Interest Expense.* Interest expense, net for the thirteen weeks ended August 3, 2002 decreased to \$2.4 million, or 0.9% of net sales, from \$2.7 million, or 1.1% of net sales, in the thirteen weeks ended August 4, 2001. The decrease in interest expense is primarily due to a lower average debt balance as a result of the proceeds from the secondary offering used to pay down debt and a lower effective borrowing rate.

*Other Income.* Other income was \$0.2 million for the thirteen weeks ended August 3, 2002 compared to \$0.5 million for the thirteen weeks ended August 4, 2001. The decrease is primarily attributable to a one-time gain of \$0.2 million on the sale of certain assets that were held in Edmonton, Alberta, Canada, in the prior year quarter.

*Income Taxes.* The Company's income tax expense for the thirteen weeks ended August 3, 2002 was \$4.0 million compared to income tax expense of \$1.2 million for the thirteen weeks ended August 4, 2001. The Company's estimated effective tax rate was 38.8% for the thirteen weeks ended August 3, 2002 compared to 39.0% for the thirteen weeks ended August 4, 2001.

### **TWENTY-SIX WEEKS ENDED AUGUST 3, 2002 COMPARED TO TWENTY-SIX WEEKS ENDED AUGUST 4, 2001**

*Net Sales.* Net sales for the twenty-six weeks ended August 3, 2002 were \$506.7 million compared to \$400.6 million for the twenty-six weeks ended August 4, 2001. Last year's sales only include Oshman's results after the June 7, 2001 acquisition date. Comparable store sales, excluding Oshman's, for the period increased by 2.0% versus the prior year's comparable period. This comparable sales performance was primarily due to strong comparative sales in the first quarter due to strong sales in apparel and hardgoods offset by a challenging sales environment, due in part to unseasonable weather conditions and an overall weak retail environment, in the second quarter.

*Gross Profit.* Gross profit for the twenty-six weeks ended August 3, 2002 was \$129.5 million, or 25.6% of net sales, as compared to \$98.7 million, or 24.6% of net sales, for the twenty-six weeks ended August 4, 2001. The increase as a percent of sales is due to a number of factors including: a less promotional strategy taken during the period; synergies being realized from the Oshman's acquisition;

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favorable shrink results from physical inventories taken during the period; systems investment which is allowing the Company to better manage in-stock positions, and the addition of key personnel in the buying organization, particularly in the softlines department.

*Operating Expenses.* Operating expenses for the twenty-six weeks ended August 3, 2002 were \$110.3 million, or 21.8% of net sales, compared to \$86.7 million, or 21.6% of net sales, for the period ended August 4, 2001. Operating expense dollars increased due to the Oshman's acquisition versus the year ago quarter. As a percentage of sales, operating expenses increased slightly due primarily to increased store payroll, partially offset by decreased advertising costs.

*Merger Integration Costs.* Merger integration costs for the twenty-six weeks ended August 3, 2002 were \$0 compared to \$3.5 million, or 0.9% of net sales, for the period ended August 4, 2001. The Company has not recorded any merger integration costs since the fourth quarter of fiscal 2001.

*Operating Income.* As a result of the factors described above, the Company recorded operating income for the twenty-six weeks ended August 3, 2002 of \$19.2 million compared to operating income of \$8.5 million for the twenty-six weeks ended August 4, 2001.

*Interest Expense.* Interest expense, net for the twenty-six weeks ended August 3, 2002 increased to \$5.1 million, or 1.0% of net sales, from \$4.9 million, or 1.2% of net sales, in the twenty-six weeks ended August 4, 2001. The increase in interest expense dollars is primarily due to a higher average debt balance due to the Oshman's acquisition offset by a decrease in the effective borrowing rate and lower interest costs as a

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result of the proceeds from the secondary offering used to pay down debt.

*Other Income.* Other income was \$0.4 million for the twenty-six weeks ended August 3, 2002 compared to \$0.5 million for the twenty-six weeks ended August 4, 2001. The decrease is primarily attributable to a one-time gain of \$0.2 million on the sale of certain assets that were held in Edmonton, Alberta, Canada, in the prior year, slightly offset by increased sales tax handling income, due to increased sales volume as a result of the acquisition of Oshman's.

*Income Taxes.* The Company's income tax expense for the twenty-six weeks ended August 3, 2002 was \$5.6 million compared to income tax expense of \$1.6 million for the twenty-six weeks ended August 4, 2001. The Company's estimated effective tax rate was 38.7% for the twenty-six weeks ended August 3, 2002 compared to 39.0% for the twenty-six weeks ended August 4, 2001.

### LIQUIDITY AND CAPITAL RESOURCES

The Company's primary capital requirements are for inventory, capital improvements, and pre-opening expenses to support the Company's expansion plans, as well as for various investments in store remodeling, store fixtures, ongoing infrastructure improvements and the company's current stock repurchase program.

#### Cash Flow Analysis

|   | Twenty-six weeks ended |                   |
|---|------------------------|-------------------|
|   | August 3,<br>2002      | August 4,<br>2001 |
| Cash provided by (used in) operating activities | \$ (18,996)            | \$ 2,309          |
| Cash used in investing activities               | (11,561)               | (51,252)          |
| Cash provided by financing activities           | 33,314                 | 60,708            |
| Capital expenditures                            | 11,585                 | 12,027            |

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|                      | As of             |                   |
|----------------------|-------------------|-------------------|
|                      | August 3,<br>2002 | August 4,<br>2001 |
| Long-term debt       | \$ 146,702        | \$ 166,608        |
| Working capital      | 194,428           | 151,231           |
| Current ratio        | 1.94              | 1.69              |
| Debt to equity ratio | 0.76              | 1.09              |

Cash used in operating activities in the first six months of fiscal 2002 was primarily the result of inventory purchases and payments of accounts payable. These cash uses were partially offset by cash generated by net income adjusted for non-cash charges during the period.

Cash used in investing activities for the twenty-six weeks ended August 3, 2002 was primarily for capital expenditures. These expenditures were primarily for new stores, store remodeling, store fixtures, and the purchase or enhancement of certain information systems.

Cash provided by financing activities in the first six months of fiscal 2002 primarily represents proceeds from the secondary stock offering and proceeds from the sale of common stock under option plans offset by net payments on the Company's line of credit and payments made to purchase treasury stock.

The Company's liquidity and capital needs have been met by cash from operations and borrowings under a revolving line of credit (the "Credit Agreement") with CIT/Business Credit, Inc., as agent, ("CIT"). In connection with the Oshman's acquisition, the Company increased its revolving line of credit from \$175 million to \$300 million. The long-term debt currently consists of the Credit Agreement, which allows the Company to borrow up to 70% of its eligible inventories (as defined in the Credit Agreement) during the year and up to 75% of its eligible inventories for two consecutive 90 day periods in the first loan year. Borrowings are limited to the lesser of \$300 million or the amount calculated in accordance with the borrowing base, and are secured by substantially all inventories, trade receivables, equipment, and intangible assets. The lenders may not demand repayment of principal, absent an occurrence of default under the Credit Agreement, prior to June 7, 2005. The Credit Agreement contains certain covenants, including financial covenants that require the Company to maintain a specified minimum level of tangible net worth at all times and specified earnings before income taxes, depreciation and amortization to interest ratios. Gart Sports Company's ability to declare or pay dividends on its common stock is not limited under the revolving line of credit. The revolving line of credit



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does, however, limit the amount of dividends that may be declared or paid on the common stock of its subsidiaries and the amount of loans that may be made to Gart Sports Company. The subsidiaries may loan its parent up to \$10.0 million in the aggregate and declare up to \$6.0 million in dividends each fiscal year. The Company is in compliance with all covenants under the Credit Agreement. In connection with the Credit Agreement, the Company pledged all of the outstanding common stock or its operating retail subsidiaries as collateral for the Credit Agreement.

Under the terms of the revolving credit facility, loan interest is payable monthly at Chase Manhattan Bank's prime rate plus a margin rate that cannot exceed 0.25% or, at the option of the Company, at Chase Manhattan Bank's LIBOR rate plus a margin that cannot exceed 2.25%. The Company's margin rates for the first loan year were 0.0% on prime and 2.0% on LIBOR borrowings. The margin rates on borrowings subsequent to June 7, 2002 are 0.25% on prime and 2.25% on LIBOR. Beginning November 3, 2002, the margin rates on prime and LIBOR borrowings may be reduced to as low as 0.0% and 1.50%, respectively, if certain Earnings Before Interest, Taxes, Depreciation, and Amortization ("EBITDA") levels are achieved. There was \$146.7 million outstanding under the credit facility as of August 3, 2002, and \$78.1 million was available for borrowing. As a result of the stock offering discussed in note 9 to the consolidated financial statements, the Company paid down approximately \$53 million in debt by June 12, 2002.

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On May 29, 2002, the Company completed a secondary stock offering for 3.5 million shares. This offering resulted in net proceeds of approximately \$53 million from the sale of 1.75 million new shares.

The Company repurchased 459,999 common shares totaling approximately \$9.4 million during the quarter ended August 3, 2002 under a common share repurchase program approved by the Board of Directors. As of August 8, 2002 the Company has authorization to repurchase up to an additional \$15.1 million of shares.

The Company entered into an interest rate swap agreement on June 28, 2001 to minimize the risks and costs associated with its financing activities. The notional interest rate swap amount is \$20.0 million and the swap agreement terminates on June 30, 2004. Under the swap agreement, the Company pays fixed rate interest and receives variable interest rate payments periodically over the life of the instrument. See note 7 to the consolidated financial statements.

The Internal Revenue Service has proposed adjustments to the 1992 and 1993 consolidated federal income tax returns of the Company and its former parent due to the manner in which LIFO inventories were characterized on such returns. Based on management's discussion with the Company's former parent, the Company believes the potential accelerated tax liability, which could have a negative effect on liquidity in the near term, ranges from approximately \$0 to \$9.7 million. The Company recorded approximately \$9.7 million as a long-term net deferred tax liability for the tax effect of the LIFO inventory basis difference. In addition, the loss from possible assessed interest charges resulting from the proposed adjustments ranges from approximately \$0 to \$3.3 million. The Company has accrued approximately \$1.2 million for potential interest charges in the consolidated financial statements. The Company does not expect that any penalties will be assessed relating to this matter although the Company cannot be certain that penalties will not be assessed. Any accelerated tax liability, including interest charges and penalties, may have a material impact on the Company's liquidity. See note 6 to the Consolidated Financial Statements.

Capital expenditures are projected to be approximately \$23 to \$25 million in fiscal 2002. These capital expenditures will be primarily for new store openings, store remodeling, store fixtures, information systems, and distribution center facilities. The Company leases all of its store locations and intends to continue to finance its new stores with long-term operating leases. Based upon stores opened in fiscal 2001, newly constructed superstores require a cash investment of approximately \$1.6 million for a 42,000 square foot store and approximately \$1.3 million for a 32,000 square foot store. The Company plans to open eight new stores in fiscal 2002. As of August 3, 2002, the Company had spent approximately \$11.6 million on capital expenditures.

The Company believes that cash generated from operations, combined with funds available under the Credit Agreement, will be sufficient to fund projected capital expenditures, future treasury share purchases, if any, and other working capital requirements for the foreseeable future. The Company intends to utilize the Credit Agreement to meet seasonal fluctuations in cash flow requirements.

### **SEASONALITY AND INFLATION**

The fourth quarter has historically been the strongest quarter for the Company. The Company believes that two primary factors contribute to this seasonality. First, increased sales of cold weather sporting goods, including sales of ski and snowboard merchandise during the quarter, which corresponds with much of the ski and snowboard season. Second, holiday sales contribute significantly to the Company's operating results. As a result of these factors, inventory levels, which gradually increase beginning in April, generally reach their peak in November and then decline to their lowest level following the December holiday season. Any decrease in sales for the fourth quarter, whether due to a slow holiday selling season, poor snowfall in ski areas near the Company's markets or otherwise, could have a material adverse effect on the

Company's business, financial condition and operating results for the entire fiscal year.

Although the operations of the Company are influenced by general economic conditions, the Company does not believe that inflation has a material impact on the Company's results of operations. The Company believes that it is generally able to pass along any inflationary increases in costs to its customers.

**NEW ACCOUNTING PRONOUNCEMENTS**

In June 2001, the FASB issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations consummated after June 30, 2001 and establishes criteria for recognizing intangible assets separately from goodwill.

SFAS No. 142 requires that upon adoption, amortization of goodwill and intangible assets deemed to have indefinite lives will cease and instead, the carrying value of goodwill and these intangibles will be evaluated for impairment on an annual basis. In addition, a transitional impairment test is required as of the date of adoption. Other intangible assets will continue to be amortized over their useful lives and periodically reviewed for impairment. The Company adopted SFAS No. 142 for the period commencing February 3, 2002, the beginning of its fiscal 2002. The Company completed its initial impairment analysis of its existing goodwill in the first quarter of fiscal 2002, and determined that no impairment was indicated. The adoption of SFAS No. 142 did not have a material impact on the Company's consolidated financial position, results of operations, or cash flows in regard to the impairment provisions of the statement while the application of the non-amortization provisions of the statement will result in the cessation of amortization of approximately \$1.1 million per year.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses certain implementation issues related to SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" and establishes a single accounting model, based on the framework established in SFAS No. 121, for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. The Company adopted this statement on February 3, 2002, and there was not a material impact on results of operations or financial position.

In May 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, 64, Amendment of SFAS No. 13, and Technical Corrections." SFAS No. 145 rescinds FASB No. 4, "Reporting Gains and Losses from Extinguishment of Debt," and an amendment of that statement, SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." As a result, gains and losses from extinguishment of debt will no longer be aggregated and classified as an extraordinary item, net of related income tax effect, on the statement of earnings. SFAS No. 145 is effective for fiscal years beginning after May 15, 2002, with earlier application encouraged.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS 146 requires that a liability for a cost associated with an exit or disposal activity is recognized at fair value when the liability is incurred rather than at the date of a commitment to an exit or disposal plan. This statement is effective for exit or disposal activities initiated after December 31, 2002.

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

The Company's primary interest rate risk exposure results from the Company's long-term debt agreement. The Company's long-term debt bears interest at variable rates that are tied to either the U.S. prime rate or LIBOR at the time of the borrowing. The Company maintains portions of its debt in LIBOR tranches that mature in one to nine months. As those tranches mature, the interest rates on the Company's outstanding borrowings are changed to reflect current prime or LIBOR rates. Therefore, the Company's interest expense changes as prime or LIBOR change. During the second

quarter of fiscal 2001, the Company entered into an interest rate swap instrument, designated as a cash flow hedge as shown in the following table:

|                      |                        |
|----------------------|------------------------|
| <b>Rate received</b> | <b>Notional amount</b> |
|----------------------|------------------------|

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| Rate<br>paid |                |               | Fair value at<br>08/03/02 |
|--------------|----------------|---------------|---------------------------|
| 5.35%        | 3-mo. US Libor | \$ 20,000,000 | \$ (747,000)              |

Based on the Company's overall interest rate exposure at August 3, 2002, a hypothetical instantaneous increase or decrease of one percentage point in interest rates applied to borrowings under the credit facility would change the Company's after-tax earnings by approximately \$779,000 over a 12-month period.

The Company's exposure to foreign currency exchange rates is limited because the Company does not operate any stores outside of the United States. The Company does not consider the market risk exposure relating to foreign currency exchange to be material. Foreign currency fluctuations did not have a material impact on the Company during the second quarter of fiscal 2002 or 2001.

The fair value of the Company's investments in marketable equity securities at August 3, 2002 was \$109,000. The fair value of these investments will fluctuate as the quoted market prices of such securities fluctuate. As of August 3, 2002, the fair value of the Company's investments in marketable equity securities was \$93,000 less than the adjusted basis of those investments. Such unrealized holding gain has not been recognized in the Company's consolidated statement of operations, but rather has been recorded as a component of stockholders' equity in other comprehensive loss. The actual gain or loss that the Company will realize when such investments are sold will depend on the fair value of such securities at the time of sale. Based on the Company's marketable equity securities portfolio and quoted market prices at August 3, 2002, a 50% increase or decrease in the market price of such securities would result in an increase or decrease of approximately \$54,000 in the fair value of the marketable equity securities portfolio. Although changes in quoted market prices may affect the fair value of the marketable equities securities portfolio and cause unrealized gains or losses, such gains or losses would not be realized unless the investments are sold or determined to have a decline in value, which is other than temporary.

### PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The information discussed herein includes "forward-looking statements" within the meaning of the federal securities laws. Although the Company believes that the expectations reflected in such forward looking statements are reasonable, the Company's actual results could differ materially as a result of certain factors, including, but not limited to: the Company's ability to manage its expansion efforts in existing and new markets, risks associated with the acquisition of companies, availability of suitable new store locations at acceptable terms, general economic conditions, and retail and sporting goods business conditions, specifically, availability of merchandise to meet fluctuating consumer demands, fluctuating sales margins, increasing competition in sporting goods and apparel retailing, as well as other factors described from time to time in the Company's periodic reports, including the Annual Report of the Company on Form 10-K for its year ended February 2, 2002, filed with the Securities and Exchange Commission.

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## PART II OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The Company is, from time to time, involved in various legal proceedings incidental to the conduct of its business. The Company believes that the outcome of all such pending legal proceedings to which it is a party will not, in the aggregate, have a material adverse effect on the Company's business, financial condition, or operating results.

On July 24, 1997, the Internal Revenue Service proposed adjustments to the Company and its former parent's 1992 and 1993 federal income tax returns in conjunction with its former parent's Internal Revenue Service examination. The proposed adjustments related to the manner in which LIFO inventories were characterized on such returns. The Company has taken the position that the inventory acquired in connection with the acquisition of its former parent was appropriately allocated to its inventory pools. The Internal Revenue Service has asserted the inventory was acquired at a bargain purchase price and should be allocated to a separate pool and liquidated as inventory turns. The Internal Revenue Service has asserted that this basis difference should have been reflected in taxable income in 1992 and 1993. Based on management's discussion with the Company's former parent, the Company believes the potential accelerated tax liability, which could have a negative effect on liquidity in the near term, ranges from approximately \$0 to \$9.7 million. The Company recorded approximately \$9.7 million as a long-term net deferred tax liability for the tax effect of the LIFO inventory basis difference. In addition, the loss from possible assessed interest charges resulting from the proposed adjustments ranges from approximately \$0 to \$3.3 million. The Company has accrued approximately \$1.2 million for potential interest charges in the consolidated financial statements. The Company does not expect that any penalties will be assessed relating to this matter although the Company cannot be certain that penalties will not be assessed. Any accelerated tax liability, including interest charges and penalties, may have a material impact on the Company's liquidity.

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In June 2000, a former employee of Sportmart brought two class action complaints in California against the Company, alleging certain wage and hour claims in violation of the California Labor Code, California Business and Professional Code section 17200 and other related matters. One complaint alleges that the Company classified certain managers in its California stores as exempt from overtime pay when they would have been classified as non-exempt and paid overtime. The second complaint alleges that the Company failed to pay hourly employees in California stores for all hours worked. In March 2001, a third class action complaint was filed in the same court in California alleging the same wage and hour violations regarding classification of certain managers as exempt from overtime pay. In July 2001, a fourth complaint was filed alleging that store managers should also not be classified as employees exempt from overtime pay. All the complaints seek compensatory damages, punitive damages and penalties. The amount of damages sought is unspecified. Although the court has denied motions to dismiss the first two complaints, the Company intends to vigorously defend these matters and at this time, the Company has not ascertained the future liability, if any, as a result of these complaints. The Company has not accrued any reserves related to these claims.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

#### A. EXHIBITS.

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 99.1                      | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350). |
| 99.2                      | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350). |

#### B. REPORTS ON FORM 8-K

The Company filed no reports on Form 8-K during the quarter ended August 3, 2002.

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on September 17, 2002 on its behalf by the undersigned thereunto duly authorized.

GART SPORTS COMPANY

By: /s/ JOHN DOUGLAS MORTON

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John Douglas Morton,  
Chairman of the Board of Directors, President and Chief  
Executive Officer

By: /s/ THOMAS T. HENDRICKSON

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Thomas T. Hendrickson,  
Executive Vice President, Chief Financial Officer and Treasurer

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CERTIFICATIONS

I, John Douglas Morton, Chairman of the Board of Directors, President and Chief Executive Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Gart Sports Company;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

Date: September 17, 2002.

/s/ JOHN DOUGLAS MORTON

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John Douglas Morton  
Chairman of the Board of Directors, President and Chief Executive Officer  
Gart Sports Company  
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CERTIFICATIONS

I, Thomas T. Hendrickson, Executive Vice President, Chief Financial Officer and Treasurer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Gart Sports Company;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

Date: September 17, 2002.

/s/ THOMAS T. HENDRICKSON

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Thomas T. Hendrickson  
Executive Vice President, Chief Financial Officer and Treasurer  
Gart Sports Company  
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