WILLIAMS SONOMA INC
Form 10-Q
September 11, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended August 2, 2009.

or

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

For the transition period from __________ to __________

Commission File Number: 001-14077

WILLIAMS-SONOMA, INC.

(Exact name of registrant as specified in its charter)

California	94-2203880
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3250 Van Ness Avenue, San Francisco, CA	94109
(Address of principal executive offices)	(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 _ü_ No ___

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ___ No ___

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

Large accelerated filer _ü_	Accelerated filer ___
Non-accelerated filer ___ (Do not check if a smaller reporting company)	Smaller reporting company ___

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ___ No _ü_

As of August 30, 2009, 105,732,430 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 AUGUST 2, 2009

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PART I. FINANCIAL INFORMATION

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ITEM 1. FINANCIAL STATEMENTS

WILLIAMS-SONOMA, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

Dollars and shares in thousands, except per share amounts	August 2, 2009	February 1, 2009	August 3, 2008
ASSETS			
Current assets			
Cash and cash equivalents	$ 165,315	$ 148,822	$ 38,544
Accounts receivable	40,322	37,405	62,729
Merchandise inventories, net	517,028	572,899	656,641
Prepaid catalog expenses	38,909	36,424	50,087
Prepaid expenses	52,511	45,354	49,522
Deferred income taxes	90,559	90,349	91,808
Other assets	9,233	9,420	9,140
Total current assets	913,877	940,673	958,471
Property and equipment, net	885,334	942,219	980,857
Non-current deferred income taxes	39,065	36,555	47,355
Other assets	15,584	16,017	18,367
Total assets	$ 1,853,860	$ 1,935,464	$ 2,005,050
LIABILITIES AND SHAREHOLDERS EQUITY			
Current liabilities			
Accounts payable	$ 129,798	$ 162,362	$ 159,993
Accrued salaries, benefits and other	66,616	75,732	85,248
Customer deposits	191,406	192,209	200,554
Income taxes payable	-	112	12,882
Current portion of long-term debt	14,800	14,702	14,568
Other liabilities	23,327	15,620	16,772
Total current liabilities	425,947	460,737	490,017
Deferred rent and lease incentives	250,840	264,672	269,487
Long-term debt	8,915	10,259	10,050
Other long-term obligations	52,467	51,812	53,055
Total liabilities	738,169	787,480	822,609
Commitments and contingencies			
Shareholders equity			
Preferred stock, $.01 par value, 7,500 shares authorized, none issued	-	-	-
Common stock, $.01 par value, 253,125 shares authorized, issued and outstanding: 105,732, 105,664 and 105,584 shares at August 2, 2009, February 1, 2009 and August 3, 2008, respectively	1,057	1,057	1,056
Additional paid-in capital	424,096	416,366	417,802
Retained earnings	681,112	725,052	749,483
Accumulated other comprehensive income	9,426	5,509	14,100
Total shareholders equity	1,115,691	1,147,984	1,182,441
Total liabilities and shareholders equity	$ 1,853,860	$ 1,935,464	$ 2,005,050

See Notes to Condensed Consolidated Financial Statements.

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WILLIAMS-SONOMA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
Dollars and shares in thousands, except per share amounts	August 2, 2009	August 3, 2008	August 2, 2009	August 3, 2008
Net revenues	$ 672,114	$ 819,621	$ 1,283,729	$ 1,601,405
Cost of goods sold	456,773	540,774	884,425	1,046,339
Gross margin	215,341	278,847	399,304	555,066
Selling, general and administrative expenses	214,906	253,424	428,109	512,760
Interest income	55	187	102	763
Interest expense	433	377	751	774
Earnings (loss) before income taxes	57	25,233	(29,454)	42,295
Income tax expense (benefit)	(342)	6,849	(11,148)	13,464
Net earnings (loss)	$ 399	$ 18,384	$ (18,306)	$ 28,831
Basic earnings (loss) per share	$ 0.00	$ 0.17	$ (0.17)	$ 0.27
Diluted earnings (loss) per share	$ 0.00	$ 0.17	$ (0.17)	$ 0.27
Shares used in calculation of earnings (loss) per share:				
Basic	105,719	105,561	105,685	105,462
Diluted	107,033	107,010	105,685	107,088

See Notes to Condensed Consolidated Financial Statements.

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WILLIAMS-SONOMA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Twenty-Six Weeks Ended August 2,	August 3,
Dollars in thousands	2009	2008
Cash flows from operating activities:		
Net earnings (loss)	$ (18,306)	$ 28,831
Adjustments to reconcile net earnings (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	74,611	73,706
Loss on disposal/impairment of assets	11,304	3,710
Gain on sale of asset	-	(16,115)
Amortization of deferred lease incentives	(16,786)	(15,854)
Deferred income taxes	(3,378)	(2,859)
Tax benefit from exercise of stock-based compensation	23	854
Stock-based compensation expense	8,690	13,179
Other	-	(416)
Changes in:		
Accounts receivable	(2,801)	(15,383)
Merchandise inventories	57,209	36,837
Prepaid catalog expenses	(2,485)	4,821
Prepaid expenses and other assets	(6,319)	(16,563)
Accounts payable	(25,212)	(33,473)
Accrued salaries, benefits and other current and long-term liabilities	(1,194)	(15,948)
Customer deposits	(1,325)	(1,089)
Deferred rent and lease incentives	2,069	37,672
Income taxes payable	(112)	(71,098)
Net cash provided by operating activities	75,988	10,812
Cash flows from investing activities:		
Purchases of property and equipment	(33,062)	(112,721)
Proceeds from sale of assets	139	46,787
Proceeds from insurance reimbursement	-	632
Other	-	(152)
Net cash used in investing activities	(32,923)	(65,454)
Cash flows from financing activities:		
Repayments of long-term obligations	(1,246)	(1,354)
Net proceeds from exercise of stock options	350	132
Excess tax benefit from exercise of stock-based compensation	25	916
Payment of dividends	(25,559)	(24,970)
Other	(33)	-
Net cash used in financing activities	(26,463)	(25,276)
Effect of exchange rates on cash and cash equivalents	(109)	(488)
Net increase/(decrease) in cash and cash equivalents	16,493	(80,406)
Cash and cash equivalents at beginning of period	148,822	118,950
Cash and cash equivalents at end of period	$ 165,315	$ 38,544

See Notes to Condensed Consolidated Financial Statements.

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WILLIAMS-SONOMA, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Twenty-Six Weeks Ended August 2, 2009 and August 3, 2008

(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 August 2, 2009 and August 3, 2008, the condensed consolidated statements of operations for the thirteen and twenty-six weeks then ended and the condensed consolidated statements of cash flows for the twenty-six weeks then ended have been prepared by us, without audit. In our opinion, the financial statements include all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position at the balance sheet dates and the results of operations for the thirteen and twenty-six weeks then ended. Significant intercompany transactions and accounts have been eliminated. The balance sheet as of February 1, 2009, presented herein, has been derived from our audited balance sheet included in our Annual Report on Form 10-K for the fiscal year ended February 1, 2009.

The results of operations for the thirteen and twenty-six weeks ended August 2, 2009 are not necessarily indicative of the operating results of the full year.

Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended February 1, 2009.

Subsequent events were evaluated through September 11, 2009, the date these condensed consolidated financial statements were issued.

NOTE B. ACCOUNTING POLICIES

Recent Accounting Pronouncements

On February 2, 2009, we adopted Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*. SFAS No. 157 establishes a standard definition for fair value, provides a framework under generally accepted accounting principles for measuring fair value and expands disclosure requirements for fair value measurements. We do not have significant financial assets and liabilities or nonfinancial assets and liabilities recognized or disclosed at fair value and, as such, the adoption of SFAS No. 157 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 107-1 and Accounting Principles Board (APB) 28-1, Interim Disclosures about Fair Value of Financial Instruments. This FSP amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments, and requires disclosures about fair value of financial instruments for interim reporting periods as well as for annual financial statements. Additionally, this FSP amends APB Opinion No. 28, Interim Financial Reporting, and requires those disclosures in summarized financial information at interim reporting periods. These disclosures are required for interim reporting periods ending after June 15, 2009.

In June 2009, the FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R). SFAS No. 167 revises the consolidation guidance for variable interest entities under FASB Interpretation (FIN) No. 46(R). This statement will become effective for us on February 1, 2010. We are currently evaluating the impact this statement will have on our consolidated financial statements.

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In June 2009, the FASB approved the FASB Accounting Standards Codification, (Codification), as the single source of authoritative US generally accepted accounting principles (GAAP) for all non-governmental entities. The Codification, which launched July 1, 2009, changes the referencing and organization of accounting guidance and is effective for interim and annual periods ending after September 15, 2009. Since it is not intended to change or alter existing US GAAP, the Codification is not expected to have any impact on our financial condition or results of operations. Beginning with the third quarter of fiscal 2009, our financial statements will no longer refer to specific US GAAP standards.

NOTE C. STOCK-BASED COMPENSATION

Equity Award Programs

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

Stock-Based Compensation Expense

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

During the thirteen and twenty-six weeks ended August 2, 2009, we recognized total stock-based compensation expense, as a component of selling, general and administrative expenses, of $3,469,000 and $8,690,000, respectively. During the thirteen and twenty-six weeks ended August 3, 2008, we recognized total stock-based compensation expense, as a component of selling, general and administrative expenses, of $6,622,000 and $13,179,000, respectively.

Equity Award Exchange Program

In response to the significant decline in our stock price, on June 11, 2008, our shareholders approved an offer for our eligible employees to exchange certain outstanding option awards for restricted stock units. This offer commenced on March 16, 2009 and closed on April 10, 2009, at which time, 2,979,735 outstanding option awards were exchanged for 842,019 restricted stock units. Participants exchanged their eligible option awards for restricted stock units of an approximate equal fair value and, as such, no incremental compensation expense was recognized as a result of the exchange. The remaining unamortized compensation expense associated with the newly issued restricted stock units of approximately $19,199,000 as of April 10, 2009 is being recognized on a straight-line basis over the vesting periods of the awards of approximately 3 years.

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Stock Options

The following table summarizes our stock option activity during the twenty-six weeks ended August 2, 2009:

	Shares
Balance at February 1, 2009	5,626,543
Granted	-
Exercised	(35,300)
Canceled[1]	(1,750,051)
Balance at August 2, 2009	3,841,192
Vested at August 2, 2009	3,797,012
Vested plus expected to vest at August 2, 2009	3,836,665

[1] *As a result of the equity award exchange program, a total of 1,134,620 options were cancelled during the first quarter of fiscal 2009 in exchange for the issuance of restricted stock units.*

Stock-Settled Stock Appreciation Rights

The following table summarizes our stock-settled stock appreciation rights activity during the twenty-six weeks ended August 2, 2009:

	Shares
Balance at February 1, 2009	7,611,514
Granted	-
Converted	-
Canceled[1]	(2,541,214)
Balance at August 2, 2009	5,070,300
Vested at August 2, 2009	632,320
Vested plus expected to vest at August 2, 2009	4,175,488

[1] *As a result of the equity award exchange program, a total of 1,845,115 stock-settled stock appreciation rights were cancelled during the first quarter of fiscal 2009 in exchange for the issuance of restricted stock units.*

Restricted Stock Units

The following table summarizes our restricted stock unit activity during the twenty-six weeks ended August 2, 2009:

	Shares
Balance at February 1, 2009	1,246,333
Granted[1]	957,233
Released	(32,890)
Canceled	(249,480)
Balance at August 2, 2009	1,921,196
Vested and deferred at August 2, 2009[2]	24,771
Expected to vest at August 2, 2009	1,728,105

[1] *As a result of the equity award exchange program, a total of 842,019 restricted stock units were granted during the first quarter of fiscal 2009.*

[2] *A total of 24,771 restricted stock units vested on May 22, 2009, however, the release of the awards was deferred based on election by the holders.*

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NOTE D. BORROWING ARRANGEMENTS

Credit Facility

We have a credit facility that provides for a $300,000,000 unsecured revolving line of credit that may be used for loans or letters of credit. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the credit facility of up to $200,000,000, to provide for a total of $500,000,000 of unsecured revolving credit. The revolving line of credit facility contains certain financial covenants, including a maximum leverage ratio (funded debt adjusted for lease and rent expense to earnings before interest, income tax, depreciation, amortization and rent expense EBITDAR), a minimum fixed charge coverage ratio (calculated as EBITDAR to total fixed charges), and covenants limiting our ability to repurchase shares of stock or increase our dividend, in addition to covenants limiting our ability to dispose of assets, make acquisitions, be acquired (if a default would result from the acquisition), incur indebtedness, grant liens and make investments. The credit facility also contains events of default that include, among others, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, bankruptcy and insolvency events, material judgments, cross defaults to material indebtedness and events constituting a change of control. The occurrence of an event of default will increase the applicable rate of interest by 2.0% and could result in the acceleration of our obligations under the credit facility and an obligation of any or all of our subsidiaries that have guaranteed our credit facility to pay the full amount of our obligations under the credit facility. As of August 2, 2009, we were in compliance with our financial covenants under the credit facility and based on our current projections, expect to be in compliance throughout fiscal 2009. 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 (i) Bank of America s prime rate (or, if greater, the average rate on overnight federal funds plus one-half of one percent, or a rate based on LIBOR plus one percent) plus a margin based on our leverage ratio, or (ii) LIBOR plus a margin based on our leverage ratio. As of August 2, 2009 and August 3, 2008, no amount was outstanding under the credit facility. However, as of August 2, 2009, $40,291,000 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.

Letter of Credit Facilities

On September 4, 2009, we renewed four of our unsecured commercial letter of credit reimbursement facilities, each of which matures on September 3, 2010. Due to significant reductions in inventory purchases and an overall reduction in the number of vendors who require the use of our letter of credit facilities, we have decreased the aggregate credit available under these facilities from $155,000,000 to $125,000,000. The letter of credit facilities contain covenants and provide for events of default that are consistent with our unsecured revolving line of credit. Interest on unreimbursed amounts under the letter of credit facilities accrues at the lender s prime rate (or if greater, the average rate on overnight federal funds plus one-half of one percent) plus 2.0%. As of August 2, 2009, an aggregate of $32,360,000 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 August 2, 2009. The latest expiration possible for any future letters of credit issued under the facilities is now January 31, 2011.

Long Term Debt

As of August 2, 2009 we had $23,715,000 of long term debt obligations (consisting primarily of our Mississippi industrial development bonds and the bond-related debt associated with our Memphis-based distribution facilities), the majority of which accrue interest based on variable rates. As of August 2, 2009, the difference between the fair value and the carrying value of our long term debt was not material.

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NOTE E. COMPREHENSIVE INCOME

Comprehensive income for the thirteen and twenty-six weeks ended August 2, 2009 and August 3, 2008 was as follows:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
Dollars in thousands	August 2, 2009	August 3, 2008	August 2, 2009	August 3, 2008
Net earnings (loss)	$ 399	$ 18,384	$ (18,306)	$ 28,831
Other comprehensive income (loss)				
Foreign currency translation adjustment	2,808	(381)	3,916	(1,144)
Net unrealized gain (loss) on investment	-	(3)	-	(6)
Comprehensive income (loss)	$ 3,207	$ 18,000	$ (14,390)	$ 27,681

NOTE F. EARNINGS (LOSS) PER SHARE

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

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

Dollars and amounts in thousands, except per share amounts	Net Earnings (Loss)	Weighted Average Shares	Earnings (Loss) Per Share
Thirteen weeks ended August 2, 2009			
Basic	$ 399	105,719	$ 0.00
Effect of dilutive stock-based awards	-	1,314	
Diluted	$ 399	107,033	$ 0.00
Thirteen weeks ended August 3, 2008			
Basic	$ 18,384	105,561	$ 0.17
Effect of dilutive stock-based awards	-	1,449	
Diluted	$ 18,384	107,010	$ 0.17
Twenty-six weeks ended August 2, 2009			
Basic	$ (18,306)	105,685	$ (0.17)
Effect of dilutive stock-based awards[1]	-	-	
Diluted	$ (18,306)	105,685	$ (0.17)
Twenty-six weeks ended August 3, 2008			
Basic	$ 28,831	105,462	$ 0.27
Effect of dilutive stock-based awards	-	1,626	
Diluted	$ 28,831	107,088	$ 0.27

[1] *Due to the net loss recognized for the twenty-six weeks ended August 2, 2009, all stock-based awards were excluded from the calculation of diluted earnings (loss) per share as their inclusion would be anti-dilutive.*

Stock-based awards of 4,499,000 and 6,438,000 for the thirteen weeks ended and 10,833,000 and 6,054,000 for the twenty-six weeks ended August 2, 2009 and August 3, 2008, respectively, were not included in the computation of diluted earnings (loss) per share, as their inclusion would be anti-dilutive.

NOTE G. LEGAL PROCEEDINGS

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

NOTE H. ASSET IMPAIRMENT AND LEASE TERMINATION CHARGES

We review the carrying value of all long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. If a long-lived asset is found to be impaired, the amount recognized for impairment is equal to the difference between the net carrying value and the asset s fair value. Long-lived assets are measured at fair value on a nonrecurring basis using Level 3 inputs as defined in the fair value hierarchy. The fair value is estimated based upon future cash flows (discounted at a rate that is commensurate with the risk and approximates our weighted average cost of capital). For any store or facility closures where a lease obligation still exists, we record the estimated future liability associated with the rental obligation on the date the store or facility is closed. Most store and facility closures, however, occur upon the lease expiration. Should store profitability and general economic, market or business conditions continue to decline, we may be required to record additional impairment charges and/or lease termination charges.

During the thirteen and twenty-six weeks ended August 2, 2009, we recorded expense of approximately $8,582,000 and $14,708,000, respectively, associated with asset impairment and early lease termination charges for underperforming retail stores, of which $7,448,000 and $13,530,000 are recorded within selling, general and administrative expenses.

During the thirteen and twenty-six weeks ended August 3, 2008, we recorded expense of approximately $1,474,000 and $2,070,000, respectively, within selling, general and administrative expenses associated with asset impairment charges for underperforming retail stores. During the twenty-six weeks ended August 3, 2008, we also recorded a benefit of approximately $9,350,000 within selling, general and administrative expenses related to an incentive payment received from a landlord to compensate us for terminating a store lease prior to its expiration.

In addition, during the third quarter of fiscal 2009 we expect to incur charges of approximately $6,500,000, or $0.04 per diluted share, related to the exit of excess distribution capacity.

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.

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. Our operating segments are aggregated at the channel level for reporting purposes due to the fact that our brands are interdependent for economies of scale and we do not maintain fully allocated income statements at the brand level. As a result, material financial decisions related to the brands are made at the channel level. Furthermore, it is not practicable for us to report revenue by product group.

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

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

Segment Information

Dollars in thousands	Retail	Direct-to-Customer	Unallocated	Total
Thirteen weeks ended August 2, 2009				
Net revenues[1]	$ 400,239	$ 271,875	$ -	$ 672,114
Depreciation and amortization expense	24,282	5,172	8,838	38,292
Earnings (loss) before income taxes[2,3]	2,123	41,850	(43,916)	57
Capital expenditures	5,616	3,327	3,483	12,426
Thirteen weeks ended August 3, 2008				
Net revenues[1]	$ 463,239	$ 356,382	$ -	$ 819,621
Depreciation and amortization expense	24,654	5,237	6,683	36,574
Earnings (loss) before income taxes[2,4]	6,476	52,573	(33,816)	25,233
Capital expenditures	44,815	5,843	8,582	59,240
Twenty-six weeks ended August 2, 2009				
Net revenues[1]	$ 757,618	$ 526,111	$ -	$ 1,283,729
Depreciation and amortization expense	47,601	10,507	16,503	74,611
Earnings (loss) before income taxes[2,3]	(11,587)	71,832	(89,699)	(29,454)
Assets[5]	984,400	267,380	602,080	1,853,860
Capital expenditures	19,785	6,428	6,849	33,062
Twenty-six weeks ended August 3, 2008				
Net revenues[1]	$ 896,790	$ 704,615	$ -	$ 1,601,405
Depreciation and amortization expense	50,073	10,219	13,414	73,706
Earnings (loss) before income taxes[2,4,5]	24,445	102,177	(84,327)	42,295
Assets[6]	1,184,705	339,735	480,610	2,005,050
Capital expenditures	88,383	9,551	14,787	112,721

[1] *Includes net revenues in the retail channel of approximately $16.7 million and $20.3 million for the thirteen weeks ended August 2, 2009 and August 3, 2008, respectively, and $30.2 million and $38.4 million for the twenty-six weeks ended August 2, 2009 and August 3, 2008, respectively, related to our foreign operations.*

[2] *Includes expenses in the retail channel of approximately $7.2 million and $1.5 million for the thirteen weeks ended August 2, 2009 and August 3, 2008, respectively, and $13.4 million and $2.1 million for the twenty-six weeks ended August 2, 2009 and August 3, 2008, respectively, related to asset impairment and early lease termination charges for underperforming retail stores.*

[3] *Unallocated costs before income taxes include $1.3 million for the thirteen and twenty-six weeks ended August 2, 2009 related to exiting excess distribution capacity.*

[4] *Unallocated costs before income taxes include a benefit of approximately $16.0 million related to a gain on the sale of a corporate aircraft.*

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

[6] *Includes $30.4 million and $31.9 million of long-term assets as of August 2, 2009 and August 3, 2008, 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 macroeconomic and retail trends; statements related to a trend of gradual revenue improvement; statements related to an improvement in our year-over-year gross margin; statements related to an expected improvement in West Elm s revenues in the third and fourth quarters; statements related to assessing the long-term market potential of the Williams-Sonoma Home brand; statements related to attracting new customers to the brands and driving increased traffic in all channels; statements related to the opportunity in the refinement of the balance between catalog circulation and on-line marketing; statements related to the benefits of our inventory initiatives; statements related to the benefits of our Asian furniture sourcing initiative; statements related to the benefits of our returns, replacement and damages initiatives; statements related to eliminating excess distribution capacity and excess office space; statements related to seeing a revenue decline in fiscal 2009 as compared to fiscal 2008; statements related to opening franchised stores in the Middle East; statements related to future store profitability; statements related to impairment and lease termination charges; statements related to our initiatives for the remainder of the year and the ability of these initiatives to improve our bottom line, strengthen our balance sheet and improve the positioning of our brands; statements related to the adequacy and use of our available cash; statements related to the future payment of a dividend; statements related to compliance with our bank covenants; statements related to our projected capital expenditures; 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, predic potential, continue, or the negative of such terms, or other comparable terminology.

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

OVERVIEW

We are a specialty retailer of products for the home. The 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 2008, retail net revenues accounted for 58.4% of our business and direct-to-customer net revenues accounted for 41.6% of our business. Based on their contribution to our net revenues in fiscal 2008, the core brands in both the retail and

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direct-to-customer channels are: Pottery Barn, which sells casual home furnishings; Williams-Sonoma, which sells cooking and entertaining essentials; and Pottery Barn Kids, which sells stylish children s furnishings.

The following discussion and analysis of financial condition, results of operations, and liquidity and capital resources for the thirteen weeks ended August 2, 2009 (second quarter of fiscal 2009), as compared to the thirteen weeks ended August 3, 2008 (second quarter of fiscal 2008) and the twenty-six weeks ended August 2, 2009 (year-to-date 2009), as compared to the twenty-six weeks ended August 3, 2008 (year-to-date 2008), should be read in conjunction with our condensed consolidated financial statements and the notes thereto.

All explanations of changes in operational results are discussed in order of their magnitude.

Second Quarter of Fiscal 2009 Financial Results

During the second quarter of fiscal 2009, our net revenues decreased 18.0% to $672,114,000 from $819,621,000 for the second quarter of fiscal 2008. This decrease was driven by declining revenues in all brands primarily due to the continued negative impact of the general economic environment during the second quarter of fiscal 2009.

Our diluted earnings per share in the second quarter of fiscal 2009 was $0.00 (including a $0.05 per diluted share charge for asset impairment and early lease termination costs and the exit of excess distribution capacity) compared to diluted earnings per share of $0.17 (including a $0.09 per diluted share gain on the sale of a corporate aircraft, partially offset by a $0.01 per diluted share charge for asset impairment costs) in the second quarter of fiscal 2008.

Retail net revenues in the second quarter of fiscal 2009 decreased $63,000,000, or 13.6%, compared to the second quarter of fiscal 2008. All brands had declining net revenues during the quarter led by Pottery Barn, Williams-Sonoma and Pottery Barn Kids. This decrease was driven by the continued negative impact of the general economic environment which resulted in a comparable store sales decrease of 15.3%, partially offset by a 4.6% increase in retail leased square footage, including 16 net new stores.

Direct-to-customer net revenues in the second quarter of fiscal 2009 decreased $84,507,000, or 23.7%, compared to the second quarter of fiscal 2008. All brands had declining net revenues during the quarter, led primarily by Pottery Barn, Pottery Barn Kids, PBteen and West Elm due to the continued negative impact of the general economic environment and a decrease in catalog and page circulation of 18.7% and 24.8%, respectively (including the impact of our catalog circulation optimization strategy).

In our core brands, net revenues in the second quarter of fiscal 2009 decreased by 17.2% compared to the second quarter of fiscal 2008. This decline was driven by a decrease in Pottery Barn Kids, Pottery Barn and Williams-Sonoma, primarily resulting from the overall negative impact of the general economic environment. In the Pottery Barn Kids brand, net revenues decreased 24.9%, including a comparable store sales decrease of 22.3% and a $3,000,000 charge from a voluntary product recall. In the Pottery Barn brand, although net revenues decreased 19.2% and comparable store sales decreased 15.9%, the results were encouraging because we believe they demonstrate a trend of gradual revenue improvement and an affirmation that our strategies to reinvigorate the business are resonating with our customers. In the Williams-Sonoma brand, we continued to see the same economic resilience we have seen all year. Although net revenues declined 9.0%, including a comparable store sales decline of 11.0%, we believe we will see an improvement in our year-over-year gross margin due to our inventory position and seasonal shift in product mix in the second half of fiscal 2009.

Similar to our core brands, our emerging brands (West Elm, PBteen and Williams-Sonoma Home) also continued to be negatively impacted by the general economic environment, where net revenues decreased 22.3% due to a decrease in West Elm, PBteen and Williams-Sonoma Home.

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In the West Elm brand, the decline in net revenues, while consistent with our other home furnishings brands, was partially impacted by vendor-related production issues which led to a low in-stock position in a few key furniture categories. As these issues are currently being resolved, we are optimistic that we will see an improvement in West Elm s revenues in the third and fourth quarters since more than half of the brand s business is driven by furniture related sales.

In the PBteen brand, although net revenues declined 22.4% during the second quarter of fiscal 2009 compared to a 25.1% increase during the second quarter of fiscal 2008, PBteen remains the best performing brand in the company on a two-year trend basis.

In the Williams-Sonoma Home brand, the second quarter of fiscal 2009 remained very challenging for us and, as such, we are prioritizing profitability of the brand over growth and will continue to assess the brand s long-term market potential as the state of the luxury home furnishings sector becomes clearer.

Second Quarter of Fiscal 2009 Operational Results

Across all brands, we remained focused on the initiatives that we believe are critical in gaining market share in this environment: superior customer service, innovative merchandising and a strong value proposition. We are making meaningful progress in all of these areas and are optimistic that the increased penetration of exclusive product and accessible price points in the second half of the year will attract new customers to the brands and drive increased traffic in all channels.

In direct marketing, we continued to move forward with our catalog circulation optimization strategy. During the second quarter of fiscal 2009, year-over-year advertising expense declined 26%, net of a 34% increase in online marketing. We continue to believe that refining the balance between catalogs mailed and online marketing is an opportunity for us.

In our supply chain, we continued to redesign our distribution network (including regionalizing our large cube inventory closer to our customer base) and expand our Asian furniture sourcing base. We also continued to see both customer service and financial benefits from our ongoing returns, replacements and damages initiatives. Each of these initiatives is driving increased margin dollars, as is our strong inventory management strategy, where at the end of the second quarter of fiscal 2009, year-over-year merchandise inventories were down $139,613,000, or 21.3%.

We also continued to make progress on our occupancy cost reduction initiatives, including increasing fiscal 2009 permanent store closures from nine to sixteen, renegotiating store leases and, where possible, capitalizing on favorable lease terms within our existing agreements, and positioning ourselves to eliminate 1,200,000 square feet of excess distribution capacity and 80,000 square feet of excess office space in San Francisco during the third quarter of fiscal 2009.

Fiscal 2009

As we look forward to the balance of the year, we expect to see a net revenue decline of 12% to 15% in fiscal 2009 as compared to fiscal 2008, reflective of the current economic conditions. Despite this expected net revenue decline, we remain committed to optimizing growth, profitability and cash flow by focusing on the following initiatives for the balance of the year: capturing market share through innovative merchandising and a greater emphasis on opening price points; delivering superior customer service; continuing our catalog circulation optimization strategy; and driving efficiencies in our worldwide supply chain.

We believe that all of these initiatives will improve our bottom line, strengthen our balance sheet and position our brands to emerge stronger when the economy improves.

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Additionally, we will be working closely with M.H. Alshaya to open our first four franchised stores in the Middle East in 2010. While this has no immediate financial benefit to us, it is a strategic step toward a longer term international growth plan.

Finally, in fiscal 2009, we expect to continue to return excess capital to our shareholders through a quarterly cash dividend of $0.12 per diluted share for an indicated annual cash dividend of $0.48 per diluted share, or approximately $51,000,000, subject to capital availability.

Results of Operations

NET REVENUES

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

The following table summarizes our net revenues for the second quarter of fiscal 2009 and fiscal 2008, and year-to-date 2009 and 2008:

	Thirteen Weeks Ended				Twenty-Six Weeks Ended			
Dollars in thousands	August 2, 2009	% Total	August 3, 2008	% Total	August 2, 2009	% Total	August 3, 2008	% Total
Retail revenues	$ 400,239	59.5%	$ 463,239	56.5%	$ 757,618	59.0%	$ 896,790	56.0%
Direct-to-customer revenues	271,875	40.5%	356,382	43.5%	526,111	41.0%	704,615	44.0%
Net revenues	$ 672,114	100.0%	$ 819,621	100.0%	$ 1,283,729	100.0%	$ 1,601,405	100.0%

Net revenues in the second quarter of fiscal 2009 decreased by $147,507,000, or 18.0%, compared to the second quarter of fiscal 2008, despite a 4.6% year-over-year increase in retail leased square footage, including 16 net new stores. This decrease was driven by declining revenues in all brands primarily due to the continued negative impact of the general economic environment during the second quarter of fiscal 2009, which resulted in a comparable store sales decrease of 15.3%. Additionally, our catalog and page circulation decreased 18.7% and 24.8%, respectively (including the impact of our catalog circulation optimization strategy).

Net revenues for year-to-date 2009 decreased by $317,676,000, or 19.8%, compared to year-to-date 2008, despite a 4.6% year-over-year increase in retail leased square footage, including 16 net new stores. This decrease was driven by declining revenues in all brands primarily due to the continued negative impact of the general economic environment during year-to-date 2009, which resulted in a comparable store sales decrease of 18.1%. Additionally, our catalog and page circulation decreased 17.9% and 23.7%, respectively (including the impact of our catalog circulation optimization strategy).

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RETAIL REVENUES AND OTHER DATA

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
Dollars in thousands	August 2, 2009	August 3, 2008	August 2, 2009	August 3, 2008
Retail revenues	$ 400,239	$ 463,239	$ 757,618	$ 896,790
Percent decline in retail revenues	(13.6%)	(4.9%)	(15.5%)	(4.6%)
Percent decrease in comparable store sales	(15.3%)	(11.7%)	(18.1%)	(10.4%)
Number of stores - beginning of period	630	603	627	600
Number of new stores	-	8	7	15
Number of new stores due to remodeling[1]	3	11	5	13
Number of closed stores due to remodeling[1]	(2)	(7)	(5)	(12)
Number of permanently closed stores	(2)	(2)	(5)	(3)
Number of stores - end of period	629	613	629	613
Store selling square footage at period-end	3,871,000	3,713,000	3,871,000	3,713,000
Store leased square footage (LSF) at period-end	6,235,000	5,959,000	6,235,000	5,959,000

[1] Remodeled stores are defined as those stores temporarily closed and subsequently reopened during the period due to square footage expansion, store modification or relocation.

	Store Count				Store Count	Avg. LSF Per Store	Avg. LSF Per Store
	May 3, 2009	Openings	Closings	August 2, 2009	August 3, 2008	August 2, 2009	August 3, 2008
Williams-Sonoma	263	2	(2)	263	260	6,300	6,200
Pottery Barn	204	-	-	204	200	12,900	12,700
Pottery Barn Kids	95	-	(2)	93	95	8,000	7,900
West Elm	39	-	-	39	32	17,300	17,400
Williams-Sonoma Home	11	-	-	11	9	13,200	14,300
Outlets	18	1	-	19	17	19,500	21,300
Total	630	3	(4)	629	613	9,900	9,700

Retail net revenues in the second quarter of fiscal 2009 decreased $63,000,000, or 13.6%, compared to the second quarter of fiscal 2008 despite a 4.6% increase in retail leased square footage, including 16 net new stores. All brands had declining net revenues during the quarter led by Pottery Barn, Williams-Sonoma and Pottery Barn Kids. This decrease was driven by the continued negative impact of the general economic environment, which resulted in a comparable store sales decrease of 15.3%.

Retail net revenues for year-to-date 2009 decreased $139,172,000, or 15.5%, compared to year-to-date 2008 despite a 4.6% increase in retail leased square footage, including 16 net new stores. All brands had declining net revenues during the year led by Pottery Barn, Williams-Sonoma and Pottery Barn Kids. This decrease was driven by the continued negative impact of the general economic environment, which resulted in a comparable store sales decrease of 18.1%.

Comparable Store Sales

Comparable stores are defined as those stores in which gross square footage did not change by more than 20% in the previous 12 months and which have been open for at least 12 consecutive months without closure for seven or more consecutive days. By measuring the year-over-year sales of merchandise in the stores that have a history of being open for a full comparable 12 months or more, we can better gauge how the core store base is performing since it excludes new store openings, store remodelings and expansions. Comparable stores exclude new retail concepts until such time as we believe that comparable store results in those concepts are of sufficient size to

evaluate the performance of the retail strategy. Therefore, in both fiscal 2009 and fiscal 2008, West Elm and Williams-Sonoma Home were excluded.

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

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
Percent decrease in comparable store sales	August 2, 2009	August 3, 2008	August 2, 2009	August 3, 2008
Williams-Sonoma	(11.0%)	(4.5%)	(13.1%)	(4.6%)
Pottery Barn	(15.9%)	(16.0%)	(19.1%)	(13.3%)
Pottery Barn Kids	(22.3%)	(13.5%)	(23.7%)	(12.3%)
Outlets	(18.2%)	(12.6%)	(22.3%)	(12.8%)
Total	(15.3%)	(11.7%)	(18.1%)	(10.4%)

Various factors affect comparable store sales, including the overall economic and general retail sales environment as well as current local and global economic conditions, each of which were significant factors in the overall decline of our comparable store sales in fiscal 2009. Additional factors have affected our comparable store sales results in the past and may continue to affect them in the future, such as the number, size and location of stores we open, close, remodel or expand in any period, 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 and discount retailers), the timing of our releases of new merchandise and promotional events, the success of marketing programs, the cannibalization of existing store sales by our new stores, changes in catalog circulation, strength in our direct-to-customer business and fluctuations in foreign exchange rates. Among other things, weather conditions can affect comparable store sales because inclement weather can alter consumer behavior or require us to close certain stores temporarily and thus reduce store traffic. Even if stores are not closed, many customers may decide to avoid going to stores in bad weather. These factors have caused our comparable store sales to fluctuate significantly in the past on an annual, quarterly and monthly basis and, as a result, we expect that comparable store sales will continue to fluctuate in the future.

DIRECT-TO-CUSTOMER REVENUES

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
Dollars in thousands	August 2, 2009	August 3, 2008	August 2, 2009	August 3, 2008
Catalog revenues[1]	$ 62,302	$ 91,252	$ 122,394	$ 187,964
Internet revenues[1]	209,573	265,130	403,717	516,651
Total direct-to-customer revenues[1]	$ 271,875	$ 356,382	$ 526,111	$ 704,615
Percent decrease in direct-to-customer revenues	(23.7%)	(4.3%)	(25.3%)	(4.1%)
Percent decrease in number of catalogs circulated	(18.7%)	(20.5%)	(17.9%)	(18.4%)
Percent decrease in number of pages circulated	(24.8%)	(31.1%)	(23.7%)	(28.1%)

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

Direct-to-customer net revenues in the second quarter of fiscal 2009 decreased $84,507,000, or 23.7%, compared to the second quarter of fiscal 2008. All brands had declining net revenues during the quarter, led primarily by Pottery Barn, Pottery Barn Kids, PBteen and West Elm due to the continued negative impact of the general economic environment and a decrease in catalog and page circulation of 18.7% and 24.8%, respectively (including the impact of our catalog circulation optimization strategy). In addition, net revenues generated in our

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Internet business decreased 21.0% to $209,573,000 for the second quarter of fiscal 2009 compared to $265,130,000 for the second quarter of fiscal 2008.

Direct-to-customer net revenues for year-to-date 2009 decreased $178,504,000, or 25.3%, compared to year-to-date 2008. All brands had declining net revenues during the quarter, led primarily by Pottery Barn and Pottery Barn Kids, due to the continued negative impact of the general economic environment and a decrease in catalog and page circulation of 17.9% and 23.7%, respectively (including the impact of our catalog circulation optimization strategy). In addition, net revenues generated in our Internet business decreased 21.9% to $403,717,000 for year-to-date 2009 compared to $516,651,000 for year-to-date 2008.

COST OF GOODS SOLD

	Thirteen Weeks Ended				Twenty-Six Weeks Ended			
			August 3,				August 3,	
Dollars in thousands	August 2, 2009	% Net Revenues	2008	% Net Revenues	August 2, 2009	% Net Revenues	2008	% Net Revenues
Cost of goods sold	$ 456,773	68.0%	$ 540,774	66.0%	$ 884,425	68.9%	$ 1,046,339	65.3%

Cost of goods sold includes cost of goods, occupancy expenses and shipping costs. Cost of goods consists of cost of merchandise, inbound freight expenses, freight-to-store expenses and other inventory related costs such as shrinkage, damages and replacements. Occupancy expenses consist of rent, depreciation and other occupancy costs, including common area maintenance and utilities. Shipping costs consist of third party delivery services and shipping materials.

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

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

Second Quarter of Fiscal 2009 vs. Second Quarter of Fiscal 2008

Cost of goods sold decreased by $84,001,000, or 15.5%, in the second quarter of fiscal 2009 compared to the second quarter of fiscal 2008. However, cost of goods sold as a percentage of net revenues increased to 68.0% in the second quarter of fiscal 2009 from 66.0% in the second quarter of fiscal 2008. This increase as a percentage of net revenues was primarily driven by an approximate 275 basis point deleverage of fixed occupancy expenses resulting from declining sales as well as the impact of charges associated with exiting excess distribution capacity, partially offset by reductions in freights costs and lower replacements and damages.

In the retail channel, cost of goods sold as a percentage of net revenues increased 80 basis points in the second quarter of fiscal 2009 compared to the second quarter of fiscal 2008. This increase as a percentage of net revenues was primarily driven by the deleverage of fixed occupancy expenses resulting from declining sales, partially offset by a decrease in cost of merchandise and freight costs.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues increased 50 basis points in the second quarter of fiscal 2009 compared to the second quarter of fiscal 2008. This increase as a percentage of net revenues was primarily driven by the deleverage of fixed occupancy expenses resulting from declining sales and an increase in cost of merchandise (including the impact of increased markdowns), partially offset by reductions in shipping costs and lower replacements.

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Year-to-Date 2009 vs. Year-to-Date 2008

Cost of goods sold for year-to-date 2009 decreased by $161,914,000, or 15.5%, compared to year-to-date 2008. However, cost of goods sold as a percentage of net revenues increased to 68.9% for year-to-date 2009 from 65.3% for year-to-date 2008. This increase as a percentage of net revenues was primarily driven by the deleverage of fixed occupancy expenses due to declining sales and an increase in cost of merchandise (including the impact of increased markdowns), partially offset by a reduction in freight costs and lower replacements.

In the retail channel, cost of goods sold as a percentage of net revenues increased 270 basis points for year-to-date 2009 compared to year-to-date 2008. This increase as a percentage of net revenues primarily resulted from the deleverage of fixed occupancy expenses due to declining sales.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues increased 180 basis points for year-to-date 2009 compared to year-to-date 2008. This increase as a percentage of net revenues primarily resulted from an increase in cost of merchandise (including the impact of increased markdowns) and the deleverage of fixed occupancy expenses resulting from declining sales, partially offset by reductions in shipping costs and lower replacements.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

	Thirteen Weeks Ended				Twenty-Six Weeks Ended			
Dollars in thousands	August 2, 2009	% Net Revenues	August 3, 2008	% Net Revenues	August 2, 2009	% Net Revenues	August 3, 2008	% Net Revenues
Selling, general and administrative expenses	$ 214,906	32.0%	$ 253,424	30.9%	$ 428,109	33.3%	$ 512,760	32.0%

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

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

Second Quarter of Fiscal 2009 vs. Second Quarter of Fiscal 2008

Selling, general and administrative expenses decreased by $38,518,000, or 15.2%, in the second quarter of fiscal 2009 compared to the second quarter of fiscal 2008. However, selling, general and administrative expenses as a percentage of net revenues increased to 32.0% in the second quarter of fiscal 2009 from 30.9% in the second quarter of fiscal 2008. This increase as a percentage of net revenues was primarily driven by a benefit of approximately $16,000,000 related to a gain on the sale of a corporate aircraft in the second quarter of fiscal 2008 that did not recur in fiscal 2009, and asset impairment and early lease termination charges of $7,448,000 for underperforming retail stores in the second quarter of fiscal 2009 compared to $1,474,000 for asset impairment charges in the second quarter of fiscal 2008. This increase as a percentage of net revenues was partially offset by reductions in total advertising costs resulting from the continuation of our catalog circulation optimization strategy and reductions in other general expenses.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues remained relatively flat in the second quarter of fiscal 2009 compared to the second quarter of fiscal 2008. This was

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primarily driven by asset impairment and early lease termination charges for underperforming retail stores in the second quarter of fiscal 2009, offset by a decrease in employment costs including the benefit of our infrastructure cost reduction program, as well as reductions in other general expenses.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased 120 basis points in the second quarter of fiscal 2009 compared to the second quarter of fiscal 2008. This decrease as a percentage of net revenues was primarily driven by a reduction in total advertising costs resulting from the continuation of our catalog circulation optimization strategy, partially offset by the deleverage of employment costs due to declining sales.

Year-to-Date 2009 vs. Year-to-Date 2008

Selling, general and administrative expenses for year-to-date 2009 decreased by $84,651,000, or 16.5%, compared to year-to-date 2008. However, selling, general and administrative expenses as a percentage of net revenues increased to 33.3% for year-to-date 2009 from 32.0% for year-to-date 2008. This increase as a percentage of net revenues was primarily driven by a benefit of approximately $16,000,000 related to a gain on the sale of a corporate aircraft and a benefit of approximately $9,350,000 related to an incentive payment received from a landlord to compensate us for terminating a store lease prior to its expiration recorded in fiscal 2008, neither of which recurred in fiscal 2009, as well as asset impairment and early lease termination charges of $13,530,000 for underperforming retail stores for year-to-date 2009 compared to $1,474,000 for year-to-date 2008, and the deleverage of employment costs due to declining sales. This increase as a percentage of net revenues was partially offset by reductions in total advertising costs resulting from the continuation of our catalog circulation optimization strategy and reductions in other general expenses.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues increased 160 basis points for year-to-date 2009 compared to year-to-date 2008. This increase as a percentage of net revenues was primarily driven by asset impairment and early lease termination charges for underperforming retail stores for year-to-date 2009 and a fiscal 2008 early lease termination benefit received from a landlord that did not recur in fiscal 2009, partially offset by a decrease in employment costs including the benefit of our infrastructure cost reduction program, as well as reductions in other general expenses.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased 100 basis points for year-to-date 2009 compared to year-to-date 2008. This decrease as a percentage of net revenues was primarily driven by reductions in total advertising costs resulting from the continuation of our catalog circulation optimization strategy, partially offset by the deleverage of employment costs due to declining sales.

INCOME TAXES

The effective rate was a benefit of 37.8% for year-to-date 2009 and an expense of 31.8% for year-to-date 2008. The effective tax rate for year-to-date 2009 was primarily the result of our year-to-date net loss.

We expect the effective tax rate to be in the range of 37.0% to 42.0% in fiscal 2009. Throughout the year, we expect that there could be ongoing variability in our quarterly tax rates due to volatility in earnings or losses in addition to taxable events that occur and exposures that are re-evaluated.

LIQUIDITY AND CAPITAL RESOURCES

As of August 2, 2009, we held $165,315,000 in cash and cash equivalent funds. As is consistent with our industry, our cash balances are seasonal in nature, with the fourth quarter historically representing a significantly higher level of cash than other periods. This cash balance, however, is our second highest cash balance at the end of the second quarter in our history.

Throughout the fiscal year, we utilize our cash balances to build our inventory levels in preparation for our fourth quarter holiday sales. In fiscal 2009, we plan to use our cash resources to fund our inventory and inventory related purchases, catalog advertising and marketing initiatives, purchases of property and equipment and dividend payments. In addition to the current cash balances on-hand, as of August 2, 2009, we have a credit facility that provides for a $300,000,000 unsecured revolving line of credit that may be used for loans or letters of credit. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the credit facility of up to $200,000,000, to provide for a total of $500,000,000 of unsecured revolving credit. As of August 2, 2009 and August 3, 2008, no amount was outstanding under this credit facility and we do not expect to need to access the line of credit at any time during the remainder of fiscal 2009. However, as of August 2, 2009, $40,291,000 in issued but undrawn standby letters of credit was outstanding under this credit facility. Additionally, as of August 2, 2009, we had five unsecured commercial letter of credit reimbursement facilities for a total of $155,000,000 of available credit. On September 4, 2009, due to significant reductions in inventory purchases and an overall reduction in the number of vendors who require the use of our letter of credit facilities, four of these facilities were subsequently renewed and the total available credit under the facilities is now $125,000,000. As of August 2, 2009, an aggregate of $32,360,000 was outstanding under these letter of credit facilities, which represent only a future commitment to fund inventory purchases to which we had not taken legal title as of August 2, 2009. We believe our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations over the next 12 months. Further, we are currently in compliance with all of our bank covenants and expect to remain in compliance throughout fiscal 2009.

For year-to-date 2009, net cash provided by operating activities was $75,988,000 compared to net cash provided by operating activities of $10,812,000 for year-to-date 2008. Net cash provided by operating activities for year-to-date 2009 was primarily attributable to a decrease in merchandise inventories due to our continued inventory reduction initiatives, partially offset by a decrease in accounts payable reflecting an overall decrease in expenditures. Net cash provided by operating activities for year-to-date 2009 increased compared to year-to-date 2008 primarily due to a decrease in income taxes payable in fiscal 2009 resulting from a reduction in our net income, as well as a reduction in merchandise inventories.

For year-to-date 2009, net cash used in investing activities was $32,923,000 compared to net cash used in investing activities of $65,454,000 for year-to-date 2008. For year-to-date 2009, purchases of property and equipment were $33,062,000, comprised of $18,611,000 for stores, $11,876,000 for systems development projects (including e-commerce websites) and $2,575,000 for distribution, facility infrastructure and other projects. Net cash used in investing activities for year-to-date 2009 decreased compared to year-to-date 2008 primarily due to a reduction in purchases of property and equipment resulting from a decrease in the number of new and remodeled stores we expect to open during fiscal 2009 and an overall reduction in all other capital expenditures, as well as proceeds received from the sale of a corporate aircraft during fiscal 2008, which did not recur in fiscal 2009.

For fiscal 2009, we anticipate investing $90,000,000 to $95,000,000 in the purchase of property and equipment, primarily for the construction of 9 new stores and 8 remodeled or expanded stores, systems development projects (including e-commerce websites), and distribution, facility infrastructure and other projects.

For year-to-date 2009, net cash used in financing activities was $26,463,000 compared to net cash used in financing activities of $25,276,000 for year-to-date 2008. Net cash used in financing activities for year-to-date 2009 and year-to-date 2008 was primarily attributable to the payment of dividends.

Dividend Policy

Our quarterly cash dividend is $0.12 per common share. The indicated annual cash dividend, subject to capital availability, is $0.48 per common share, or approximately $51,000,000 in fiscal 2009. Our quarterly cash dividend may be limited or terminated at any time.

Critical Accounting Policies

Management s Discussion and Analysis of Financial Condition and Results of Operations is based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. The estimates and assumptions are evaluated on an ongoing basis and are based on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results may differ significantly from these estimates. During the second quarter of fiscal 2009, there have been no significant changes to the policies discussed in our Annual Report on Form 10-K for the year ended February 1, 2009.

Impact of Inflation

The impact of inflation on results of operations was not significant for year-to-date 2009 or year-to-date 2008.

Seasonality

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risks, which include significant deterioration of the U.S. and foreign markets, changes in U.S. interest rates, foreign currency exchange rates, including any devaluation of the U.S. dollar, and the effects of uncertain economic forces which may affect the prices we pay our vendors in the foreign countries in which we do business. We do not engage in financial transactions for trading or speculative purposes.

Interest Rate Risk

As of August 2, 2009, we have three debt instruments with variable interest rates which subject us to risks associated with changes in interest rates (the interest payable on our credit facility, our Mississippi industrial development bond and the bond-related debt associated with one of our Memphis-based distribution facilities). As of August 2, 2009, the total outstanding principal balance on these instruments was $13,575,000 (with a weighted average interest rate of approximately 1.7%). If interest rates on these existing variable rate debt instruments rose 17 basis points (an approximate 10% increase in the associated variable rates as of August 2, 2009), our results from operations and cash flows would not be materially affected.

In addition, we have fixed and variable income investments consisting of short-term investments classified as cash and cash equivalents, which are also affected by changes in market interest rates. As of August 2, 2009, our investments, made solely in U.S. Treasury bills and money market funds, are stated at cost and approximate their fair values. An increase in interest rates of 10% would have an immaterial effect on the value of these investments. Declines in interest rates, however, have and would in the future decrease the income derived from these investments.

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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. Only approximately 3% of our international purchase transactions are in currencies other than the U.S. dollar, primarily the euro. Any currency risks related to these international purchase transactions were not significant to us during year-to-date 2009 and year-to-date 2008. Since we pay for the majority of our international purchases in U.S. dollars, however, a decline in the U.S. dollar relative to other foreign currencies would subject us to risks associated with increased purchasing costs from our vendors in their effort to offset any lost profits associated with any currency devaluation. We cannot predict with certainty the effect these increased costs may have on our financial statements or results of operations.

In addition, as of August 2, 2009, we have 17 retail stores in Canada and limited sourcing operations in both Europe and Asia, each of which expose us to market risk associated with foreign currency exchange rate fluctuations. Although these exchange rate fluctuations have not been material to us in the past, we may enter into foreign currency contracts in the future to minimize any currency remeasurement risk associated with the intercompany assets and liabilities of our subsidiaries. We did not enter into any foreign currency contracts during year-to-date 2009 or year-to-date 2008.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of August 2, 2009, an evaluation was performed by management, with the participation of our Chief Executive Officer (CEO) and our Executive Vice President, Chief Operating and Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow timely discussions regarding required disclosures, and that such information is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

Changes in Internal Control Over Financial Reporting

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

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

A description of the risks and uncertainties associated with our business is set forth below. You should carefully consider such risks and uncertainties, together with the other information contained in this report and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled Management s Discussion and Analysis of Financial Condition and Results of

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Operations and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.

The recent changes in general economic conditions, and the resulting impact on consumer confidence and consumer spending, could continue to adversely impact our results of operations.

Our financial performance is subject to changes in general economic conditions and the impact of such economic conditions on levels of consumer confidence and consumer spending. Recently, consumer confidence and consumer spending have deteriorated significantly, and could remain depressed for an extended period of time. Consumer purchases of discretionary items, including our merchandise, generally decline during periods where disposable income is adversely affected, unemployment rates increase or there is economic uncertainty. The current economic environment could cause our vendors to go out of business or our banks to discontinue lending us or our vendors money or it could cause us to undergo additional restructurings, any of which would adversely impact our business and operating results.

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

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

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

Our success depends, in large part, upon our ability to identify and analyze factors affecting our business and to anticipate and respond in a timely manner to changing merchandise trends and customer demands. For example, in the specialty home products business, style and color trends are constantly evolving. Consumer preferences cannot be predicted with certainty and may change between selling seasons. Changes in customer preferences and buying trends may also affect our brands differently. We must be able to stay current with preferences and trends in our brands and address the customer tastes for each of our target customer demographics. We must also be able to identify and adjust the customer offerings in our brands to cater to customer demands. For example, a change in customer preferences for children s room furnishings may not correlate to a similar change in buying trends for other home furnishings. If we misjudge either the market for our merchandise or our customers purchasing habits, our sales may decline significantly, and we may be required to mark down certain products to sell the resulting excess inventory or to sell such inventory through our outlet stores or other liquidation channels at prices which are significantly lower than our retail prices, either of which would negatively impact our business and operating results.

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

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

The specialty retail and direct-to-customer business is highly competitive. Our specialty retail stores, direct mail catalogs and e-commerce websites compete with other retail stores, other direct mail catalogs and other e-commerce websites that market lines of merchandise similar to ours. We compete with national, regional and local businesses utilizing a similar retail store strategy, as well as traditional furniture stores, department stores and specialty stores. The substantial sales growth in the direct-to-customer industry within the last decade has encouraged the entry of many new competitors and an increase in competition from established companies. In addition, the decline in the global economic environment has led to increased competition from discount retailers selling similar products at reduced prices. The competitive challenges facing us include:

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

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

We depend on key domestic and foreign agents and vendors for timely and effective sourcing of our merchandise, and we may not be able to acquire products in sufficient quantities and at acceptable prices to meet our needs which would impact our operations and financial results.

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

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

In addition, we are subject to certain risks, including availability of raw materials, labor disputes, union organizing activities, vendor financial liquidity, inclement weather, natural disasters, and general economic and political conditions that could limit our vendors ability to provide us with quality merchandise on a timely basis and at a price that is commercially acceptable. For these or other reasons, one or more of our vendors might not adhere to our quality control standards, and we might not identify the deficiency before merchandise ships to our stores or customers. In addition, our vendors may have difficulty adjusting to our changing demands and growing business. Our vendors failure to manufacture or import quality merchandise in a timely and effective manner could damage our reputation and brands, and could lead to an increase in customer litigation against us and an attendant increase in our routine litigation costs. Further, any merchandise that we receive, even if it meets our quality standards, could become subject to a recall, which would damage our reputation and brands, and harm our business. Recently enacted legislation has given the U.S. Consumer Product Safety Commission increased regulatory and enforcement power, particularly with regard to children s safety. As a result, companies like ours are recalling more products and incurring recall-related expenses. For example, in the second quarter of fiscal 2009, our Pottery Barn Kids brand incurred a $3,000,000 charge to earnings before income taxes from a voluntary product recall.

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

In fiscal 2008, we sourced our products from vendors in 42 countries outside of the United States. Approximately 59% of our merchandise purchases were foreign-sourced, predominantly from Asia. Our dependence on foreign vendors means that we may be affected by changes in the value of the U.S. dollar relative to other foreign currencies, as well as increases in the cost of living in the vendors local countries due to the economic slowdown. For example, any upward valuation in the Chinese yuan, the euro, or any other foreign currency against the U.S. dollar may result in higher costs to us for those goods. In addition, an increase in the cost of living in the foreign countries in which our vendors operate may result in an increase in our costs or in our vendors going out of business. In fiscal 2009, although approximately 97% of our foreign purchases of merchandise are negotiated and paid for in U.S. dollars, declines in foreign currencies and currency exchange rates might negatively affect the profitability and business prospects of one or more of our foreign vendors. This, in turn, might cause such foreign vendors to demand higher prices for merchandise in their effort to offset any lost profits associated with any currency devaluation, delay merchandise shipments to us, or discontinue selling to us, any of which could ultimately reduce our sales or increase our costs.

We are also subject to other risks and uncertainties associated with changing economic and political conditions in foreign countries. These risks and uncertainties include import duties and quotas, compliance with anti-dumping regulations, work stoppages, economic uncertainties and adverse economic conditions (including inflation and recession), foreign government regulations, employment matters, wars and fears of war, political unrest, natural disasters 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, an economic downturn in or failure of foreign markets may result in financial instabilities for our foreign vendors, which may cause our foreign vendors to decrease production, discontinue selling to us, or to cease operations altogether. Our overseas operations in Europe and

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Asia could also be affected by changing economic and political conditions in foreign countries, any of which could have a negative effect on our business, financial condition and operating results.

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

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

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

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 or close existing stores successfully will depend upon a number of factors, including:

- general economic conditions;
- our identification of, and the availability of, suitable store locations;
- our success in negotiating new leases or terminating existing leases on acceptable terms;
- the success of other retail stores in and around our retail locations;
- our ability to secure required governmental permits and approvals;
- our hiring and training of skilled store operating personnel, especially management; and
- the availability of financing on acceptable terms, if at all
- the financial stability of our landlords and potential landlords

Many of these factors are beyond our control. For example, for the purpose of identifying suitable store locations, we rely, in part, on demographic surveys regarding location of consumers in our target market segments. While we believe that the surveys and other relevant information are helpful indicators of suitable store locations, we recognize that these information sources cannot predict future consumer preferences and buying trends with complete accuracy. In addition, changes in demographics, in the types of merchandise that we sell and in the pricing of our products may reduce the number of suitable store locations. Further, time frames for lease negotiations and store development vary from location to location and can be subject to unforeseen delays. 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. Additionally, in these economic times, we may not be able to renegotiate the terms of our current leases or close our underperforming stores, both of which could negatively impact our operating results.

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

The success of our business depends on our ability to timely and effectively deliver merchandise to our stores and customers. We cannot control all of the various factors that might affect our fulfillment rates in direct-to-customer sales and timely and effective merchandise delivery to our stores. We rely upon third party carriers for our merchandise shipments and reliable data regarding the timing of those shipments, including shipments to our

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customers and to and from all of our stores. In addition, we are heavily dependent upon two carriers for the delivery of our merchandise to our customers. Accordingly, we are subject to the risks, including labor disputes, union organizing activity, inclement weather, natural disasters, the closure of their offices or a reduction in operational hours due to an economic slowdown 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 been volatile and airline and other transportation companies struggle to operate profitably, which could lead to increased fulfillment expenses. Any fulfillment costs could negatively affect our business and operating results by increasing our transportation costs and decreasing the efficiency of our shipments.

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

Our direct-to-customer business depends on our ability to maintain efficient and uninterrupted order-taking and fulfillment operations in our call centers and on our e-commerce websites. Disruptions or slowdowns in these areas could result from disruptions in telephone service or power outages, inadequate system capacity, system issues, computer viruses, security breaches, human error, changes in programming, union organizing activity, disruptions in our third party labor contracts, natural disasters or adverse weather conditions. Industries that are particularly seasonal, such as the home furnishings business, face a higher risk of harm from operational disruptions during peak sales seasons. These problems could result in a reduction in sales as well as increased selling, general and administrative expenses.

In addition, we face the risk that we cannot hire enough qualified employees, 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 and harm our operating results.

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

Declines in our comparable store sales may harm our operating results and cause a decline in the market price of our common stock.

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

Our comparable store sales have fluctuated significantly in the past on an annual, quarterly and monthly basis, and we expect that comparable store sales will continue to fluctuate in the future. Past comparable store sales are no indication of future results. Comparable store sales have decreased in the past and are expected to continue to decrease in fiscal 2009. Our ability to improve our comparable store sales results depends, in large part, on maintaining and improving our forecasting of customer demand and buying trends, selecting effective marketing techniques, 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.

Catalog mailings are an important component of our business. Postal rate increases, paper costs, printing costs and other catalog distribution costs affect the cost of our catalog mailings. We rely on discounts from the basic postal rate structure, which could be changed or discontinued at any time. Our cost of paper has fluctuated significantly during the past three fiscal years, and our paper costs may continue to fluctuate in the future. Future increases in postal rates, paper costs or printing costs would have a negative impact on our operating results to the extent that we are unable to offset such increases by raising prices or by implementing more efficient printing, mailing, delivery and order fulfillment systems. In addition, if the performance of our catalogs declines or we misjudge the correlation between our catalog circulation and net sales, or if our catalog circulation optimization strategy overall is not successful, our results of operations could be negatively impacted.

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, the sizing and timing of delivery of the catalogs as well as the general retail sales environment and current domestic and global economic conditions. In addition, environmental organizations and other consumer advocacy groups may attempt to create an unfavorable impression of our paper use in catalogs and our distribution of catalogs generally, which may have a negative effect on our sales and our reputation. In addition, we depend upon external vendors to print our catalogs. The failure to effectively produce or distribute our catalogs could affect the timing of catalog delivery. The timing of catalog delivery has been and can be affected by postal service delays. Any delays in the timing of catalog delivery could cause customers to forego or defer purchases.

If we are unable to effectively manage our Internet business, our reputation and operating results may be harmed.

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

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

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

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

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.

If we are unable to introduce new brands and brand extensions successfully, or to reposition existing brands, we may not be able to grow our business.

We have in the past and may in the future introduce new brands and brand extensions, or reposition existing brands. Our newest brands West Elm, PBteen and Williams-Sonoma Home and any other new brands, however, may not be successful growth vehicles. Further, if we devote time and resources to new brands, brand extensions or brand repositioning, and those businesses are not as successful as we planned, then we risk damaging our overall business results. Alternatively, if our new brands, brand extensions or repositioned brands 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 increase our expenses and have a negative impact on our business.

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

Our inability or failure to protect our intellectual property would have a negative impact on our brands, goodwill and operating results.

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. In industries in which many competitors market and sell similar products, protection of intellectual property and maintenance of distinct branding are particularly important. We may not be able to adequately protect our intellectual property. In addition, the costs of defending our intellectual property may adversely affect our operating results.

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

We are involved in lawsuits, claims and proceedings incident to the ordinary course of our business. Litigation is inherently unpredictable. Any claims against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources. There are an increasing number of cases being filed against companies generally, including a growing number of business method patent infringement lawsuits. There has also been a rise in lawsuits against companies like us that collect personal information from customers. In addition, there has been an increase in lawsuits alleging violations of the California labor laws against companies with large numbers of California-based employees, especially retailers. The cost of defending claims against us or the ultimate resolution of such claims may harm our business and operating results. In addition, the significant deterioration in the global financial markets can create a more litigious environment and therefore subjects us to increased exposure to shareholder lawsuits.

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

To be successful, we need to manage our operating costs and continue to look for opportunities to reduce costs. We recognize that we may need to increase the number of our employees, especially during peak sales seasons, and incur other expenses to support new brands and brand extensions, as well as the opening of new stores and direct-to-customer growth of our existing brands. Alternatively, if we are unable to make substantial adjustments to our cost structure during times of uncertainty, such as this current economic environment, we may incur unnecessary expenses, may have too few resources to properly run our business, or our business and operating results may be negatively impacted. From time to time, we may also experience union organizing activity in currently non-union facilities. Union organizing activity may result in work slowdowns or stoppages and higher labor costs. In addition, there appears to be a growing number of wage-and-hour lawsuits against retail companies, especially in California.

We contract with various agencies to provide us with qualified personnel for our workforce. Any negative publicity regarding these agencies, such as in connection with immigration issues or employment practices, could damage our reputation, disrupt our ability to obtain needed labor or result in financial harm to our business, including the potential loss of business-related financial incentives in the jurisdictions where we operate.

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

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

Our success depends, in part, on our ability to source and distribute merchandise efficiently through appropriate systems and procedures. We are in the process of substantially modifying our information technology systems which 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 could affect our ability to get the correct products into the appropriate stores and delivered to customers. We may not successfully launch these new systems, or the launch of such systems may result in disruptions to our business operations. In addition, changes to any of our software implementation strategies could result in the impairment of software-related assets. We are also subject to the risks associated with the ability of our vendors to provide information technology solutions to meet our needs. Any disruptions could negatively impact our business and operating results.

We outsource certain aspects of our business to third party vendors and are in the process of in sourcing certain business functions from third party vendors, both of which subject us to risks, including disruptions in our business and increased costs.

We outsource certain aspects of our business to third party vendors that subject us to risks of disruptions in our business as well as increased costs. For example, we utilize outside vendors for such things as payroll processing and various information technology and distribution center services. Accordingly, we are subject to the risks associated with their ability to successfully provide the necessary services to meet our needs. If our vendors are unable to adequately protect our data and information is lost, our ability to deliver our services is interrupted, or our vendors fees are more than expected, then our business and operating results may be negatively impacted.

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

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

We have entered into a franchise agreement with an unaffiliated franchisee to operate stores in the Middle East. Under this agreement, a third party will operate stores that sell goods purchased from us under our brand names. We have no prior experience operating through these types of third party arrangements, and this arrangement may not be successful. The administration of this relationship may divert management attention and require more resources than we expect. While we expect that this will be a small part of our business in the near future, if successful, we plan to continue to increase the number of stores and countries in which these franchises operate as part of our efforts to expand internationally. The effect of these arrangements on our business and results of operations is uncertain and will depend upon various factors, including the demand for our products in new markets internationally. In addition, certain aspects of these arrangements are not directly in our control, such as the ability of this third party to meet their projections regarding store openings and sales. Moreover, while the agreement we have entered into may provide us with certain termination rights, to the extent that this third party does not operate their stores in a manner consistent with our requirements regarding our brand identities and customer experience standards, the value of our brands could be impaired. Failure to protect the value of our

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brands could have an adverse effect on our results of operations.

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

We provide extensive public guidance on our expected operating and financial results for future periods. Although we believe that this guidance provides investors and analysts with a better understanding of management s expectations for the future and is useful to our shareholders and potential shareholders, such guidance is comprised of forward-looking statements subject to the risks and uncertainties described in this report and in our other public filings and public statements. Our actual results may not always be in line with or exceed the guidance we have provided, especially in times of great economic uncertainty. In the past, when we have reduced our previously provided guidance, the market price of our common stock has declined. If, in the future, our operating or financial results for a particular period do not meet our guidance or the expectations of investment analysts or if we reduce our guidance for future periods, the market price of our common stock may decline as well.

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

Our quarterly results have fluctuated in the past and may fluctuate in the future, depending upon a variety of factors, including shifts in the timing of holiday selling seasons, including Valentine s Day, Easter, Halloween, Thanksgiving and Christmas. A significant portion of our revenues and net earnings has been realized during the period from October through December each year. In anticipation of increased holiday sales activity, we incur certain significant incremental expenses prior to and during peak selling seasons, particularly October through December, including fixed catalog production and mailing costs and the costs associated with hiring a substantial number of temporary employees to supplement our existing workforce. For example, we realized significantly lower-than-expected revenues and net earnings during the October through December selling season of fiscal 2008 due to the economic downturn, which affected our business, operating results and stock price.

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

We regularly review and evaluate our liquidity and capital needs. We currently believe that our available cash, cash equivalents, 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, we might experience periods during which we encounter additional cash needs during the course of our fiscal year, and we might need additional external funding to support our operations. Although we were able to amend our line of credit facility during fiscal 2008 on acceptable terms, in the event we require additional liquidity from our lenders, such funds may not be available to us or may not be available to us on acceptable terms. For example, in the event we were to breach any of our financial covenants, our banks would not be required to provide us with additional funding, or they may require us to renegotiate our existing credit facility on less acceptable terms. In addition, we may not be able to renew our letters of credit that we use to help pay our suppliers on terms that are acceptable to us, or at all, as the availability of letter of credit facilities may continue to be limited. Further, the providers of such credit may reallocate the available credit to other borrowers. If we are unable to access credit at the levels we require, or the cost of credit is greater than expected, it could adversely affect our operating results.

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

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

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

Our current quarterly cash dividend is $0.12 per common share. The dividend program requires the use of a significant portion of our cash earnings. As a result, we may not retain a sufficient amount of cash to fund our operations or finance future growth opportunities, new product development initiatives and unanticipated capital expenditures. Our Board of Directors may, at its discretion, decrease the intended level of dividends or entirely discontinue the payment of dividends at any time. Our ability to pay dividends will depend on our ability to generate sufficient cash flows from operations in the future. This ability may be subject to certain economic, financial, competitive and other factors that are beyond our control. Any failure to pay dividends 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.

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

We have evaluated and tested our internal controls in order to allow management to report on, and our registered independent public accounting firm to attest to, our internal controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002. 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 our business and the perception of us in the financial markets. 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 operating results.

Changes to existing accounting rules or regulations may impact our future operating results. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective. The introduction of new accounting rules or regulations and varying interpretations of existing accounting rules or regulations have occurred and may occur in the future. Future changes to accounting rules or regulations or the questioning of current accounting practices may adversely affect our operating results.

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

We make certain estimates and projections in connection with impairment analyses for certain of our store locations and other property and equipment, including information technology systems, in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. These impairment analyses require that we review for impairment all stores for which current or projected 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

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value of the asset exceeds the undiscounted future cash flows over the remaining life of the lease. These calculations require us to make a number of estimates and projections of future results, 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, including information technology systems. These impairment charges have been significant in the past and may be in the future and, as a result of these charges, our operating results have been and may be adversely affected. For example, during fiscal 2008 and year-to-date 2009, we recorded impairment charges related to underperforming retail stores.

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

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

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

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

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

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

In addition, our main offices are located in the San Francisco Bay Area, where competition for personnel with retail and technology skills can be intense. If we fail to identify, attract, retain and motivate these skilled personnel, especially in this challenging economic environment, our business may be harmed. Further, in the event we need to hire additional personnel, we may experience difficulties in attracting and successfully hiring such individuals due to competition for highly skilled personnel as well as the significantly higher cost of living expenses in our market.

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

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

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

Our Annual Meeting of Shareholders was held on May 22, 2009. 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 successor is elected and qualified:

Name	For	Withheld
W. Howard Lester	97,498,123	2,760,733
Adrian D.P. Bellamy	80,918,801	19,340,055
Patrick J. Connolly	99,237,333	1,021,523
Adrian T. Dillon	99,265,876	992,980
Anthony A. Greener	80,964,305	19,294,551
Ted W. Hall	81,002,477	19,256,379
Michael R. Lynch	99,247,453	1,011,403
Richard T. Robertson	81,011,206	19,247,650
David B. Zenoff	99,245,129	1,013,727

(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 January 31, 2010:

For	Against	Abstain	Broker Non-Vote
98,216,727	1,573,682	468,447	0

(III) The shareholders did not approve, by the vote indicated, a shareholder proposal recommending that the Board of Directors adopt a policy to appoint, whenever possible, an independent director who has not previously served as one of our executive officers to serve as Chairman:

For	Against	Abstain	Broker Non-Vote
29,876,576	50,177,293	91,299	20,113,688

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ITEM 6. EXHIBITS

(a) Exhibits

Exhibit Number	Exhibit Description
10.1	Form of Williams-Sonoma, Inc. Indemnification 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 11, 2009