KIRKLAND'S, INC
Form 10-Q
September 06, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended July 28, 2012,

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: 000-49885

KIRKLAND S, INC.

(Exact name of registrant as specified in its charter)

Tennessee	**62-1287151**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
2501 McGavock Pike, Suite 1000	
Nashville, Tennessee	**37214**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (615) 872-4800

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 x 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 x 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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Stock, no par value 17,061,605 shares outstanding as of August 22, 2012.

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KIRKLAND S, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	July 28, 2012 (Unaudited)	January 28, 2012	July 30, 2011 (Unaudited)
ASSETS			
Current assets:			
Cash and cash equivalents	$ 49,614	$ 83,123	$ 75,106
Inventories, net	49,773	47,306	47,656
Income taxes receivable	3,727		3,880
Deferred income taxes	1,635	1,657	3,274
Prepaid expenses and other current assets	10,138	7,784	9,283
Total current assets	114,887	139,870	139,199
Property and equipment, net	68,840	60,315	51,940
Non-current deferred income taxes	1,086	1,108	1,394
Other assets	1,425	1,296	847
Total assets	$ 186,238	$ 202,589	$ 193,380
LIABILITIES AND SHAREHOLDERS EQUITY			
Current liabilities:			
Accounts payable	$ 22,583	$ 21,592	$ 17,011
Income taxes payable		3,146	
Accrued expenses	20,772	21,805	21,527
Total current liabilities	43,355	46,543	38,538
Deferred rent	35,545	34,311	27,690
Other liabilities	4,614	4,073	4,309
Total liabilities	83,514	84,927	70,537
Shareholders equity:			
Common stock, no par value; 100,000,000 shares authorized; 17,061,615; 18,360,739; and 20,216,076 shares issued and outstanding at July 28, 2012, January 28, 2012, and July 30, 2011, respectively	152,055	150,352	148,611
Accumulated deficit	(49,331)	(32,690)	(25,768)
Total shareholders equity	102,724	117,662	122,843
Total liabilities and shareholders equity	$ 186,238	$ 202,589	$ 193,380

The accompanying notes are an integral part of these financial statements.

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KIRKLAND S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(in thousands, except per share data)

	13-Week Period Ended		26-Week Period Ended	
	July 28, 2012	July 30, 2011	July 28, 2012	July 30, 2011
Net sales	$ 91,004	$ 89,701	$ 188,792	$ 184,104
Cost of sales (exclusive of depreciation as shown below)	61,010	58,856	120,329	115,171
Gross profit	29,994	30,845	68,463	68,933
Operating expenses:				
Compensation and benefits	18,733	17,565	38,029	36,359
Other operating expenses	12,008	11,187	24,996	22,074
Depreciation	3,205	2,733	6,220	5,974
Total operating expenses	33,946	31,485	69,245	64,407
Operating income (loss)	(3,952)	(640)	(782)	4,526
Interest expense, net	67	36	147	70
Other income, net	(45)	(78)	(128)	(75)
Income (loss) before income taxes	(3,974)	(598)	(801)	4,531
Income tax expense (benefit)	(1,977)	(118)	(759)	1,841
Net income (loss)	$ (1,997)	$ (480)	$ (42)	$ 2,690
Earnings (loss) per share:				
Basic	$ (0.11)	$ (0.02)	$ (0.00)	$ 0.13
Diluted	$ (0.11)	$ (0.02)	$ (0.00)	$ 0.13
Weighted average shares for basic earnings (loss) per share:	17,470	19,957	17,869	19,936
Effect of dilutive stock equivalents				709
Adjusted weighted average shares for diluted earnings (loss) per share	17,470	19,957	17,869	20,645

The accompanying notes are an integral part of these financial statements.

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KIRKLAND S, INC.

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)

(in thousands, except share data)

	Common Stock Shares	Common Stock Amount	Accumulated Deficit	Total Shareholders Equity
Balance at January 28, 2012	18,360,739	$ 150,352	$ (32,690)	$ 117,662
Exercise of employee stock options and employee stock purchases	90,176	150		150
Tax benefit from exercise of stock options		120		120
Net share settlement of stock options	(27,402)			
Stock-based compensation expense		1,456		1,456
Repurchase and retirement of common stock	(1,361,898)	(23)	(16,599)	(16,622)
Net loss			(42)	(42)
Balance at July 28, 2012	17,061,615	$ 152,055	$ (49,331)	$ 102,724

The accompanying notes are an integral part of these financial statements.

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KIRKLAND S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands)

	26-Week Period Ended	
	July 28, 2012	**July 30, 2011**
Cash flows from operating activities:		
Net income (loss)	$ (42)	$ 2,690
Adjustments to reconcile net income (loss) to net cash used in operating activities: Depreciation of property and equipment	6,220	5,974
Amortization of landlord construction allowances	(2,167)	(2,662)
Amortization of debt issue costs	38	12
Loss on disposal of property and equipment	41	128
Cash received for landlord construction allowances	2,309	3,093
Stock-based compensation expense	1,456	1,649
Excess tax benefits from exercise of stock options and restricted stock	(120)	(1,124)
Deferred income taxes	44	300
Changes in assets and liabilities:		
Inventories, net	(2,467)	(3,204)
Prepaid expenses and other current assets	(1,076)	(1,815)
Other noncurrent assets	(160)	(123)
Accounts payable	991	(3,225)
Income taxes refundable/payable	(6,753)	(4,045)
Accrued expenses and other current and noncurrent liabilities	(678)	(3,254)
Net cash used in operating activities	(2,364)	(5,606)
Cash flows from investing activities:		
Capital expenditures	(14,786)	(11,811)
Net cash used in investing activities	(14,786)	(11,811)
Cash flows from financing activities:		
Refinancing costs	(7)	
Excess tax benefits from exercise of stock options and restricted stock	120	1,124
Exercise of stock options and employee stock purchases	150	177
Repurchase and retirement of common stock	(16,622)	
Net cash provided by (used in) financing activities	(16,359)	1,301
Cash and cash equivalents:		
Net decrease	(33,509)	(16,116)
Beginning of the period	83,123	91,222
End of the period	$ 49,614	$ 75,106

The accompanying notes are an integral part of these financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 Basis of Presentation

Kirkland s, Inc. (the Company) is a specialty retailer of home décor and gifts with 302 stores in 30 states as of July 28, 2012. The condensed consolidated financial statements of the Company include the accounts of Kirkland s, Inc. and its wholly-owned subsidiaries, Kirkland s Stores, Inc., Kirkland s DC, Inc., Kirkland s Texas, LLC, and Kirklands.com, LLC. Significant intercompany accounts and transactions have been eliminated.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. These financial statements should be read in conjunction with the audited financial statements included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 12, 2012.

It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than those at fiscal year-end. In addition, because of seasonality factors, the results of the Company s operations for the 13-week period ended July 28, 2012 are not indicative of the results to be expected for any other interim period or for the entire fiscal year. The Company s fiscal year ends on the Saturday closest to January 31, resulting in years of either 52 or 53 weeks. All references to a fiscal year refer to the fiscal year ending on the Saturday closest to January 31 of the following year.

The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from the estimates and assumptions used.

Changes in estimates are recognized in the period when new information becomes available to management. Areas where the nature of the estimate makes it possible that actual results could materially differ from amounts estimated include: impairment assessments on long-lived assets, inventory reserves, self-insurance reserves, income tax liabilities, stock-based compensation, gift card breakage, customer loyalty program accruals and contingent liabilities.

Note 2 Income Taxes

An estimate of the annual effective tax rate is used at each interim period based on the facts and circumstances available at that time, while the actual effective tax rate is calculated at year-end. For the 13-week period ended July 28, 2012, the Company recorded an income tax benefit of 49.7% of the loss before income taxes. In the prior year period, the Company recorded income tax benefit of 19.7% of the loss before income taxes. The increase in the rate reflects approximately $400,000 of federal and state employment tax credits received in the second quarter of 2012 that related to prior years and in excess of our previous estimates. For the 26-week period ended July 28, 2012, the Company recorded an income tax benefit of 94.8% of the pre-tax loss. In the prior year period, the Company recorded income tax expense of 40.6% of pre-tax income.

Note 3 Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding during each period presented, which excludes non-vested restricted stock units. Diluted earnings per share is computed by dividing net income by the weighted average number of shares outstanding plus the dilutive effect of stock equivalents outstanding during the applicable periods using the treasury stock method. Diluted earnings per share reflects the potential dilution that could occur if options to purchase stock were exercised into common stock. Stock options that were not included in the computation of diluted earnings per share because to do so would have been antidilutive were 1.6 million and 1.9 million shares for the 13-week periods ended July 28, 2012, and July 30, 2011, and 1.6 million and approximately 342,000 for the 26-week periods ended July 28, 2012, and July 30, 2011, respectively.

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Note 4 Commitments and Contingencies

The Company is party to pending legal proceedings and claims. Although the outcome of such proceedings and claims cannot be determined with certainty, the Company s management is of the opinion that it is unlikely that these proceedings and claims in excess of insurance coverage will have a material effect on the financial condition, operating results or cash flows of the Company.

Note 5 Stock-Based Compensation

The Company maintains equity incentive plans under which it may grant non-qualified stock options, incentive stock options, restricted stock, restricted stock units, or stock appreciation rights to employees, non-employee directors and consultants.

The Company granted 175,000 stock options and 94,000 restricted stock units during the 13-week and 26-week periods ended July 28, 2012. This compares to 172,500 stock options and 89,000 restricted stock units granted in the 13-week and 26-week periods ended July 30, 2011. Total stock-based compensation expense (a component of compensation and benefits) was $663,000 for the 13-week period ended July 28, 2012, and $1.5 million for the 26-week period ended July 28, 2012, compared to $900,000 and $1.6 million, respectively, for the comparable prior year periods. Compensation expense is recognized on a straight-line basis over the vesting periods of each grant. There have been no material changes in the assumptions used to compute compensation expense during the current quarter.

Note 6 Stock Repurchase Program

On August 19, 2011, the Company announced that its Board of Directors authorized a stock repurchase plan providing for the purchase in the aggregate of up to $40 million of the Company s outstanding common stock from time to time until February 2013. Through July 28, 2012, the Company repurchased and retired a total of approximately 3.4 million shares at an aggregate cost of $40 million, completing the repurchase authorization.

Note 7 Related Party Transactions

In July 2009, the Company entered into an agreement with a related party vendor to purchase merchandise inventory. The vendor is considered a related party for financial reporting purposes because its principal is the spouse of the Company s Vice President of Merchandising. During the second quarter of fiscal 2012 and 2011, purchases from this vendor totaled approximately $5.6 million, or 11% of total merchandise purchases, and $5.4 million, or 11% of merchandise purchases, respectively. During the first half of fiscal 2012 and fiscal 2011, purchases from this vendor totaled approximately $11.4 million, or 12% of total merchandise purchases, and $9.8 million, or 11% of total merchandise purchases, respectively. Included in cost of sales for the second quarter of fiscal 2012 and 2011 were $5.8 million and $4.8 million, respectively, related to this vendor. Included in cost of sales for the first half of fiscal 2012 and 2011 were $11.6 million and $9.4 million, respectively related to this vendor. Payable amounts outstanding to this vendor were approximately $1.7 million and $1.4 million as of July 28, 2012 and July 30, 2011, respectively. The Company s payable terms with this vendor are consistent with the terms offered by other vendors in the ordinary course of business.

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

Forward Looking Statements

This Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to provide an understanding of our financial condition, change in financial condition, cash flow, liquidity and results of operations. The following MD&A discussion should be read in conjunction with the condensed consolidated financial statements and notes to those statements that appear elsewhere in this Form 10-Q and in the Company s Annual Report on Form 10-K, filed April 12, 2012. The following discussion contains forward-looking statements that reflect the Company s plans, estimates and beliefs. The Company s actual results could differ materially from those discussed or referred to in the forward-looking statements. Factors that could cause or contribute to any differences include, but are not limited to, those discussed under the caption Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995 and under Part II, Item 1A Risk Factors .

General

We are a specialty retailer of home décor and gifts in the United States, operating 302 stores in 30 states as of July 28, 2012. Our stores present a broad selection of distinctive merchandise, including framed art, mirrors, wall décor, candles and

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related items, lamps, decorative accessories, accent furniture, textiles, garden-related accessories and artificial floral products. Our stores also offer an extensive assortment of holiday merchandise during seasonal periods as well as items carried throughout the year suitable for gift-giving. In addition, we use innovative design and packaging to market home décor items as gifts. We provide our predominantly female customers an engaging shopping experience characterized by a diverse, ever-changing merchandise selection at prices which provide discernable value to the customer. Our stores offer a unique combination of style and value that has led to our emergence as a leader in home décor and has enabled us to develop a strong customer franchise.

During the 13-week period ended July 28, 2012, we opened 10 new stores and closed 5 stores. The following table summarizes our stores and square footage under lease:

	As of July 28, 2012	As of July 30, 2011
Number of stores	302	294
Square footage	2,130,577	1,954,095
Average square footage per store	7,055	6,647

13-Week Period Ended July 28, 2012 Compared to the 13-Week Period Ended July 30, 2011

Results of operations. The table below sets forth selected results of our operations both in dollars (in thousands) and as a percentage of net sales for the periods indicated:

	13-Week Period Ended					
	July 28, 2012		July 30, 2011		Change	
	$	%	$	%	$	%
Net sales	$ 91,004	100.0%	$ 89,701	100.0%	$ 1,303	1.5%
Cost of sales	61,010	67.0%	58,856	65.6%	2,154	3.7%
Gross profit	29,994	33.0%	30,845	34.4%	(851)	(2.8%)
Operating expenses:						
Compensation and benefits	18,733	20.6%	17,565	19.6%	1,168	6.6%
Other operating expenses	12,008	13.2%	11,187	12.5%	821	7.3%
Depreciation	3,205	3.5%	2,733	3.0%	472	17.3%
Total operating expenses	33,946	37.3%	31,485	35.1%	2,461	7.8%
Operating loss	(3,952)	(4.3%)	(640)	(0.7%)	(3,312)	517.5%
Interest expense, net	67	0.1%	36	0.0%	31	86.2%
Other income, net	(45)	(0.0%)	(78)	(0.1%)	33	(42.3%)
Loss before income taxes	(3,974)	(4.4%)	(598)	(0.7%)	(3,376)	564.6%
Income tax benefit	(1,977)	(2.2%)	(118)	(0.1%)	(1,859)	1,575.5%
Net loss	$ (1,997)	(2.2%)	$ (480)	(0.5%)	$ (1,517)	316.1%

Net sales. Net sales increased 1.5% to $91.0 million for the second fiscal quarter of 2012 compared to $89.7 million for the prior year period. The impact of net new store growth accounted for an increase in sales of $4.2 million. These increases in net sales were offset by a decline in comparable store sales, including E-commerce sales, of 3.6%, accounting for a $2.9 million decline versus the prior year quarter. Comparable store sales decreased 8% in the prior year period. The E-commerce business was up 111% versus the prior year period, while comparable store sales at brick-and-mortar stores was down 5.8%. For brick-and-mortar stores, the comparable store sales decrease for the second quarter of 2012 was primarily due to a decrease in number of transactions, partially offset by an increase in the average ticket. The decrease in transactions resulted from a decline in the conversion rate and a slight decrease in traffic. The increase in the average ticket reflected an increase in items sold per transaction, offset partially by a slight decline in average retail selling price. The merchandise categories contributing most to the comparable store sales decline were decorative accessories, wall décor, textiles and frames.

Gross profit. Gross profit as a percentage of total revenue decreased from 34.4% in the second quarter of 2011 to 33.0% in the second quarter of 2012. Merchandise margins decreased from 50.4% in the second quarter of fiscal 2011 to 49.7% in the second quarter of fiscal 2012. Merchandise margin is calculated as net sales minus product cost of sales. Merchandise margin excludes outbound freight, store occupancy and central distribution costs. The decrease in merchandise margin was primarily the result of higher promotional activity and increased markdowns. Store occupancy costs as a percentage of net sales increased 0.2%. This increase resulted from the decline in comparable store sales. Outbound freight costs and central distribution expenses increased as a percentage of sales primarily due to an increase in shipping and packaging costs associated with E-commerce, as well as comparable store sales deleverage.

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Compensation and benefits. At the store-level, the compensation and benefits expense ratio increased slightly over the prior year period primarily due to the negative comparable store sales performance. At the corporate level, the compensation and benefits ratio increased over the prior year period primarily due to reversal of a corporate management bonus accrual estimate in the second quarter of fiscal 2011.

Other operating expenses. Other operating expenses increased as a percentage of net sales versus the prior year period due to increases in marketing and information technology expenses, as well as deleverage due to the decline in comparable store sales.

Depreciation. The increase in depreciation as a percentage of sales reflects an increase in capital expenditures during the last two fiscal years.

Income tax expense. We recorded an income tax benefit of approximately $2.0 million, or 49.7% of pre-tax loss during the second quarter of fiscal 2012, versus a benefit of approximately $118,000, or 19.7% of pre-tax loss, in the prior year quarter. During the second quarter of 2012, we recorded state and federal employment tax credits totaling approximately $400,000 that related to prior year periods and in excess of our previous estimates.

Net income and earnings per share. As a result of the foregoing, we reported a net loss of $2.0 million, or $0.11 per diluted share, for the second quarter of fiscal 2012 as compared to net loss of $0.5 million, or $0.02 per diluted share, for the second quarter of fiscal 2011.

26-Week Period Ended July 28, 2012 Compared to the 26-Week Period Ended July 30, 2011

Results of operations. The table below sets forth selected results of our operations in dollars and expressed as a percentage of net sales for the periods indicated (dollars in thousands):

	26-Week Period Ended					
	July 28, 2012		July 30, 2011		Change	
	$	%	$	%	$	%
Net sales	$ 188,792	100.0%	$ 184,104	100.0%	4,688	2.5%
Cost of sales	120,329	63.7%	115,171	62.6%	5,158	4.5%
Gross profit	68,463	36.3%	68,933	37.4%	(470)	(0.7%)
Operating expenses:						
Compensation and benefits	38,029	20.1%	36,359	19.7%	1,670	4.6%
Other operating expenses	24,996	13.2%	22,074	12.0%	2,922	13.2%
Depreciation	6,220	3.3%	5,974	3.2%	246	4.1%
Total operating expenses	69,245	36.7%	64,407	35.0%	4,838	7.5%
Operating income (loss)	(782)	(0.4%)	4,526	2.5%	(5,308)	(117.3%)
Interest expense, net	147	0.1%	70	0.0%	77	110.0%
Other income, net	(128)	(0.1%)	(75)	(0.0%)	(53)	70.7%
Income (loss) before income taxes	(801)	(0.4%)	4,531	2.5%	(5,332)	(117.7%)
Income tax expense (benefit)	(759)	(0.4%)	1,841	1.0%	(2,600)	(141.2%)
Net income (loss)	$ (42)	(0.0%)	$ 2,690	1.5%	$ (2,732)	(101.6%)

Net sales. Net sales increased 2.5% to $188.8 million for the first half of fiscal 2012 from $184.1 million for the prior year period. The impact of net new store growth accounted for an increase in net sales of $8.7 million. This increase was partially offset by a decline in comparable store sales, including E-commerce sales, of 2.4%, accounting for a $4.0 million decline versus the prior year period. Comparable store sales decreased 8.2% in the prior year period. The E-commerce business was up 106% versus the prior year period, while comparable store sales at brick-and-mortar stores was down 4.4%. For brick-and-mortar stores, the comparable store sales decrease was primarily due to a decline in number of transactions, offset by a slight increase in the average ticket. The decline in transactions resulted from a decline in the conversion rate and slightly lower traffic. The slight increase in average ticket was the result of an increase in items per transaction. Categories contributing most to the comparable store sales decline were wall décor, decorative accessories and frames.

Gross profit. Gross profit as a percentage of total revenue decreased from 37.4% in the first half of fiscal 2011 to 36.3% in the first half of fiscal 2012. Merchandise margins were 52.7% in the first half of fiscal 2012, as well as in the first half of fiscal 2011. Store occupancy costs as a percentage of net sales increased 0.6%. This increase resulted primarily from the decline in comparable stores sales. Outbound freight costs and central distribution expenses also increased as a percentage of sales primarily due to deleverage, an increase in diesel fuel costs, and shipping and packaging costs associated with E-commerce.

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Compensation and benefits. At the store-level, the compensation and benefits expense ratio increased slightly for the first half of fiscal 2012 as compared to the first half of 2011 primarily due to the negative comparable store sales performance. At the corporate level, the compensation and benefits ratio was higher for the first half of 2012 as compared to the first half of 2011 due to increases in insurance and employee benefit costs.

Other operating expenses. Other operating expenses increased as a percentage of net sales for the first half of fiscal 2012 due to increases in marketing and information technology expenses, as well as deleverage due to the decline in comparable store sales.

Depreciation. The increase in depreciation as a percentage of sales versus the prior year period reflects an increase in capital expenditures over the last two fiscal years.

Income tax expense. We recorded income tax benefit of $759,000, or 94.8% of pre-tax loss during the first half of fiscal 2012, versus an expense of approximately $1.8 million, or 40.6% of pre-tax income, during the prior year period. During the second quarter of 2012, we recorded state and federal employment tax credits totaling approximately $400,000 that related to prior year periods and in excess of our previous estimates.

Net income and earnings per share. As a result of the foregoing, we reported a net loss of $42,000, or ($0.00) per diluted share, for the first half of fiscal 2012 as compared to net income of $2.7 million, or $0.13 per share, for the first half of fiscal 2011.

Liquidity and Capital Resources

Our principal capital requirements are for working capital and capital expenditures. Working capital consists mainly of merchandise inventories offset by accounts payable, which typically reach their peak by the end of the third quarter of each fiscal year. Capital expenditures primarily relate to new store openings; existing store expansions, remodels or relocations; and purchases of equipment or information technology assets for our stores, distribution facilities and corporate headquarters. Historically, we have funded our working capital and capital expenditure requirements with internally generated cash and borrowings under our credit facility.

Cash flows from operating activities. Net cash used in operating activities was approximately $2.4 million and $5.6 million for the first half of fiscal 2012 and fiscal 2011, respectively. Cash flows from operating activities depend heavily on operating performance, changes in working capital and the timing and amount of payments for income taxes. The change in the amount of cash used in operations as compared to the prior year period was primarily the result of an increase in the build-up of accounts payable due to the timing of inventory receipts and payments. Additionally, the build-up of inventory balances was lower in first half of fiscal 2012, as compared to fiscal 2011. Finally, corporate management bonus payout contributed to increased cash outlay in the first half of 2011 as compared to the same period in 2012. These factors were offset somewhat by the decline in operating performance as well as an increase in taxes paid to $7.0 million for the first half of fiscal 2012 versus $5.8 million in the prior year period.

Inventory levels at the end of the second quarter of fiscal 2012 were $49.8 million, an increase of $2.1 million from the second quarter of fiscal 2011. The increase in inventory resulted from E-commerce inventory growth in support of sales expected for the second half of the year, and partly due to lower than expected brick-and-mortar sales for the first half of the year. Inventory levels at brick-and-mortar stores at the end of the second quarter 2012 were down 2% versus the prior year. At the end of the second quarter of 2012, inventory per retail square foot was 7% lower than the end of the same period last year.

Cash flows from investing activities. Net cash used in investing activities for the first half of fiscal 2012 consisted of $14.8 million in capital expenditures as compared to $11.8 million in capital expenditures for the prior year period. The capital expenditures primarily related to new store construction, information technology projects, and store improvements. During the first half of fiscal 2012, we opened 15 stores compared to 10 stores during the first half of fiscal 2011. We expect that capital expenditures for fiscal 2012 will be approximately $29 to $32 million, primarily to fund the leasehold improvements of new stores, make improvements in our information technology infrastructure, and maintain our investments in existing stores and our distribution center.

Cash flows from financing activities. Net cash used in financing activities was approximately $16.4 million for the first half of fiscal 2012, and was primarily related to the repurchase and retirement of common stock. Net cash provided by financing activities was approximately $1.3 million for the first half of fiscal 2011, and related to the exercise of employee stock options, employee stock purchases, and the related tax benefits.

Revolving credit facility. On August 19, 2011, we entered into an Amended and Restated Credit Agreement, dated as of August 19, 2011 (the Credit Agreement), with Bank of America, N.A. as administrative agent and collateral agent, and the lenders named therein (the Lenders), replacing our prior credit agreement entered into in 2004. The Credit Agreement increased our senior secured revolving credit facility from

$45 million to $50 million and extended the maturity date to August 2016. Borrowings under the facility bear interest at an annual rate equal to LIBOR plus a margin ranging from 175 to 225 basis points with no LIBOR floor. Additionally, a fee of 0.375% per annum is assessed on the unused portion of the facility.

Pursuant to the Credit Agreement, borrowings are subject to certain customary conditions and contain customary events of default, including, without limitation, failure to make payments, a cross-default to certain other debt, breaches of covenants, breaches of representations and warranties, a change in control, certain monetary judgments and bankruptcy and ERISA events. Upon any such event of default, the principal amount of any unpaid loans and all other obligations under the Credit Agreement may be declared immediately due and payable. The maximum availability under the facility is limited by a borrowing base formula which consists of a percentage of eligible inventory and eligible credit card receivables, less reserves.

Also on August 19, 2011, we entered into an Amended and Restated Security Agreement, dated as of August 19, 2011 with our Lenders. Pursuant to the Security Agreement, we pledged and granted to the administrative agent, for the benefit of itself and the secured parties specified therein, a lien on and security interest in all of the rights, title and interest in substantially all of our assets to secure the payment and performance of the obligations under the Credit Agreement.

As of July 28, 2012, we were in compliance with the covenants in the facility and there were no outstanding borrowings under the credit facility, with approximately $32 million available for borrowing. We do not anticipate any borrowings under the credit facility during fiscal 2012.

At July 28, 2012, our balance of cash and cash equivalents was approximately $49.6 million and the borrowing availability under our facility was $32 million. We believe that the combination of our cash balances, line of credit availability and cash flow from operations will be sufficient to fund our planned capital expenditures and working capital requirements for at least the next twelve months.

Share repurchase authorization. On August 19, 2011, we announced that our Board of Directors authorized a stock repurchase plan providing for the purchase in the aggregate of up to $40 million of our outstanding common stock from time to time until February 2013. Through July 28, 2012, we repurchased and retired a total of approximately 3.4 million shares at an aggregate cost of $40 million, completing the repurchase authorization.

Related Party Transactions

In July 2009, we entered into an agreement with a related party vendor to purchase merchandise inventory. The vendor is considered a related party for financial reporting purposes because its principal is the spouse of our Vice President of Merchandising. During the second quarter of fiscal 2012 and 2011, purchases from this vendor totaled approximately $5.6 million, or 11% of total merchandise purchases, and $5.4 million, or 11% of merchandise purchases, respectively. During the first half of fiscal 2012 and fiscal 2011, purchases from this vendor totaled approximately $11.4 million, or 12% of total merchandise purchases, and $9.8 million, or 11% of total merchandise purchases, respectively. Included in cost of sales for the second quarter of fiscal 2012 and 2011 were $5.8 million and $4.8 million, respectively, related to this vendor. Included in cost of sales for the first half of fiscal 2012 and 2011 were $11.6 million and $9.4 million, respectively related to this vendor. Payable amounts outstanding to this vendor were approximately $1.7 million and $1.4 million as of July 28, 2012 and July 30, 2011, respectively. Our payable terms with this vendor are consistent with the terms offered by other vendors in the ordinary course of business.

Significant Contractual Obligations and Commercial Commitments

Construction commitments

We had commitments for new store construction projects totaling approximately $1.8 million at July 28, 2012.

Critical Accounting Policies and Estimates

There have been no significant changes to our critical accounting policies during fiscal 2012. Refer to our Annual Report on Form 10-K for the fiscal year ended January 28, 2012, for a summary of our critical accounting policies.

Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995

The following information is provided pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Certain statements under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-Q are forward-looking statements made pursuant to these provisions. Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that

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does not directly relate to any historical or current fact. Words such as should, likely to, forecasts, strategy, goal, anticipates, believes, estimates, intends, plans, projects, and similar expressions, may identify such forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from the results projected in such statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

The factors listed below under the heading Risk Factors and in the other sections of this Form 10-Q provide examples of risks, uncertainties and events that could cause our actual results to differ materially from the expectations expressed in our forward-looking statements.

These forward-looking statements speak only as of the date of this report and, except as required by law, we undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this report.

We caution readers that the following important factors, among others, have in the past, in some cases, affected and could in the future affect our actual results of operations and cause our actual results to differ materially from the results expressed in any forward-looking statements made by us or on our behalf.

If We Do Not Generate Sufficient Cash Flow, We May Not Be Able to Implement Our Growth Strategy.

If We Are Unable to Profitably Open and Operate New Stores, We May Not Be Able to Adequately Execute Our Growth Strategy, Resulting in a Decrease in Net Sales and Net Income.

Our Success Depends Upon our Marketing, Advertising and Promotional Efforts. If We are Unable to Implement Them Successfully, or if Our Competitors are More Effective Than We are, Our Revenue May Be Adversely Affected.

Our Results Could be Negatively Impacted if any of our Primary Brands Suffers a Substantial Impediment to its Reputation Due to Real or Perceived Quality Issues.

Product Liability Claims Could Adversely Affect Our Reputation.

Weather Conditions Could Adversely Affect Our Sales and/or Profitability by Affecting Consumer Shopping Patterns.

Our Performance May Be Affected by General Economic Conditions.

Changes in Accounting and Tax Rules and Regulations May Adversely Affect our Operating Results.

We May Not Be Able to Successfully Anticipate Consumer Trends and Our Failure to Do So May Lead to Loss of Consumer Acceptance of Our Products Resulting in Reduced Net Sales.

Our Freight Costs and thus Our Cost of Goods Sold are Impacted by Changes in Fuel Prices.

New Legal Requirements Could Adversely Affect Our Operating Results.

The Market Price for Our Common Stock Might Be Volatile and Could Result in a Decline in the Value of Your Investment.

Our Comparable Store Net Sales Fluctuate Due to a Variety of Factors.

Failure to Protect the Integrity and Security of Individually Identifiable Data of Our Customers and Employees Could Expose Us to Litigation and Damage Our Reputation.

We Face an Extremely Competitive Specialty Retail Business Market, and Such Competition Could Result in a Reduction of Our Prices and a Loss of Our Market Share.

We Depend on a Number of Vendors to Supply Our Merchandise, and Any Delay in Merchandise Deliveries from Certain Vendors May Lead to a Decline in Inventory Which Could Result in a Loss of Net Sales.

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We Are Dependent on Foreign Imports for a Significant Portion of Our Merchandise, and Any Changes in the Trading Relations and Conditions Between the United States and the Relevant Foreign Countries May Lead to a Decline in Inventory Resulting in a Decline in Net Sales, or an Increase in the Cost of Sales Resulting in Reduced Gross Profit.

Our Success Is Highly Dependent on Our Planning and Control Processes and Our Supply Chain, and Any Disruption in or Failure to Continue to Improve These Processes May Result in a Loss of Net Sales and Net Income.

Our Business Is Highly Seasonal and Our Fourth Quarter Contributes a Disproportionate Amount of Our Net Sales, Net Income and Cash Flow, and Any Factors Negatively Impacting Us During Our Fourth Quarter Could Reduce Our Net Sales, Net Income and Cash Flow, Leaving Us with Excess Inventory and Making It More Difficult for Us to Finance Our Capital Requirements.

We May Experience Significant Variations in Our Quarterly Results.

Our Hardware and Software Systems Are Vulnerable to Damage that Could Harm Our Business.

We Depend on Key Personnel, and if We Lose the Services of Any Member of Our Senior Management Team, We May Not Be Able to Run Our Business Effectively.

Our Charter and Bylaw Provisions and Certain Provisions of Tennessee Law May Make It Difficult in Some Respects to Cause a Change in Control of Kirkland s and Replace Incumbent Management.

Concentration of Ownership among Our Existing Directors, Executive Officers, and Their Affiliates May Prevent New Investors from Influencing Significant Corporate Decisions.

If We Fail to Maintain an Effective System of Internal Control, We May Not Be Able to Accurately Report Our Financial Results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company does not utilize financial instruments for trading or other speculative purposes, nor does it utilize leveraged financial instruments. There have been no material changes in the market risk factors from those disclosed in the Company s Form 10-K for the year ended January 28, 2012.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures*. Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15(d)-(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act) have concluded that as of July 28, 2012 our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by the Company in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

(b) *Change in internal controls over financial reporting*. There have been no changes in internal controls over financial reporting identified in connection with the foregoing evaluation that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved in various routine legal proceedings incidental to the conduct of our business. We believe any resulting liability from existing legal proceedings, individually or in the aggregate, will not have a material adverse effect on our operations or financial condition.

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ITEM 1A. RISK FACTORS

In addition to factors set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995, in Part I Item 2 of this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended January 28, 2012, which could materially affect our business, financial condition or future results. The risks described in this report and in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

As of the date of this filing, there have been no material changes in our risk factors from those disclosed in Part I, Item 1A, of our Annual Report on Form 10-K for the fiscal year ended January 28, 2012.

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

Shares of common stock repurchased by the Company during the first two quarters of fiscal 2012, ending July 28, 2012, were as follows:

Issuer Repurchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Program (in 000s)
January 29, 2012 to February 25, 2012	84,271	$ 14.36	84,271	$ 15,412
February 26, 2012 to March 31, 2012		$		$ 15,412
April 01, 2012 to April 28, 2012	135,163	$ 14.76	135,163	$ 13,418
April 29, 2012 to May 26, 2012	319,415	$ 12.88	319,415	$ 9,303
May 27, 2012 to June 30, 2012	785,185	$ 11.28	785,185	$ 447
July 1, 2012 to July 28, 2012	37,864	$ 11.80	37,864	$ 0
Total	1,361,898	$ 12.21	1,361,898	$ 0

On August 19, 2011, the Company announced that its Board of Directors authorized a stock repurchase plan providing for the purchase in the aggregate of up to $40 million of the Company s outstanding common stock from time to time until February 2013. Through July 28, 2012, the Company repurchased and retired a total of approximately 3.4 million shares at an aggregate cost of $40 million, completing the repurchase authorization.

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ITEM 6. EXHIBITS

(a) Exhibits.

Exhibit No.	Description of Document
31.1	Certification of the President and Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
31.2	Certification of the Senior Vice President and Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
32.1	Certification of the President and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of the Senior Vice President and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101	Interactive Data File (Quarterly Report on Form 10-Q, for the quarter ended July 28, 2012, furnished in XBRL (eXtensible Business Reporting Language))

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SIGNATURES

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

Date: September 6, 2012	KIRKLAND S, INC.
	/s/ Robert E. Alderson Robert E. Alderson
	President and Chief Executive Officer
	(Principal Executive Officer)
Date: September 6, 2012	/s/ W. Michael Madden W. Michael Madden
	Senior Vice President and Chief Financial Officer
	(Principal Financial Officer and Principal Accounting Officer)

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