

KIRKLAND'S, INC  
Form 10-Q  
December 12, 2013  
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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 November 2, 2013,**

**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)**

|   |   |
|---|---|
| <b>Tennessee</b><br><b>(State or other jurisdiction of</b><br><b>incorporation or organization)</b> | <b>62-1287151</b><br><b>(IRS Employer</b><br><b>Identification No.)</b> |
| <b>2501 McGavock Pike, Suite 1000</b>   |   |
| <b>Nashville, Tennessee</b><br><b>(Address of principal executive offices)</b>                      | <b>37214</b><br><b>(Zip Code)</b>                                       |
| <b>Registrant's telephone number, including area code: (615) 872-4800</b>                           |   |

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

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

|  |   |
|--|---|
| Large accelerated filer <input type="checkbox"/> | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/>   | Smaller reporting company <input type="checkbox"/>    |

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

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 17,296,709 shares outstanding as of December 6, 2013.

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**KIRKLAND S, INC.**

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(in thousands, except share data)

|   | November 2,<br>2013<br>(Unaudited) | February 2,<br>2013 | October 27,<br>2012<br>(Unaudited) |
|---|------------------------------------|---------------------|------------------------------------|
| <b>ASSETS</b>   |                                    |                     |                                    |
| Current assets:   |                                    |                     |                                    |
| Cash and cash equivalents   | \$ 54,634                          | \$ 67,797           | \$ 34,339                          |
| Inventories, net  | 68,833                             | 49,577              | 64,191                             |
| Income taxes receivable   | 4,491                              |                     | 4,479                              |
| Deferred income taxes   | 1,687                              | 1,602               | 1,497                              |
| Prepaid expenses and other current assets   | 7,989                              | 9,370               | 9,917                              |
| Total current assets  | 137,634                            | 128,346             | 114,423                            |
| Property and equipment, net   | 79,664                             | 78,499              | 76,004                             |
| Non-current deferred income taxes   |                                    |                     | 803                                |
| Other assets  | 1,823                              | 1,559               | 1,457                              |
| Total assets  | \$ 219,121                         | \$ 208,404          | \$ 192,687                         |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                                    |                     |                                    |
| Current liabilities:  |                                    |                     |                                    |
| Accounts payable  | \$ 24,751                          | \$ 21,642           | \$ 27,793                          |
| Income taxes payable  |                                    | 520                 |                                    |
| Accrued expenses  | 23,886                             | 21,009              | 19,874                             |
| Total current liabilities   | 48,637                             | 43,171              | 47,667                             |
| Deferred rent   | 38,906                             | 39,303              | 37,490                             |
| Non-current deferred income taxes   | 2,966                              | 3,128               |                                    |
| Other liabilities   | 5,406                              | 4,927               | 4,593                              |
| Total liabilities   | \$ 95,915                          | \$ 90,529           | \$ 89,750                          |
| Shareholders equity:  |                                    |                     |                                    |
| Preferred stock, no par value, 10,000,000 shares authorized; no shares issued or outstanding at November 2, 2013, February 2, 2013, or October 27, 2012, respectively                                     |                                    |                     |                                    |
| Common stock, no par value; 100,000,000 shares authorized; 17,282,395; 17,078,092; and 17,070,553 shares issued and outstanding at November 2, 2013, February 2, 2013, and October 27, 2012, respectively |                                    |                     |                                    |
|   | 156,496                            | 153,369             | 152,684                            |
| Accumulated deficit   | (33,290)                           | (35,494)            | (49,747)                           |

|   |            |            |            |
|---|------------|------------|------------|
| Total shareholders equity                 | 123,206    | 117,875    | 102,937    |
| Total liabilities and shareholders equity | \$ 219,121 | \$ 208,404 | \$ 192,687 |

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

**Table of Contents****KIRKLAND S, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)****(in thousands, except per share data)**

|  | <b>13-Week Period Ended</b> |                    | <b>39-Week Period Ended</b> |                    |
|--|-----------------------------|--------------------|-----------------------------|--------------------|
|  | <b>November 2,</b>          | <b>October 27,</b> | <b>November 2,</b>          | <b>October 27,</b> |
|  | <b>2013</b>                 | <b>2012</b>        | <b>2013</b>                 | <b>2012</b>        |
| Net sales  | \$ 106,134                  | \$ 96,688          | \$ 304,490                  | \$ 285,480         |
| Cost of sales  | 64,999                      | 62,669             | 188,306                     | 182,998            |
| Gross profit   | 41,135                      | 34,019             | 116,184                     | 102,482            |
| Operating expenses:  |                             |                    |                             |                    |
| Compensation and benefits  | 21,431                      | 19,152             | 61,285                      | 57,181             |
| Other operating expenses   | 13,961                      | 12,491             | 39,653                      | 37,487             |
| Depreciation   | 4,049                       | 3,122              | 11,790                      | 9,342              |
| Total operating expenses   | 39,441                      | 34,765             | 112,728                     | 104,010            |
| Operating income (loss)  | 1,694                       | (746)              | 3,456                       | (1,528)            |
| Interest expense, net  | 70                          | 70                 | 209                         | 217                |
| Other income, net  | (58)                        | (51)               | (172)                       | (179)              |
| Income (loss) before income taxes                                      | 1,682                       | (765)              | 3,419                       | (1,566)            |
| Income tax expense (benefit)   | 674                         | (349)              | 1,215                       | (1,108)            |
| Net income (loss)  | \$ 1,008                    | \$ (416)           | \$ 2,204                    | \$ (458)           |
| Earnings (loss) per share:   |                             |                    |                             |                    |
| Basic  | \$ 0.06                     | \$ (0.02)          | \$ 0.13                     | \$ (0.03)          |
| Diluted  | \$ 0.06                     | \$ (0.02)          | \$ 0.13                     | \$ (0.03)          |
| Weighted average shares for basic earnings (loss) per share:           |                             |                    |                             |                    |
|  | 17,269                      | 17,067             | 17,176                      | 17,602             |
| Effect of dilutive stock equivalents                                   | 494                         |                    | 435                         |                    |
| Adjusted weighted average shares for diluted earnings (loss) per share | 17,763                      | 17,067             | 17,611                      | 17,602             |

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

**Table of Contents****KIRKLAND S, INC.****CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)****(in thousands, except share data)**

|   | <b>Common Stock</b> |               | <b>Accumulated</b> | <b>Total</b>        |
|---|---------------------|---------------|--------------------|---------------------|
|   | <b>Shares</b>       | <b>Amount</b> | <b>Deficit</b>     | <b>Shareholders</b> |
|   |                     |               |                    | <b>Equity</b>       |
| Balance at February 2, 2013                                     | 17,078,092          | \$ 153,369    | \$ (35,494)        | \$ 117,875          |
| Exercise of employee stock options and employee stock purchases | 299,004             | 209           |                    | 209                 |
| Tax benefit from exercise of stock options                      |                     | 1,464         |                    | 1,464               |
| Net share settlement of stock options                           | (205,701)           | (658)         |                    | (658)               |
| Issuance of restricted stock                                    | 111,000             |               |                    |                     |
| Stock-based compensation expense                                |                     | 2,112         |                    | 2,112               |
| Net income  |                     |               | 2,204              | 2,204               |
| Balance at November 2, 2013                                     | 17,282,395          | \$ 156,496    | \$ (33,290)        | \$ 123,206          |

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

**Table of Contents****KIRKLAND S, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(in thousands)

|  | <b>39-Week Period Ended</b> |                             |
|--|-----------------------------|-----------------------------|
|  | <b>November 2,<br/>2013</b> | <b>October 27,<br/>2012</b> |
| <b>Cash flows from operating activities:</b>   |                             |                             |
| Net income (loss)  | \$ 2,204                    | \$ (458)                    |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                             |                             |
| Depreciation of property and equipment   | 11,790                      | 9,342                       |
| Amortization of landlord construction allowances   | (4,330)                     | (2,993)                     |
| Amortization of debt issue costs   | 58                          | 57                          |
| Gain (loss) on disposal of property and equipment  | 109                         | (35)                        |
| Cash received for landlord construction allowances   | 5,825                       | 5,393                       |
| Stock-based compensation expense   | 2,112                       | 2,085                       |
| Excess tax benefits from exercise of stock options and restricted stock                            | (1,464)                     | (46)                        |
| Deferred income taxes  | (247)                       | 465                         |
| Changes in assets and liabilities:   |                             |                             |
| Inventories, net   | (19,256)                    | (16,885)                    |
| Prepaid expenses and other current assets  | (482)                       | (852)                       |
| Other noncurrent assets  | (322)                       | (212)                       |
| Accounts payable   | 3,109                       | 6,201                       |
| Income taxes receivable  | (3,547)                     | (7,579)                     |
| Accrued expenses and other current and noncurrent liabilities                                      | 3,327                       | (1,913)                     |
| Net cash used in operating activities  | (1,114)                     | (7,430)                     |
| <b>Cash flows from investing activities:</b>   |                             |                             |
| Capital expenditures   | (13,064)                    | (24,996)                    |
| Net cash used in investing activities  | (13,064)                    | (24,996)                    |
| <b>Cash flows from financing activities:</b>   |                             |                             |
| Refinancing costs  |                             | (6)                         |
| Excess tax benefits from exercise of stock options and restricted stock                            | 1,464                       | 46                          |
| Employee stock purchases   | 209                         | 224                         |
| Repurchase and retirement of common stock  |                             | (16,622)                    |
| Cash used to settle withholding taxes on the vesting of restricted stock                           | (658)                       |                             |
| Net cash provided by (used in) financing activities  | 1,015                       | (16,358)                    |
| <b>Cash and cash equivalents:</b>  |                             |                             |



|                         |           |           |
|-------------------------|-----------|-----------|
| Net decrease            | (13,163)  | (48,784)  |
| Beginning of the period | 67,797    | 83,123    |
| End of the period       | \$ 54,634 | \$ 34,339 |

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

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**KIRKLAND'S, INC.**

**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 323 stores in 35 states as of November 2, 2013. 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 18, 2013.

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 November 2, 2013 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 reasonably possible that actual results could materially differ from amounts estimated include, but are not limited to, impairment assessments on long-lived assets, asset retirement obligations, inventory reserves, self-insurance reserves, income tax liabilities, stock-based compensation, employee bonus accruals, 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 November 2, 2013, the Company recorded an income tax expense of 40.1% of pre-tax income. In the prior year period, the Company recorded an income tax benefit of 45.6% of the loss before income taxes. During the 13-week period ended October 27, 2012, the Company reversed a portion of its reserve for uncertain income tax positions for which the statute of limitations expired. This adjustment resulted in an income tax benefit of approximately \$205,000. For the 39-week period ended November 2, 2013, the Company recorded an income tax expense of 35.5% of pre-tax income. In the prior year period, the Company recorded an income tax benefit of 70.8% of the loss before income taxes. In addition to the activity noted in the prior year period, during the 13-week period ended July 28, 2012, the

Company recorded state and federal employment tax credits totaling approximately \$400,000 that related to prior year periods and in excess of previous estimates.

**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 425,000 and 1.7 million shares for the 13-week periods ended November 2, 2013, and October 27, 2012, respectively, and 518,000 and 1.7 million shares for the 39-week periods ended November 2, 2013, and October 27, 2012, 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 any 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 200,000 stock options and 104,000 restricted stock units during the 39-week period ended November 2, 2013. This compares to 175,000 stock options and 94,000 restricted stock units granted in the 39-week period ended October 27, 2012. Total stock-based compensation expense (a component of compensation and benefits) was \$720,000 for the 13-week period ended November 2, 2013, and \$2.1 million for the 39-week period ended November 2, 2013, compared to \$630,000 and \$2.1 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 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 13-week periods ended November 2, 2013 and October 27, 2012, purchases from this vendor totaled approximately \$9.7 million, or 15.3% of total merchandise purchases, and \$8.3 million, or 13.5% of merchandise purchases, respectively. During the 39-week periods ended November 2, 2013 and October 27, 2012, purchases from this vendor totaled approximately \$23.1 million, or 14.4% of total merchandise purchases, and \$19.7 million, or 12.4% of merchandise purchases, respectively. Included in cost of sales for the 13-week periods ended November 2, 2013 and October 27, 2012 were \$6.4 million and \$5.3 million, respectively, related to this vendor. Included in cost of sales for the 39-week periods ended November 2, 2013 and October 27, 2012 were \$18.5 million and \$16.9 million, respectively, related to this vendor. Payable amounts outstanding to this vendor were approximately \$2.2 million and \$3.7 million as of November 2, 2013 and October 27, 2012, 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 18, 2013. 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 323 stores in 35 states as of November 2, 2013. Our stores present a broad selection of distinctive merchandise, including framed art, mirrors, wall décor, candles and related items, lamps, decorative accessories, accent furniture, textiles, garden-related accessories and artificial floral

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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 discernible 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 November 2, 2013, we opened 9 new stores and closed 3 stores. The following table summarizes our stores and square footage under lease:

|                                  | <b>As of<br/>November 2,<br/>2013</b> | <b>As of<br/>October 27,<br/>2012</b> |
|----------------------------------|---------------------------------------|---------------------------------------|
| Number of stores                 | 323                                   | 308                                   |
| Square footage                   | 2,387,942                             | 2,201,060                             |
| Average square footage per store | 7,393                                 | 7,146                                 |

**13-Week Period Ended November 2, 2013 Compared to the 13-Week Period Ended October 27, 2012**

*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:

|                                   | <b>13-Week Period Ended</b> |        |                         |        |               |          |
|-----------------------------------|-----------------------------|--------|-------------------------|--------|---------------|----------|
|                                   | <b>November 2, 2013</b>     |        | <b>October 27, 2012</b> |        | <b>Change</b> |          |
|                                   | \$                          | %      | \$                      | %      | \$            | %        |
| Net sales                         | \$ 106,134                  | 100.0% | \$ 96,688               | 100.0% | \$ 9,446      | 9.8%     |
| Cost of sales                     | 64,999                      | 61.2%  | 62,669                  | 64.8%  | 2,330         | 3.7%     |
| Gross profit                      | 41,135                      | 38.8%  | 34,019                  | 35.2%  | 7,116         | 20.9%    |
| Operating expenses:               |                             |        |                         |        |               |          |
| Compensation and benefits         | 21,431                      | 20.2%  | 19,152                  | 19.8%  | 2,279         | 11.9%    |
| Other operating expenses          | 13,961                      | 13.2%  | 12,491                  | 12.9%  | 1,470         | 11.8%    |
| Depreciation                      | 4,049                       | 3.8%   | 3,122                   | 3.2%   | 927           | 29.7%    |
| Total operating expenses          | 39,411                      | 37.2%  | 34,765                  | 36.0%  | 4,646         | 13.4%    |
| Operating income (loss)           | 1,694                       | 1.6%   | (746)                   | (0.8%) | 2,440         | (327.1%) |
| Interest expense, net             | 70                          | 0.1%   | 70                      | 0.1%   |               | 0.0%     |
| Other income, net                 | (58)                        | (0.1%) | (51)                    | (0.1%) | (7)           | 13.7%    |
| Income (loss) before income taxes | 1,682                       | 1.6%   | (765)                   | (0.8%) | 2,447         | (319.9%) |
| Income tax expense (benefit)      | 674                         | 0.6%   | (349)                   | (0.4%) | 1,023         | (293.1%) |
| Net income (loss)                 | \$ 1,008                    | 0.9%   | \$ (416)                | (0.4%) | \$ 1,424      | (342.3%) |

*Net sales.* Net sales increased 9.8% to \$106.1 million for the third fiscal quarter of 2013 compared to \$96.7 million for the prior year period. The impact of net new store growth contributed to an increase in net sales of \$5.0 million during the quarter. An increase in comparable store sales, including e-commerce sales, of 4.9%, contributed an increase over the prior year quarter of \$4.4 million. Comparable store sales decreased 4.7% in the third quarter of fiscal 2012. For the third fiscal quarter of 2013, E-commerce sales were up 34% versus the prior year period accompanied by an increase in comparable store sales at brick-and-mortar stores of 3.7%. For brick-and-mortar stores, the comparable store sales increase was primarily due to an increase in the average ticket combined with a slight increase in the number of transactions. The increase in the average ticket reflected an increase in the average retail price per item, partially offset by a small decline in items per transaction. The increase in transactions resulted from an increase in conversion, partially offset by a slight decline in traffic. The E-commerce increase was driven by an increase in site visits and average order size. The merchandise categories contributing most to the comparable store sales increase were holiday, mirrors, wall décor, textiles, and housewares, partially offset by declines in art, frames, and floral.

*Gross profit.* Gross profit as a percentage of net sales increased to 38.8% in the third quarter of 2013 from 35.2% in the third quarter of 2012. The overall increase in gross profit margin was primarily due to a higher merchandise margin, which increased to 55.2% in the third quarter of fiscal 2013 from 52.1% in the third quarter of fiscal 2012. Merchandise margin is calculated as net sales minus product cost of sales (including inbound freight), inventory shrinkage, and loyalty reward program discounts. Merchandise margin excludes outbound freight, store occupancy and central distribution costs. The increase in merchandise margin was primarily the result of a reduction in promotional activity and markdowns coupled with lower inbound freight costs. Store occupancy costs and central distribution expenses as a percentage of net sales were down in the third quarter of 2013 as compared to the prior year period due to leverage from higher comparable store sales. Outbound freight costs for the same period were up slightly, primarily due to an increase in shipping costs for e-Commerce.

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*Compensation and benefits.* Compensation and benefits expenses for stores increased in dollars due to an increased store count but decreased as a percentage of net sales from better store-level payroll management for the third quarter of fiscal 2013 as compared to the third quarter of 2012. At the corporate level, the compensation and benefits ratio increased over the prior year period primarily due to increased incentive pay accruals.

*Other operating expenses.* Other operating expenses increased in dollars and as a percentage of net sales. This is primarily due to an approximate \$1 million increase in advertising spend over the prior year quarter, as we continue to invest in and expand our branding activities. Excluding advertising expense, the remaining operating expenses decreased as a percentage of sales compared to the prior year quarter.

*Depreciation.* The increase in depreciation as a percentage of sales reflects an increase in capital expenditures in recent fiscal years and the implementation of major technology upgrades during fiscal 2012.

*Income tax expense.* We recorded income tax expense of approximately \$674,000, or 40.1% of pre-tax income during the third quarter of fiscal 2013, versus a tax benefit of approximately \$349,000, or 45.6% of pre-tax loss, in the prior year quarter. During the 13-week period ended October 27, 2012, the Company reversed a portion of its reserve for uncertain income tax positions for which the statute of limitations expired. This adjustment resulted in an income tax benefit of approximately \$205,000.

*Net income and earnings per share.* As a result of the foregoing, we reported net income of \$1.0 million, or \$0.06 per diluted share, for the third quarter of fiscal 2013 as compared to net loss of \$416,000, or (\$0.02) per diluted share, for the third quarter of fiscal 2012.

**39-week Period Ended November 2, 2013 Compared to the 39-week Period Ended October 27, 2012**

*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:

|                                   | 39-week Period Ended |        |                  |        |           |          |
|-----------------------------------|----------------------|--------|------------------|--------|-----------|----------|
|                                   | November 2, 2013     |        | October 27, 2012 |        | Change    |          |
|                                   | \$                   | %      | \$               | %      | \$        | %        |
| Net sales                         | \$ 304,490           | 100.0% | \$ 285,480       | 100.0% | \$ 19,010 | 6.7%     |
| Cost of sales                     | 188,306              | 61.8%  | 182,998          | 64.1%  | 5,308     | 2.9%     |
| Gross profit                      | 116,184              | 38.2%  | 102,482          | 35.9%  | 13,702    | 13.4%    |
| Operating expenses:               |                      |        |                  |        |           |          |
| Compensation and benefits         | 61,285               | 20.1%  | 57,181           | 20.0%  | 4,104     | 7.2%     |
| Other operating expenses          | 39,653               | 13.0%  | 37,487           | 13.1%  | 2,166     | 5.8%     |
| Depreciation                      | 11,790               | 3.9%   | 9,342            | 3.3%   | 2,448     | 26.2%    |
| Total operating expenses          | 112,728              | 37.0%  | 104,010          | 36.4%  | 8,718     | 8.4%     |
| Operating income (loss)           | 3,456                | 1.1%   | (1,528)          | (0.5%) | 4,984     | (326.2%) |
| Interest expense, net             | 209                  | 0.1%   | 217              | 0.1%   | (8)       | (3.7%)   |
| Other income, net                 | (172)                | (0.1%) | (179)            | (0.1%) | 7         | (3.9%)   |
| Income (loss) before income taxes | 3,419                | 1.1%   | (1,566)          | (0.5%) | 4,985     | (318.3%) |



|                              |          |      |          |        |          |          |
|------------------------------|----------|------|----------|--------|----------|----------|
| Income tax expense (benefit) | 1,215    | 0.4% | (1,108)  | (0.4%) | 2,323    | (209.7%) |
| Net income (loss)            | \$ 2,204 | 0.7% | \$ (458) | (0.2%) | \$ 2,662 | (581.2%) |

*Net sales.* Net sales increased 6.7% to \$304.5 million for the first three quarters of fiscal 2013 compared to \$285.5 million for the prior year period. The impact of net new store growth contributed an increase to net sales of \$16.9 million. This increase in net sales was also attributable to an increase in comparable store sales, including e-commerce sales, of 0.8%, which aided the year-over-year increase by \$2.1 million. Comparable store sales decreased 3.2% in the prior year period. For the first three quarters of fiscal 2013, E-commerce sales were up 26.6% versus the prior year period, while comparable store sales at brick-and-mortar stores were down 0.2%. For brick-and-mortar stores, the comparable store sales decrease 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 traffic, partially offset by an increase in conversion. The increase in the average ticket reflected an increase in average retail selling price coupled with a slight increase in items sold per transaction. The E-commerce increase was driven by an increase in site visits and slight increase in average order size. The merchandise categories contributing most to the comparable store sales increase were holiday, mirrors, and ornamental wall décor, and were partially offset by decreased performance in art, floral, and frames.

*Gross profit.* Gross profit as a percentage of net sales increased to 38.2% in the first three quarters of 2013 from 35.9% in the first three quarters of 2012. The overall increase in gross profit margin was primarily due to a higher merchandise margin, which increased to 54.6% in the first three quarters of fiscal 2013 from 52.5% in the first three quarters of fiscal 2012.

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Merchandise margin is calculated as net sales minus product cost of sales (including inbound freight), inventory shrinkage, and loyalty reward program discounts. Merchandise margin excludes outbound freight, store occupancy and central distribution costs. The increase in merchandise margin was primarily the result of a reduction in promotional activity and markdowns, slightly offset by higher inbound freight costs. Store occupancy costs, outbound freight costs, and central distribution expenses as a percentage of net sales were essentially flat in the first three quarters of 2013 as compared to the prior year period.

*Compensation and benefits.* Compensation and benefits expenses for stores increased in dollars as a result of an increase in store count but decreased as a percentage of net sales from better store-level payroll management for the first three quarters of fiscal 2013 as compared to the first three quarters of 2012. At the corporate level, the compensation and benefits ratio increased over the prior year period primarily due to increased incentive pay accruals.

*Other operating expenses.* Other operating expenses increased in dollars but decreased slightly as a percentage of net sales versus the prior year period. The third quarter of fiscal 2013 had approximately \$1 million in increased advertising spend over the prior year quarter, as we continue to invest in and expand our branding activities.

*Depreciation.* The increase in depreciation as a percentage of sales reflects an increase in capital expenditures in recent fiscal years and the implementation of major technology upgrades during fiscal 2012.

*Income tax expense.* We recorded income tax expense of approximately \$1.2 million, or 35.5% of pre-tax income during the first three quarters of fiscal 2013, versus a tax benefit of approximately \$1.1 million, or 70.8% of pre-tax loss, in the prior year period. During the 13-week period ended October 27, 2012, the Company reversed a portion of its reserve for uncertain income tax positions for which the statute of limitations expired. This adjustment resulted in an income tax benefit of approximately \$205,000. In addition to the activity noted in the prior year period, during the 13-week period ended July 28, 2012, the Company recorded state and federal employment tax credits totaling approximately \$400,000 that related to prior year periods and in excess of previous estimates.

*Net income and earnings per share.* As a result of the foregoing, we reported net income of \$2.2 million, or \$0.13 per diluted share, for the first three quarters of fiscal 2013 as compared to net loss of \$458,000, or (\$0.03) per diluted share, for the first three quarters of fiscal 2012.

**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 early portion of the fourth 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 \$1.1 million for the first three quarters of fiscal 2013, compared to net cash used in operating activities of \$7.4 million for the first three quarters of 2012. 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 improved operating performance, a \$1.5 million decrease in income taxes paid and an increase in accrued expenses, partially offset by higher inventory levels and lower accounts payable. The increase in accrued expenses is primarily attributable to \$2.0 million of incentive pay accruals that were not present in the prior year period. The decrease in accounts payable is primarily due to the timing

of our inventory receipt flow this year versus the prior period.

*Cash flows from investing activities.* Net cash used in investing activities for the first three quarters of fiscal 2013 consisted of \$13.0 million in capital expenditures as compared to \$25.0 million in capital expenditures for the prior year period. The capital expenditures in both periods primarily related to new store construction and information technology assets. During the first three quarters of fiscal 2013, we opened 16 stores compared to 25 stores during the first three quarters of fiscal 2012. We expect that capital expenditures for all of fiscal 2013 will be approximately \$18 to \$19 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 provided by financing activities was approximately \$1.0 million for the first three quarters of fiscal 2013, and related to the exercise of employee stock options, the vesting of restricted stock units, employee stock purchases, and the related tax benefits. Net cash used in financing activities was approximately \$16.4 million for the first three quarters of fiscal 2012, and primarily related to the repurchase and retirement of common stock.

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*Revolving credit facility.* On August 19, 2011, we entered into an Amended and Restated Credit Agreement (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 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 November 2, 2013, we were in compliance with the covenants in the facility and there were no outstanding borrowings under the credit facility, with approximately \$50.0 million available for borrowing.

At November 2, 2013, our balance of cash and cash equivalents was approximately \$54.6 million. We do not anticipate any borrowings under the credit facility during fiscal 2013. We believe that the combination of our cash balances 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.

## **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 13-week periods ended November 2, 2013 and October 27, 2012, purchases from this vendor totaled approximately \$9.7 million, or 15.3% of total merchandise purchases, and \$8.3 million, or 13.5% of merchandise purchases, respectively. During the 39-week periods ended November 2, 2013 and October 27, 2012, purchases from this vendor totaled approximately \$23.1 million, or 14.4% of total merchandise purchases, and \$19.7 million, or 12.4% of merchandise purchases, respectively. Included in cost of sales for the 13-week periods ended November 2, 2013 and October 27, 2012 were \$6.4 million and \$5.3 million, respectively, related to this vendor. Included in cost of sales for the 39-week periods ended November 2, 2013 and October 27, 2012 were \$18.5 million and \$16.9 million, respectively, related to this vendor. Payable amounts outstanding to this vendor were approximately \$2.2 million and \$3.7 million as of November 2, 2013 and October 27, 2012, 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*

The Company had commitments for new store construction projects totaling approximately \$1.2 million at November 2, 2013.

**Critical Accounting Policies and Estimates**

There have been no significant changes to our critical accounting policies during fiscal 2013. Refer to our Annual Report on Form 10-K for the fiscal year ended February 2, 2013, for a summary of our critical accounting policies.

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**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 does not directly relate to any historical or current fact. Words such as should, likely to, forecasts, strategy, goal, anticipates, believes, expects, estimates, intends, plans, projects, and similar 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.

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 Results Could be Negatively Impacted if our Merchandise Offering Suffers a Substantial Impediment to its Reputation Due to Real or Perceived Quality Issues.

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.

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.

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.

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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; The Expansion of Our e-Commerce Business Has Inherent Cybersecurity Risks That May Result in Business Disruptions.

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.

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 February 2, 2013.

#### **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 November 2, 2013 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.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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.

**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 February 2, 2013, 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.

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**ITEM 6. EXHIBITS**

(a) Exhibits.

| <b>Exhibit No.</b> | <b>Description of Document</b>  |
|--------------------|---|
| 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<br>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 November 2, 2013, 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.

KIRKLAND S, INC.

Date: December 12, 2013

/s/ Robert E. Alderson  
Robert E. Alderson  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: December 12, 2013

/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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