

Zumiez Inc  
Form 10-Q  
August 28, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C.

**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 AUGUST 2, 2008**

**OR**

**o**

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

**Commission file number 000-51300**

**ZUMIEZ INC.**

(Exact name of registrant as specified in its charter)

**Washington**

(State or other jurisdiction of  
incorporation or organization)

**91-1040022**

(I.R.S. Employer Identification No.)

**6300 Merrill Creek Parkway, Suite B, Everett, WA 98203**

(Address of principal executive offices) (Zip Code)

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Registrant's telephone number, including area code: **(425) 551-1500**

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  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

Number of shares of Common Stock outstanding as of August 28, 2008 was 29,399,608 shares.

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**ZUMIEZ INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share amounts)

	August 2, 2008 (Unaudited)	February 2, 2008
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 8,075	\$ 11,945
Marketable securities	58,516	64,587
Receivables	8,276	4,775
Inventory	72,080	48,721
Prepaid expenses and other	5,655	4,440
Deferred tax assets	3,267	1,089
<b>Total current assets</b>	<b>155,869</b>	<b>135,557</b>
Leasehold improvements and equipment, net	75,994	65,937
Goodwill	13,154	13,154
Marketable securities - long-term	1,847	
Deferred tax assets	1,655	1,447
<b>Total long-term assets</b>	<b>92,650</b>	<b>80,538</b>
<b>Total assets</b>	<b>\$ 248,519</b>	<b>\$ 216,095</b>
<b>Liabilities and Shareholders Equity</b>		
<b>Current liabilities</b>		
Trade accounts payable	\$ 44,594	\$ 19,672
Book overdraft	2,201	7,384
Accrued payroll and payroll taxes	3,495	5,097
Income taxes payable	2,730	47
Current portion of deferred rent and tenant allowances	2,631	2,136
Other accrued liabilities	8,673	9,060
<b>Total current liabilities</b>	<b>64,324</b>	<b>43,396</b>
Long-term deferred rent and tenant allowances, less current portion	22,657	18,097
<b>Total liabilities</b>	<b>86,981</b>	<b>61,493</b>
Commitments and contingencies (Note 3)		
<b>Shareholders equity</b>		
Preferred stock, no par value, 40,000,000 shares authorized; none issued and outstanding		
Common stock, no par value, 100,000,000 shares authorized; 29,399,608 shares issued and outstanding at August 2, 2008, 29,002,852 shares issued and outstanding at February 2, 2008	72,544	69,297
Accumulated other comprehensive income	64	464
Retained earnings	88,930	84,841
<b>Total shareholders equity</b>	<b>161,538</b>	<b>154,602</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 248,519</b>	<b>\$ 216,095</b>

See accompanying notes to condensed consolidated financial statements



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**ZUMIEZ INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except share and per share amounts)  
**(Unaudited)**

	Three Months Ended		Six Months Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Net sales	\$ 92,258	\$ 81,974	\$ 170,960	\$ 150,765
Cost of goods sold	62,155	53,783	116,297	100,853
<b>Gross profit</b>	<b>30,103</b>	<b>28,191</b>	<b>54,663</b>	<b>49,912</b>
Selling, general and administrative expenses	26,191	23,489	49,125	43,027
<b>Operating profit</b>	<b>3,912</b>	<b>4,702</b>	<b>5,538</b>	<b>6,885</b>
Interest income, net	495	327	1,084	753
Other expense				(1)
<b>Earnings before income taxes</b>	<b>4,407</b>	<b>5,029</b>	<b>6,622</b>	<b>7,637</b>
Provision for income taxes	1,680	1,911	2,533	2,902
<b>Net income</b>	<b>\$ 2,727</b>	<b>\$ 3,118</b>	<b>\$ 4,089</b>	<b>\$ 4,735</b>
Basic net income per share	\$ 0.09	\$ 0.11	\$ 0.14	\$ 0.17
Diluted net income per share	\$ 0.09	\$ 0.11	\$ 0.14	\$ 0.16
Weighted average shares used in computation of earnings per share:				
Basic	29,072,536	28,540,326	29,042,861	28,478,125
Diluted	29,378,589	29,186,270	29,374,015	29,094,234

See accompanying notes to condensed consolidated financial statements

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**ZUMIEZ INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY**  
**(in thousands)**  
**(Unaudited)**

	Shares	Common Stock Amount	Accumulated Comprehensive Income (Loss)	Retained Earnings	Total
<b>Balance at February 2, 2008</b>	29,003	\$ 69,297	\$ 464	\$ 84,841	\$ 154,602
Common stock issued including tax benefit of \$509	397	1,118			1,118
Stock-based compensation expense		2,129			2,129
Unrealized losses, net			(400)		(400)
Net income				4,089	4,089
<b>Balance at August 2, 2008</b>	29,400	\$ 72,544	\$ 64	\$ 88,930	\$ 161,538

See accompanying notes to condensed consolidated financial statements



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## ZUMIEZ INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	For the Six Months Ended	
	August 2, 2008	August 4, 2007
<b>Cash flows from operating activities:</b>		
Net income	\$ 4,089	\$ 4,735
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	9,170	6,764
Deferred tax expense	(2,424)	(1,623)
Stock-based compensation expense	2,129	2,174
Loss on disposal of assets	138	100
Excess tax benefit from stock options	(509)	(11,410)
Changes in operating assets and liabilities:		
Receivables	(3,501)	(683)
Inventory	(23,359)	(19,646)
Prepaid expenses and other	(1,215)	(864)
Trade accounts payable	24,922	14,241
Accrued payroll and payroll taxes	(1,602)	(1,466)
Income taxes payable	3,192	(2,666)
Other accrued liabilities	(387)	(241)
Deferred rent and tenant allowances	5,055	3,841
<b>Net cash provided by (used in) operating activities</b>	<b>15,698</b>	<b>(6,744)</b>
<b>Cash flows from investing activities:</b>		
Additions to leasehold improvements and equipment	(19,006)	(19,135)
Purchases of marketable securities	(51,722)	(37,854)
Sales and maturities of marketable securities	55,225	54,296
<b>Net cash used in investing activities</b>	<b>(15,503)</b>	<b>(2,693)</b>
<b>Cash flows from financing activities:</b>		
Change in book overdraft	(5,183)	(6,083)
Proceeds from exercise of stock options	609	2,088
Excess tax benefit from stock options	509	11,410
<b>Net cash provided by (used in) financing activities</b>	<b>(4,065)</b>	<b>7,415</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(3,870)</b>	<b>(2,022)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>11,945</b>	<b>8,161</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 8,075</b>	<b>\$ 6,139</b>
<b>Supplemental disclosure on cash flow information:</b>		
Cash paid during the period for interest	\$ 9	\$ 1
Cash paid during the period for income taxes	1,768	7,320
Non-cash investing activities - acquisition costs in other accrued liabilities		250

See accompanying notes to condensed consolidated financial statements



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**ZUMIEZ INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Nature of Business and Basis of Presentation**

**Basis of Presentation** The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements.

In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the condensed consolidated balance sheet as of August 2, 2008, the condensed consolidated statements of operations for the three and six months ended August 2, 2008 and August 4, 2007, the condensed consolidated statement of changes in shareholders' equity for the six months ended August 2, 2008 and the condensed consolidated statements of cash flows for the six months ended August 2, 2008 and August 4, 2007.

The financial data at February 2, 2008 is derived from audited financial statements which are included in the Company's Annual Report on Form 10-K for the year ended February 2, 2008, and should be read in conjunction with the audited financial statements and notes thereto. Interim results are not necessarily indicative of results for the full year.

**Principles of Consolidation** The unaudited condensed consolidated financial statements include the accounts of Zumiez Inc. and its subsidiary, Zumiez Nevada, LLC, (collectively, the Company ). All significant inter-company transactions and balances are eliminated in consolidation.

**Use of Estimates** The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. These estimates can also affect supplemental information disclosed by the Company, including information about contingencies, risk, and financial condition. In preparing the financial statements, the Company makes routine estimates and judgments in determining the net realizable value of accounts receivable, inventory, fixed assets, prepaid assets, goodwill and certain liabilities. Some of the more significant estimates include the allowance for sales returns, the reserve for inventory valuation estimates and the expected useful lives of fixed assets. Actual results could differ from those estimates. The results of operations for the three and six months ended August 2, 2008 are not necessarily indicative of the results that might be expected for fiscal 2008. For further

information, refer to the Company's financial statements and notes included in the Company's Form 10-K filed on March 25, 2008.

**Nature of Business** The Company is a leading specialty retailer of action sports related apparel, footwear, equipment and accessories operating under the Zumiez brand name. As of August 2, 2008, the Company operated 324 stores primarily located in shopping malls, giving the Company a presence in 28 states. The Company's stores cater to young men and women between the ages of 12 and 24 who seek brands representing a lifestyle centered on activities that include skateboarding, surfing, snowboarding, bicycle motocross (or BMX) and motocross. The Company supports the action sports lifestyle and promotes its brand through a multi-faceted marketing approach that is designed to integrate its brand image with its customers' activities and interests. In addition, the Company operates a website that sells merchandise online and provides content and a community for its target customers. The Company, based in Everett, WA, was formed in August 1978 and operates within one reportable segment.

**Fiscal Year** The Company uses a fiscal calendar widely used by the retail industry which results in a fiscal year consisting of a 52-week or 53-week period ending on the Saturday closest to January 31. Each fiscal year consists of four 13-week quarters, with an extra week added to the fourth quarter every five or six years. Fiscal 2007 was the 52-week period ended February 2, 2008. The first six months of fiscal 2008 was the 26-week period ended August 2, 2008. The first six months of fiscal 2007 was the 26-week period ended August 4, 2007. Fiscal 2008 is the 52-week period ending January 31, 2009.

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**Revision to Previously Issued Statements of Cash Flows** For the six months ended August 4, 2007, we have corrected the classification of changes in income tax receivable from changes in receivables to changes in income tax payable of \$7.5 million to conform with the six months ended August 2, 2008 and fiscal 2007 presentations. There was no impact on cash used in operations for the six months ended August 4, 2007 or on the net decrease in cash and cash equivalents on the statements of cash flows. The Company has determined these adjustments are not material to the condensed consolidated financial statements.

## 2. Summary of Significant Accounting Policies

Information regarding the Company's significant accounting policies is contained in Note 2, Summary of Significant Accounting Policies, to the consolidated financial statements in the Company's Form 10-K filed on March 25, 2008. Presented below in this note and the following notes is supplemental information that should be read in conjunction with Notes to Consolidated Financial Statements in that annual report.

**Marketable Securities** At August 2, 2008, marketable securities, classified as available for sale, were \$60.4 million and consisted primarily of municipal and U.S. agency debt instruments with original maturities over 90 days. As of August 2, 2008, we had \$1.8 million invested, net of impairment charge of \$0.2 million, in auction rate securities, which are classified as long-term, available-for-sale marketable securities on our condensed consolidated balance sheet. We reduced our holdings of auction rate securities during 2007 through the auction process.

Auction rate securities are generally long-term debt instruments that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined calendar intervals. This mechanism generally allows existing investors to rollover their holdings and continue to own their respective securities or liquidate their holdings by selling their securities at par value. Historically, we have invested in these securities for short periods of time as part of our cash management program. However, the recent uncertainties in the credit markets have prevented us and other investors from liquidating holdings of auction rate securities in recent auctions for these securities because the amount of securities submitted for sale has exceeded the amount of purchase orders. Should the auctions continue to fail, we anticipate we have the ability to hold these securities until the liquidity in the market improves. These investments are fully collateralized by the United States government and are insured against loss of principal and interest by a bond insurer whose current credit rating is AA. Although we are uncertain as to when the liquidity issues relating to these investments will improve, we consider these issues to be only temporary. It is possible that further declines in fair value may occur, and those declines, if any, would be recognized in other comprehensive loss. We continue to monitor the market for auction rate securities and consider its impact, if any, on the fair market value of the investments.

**Receivables** At August 2, 2008 and February 2, 2008 the Company receivables included the following:

	August 2, 2008	February 2, 2008
Tenant allowances receivable	\$ 3,372	\$ 1,334
Credit cards receivable	3,459	2,108
Interest receivable	535	557
Vendor credits	525	212
Employee receivables	197	257

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Other receivables		188		307
	\$	8,276	\$	4,775

The Company does not extend credit to its customers except through independent third-party credit cards.

**Merchandise Inventories** Merchandise inventories are valued at the lower of cost or market. The cost of merchandise inventories are based upon an average cost methodology. Merchandise inventories may include items that have been written down to the Company's best estimate of their net realizable value. The Company's decisions to write-down its merchandise inventories are based on its current rate of sale, the age of the inventory and other factors. Actual final sales prices to customers may be higher or lower than the Company's estimated net realizable value and could result in a fluctuation in gross profit. Historically, any additional write-downs have not been significant to the Company. We have reserved for inventory as of August 2, 2008 and February 2, 2008 in the amounts of approximately \$2.7 million and \$3.0 million, respectively. The inventory reserve includes inventory whose estimated market value is below cost, and an estimate for inventory shrinkage.

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These reserve amounts are evaluated quarterly. The inventory related to these reserves is not marked up in subsequent periods.

**Fair Value of Financial Instruments** Statement of Financial Accounting Standards No. 107 *Disclosures about Fair Value of Financial Instruments* ( SFAS No. 107 ), requires management to disclose the estimated fair value of certain assets and liabilities as financial instruments. Financial instruments are generally defined by SFAS No. 107 as cash, evidence of ownership interest in an entity, or a contractual obligation that both conveys to one entity a right to receive cash or other financial instruments from another entity and imposes on the other entity the obligation to deliver cash or other financial instruments to the first entity. At August 2, 2008 and February 2, 2008, the carrying amounts of cash and cash equivalents, receivables, payables and other accrued liabilities approximated fair value because of the short maturity of these financial instruments. The carrying value of marketable securities, approximate the fair value because these financial instruments have floating interest rates, which reflect current market conditions. Contractual maturities of investments underlying our available-for-sale securities at August 2, 2008 included \$1.8 million in auction rate securities, net of \$0.2 million impairment. Based on current market conditions, auctions related to these securities may be unsuccessful at the scheduled auctions in fiscal 2009. Unsuccessful auctions could result in our holding securities beyond their next scheduled auction reset dates if a secondary market does not develop; therefore, limiting the short-term liquidity of these investments.

**Cost of Goods Sold** Cost of goods sold consists of the cost of merchandise sold to customers, inbound shipping costs, internet shipping costs, distribution costs, depreciation on leasehold improvements at the distribution center, buying and merchandising costs and store occupancy costs. This may not be comparable to the way in which the Company's competitors or other retailers compute their cost of goods sold. In the six month period ended August 4, 2007, the Company previously reported shipping costs on internet sales in selling, general and administrative expense. During the three and six months ended August 4, 2007, the Company reclassified approximately \$94,000 and \$176,000, respectively, of this expense to cost of goods sold.

**Stock Compensation** Effective January 29, 2006, the Company adopted the fair value method of accounting for stock-based compensation arrangements in accordance with Financial Accounting Standards Board ( FASB ) Statement No. 123(R), *Share-Based Payment* ( SFAS No. 123(R) ), using the modified prospective method of transition. Under the provisions of SFAS No. 123(R), the estimated fair value of share-based awards granted under the 2005 Stock Incentive Plan is recognized as compensation expense over the vesting period. Using the modified prospective method, compensation expense is recognized beginning with the effective date of adoption of SFAS No. 123(R) for all share-based payments (i) granted after the effective date of adoption and (ii) granted prior to the effective date of adoption and after the Company's initial public offering on May 5, 2005. Prior to January 29, 2006, the Company accounted for stock-based employee compensation plans using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and its related interpretations. Under the provisions of APB 25, no compensation expense was recognized when stock options were granted with exercise prices equal to or greater than market value on the date of grant.

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The fair value of stock option grants are estimated on the date of grant using the Black-Scholes option pricing method with the following weighted-average assumptions used for grants issued during the six month periods ended August 2, 2008.

	<b>For the Six Months Ended August 2, 2008</b>	
Dividend yield		%
Volatility rate	55.20%	
Average expected life (in years):		
Expected lives-Five years	6.50	
Expected lives-Four years	6.25	
Average risk-free interest rate:	2.78%	



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The following table summarizes the Company's stock option activity for the six months ended August 2, 2008 (in thousands except weighted-average exercise price):

	<b>Stock Options</b>		<b>Weighted-Average Exercise Price</b>
Outstanding at February 2, 2008	1,958	\$	16.29
Granted year to date	155	\$	14.17
Exercised year to date	(79)	\$	3.45
Forfeited year to date	(54)	\$	32.73
Outstanding at August 2, 2008	1,980	\$	18.26
Exercisable at August 2, 2008	684	\$	10.33

During the six months ended August 2, 2008, the Company granted 155,000 stock options with a Black-Scholes weighted average fair value of \$7.83 and an exercise price of \$14.17. In connection with these grants, the Company recognized approximately \$222,000 of stock-based compensation expense for the six months ended August 2, 2008.

The following table summarizes the Company's restricted stock activity for the six months ended August 2, 2008 (in thousands except weighted-average exercise price):

	<b>Restricted Stock</b>		<b>Grant Date Weighted Average Fair Value</b>
Outstanding at February 2, 2008	16	\$	37.19
Granted year to date	285	\$	14.33
Vested year to date	(3)	\$	38.19
Forfeited year to date	(3)	\$	14.00
Outstanding at August 2, 2008	295	\$	16.37

During the six months ended August 2, 2008, the Company granted approximately 285,000 shares of restricted stock with a weighted average fair market value on the date of grant of \$14.33 per share. In connection with these grants, the Company recognized approximately \$325,000 in stock-based compensation expense during the six months ended August 2, 2008. There were 10,000 shares of performance-based restricted stock included in the calculation of stock-based compensation expense for the six months ended August 2, 2008.

During the six months ended August 2, 2008, the Company issued 40,000 shares of performance-based restricted stock that will vest between 0% and 100% based upon a predetermined earnings milestone. If performance-based milestones are not met, the restricted stock will not vest, in which case, any compensation expense we have recognized to date will be reversed.

The Company recorded approximately \$1.2 million and \$2.1 million of total stock-based compensation expense for the three and six months ended August 2, 2008, of which approximately \$0.1 million and \$0.3 million, respectively, was attributable to the Board of Directors. The Company recorded approximately \$1.4 million and \$2.2 million of stock-based compensation for the three and six months ended August 4,

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2007, of which approximately \$0.4 million and \$0.5 million, respectively, was attributable to the Board of Directors. The stock-based compensation expense is calculated on an accelerated method for stock options and a straight-line basis for restricted stock over the vesting periods of the related equity grant. This charge had no impact on the Company's reported cash flows. For the six months ended August 2, 2008 and August 4, 2007, the Company recorded approximately \$40,000 and \$80,000, respectively, in stock-based compensation expense pursuant to APB 25. At August 2, 2008 and February 2, 2008, there was approximately \$10.3 million and \$9.2 million, respectively, of total unrecognized compensation cost related to unvested stock options and restricted stock grants of

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which approximately \$0.4 million and \$0.5 million, respectively, was attributable to the Board of Directors. This cost is expected to be recognized over a weighted-average period of approximately three to eight years. The Company accounts for unvested stock-based employee compensation arrangements granted prior to its initial public offering on the intrinsic value method in accordance with the provisions of APB No. 25, and related amendments and interpretations.

**Goodwill** In accordance with Statement of Financial Accounting Standards No. 142, *Accounting for Goodwill and Other Intangible Assets* ( SFAS No. 142 ), the Company does not amortize goodwill derived from purchase business combinations. The Company evaluates the recoverability of goodwill annually based on a two-step impairment test. The first step compares the fair value of each reporting unit with its carrying amount, including goodwill. If the carrying amount exceeds fair value, then the second step of the impairment test is performed to measure the amount of any impairment loss. Additional impairment assessments may be performed on an interim basis if the Company encounters events or changes in circumstances that would indicate that, more likely than not, the book value of goodwill has been impaired. There was no impairment of goodwill in the 2007 fiscal year or for the six months ended August 2, 2008.

**Recent accounting pronouncements**

In February 2008, the Financial Accounting Standards Board ( FASB ) issued FSP No. SFAS 157-2, which delays the effective date of SFAS No.157, *Fair Value Measurements*, for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Nonfinancial assets and nonfinancial liabilities would include all assets and liabilities other than those meeting the definition of a financial asset or financial liability as defined in paragraph 6 of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This FASB Staff Position defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of FSP No. FAS 157-2. We are currently evaluating the effects, if any, that FSP No. SFAS 157-2 may have on our condensed consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* including an amendment of FASB Statement No. 115, which provides entities with an option to report selected financial assets and liabilities at fair value. SFAS No.159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This statement is effective as of the beginning of the first fiscal year that begins after November 15, 2007. At the effective date, an entity may elect the fair value option for eligible items that exist at that date. The entity shall report the effect of the first re-measurement to fair value as a cumulative-effect adjustment to the opening balance of retained earnings. The Company has not elected the fair value option for eligible items that existed as of February 3, 2008.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS No. 141(R) ), which replaces SFAS No. 141, *Business Combinations* ( SFAS No. 141 ). SFAS No. 141(R) retains the underlying concepts of SFAS No. 141 in that all business combinations are still required to be accounted for at fair value under the acquisition method of accounting but SFAS No. 141(R) changed the method of applying the acquisition method in a number of significant aspects. Acquisition costs will generally be expensed as incurred; non-controlling interests will be valued at fair value at the acquisition date; in-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date; restructuring costs associated with a business combination will generally be expensed subsequent to the acquisition date; and changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense. SFAS No. 141(R) is effective on a prospective basis for all business combinations for which the acquisition date is on or after the beginning of the first annual period subsequent to December 15, 2008, with the exception of the accounting for

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valuation allowances on deferred taxes and acquired tax contingencies. SFAS No. 141(R) amends SFAS No. 109, *Accounting for Income Taxes*, such that adjustments made to valuation allowances on deferred taxes and acquired tax contingencies associated with acquisitions that closed prior to the effective date of SFAS No. 141(R) would also apply the provisions of SFAS No. 141(R). Early adoption is not permitted. The Company does not expect the adoption of SFAS No. 141(R) to have a material effect on its consolidated financial position or results of operations.

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements*. SFAS No. 160 amends Accounting Research Bulletin No. 51, *Consolidated Financial Statements* and requires (i) classification of non-controlling interests, commonly referred to as minority interests, within stockholders' equity, (ii) net income to include the net income attributable to the non-controlling interest and (iii) enhanced disclosure of activity related to

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non-controlling interests. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. We will evaluate the impact, if any, that the adoption of SFAS No. 160 could have on our condensed consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position 142-3, *Determination of the Useful Lives of Intangible Assets* ( FSP 142-3 ), which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB No. 142, *Goodwill and Other Intangible Assets*. The intent of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R) and other U.S. generally accepted accounting principles. The Company does not expect the adoption of FSP 142-3 to have a material effect on its consolidated financial position or results of operations.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS 162 ). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles. SFAS 162 is effective 60 days following the Securities and Exchange Commission's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. This statement will not have an impact on the Company's condensed consolidated financial statements.

### 3. Commitments and Contingencies

**Leases** The Company is committed under operating leases for all of its retail store locations. In addition to minimum future lease payments, all store leases provide for additional rental payments based on sales, as well as common area maintenance charges. Total rent expense, base rent and contingent rent for the three and six month periods ended August 2, 2008 and August 4, 2007 (in thousands) are as follows:

	For the Three Months Ended		For the Six Months Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Store base rent expense	\$ 7,308	\$ 5,708	\$ 14,095	\$ 11,169
Other base rent expense	243	244	486	487
Total base rent expense	7,551	5,952	14,581	11,656
Contingent and other rent expense	4,915	4,231	9,368	7,851
Total rent expense	\$ 12,466	\$ 10,183	\$ 23,949	\$ 19,507

**Litigation** On December 10, 2007, a putative class action complaint was filed in the U.S. District Court for the Western District of Washington against the Company and certain of its current and former directors and officers. The complaint asserts claims under Sections 10(b), 20(a), and 20A of the Securities Exchange Act of 1934, as amended, and Rule 10b-5. A substantially similar complaint was filed in the same court on December 14, 2007. These cases, which were subsequently consolidated, purported to be brought on behalf of a class of purchasers of the Company's stock during the period March 14, 2007 to November 7, 2007. Plaintiffs filed a consolidated amended complaint on May 5, 2008, extending the class period to January 4, 2008, and alleging that the defendants violated the federal securities laws during this period of time by, among other things, making misrepresentations about the Company's

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projected financial results in order to artificially inflate the Company's stock price. Plaintiffs are seeking compensatory damages in an unspecified amount, interest, and an award of attorneys' fees and costs.

On July 21, 2008, defendants filed a motion to dismiss the amended complaint. Plaintiffs have until September 19, 2008 to oppose that motion, and defendants reply is due on or before October 20, 2008.

In addition, on December 20, 2007, a shareholder derivative action was filed in the Superior Court of the State of Washington (Snohomish County), allegedly on behalf of and for the benefit of the Company, against certain of the Company's current directors and current and former officers. The Company was named as a nominal defendant. The derivative complaint is based on the same allegations of fact as in the securities class action, and claims that the defendant directors and officers breached fiduciary duties, abused their control, engaged in gross mismanagement, wasted corporate assets, unjustly enriched themselves, and engaged in insider trading. The complaint seeks unspecified damages, restitution, disgorgement of profits, equitable and injunctive relief, attorneys' fees, costs, and expenses. Because the complaint is derivative in nature, it does not seek monetary damages from the Company. However, the Company may be required throughout the pendency of the action

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to advance the legal fees and costs incurred by the defendant directors and officers. Under the terms of its corporate bylaws and related indemnity agreements, the Company is obligated to indemnify all current and former officers and directors involved in civil, criminal, or investigative matters, in connection with their service. The Company is also obligated to advance fees and expenses, but only if the involved officer or director acted in good faith. There is no limit on the indemnification payments the Company could be required to make under these provisions. At this time, the Company does not believe that any potential fees or expense arising from officer and director indemnification will be material.

On April 28, 2008, Zumiez moved to dismiss the derivative complaint for failure to make a demand on Zumiez's Board of Directors. Plaintiff filed his response on June 27, 2008. Before Zumiez was to file its reply, it agreed with the plaintiff to stay the derivative action pending the outcome of the motion to dismiss in the federal securities action. On August 3, 2008 the court overseeing the derivative litigation approved the stay.

The Company is unable to predict the outcome of these cases. A court determination in any of these actions against the Company could result in significant liability and could have a material adverse effect on the Company's business, results of operations or financial condition.

On March 5, 2008, a former employee commenced an action against the Company in California state court (Evan Johnson v. Zumiez, Inc., et al., Case No. RG08374968, Alameda County Superior Court) alleging that the Company failed to pay all overtime wages owing to him and other employees, failed to provide meal breaks as required by California law, failed to provide employees with proper itemized wage statements (pay stubs) as required by California law, and failed to pay terminated employees waiting time penalties under California Labor Code section 203. On April 28, 2008, plaintiff filed a first amended complaint which adds an additional claim that employees under age 18 worked more hours than permitted by the Labor Code; the first amended complaint also seeks to recover penalties under the Private Attorney General Act for alleged violation of various Labor Code sections. The company filed an answer to the first amended complaint on May 20, 2008, denying the allegations of the complaint and asserting affirmative defenses. The parties are engaged in discovery. The suit was filed as a putative class action, but no motion requesting certification of the case as a class action has been filed. No trial date has been set. At this early stage of the case, it is not possible to estimate the amount or range of potential loss with any degree of certainty.

**Insurance Reserves** The Company is responsible for medical insurance claims up to a specified aggregate amount. The Company maintains a reserve for estimated medical insurance claims based on historical claims experience and other estimated assumptions.

**4. Fair Value Measurements** Effective February 3, 2008 (the first day of our 2008 fiscal year), the Company adopted SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements under SFAS 157 is as follows:

- Level 1 Quoted prices in active markets for identical assets or liabilities;
- Level 2 Quoted prices for similar assets or liabilities in active markets or inputs that are observable;

- Level 3 Inputs that are unobservable.

The following table summarizes assets measured at fair value on a recurring basis at August 2, 2008, as required by SFAS 157:

	Level 1	Level 2	Level 3
	(in thousands)		
Marketable securities	\$	\$ 58,516	\$ 1,847

The \$1.8 million in Level 3 marketable securities represents two \$1.0 million auction rate securities net of impairment charge of \$0.2 million. One of these \$1.0 million securities failed to sell at its scheduled auction in March 2008. The interest rate of this security reset to a tax-free rate of 6.55%. In May 2008, the remaining \$1.0 million security failed to sell at its scheduled auction. The interest rate of this security was reset to a tax-free rate of 3.20%. The next scheduled auction for these securities is in fiscal 2009. Based on market conditions, the Company changed its valuation methodology for auction rate securities to a valuation method based on numerous assumptions including assessments of the underlying structure of each security, expected cash flows, credit ratings, liquidity and other relevant factors during the first quarter of fiscal 2008.



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Accordingly, these securities are classified as Level 3 within SFAS 157's valuation hierarchy since the Company's initial adoption of SFAS 157 at February 3, 2008. These assumptions, assessments and the interpretations of relevant market data are subject to uncertainties, are difficult to predict and require significant judgment. The use of different assumptions, applying different judgment to inherently subjective matters and changes in future market conditions could result in significantly different estimates of fair value.

As a result of the temporary declines in fair value for the Company's auction rate securities, which the Company attributes to current liquidity issues rather than credit issues, it has recorded an unrealized loss of approximately \$0.2 million to accumulated other comprehensive loss in the condensed consolidated balance sheet as of August 2, 2008. The Company believes the current illiquid conditions are temporary in nature and that it has the ability to hold the auction rate securities until liquidity returns to the market. If it is later determined that the fair value of these securities is other-than-temporarily impaired, the Company will record a loss in the consolidated statement of operations. Due to the Company's belief that the market for these investments may take in excess of twelve months to fully recover, the Company has classified them as noncurrent assets on the accompanying condensed consolidated balance sheet as of August 2, 2008.

The \$58.5 million in Level 2 marketable securities includes corporate and municipal bonds traded in the over-the-counter market. Fair values are based on quoted market prices for similar assets or liabilities or determined using inputs that use as their basis readily observable market data that are actively quoted and can be validated through external sources, including third-party pricing services, brokers, and market transactions.

The following table presents the changes in the Level 3 fair-value category for the six months ended August 2, 2008. The Company classifies financial instruments in Level 3 of the fair-value hierarchy when there is reliance on at least one significant unobservable input to the valuation model. In addition to these unobservable inputs, the valuation models for Level 3 financial instruments may also rely on a number of inputs that are readily observable either directly or indirectly.

	February 2, 2008	Transfers in and/or (out) of Level 3	Total unrealized loss included in Accumulated Comprehensive Loss	August 2, 2008
	(in thousands)			
Marketable securities	\$	\$ 2,000	\$ (153)	\$ 1,847

**5. Net Income Per Share, Basic and Diluted** Basic net income per share is based on the weighted average number of common shares outstanding during the period. Diluted net income per share is based on the weighted average number of common shares and common share equivalents outstanding during the period. Common share equivalents included in the computation represent shares issuable upon assumed exercise of outstanding stock options and non-vested restricted stock and employee stock purchase plan share equivalents. Potentially anti-dilutive securities not included in the calculation of diluted earnings per share include options to purchase common stock where the option exercise price is greater than the average market price of the Company's common stock during the period reported. Total common stock options not included in the calculation of diluted earnings per share were 861,712 and 5,000 for the three and six months ended August 2, 2008 and August 4, 2007, respectively. There were 251,024 and 207,825 of non-vested restricted shares included in the calculation of diluted earnings per share for the three and six months ended August 2, 2008, respectively.



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

	For the Three Months Ended		For the Six Months Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Net income	\$ 2,727	\$ 3,118	\$ 4,089	\$ 4,735
Weighted average common shares for basic net income per share	29,072,536	28,540,326	29,042,861	28,478,125
Dilutive effect of stock options and restricted stock	306,053	645,944	331,154	616,109
Weighted average common shares for diluted net income per share	29,378,589	29,186,270	29,374,015	29,094,234
Basic net income per share	\$ 0.09	\$ 0.11	\$ 0.14	\$ 0.17
Diluted net income per share	\$ 0.09	\$ 0.11	\$ 0.14	\$ 0.16

**6. Goodwill** In connection with the acquisition of Action Concepts Fast Forward, Ltd., on June 24, 2006 the Company recorded goodwill in accordance with SFAS 141 *Business Combinations*. During the quarter ended August 2, 2008, the Company released \$250,000 of restricted cash held in escrow that was payable to Action Concepts Fast Forward, Ltd. The Company recorded \$13.2 million of goodwill as the excess of the purchase price of \$15.5 million over the fair value of the net amounts assigned to assets acquired and liabilities assumed. In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, the Company will continue to assess, in accordance with our goodwill policy as stated in Note 2, whether goodwill is impaired.

**7. Related Party Transactions** The Company committed charitable contributions to Zumiez Foundation in the six months ended August 2, 2008 of approximately \$43,000. The Company committed charitable contributions to the Zumiez Foundation in the six months ended August 4, 2007 of approximately \$210,000.

### **Item 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this quarterly report. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those discussed in the section entitled "Risk Factors" in our Form 10-K filed with the SEC on March 25, 2008 and in this Form 10-Q.*

*Forward-looking statements are based on our expectations regarding net sales, selling, general and administrative expenses, profitability, financial position, business strategy, new store openings, and plans and objectives of management. The words believe, may, will, estimate, continue, anticipate, intend, expect and similar expressions, as they relate to us and our business, industry, markets and consumers, are intended to identify forward-looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including, among others, those described in "Risk Factors" and elsewhere in this quarterly report and in the Form 10-K referred to in the preceding paragraph. New risk factors emerge from time to time and it is not possible for our management to predict all risk factors, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. We assume no obligation to update any forward-looking statements as a result of new information, future events or developments. References in the following discussion to we, us, our, the Company*

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*and similar references mean Zumiez Inc. and its consolidated subsidiary, unless otherwise expressly stated or the context otherwise requires.*

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**Overview**

We are a mall based specialty retailer of action sports related apparel, footwear, equipment and accessories operating under the Zumiez brand name. Our stores cater to young men and women between the ages of 12 and 24 who seek brands representing a lifestyle centered on activities that include skateboarding, surfing, snowboarding, BMX, and motocross. We support the action sports lifestyle and promote our brand through a multi-faceted marketing approach that is designed to integrate our brand image with our customers' activities and interests.

**General**

Net sales constitute gross sales net of estimated returns. Net sales include our in-store sales and our internet sales and, accordingly, information in this quarterly report with respect to comparable store sales includes internet sales. Our internet sales are and have historically been approximately 1% of total sales. Sales with respect to gift cards are deferred and recognized when gift cards are redeemed.

We report comparable store sales based on net sales, and stores are included in our comparable store sales beginning on the first anniversary of their first day of operation. Changes in our comparable store sales between two periods are based on net sales of stores which were in operation during both of the two periods being compared and, if a store is included in the calculation of comparable store sales for only a portion of one of the two periods being compared, then that store is included in the calculation for only the comparable portion of the other period. When additional square footage is added to a store that is included in comparable store sales, the store remains in comparable store sales. There may be variations in the way in which some of our competitors and other apparel retailers calculate comparable or same store sales. As a result, data regarding our comparable store sales may not be comparable to similar data made available by our competitors or other retailers.

Cost of goods sold consists of the cost of merchandise sold to customers, inbound shipping costs, internet shipping costs, distribution costs, depreciation on leasehold improvements at our distribution center, buying and merchandising costs and store occupancy costs. This may not be comparable to the way in which our competitors or other retailers compute their cost of goods sold.

Selling, general and administrative expenses consist primarily of store personnel wages and benefits, administrative staff and infrastructure expenses, store supplies, depreciation on leasehold improvements at our home office and stores, facility expenses, training, advertising and marketing costs. Credit card fees, insurance and other miscellaneous operating costs are also included in selling, general and administrative expenses. This may not be comparable to the way in which our competitors or other retailers compute their selling, general and administrative expenses.

**Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in conformance with accounting principles generally accepted in the United States of America ( GAAP ). In preparing financial statements in accordance with GAAP, we are required to make estimates and assumptions that have an impact on the assets, liabilities, revenue and expense amounts reported. These estimates can also affect supplemental information disclosed by us, including information about contingencies, risk,

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and financial condition. We believe, given current facts and circumstances, that our estimates and assumptions are reasonable, adhere to GAAP, and are consistently applied. Inherent in the nature of an estimate or assumption is the fact that actual results may differ from estimates and estimates may vary as new facts and circumstances arise. In preparing the financial statements, we make routine estimates and judgments in determining the net realizable value of accounts receivable, inventory, fixed assets, prepaid assets, goodwill and certain liabilities. We believe our most critical accounting estimates and assumptions are in the following areas:

*Impairment of Marketable and Non-Marketable Securities.* We periodically review our marketable securities for impairment. If we conclude that any of these investments are impaired, we determine whether such impairment is other-than-temporary as defined under FSP 115-1. Factors we consider to make such a determination include the duration and severity of the impairment, as well as the reason for the decline in value and the potential recovery period. If any impairment is considered other-than-temporary, we will write down the asset to its fair value and take a corresponding charge to our consolidated statement of operations.

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*Valuation of merchandise inventories.* We carry our merchandise inventories at the lower of cost or market. Merchandise inventories may include items that have been written down to our best estimate of their net realizable value. Our decisions to write-down our merchandise inventories are based on our current rate of sale, the age of the inventory and other factors. Actual final sales prices to our customers may be higher or lower than our estimated sales prices and could result in a fluctuation in gross margin. Historically, any additional write-downs have not been significant and we do not adjust the historical carrying value of merchandise inventories upwards based on actual sales experience.

*Leasehold improvements and equipment.* We review the carrying value of our leasehold improvements and equipment for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Measurement of the impairment loss is based on the fair value of the asset or group of assets. Generally, fair value will be determined using valuation techniques, such as the expected present value of future cash flows. The actual economic lives of these assets may be different than our estimated useful lives, thereby resulting in a different carrying value. These evaluations could result in a change in the depreciable lives of those assets and therefore our depreciation expense in future periods.

*Revenue recognition and sales returns reserve.* We recognize revenue upon purchase by customers at our retail store locations or upon shipment for orders placed through our website as both title and risk of loss have transferred. We offer a return policy of generally 30 days and we accrue for estimated sales returns based on our historical sales returns results. The amounts of these sales returns reserves vary during the year due to the seasonality of our business. Actual sales returns could be higher or lower than our estimated sales returns due to customer buying patterns that could differ from historical trends.

*Impairment of Long-Lived Assets.* We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is determined by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered impaired, the impairment recognized is measured by comparing projected individual store discounted cash flow to the asset carrying values. Declines in projected store cash flow could result in the impairment of assets.

*Accounting for Income Taxes.* As part of the process of preparing the condensed consolidated financial statements, income taxes are estimated for each of the jurisdictions in which we operate. This process involves estimating actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the balance sheet. The likelihood that deferred tax assets will be recovered from future taxable income is assessed, recognizing that future taxable income may give rise to new deferred tax assets. To the extent that future recovery is not likely, a valuation allowance would be established. To the extent that a valuation allowance is established or increased, an expense will be included within the tax provision in the income statement.

Significant management judgment is required in determining the provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against net deferred tax assets. Based on our history of operating earnings, no valuation allowance has been recorded as of

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August 2, 2008. In the event that actual results differ from these estimates, or these estimates are adjusted in future periods, a valuation allowance may need to be established, which could impact our financial position and results of operations. The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), on January 1, 2007. The Company's policy is to recognize penalties and interest related to unrecognized tax benefits in income tax expense. Provisions for income taxes are based on numerous factors that are subject to audit by the Internal Revenue Service and the tax authorities in the various jurisdictions in which we do business.

*Stock-based compensation.* Effective January 29, 2006, we adopted the fair value method of accounting for stock-based compensation arrangements in accordance with FASB Statement No. 123(R), *Share-Based Payment* ( SFAS No. 123(R) ), using the modified prospective method of transition. Under the provisions of SFAS No. 123(R), the estimated fair value of share-based awards granted under the 2005 Stock Incentive Plan is recognized as compensation expense over the vesting period. Using the modified prospective method, compensation expense is recognized beginning with the effective date of adoption of SFAS No. 123(R) for all share-based issuances (i) granted after the effective date of adoption and (ii) granted prior to the effective date of adoption and after our initial public offering on May 5, 2005. Prior to January 29, 2006, we accounted for stock-based employee compensation plans using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and its related



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interpretations. Under the provisions of APB 25, no compensation expense was recognized when stock options were granted with exercise prices equal to or greater than market value on the date of grant.

We account for unvested stock-based employee compensation arrangements granted prior to our initial public offering on the intrinsic value method as allowed by SFAS 123(R).

**Results of Operations**

The following table presents, for the periods indicated, selected items in the statements of operations as a percent of net sales:

	For the Three Months Ended		For the Six Months Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	67.4	65.6	68.0	66.9
Gross profit	32.6	34.4	32.0	33.1
Selling, general and administrative expenses	28.4	28.7	28.7	28.5
Operating profit	4.2	5.7	3.3	4.6
Interest income, net	0.6	0.4	0.6	0.5
Earnings before income taxes	4.8	6.1	3.9	5.1
Provision for income taxes	1.8	2.3	1.5	2.0
Net Income	3.0%	3.8%	2.4%	3.1%

**Three Months (13 weeks) Ended August 2, 2008 Compared With Three Months (13 weeks) Ended August 4, 2007***Net Sales*

Net sales increased to \$92.3 million for the three months ended August 2, 2008 from \$82.0 million for the three months ended August 4, 2007, an increase of \$10.3 million, or 12.5%.

Comparable store net sales decreased 1.7% for the three months ended August 2, 2008 compared to the three months ended August 4, 2007. The decrease in comparable store net sales was primarily due to lower net sales of juniors apparel, men's apparel, and accessories partially offset by higher net sales of footwear and skate hardgoods. For information as to how we define comparable stores, see General above.

The increase in total net sales was due to an increase in net sales from non-comparable stores of approximately \$11.7 million partially offset by a decrease in comparable store net sales of approximately \$1.4 million. The increase in non-comparable store net sales was primarily due to the opening of 58 new stores subsequent to August 4, 2007.

***Gross Profit***

Gross profit for the three months ended August 2, 2008 was \$30.1 million compared with \$28.2 million for the three months ended August 4, 2007, an increase of approximately \$1.9 million, or 6.8%. As a percentage of net sales, gross profit decreased to 32.6% for the three months ended August 2, 2008 from 34.4% for the three months ended August 4, 2007. The reduction in gross profit as a percent of net sales was driven by store occupancy costs growing at a faster rate than sales and to a lesser extent a decline in gross margin on apparel products.

***Selling, General and Administrative Expenses***

Selling, general and administrative, or SG&A expenses in the three months ended August 2, 2008 were \$26.2 million compared with \$23.5 million in the three months ended August 4, 2007, an increase of \$2.7 million, or 11.5%. This increase was primarily the result of costs associated with operating new stores and to a lesser extent increases in infrastructure and administrative staff to support our growth. As a percentage of net sales, SG&A expenses decreased to 28.4% in the three months ended August 2, 2008 from 28.7% in the three months ended August 4, 2007. The decrease in SG&A expenses as a percentage of net sales was primarily attributable to a decrease in stock-based compensation, incentive compensation and

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credit card fees partially offset by increased store payroll and payroll related costs, additional depreciation on new stores and administrative support for new store growth.

***Operating Profit***

As a result of the above factors, operating profit was \$3.9 million in the three months ended August 2, 2008 compared with \$4.7 million in the three months ended August 4, 2007, a decrease of \$0.8 million or 16.8%. As a percentage of net sales, operating profit was 4.2% in the three months ended August 2, 2008 compared with 5.7% in the three months ended August 4, 2007.

***Provision for Income Taxes***

Provision for income taxes was \$1.7 million for the three months ended August 2, 2008 compared with \$1.9 million for the three months ended August 4, 2007. Our income tax rate was relatively consistent for both referenced periods.

***Net Income***

Net income was \$2.7 million in the three months ended August 2, 2008 compared to \$3.1 million in the three months ended August 4, 2007, a decrease of \$0.4 million, or 12.5%. As a percentage of net sales, net income was 3.0% in the three months ended August 2, 2008 compared with 3.8% in the three months ended August 4, 2007.

**Six Months (26 weeks) Ended August 2, 2008 Compared With Six Months (26 weeks) Ended August 4, 2007**

***Net Sales***

Net sales increased to \$171.0 million for the six months ended August 2, 2008 from \$150.8 million for the six months ended August 4, 2007, an increase of \$20.2 million, or 13.4%.

Comparable store net sales decreased by 1.3% for the six months ended August 2, 2008 compared to the six months ended August 4, 2007. The decrease in comparable store net sales was primarily due to lower net sales of men's apparel, juniors apparel and accessories partially offset by higher net sales of footwear and skate hardgoods. For information as to how we define comparable stores, see "General" above.

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The increase in total net sales was due to an increase in non-comparable store net sales of approximately \$22.2 million partially offset by a decrease in net sales from comparable stores of approximately \$2.0 million. The increase in non-comparable store net sales was primarily due to the opening of 58 new stores subsequent to August 4, 2007.

### *Gross Profit*

Gross profit for the six months ended August 2, 2008 was \$54.7 million compared with \$49.9 million for the six months ended August 4, 2007, an increase of \$4.8 million, or 9.5%. As a percentage of net sales, gross profit decreased to 32.0% for the six months ended August 2, 2008 from 33.1% for the six months ended August 4, 2007. The decline in gross profit as a percent of net sales was driven primarily by store occupancy costs growing at a faster rate than sales.

### *Selling, General and Administrative Expenses*

Selling, general and administrative, SG&A, expenses for the six months ended August 2, 2008 were \$49.1 million compared with \$43.0 million in the six months ended August 4, 2007, an increase of \$6.1 million, or 14.2%. This increase was primarily the result of costs associated with operating new stores as well as increases in infrastructure and administrative staff to support our growth partially offset by a decrease in stock-based compensation and incentive compensation expenses. As a percentage of net sales, SG&A expenses increased to 28.7% in the six months ended August 2, 2008 from 28.5% in the six months ended August 4, 2007. The increase in SG&A expenses as a percentage of net sales was primarily attributable to additional new store depreciation and store wages and benefits relative to the growth in net sales somewhat offset by a decrease in stock-based compensation and incentive compensation expenses.

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***Operating Profit***

As a result of the above factors, operating profit decreased to \$5.5 million for the six months ended August 2, 2008 compared with \$6.9 million for the six months ended August 4, 2007 a decrease of \$1.3 million, or 19.6%. As a percentage of net sales, operating profit was 3.3% and 4.6% for the six months ended August 2, 2008 and August 4, 2007, respectively.

***Provision for Income Taxes***

Provision for income taxes was \$2.5 million for the six months ended August 2, 2008 compared with \$2.9 million for the six months ended August 4, 2007.

***Net Income***

Net income decreased to \$4.1 million for the six months ended August 2, 2008 from net income of \$4.7 million for the six months ended August 4, 2007, a decrease of \$0.6 million or 13.6%. As a percentage of net sales, net income was 2.4% and 3.1% for the six months ended August 2, 2008 and August 4, 2007, respectively.

**Liquidity and Capital Resources**

Our primary capital requirements are for inventory, store fixtures, store construction and remodeling, capital investments and ongoing infrastructure improvements such as technology enhancements and distribution capabilities. Historically, our main sources of liquidity have been cash flows from operations, borrowings under our revolving credit facility and proceeds from the sale of our equity securities.

The significant components of our working capital are inventory and liquid assets such as cash, marketable securities and receivables, specifically tenant allowances and credit card receivables, reduced by short-term debt, accounts payable and accrued expenses. Our working capital position benefits from the fact that we generally collect cash from sales to customers the same day or within several days of the related sale, while we typically have extended payment terms with our vendors.

As of August 2, 2008, we held two \$1.0 million Auction Rate Securities valued at \$1.8 million, net of approximately \$0.2 million impairment charge. One of these \$1.0 million securities failed to sell at its scheduled auction in March 2008. In May 2008, the remaining \$1.0 million security failed to sell at its scheduled auction. The interest rates for these securities reset to a prescribed failure tax-free rate of 6.55% and 3.20%, respectively. We currently do not intend to hold these securities beyond their next auction date and will try to sell these securities when their auction dates come up in March 2009 and May 2009. However, the recent uncertainties in the credit markets have prevented us and other investors from liquidating holdings of auction rate securities in recent auctions for these securities because the amount of securities submitted for

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sale has exceeded the amount of purchase orders. If the March 2009 and May 2009 auctions fail, we plan to hold these securities until the next auction date and the securities coupon rate will reset to a prescribed failure rate. Unsuccessful auctions could result in our holding securities beyond their next scheduled auction reset dates if a secondary market does not develop; therefore, limiting the short-term liquidity of these investments. These securities have been reclassified from current to long term assets on our condensed consolidated balance sheet as of August 2, 2008.

Our capital requirements include construction and fixture costs related to the opening of new stores and remodeling expenditures for existing stores. Future capital requirements will depend on many factors, including the pace of new store openings, the availability of suitable locations for new stores, and the nature of arrangements negotiated with landlords. In that regard, our net investment to open a new store has varied significantly in the past due to a number of factors, including the geographic location and size of the new store, and is likely to vary significantly in the future. During fiscal 2008, we expect to spend approximately \$33.0 to \$35.0 million on capital expenditures, a majority of which will relate to leasehold improvements and fixtures for the 57 total new stores we plan to open in fiscal 2008, and a smaller amount will relate to equipment, systems and improvements for our distribution center and support infrastructure. However, there can be no assurance that the number of stores that we actually open in fiscal 2008 will not be different from the number of stores we plan to open, or that actual fiscal 2008 capital expenditures will not differ from this expected amount.

We expect cash flows from operations and available borrowings under our revolving credit facility will be sufficient to meet our foreseeable cash requirements for operations and planned capital expenditures for at least the next twelve months. Beyond this time frame, if these sources are not sufficient to meet our capital requirements, then we will be required to obtain

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additional equity or debt financing in the future. There can be no assurance that equity or debt financing will be available to us when we need it or, if available, that the terms will be satisfactory to us and not dilutive to our then-current shareholders.

Net cash provided by operating activities for the six months ended August 2, 2008 was approximately \$15.7 million primarily related to increased trade accounts payable, taxes payable, depreciation and deferred rent, partially offset by an increase in inventory and receivables. Net cash used in operating activities for the six months ended August 4, 2007 was \$6.7 million primarily related to an increase in inventory and receivables partially offset by an increase in trade accounts payable and an increase in depreciation.

Net cash used in investing activities was \$15.5 million for the six months ended August 2, 2008, related to \$19.0 million of capital expenditures for new store openings and existing store renovations partially offset by the \$3.5 million in net sales of marketable securities. Net cash used in investing activities was \$2.7 million for the six months ended August 4, 2007, related to capital expenditures for new store openings and existing store renovations predominately offset by the net sales of marketable securities.

Net cash used in financing activities for the three months ended August 4, 2008 was \$4.1 million related to the payment of book overdrafts somewhat offset by proceeds received from exercise of stock options and the related tax benefit. Net cash provided by financing activities for the three months ended August 4, 2007 was \$7.4 million related to proceeds received from exercise of stock options and the related tax benefit partially offset by the payment of book overdrafts.

We have a credit agreement with Wells Fargo HSBC Trade Bank, N.A. The credit agreement provides us with a secured revolving credit facility until August 30, 2009 of up to \$25.0 million. The secured revolving credit facility provides for the issuance of standby commercial letters of credit in an amount not to exceed \$5.0 million outstanding at any time and with a term not to exceed 365 days, although the amount of borrowings available at any time under our secured revolving credit facility is reduced by the amount of standby letters of credit outstanding at that time. There were no outstanding borrowings under the secured revolving credit facility at August 2, 2008 or February 2, 2008. The Company had open letters of credit outstanding under our secured revolving credit facility of \$3.6 million at August 2, 2008 and approximately \$0.5 million at February 2, 2008. The secured revolving credit facility bears interest at floating rates based on the lower of the prime rate (5.00% at August 2, 2008) minus 0.50% or the LIBOR rate (3.26% at August 2, 2008), plus 1.00% for advances over \$500,000 for a minimum of 30 days and a maximum of 180 days. The credit agreement contains a number of restrictions and covenants that generally limit our ability to, among other things, (1) incur additional debt, (2) undergo a change in ownership and (3) enter into certain transactions. The credit agreement also contains financial covenants that require us to meet certain specified financial tests and ratios, including, minimum net income after taxes, maximum total liabilities divided by tangible net worth and minimum quick asset ratio. All of our personal property, including, among other things, our inventory, equipment and fixtures, has been pledged to secure our obligations under the credit agreement. We must also provide financial information and statements to our lender. We were in compliance with all such covenants at August 2, 2008.

**Contractual Obligations and Commercial Commitments**

There was no material changes outside the ordinary course of business in our contractual obligations during the three months ended August 2, 2008. Our operating lease obligations are not recognized as liabilities in the financial statements. The following table summarizes the total amount of future payments (in thousands) due under certain of our contractual obligations at August 2, 2008:

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<b>Contractual Obligations</b>	<b>Total</b>	<b>Less than 1 Year</b>	<b>1- 3 Years</b>	<b>3-5 Years</b>	<b>More than 5 Years</b>
Operating Lease Obligations	\$ 265,540	\$ 16,273	\$ 65,255	\$ 61,264	\$ 122,748
Purchase Obligations	95,127	95,127			
Letters of Credit	3,563	3,563			
	\$ 364,230	\$ 114,963	\$ 65,255	\$ 61,264	\$ 122,748

We occupy our retail stores and combined home office and distribution center under operating leases generally with terms of five to ten years. Some of our leases have early cancellation clauses, which permit the lease to be terminated by us if certain sales levels are not met in specific periods. Some leases contain renewal options for periods ranging from one to five years under substantially the same terms and conditions as the original leases. In addition to future minimum lease payments,



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substantially all of our store leases provide for additional rental payments (or percentage rent ) if sales at the respective stores exceed specified levels, as well as the payment of common area maintenance charges and real estate taxes, unless guaranteed in the lease agreement. Amounts in the above table do not include percentage rent, common area maintenance charges or real estate taxes. Most of our lease agreements have defined escalating rent provisions, which we have straight-lined over the term of the lease, including any lease renewals deemed to be probable. For certain locations, we receive cash tenant allowances and we have reported these amounts as a deferred liability that is amortized to rent expense over the term of the lease, including any lease renewals deemed to be probable. Rent expense, including common area maintenance and other occupancy costs, was \$23.9 million and \$19.5 million for the six months ended August 2, 2008 and August 4, 2007, respectively.

At August 2, 2008, we had outstanding purchase orders to acquire merchandise from vendors of approximately \$95.1 million. We have an option to cancel these commitments with no notice prior to shipment. At August 2, 2008, we had approximately \$3.6 million of letters of credit outstanding.

## **Off-Balance Sheet Obligations**

Our only off-balance sheet contractual obligations and commercial commitments as of August 2, 2008 related to operating lease obligations, open purchase orders, and letters of credit. We have excluded these items from our balance sheet in accordance with GAAP. We presently do not have any non-cancelable purchase commitments. At August 2, 2008, we had outstanding purchase orders to acquire merchandise from vendors for approximately \$95.1 million. These purchases are expected to be financed by cash flows from operations and borrowings under our secured revolving credit facility. We have an option to cancel these commitments with no notice prior to shipment. At August 2, 2008, we had \$3.6 million of letters of credit outstanding under our secured revolving credit facility. At August 2, 2008, we were committed to property owners for operation lease obligations in the amount of \$265.5 million. Most of our leases contain cancellation or kick-out clauses in our favor that relieve us from any future obligation under a lease if specified sales levels are not achieved by a specific date.

## **Impact of Inflation**

We do not believe that inflation has had a material impact on our net sales or operating results in the recent past. There can be no assurance that our business will not be affected by inflation in the future.

## **Risk Factors**

*Investing in our securities involves a high degree of risk. The following risk factors, issues and uncertainties should be considered in evaluating our future prospects. In particular, keep these risk factors in mind when you read forward-looking statements elsewhere in this report. Forward-looking statements relate to our expectations for future events and time periods. Generally, the words anticipate, believe, expect, intend and similar expressions identify forward-looking statements. Forward looking statements involve risks and uncertainties, and future events and circumstances could differ significantly from those anticipated in the forward looking statements. Any of the following risks could harm our business, operating results or financial condition and could result in a complete loss of your investment. Additional risks and uncertainties that are not yet identified or that we currently think are immaterial may also harm our business and financial condition in the future.*

*Our growth strategy depends on our ability to open and operate a significant number of new stores each year, which could strain our resources and cause the performance of our existing stores to suffer.*

Our growth largely depends on our ability to open and operate new stores successfully. However, our ability to open new stores is subject to a variety of risks and uncertainties, and we may be unable to open new stores as planned, and any failure to successfully open and operate new stores would have a material adverse effect on our results of operations and on the market price of our common stock. We intend to continue to open a significant number of new stores in future years while remodeling a portion of our existing store base annually. In addition, our proposed expansion will place increased demands on our operational, managerial and administrative resources. These increased demands could cause us to operate our business less effectively, which in turn could cause deterioration in the financial performance of our individual stores and our overall business. To the extent our new store openings are in markets where we already have stores, we may experience reduced net sales in existing stores in those markets. In addition, successful execution of our growth strategy may require that we obtain additional financing, and we cannot assure you that we will be able to obtain that financing on acceptable terms or at all.

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*If we fail to effectively execute our expansion strategy, we may not be able to successfully open new store locations in a timely manner, if at all, which could have an adverse affect on our net sales and results of operations.*

Our ability to open and operate new stores successfully depends on many factors, including, among others, our ability to:

- identify suitable store locations, the availability of which is outside of our control;
- negotiate acceptable lease terms, including desired tenant improvement allowances;
- source sufficient levels of inventory at acceptable costs to meet the needs of new stores;
- hire, train and retain store personnel;
- successfully integrate new stores into our existing operations; and
- identify and satisfy the merchandise preferences of new geographic areas.

In addition, many of our planned new stores are to be opened in regions of the United States in which we currently have few, or no, stores. The expansion into these markets may present competitive, merchandising and distribution challenges that are different from those currently encountered in our existing markets. Any of these challenges could adversely affect our business and results of operations.

*Our business is dependent upon our being able to anticipate, identify and respond to changing fashion trends, customer preferences and other fashion-related factors; failure to do so could have a material adverse effect on us.*

Customer tastes and fashion trends in the action sports lifestyle market are volatile and tend to change rapidly. Our success depends on our ability to effectively anticipate, identify and respond to changing fashion tastes and consumer preferences, and to translate market trends into appropriate, saleable product offerings in a timely manner. If we are unable to successfully anticipate, identify or respond to changing styles or trends and misjudge the market for our products or any new product lines, our sales may be lower than predicted and we may be faced with a substantial amount of unsold inventory or missed opportunities. In response to such a situation, we may be forced to rely on markdowns or promotional sales to dispose of excess or slow-moving inventory, which could have a material adverse effect on our results of operations.

***Our ability to attract customers to our stores depends heavily on the success of the shopping malls in which our stores are located; any decrease in customer traffic in those malls could cause our sales to be less than expected.***

In order to generate customer traffic we depend heavily on locating our stores in prominent locations within successful shopping malls. Sales at these stores are derived, in part, from the volume of traffic in those malls. Our stores benefit from the ability of a mall's other tenants to generate consumer traffic in the vicinity of our stores and the continuing popularity of malls as shopping destinations. Our sales volume and mall traffic generally may be adversely affected by, among other things, economic downturns in a particular area, competition from internet retailers, non-mall retailers and other malls, increases in gasoline prices and the closing or decline in popularity of other stores in the malls in which we are located. A reduction in mall traffic as a result of these or any other factors could have a material adverse effect on our business, results of operations and financial condition.

***Our sales and inventory levels fluctuate on a seasonal basis, leaving our operating results particularly susceptible to changes in back-to-school and holiday shopping patterns.***

Our sales are typically disproportionately higher in the third and fourth fiscal quarters of each fiscal year due to increased sales during the back-to-school and winter holiday shopping seasons. Sales during these periods cannot be used as an accurate indicator of annual results. Our sales in the first and second fiscal quarters are typically lower than in our third and fourth fiscal quarters due, in part, to the traditional retail slowdown immediately following the winter holiday season. Any significant decrease in sales during the back-to-school and winter holiday seasons would have a material adverse effect on our financial condition and results of operations. In addition, in order to prepare for the back-to-school and winter holiday shopping seasons, we must order and keep in stock significantly more merchandise than we carry during other parts of the

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year. Any unanticipated decrease in demand for our products during these peak shopping seasons could require us to sell excess inventory at a substantial markdown, which could have a material adverse effect on our business, results of operations and financial condition.

*Our quarterly results of operations are volatile and may decline.*

Our quarterly results of operations have fluctuated significantly in the past and can be expected to continue to fluctuate significantly in the future. As discussed above, our sales and operating results are typically lower in the first and second quarters of our fiscal year due, in part, to the traditional retail slowdown immediately following the winter holiday season. Our quarterly results of operations are affected by a variety of other factors, including:

- the timing of new store openings and the relative proportion of our new stores to mature stores;
  
- whether we are able to successfully integrate any new stores that we acquire and the presence or absence of any unanticipated liabilities in connection therewith;
  
- fashion trends and changes in consumer preferences;
  
- calendar shifts of holiday or seasonal periods;
  
- changes in our merchandise mix;
  
- timing of promotional events;
  
- general economic conditions and, in particular, the retail sales environment;
  
- actions by competitors or mall anchor tenants;

- weather conditions;
- the level of pre-opening expenses associated with our new stores; and
- inventory shrinkage beyond our historical average rates.

***Failure to successfully integrate any businesses or stores that we acquire could have an adverse impact on our results of operations and financial performance.***

We may from time to time acquire other retail stores, individually or in groups, or businesses. We may experience difficulties in assimilating any stores or businesses we may acquire, and any such acquisitions may also result in the diversion of our capital and our management's attention from other business issues and opportunities. We may not be able to successfully integrate any stores or businesses that we may acquire, including their facilities, personnel, financial systems, distribution, operations and general operating procedures. If we fail to successfully integrate acquisitions or if such acquisitions fail to provide the benefits that we expect to receive, we could experience increased costs and other operating inefficiencies, which could have an adverse effect on our results of operations and financial performance.

***Our business is susceptible to weather conditions that are out of our control including the potential risks of unpredictable weather patterns, including any weather patterns associated with global warming, and the resultant unseasonable weather could have a negative impact on our results of operations.***

Our business is susceptible to unseasonable weather conditions. For example, extended periods of unseasonably warm temperatures (including any weather patterns associated with global warming) during the winter season or cool weather during the summer season could render a portion of our inventory incompatible with those unseasonable conditions. These prolonged unseasonable weather conditions, particularly in regions of the United States where we have a concentration of stores, could have a material adverse effect on our business and results of operations.

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***We may be unable to compete favorably in the highly competitive retail industry, and if we lose customers to our competitors, our sales could decrease.***

The teenage and young adult retail apparel, hardgoods and accessories industry is highly competitive. We compete with other retailers for vendors, teenage and young adult customers, suitable store locations, qualified store associates and management personnel. In the softgoods market which includes apparel, accessories and footwear, we currently compete with a large number of other teenage-focused retailers. In addition, in the softgoods market we compete with independent specialty shops, department stores, and direct marketers that sell similar lines of merchandise and target customers through catalogs and e-commerce. In the hardgoods market which includes skateboards, snowboards, bindings, components and other equipment, we compete directly or indirectly with the following categories of companies: other specialty retailers that compete with us across a significant portion of our merchandising categories, such as local snowboard and skate shops, large-format sporting goods stores and chains and internet retailers.

Some of our competitors are larger than we are and have substantially greater financial, marketing and other resources than we do. Direct competition with these and other retailers may increase significantly in the future, which could require us, among other things, to lower our prices and could result in the loss of our customers. Current and increased competition could have a material adverse effect on our business, results of operations and financial condition.

***If we fail to maintain good relationships with vendors or if a vendor is otherwise unable or unwilling to supply us with adequate quantities of their products at acceptable prices, our business and financial performance could suffer.***

Our business is dependent on continued good relations with our vendors. In particular, we believe that we generally are able to obtain attractive pricing and other terms from vendors because we are perceived as a desirable customer, and deterioration in our relationship with our vendors would likely have a material adverse effect on our business. We do not have any contractual relationships with our vendors and, accordingly, there can be no assurance that our vendors will provide us with an adequate supply or quality of products or acceptable pricing. Our vendors could discontinue selling to us or raise the prices they charge at any time. There can be no assurance that we will be able to acquire desired merchandise in sufficient quantities on terms acceptable to us in the future. Also, certain of our vendors sell their products directly to the retail market and therefore compete with us directly, and other vendors may decide to do so in the future. There can be no assurance that such vendors will not decide to discontinue supplying their products to us, supply us only less popular or lesser quality items, raise the prices they charge us or focus on selling their products directly. Any inability to acquire suitable merchandise at acceptable prices, or the loss of one or more key vendors, would have a material adverse effect on our business, results of operations and financial condition.

***If we lose key management or are unable to attract and retain the talent required for our business, our financial performance could suffer.***

Our performance depends largely on the efforts and abilities of our senior management, including our Co-Founder and Chairman, Thomas D. Champion, our President and Chief Executive Officer, Richard M. Brooks, our Chief Financial Officer, Trevor S. Lang, our Executive Vice President and General Merchandising Manager, Lynn K. Kilbourne and our Executive Vice President of Stores, Ford K. Wright. None of our employees, except Mr. Brooks, has an employment agreement with us and we do not plan to obtain key person life insurance covering any of our employees. If we lose the services of one or more of our key executives, we may not be able to successfully manage our business or achieve our growth objectives. As our business grows, we will need to attract and retain additional qualified management personnel in a timely manner and we may not be able to do so.

*Our failure to meet our staffing needs could adversely affect our ability to implement our growth strategy and could have a material impact on our results of operations.*

Our success depends in part upon our ability to attract, motivate and retain a sufficient number of qualified employees, including regional managers, district managers, store managers and store associates, who understand and appreciate our corporate culture based on a passion for the action sports lifestyle and are able to adequately represent this culture to our customers. Qualified individuals of the requisite caliber, skills and number needed to fill these positions may be in short supply in some areas, and the employee turnover rate in the retail industry is high. Competition for qualified employees could require us to pay higher wages to attract a sufficient number of suitable employees. If we are unable to hire and retain store managers and store associates capable of consistently providing a high level of customer service, as demonstrated by their enthusiasm for our culture and knowledge of our merchandise, our ability to open new stores may be



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impaired and the performance of our existing and new stores could be materially adversely affected. We are also dependent upon temporary personnel to adequately staff our stores and distribution center, particularly during busy periods such as the back-to-school and winter holiday seasons. There can be no assurance that we will receive adequate assistance from our temporary personnel, or that there will be sufficient sources of temporary personnel. Although our employees are not currently covered by collective bargaining agreements, we cannot guarantee that our employees will not elect to be represented by labor unions in the future, which could increase our labor costs and could subject us to the risk of work stoppages and strikes. Any such failure to meet our staffing needs, any material increases in employee turnover rates, any increases in labor costs or any work stoppages or interruptions or strikes could have a material adverse effect on our business or results of operations.

***Our operations, including our sole distribution center, are concentrated in certain regions in the United States, which makes us susceptible to adverse conditions in these regions.***

Our home office and sole distribution center are located in a single facility in Washington, and a substantial number of our stores are located in Washington and the western half of the United States. We also have a substantial number of stores in the New York/New Jersey region and Texas. As a result, our business may be more susceptible to regional factors than the operations of more geographically diversified competitors. These factors include, among others, economic and weather conditions, demographic and population changes and fashion tastes. In addition, we rely on a single distribution center in Everett, Washington to receive, store and distribute merchandise to all of our stores and to fulfill our internet sales. As a result, a natural disaster or other catastrophic event, such as an earthquake affecting western Washington, in particular, or the West Coast, in general, could significantly disrupt our operations and have a material adverse effect on our business, results of operations and financial condition.

***We are required to make substantial rental payments under our operating leases and any failure to make these lease payments when due would likely have a material adverse effect on our business and growth plans.***

We do not own any of our retail stores or our combined home office and distribution center, but instead we lease all of these facilities under operating leases. Payments under these operating leases account for a significant portion of our operating expenses. For example, total rental expense, including additional rental payments (or percentage rent) based on sales of some of the stores, common area maintenance charges and real estate taxes, under operating leases was \$23.9 million and \$19.5 million for the six months ended August 2, 2008 and August 4, 2007, respectively, and \$22.2 million, \$31.9 million and \$43.5 million for fiscal 2005, 2006, and 2007 respectively. As of August 2, 2008, we were a party to operating leases requiring future minimum lease payments aggregating approximately \$142.8 million through fiscal year 2012 and approximately \$122.7 million thereafter. In addition, substantially all of our store leases provide for additional rental payments based on sales of the respective stores, as well as common area maintenance charges and other costs, and require that we pay real estate taxes, none of which is included in the amount of future minimum lease payments. We expect that any new stores we open will also be leased by us under operating leases, which will further increase our operating lease expenses.

Our substantial operating lease obligations could have significant negative consequences, including:

- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our ability to obtain additional financing;

- requiring that a substantial portion of our available cash be applied to pay our rental obligations, thus reducing cash available for other purposes;
- limiting our flexibility in planning for or reacting to changes in our business or in the industry in which we compete; and placing us at a disadvantage with respect to some of our competitors.

We depend on cash flow from operations to pay our lease expenses and to fulfill our other cash needs. If our business does not generate sufficient cash flow from operating activities, and sufficient funds are not otherwise available to us from borrowings under bank loans or from other sources, we may not be able to service our operating lease expenses, grow our business, respond to competitive challenges or to fund our other liquidity and capital needs, which would have a material adverse effect on us.

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***The terms of our revolving credit facility impose operating and financial restrictions on us that may impair our ability to respond to changing business and economic conditions. This impairment could have a significant adverse impact on our business.***

We have a \$25 million credit agreement with Wells Fargo HSBC Trade Bank, N.A., which we use for inventory financing and other general corporate purposes, that contains a number of restrictions and covenants that generally limit our ability to, among other things, (1) incur additional indebtedness, (2) undergo a change in ownership and (3) enter into certain transactions. In addition, all of our personal property, including our inventory, equipment and fixtures, secure our obligations under the credit agreement. Our credit agreement also contains financial covenants that require us to meet certain specified financial tests and ratios, including minimum net income after taxes, maximum total liabilities divided by tangible net worth and minimum quick asset ratio. Our ability to comply with these ratios may be affected by events beyond our control.

A breach of any of these restrictive covenants or our inability to comply with the required financial tests or ratios could result in a default under the credit agreement. If a default occurs, the lender may elect to declare all borrowings outstanding, together with accrued interest and other fees, to be immediately due and payable. If we are unable to repay outstanding borrowings when due, whether at their maturity or if declared due and payable by the lender following a default, the lender has the right to proceed against the collateral granted to it to secure the indebtedness. As a result, any breach of these covenants or failure to comply with these tests or ratios could have a material adverse effect on us. There can be no assurance that we will not breach the covenants or fail to comply with the tests or ratios in our credit agreement or any other debt agreements we may enter into in the future and, if a breach occurs, there can be no assurance that we will be able to obtain necessary waivers or amendments from the lenders.

The restrictions contained in our credit agreement could: (1) limit our ability to plan for or react to market conditions or meet capital needs or otherwise restrict our activities or business plans; and (2) adversely affect our ability to finance our operations, strategic acquisitions, investments or other capital needs or to engage in other business activities that would be in our interest.

***Our business could suffer as a result of small parcel delivery services such as United Parcel Service or Federal Express being unable to distribute our merchandise.***

We rely upon small parcel delivery services for our product shipments, including shipments to, from and between our stores. Accordingly, we are subject to risks, including employee strikes and inclement weather, which may affect their ability to meet our shipping needs. Among other things, any circumstances that require us to use other delivery services for all or a portion of our shipments could result in increased costs and delayed deliveries and could harm our business materially. In addition, although we have contracts with small parcel delivery services, we have the right to terminate these contracts upon 30 days written notice. Although the contracts with these small parcel delivery services provide certain discounts from the shipment rates in effect at the time of shipment, the contracts do not limit their ability to raise the shipment rates at any time. Accordingly, we are subject to the risk that small parcel delivery services may increase the rates they charge, that they may terminate their contracts with us, that they may decrease the rate discounts provided to us when an existing contract is renewed or that we may be unable to agree on the terms of a new contract with them, any of which could materially adversely affect our operating results.

***Our business could suffer if a manufacturer fails to use acceptable labor practices.***

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We do not control our vendors or the manufacturers that produce the products we buy from them, nor do we control the labor practices of our vendors and these manufacturers. The violation of labor or other laws by any of our vendors or these manufacturers, or the divergence of the labor practices followed by any of our vendors or these manufacturers from those generally accepted as ethical in the United States, could interrupt, or otherwise disrupt, the shipment of finished products to us or damage our reputation. Any of these, in turn, could have a material adverse effect on our financial condition and results of operations. In that regard, most of the products sold in our stores are manufactured overseas, primarily in Asia and Central America, which may increase the risk that the labor practices followed by the manufacturers of these products may differ from those considered acceptable in the United States.

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***Our failure to adequately anticipate a correct mix of private label merchandise may have a material adverse effect on our business.***

Sales from private label merchandise accounted for 15.4% of our net sales in fiscal year 2007. We may take steps to increase the percentage of net sales of private label merchandise in the future, although there can be no assurance that we will be able to achieve increases in private label merchandise sales as a percentage of net sales. Because our private label merchandise generally carries higher gross margins than other merchandise, our failure to anticipate, identify and react in a timely manner to fashion trends with our private label merchandise would likely have a material adverse effect on our comparable store sales, financial condition and results of operations.

***Most of our merchandise is produced by foreign manufactures therefore, the availability and costs of these products may be negatively affected by risks associated with international trade and other international conditions.***

Manufacturers outside of the United States produce most of our merchandise. Some of these facilities are located in regions that may be affected by natural disasters, political instability or other conditions that could cause a disruption in trade. Trade restrictions such as increased tariffs or quotas, or both, could also affect the importation of merchandise generally, and increase the cost, and reduce the supply of merchandise available to us. Any reduction in merchandise available to us or any increase in its cost due to tariffs, quotas or local issues that disrupt trade could have a material adverse effect on our results of operations. Although the prices charged by vendors for the merchandise we purchase are all denominated in United States dollars, a continued decline in the relative value of the United States dollar to foreign currencies could lead to increased merchandise costs, which could negatively affect our competitive position and our results of operation.

***If our information systems hardware or software fails to function effectively or does not scale to keep pace with our planned growth, our operations could be disrupted and our financial results could be harmed.***

Over the past several years, we have made improvements to our existing hardware and software systems, as well as implemented new systems. If these or any other information systems and software do not work effectively, this could adversely impact the promptness and accuracy of our transaction processing, financial accounting and reporting and our ability to manage our business and properly forecast operating results and cash requirements. To manage the anticipated growth of our operations and personnel, we may need to continue to improve our operational and financial systems, transaction processing, procedures and controls, and in doing so could incur substantial additional expenses that could impact our financial results.

***Our inability or failure to protect our intellectual property or our infringement of other s intellectual property could have a negative impact on our operating results.***

We believe that our trademarks and domain names are valuable assets that are critical to our success. The unauthorized use or other misappropriation of our trademarks or domain names could diminish the value of the Zumiez brand, our store concept, our private label brands or our goodwill and cause a decline in our net sales. Although we have secured or are in the process of securing protection for our trademarks and domain names in a number of countries outside of the United States, there are certain countries where we do not currently have or where we do not currently intend to apply for protection for certain trademarks or at all. Also, the efforts we have taken to protect our trademarks may not be sufficient or effective. Therefore, we may not be able to prevent other persons from using our trademarks or domain names outside of the United States, which also could adversely affect our business. We are also subject to the risk that we may infringe on the intellectual property

rights of third parties. Any infringement or other intellectual property claim made against us, whether or not it has merit, could be time-consuming, result in costly litigation, cause product delays or require us to pay royalties or license fees. As a result, any such claim could have a material adverse effect on our operating results.

*The effects of war or acts of terrorism could adversely affect our business.*

Substantially all of our stores are located in shopping malls. Any threat of terrorist attacks or actual terrorist events, particularly in public areas, could lead to lower customer traffic in shopping malls. In addition, local authorities or mall management could close shopping malls in response to security concerns. Mall closures, as well as lower customer traffic due to security concerns, would likely result in decreased sales. Additionally, the escalation of the armed conflicts in the Middle East, or the threat, escalation or commencement of war or other armed conflict elsewhere, could significantly diminish consumer spending, and result in decreased sales for us. Decreased sales would have a material adverse effect on our business, financial condition and results of operations.

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***The outcome of litigation could have a material adverse effect on our business and may result in substantial costs and could divert management's attention.***

We are involved, from time to time, in litigation incidental to our business including complaints filed by investors. This litigation could result in substantial costs, and could divert management's attention and resources, which could harm our business. Risks associated with legal liability are often difficult to assess or quantify, and their existence and magnitude can remain unknown for significant periods of time. While we maintain director and officer insurance, the amount of insurance coverage may not be sufficient to cover a claim and the continued availability of this insurance cannot be assured. As a result, there can be no assurance that the actual outcome of pending or future litigation will not have a material adverse effect on our results of operations or financial condition.

***Our operations expose us to the risk of litigation which could lead to significant potential liability and costs that could harm our business, financial condition or results of operations.***

We employ a substantial number of full-time and part-time employees, a majority of whom are employed at our store locations. As a result, we are subject to a large number of federal and state laws and regulations relating to employment. This creates a risk of potential claims that we have violated laws related to discrimination and harassment, health and safety, wage and hour laws, criminal activity, personal injury and other claims. We are also subject to other types of claims in the ordinary course of our business. Some or all of these claims may give rise to litigation, which could be time-consuming for our management team, costly and harmful to our business.

In addition, we are exposed to the risk of class action litigation. The costs of defense and the risk of loss in connection with class action suits are greater than in single-party litigation claims. Due to the costs of defending against such litigation, the size of judgments that may be awarded against us, and the loss of significant management time devoted to such litigation, we cannot assure you that such litigation will not disrupt our business or impact our financial results.

***Our internet operations subject us to numerous risks that could have an adverse effect on our results of operations.***

Although internet sales constitute a small portion of our overall sales, our internet operations subject us to certain risks that could have an adverse effect on our operational results, including:

- diversion of traffic and sales from our stores;
- liability for online content; and

- risks related to the computer systems that operate our website and related support systems, including computer viruses and electronic break-ins and similar disruptions.

In addition, risks beyond our control such as governmental regulation of the internet, entry of our vendors in the internet business in competition with us, online security breaches and general economic conditions specific to the internet and online commerce could have an adverse effect on our results of operations.

*We have incurred and will continue to incur significant expenses as a result of being a public company, which will negatively impact our financial performance.*

We completed our initial public offering in May 2005 and we have incurred and will continue to incur significant legal, accounting, insurance and other expenses as a result of being a public company. The Sarbanes-Oxley Act of 2002, as well as related rules implemented by the SEC and The Nasdaq Global Market, has required changes in corporate governance practices of public companies. Compliance with these laws, rules and regulations, including compliance with Section 404 of the Sarbanes-Oxley Act as discussed in the following risk factor, have caused and will continue to cause us to incur significant costs and expenses, including legal and accounting costs, and have made and will continue to make some activities more time-consuming and costly. These laws, rules and regulations have made it more expensive for us to obtain director and officer liability insurance, and we have been required to accept reduced policy limits and coverage. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as officers. As a result of the foregoing, we have incurred and we expect to incur significant legal, accounting, insurance and certain other expenses on an ongoing basis, which will negatively impact our financial performance and could have a material adverse effect on our results of operations and financial condition.



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***Failure to maintain adequate financial and management processes and controls could lead to errors in our financial reporting and could harm our ability to manage our expenses.***

Reporting obligations as a public company and our anticipated growth are likely to place a considerable strain on our financial and management systems, processes and controls, as well as on our personnel. In addition, we are required to document and test our internal controls over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 so that our management can certify as to the effectiveness of our internal controls and our independent registered public accounting firm can render an opinion on the effectiveness of our internal control over financial reporting on an annual basis. This process requires us to document our internal controls over financial reporting and to potentially make significant changes thereto, if applicable. As a result, we have incurred and expect to continue to incur substantial expenses to test our financial controls and systems, and we have been and in the future may be required to improve our financial and managerial controls, reporting systems and procedures, to incur substantial expenses to make such improvements and to hire additional personnel. If our management is ever unable to certify the effectiveness of our internal controls or if our independent registered public accounting firm cannot render an opinion on the effectiveness of our internal control over financial reporting, or if material weaknesses in our internal controls are ever identified, we could be subject to regulatory scrutiny and a loss of public confidence, which could have a material adverse effect on our business and our stock price. In addition, if we do not maintain adequate financial and management personnel, processes and controls, we may not be able to accurately report our financial performance on a timely basis, which could cause a decline in our stock price and adversely affect our ability to raise capital.

***The security of our databases that contain personal information of our retail customers could be breached, which could subject us to adverse publicity, litigation, and expenses. In addition, if we are unable to comply with security standards created by the credit card industry, our operations could be adversely affected.***

Database privacy, network security, and identity theft are matters of growing public concern. In an attempt to prevent unauthorized access to our network and databases containing confidential, third-party information, we have installed privacy protection systems, devices, and activity monitoring on our network. Nevertheless, if unauthorized parties gain access to our networks or databases, they may be able to steal, publish, delete, or modify our private and sensitive third-party information. In such circumstances, we could be held liable to our customers or other parties or be subject to regulatory or other actions for breaching privacy rules. This could result in costly investigations and litigation, civil or criminal penalties, and adverse publicity that could adversely affect our financial condition, results of operations, and reputation. Further, if we are unable to comply with the security standards, established by banks and the credit card industry, we may be subject to fines, restrictions, and expulsion from card acceptance programs, which could adversely affect our retail operations.

***The current uncertainty surrounding the United States economy coupled with cyclical economic trends in action sports retailing could have a material adverse effect on our results of operations.***

The action sports retail industry historically has been subject to substantial cyclicality. As economic conditions in the United States change, the trends in discretionary consumer spending become unpredictable and discretionary consumer spending could be reduced due to uncertainties about the future. When discretionary consumer spending is reduced, purchases of action sports apparel and related products may decline. A recession in the general economy or continued uncertainties regarding future economic prospects could have a material adverse effect on our results of operations.

***We may fail to meet analyst expectations, which could cause the price of our stock to decline.***

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Our common stock is traded publicly and various securities analysts follow our financial results and issue reports on us. These reports include information about our historical financial results as well as the analysts' estimates of our future performance. The analysts' estimates are based upon their own opinions and are often different from our estimates or expectations. If our operating results are below the estimates or expectations of public market analysts and investors, our stock price could decline. Recently, a securities class action litigation was brought against us and such actions are frequently brought against other companies following a decline in the market price of their securities. If our stock price is volatile, we may become involved in this type of litigation in the future. Any litigation could result in substantial costs and a diversion of management's attention and resources that are needed to successfully run our business.

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*The trading price of our investment in marketable securities may fluctuate*

We invest our excess cash in diversified high credit money market accounts, US treasuries, certificates of deposit, municipal bonds and auction rate securities. The investments have historically been considered very safe investments with very minimal default rates. However, the recent uncertainties in the credit markets have prevented us and other investors from liquidating holdings of auction rate securities in recent auctions for these securities because the amount of securities submitted for sale has exceeded the amount of purchase orders. We reduced our holdings of auction rate securities during 2007 through the auction process. As of August 2, 2008, we had \$1.8 million invested in auction rate securities, which are classified as long-term marketable securities on our condensed consolidated balance sheet. In the quarter ended August 2, 2008 we incurred an impairment charge on these investments of approximately \$0.2 million. If market liquidity issues continue, we may have additional impairment charges on these investments.

**Item 3: Quantitative and Qualitative Disclosures About Market Risk**

*Credit Facility Risk.* During different times of the year, due to the seasonality of our business, we have borrowed under our revolving credit facility. To the extent we borrow under our secured revolving credit facility, which bears interests at floating rates based on either the prime rate or LIBOR, we are exposed to market risk related to changes in interest rates. At August 2, 2008, we had no borrowings outstanding under our secured revolving credit facility. At August 2, 2008, we had \$3.6 million of letters of credit outstanding under our secured revolving credit facility. We are not a party to any derivative financial instruments.

*Interest Rate Risk.* We invest in a variety of securities, consisting primarily of investments in interest-bearing demand deposit accounts with financial institutions, tax-exempt money market funds and debt securities of corporations and municipalities. By policy, we limit the amount of credit exposure to any one issuer.

Investments in both fixed rate and floating rate interest earning products carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. Due in part to these factors, our income from investments may decrease in the future.

**Item 4: Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures.* We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Securities Exchange Act Rule 13a-15(e)). Based on this evaluation, our CEO and CFO concluded that, as of August 2, 2008, our disclosure controls and procedures were effective.

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Disclosure controls and procedures, no matter how well designed and implemented, can provide only reasonable assurance of achieving an entity's disclosure objectives. The likelihood of achieving such objectives is affected by limitations inherent in disclosure controls and procedures. These include the fact that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human failures such as simple errors or mistakes or intentional circumvention of the established process.

*Changes in Internal Control Over Financial Reporting.* There has been no change in our internal control over financial reporting (as defined in Securities Exchange Act Rule 13a-15(f)) during the quarter ended August 2, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are involved from time to time in litigation incidental to our business. The Company is unable to predict the outcome of litigated cases. A court determination in any of litigation actions against the Company could result in significant liability and could have a material adverse effect on the Company's business, results of operations or financial condition.

See Note 3 to the Notes to Condensed Consolidated Financial Statements found in Item 1 of this Form 10-Q (listed under "Litigation" under "Commitments and Contingencies").

**Item 1A. Risk Factors**

Please refer to the Risk Factors set forth in Item 2 of Part I of this Form 10-Q as well as the risk factors previously disclosed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended February 2, 2008. There have been no material changes in the risk factors set forth in our Annual Report on Form 10-K for the year ended February 2, 2008.

**Item 2. Changes in Securities; Use of Proceeds and Issuer Purchases of Equity Securities**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

At our Annual Meeting of Shareholders held on May 28, 2008, the following proposals were adopted by the following number of votes:

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Proposal Number One: The election of two directors to hold office until the 2011 Annual Meeting of Shareholders. Each of the following nominees for director was elected to serve for a three-year term, by the following margins of votes:

<b>Nominees</b>	<b>For</b>	<b>Withheld</b>
Thomas D. Campion	27,690,811	333,195
David M. DeMattei	27,906,147	117,859

Proposal Number Two: Ratification of selection of Moss Adams LLP, independent registered public accounting firm, reappointed by the Board of Directors to audit the consolidated financial statements of the Company for the fiscal year ending January 31, 2009:

<b>Independent Registered Public Accountants</b>	<b>For</b>	<b>Against</b>	<b>Abstain</b>
Moss Adams LLP	27,991,670	25,493	6,842

### Item 5. Other Information

None

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**Item 6. Exhibits**

Exhibits

<b>Exhibit No.</b>	<b>Description of Exhibits</b>
31.1	Certification of the Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certifications of the Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350

**SIGNATURE**

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

ZUMIEZ INC.

By:

/s/ TREVOR S. LANG  
Trevor S. Lang  
Chief Financial Officer

Dated: August 28, 2008