

WILLIAMS SONOMA INC  
Form 10-Q  
September 10, 2010

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended August 1, 2010.

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-14077

**WILLIAMS-SONOMA, INC.**

(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of incorporation or organization)

94-2203880  
(I.R.S. Employer Identification No.)

3250 Van Ness Avenue, San Francisco, CA  
(Address of principal executive offices)

94109  
(Zip Code)

Registrant's telephone number, including area code: (415) 421-7900

## Edgar Filing: WILLIAMS SONOMA INC - Form 10-Q

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

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

As of August 29, 2010, 106,154,500 shares of the registrant's Common Stock were outstanding.

---

WILLIAMS-SONOMA, INC.

REPORT ON FORM 10-Q

FOR THE QUARTER ENDED AUGUST 1, 2010

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

|                                                                                                                                      | PAGE |
|--------------------------------------------------------------------------------------------------------------------------------------|------|
| Item 1. <u>Financial Statements</u>                                                                                                  | 2    |
| <u>Condensed Consolidated Balance Sheets as of August 1, 2010, January 31, 2010 and August 2, 2009</u>                               |      |
| <u>Condensed Consolidated Statements of Operations for the Thirteen and Twenty-Six Weeks Ended August 1, 2010 and August 2, 2009</u> |      |
| <u>Condensed Consolidated Statements of Cash Flows for the Twenty-Six Weeks Ended August 1, 2010 and August 2, 2009</u>              |      |
| <u>Notes to Condensed Consolidated Financial Statements</u>                                                                          |      |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                                 | 13   |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>                                                            | 22   |
| Item 4. <u>Controls and Procedures</u>                                                                                               | 23   |

PART II. OTHER INFORMATION

|                                                                            |    |
|----------------------------------------------------------------------------|----|
| Item 1. <u>Legal Proceedings</u>                                           | 23 |
| Item 1A. <u>Risk Factors</u>                                               | 23 |
| Item 2. <u>Unregistered Sales of Equity Securities And Use of Proceeds</u> | 36 |
| Item 6. <u>Exhibits</u>                                                    | 37 |

## ITEM 1. FINANCIAL STATEMENTS

## WILLIAMS-SONOMA, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

|                                                                                                                                                                                            | August 1,<br>2010 | January 31,<br>2010 | August 2,<br>2009 |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|---------------------|-------------------|
| <i>Dollars and shares in thousands, except per share amounts</i>                                                                                                                           |                   |                     |                   |
| <b>ASSETS</b>                                                                                                                                                                              |                   |                     |                   |
| Current assets                                                                                                                                                                             |                   |                     |                   |
| Cash and cash equivalents                                                                                                                                                                  | \$ 404,037        | \$ 513,943          | \$ 165,315        |
| Restricted cash                                                                                                                                                                            | 12,502            | 0                   | 0                 |
| Accounts receivable, net                                                                                                                                                                   | 37,888            | 44,187              | 40,322            |
| Merchandise inventories, net                                                                                                                                                               | 518,623           | 466,124             | 517,028           |
| Prepaid catalog expenses                                                                                                                                                                   | 41,798            | 32,777              | 38,909            |
| Prepaid expenses                                                                                                                                                                           | 42,165            | 22,109              | 52,511            |
| Deferred income taxes                                                                                                                                                                      | 92,241            | 92,195              | 90,559            |
| Other assets, net                                                                                                                                                                          | 7,718             | 8,858               | 9,233             |
| Total current assets                                                                                                                                                                       | 1,156,972         | 1,180,193           | 913,877           |
| Property and equipment, net                                                                                                                                                                | 771,635           | 829,027             | 885,334           |
| Non-current deferred income taxes                                                                                                                                                          | 52,129            | 53,809              | 39,065            |
| Other assets                                                                                                                                                                               | 14,757            | 16,140              | 15,584            |
| Total assets                                                                                                                                                                               | \$ 1,995,493      | \$ 2,079,169        | \$ 1,853,860      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                                                                                                                                |                   |                     |                   |
| Current liabilities                                                                                                                                                                        |                   |                     |                   |
| Accounts payable                                                                                                                                                                           | \$ 184,135        | \$ 188,241          | \$ 129,798        |
| Accrued salaries, benefits and other                                                                                                                                                       | 83,188            | 107,710             | 66,616            |
| Customer deposits                                                                                                                                                                          | 190,347           | 195,185             | 191,406           |
| Income taxes payable                                                                                                                                                                       | 17,507            | 48,260              | 0                 |
| Current portion of long-term debt                                                                                                                                                          | 1,714             | 1,587               | 14,800            |
| Other liabilities                                                                                                                                                                          | 25,279            | 22,499              | 23,327            |
| Total current liabilities                                                                                                                                                                  | 502,170           | 563,482             | 425,947           |
| Deferred rent and lease incentives                                                                                                                                                         | 221,086           | 241,300             | 250,840           |
| Long-term debt                                                                                                                                                                             | 7,197             | 8,672               | 8,915             |
| Other long-term obligations                                                                                                                                                                | 58,383            | 54,120              | 52,467            |
| Total liabilities                                                                                                                                                                          | 788,836           | 867,574             | 738,169           |
| Commitments and contingencies                                                                                                                                                              |                   |                     |                   |
| Shareholders' equity                                                                                                                                                                       |                   |                     |                   |
| Preferred stock, \$.01 par value, 7,500 shares authorized, none issued                                                                                                                     | 0                 | 0                   | 0                 |
| Common stock, \$.01 par value, 253,125 shares authorized, issued and outstanding: 106,483, 106,962 and 105,732 shares at August 1, 2010, January 31, 2010 and August 2, 2009, respectively | 1,065             | 1,070               | 1,057             |
| Additional paid-in capital                                                                                                                                                                 | 462,106           | 448,848             | 424,096           |
| Retained earnings                                                                                                                                                                          | 732,290           | 751,290             | 681,112           |
| Accumulated other comprehensive income                                                                                                                                                     | 11,196            | 10,387              | 9,426             |
| Total shareholders' equity                                                                                                                                                                 | 1,206,657         | 1,211,595           | 1,115,691         |
| Total liabilities and shareholders' equity                                                                                                                                                 | \$ 1,995,493      | \$ 2,079,169        | \$ 1,853,860      |

See Notes to Condensed Consolidated Financial Statements.

## WILLIAMS-SONOMA, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

|                                                                  | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|------------------------------------------------------------------|----------------------|-------------------|------------------------|-------------------|
|                                                                  | August 1,<br>2010    | August 2,<br>2009 | August 1,<br>2010      | August 2,<br>2009 |
| <i>Dollars and shares in thousands, except per share amounts</i> |                      |                   |                        |                   |
| Net revenues                                                     | \$ 775,554           | \$ 672,114        | \$ 1,493,191           | \$ 1,283,729      |
| Cost of goods sold                                               | 488,827              | 456,773           | 935,906                | 884,425           |
| Gross margin                                                     | 286,727              | 215,341           | 557,285                | 399,304           |
| Selling, general and administrative expenses                     | 235,530              | 214,906           | 473,627                | 428,109           |
| Interest (income) expense, net                                   | 123                  | 378               | 251                    | 649               |
| Earnings (loss) before income taxes                              | 51,074               | 57                | 83,407                 | (29,454)          |
| Income tax expense (benefit)                                     | 20,315               | (342)             | 33,110                 | (11,148)          |
| Net earnings (loss)                                              | \$ 30,759            | \$ 399            | \$ 50,297              | \$ (18,306)       |
| Basic earnings (loss) per share                                  | \$ 0.29              | \$ 0.00           | \$ 0.47                | \$ (0.17)         |
| Diluted earnings (loss) per share                                | \$ 0.28              | \$ 0.00           | \$ 0.46                | \$ (0.17)         |
| Shares used in calculation of earnings (loss) per share:         |                      |                   |                        |                   |
| Basic                                                            | 107,668              | 105,719           | 107,370                | 105,685           |
| Diluted                                                          | 110,224              | 107,033           | 109,895                | 105,685           |

See Notes to Condensed Consolidated Financial Statements.

## WILLIAMS-SONOMA, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

|                                                                                                      | Twenty-Six Weeks Ended |             |
|------------------------------------------------------------------------------------------------------|------------------------|-------------|
|                                                                                                      | August 1,              | August 2,   |
|                                                                                                      | 2010                   | 2009        |
| <i>Dollars in thousands</i>                                                                          |                        |             |
| Cash flows from operating activities:                                                                |                        |             |
| Net earnings (loss)                                                                                  | \$ 50,297              | \$ (18,306) |
| Adjustments to reconcile net earnings (loss) to net cash provided by (used in) operating activities: |                        |             |
| Depreciation and amortization                                                                        | 73,882                 | 74,611      |
| (Gain) loss on sale/disposal of assets                                                               | (2,033)                | 903         |
| Impairment of assets                                                                                 | 2,032                  | 10,401      |
| Amortization of deferred lease incentives                                                            | (19,709)               | (16,786)    |
| Deferred income taxes                                                                                | (6,327)                | (3,378)     |
| Tax benefit from exercise of stock-based awards                                                      | 8,011                  | 23          |
| Stock-based compensation expense                                                                     | 15,269                 | 8,690       |
| Changes in:                                                                                          |                        |             |
| Accounts receivable                                                                                  | 6,345                  | (2,801)     |
| Merchandise inventories                                                                              | (52,160)               | 57,209      |
| Prepaid catalog expenses                                                                             | (9,021)                | (2,485)     |
| Prepaid expenses and other assets                                                                    | (17,952)               | (6,319)     |
| Accounts payable                                                                                     | (2,561)                | (25,212)    |
| Accrued salaries, benefits and other current and long-term liabilities                               | (18,710)               | (1,194)     |
| Customer deposits                                                                                    | (4,991)                | (1,325)     |
| Deferred rent and lease incentives                                                                   | (743)                  | 2,069       |
| Income taxes payable                                                                                 | (30,740)               | (112)       |
| Net cash (used in) provided by operating activities                                                  | (9,111)                | 75,988      |
| Cash flows from investing activities:                                                                |                        |             |
| Purchases of property and equipment                                                                  | (30,889)               | (33,062)    |
| Restricted cash deposits                                                                             | (12,502)               | 0           |
| Proceeds from sale of assets                                                                         | 10,715                 | 139         |
| Net cash used in investing activities                                                                | (32,676)               | (32,923)    |
| Cash flows from financing activities:                                                                |                        |             |
| Repayments of long-term obligations                                                                  | (1,348)                | (1,246)     |
| Net proceeds from exercise of stock-based awards                                                     | 9,573                  | 350         |
| Tax withholdings related to stock-based awards                                                       | (11,024)               | 0           |
| Excess tax benefit from exercise of stock-based awards                                               | 5,992                  | 25          |
| Payment of dividends                                                                                 | (27,023)               | (25,559)    |
| Repurchase of common stock                                                                           | (44,306)               | 0           |
| Other                                                                                                | 0                      | (33)        |
| Net cash used in financing activities                                                                | (68,136)               | (26,463)    |
| Effect of exchange rates on cash and cash equivalents                                                | 17                     | (109)       |
| Net (decrease) increase in cash and cash equivalents                                                 | (109,906)              | 16,493      |
| Cash and cash equivalents at beginning of period                                                     | 513,943                | 148,822     |
| Cash and cash equivalents at end of period                                                           | \$ 404,037             | \$ 165,315  |

See Notes to Condensed Consolidated Financial Statements.

---

WILLIAMS-SONOMA, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Twenty-Six Weeks Ended August 1, 2010 and August 2, 2009

(Unaudited)

**NOTE A. FINANCIAL STATEMENTS - BASIS OF PRESENTATION**

These financial statements include Williams-Sonoma, Inc. and its wholly owned subsidiaries ( we, us or our ). The condensed consolidated balance sheets as of August 1, 2010 and August 2, 2009, the condensed consolidated statements of operations for the thirteen and twenty-six weeks then ended and the condensed consolidated statements of cash flows for the twenty-six weeks then ended have been prepared by us, without audit. In our opinion, the financial statements include all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position at the balance sheet dates and the results of operations for the thirteen and twenty-six weeks then ended. Significant intercompany transactions and accounts have been eliminated. The balance sheet as of January 31, 2010, presented herein, has been derived from our audited balance sheet included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2010.

The results of operations for the thirteen and twenty-six weeks ended August 1, 2010 are not necessarily indicative of the operating results of the full year.

Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2010.

**NOTE B. BORROWING ARRANGEMENTS**

*Credit Facility*

We have a credit facility that provides for a \$300,000,000 unsecured revolving line of credit that may be used for loans or letters of credit. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the credit facility of up to \$200,000,000, to provide for a total of \$500,000,000 of unsecured revolving credit. The revolving line of credit facility contains certain financial covenants, including a maximum leverage ratio (funded debt adjusted for lease and rent expense to earnings before interest, income tax, depreciation, amortization and rent expense EBITDAR ), a minimum fixed charge coverage ratio (calculated as EBITDAR to total fixed charges), and covenants limiting our ability to repurchase shares of stock or increase our dividend, in addition to covenants limiting our ability to dispose of assets, make acquisitions, be acquired (if a default would result from the acquisition), incur indebtedness, grant liens and make investments. The credit facility also contains events of default that include, among others, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, bankruptcy and insolvency events, material judgments, cross defaults to material indebtedness and events constituting a change of control. The occurrence of an event of default will increase the applicable rate of interest by 2.0% and could result in the acceleration of our obligations under the credit facility and an obligation of any or all of our subsidiaries that have guaranteed our credit facility to pay the full amount of our obligations under the credit facility. As of August 1, 2010, we were in compliance with our financial covenants under the credit facility and, based on current projections, expect to be in compliance throughout fiscal 2010. The credit facility matures on October 4, 2011, at which time all outstanding borrowings must be repaid and all outstanding letters of credit must be cash collateralized.

We may elect interest rates calculated at (i) Bank of America's prime rate (or, if greater, the average rate on overnight federal funds plus one-half of one percent, or a rate based on LIBOR plus one percent) plus a margin based on our leverage ratio, or (ii) LIBOR plus a margin based on our leverage ratio. During the thirteen and twenty-six weeks ended August 1, 2010 and August 2, 2009, respectively, we had no borrowings under the credit facility, and no amounts were outstanding as of August 1, 2010 or August 2, 2009. Additionally, as of August 1, 2010,

\$15,180,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. The standby letters of credit were issued to secure the liabilities associated with workers' compensation and other insurance programs.

#### *Restricted Cash*

On April 16, 2010, we entered into a Collateral Trust Agreement (the "Agreement") to replace a portion of our standby letters of credit, which secure the liabilities associated with our workers' compensation and other insurance programs. Under the Agreement, we are obligated to fund the trust with an initial deposit of \$12,500,000 and to reinvest interest income up to a maximum of 110% of the initial deposit thereby guaranteeing our obligation for any losses below our insurance deductibles. The Agreement is renewable annually and is cancellable upon 90 days written notice with the insurance provider's and our mutual consent. As of August 1, 2010, restricted cash related to the Agreement was \$12,502,000.

#### *Letter of Credit Facilities*

As of August 1, 2010, we had four unsecured letter of credit reimbursement facilities for a total of \$125,000,000. On September 3, 2010, we renewed three of our four unsecured commercial letter of credit reimbursement facilities, each of which matures on September 2, 2011. Due to reductions in inventory purchases over the past twelve months and an overall reduction in the number of vendors who require the use of our letter of credit facilities, we have decreased the aggregate credit available under these facilities from \$125,000,000 to \$90,000,000. The letter of credit facilities contain covenants and provide for events of default that are consistent with our unsecured revolving line of credit. Interest on unreimbursed amounts under the letter of credit facilities accrues at the lender's prime rate (or if greater, the average rate on overnight federal funds plus one-half of one percent) plus 2.0%. As of August 1, 2010, an aggregate of \$29,817,000 was outstanding under the letter of credit facilities, which represent only a future commitment to fund inventory purchases to which we had not taken legal title. The latest expiration possible for any future letters of credit issued under the facilities is January 30, 2012.

#### *Long-Term Debt*

As of August 1, 2010, we had \$8,911,000 of long-term debt obligations, consisting primarily of the bond-related debt associated with one of our Memphis-based distribution facilities, which accrues interest based on a variable rate. As of August 1, 2010, the carrying value of our long-term debt approximates fair value.

### **NOTE C. STOCK-BASED COMPENSATION**

#### *Equity Award Programs*

On May 26, 2010, our shareholders approved an amendment and restatement of our Amended and Restated 2001 Long-Term Incentive Plan (the "Plan") to, among other things, increase the shares issuable by 2,500,000 shares, extend the term to 2020 and limit the maximum term on option awards granted to seven years. The Plan provides for grants of incentive stock options, nonqualified stock options, stock-settled stock appreciation rights (collectively, "option awards"), restricted stock awards, restricted stock units, deferred stock awards (collectively, "stock awards") and dividend equivalents up to an aggregate of 18,459,903 shares. Awards may be granted under the Plan to officers, employees and non-employee Board members of the company or any parent or subsidiary. Annual grants are limited to 1,000,000 shares covered by option awards and 400,000 shares covered by stock awards on a per person basis. All grants of option awards made under the Plan now have a maximum term of seven years, as amended, except incentive stock options that may be issued to 10% shareholders, which have a maximum term of five years. The Plan previously provided for a maximum term of ten years for option awards. The exercise price of these option awards is not less than 100% of the closing price of our stock on the day prior to the grant date or not less than 110% of such closing price for an incentive stock option granted to a 10% shareholder. Option awards granted to employees generally vest over a period of four to five years. Stock awards granted to employees generally vest over a period of three to five years for service based awards. Certain

option awards, stock awards and other agreements contain vesting acceleration clauses resulting from events including, but not limited to, retirement, merger or a similar corporate event. Option and stock awards granted to non-employee Board members generally vest in one year. Non-employee Board members automatically receive stock awards on the date of their initial election to the Board and annually thereafter on the date of the annual meeting of shareholders (so long as they continue to serve as a non-employee Board member). Shares issued as a result of award exercises will be funded with the issuance of new shares.

#### *Stock-Based Compensation Expense*

We measure and record stock-based compensation expense in our consolidated financial statements for all employee stock-based awards using a fair value method. During the thirteen and twenty-six weeks ended August 1, 2010, we recognized total stock-based compensation expense, as a component of selling, general and administrative expenses, of \$6,513,000 and \$15,269,000, respectively (including stock-based compensation expense of approximately \$815,000 and \$4,042,000, respectively, associated with the retirement of our Chairman and Chief Executive Officer). During the thirteen and twenty-six weeks ended August 2, 2009, we recognized total stock-based compensation expense, as a component of selling, general and administrative expenses, of \$3,469,000 and \$8,690,000, respectively.

#### *Stock Options*

The following table summarizes our stock option activity during the twenty-six weeks ended August 1, 2010:

|                                                | Shares    |
|------------------------------------------------|-----------|
| Balance at January 31, 2010                    | 2,613,132 |
| Granted                                        | 0         |
| Exercised                                      | (858,562) |
| Canceled                                       | (4,760)   |
| Balance at August 1, 2010                      | 1,749,810 |
| Vested at August 1, 2010                       | 1,746,410 |
| Vested plus expected to vest at August 1, 2010 | 1,749,694 |

#### *Stock-Settled Stock Appreciation Rights*

The following table summarizes our stock-settled stock appreciation right activity during the twenty-six weeks ended August 1, 2010:

|                                                | Shares    |
|------------------------------------------------|-----------|
| Balance at January 31, 2010                    | 4,547,975 |
| Granted                                        | 359,375   |
| Converted                                      | (602,575) |
| Canceled                                       | (84,610)  |
| Balance at August 1, 2010                      | 4,220,165 |
| Vested at August 1, 2010                       | 1,098,290 |
| Vested plus expected to vest at August 1, 2010 | 3,714,604 |

*Restricted Stock Units*

The following table summarizes our restricted stock unit activity during the twenty-six weeks ended August 1, 2010:

|                                                | Shares    |
|------------------------------------------------|-----------|
| Balance at January 31, 2010                    | 1,887,160 |
| Granted                                        | 1,243,508 |
| Released                                       | (448,900) |
| Canceled                                       | (47,035)  |
| Balance at August 1, 2010                      | 2,634,733 |
| Vested plus expected to vest at August 1, 2010 | 2,257,724 |

**NOTE D. COMPREHENSIVE INCOME (LOSS)**

Comprehensive income (loss) for the thirteen and twenty-six weeks ended August 1, 2010 and August 2, 2009 was as follows:

|                                         | Thirteen Weeks Ended<br>August 2,<br>August 1,<br>2010 |          | Twenty-Six Weeks Ended<br>August 2,<br>August 1,<br>2010 |             |
|-----------------------------------------|--------------------------------------------------------|----------|----------------------------------------------------------|-------------|
| <i>Dollars in thousands</i>             | 2010                                                   | 2009     | 2010                                                     | 2009        |
| Net earnings (loss)                     | \$ 30,759                                              | \$ 399   | \$ 50,297                                                | \$ (18,306) |
| Other comprehensive income (loss)       |                                                        |          |                                                          |             |
| Foreign currency translation adjustment | (885)                                                  | 2,808    | 807                                                      | 3,916       |
| Comprehensive income (loss)             | \$ 29,874                                              | \$ 3,207 | \$ 51,104                                                | \$ (14,390) |

**NOTE E. EARNINGS (LOSS) PER SHARE**

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

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

| <i>Dollars and amounts in thousands, except per share amounts</i> | Net Earnings<br>(Loss) | Weighted Average<br>Shares | Earnings (Loss)<br>Per Share |
|-------------------------------------------------------------------|------------------------|----------------------------|------------------------------|
| Thirteen weeks ended August 1, 2010                               |                        |                            |                              |
| Basic                                                             | \$ 30,759              | 107,668                    | \$ 0.29                      |
| Effect of dilutive stock-based awards                             |                        | 2,556                      |                              |
| Diluted                                                           | \$ 30,759              | 110,224                    | \$ 0.28                      |
| Thirteen weeks ended August 2, 2009                               |                        |                            |                              |
| Basic                                                             | \$ 399                 | 105,719                    | \$ 0.00                      |
| Effect of dilutive stock-based awards                             |                        | 1,314                      |                              |
| Diluted                                                           | \$ 399                 | 107,033                    | \$ 0.00                      |
| Twenty-six weeks ended August 1, 2010                             |                        |                            |                              |
| Basic                                                             | \$ 50,297              | 107,370                    | \$ 0.47                      |
| Effect of dilutive stock-based awards                             |                        | 2,525                      |                              |
| Diluted                                                           | \$ 50,297              | 109,895                    | \$ 0.46                      |
| Twenty-six weeks ended August 2, 2009                             |                        |                            |                              |
| Basic                                                             | \$ (18,306)            | 105,685                    | \$ (0.17)                    |
| Effect of dilutive stock-based awards <sup>1</sup>                |                        | 0                          |                              |
| Diluted                                                           | \$ (18,306)            | 105,685                    | \$ (0.17)                    |

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

Stock-based awards of 1,995,000 and 4,499,000 for the thirteen weeks ended and 2,008,000 and 10,833,000 for the twenty-six weeks ended August 1, 2010 and August 2, 2009, respectively, were not included in the computation of diluted earnings (loss) per share, as their inclusion would be anti-dilutive.

#### NOTE F. ASSET IMPAIRMENT AND LEASE TERMINATION CHARGES

We review the carrying value of all long-lived assets for impairment, primarily at a store level, whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. We review for impairment all stores for which current or projected cash flows from operations are not sufficient to recover the carrying value of the assets. Impairment results when the carrying value of the assets exceeds the store's undiscounted future cash flows over the remaining life of the lease. Our estimate of undiscounted future cash flows over the store lease term (generally 5 to 22 years) is based upon our experience, historical operations of the stores and estimates of future store profitability and economic conditions. The future estimates of store profitability and economic conditions require estimating such factors as sales growth, gross margin, employment rates, lease escalations, inflation on operating expenses and the overall economics of the retail industry, and are therefore subject to variability and difficult to predict. If a long-lived asset is found to be impaired, the amount recognized for impairment is equal to the difference between the net carrying value and the asset's fair value. Long-lived assets are measured at fair value on a nonrecurring basis using Level 3 inputs as defined in the fair value hierarchy. The fair value is estimated based upon future cash flows (discounted at a rate that is commensurate with the risk and approximates our weighted average cost of capital).

For any store or facility closure where a lease obligation still exists, we record the estimated future liability associated with the rental obligation on the cease use date.

During the thirteen and twenty-six weeks ended August 1, 2010, we recorded expense of approximately \$4,280,000 (of which \$4,110,000 is recorded within selling, general and administrative expenses and the remainder within cost of goods sold) and \$10,317,000 (of which \$9,689,000 is recorded within selling, general

and administrative expenses and the remainder within cost of goods sold), respectively, associated with asset impairment and early lease termination charges for underperforming retail stores. We also recorded a net benefit in selling, general and administrative expenses of \$403,000 during the thirteen and twenty-six weeks ended August 1, 2010 related to the exit of excess distribution capacity.

During the thirteen and twenty-six weeks ended August 2, 2009, we recorded expense of approximately \$7,246,000 (of which \$7,132,000 is recorded within selling, general and administrative expenses and the remainder within cost of goods sold) and \$13,373,000 (of which \$13,214,000 is recorded within selling, general and administrative expenses and the remainder within cost of goods sold), respectively, associated with asset impairment and early lease termination charges for underperforming retail stores. We also recorded \$1,335,000 during the thirteen and twenty-six weeks ended August 2, 2009 related to the exit of excess distribution capacity, of which \$1,019,000 is recorded in cost of good sold and the remainder within selling, general and administrative expenses.

#### **NOTE G. SEGMENT REPORTING**

We have two reportable segments, retail and direct-to-customer. The retail segment has five merchandising concepts which sell products for the home (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, West Elm and Williams-Sonoma Home). The five retail merchandising concepts are operating segments, which have been aggregated into one reportable segment, retail. The direct-to-customer segment has six merchandising concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, PBteen, West Elm and Williams-Sonoma Home) and sells similar products through our seven direct mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed and Bath, PBteen, West Elm and Williams-Sonoma Home) and six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and wshome.com). Management's expectation is that the overall economic characteristics of each of our major concepts within each reportable segment will be similar over time based on management's judgment that the operating segments have had similar historical economic characteristics and are expected to have similar long-term financial performance in the future.

These reportable segments are strategic business units that offer similar home-centered products. They are managed separately because the business units utilize two distinct distribution and marketing strategies. Based on management's best estimate, our operating segments include allocations of certain expenses, including advertising and employment costs, to the extent they have been determined to benefit both channels. These operating segments are aggregated at the channel level for reporting purposes due to the fact that our brands are interdependent for economies of scale and we do not maintain fully allocated income statements at the brand level. As a result, material financial decisions related to the brands are made at the channel level. Furthermore, it is not practicable for us to report revenue by product group.

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

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

## Segment Information

|                                                      | Direct-to- |            |             |              |
|------------------------------------------------------|------------|------------|-------------|--------------|
|                                                      | Retail     | Customer   | Unallocated | Total        |
| <i>Dollars in thousands</i>                          |            |            |             |              |
| Thirteen weeks ended August 1, 2010                  |            |            |             |              |
| Net revenues <sup>1</sup>                            | \$ 449,876 | \$ 325,678 | \$ 0        | \$ 775,554   |
| Depreciation and amortization expense                | 21,870     | 5,313      | 7,697       | 34,880       |
| Earnings (loss) before income taxes <sup>2,3,4</sup> | 34,446     | 68,344     | (51,716)    | 51,074       |
| Capital expenditures                                 | 5,718      | 3,065      | 4,675       | 13,458       |
| Thirteen weeks ended August 2, 2009                  |            |            |             |              |
| Net revenues <sup>1</sup>                            | \$ 400,239 | \$ 271,875 | \$ 0        | \$ 672,114   |
| Depreciation and amortization expense                | 24,282     | 5,172      | 8,838       | 38,292       |
| Earnings (loss) before income taxes <sup>2,4</sup>   | 2,123      | 41,850     | (43,916)    | 57           |
| Capital expenditures                                 | 5,616      | 3,327      | 3,483       | 12,426       |
| Twenty-six weeks ended August 1, 2010                |            |            |             |              |
| Net revenues <sup>1</sup>                            | \$ 861,656 | \$ 631,535 | \$ 0        | \$ 1,493,191 |
| Depreciation and amortization expense                | 47,942     | 10,697     | 15,243      | 73,882       |
| Earnings (loss) before income taxes <sup>2,3,4</sup> | 57,026     | 136,955    | (110,574)   | 83,407       |
| Assets <sup>5</sup>                                  | 896,831    | 282,213    | 816,449     | 1,995,493    |
| Capital expenditures                                 | 13,652     | 6,821      | 10,416      | 30,889       |
| Twenty-six weeks ended August 2, 2009                |            |            |             |              |
| Net revenues <sup>1</sup>                            | \$ 757,618 | \$ 526,111 | \$ 0        | \$ 1,283,729 |
| Depreciation and amortization expense                | 47,601     | 10,507     | 16,503      | 74,611       |
| Earnings (loss) before income taxes <sup>2,4</sup>   | (11,587)   | 71,832     | (89,699)    | (29,454)     |
| Assets <sup>5</sup>                                  | 984,400    | 267,380    | 602,080     | 1,853,860    |
| Capital expenditures                                 | 19,785     | 6,428      | 6,849       | 33,062       |

<sup>1</sup> Includes net revenues in the retail channel of approximately \$25.2 million and \$16.7 million for the thirteen weeks ended August 1, 2010 and August 2, 2009, respectively, and \$45.6 million and \$30.2 million for the twenty-six weeks ended August 1, 2010 and August 2, 2009, respectively, related to our foreign operations.

<sup>2</sup> Includes expenses in the retail channel of approximately \$4.3 million and \$7.2 million for the thirteen weeks ended August 1, 2010 and August 2, 2009, respectively, and \$10.3 million and \$13.4 million for the twenty-six weeks ended August 1, 2010 and August 2, 2009, respectively, related to asset impairment and early lease termination charges for underperforming retail stores.

<sup>3</sup> Unallocated costs before income taxes includes \$1.0 million and \$4.3 million for the thirteen and twenty-six weeks ended August 1, 2010, respectively, related to the retirement of our Chief Executive Officer.

<sup>4</sup> Unallocated costs before income taxes include a net benefit of \$0.4 million for the thirteen and twenty-six weeks ended August 1, 2010 and expense of \$1.3 million for the thirteen and twenty-six weeks ended August 2, 2009 related to the exit of excess distribution capacity.

<sup>5</sup> Includes \$28.1 million and \$30.4 million of long-term assets as of August 1, 2010 and August 2, 2009, respectively, related to our foreign operations.

## NOTE H: RETIREMENT AND CONSULTING AGREEMENT

On January 25, 2010, the independent members of the Board of Directors (the "Board") of Williams-Sonoma, Inc. (the "Company") approved the Company's entry into a Retirement and Consulting Agreement (the "Agreement") with W. Howard Lester, the Company's Chairman and Chief Executive Officer. Pursuant to the terms of the Agreement, Mr. Lester retired as Chairman and Chief Executive Officer and as a member of the Board on May 26, 2010. Upon his retirement and in recognition of his contributions to the Company, Mr. Lester received, among other things, accelerated vesting of his outstanding stock options, stock-settled stock appreciation rights and restricted stock units. The total expense recorded in the twenty-six weeks ended August 1, 2010 associated with Mr. Lester's retirement, consisting primarily of stock-based compensation expense, was approximately \$4,319,000.

#### **NOTE I. CONSOLIDATION OF MEMPHIS-BASED DISTRIBUTION FACILITIES**

Our Memphis-based distribution facilities include an operating lease entered into in July 1983 for a distribution facility in Memphis, Tennessee. The lessor is a general partnership ( Partnership 1 ) comprised of W. Howard Lester, our Chairman of the Board of Directors and Chief Executive Officer through May 26, 2010 (Chairman Emeritus thereafter) and James A. McMahan, a Director Emeritus and a significant shareholder. Partnership 1 does not have operations separate from the leasing of this distribution facility and does not have lease agreements with any unrelated third parties.

Our other Memphis-based distribution facility includes an operating lease entered into in August 1990 for another distribution facility that is adjoined to the Partnership 1 facility in Memphis, Tennessee. The lessor is a general partnership ( Partnership 2 ) comprised of W. Howard Lester, James A. McMahan and two unrelated parties. Partnership 2 does not have operations separate from the leasing of this distribution facility and does not have lease agreements with any unrelated third parties.

Both partnerships financed the construction of the distribution facilities and related addition through the sale of industrial development bonds. Quarterly interest and annual principal payments on the bonds are required through maturity and the terms of the lease automatically renew on an annual basis until the bonds are fully repaid. The two partnerships described above qualify as variable interest entities ( VIEs ) due to their related party relationship with us and our obligation to renew the leases until the bonds are fully repaid. Accordingly, the two related party VIE partnerships, from which we lease our Memphis-based distribution facilities, are consolidated by us. As of August 1, 2010, our consolidated balance sheet includes \$15,462,000 in assets (primarily buildings), \$8,513,000 in debt and \$6,949,000 in other long-term liabilities related to these leases. We have no other VIE relationships which meet the criteria for consolidation.

#### **NOTE J. COMMITMENTS AND CONTINGENCIES**

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

#### **NOTE K. STOCK REPURCHASE PROGRAM**

In May 2010, our Board of Directors authorized a stock repurchase program to purchase up to \$60,000,000 of our common stock through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. The authorization of the stock repurchase program reflects the Board of Director's objective to offset dilution from equity compensation programs on an on-going basis. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. The stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

During the thirteen weeks ended August 1, 2010, we repurchased and retired 1,718,150 shares of our common stock at a weighted average cost of \$25.79 per share and a total cost of approximately \$44,306,000. As of August 1, 2010, the amount remaining under our currently authorized stock repurchase program is \$15,694,000. Subsequent to quarter-end, we completed all remaining share repurchases under this program and our Board of Directors authorized a new share repurchase program to purchase up to \$65,000,000 of the Company's outstanding common stock.

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

### FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they do not fully materialize or are proven incorrect, could cause our business and results of operations to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include: projections of earnings, revenues or financial items, statements related to the impact of accounting changes; statements related to our expected effective tax rate; statements related to our plans to market the Williams-Sonoma Home brand through an online and limited store-in-store strategy with the Williams-Sonoma brand; statements related to our international business and our longer term international growth plan, including five additional franchised stores planned for 2011; statements related to our continuing to focus on the key initiatives that are driving our momentum; statements related to factors which may affect our comparable store sales results in the future; statements related to fluctuations in our comparable store sales; statements related to our plans to use our cash resources to fund our inventory and inventory related purchases, advertising and marketing initiatives, purchases of property and equipment, stock repurchases and dividend payments; statements related to our compliance with bank covenants; statements related to our belief that our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations over the next 12 months; statements related to our planned investments in the purchase of property and equipment, systems development projects, and distribution, facility infrastructure and other projects; statements related to the timing and actual number of shares repurchased under our stock repurchase program; statements related to the future payment of dividends; statements related to our plans to enter into foreign currency contracts; statements related to macroeconomic and retail trends; statements related to assessing the long-term strategy for the Williams-Sonoma Home brand; and statements of belief and statements of assumptions underlying any of the foregoing. You can identify these and other forward-looking statements by the use of words such as may, should, expects, plans, anticipates, believes, estimates, predicts, intends, or the negative of such terms, or other comparable terminology.

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

### OVERVIEW

We are a specialty retailer of products for the home. The retail segment of our business sells our products through our five retail store concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, West Elm and Williams-Sonoma Home). The direct-to-customer segment of our business sells similar products through our seven direct-mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed and Bath, PBteen, West Elm and Williams-Sonoma Home) and six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and wshome.com). Based on their contribution to our net revenues, the core brands in both the retail and direct-to-customer channels are: Pottery Barn, which sells casual home furnishings; Williams-Sonoma, which sells cooking and entertaining essentials; and Pottery Barn Kids, which sells stylish children's furnishings.

The following discussion and analysis of financial condition, results of operations, and liquidity and capital resources for the thirteen weeks ended August 1, 2010 (second quarter of fiscal 2010), as compared to the thirteen weeks ended August 2, 2009 (second quarter of fiscal 2009) and the twenty-six weeks ended August 1, 2010 (year-to-date 2010), as compared to the twenty-six weeks

ended August 2, 2009 ( year-to-date 2009 ), should be read in conjunction with our condensed consolidated financial statements and the notes thereto.

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

#### *Second Quarter of Fiscal 2010 Financial Results*

During the second quarter of fiscal 2010, our net revenues increased 15.4% to \$775,554,000 from \$672,114,000 in the second quarter of fiscal 2009. Diluted earnings per share in the second quarter of fiscal 2010 increased to \$0.28 per diluted share as compared to \$0.00 in the second quarter of fiscal 2009, including a \$0.03 and \$0.05 charge from unusual business events, respectively. We continued to see ongoing strength across all of our brands during the quarter driven by innovative merchandising at compelling price points combined with highly targeted marketing and a superior customer experience. We also ended the quarter with cash and cash equivalents of \$404,037,000 after repurchasing approximately \$44,306,000 of our common stock.

Retail net revenues in the second quarter of fiscal 2010 increased \$49,637,000, or 12.4%, compared to the second quarter of fiscal 2009. This increase was driven by growth of 13.6% in comparable store sales, partially offset by a 3.0% year-over-year reduction in retail leased square footage, including 20 net fewer stores. Increased net revenues during the quarter were driven by the Pottery Barn, Williams-Sonoma and West Elm brands.

Direct-to-customer net revenues in the second quarter of fiscal 2010 increased \$53,803,000, or 19.8%, compared to the second quarter of fiscal 2009, which were reduced by \$3,000,000 due to the impact of a voluntary product recall. This net revenue increase was driven by growth in the Pottery Barn, Pottery Barn Kids and PBteen brands. Internet net revenues, our fastest growing channel, increased 27.6% to \$267,470,000 in the second quarter of fiscal 2010 compared to \$209,573,000 in the second quarter of fiscal 2009.

In our core brands, net revenues in the second quarter of fiscal 2010 increased 15% compared to the second quarter of fiscal 2009. Pottery Barn saw the greatest increase, followed by Pottery Barn Kids and Williams-Sonoma. In the Pottery Barn brand, net revenues in the second quarter increased 19%, including a comparable store sales increase of 17.3%, with continuing momentum in both the retail and direct-to-customer channels. In the Pottery Barn Kids brand, net revenues increased 20%, including an 18.9% increase in comparable store sales and a 3% benefit from a reduction in product recalls, partially offset by a 7% reduction in retail leased square footage. In the Williams-Sonoma brand, net revenues increased 6%, including a comparable store sales increase of 8.3%.

In our emerging brands, including West Elm, PBteen and Williams-Sonoma Home, net revenues increased 16% in the second quarter of fiscal 2010 compared to the second quarter of fiscal 2009, driven by increasing net revenues in the West Elm and PBteen brands. PBteen continues to be the top performing brand in the company as net revenues increased 22% and the brand delivered its highest second quarter operating contribution since its launch.

In the Williams-Sonoma Home brand, our restructuring process continued and we were successful in reducing the brand's year-over-year operating loss as well as in negotiating the year-end closure or rebranding of eight of our eleven stand-alone stores. As we look forward to next year, we will continue to market the brand through an online and limited store-in-store strategy with the Williams-Sonoma brand.

#### *Second Quarter of Fiscal 2010 Operational Results*

In supply chain, we successfully completed the first phase of our east coast distribution consolidation and continued to see ongoing benefits from our hub distribution strategies. We also saw incremental savings from our newly introduced packaging optimization and domestic transportation initiatives. All of these initiatives, combined with strong inventory management, improved our gross margin during the second quarter of fiscal 2010.

In direct marketing, we continued to identify new opportunities to build brand awareness and customer engagement through targeted e-mail, paid search, affiliate marketing and mobile technologies. All of these initiatives, combined with our catalog circulation optimization strategy, contributed to an ongoing increase in online traffic and conversion rates, while reducing the company's overall advertising rate despite an increase in e-marketing expenses.

In our international business, we are pleased with the performance of our first four franchised stores in Dubai and Kuwait. We believe this business is a strategic step toward a longer term international growth plan, including five additional stores planned for 2011.

#### *Fiscal 2010*

As we look forward to the balance of the year, based on the continuing momentum we are seeing in our business, we now expect to see net revenue growth of 9% to 11% and diluted earnings per share of approximately \$1.52 to \$1.59 in fiscal 2010 compared to \$0.72 in fiscal 2009. We will continue to focus on the key initiatives that are driving this momentum, including implementing innovative growth strategies to capture market share, delivering superior customer service, executing our catalog and internet marketing initiatives, driving supply chain efficiencies and maximizing profitability and cash flow.

Lastly, in May 2010, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.13 to \$0.15 per common share and a share repurchase program to purchase up to \$60,000,000 of our common stock. Subsequent to quarter-end, we completed all remaining share repurchases under this program and our Board of Directors authorized a new share repurchase program to purchase up to \$65,000,000 of the Company's outstanding common stock. The authorization of the stock repurchase program reflects the Board of Directors' objective to offset dilution from equity compensation programs on an on-going basis.

### *Results of Operations*

#### **NET REVENUES**

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

The following table summarizes our net revenues for the second quarter of fiscal 2010 and fiscal 2009, and year-to-date 2010 and 2009:

| <i>Dollars in thousands</i> | Thirteen Weeks Ended |               |                   |               | Twenty-Six Weeks Ended |               |                     |               |
|-----------------------------|----------------------|---------------|-------------------|---------------|------------------------|---------------|---------------------|---------------|
|                             | August 1,<br>2010    | % Total       | August 2,<br>2009 | % Total       | August 1,<br>2010      | % Total       | August 2,<br>2009   | % Total       |
| Retail revenues             | \$ 449,876           | 58.0%         | \$ 400,239        | 59.5%         | \$ 861,656             | 57.7%         | \$ 757,618          | 59.0%         |
| Direct-to-customer revenues | 325,678              | 42.0%         | 271,875           | 40.5%         | 631,535                | 42.3%         | 526,111             | 41.0%         |
| <b>Net revenues</b>         | <b>\$ 775,554</b>    | <b>100.0%</b> | <b>\$ 672,114</b> | <b>100.0%</b> | <b>\$ 1,493,191</b>    | <b>100.0%</b> | <b>\$ 1,283,729</b> | <b>100.0%</b> |

Net revenues in the second quarter of fiscal 2010 increased by \$103,440,000, or 15.4%, compared to the second quarter of fiscal 2009. This increase was driven by increased revenues in the Pottery Barn, Pottery Barn Kids, West Elm and Williams-Sonoma brands, primarily due to comparable store sales growth of 13.6%, partially offset by a 3.0% year-over-year reduction in retail leased square footage, including 20 net fewer stores.

Net revenues for year-to date 2010 increased by \$209,462,000, or 16.3%, compared to year-to-date 2009. This increase was driven by increased revenues in the Pottery Barn, Pottery Barn Kids, and Williams-Sonoma brands, primarily due to comparable store sales growth of 15.2%, partially offset by a 3.0% year-over-year reduction in retail leased square footage, including 20 net fewer stores.

## RETAIL REVENUES AND OTHER DATA

|                                                        | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|--------------------------------------------------------|----------------------|-------------------|------------------------|-------------------|
|                                                        | August 1,<br>2010    | August 2,<br>2009 | August 1,<br>2010      | August 2,<br>2009 |
| <i>Dollars in thousands</i>                            |                      |                   |                        |                   |
| Retail revenues                                        | \$ 449,876           | \$ 400,239        | \$ 861,656             | \$ 757,618        |
| Percent increase (decrease) in retail revenues         | 12.4%                | (13.6%)           | 13.7%                  | (15.5%)           |
| Percent increase (decrease) in comparable store sales  | 13.6%                | (15.3%)           | 15.2%                  | (18.1%)           |
| Number of stores - beginning of period                 | 610                  | 630               | 610                    | 627               |
| Number of new stores                                   | 0                    | 0                 | 3                      | 7                 |
| Number of new stores due to remodeling <sup>1</sup>    | 1                    | 3                 | 5                      | 5                 |
| Number of closed stores due to remodeling <sup>1</sup> | (1)                  | (2)               | (3)                    | (5)               |
| Number of permanently closed stores                    | (1)                  | (2)               | (6)                    | (5)               |
| Number of stores - end of period                       | 609                  | 629               | 609                    | 629               |
| Store selling square footage at period-end             | 3,742,000            | 3,871,000         | 3,742,000              | 3,871,000         |
| Store leased square footage ( LSF ) at period-end      | 6,047,000            | 6,235,000         | 6,047,000              | 6,235,000         |

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

|                      | Store Count    |          |          | Avg. LSF                       |                                |
|----------------------|----------------|----------|----------|--------------------------------|--------------------------------|
|                      | May 2,<br>2010 | Openings | Closings | Per Store<br>August 1,<br>2010 | Per Store<br>August 2,<br>2009 |
| Williams-Sonoma      | 259            | 1        | 0        | 260                            | 263                            |
| Pottery Barn         | 199            | 0        | (2)      | 197                            | 204                            |
| Pottery Barn Kids    | 85             | 0        | 0        | 85                             | 93                             |
| West Elm             | 37             | 0        | 0        | 37                             | 39                             |
| Williams-Sonoma Home | 11             | 0        | 0        | 11                             | 11                             |
| Outlets              | 19             | 0        | 0        | 19                             | 19                             |
| Total                | 610            | 1        | (2)      | 609                            | 629                            |

Retail net revenues in the second quarter of fiscal 2010 increased \$49,637,000, or 12.4%, compared to the second quarter of fiscal 2009. This increase was driven by growth of 13.6% in comparable store sales, partially offset by a 3.0% year-over-year reduction in retail leased square footage, including 20 net fewer stores. Increased net revenues during the quarter were driven by the Pottery Barn, Williams-Sonoma and West Elm brands.

Retail net revenues for year-to-date 2010 increased \$104,038,000, or 13.7%, compared to year-to-date 2009. This increase was driven by growth of 15.2% in comparable store sales, partially offset by a 3.0% year-over-year reduction in retail leased square footage, including 20 net fewer stores. Increased net revenues during the quarter were driven by the Pottery Barn, Williams-Sonoma, West Elm and Pottery Barn Kids brands.

### Comparable Store Sales

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

concepts until such time as we believe that comparable store results in those concepts are of sufficient size to evaluate the performance of the retail strategy. Therefore, in both fiscal 2010 and fiscal 2009, total comparable store sales exclude the West Elm and Williams-Sonoma Home concepts.

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

|                                                              | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|--------------------------------------------------------------|----------------------|-------------------|------------------------|-------------------|
|                                                              | August 1,<br>2010    | August 2,<br>2009 | August 1,<br>2010      | August 2,<br>2009 |
| <i>Percent increase (decrease) in comparable store sales</i> |                      |                   |                        |                   |
| Williams-Sonoma                                              | 8.3%                 | (11.0%)           | 9.4%                   | (13.1%)           |
| Pottery Barn                                                 | 17.3%                | (15.9%)           | 20.1%                  | (19.1%)           |
| Pottery Barn Kids                                            | 18.9%                | (22.3%)           | 20.8%                  | (23.7%)           |
| Outlets                                                      | 8.1%                 | (18.2%)           | 2.9%                   | (22.3%)           |
| Total                                                        | 13.6%                | (15.3%)           | 15.2%                  | (18.1%)           |

Various factors affect comparable store sales, including the overall economic and general retail sales environment as well as current local and global economic conditions, each of which were significant factors in our comparable store sales results for the thirteen and twenty-six weeks ended August 1, 2010 and August 2, 2009, respectively. Additional factors have affected our comparable store sales results in the past and may continue to affect them in the future, such as the number, size and location of stores we open, close, remodel or expand in any period, consumer preferences and buying trends, changes in sales mix among distribution channels, our ability to efficiently source and distribute products, changes in our merchandise mix, competition (including competitive promotional activity and discount retailers), the timing of our releases of new merchandise and promotional events, the success of marketing programs, the cannibalization of existing store sales by our new stores, the benefits of closing underperforming stores in multi-store markets, changes in catalog circulation and in our direct-to-customer business and fluctuations in foreign exchange rates. Among other things, weather conditions can affect comparable store sales because inclement weather can alter consumer behavior or require us to close certain stores temporarily and thus reduce store traffic. Even if stores are not closed, many customers may decide to avoid going to stores in bad weather. These factors have caused our comparable store sales to fluctuate significantly in the past on an annual, quarterly and monthly basis and, as a result, we expect that comparable store sales will continue to fluctuate in the future.

#### DIRECT-TO-CUSTOMER REVENUES

|                                                              | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|--------------------------------------------------------------|----------------------|-------------------|------------------------|-------------------|
|                                                              | August 1,<br>2010    | August 2,<br>2009 | August 1,<br>2010      | August 2,<br>2009 |
| <i>Dollars in thousands</i>                                  |                      |                   |                        |                   |
| Catalog revenues                                             | \$ 58,208            | \$ 62,302         | \$ 124,076             | \$ 122,394        |
| Internet revenues                                            | 267,470              | 209,573           | 507,459                | 403,717           |
| Total direct-to-customer revenues                            | \$ 325,678           | \$ 271,875        | \$ 631,535             | \$ 526,111        |
| Percent increase (decrease) in direct-to-customer revenues   | 19.8%                | (23.7%)           | 20.0%                  | (25.3%)           |
| Percent increase (decrease) in number of catalogs circulated | 1.2%                 | (18.7%)           | (0.9%)                 | (17.9%)           |
| Percent decrease in number of pages circulated               | (0.9%)               | (24.8%)           | (2.5%)                 | (23.7%)           |

Direct-to-customer net revenues in the second quarter of fiscal 2010 increased \$53,803,000, or 19.8%, compared to the second quarter of fiscal 2009, which were reduced by \$3,000,000 due to the impact of a voluntary product recall. This net revenue increase was driven by growth in the Pottery Barn, Pottery Barn Kids and PBteen brands. Internet net revenues, our fastest growing channel, increased 27.6% to \$267,470,000 in the second quarter of fiscal 2010 compared to \$209,573,000 in the second quarter of fiscal 2009.

Direct-to-customer net revenues for year-to-date 2010 increased \$105,424,000, or 20.0%, compared to year-to-date 2009 driven by growth in the Pottery Barn, Pottery Barn Kids and PBteen brands. Internet net revenues for year-to-date 2010 increased 25.7% to \$507,459,000 versus \$403,717,000 for year-to-date 2009.

## COST OF GOODS SOLD

|                                 | Thirteen Weeks Ended |                   |                   |                   | Twenty-Six Weeks Ended |                   |                   |                   |
|---------------------------------|----------------------|-------------------|-------------------|-------------------|------------------------|-------------------|-------------------|-------------------|
|                                 | August 1,<br>2010    | % Net<br>Revenues | August 2,<br>2009 | % Net<br>Revenues | August 1,<br>2010      | % Net<br>Revenues | August 2,<br>2009 | % Net<br>Revenues |
| <i>Dollars in thousands</i>     |                      |                   |                   |                   |                        |                   |                   |                   |
| Cost of goods sold <sup>1</sup> | \$ 488,827           | 63.0%             | \$ 456,773        | 68.0%             | \$ 935,906             | 62.7%             | \$ 884,425        | 68.9%             |

<sup>1</sup>Includes total occupancy expenses of \$124,947,000 and \$127,273,000 for the second quarter of fiscal 2010 and fiscal 2009, respectively, and \$250,087,000 and \$255,597,000 for year-to-date 2010 and year-to-date 2009, respectively.

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

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

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

### *Second Quarter of Fiscal 2010 vs. Second Quarter of Fiscal 2009*

Cost of goods sold increased by \$32,054,000, or 7.0%, in the second quarter of fiscal 2010 compared to the second quarter of fiscal 2009. Cost of goods sold as a percentage of net revenues decreased to 63.0% in the second quarter of fiscal 2010 from 68.0% in the second quarter of fiscal 2009. This decrease was primarily driven by the leverage of fixed occupancy expenses due to increasing net revenues, reduced markdown activity, a decrease in occupancy expense dollars, a reduction in the impact of product recalls and lower replacement and damages expense.

In the retail channel, cost of goods sold as a percentage of net revenues decreased 490 basis points in the second quarter of fiscal 2010 compared to the second quarter of fiscal 2009. This decrease as a percentage of net revenues was primarily driven by the leverage of fixed occupancy expenses due to increasing net revenues and reduced markdown activity.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues decreased 290 basis points in the second quarter of fiscal 2010 compared to the second quarter of fiscal 2009. This decrease as a percentage of net revenues was primarily driven by reduced markdown activity, the leverage of fixed occupancy expenses due to increasing net revenues and lower replacement and damages expense.

### *Year-to-Date 2010 vs. Year-to-Date 2009*

Cost of goods sold for year-to-date 2010 increased \$51,481,000, or 5.8%, compared to year-to-date 2009. Cost of goods sold as a percentage of net revenues decreased to 62.7% for year-to-date 2010 from 68.9% for year-to-date

2009. This decrease was primarily driven by the leverage of fixed occupancy expenses due to increasing net revenues, reduced markdown activity, an actual decrease in occupancy expense dollars, a reduction in the impact of product recalls and lower replacement and damages expense.

In the retail channel, cost of goods sold as a percentage of net revenues decreased 600 basis points for year-to-date 2010 compared to year-to-date 2009. This decrease as a percentage of net revenues was primarily driven by the leverage of fixed occupancy expenses due to increasing net revenues, reduced markdown activity and an actual decrease in occupancy expense dollars.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues decreased 470 basis points for year-to-date 2010 compared to year-to-date 2009. This decrease as a percentage of net revenues was primarily driven by reduced markdown activity, the leverage of fixed occupancy expenses due to increasing net revenues, lower replacement and damages expense and an actual decrease in occupancy expense dollars.

## SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

|                                              | Thirteen Weeks Ended |                   |                   |                   | Twenty-Six Weeks Ended |                   |                   |                   |
|----------------------------------------------|----------------------|-------------------|-------------------|-------------------|------------------------|-------------------|-------------------|-------------------|
|                                              | August 1,<br>2010    | % Net<br>Revenues | August 2,<br>2009 | % Net<br>Revenues | August 1,<br>2010      | % Net<br>Revenues | August 2,<br>2009 | % Net<br>Revenues |
| <i>Dollars in thousands</i>                  |                      |                   |                   |                   |                        |                   |                   |                   |
| Selling, general and administrative expenses | \$ 235,530           | 30.4%             | \$ 214,906        | 32.0%             | \$ 473,627             | 31.7%             | \$ 428,109        | 33.3%             |

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

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

### *Second Quarter of Fiscal 2010 vs. Second Quarter of Fiscal 2009*

Selling, general and administrative expenses increased by \$20,624,000, or 9.6%, in the second quarter of fiscal 2010 compared to the second quarter of fiscal 2009. Including expense of approximately \$4,110,000 for charges associated with our underperforming retail stores and \$972,000 associated with the retirement of our Chairman and Chief Executive Officer, selling, general and administrative expenses as a percentage of net revenues decreased to 30.4% in the second quarter of fiscal 2010 from 32.0% in the second quarter of fiscal 2009 (which included \$7,132,000 from asset impairment and early lease termination charges for underperforming retail stores). This decrease as a percentage of net revenues was primarily driven by the leverage of fixed expenses due to increasing net revenues, a reduction in charges associated with our underperforming retail stores and a benefit from a gain on the sale of assets, partially offset by increased incentive compensation and internet advertising expenses and charges associated with the retirement of our Chairman and Chief Executive Officer.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues decreased 220 basis points in the second quarter of fiscal 2010 compared to the second quarter of fiscal 2009. This was primarily driven by the leverage of fixed expenses due to increasing net revenues and a reduction in charges associated with our underperforming retail stores.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased 260 basis points in the second quarter of fiscal 2010 compared to the second quarter of fiscal 2009. This decrease as a percentage of net revenues was primarily driven by the leverage of fixed expenses due to increasing net revenues, partially offset by increased internet advertising expenses.

*Year-to-Date 2010 vs. Year-to-Date 2009*

Selling, general and administrative expenses for year-to-date 2010 increased by \$45,518,000, or 10.6%, compared to year-to-date 2009. Including expense of approximately \$9,689,000 from asset impairment and early lease termination charges for underperforming retail stores and \$4,319,000 associated with the retirement of our Chairman and Chief Executive Officer, selling, general and administrative expenses as a percentage of net revenues decreased to 31.7% for year-to-date 2010 from 33.3% for year-to-date 2009 (which included \$13,214,000 from asset impairment and early lease termination charges for underperforming retail stores). This decrease as a percentage of net revenues was primarily driven by the leverage of fixed expenses due to increasing net revenues, a reduction in charges associated with our underperforming retail stores and a benefit from a gain on the sale of assets, partially offset by increased incentive compensation, internet advertising expenses and charges associated with the retirement of our Chairman and Chief Executive Officer.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues decreased 210 basis points for year-to-date 2010 compared to year-to-date 2009. This was primarily driven by a reduction in other general expenses, the leverage of fixed expenses due to increasing net revenues and a reduction in charges associated with our underperforming retail stores.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased 330 basis points for year-to-date 2010 compared to year-to-date 2009. This decrease as a percentage of net revenues was primarily driven by the leverage of fixed expenses due to increasing net revenues, partially offset by increased internet advertising expenses.

## **INCOME TAXES**

The effective rate was an expense of 39.7% for year-to-date 2010 and a benefit of 37.8% for year-to-date 2009. The effective tax rate for year-to-date 2009 was primarily the result of our year-to-date 2009 net loss.

We expect the effective tax rate to be in the range of 38% to 40% in fiscal 2010. Throughout the year, we expect that there could be ongoing variability in our quarterly tax rates due to volatility in earnings or losses in addition to taxable events that occur and exposures that are re-evaluated.

## **LIQUIDITY AND CAPITAL RESOURCES**

As of August 1, 2010, we held \$404,037,000 in cash and cash equivalent funds, the majority of which are held in money market funds and highly liquid U.S. Treasury bills. As is consistent with our industry, our cash balances are seasonal in nature, with the fourth quarter historically representing a significantly higher level of cash than other periods.

Throughout the fiscal year, we utilize our cash balances to build our inventory levels in preparation for our fourth quarter holiday sales. In fiscal 2010, we plan to use our cash resources to fund our inventory and inventory-related purchases, advertising and marketing initiatives, purchases of property and equipment, stock repurchases and dividend payments. In addition to the current cash balances on hand, we have a credit facility that provides for a \$300,000,000 unsecured revolving line of credit that may be used for loans or letters of credit. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the credit facility of up to \$200,000,000 to provide for a total of \$500,000,000 of unsecured revolving credit. During the thirteen and twenty-six weeks ended August 1, 2010 and August 2, 2009, respectively, we had no borrowings under the credit facility, and no amounts were outstanding as of August 1, 2010 or August 2, 2009. Additionally, as of August 1, 2010, \$15,180,000 in issued but

undrawn standby letters of credit was outstanding under the credit facility. On April 16, 2010, we entered into a collateral trust agreement to replace a portion of our standby letters of credit. As of August 1, 2010, restricted cash deposits related to this agreement were \$12,502,000. Further, as of August 1, 2010, we had four unsecured letter of credit reimbursement facilities for a total of \$125,000,000. On September 3, 2010, due to reductions in inventory purchases over the past twelve months and an overall reduction in the number of vendors who require the use of our letter of credit facilities, three of these facilities were renewed and the total amount of available credit under these facilities was reduced to \$90,000,000. As of August 1, 2010, an aggregate of \$29,817,000 was outstanding under these letter of credit facilities, which represent only a future commitment to fund inventory purchases to which we had not taken legal title. We are currently in compliance with all of our bank covenants and, based on our current projections, we expect to remain in compliance throughout fiscal 2010. We believe our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations over the next 12 months.

For year-to-date 2010, net cash used in operating activities was \$9,111,000 compared to net cash provided by operating activities of \$75,988,000 for year-to-date 2009. Net cash used in operating activities for year-to-date 2010 and as compared to year-to-date 2009 was primarily attributable to an increase in merchandise inventories and a decrease in income taxes payable due to the payment of income taxes in 2010.

For year-to-date 2010, net cash used in investing activities was \$32,676,000 compared to net cash used in investing activities of \$32,923,000 for year-to-date 2009. For year-to-date 2010, net cash used in investing activities was primarily attributable to purchases of property and equipment of \$30,889,000, comprised of \$9,450,000 for stores, \$17,568,000 for systems development projects (including e-commerce websites) and \$3,871,000 for distribution, facility infrastructure and other projects. For year-to-date 2010, net cash used in investing activities was relatively flat as compared to year-to-date 2009 primarily due to restricted cash deposits, partially offset by proceeds from the sale of assets.

For fiscal 2010, we anticipate investing \$75,000,000 in the purchase of property and equipment, primarily for the construction of 4 new stores and 6 remodeled or expanded stores, systems development projects (including e-commerce websites), and distribution, facility infrastructure and other projects.

For year-to-date 2010, net cash used in financing activities was \$68,136,000 compared to net cash used in financing activities of \$26,463,000 for year-to-date 2009. For year-to-date 2010, net cash used in financing activities was primarily attributable to the repurchase of common stock of \$44,306,000, the payment of dividends and tax withholdings related to stock-based awards, partially offset by net proceeds from the exercise of stock-based awards. Compared to year-to-date 2009, cash used in financing activities increased primarily due to the repurchase of common stock.

#### *Stock Repurchase Program*

In May 2010, our Board of Directors authorized a stock repurchase program to purchase up to \$60,000,000 of our common stock through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. The authorization of the stock repurchase program reflects the Board of Directors' objective to offset dilution from equity compensation programs on an on-going basis. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. The stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

During the second quarter of fiscal 2010, we repurchased and retired 1,718,150 shares of our common stock at a weighted average cost of \$25.79 per share and a total cost of approximately \$44,306,000. As of August 1, 2010, the amount remaining under our currently authorized stock repurchase program is \$15,694,000. Subsequent to quarter-end, we completed all remaining share repurchases under this program and our Board of Directors authorized a new share repurchase program to purchase up to \$65,000,000 of the Company's outstanding common stock.

#### *Dividend Policy*

In May 2010, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.13 to \$0.15 per common share. The indicated annual cash dividend, subject to capital availability, is \$0.60 per common share, or approximately \$65,000,000. Our quarterly cash dividend may be limited or terminated at any time.

#### *Critical Accounting Policies*

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. The estimates and assumptions are evaluated on an ongoing basis and are based on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results may differ significantly from these estimates. During the second quarter of fiscal 2010, there have been no significant changes to the policies discussed in our Annual Report on Form 10-K for the year ended January 31, 2010.

#### *Impact of Inflation*

The impact of inflation on results of operations was not significant for year-to-date 2010 or year-to-date 2009.

#### *Seasonality*

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

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

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

#### *Interest Rate Risk*

As of August 1, 2010, we had two debt instruments with variable interest rates which subject us to risks associated with changes in interest rates, the interest payable on our credit facility and the bond-related debt associated with one of our Memphis-based distribution facilities. As of August 1, 2010, the total outstanding principal balance on these instruments was \$175,000 (with an interest rate of 1.3%) solely pertaining to our bond-related debt associated with our Memphis-based distribution facility. As of August 1, 2010, no amounts were outstanding under our credit facility. If interest rates on these existing variable rate debt instruments rose 10%, our results from operations and cash flows would not be materially affected.

In addition, we have fixed and variable income investments consisting of short-term investments classified as cash and cash equivalents, which are also affected by changes in market interest rates. As of August 1, 2010, our investments, made primarily in money market funds and highly liquid U.S. Treasury bills, are stated at cost and approximate their fair values.

### *Foreign Currency Risks*

We purchase a significant amount of inventory from vendors outside of the U.S. in transactions that are denominated in U.S. dollars. Only approximately 4% of our international purchase transactions are in currencies other than the U.S. dollar, primarily the euro. Any currency risks related to these international purchase transactions were not significant to us during year-to-date 2010 and year-to-date 2009. Since we pay for the majority of our international purchases in U.S. dollars, however, a decline in the U.S. dollar relative to other foreign currencies would subject us to risks associated with increased purchasing costs from our vendors in their effort to offset any lost profits associated with any currency devaluation. We cannot predict with certainty the effect these increased costs may have on our financial statements or results of operations.

In addition, as of August 1, 2010, we have 17 retail stores in Canada and limited sourcing operations in both Europe and Asia, each of which expose us to market risk associated with foreign currency exchange rate fluctuations. Although these exchange rate fluctuations have not been material to us in the past, we may enter into foreign currency contracts in the future to minimize any currency remeasurement risk associated with the intercompany assets and liabilities of our subsidiaries. We did not enter into any foreign currency contracts during year-to-date 2010 or year-to-date 2009.

## **ITEM 4. CONTROLS AND PROCEDURES**

### *Evaluation of Disclosure Controls and Procedures*

As of August 1, 2010, an evaluation was performed by management, with the participation of our Chief Executive Officer ( CEO ) and our Executive Vice President, Chief Operating and Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow timely discussions regarding required disclosures, and that such information is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

### *Changes in Internal Control Over Financial Reporting*

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

## **PART II - OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

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

### **ITEM 1A. RISK FACTORS**

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

included in the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.

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

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

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

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

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

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

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

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

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

anticipating and quickly responding to changing consumer demands or preferences better than our competitors;

maintaining favorable brand recognition and achieving customer perception of value;

effectively marketing and competitively pricing our products to consumers in several diverse market segments;

developing innovative, high-quality products in colors and styles that appeal to consumers of varying age groups and tastes, and in ways that favorably distinguish us from our competitors; and

effectively managing our supply chain and distribution strategies in order to provide our products to our consumers on a timely basis and minimize returns, replacements, and damaged products.

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

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

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

Any inability to acquire suitable merchandise on acceptable terms or the loss of one or more of our key agents or vendors could have a negative effect on our business and operating results because we would be missing products

that we felt were important to our assortment, unless and until alternative supply arrangements are secured. We may not be able to develop relationships with new agents or vendors, and products from alternative sources, if any, may be of a lesser quality and/or more expensive than those we currently purchase.

In addition, we are subject to certain risks, including risks related to the availability of raw materials, labor disputes, union organizing activities, vendor financial liquidity, inclement weather, natural disasters, general economic and political conditions and regulations to address climate change that could limit our vendors' ability to provide us with quality merchandise on a timely basis and at prices that are commercially acceptable. For these or other reasons, one or more of our vendors might not adhere to our quality control standards, and we might not identify the deficiency before merchandise ships to our stores or customers. In addition, our vendors may have difficulty adjusting to our changing demands and growing business. Our vendors' failure to manufacture or import quality merchandise in a timely and effective manner could damage our reputation and brands, and could lead to an increase in customer litigation against us and an attendant increase in our routine litigation costs. Further, any merchandise that we receive, even if it meets our quality standards, could become subject to a recall, which could damage our reputation and brands, and harm our business. Recently enacted legislation has given the U.S. Consumer Product Safety Commission increased regulatory and enforcement power, particularly with regard to children's safety, among other areas. As a result, companies like ours may be subject to more product recalls and incurring higher recall-related expenses. Any recalls or other safety issues could potentially harm our brands' images.

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

In fiscal 2009, we sourced our products from vendors in 40 countries outside of the United States. Approximately 59% of our merchandise purchases were foreign-sourced, predominantly from Asia. Our dependence on foreign vendors means that we may be affected by changes in the value of the U.S. dollar relative to other foreign currencies. For example, any upward valuation in the Chinese yuan, the euro, or any other foreign currency against the U.S. dollar may result in higher costs to us for those goods. Although approximately 96% of our foreign purchases of merchandise are negotiated and paid for in U.S. dollars, declines in foreign currencies and currency exchange rates might negatively affect the profitability and business prospects of one or more of our foreign vendors. This, in turn, might cause such foreign vendors to demand higher prices for merchandise in their effort to offset any lost profits associated with any currency devaluation, delay merchandise shipments to us, or discontinue selling to us, any of which could ultimately reduce our sales or increase our costs. In addition, an increase in the cost of living in the foreign countries in which our vendors operate may result in an increase in our costs or in our vendors going out of business.

We are also subject to other risks and uncertainties associated with changing economic and political conditions in foreign countries. These risks and uncertainties include import duties and quotas, compliance with anti-dumping regulations, work stoppages, economic uncertainties and adverse economic conditions (including inflation and recession), foreign government regulations, employment matters, wars and fears of war, political unrest, natural disasters, regulations to address climate change and other trade restrictions. We cannot predict whether any of the countries in which our products are currently manufactured or may be manufactured in the future will be subject to trade restrictions imposed by the U.S. or foreign governments or the likelihood, type or effect of any such restrictions. Any event causing a disruption or delay of imports from foreign vendors, including the imposition of additional import restrictions, restrictions on the transfer of funds and/or increased tariffs or quotas, or both, could increase the cost or reduce the supply of merchandise available to us and adversely affect our business, financial condition and operating results. Furthermore, some or all of our foreign vendors' operations may be adversely affected by political and financial instability resulting in the disruption of trade from exporting countries, restrictions on the transfer of funds and/or other trade disruptions. In addition, an economic downturn in or failure of foreign markets may result in financial instabilities for our foreign vendors, which may cause our foreign vendors to decrease production, discontinue selling to us, or to cease operations altogether. Our overseas

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

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

In addition, as we continue to expand our overseas operations, we are subject to certain U.S. laws, including the Foreign Corrupt Practices Act, in addition to the laws of the foreign countries in which we operate. We must ensure that our employees comply with these laws. If any of our overseas operations, or our employees or agents, violates such laws, we could become subject to sanctions or other penalties that could negatively affect our reputation, business and operating results.

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

Historically, the majority of our net revenues have been generated by our retail stores. Our ability to open additional stores or close existing stores successfully will depend upon a number of factors, including:

general economic conditions;

our identification of, and the availability of, suitable store locations;

our success in negotiating new leases and amending or terminating existing leases on acceptable terms;

the success of other retail stores in and around our retail locations;

our ability to secure required governmental permits and approvals;

our hiring and training of skilled store operating personnel, especially management;

the availability of financing on acceptable terms, if at all; and

the financial stability of our landlords and potential landlords.

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

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

## Edgar Filing: WILLIAMS SONOMA INC - Form 10-Q

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

our customers and to and from all of our stores. In addition, we are heavily dependent upon two carriers for the delivery of our merchandise to our customers. Accordingly, we are subject to risks, including labor disputes, union organizing activity, inclement weather, natural disasters, the closure of such carriers' offices or a reduction in operational hours due to an economic slowdown, possible acts of terrorism associated with such carriers' ability to provide delivery services to meet our shipping needs and disruptions or increased fuel costs associated with any regulations to address climate change. Failure to deliver merchandise in a timely and effective manner could damage our reputation and brands. In addition, fuel costs have been volatile and airline and other transportation companies continue to struggle to operate profitably, which could lead to increased fulfillment expenses. Any rise in fulfillment costs could negatively affect our business and operating results by increasing our transportation costs and decreasing the efficiency of our shipments.

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

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

In addition, we face the risk that we cannot hire enough qualified employees to support our direct-to-customer operations, or that there will be a disruption in the labor we hire from our third party providers, especially during our peak season. The need to operate with fewer employees could negatively impact our customer service levels and our operations.

*Our facilities and systems, as well as those of our vendors, are vulnerable to natural disasters and other unexpected events, any of which could result in an interruption in our business and harm our operating results.*

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

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

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

These factors have caused and may continue to cause our comparable store sales results to differ materially from prior periods and from earnings guidance we have provided. For example, the overall economic and general retail sales environment, as well as current local and global economic conditions, has caused a significant decline in our comparable store sales results in the recent past.

Our comparable store sales have fluctuated significantly in the past on an annual, quarterly and monthly basis, and we expect that comparable store sales will continue to fluctuate in the future. Comparable store sales have decreased in the past and may decrease in fiscal 2010, however, past comparable store sales are not necessarily an indication of future results. Our ability to improve our comparable store sales results depends, in large part, on maintaining and improving our forecasting of customer demand and buying trends, selecting effective marketing techniques, effectively driving traffic to our stores through marketing and various promotional events, providing an appropriate mix of merchandise for our broad and diverse customer base and using effective pricing strategies. Any failure to meet the comparable store sales expectations of investors and securities analysts in one or more future periods could significantly reduce the market price of our common stock.

*Our failure to successfully manage the costs and performance of our catalog mailings might have a negative impact on our business.*

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

We have historically experienced fluctuations in customer response to our catalogs. Customer response to our catalogs is substantially dependent on merchandise assortment, merchandise availability and creative presentation, as well as the selection of customers to whom the catalogs are mailed, changes in mailing strategies, the sizing and timing of delivery of the catalogs, as well as the general retail sales environment and current domestic and global economic conditions. In addition, environmental organizations and other consumer advocacy groups may attempt to create an unfavorable impression of our paper use in catalogs and our distribution of catalogs generally, which may have a negative effect on our sales and our reputation. In addition, we depend upon external vendors to print our catalogs. The failure to effectively produce or distribute our catalogs could affect the timing of catalog delivery. The timing of catalog delivery has been and can be affected by postal service delays. Any delays in the timing of catalog delivery could cause customers to forego or defer purchases, negatively impacting our business and operating results.

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

Our internet business has been our fastest growing channel over the last several years and continues to be a significant part of our sales success. The success of our internet business depends, in part, on factors over which we have limited control. We must successfully respond to changing consumer preferences and buying trends relating to internet usage. We are also vulnerable to certain additional risks and uncertainties associated with the internet, including changes in required technology interfaces, website downtime and other technical failures, costs and technical issues as we upgrade our website software, computer viruses, changes in applicable federal and state regulations, security breaches and consumer privacy concerns. In addition, we must keep up to date with competitive technology trends, including the use of improved technology, creative user interfaces and other

internet marketing tools such as paid search, which may increase costs and which may not succeed in increasing sales or attracting customers. Our failure to successfully respond to these risks and uncertainties might adversely affect the sales in our internet business, as well as damage our reputation and brands.

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

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

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

During the past several years, with the launch and expansion of our internet business, new brands and brand extensions, our overall business has become substantially more complex. The changes in our business have forced us to develop new expertise and face new challenges, risks and uncertainties. For example, we face the risk that our internet business might cannibalize a significant portion of our retail and catalog businesses, and we face the risk of catalog circulation cannibalizing our retail sales. While we recognize that our internet sales cannot be entirely incremental to sales through our retail and catalog channels, we seek to attract as many new customers as possible to our e-commerce websites. We continually analyze the business results of our three channels and the relationships among the channels in an effort to find opportunities to build incremental sales.

*If we are unable to introduce new brands and brand extensions successfully, or to reposition or close existing brands, our business and operating results may be negatively impacted.*

We have in the past and may in the future introduce new brands and brand extensions, or reposition or close existing brands. Our newest brands West Elm, PBteen and Williams-Sonoma Home and any other new brands, may not grow as we project and plan for. Further, if we devote time and resources to new brands, brand extensions or brand repositioning, and those businesses are not as successful as we planned, then we risk damaging our overall business results. Alternatively, if our new brands, brand extensions or repositioned brands prove to be very successful, we risk hurting our other existing brands through the potential migration of existing brand customers to the new businesses. In addition, we may not be able to introduce new brands and brand extensions, or to reposition brands, in a manner that improves our overall business and operating results and may therefore be forced to close the brands. For example, in fiscal 2009, after another difficult year and an extensive review of our strategic alternatives, we concluded that the future potential of the Williams-Sonoma Home brand is limited. As such, we are working on a plan to restructure the unprofitable segments of the business, including the operations of our 11 retail stores. As part of this restructuring, it is our intent to market those merchandising categories that support our bridal registry, expanded flagship and designer assortments through the Williams-Sonoma kitchen brand. These categories will be available both on-line and in select Williams-Sonoma stores.

*Our inability to obtain commercial insurance at acceptable prices or our failure to adequately reserve for self-insured exposures might increase our expenses and have a negative impact on our business.*

We believe that commercial insurance coverage is prudent in certain areas of our business for risk management. Insurance costs may increase substantially in the future and may be affected by natural catastrophes, fear of terrorism, financial irregularities and other fraud at publicly-traded companies, intervention

by the government and a decrease in the number of insurance carriers. In addition, the carriers with which we hold our policies may go out of business, or may be otherwise unable to fulfill their contractual obligations. In addition, for certain types or levels of risk, such as risks associated with earthquakes, hurricanes or terrorist attacks, we may determine that we cannot obtain commercial insurance at acceptable prices, if at all. Therefore, we may choose to forego or limit our purchase of relevant commercial insurance, choosing instead to self-insure one or more types or levels of risks. We are primarily self-insured for workers' compensation, employee health benefits and product and general liability claims. If we suffer a substantial loss that is not covered by commercial insurance or our self-insurance reserves, the loss and attendant expenses could harm our business and operating results. In addition, exposures exist for which no insurance may be available and for which we have not reserved.

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

We may not be able to adequately protect our intellectual property. Our trademarks, service marks, copyrights, trade dress rights, trade secrets, domain names and other intellectual property are valuable assets that are critical to our success. The unauthorized reproduction or other misappropriation of our intellectual property could diminish the value of our brands or goodwill and cause a decline in our sales. Protection of our intellectual property and maintenance of distinct branding are particularly important as they distinguish our products and services from our competitors who may sell similar products and services. In addition, the costs of defending our intellectual property may adversely affect our operating results.

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

We are involved in lawsuits, claims and proceedings incident to the ordinary course of our business. Litigation is inherently unpredictable. Any claims against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources. There is a growing number of business method patent infringement lawsuits in recent years. There has also been a rise in lawsuits against companies that collect personal information from customers. In addition, there has been an increase in employment-related lawsuits. From time to time, we have been subject to these types of lawsuits. The cost of defending claims against us or the ultimate resolution of such claims may harm our business and operating results. In addition, the significant deterioration in the global financial markets may create a more litigious environment and therefore subjects us to increased exposure to shareholder lawsuits.

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

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

We contract with various agencies to provide us with qualified personnel for our workforce. Any negative publicity regarding these agencies, such as in connection with immigration issues or employment practices, could

damage our reputation, disrupt our ability to obtain needed labor or result in financial harm to our business, including the potential loss of business-related financial incentives in the jurisdictions where we operate.

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

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

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

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

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

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

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

We have entered into a franchise agreement with the M.H. Alshaya Company, an unaffiliated franchisee to operate stores in the Middle East. Under this agreement, this third party will operate stores that sell goods purchased from us under our brand names. We have no prior experience operating through these types of third party arrangements, and this arrangement may not be successful. The administration of this relationship may divert management attention and require more resources than we expect. While we expect that this will be a small part of our business in the near future, if successful, we plan to continue to increase the number of stores and countries in which these franchises operate as part of our efforts to expand internationally. The effect of

these arrangements on our business and results of operations is uncertain and will depend upon various factors, including the demand for our products in new markets internationally. In addition, certain aspects of these arrangements are not directly within our control, such as the ability of this third party to meet its projections regarding store openings and sales. Moreover, while the agreement we have entered into may provide us with certain termination rights, to the extent that this third party does not operate its stores in a manner consistent with our requirements regarding our brand identities and customer experience standards, the value of our brands could be impaired. In addition, in connection with this new franchise agreement, we are implementing certain new processes that will subject us to additional regulations and laws, such as U.S. export regulations. Failure to comply with any applicable laws or regulations could have an adverse effect on our results of operations.

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

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

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

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

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

We regularly review and evaluate our liquidity and capital needs. We currently believe that our available cash, cash equivalents and cash flow from operations will be sufficient to finance our operations and expected capital requirements for at least the next 12 months. However, we might experience periods during which we encounter additional cash needs and we might need additional external funding to support our operations. Although we were able to amend our line of credit facility during fiscal 2008 on acceptable terms, in the event we require additional liquidity from our lenders, such funds may not be available to us or may not be available to us on acceptable terms in the future. For example, in the event we were to breach any of our financial covenants, our banks would not be required to provide us with additional funding, or they may require us to renegotiate our existing credit facility on less favorable terms. In addition, we may not be able to renew our letters of credit that we use to help pay our suppliers on terms that are acceptable to us, or at all, as the availability of letter of credit

facilities may continue to be limited. Further, the providers of such credit may reallocate the available credit to other borrowers. If we are unable to access credit at the levels we require, or the cost of credit is greater than expected, it could adversely affect our operating results.

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

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

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

In May 2010, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.13 to \$0.15 per common share and also authorized the repurchase of up to \$60,000,000 of our common stock. Subsequent to quarter-end, we completed all remaining share repurchases under this program and our Board of Directors authorized a new share repurchase program to purchase up to \$65,000,000 of the Company's outstanding common stock. The dividend and stock repurchase programs may require the use of a significant portion of our cash earnings. As a result, we may not retain a sufficient amount of cash to fund our operations or finance future growth opportunities, new product development initiatives and unanticipated capital expenditures. Further, our Board of Directors may, at its discretion, decrease the intended level of dividends or entirely discontinue the payment of dividends at any time. The stock repurchase program does not have an expiration date and may be limited at any time. Our ability to pay dividends and repurchase stock will depend on our ability to generate sufficient cash flows from operations in the future. This ability may be subject to certain economic, financial, competitive and other factors that are beyond our control. Any failure to pay dividends or repurchase stock after we have announced our intention to do so may negatively impact our reputation and investor confidence in us and may negatively impact our stock price.

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

We have evaluated and tested our internal controls in order to allow management to report on, and our registered independent public accounting firm to attest to, our internal controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002. If we are not able to continue to meet the requirements of Section 404 in a timely manner, or with adequate compliance, we would be required to disclose material weaknesses if they develop or are uncovered and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission or the New York Stock Exchange. In addition, our internal controls may not prevent or detect all errors and fraud. A control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable assurance that the objectives of the control system will be met. If any of the above were to occur, our business and the perception of us in the financial markets could be negatively impacted.

*Changes to accounting rules or regulations may adversely affect our operating results.*

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

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

We make certain estimates and projections in connection with impairment analyses for certain of our store locations and other property and equipment, including information technology systems. These impairment analyses require that we review for impairment all stores for which current or projected cash flows from operations are not sufficient to recover the carrying value of the asset. An impairment charge is required when the carrying value of the asset exceeds the undiscounted future cash flows over the remaining life of the lease. These calculations require us to make a number of estimates and projections of future results. If these estimates or projections change or prove incorrect, we may be, and have been, required to record impairment charges on certain store locations and other property and equipment, including information technology systems. These impairment charges have been significant in the past and may be in the future and, as a result of these charges, our operating results have been and may be adversely affected.

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

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

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

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

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

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

We are subject to income taxes in many U.S. and certain foreign jurisdictions. We record tax expense based on our estimates of future payments, which include reserves for estimates of probable settlements of foreign and domestic tax audits. At any one time, many tax years are subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. As a result, we expect that throughout the year there could be ongoing variability in our quarterly tax rates as taxable events occur and exposures are evaluated. In addition, our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings or by changes to existing accounting rules or regulations. Further, there is proposed tax legislation that may be enacted in the future, which could negatively impact our current or future tax structure and effective tax rates.

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

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

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

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

The following table provides information as of August 1, 2010 with respect to shares of common stock we repurchased during the second quarter of fiscal 2010.

| Fiscal period                   | Total<br>Number of<br>Shares<br>Purchased | Average Price<br>Paid per<br>Share | Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced<br>Program* | Maximum Dollar<br>Value of Shares that<br>May Yet be<br>Purchased Under the<br>Program** |
|---------------------------------|-------------------------------------------|------------------------------------|-------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------|
| May 3, 2010 to May 30, 2010     | 0                                         | \$ 0                               | 0                                                                                   | \$ 60,000,000                                                                            |
| May 31, 2010 to June 27, 2010   | 1,130,300                                 | \$ 26.52                           | 1,130,300                                                                           | \$ 30,023,000                                                                            |
| June 28, 2010 to August 1, 2010 | 587,850                                   | \$ 24.38                           | 587,850                                                                             | \$ 15,694,000                                                                            |
| Total                           | 1,718,150                                 | \$ 25.79                           | 1,718,150                                                                           | \$ 15,694,000                                                                            |

\* In May 2010, our Board of Directors authorized a stock repurchase program to purchase up to \$60,000,000 of our common stock through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. The authorization of the stock repurchase program reflects the Board of Director's objective to offset dilution from equity compensation programs on an on-going basis. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. The stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

\*\* Subsequent to quarter-end, we completed all remaining share repurchases under this program and our Board of Directors authorized a new share repurchase program to purchase up to \$65,000,000 of the Company's outstanding common stock.

## ITEM 6. EXHIBITS

### (a) Exhibits

| Exhibit  | Exhibit                                                                                                                                                                                                                                                                    |
|----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Number   | Description                                                                                                                                                                                                                                                                |
| 3.1      | Amended and Restated Bylaws (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K as filed with the Commission on June 1, 2010, File No. 001-14077)                                                                                        |
| 10.1+    | Form of Management Retention Agreement for Executive Vice Presidents and Brand Presidents, approved May 25, 2010 (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K as filed with the Commission on June 1, 2010, File No. 001-14077)  |
| 10.2     | Amendment No. 1 to Aircraft Lease Agreement by and between WHL Management LLC and the Company, dated May 26, 2010 (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K as filed with the Commission on June 1, 2010, File No. 001-14077) |
| 10.3+    | Restricted Stock Unit Award Agreement with W. Howard Lester dated May 26, 2010                                                                                                                                                                                             |
| 10.4+    | Employment Agreement with Laura Alber, dated June 11, 2010 (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K as filed with the Commission on June 17, 2010, File No. 001-14077)                                                       |
| 10.5+    | Management Retention Agreement with Laura Alber, dated June 11, 2010 (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K as filed with the Commission on June 17, 2010, File No. 001-14077)                                             |
| 10.6+    | Management Retention Agreement with Sharon McCollam, dated June 11, 2010 (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K as filed with the Commission on June 17, 2010, File No. 001-14077)                                         |
| 31.1     | Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended                                                                                                                                         |
| 31.2     | Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended                                                                                                                                         |
| 32.1     | Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                                                         |
| 32.2     | Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted                                                                                                                                                                                   |
|          | pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                                                                  |
| 101.INS* | XBRL Instance Document                                                                                                                                                                                                                                                     |
| 101.SCH* | XBRL Taxonomy Extension Schema Document                                                                                                                                                                                                                                    |
| 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase Document                                                                                                                                                                                                                      |
| 101.DEF* | XBRL Taxonomy Extension Definition Linkbase Document                                                                                                                                                                                                                       |
| 101.LAB* | XBRL Taxonomy Extension Label Linkbase Document                                                                                                                                                                                                                            |
| 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase Document                                                                                                                                                                                                                     |

+ Indicates a management contract or compensatory plan or arrangement.

\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

**SIGNATURE**

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

WILLIAMS-SONOMA, INC.

By: /s/ Sharon L. McCollam  
Sharon L. McCollam  
Executive Vice President,  
Chief Operating and Chief Financial Officer

Date: September 10, 2010