TUESDAY MORNING CORP/DE
Form 10-K
March 01, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the Fiscal Year Ended December 31, 2005

or

o 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 0-19658

Tuesday Morning Corporation

(Exact name of registrant as specified in its charter)

Delaware	**75-2398532**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6250 LBJ Freeway
Dallas, Texas 75240
(972) 387-3562
www.tuesdaymorning.com

(Address, zip code and telephone number, including area code,
of registrant s principal executive offices)

Securities registered pursuant to Section 12 (b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, $.01 par value per share**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment of this Form 10-K. x

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

The aggregate market value of shares of the registrant s common stock held by non-affiliates of the registrant at June 30, 2005 was approximately $841,619,000, based upon the closing sale price on the Nasdaq National Market reported for such date.

At February 24, 2006, there were 41,380,422 outstanding shares of the registrant s common stock.

Documents Incorporated By Reference:

Portions of the Registrant s Proxy Statement for the 2006 Annual Meeting of Stockholders are incorporated herein by reference to the extent indicated in Part III of this Form 10-K.

Forward-Looking Statements

This Form 10-K contains forward-looking statements within the meaning of the federal securities laws and the Private Securities Litigation Reform Act of 1995. These statements may be found throughout this Form 10-K, particularly under the headings Business and Management s Discussion and Analysis of Financial Condition and Results of Operation, among others. Forward-looking statements typically are identified by the use of terms such as may, will, should, expect, anticipate, believe, estimate, intend and similar words, although some forward-looking statements are expressed differently. You should consider statements that contain these words carefully because they describe our expectations, plans, strategies and goals and our beliefs concerning future business conditions, our results of operations, financial position, and our business outlook or state other forward-looking information based on currently available information. The factors listed below under the heading Risk Factors and in the other sections of this Form 10-K provide examples of risks, uncertainties and events that could cause our actual results to differ materially from the expectations expressed in our forward-looking statements.

The forward-looking statements made in this Form 10-K relate only to events as of the date on which the statements are made. Except as may be required by law, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

The terms Tuesday Morning, we, us, and our as used in this Form 10-K refer to Tuesday Morning Corporation and its subsidiaries.

PART I

Item 1. Business

Overview

We are a leading closeout retailer of upscale home furnishings, gifts and related items in the United States. We opened our first store in 1974 and currently operate 732 stores in 46 states at December 31, 2005. Our stores operate during periodic sales events, that occur in each month except January and July. We are generally closed for the first two weeks of January and July, which are traditionally weak months for retailers. We purchase first quality, brand name merchandise at closeout and sell it at prices 50% to 80% below those generally charged by department stores and specialty and catalog retailers. We do not sell seconds, irregulars, refurbished or factory rejects.

We believe that our well recognized, first quality brand name merchandise and value-based pricing have enabled us to establish and maintain strong customer loyalty. Our customers, who are predominantly women from middle and upper-income households, are brand savvy, value-conscious customers seeking quality products at discount pricing. While we offer our customers consistent merchandise categories, each sales event features limited quantities of new and appealing products within these categories, creating a treasure hunt atmosphere in our stores.

We believe that our customers are attracted to our stores by our advertising and direct mail program that emphasizes the limited quantities of first quality, brand name merchandise which we offer at attractive prices, rather than location. This has allowed us to open our stores in secondary locations of major suburban markets such as strip malls, near our middle and upper income customers. We are able to obtain flexible lease terms because of our flexibility in site selection and our no-frills format, which allows us to use a wide variety of space configurations.

In 2005, we recorded sales of $931.8 million and operating income of $96.5 million. Since 1998, our compound annual growths of sales and operating income have been 13% and 12%, respectively. In June 2005, we paid our first ever cash dividend of $0.65 per share. We intend to continue paying a dividend in the future.

Key Operating Strengths

Our success is based on the following operating strengths:

- **Unique Event-Based Format.** We distinguish ourselves from other retailers with a unique event-based selling strategy, creating the excitement of multiple grand openings and closeout sales each year. Merchandise is available in limited quantities and specific items are generally not replenished during a sales event, however, stores continue to receive new merchandise throughout a sales event. We believe that the limited quantities of specific items intensify customers sense of urgency to buy our merchandise. Accordingly, we have historically generated a majority of an event s sales in the first five days of the event. We intend to continue to adhere to this strategy, but we have increased the frequency of shipments to our stores of new and different merchandise during the later stages of sales events to encourage new and repeat customer visits.

- **Strong Sourcing Capabilities and Purchasing Flexibility.** We have developed strong sourcing capabilities that allow us to gain favorable access to first quality, brand name merchandise at attractive prices. In many cases, we are the retailer of choice to liquidate inventory due to our ability to make purchasing decisions quickly and to rapidly sell large quantities of merchandise without disrupting the manufacturers traditional distribution channels or compromising their brand image. Our flexible purchasing strategy allows us to pursue new products and merchandise

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categories from vendors as opportunities arise. We employ an experienced buying team, which has grown from 10 buyers in 1993 to 23 buyers currently, with an average of over 25 years of retail experience. Our buyers and our reputation as a preferred, reliable closeout retailer have enabled us to establish long-term relationships with a diverse group of top-of-the-line vendors.

- **Loyal Customer Base of Brand Savvy and Value-Conscious Consumers.** We have a loyal customer base consisting primarily of women ranging in age from 35 to 54 from middle and upper-income households with a median annual family income of over $60,000. In addition to making purchase decisions based on brand names and product quality, our customers are also value-conscious. We believe our value-based pricing, which enables our customers to realize savings of 50% to 80% over competing department store retail prices, has resulted in both strong customer loyalty and satisfaction. We have developed and currently maintain a proprietary mailing and email list consisting of over 8 million customers. These customers have visited our stores and requested mailings to alert them of upcoming sales events and the brand name merchandise and prices to be offered, prior to the advertising of a sales event to the general public.

- **Attractive Store Level Economics.** We have strong store level economics due to our low store operating expenses and the low initial investment required to open new stores. Our destination-oriented retail format allows us to open stores in a wide range of locations, resulting in attractive lease rates compared to those of other retailers. In addition to our low real estate costs, we maintain low operating and depreciation costs due to our no-frills, self-service format. Because we use low cost store fixtures and have low pre-opening costs, our new stores require a low initial investment and have historically generated a very attractive return on investment in their first full year.

- **Disciplined Inventory and Supply Chain Management.** We have developed disciplined inventory control and supply chain management procedures. Our purchasing flexibility and strong relationships with vendors allow us to coordinate the timing of purchases and receipt of merchandise closely with our sales events. Our merchandise and distribution systems allow us to quickly and efficiently process and ship merchandise from our distribution center to our stores. Finally, our point-of-sale systems allow us to effectively manage our inventory levels and sales performance. Our supply chain initiatives have allowed us to significantly reduce purchasing lead times and the amount of time we warehouse merchandise. Furthermore, these initiatives have resulted in a significant improvement in our inventory turnover ratio, which increased from 2.0 times per year in 2000 to 2.5 times in 2005. We have increased our shipping and sorting capacity at our main distribution center to be able to accommodate our future growth to over 900 stores.

Growth Strategy

Our growth strategy is to continue to build on our position as a leading closeout retailer of upscale home furnishings, gifts and related items in the United States by:

- **Expanding Our Store Base.** Our expansion strategy is to open new stores in both new and existing markets. This allows us to balance the cost of new market entry by leveraging advertising, purchasing, distribution and regional overhead expenses in existing markets. We plan to continue to increase our store base by approximately 65 to 70 net stores in 2006. We believe there is the potential for approximately 1,000 stores in the United States and do not anticipate any difficulties in identifying suitable additional store locations in areas with our target customer demographics.

- **Enhancing Our Sales Productivity.** We intend to increase our number of customer transactions by refining our merchandise mix and through other operating initiatives. We have increased our merchandise offerings throughout each sales event by increasing our store deliveries from 22

times per year in 2001 to over 44 times in 2005. We believe this will attract new customers, encourage repeat visits by existing customers and increase our average transaction value during the later stages of each sales event. We have increased staffing at some of our high volume stores in an effort to improve our customer service levels and drive our sales volumes.

- **Extending Our Customer Reach.** Historically, we have used direct mailings, and newspaper and print advertising to attract customers to our stores. While we believe these programs remain effective, we also believe that broadcast advertising represents an effective means to attract new customers, encourage repeat visits by our existing customers, and increase consumer awareness of Tuesday Morning. We have used television in select markets over the last four years and expect to continue our use of television advertising in 2006. We also operate our eTreasures ® program that provides our customers with an email of our newest weekly arrivals, special offers and our monthly mailer, all in the convenience of their home or office.

Industry Trends

As a closeout retailer of first quality, brand name merchandise, we benefit from attractive characteristics in the closeout industry. Closeout merchandise is generally available to closeout retailers at low prices for a variety of reasons, including the inability of a manufacturer to sell merchandise through regular channels, the discontinuance of merchandise due to a style or color change, the cancellation of orders placed by other retailers and the termination of business by a manufacturer or wholesaler. Occasionally, the closeout retailer may be able to purchase closeout merchandise because a manufacturer has excess raw materials or production capacity. Typically, closeout retailers have lower merchandise costs, capital expenditures and operating costs, allowing them to sell merchandise at lower prices than other retailers.

In addition, we benefit from several trends in the retailing industry. The increase in just-in-time inventory management techniques and the rise in retailer consolidation have both resulted in a shift of inventory risk from retailers to manufacturers. In response to an increasingly competitive market, manufacturers are introducing new products and new packaging more frequently. We believe that these trends have helped make the closeout retailer an integral part of manufacturers overall distribution strategies. As a result, we believe manufacturers are increasingly looking for larger, more sophisticated closeout retailers such as Tuesday Morning that can purchase larger and more varied quantities of merchandise and can control the distribution and advertising of specific products in order to minimize disruption to the manufacturers traditional distribution channels.

Products

We sell upscale home furnishings, gifts and related items. We do not sell seconds, irregulars, refurbished or factory rejects. Our merchandise primarily consists of lamps, rugs, crystal, dinnerware, silver serving pieces, gourmet housewares, bathroom, bedroom and kitchen accessories, linens, luggage, Christmas trim, toys, stationery and silk plants. We specialize in well-recognized, first quality, brand name merchandise, which has included Marquis crystal, Steinbach and Hummel collectibles, Royal Doulton and Wedgwood china and giftware, Martex bath towels, Samsonite luggage, Madame Alexander dolls, Calphalon cookware, Krups, KitchenAid and Cuisinart appliances, Lenox and Dansk tabletop, Wallace and Gorham flatware and many others.

We differ from discount retailers in that we do not stock continuing lines of merchandise. Because we offer a continuity of merchandise categories with ever-changing individual product offerings, we provide our customers a higher proportion of new merchandise items than general merchandisers. We are continually looking to add new complementary merchandise categories that appeal to our customers.

Purchasing

Since our inception, we have not experienced any significant difficulty in obtaining first quality, brand name closeout merchandise in adequate volumes and at attractive prices. We use a mix of domestic vendors and international vendors. As industry trends such as just-in-time inventory management, retailer consolidation and more frequent order cancellations by retailers place more inventory risk on manufacturers, we believe we will see an increase in the number of vendors looking for effective ways to reduce excess inventory. In addition, as we continue to increase our number of stores and distribution capacity, we believe our purchasing capacity will continue to increase and enable us to acquire larger quantities of closeout merchandise from individual vendors and manufacturers. Improvements in our distribution processes allow us to stock merchandise in our stores more quickly, which increases our purchasing flexibility. As a result of these trends and initiatives, we believe we will be able to take advantage of more and often larger, buying opportunities as well as offer an enhanced selection of products to our customers. In 2005, our top ten vendors accounted for approximately 10.3% of total purchases, with no one vendor accounting for more than 1.6%.

Pricing

Our pricing policy is to sell all merchandise at 50% to 80% below the retail prices generally charged by department and specialty stores. Prices are determined centrally and are uniform at all of our stores. Once a price is determined for a particular item, labels displaying three-tiered pricing are affixed to the product. A typical price tag displays a competitor s regular price, a competitor s sale price and the Tuesday Morning closeout price. Our management and buyers verify retail prices by reviewing prices published in advertisements and catalogues and manufacturers suggested retail price lists and by visiting department or specialty stores selling similar merchandise. Our management information systems provide daily sales and inventory information, which enables us to markdown unsold merchandise on a timely and systematic basis and thereby effectively manage inventory levels.

Advertising

We plan and implement an advertising program for each sale event. Prior to each sale event, we initiate a direct mailing or email to customers on our mailing list, which consists of customers who have previously visited our stores and requested mailings. These direct mailings alert customers to the opening of a sale event and the merchandise and prices we offer. We also communicate with customers by advertising in local newspapers in each of our markets and through our eTreasures® email program.

While we believe our direct mailings and newspaper and print advertising remain effective, we believe broadcast advertising may also represent an effective means to attract new customers, encourage repeat visits by our existing customers and increase consumer awareness of Tuesday Morning. We have used television advertising in select markets over the last four years and expect to continue our use of television advertising in 2006.

Stores and Store Operations

Site Selection. As part of our growth strategy, we plan to continue increasing our total number of stores. We increased our store base by 70 net stores in 2005 and currently plan to increase our store base by approximately 65 to 70 net stores in 2006. We expect our new stores to be similar in appearance and operation to our existing stores and do not anticipate any difficulties in identifying suitable additional store locations in areas with our target customer demographics.

We believe that our customers are attracted to our stores by our advertising and direct mail program that emphasizes the limited quantities of first quality, brand name merchandise which we offer at attractive prices, rather than by location. This has allowed us to open our stores in secondary locations of major

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suburban markets, such as strip malls, near our middle and upper-income customers. We are able to obtain favorable lease terms because of our flexibility in site selection and our no-frills format, which allows us to effectively use a wide variety of space configurations. As a result of this opportunistic approach to site selection, we believe our real estate costs are lower than those of other retailers.

Store Leases. Except for one store adjacent to our distribution center, we lease our store locations under non-cancelable operating leases that include optional renewal periods. Some of our leases also provide for contingent rent based upon store sales exceeding stipulated amounts.

Our store leases typically include kick clauses, which allow us, at our option, to exit the lease 24 to 36 months after entering into the lease. These kick clauses, when combined with our inexpensive and portable store fixtures provide us with flexibility in opening new stores by allowing us to quickly and cost-effectively vacate a site that does not meet our sales expectations. As a result, we seldom operate locations with store level operating losses.

Store Layout. Our opportunistic site selection and no-frills approach to presenting merchandise allow us to use a wide variety of space configurations. The size of our stores generally ranges from 6,000 to 15,000 square feet and averaged approximately 9,200 square feet in 2005. We have designed our stores to be functional, with little emphasis placed upon fixtures and leasehold improvements. We display all merchandise at each store by type and size on racks or counters, and we maintain a minimum inventory in stockrooms.

Store Operations. We operate our stores during sales events, that occur once each month except for January and July. We are generally closed for the first two weeks of January and July, which are traditionally weak months for retailers. We have increased the frequency of shipments of new merchandise during a sales event, which has resulted in improved efficiency of merchandise receiving and restocking activities at our stores. We have implemented initiatives to enhance the process by which merchandise is unloaded at the store and moved to the selling floor and we have increased our internal training program for store managers. Previously, new store managers attended our training program upon their hire or promotion. Now, each store manager receives on-going training on an annual basis through attending one of our monthly training sessions. We believe that this on-going training is a critical component to the success of our store management.

Store Management. Each store has a manager who is responsible for recruiting, training and supervising store personnel and assuring that the store is managed in accordance with our established guidelines and procedures. Store managers are full-time employees. We have increased our field management at the region and zone level to support and improve consistency of execution at our stores. When sales events are not in progress, employees review store inventory and supervise restocking activities in preparation for the next sales event. We employ part-time employees at each Tuesday Morning store to serve as cashiers and to assist in stocking during sales events.

Members of our management visit selected stores while sales are in progress to review inventory levels and presentation, personnel performance, expense controls, security and adherence to company procedures. In addition, regional managers periodically meet with senior management to review store policies and to discuss purchasing, merchandising and advertising strategies for future sales events.

Store Locations. We currently operate 732 stores in 46 states at December 31, 2005. Specific store locations can be accessed through our web site *www.tuesdaymorning.com*.

Distribution

An important aspect of our success involves our ability to process, sort and distribute inventory quickly and efficiently. All of our merchandise is ordered, received, inspected, counted, priced, ticketed and designated for individual stores at our central distribution center in the Dallas, Texas metropolitan

area. As a general rule, we carry similar products in each of our stores, but the amount of inventory each store is allocated varies depending upon size, location and sales projections for that store. Consistent with our sales event strategy, we ship most of our merchandise to our stores within a few weeks of its arrival at our distribution center. We generally do not replenish specific merchandise during a sales event; however, new merchandise is shipped to stores throughout a sales event.

We have reduced the time merchandise remains in our distribution center from several months to just a few weeks and have increased store deliveries from 22 times per year in 2001 to over 44 times in 2005, all of which has allowed us to significantly reduce the amount of inventory stored at our distribution center and maintain more consistent in-store inventory levels. The increased number of shipments also allows our stores to process shipments more effectively and restock their shelves with new merchandise during sales events. We also use a bar-code locator system to track inventory from the time it is received until it is shipped to our stores. This system allows us to locate, price, sort and ship merchandise efficiently from our central distribution center.

Management Information Systems

We have invested significant resources in computers, bar code scanners and radio frequency terminals, software programming and related equipment, technology and training, and we will continue to update these systems as necessary. We maintain a corporate local area network computer system, which includes purchase order processing, imports, transportation, distribution, point of sale and financial systems and enables us to efficiently control and process our inventory.

At the store level, we have computer-based registers that capture daily sales data at the SKU level. Sales information, inventory information, open to buy, and other operational data is distributed daily to designated levels of management and to the individuals or groups that have responsibility for specific aspects of the business.

Competition

We believe the principal factors by which we compete are price and product offering. We believe we compete effectively by pricing the merchandise we sell at 50% to 80% below department and specialty store prices and by offering a broad assortment of high-end, first quality, brand name merchandise. We currently compete against a diverse group of retailers, including department and discount stores and specialty, e-commerce and catalog retailers, which sell, among other products, home furnishing and related products. We also compete in particular markets with a substantial number of retailers that specialize in one or more types of home furnishing products that we sell. Some of these competitors have substantially greater financial resources that may, among other things, increase their ability to purchase inventory at lower costs or to initiate and sustain aggressive price competition.

We are distinguishable from our competitors in several respects. Unlike our competitors, which primarily offer continuing lines of merchandise, we offer changing lines of merchandise depending on availability at suitable prices. Most retailers in the closeout retailing industry are either general merchandisers or focus on apparel, while our focus is on primarily upscale home furnishings and related items. In addition, most closeout retailers focus on lower and middle-income consumers, while we generally cater to middle and upper-income customers. Finally, unlike other closeout retailers, which operate on a year-round basis, we annually focus on ten major sales events. We believe that our sales events create a sense of urgency and excitement on the part of our customers because they know that the availability of merchandise during a sales event is limited.

Seasonality

Our business is highly seasonal, with a significant portion of our net sales and operating income generated during the fourth quarter, which includes the holiday shopping season. Net sales in the fourth quarters of 2005, 2004 and 2003 accounted for approximately 36%, 37% and 39% respectively, of annual net sales for such years. Operating income for the fourth quarter of 2005, 2004 and 2003 accounted for approximately 58%, 59% and 63%, respectively, of annual operating income for such years.

Employees

At February 24, 2006, we employed approximately 2,000 persons on a full-time basis and approximately 6,800 individuals on a part-time basis. Our employees are not represented by any union. We have not experienced any work stoppage due to labor disagreements and we believe that our employee relations are good.

Trademarks and Tradenames

The tradename Tuesday Morning is material to our business. We have registered the name Tuesday Morning as a service mark with the United States Patent and Trademark office. We have also registered other trademarks including Closing Time® and eTreasures® .

Corporate Information

Tuesday Morning Corporation is a Delaware corporation incorporated in 1991. Our principal executive offices are located at 6250 LBJ Freeway, Dallas, Texas 75240, and our telephone number is (972) 387-3562.

We maintain an internet website at *http://www.tuesdaymorning.com*. Copies of our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such reports filed with, or furnished to, the Securities and Exchange Commission (the SEC) are available for viewing and copying at our internet website, free of charge, as soon as reasonably practicable after we file such material with, or furnish them to, the SEC.

Any materials filed by us with the SEC may also be read and copies made at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an internet website, *http://www.sec.gov*, which contains reports, proxy and information statements and other information which we file electronically with the SEC.

Item 1A. Risk Factors

Our business is subject to significant risks. You should carefully consider the risks and uncertainties described below and the other information in this Form 10-K, including our consolidated financial statements and the notes to those statements. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that we do not presently know about or that we currently believe are immaterial may also affect our business operations. If any of the events described below actually occur, our business, financial condition or results of operations could be adversely affected in a material way. This could cause the trading price of our common stock to decline, perhaps significantly, and you may lose part or all of your investment.

Risks Related to Our Business

We face a number of risks in opening new stores.

As part of our growth strategy, we intend to continue to increase our total number of stores. To do so successfully, we must open stores in new and existing markets and operate these stores on a profitable basis. We increased our net store base by 62 in 2003, 85 in 2004 and 70 in 2005 and currently plan to increase our net store base by approximately 65 to 70 net stores in 2006. We cannot assure you that we will be able to achieve our expansion goals or that we will be able to operate our new stores profitably. Further, we cannot assure you that any new store will achieve similar operating results to those of our existing stores or that new stores opened in markets in which we operate will not have a material adverse effect on the revenues and profitability of our existing stores. The success of our planned expansion will be dependent upon numerous factors, many of which are beyond our control, including the following:

- the ability of our personnel to adequately analyze and identify suitable markets and individual store sites within those markets;
- the competition for suitable store sites;
- our ability to negotiate favorable lease terms with landlords;
- our ability to obtain governmental and other third-party consents, permits and licenses needed to operate our stores;
- the availability of employees to staff new stores and our ability to hire, train, motivate and retain store personnel;
- the availability of adequate management and financial resources to properly manage an increased number of stores;
- our ability to adapt our distribution and other operational and management systems to an expanded network of stores; and
- our ability to attract customers and generate sales sufficient to operate new stores profitably.

We opened stores in several new markets during 2005 and intend to enter into additional new markets in 2006 and beyond. These markets may have different competitive conditions, consumer trends and discretionary spending patterns than our existing markets, which may cause our new stores in these markets to be less successful than stores in our existing markets.

Poor economic conditions affect consumer spending and may significantly harm our business.

The success of our business depends to a significant extent upon the level of consumer spending. A number of factors affect the level of consumer spending on merchandise that we offer, including, among other things:

- general economic, industry and weather conditions;
- high crude oil prices, that affect gasoline and heating oil prices;
- the level of consumer debt;
- interest rates;
- tax rates and policies;
- war, terrorism and other hostilities; and
- consumer confidence in future economic conditions.

The merchandise we sell generally consists of discretionary items. Reduced consumer confidence and spending may result in reduced demand for our discretionary items and may force us to take significant inventory markdowns. Reduced demand also may require increased selling and promotional expenses. Adverse economic conditions and any related decrease in consumer demand for discretionary items could have a material adverse effect on our business, results of operations and financial condition.

Our business and results of operations are subject to a broad range of uncertainties arising out of world events.

Our business and results of operations are subject to uncertainties arising out of world events. These uncertainties may include a global economy slowdown, changes in consumer spending or travel, the increase in gasoline and natural gas prices, the outbreak of illnesses such as Bird Flu and the economic consequences of military action or additional terrorist activities. Any future events arising as a result of terrorist activity or other world events may have a material impact on our business, our ability to source products, results of operations and financial condition in the future.

Our business is intensely competitive and increased or new competition could have a material adverse effect on us.

The retail home furnishings industry is intensely competitive. As a closeout retailer of home furnishings, we currently compete against a diverse group of retailers, including department and discount stores and e-commerce retailers, which sell, among other products, home furnishing products similar and often identical to those we sell. We also compete in particular markets with a substantial number of retailers that specialize in one or more types of home furnishing products that we sell. Many of these competitors have substantially greater financial resources that may allow them to initiate and sustain aggressive price competition. A number of different competitive factors could have a material adverse effect on our business, results of operations and financial condition, including:

- increased operational efficiencies of competitors;
- competitive pricing strategies, including deep discount pricing by a broad range of retailers during periods of poor consumer confidence or economic instability;
- expansion by existing competitors;
- entry by new competitors into markets in which we currently operate; and

- adoption by existing competitors of innovative store formats or retail sales methods, including e-commerce and gift cards.

We cannot assure you that we will be able to continue to compete successfully with our existing or new competitors, or that prolonged periods of deep discount pricing by our competitors will not materially harm our business.

We must continuously attract buying opportunities for closeout merchandise and anticipate consumer demand as closeout merchandise becomes available.

By its nature, specific closeout merchandise items are available from manufacturers or vendors generally on a non-recurring basis. As a result, we do not have long-term contracts with our vendors for supply, pricing or access to products, but make individual purchase decisions, which are often for large quantities. Although we have many sources of merchandise and do not foresee any shortages of closeout merchandise in the near future, we cannot assure you that manufacturers or vendors will continue to make closeout merchandise available to us in quantities or on terms acceptable to us or that our buyers will continue to identify and take advantage of appropriate buying opportunities. In addition, if we misjudge consumer demand for products, we may significantly overstock unpopular products and be forced to take significant markdowns and miss opportunities to sell more popular products. Our inability to acquire suitable merchandise in the future or to accurately anticipate consumer demand for such merchandise would have an adverse effect on our business, results of operations and financial condition.

The loss of, or disruption in, our centralized distribution center would have a material adverse effect on our business and operations.

With minor exceptions, all inventory is shipped directly from suppliers to our centralized distribution center in the Dallas, Texas metropolitan area, where the inventory is then processed, sorted and shipped to our stores. We depend in large part on the orderly operation of this receiving and distribution process, which depends, in turn, on adherence to shipping schedules and effective management of the distribution center. Although we believe that our receiving and distribution process is efficient and well positioned to support our expansion plans, we cannot assure you that we have anticipated all of the changing demands which our expanding operations will impose on our receiving and distribution system or that events beyond our control, such as disruptions in operations due to fire or other catastrophic events, labor disagreements or shipping problems, will not result in delays in the delivery of merchandise to our stores.

Our freight cost is impacted by changes in fuel prices through surcharges. Fuel prices and surcharges affect freight cost both on inbound freight from vendors to our distribution center and outbound freight from our distribution center to our stores. In addition, effective January 1, 2004, the U.S. government mandated certain changes requiring drivers of over-the-road trucks to take certain rest periods which reduce the available amount of time they can drive during a 24 hour period. Increases in fuel prices and surcharges, as well as the new driver regulations, may increase freight costs and thereby increase our cost of goods sold.

Although we maintain business interruption and property insurance, we cannot assure you that our insurance will be sufficient, or that insurance proceeds will be timely paid to us, in the event our distribution center is shut down for any reason.

The loss or departure of one or more members of our senior management could have a material adverse effect on our business.

Our future performance will depend in large part upon the efforts and abilities of our senior management, particularly Kathleen Mason, our Chief Executive Officer, and our other key employees, including our buyers. The loss of service of these persons could have a material adverse effect on our business and future prospects. We do not maintain key person life insurance for Ms. Mason or our other senior management.

We are dependent on external funding sources, which may not make available to us sufficient funds when we need them.

We, like other retailers, rely on external funding sources to finance our operations and growth. We currently believe that our cash flow from operations and funds available under our revolving credit facility will satisfy our capital requirements for the next 12 months. Our ability to obtain additional financing is dependent upon our future operating performance, general economic and competitive conditions and financial, business and other factors, many of which we cannot control.

An increase in the cost or a disruption in the flow of our imported products may significantly decrease our sales and profits.

Merchandise originally manufactured and imported from overseas is a large proportion of our total product purchases. A disruption in the shipping of our imported merchandise or an increase in the cost of those products may significantly decrease our sales and profits. In addition, if imported merchandise becomes more expensive or unavailable, the transition to alternative sources may not occur in time to meet our demands. Products from alternative sources may also be of lesser quality and more expensive than those we currently import. Risks associated with our reliance on imported products include:

- disruptions in the shipping and importation of imported products because of factors such as:
- raw material shortages, work stoppages, strikes and political unrest;
- problems with oceanic shipping, including shipping container shortages;
- increased custom inspections of import shipments or other factors causing delays in shipments;
- economic crises, international disputes and wars; and
- increases in the cost of purchasing or shipping foreign merchandise resulting from:
- loss of most favored nation trading status by the United States in relation to a particular foreign country;
- import duties, import quotas and other trade sanctions; and
- increases in shipping rates.

The products we buy abroad are often priced in foreign currencies and, therefore, we are affected by fluctuating exchange rates. In the past, we have entered into foreign currency exchange contracts with major financial institutions to hedge these fluctuations. We might not be able to successfully protect ourselves in the future against currency rate fluctuations, and our financial performance could suffer as a result. You should read Management s Discussion and Analysis of Financial Condition and Results of Operation and Quantitative and Qualitative Disclosures About Market Risk for more information about our foreign currency exchange rate exposure and hedging activities.

We are subject to environmental regulations.

Under various federal, state and local environmental laws and regulations, current or previous owners or occupants of property may become liable for the costs of removing any hazardous substances found on the property. These laws and regulations often impose liability without regard to fault. As of December 31, 2005, we leased all but one of our stores and 302,000 square feet of land and own 1,352,000 square feet of distribution facilities. In addition, we operate three aboveground diesel storage tanks at our distributions facilities. We have adopted policies regarding the handling and disposal of these products, and we train our employees on how to handle and dispose of them. Although we have not been notified of, and are not aware of, any current environmental liability, claim or non-compliance, we could incur costs in the future related to our leased properties, owned buildings or our storage tanks. We cannot assure you that our policies and training will successfully help us avoid potential violations of these environmental laws and regulations in the future.

Risks Related to Our Common Stock

Our results of operations are subject to seasonal and quarterly fluctuations, which could have a material adverse effect on the market price of our common stock.

Our business is highly seasonal, with a significant portion of our net sales and operating income generated during the fourth quarter, which includes the holiday shopping season. Net sales in the fourth quarters of 2005, 2004 and 2003 accounted for approximately 36%, 37% and 39%, respectively, of annual net sales for such years. Operating income for the fourth quarter of 2005, 2004 and 2003 accounted for approximately 58%, 59% and 63%, respectively, of annual operating income for such years. For more information about our seasonality, please read Management s Discussion and Analysis of Financial Condition and Results of Operation Quarterly Results and Seasonality. Because a significant percentage of our net sales and operating income are generated in the fourth quarter, we have limited ability to compensate for shortfalls in fourth quarter sales or earnings by changes in our operations or strategies in other quarters. A significant shortfall in results for the fourth quarter of any year could have a material adverse effect on our annual results of operations and on the market price of our common stock. Our quarterly results of operations also may fluctuate significantly based on such factors as:

- the timing of new store openings;
- the amount of net sales contributed by new and existing stores;
- the timing of certain holidays and sales events;
- changes in our merchandise mix;
- general economic, industry and weather conditions that affect consumer spending; and
- actions of competitors, including promotional activity.

A failure to grow or maintain our comparable store sales may adversely affect our stock price and impact our results of operations.

A number of factors have historically affected, and will continue to affect, our comparable store sales results, including:

- competition;
- general regional and national economic conditions;
- inclement weather such as hurricanes Katrina, Rita and Wilma that affected the Southern U.S. in the fall of 2005;
- consumer trends, such as less spending due the impact of higher gasoline prices;
- changes in our merchandise mix;
- our ability to distribute merchandise efficiently to our stores;
- timing and type of sales events, promotional activities or other advertising;
- new merchandise introductions; and

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- our ability to execute our business strategy effectively.

Our comparable store sales results have fluctuated in the past, and we believe such fluctuations may continue. Our comparable store sales decreased 4.0% in 2005 and 1.7% in 2004 and increased 3.4% in 2003. The unpredictability of our comparable store sales may cause our revenue and results of operations to vary from quarter to quarter, and an unanticipated decline in revenues or operating income may cause our stock price to fluctuate significantly. A failure to grow or maintain our comparable store sales results could have a material adverse effect on our results of operations and could cause the price of our common stock to decrease significantly.

Our largest shareholder has significant influence over us, which may affect the rights of other shareholders.

At December 31, 2005, Madison Dearborn Capital Partners II, L.P. held a 28% shareholder interest in us. This percentage represents a substantial amount of our common stock and Madison Dearborn will continue to have significant influence over election of our directors, approval of mergers, sales of assets and other matters. The interests of Madison Dearborn may conflict with the interests of other holders of our common stock.

Future sales of our common stock on the public market could depress our stock price.

If our largest shareholder sells substantial amounts of our common stock in the public market, the market price of our common stock could fall. Such sales might make it more difficult for us to sell equity or equity-related securities in the future. As of February 24, 2006, Madison Dearborn beneficially owned 11,388,526 shares of common stock, or approximately 28% of our outstanding shares. Madison Dearborn has advised us that it expects to continue to reduce its ownership interest in our company over time, subject to prevailing market conditions. We have granted Madison Dearborn certain rights with respect to the registration of shares of our common stock held by it, including the right to require that we register the sale of all or part of the shares it holds.

Provisions of our certificate of incorporation could discourage potential acquisition proposals and could deter or prevent a change in control.

Our certificate of incorporation authorizes our board of directors, subject to any limitations prescribed by law and our revolving credit facility, to issue shares of preferred stock in one or more series without shareholder approval. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire, or discouraging a third party from acquiring, a majority of our outstanding common stock.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

Stores. We lease all of our stores, except one located adjacent to our distribution facility, from unaffiliated third parties normally through non-cancelable leases. At December 31, 2005, the remaining terms of our store leases generally range from six months to five years with a small percentage out to ten years. The average initial term of a store lease is approximately five years with options available for renewal. We intend to continue to lease all of our new stores from unaffiliated third parties. Leases may contain renewal clauses which are often executed and may contain additional terms regarding percentage of rent payments.

Distribution Facilities and Corporate Headquarters. We own approximately 1,352,000 square feet of distribution facilities and a 79,000 square foot building which houses our corporate office in the Dallas, Texas metropolitan area.

We have leases on approximately 302,000 square feet of land for trailer storage, which expire in April 2009 and December 2013. We believe our current distribution facilities are adequate to meet our requirements for the next several years. We will, however, need to acquire or lease additional warehouse space in approximately two to three years to accommodate our distribution requirements as our store base grows.

Item 3. Legal Proceedings

During 2001 and 2002, we were named as a defendant in three complaints filed in the Superior Court of California in and for the County of Los Angeles. The plaintiffs are seeking to certify a statewide class made up of some of our current and former employees, which they claim are owed compensation for overtime wages, penalties and interest. The plaintiffs are also seeking attorney s fees and costs. In October 2003, we entered into a settlement agreement with a sub-class of these plaintiffs consisting of manager-in-training and management trainees which was paid in November 2005 with no material impact to our financial statements. The remaining complaint relating to our salaried managers is still open and is awaiting a trial date. We are attempting to consolidate a similar lawsuit filed in Orange County, California in 2004 with this remaining manager complaint, but no agreement has been reached with the court. This case is still in discovery. We do not expect either of these complaints to have a material impact to our financial statements.

In December 2003, we were named as a defendant in a new lawsuit filed in the Superior Court of California, in and for the County of San Diego. The plaintiffs were alleging failure to pay for minimum reporting time, travel time, split-shift premiums, meal periods and other labor issues. We entered into a settlement agreement on July 7, 2005 with the plaintiffs. The settlement was paid in December 2005 with no material impact to our financial statements.

In June 2004, we were named as a defendant in a complaint filed in the U.S. District Court, Central District of California. The plaintiff, Thomas Kinkade Company (f/k/a/ Media Arts Group Inc.), is alleging copyright infringement and false advertisements on merchandise we sold in the second quarter of 2004. This lawsuit is currently set for trial in March 2006.

We intend to vigorously defend all pending actions. We do not believe these or any other legal proceedings pending or threatened against us would have a material adverse effect on our financial condition or results of operations.

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

No matters were submitted to a vote of our security holders during the quarter ended December 31, 2005.

PART II

Item 5. Market For Registrant s Common Equity, Related Stockholder Matters and Issuer Purchasers of Equity Securities

Our common stock has traded on The NASDAQ National Market since our initial public offering on April 22, 1999, under the symbol TUES. The following table sets forth for the periods indicated the high and low sales prices per share as reported on The NASDAQ National Market.

	High	Low
Year Ended December 31, 2004		
First quarter	$ 35.19	$ 29.75
Second quarter	$ 34.95	$ 24.36
Third quarter	$ 34.85	$ 28.63
Fourth quarter	$ 36.73	$ 28.85
Year Ended December 31, 2005		
First quarter	$ 31.72	$ 27.60
Second quarter	$ 32.92	$ 25.52
Third quarter	$ 35.90	$ 24.85
Fourth quarter	$ 28.15	$ 20.85

On February 24, 2006, the last reported sale price for our common stock on The NASDAQ National Market was $21.80 per share. As of February 24, 2006, there were approximately 24 holders of record, and an estimated 21,000 beneficial owners of our common stock.

Dividend Policy

During 2004 we did not declare or pay any cash dividends on our common stock. During the second quarter of 2005, we paid our first annual cash dividend of $0.65 per share totaling $26.9 million to our common stockholders and intend in the future to continue our payment of an annual cash dividend to our stockholders.

Repurchases of Common Equity

The board of directors has not authorized us to repurchase any common stock and there were no repurchases of our common stock during the fourth quarter of 2005.

Item 6. Selected Financial Data

The following table sets forth the selected consolidated financial and operating data for, and as of the end of, each of the five years ended December 31, 2005. The statement of operations data for the years ended December 31, 2005, 2004 and 2003 and the balance sheet data as of December 31, 2005 and 2004 are derived from our audited consolidated financial statements that appear herein. The statement of operations data for the years ended December 31, 2002 and 2001 and the balance sheet data as of December 31, 2003, 2002 and 2001 are derived from our audited consolidated financial statements that are not included in this Form 10-K. The selected consolidated financial and operating data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operation and our consolidated financial statements and related notes included elsewhere in this Form 10-K.

	Year Ended December 31, 2005	2004	2003	2002	2001
	(In thousands, except per share and operating data)				
Statement of Operations Data:					
Net sales	$ 931,827	$ 897,841	$ 822,646	$ 728,846	$ 642,398
Cost of sales	574,546	556,623	513,097	461,317	421,703
Gross profit	357,281	341,218	309,549	267,529	220,695
Selling, general and administrative expenses	260,736	237,127	210,158	181,810	152,119
Operating income	96,545	104,091	99,391	85,719	68,576
Loss on early extinguishment of debt			(3,854)		
Net interest and other expense	(526)	(2,275)	(8,283)	(13,783)	(18,505)
Income before income taxes	96,019	101,816	87,254	71,936	50,071
Income tax expense	35,060	39,199	33,593	27,855	19,127
Net income	$ 60,959	$ 62,617	$ 53,661	$ 44,081	$ 30,944
Earnings per share:					
Basic	$ 1.48	$ 1.53	$ 1.32	$ 1.10	$ 0.78
Diluted	1.46	1.50	1.29	1.07	0.76
Weighted average shares outstanding:					
Basic	41,264	41,046	40,513	40,037	39,673
Diluted	41,770	41,764	41,442	41,238	40,730
Dividends per common share	$ 0.65				
Operating Data:					
Number of stores:					
Beginning of period	662	577	515	469	431
Opened during period	81	89	74	56	43
Closed during period	(11)	(4)	(12)	(10)	(5)
Open at end of period	732	662	577	515	469
Comparable store sales increase (decrease)(1)	(4.0)%	(1.7)%	3.4%	4.3%	(0.3)%
Average sales per store(2)	$ 1,330,000	$ 1,429,000	$ 1,481,000	$ 1,456,000	$ 1,402,000
Inventory turnover(3)	2.5	2.8	3.2	3.0	2.4

	As of December 31, 2005 (In thousands)	2004	2003	2002	2001
Balance Sheet Data:					
Working capital	$ 152,648	$ 115,440	$ 60,954	$ 75,195	$ 90,772
Inventories	230,639	189,132	143,023	134,947	127,843
Total assets	379,927	336,120	253,394	245,294	259,007
Total debt, including current portion				73,224	166,205
Total stockholders equity	235,362	197,150	132,094	69,175	20,054

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(1) In the first quarter of 2004, we refined our methodology for calculating our comparable store sales, in light of changes to the timing of store openings during a quarter. Stores are now included in the same store calculation at the beginning of the quarter following the anniversary date of the store opening. Previously, stores were included in the same store calculation at the beginning of the quarter that contained the anniversary date of the store opening, since the majority of our store openings used to be only at the beginning of the respective quarter. The comparable store sales increase for 2003 has been updated based on using our refined methodology. The previously reported comparable sales increase was 2.9% for 2003. Comparable store sales for 2002 and 2001 are as originally reported. Stores that relocate within the same geographic market are still considered same store for purposes of this computation. The number of days our stores are open may fluctuate from period to period.

(2) Average sales per store is the sum of the average of the sales per store for each quarter.

(3) Inventory turnover is the ratio of cost of sales to average inventory. Average inventory is calculated by taking the average of the previous year-end and quarter-end inventory levels throughout the year.

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation

The following discussion and analysis should be read in conjunction with Selected Financial Data and our consolidated financial statements and related notes included elsewhere in this Form 10-K.

Overview

- We sell upscale, name brand home furnishings, gifts and related items significantly below retail prices charged by department and specialty stores throughout 732 stores in 46 states. We have a unique event-based selling strategy that creates a sense of urgency and excitement for our customer base.

- Our store base has grown at approximately 10% per year for each of the last five years and during 2005 we expanded our store base by 81 new stores and had 11 store closures.

- During the second quarter of 2005, we paid our first annual cash dividend of $0.65 per share totaling $26.9 million to our common stockholders and intend in the future to continue our payment of an annual cash dividend to our stockholders.

- Our operating profits, combined with more efficient use of working capital and increased inventory turns over past years have increased cash flow, which has been used to reduce debt. At December 31, 2005 and 2004, we had no debt outstanding. We anticipate using our revolving credit facility in the future to fund our inventory purchases, capital expenditures and a cash dividend payment, but we expect to generate excess cash flow for the fiscal year 2006.

Corporate History

Between 1986 and 1997, we were a publicly traded company. On December 29, 1997, Madison Dearborn, other unaffiliated investors and some of the members of our management at that time acquired substantially all of our outstanding capital stock in a recapitalization transaction. Despite significant debt after the recapitalization, we continued to operate profitably (excluding recapitalization fees and expenses in 1997) and to expand our store base. In April 1999, we completed an initial public offering of our common stock, and used substantially all of the proceeds to redeem a portion of the senior subordinated notes and all of the senior preferred stock that we issued in the recapitalization.

From our initial public offering through 2000, we continued to expand our number of stores and experience strong sales growth. During this time, our warehouse inventory levels increased significantly above historical levels. In order to accommodate these higher inventory levels, we expanded the use of third party regional distribution centers. Our higher inventory levels and use of regional distribution centers resulted in additional handling, freight and distribution expenses, which negatively impacted our results of operations in 2000 and the first nine months of 2001.

In July 2000, we recruited Kathleen Mason, our current President and Chief Executive Officer. Under Ms. Mason s leadership, we have improved our focus on profitability, implemented new supply chain and inventory management strategies to control our inventory levels and to ensure increased product availability in our sales events, upgraded management information systems and initiated television advertising.

As a result of these and other initiatives, we have increased our shipping and sorting capacity at our distribution center in Dallas, Texas to accommodate our future growth to over 900 stores, to discontinue use of 16 third party regional distribution centers, to increase our inventory turnover from 2.0 times in 2000 to 2.5 times in 2005 and to reduce our long-term interest bearing debt from $187.0 million in 2000 to zero at December 31, 2005.

Critical Accounting Policies and Estimates

Management s Discussion and Analysis is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of certain assets, liabilities, sales and expenses, and related disclosure of contingent assets and liabilities. On a recurring basis, we evaluate our significant estimates which are based on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Inventory Our inventories are stated at the lower of cost or market using the retail inventory method for store inventory and the specific identification method for warehouse inventory. Amounts are removed from inventory based on the retail inventory method which applies a cost-to-retail ratio to our various retail deductions (sales, markdowns, shrink, etc.) to arrive at our cost of sales. Buying, distribution, freight and certain other general and administrative costs are capitalized as part of inventory and are expensed as cost of sales as the related inventory is sold. We conduct full physical inventories at June 30 and December 31 to measure quantities on-hand and make appropriate adjustments to our financial statements. At December 31, 2005 and 2004, our books and records have been fully adjusted for the year-end physical inventories conducted. During periods for which physical observations do not occur, we utilize an estimate for recording shrinkage reserves based on the historical trends of shrinkage as a percentage of sales. This estimate may require a favorable or unfavorable adjustment to actual results to the extent that our subsequent actual physical inventories yield a different result. Since we count our inventories twice a year, this reduces the subjective nature of our shrink percentage and can limit our exposure and risk of a significant error. If our estimated shrink percentage varies by 0.2%, the impact on our annual gross profit would be insignificant with the net income impact, after tax, of less than \$250 thousand to \$375 thousand.

Inventory is our largest asset on our balance sheet and represents approximately 61% and 56% of total assets at December 31, 2005 and 2004, respectively. Inventory increased 21.9% or \$41.5 million to \$230.6 million in 2005 from \$189.1 million in 2004. On a per store basis our inventory increased approximately 10.3%. The increase was primarily due to lower sales per store than planned and lower traffic levels than anticipated.

Markdowns We have used markdowns to promote the effective and timely sale of merchandise that allows us to consistently provide fresher merchandise to our customers. Markdowns may be temporary or permanent. Temporary markdowns are for a designated period of time with markdowns recorded based on quantities sold during the period. Permanent markdowns, which vary throughout the quarter or year in timing with higher markdowns traditionally recorded in the second and fourth quarters due primarily to seasonal merchandise, are charged to cost of sales immediately based on the total quantities on-hand in the stores. We review all inventory on an aged basis at the end of each quarterly period to ensure all necessary price actions are taken or will be taken to adequately value our inventory at the lower of cost or market. These actions which involve actual or planned permanent markdowns are considered by management to be the appropriate prices to stimulate demand for the merchandise. Actual required permanent markdowns could differ materially from management s initial estimates based on future customer demand or economic conditions.

Self-Insurance Reserves We have agreed to bear a portion of the annual cost to insure for workers compensation, general liability and medical claims. Amounts in excess of the designated risk levels are covered 100% by our insurance providers. Workers compensation claims are generally resolved within a one to four year period, but can be open and active for periods approaching seven years. There are two components that make up workers compensation costs, a wage replacement benefit and a health care benefit. Of these two components, the cost of health care has seen the most dramatic change over the last years with increases ranging from 8% to 15% annually. We establish reserves for the potential exposure on workers compensation and general liability claims based upon historical claims experience, severity factors and the use of loss development factors as determined by a third-party independent actuary. Our estimated reserves may be materially different from our future actual claim costs, and, in the future, if we conclude an adjustment to our reserves is required, the liability will then be adjusted accordingly in the period that determination is made. If our workers compensation reserves recorded in 2005 were 10% higher than the actual amount recorded, the impact on our annual net income, after tax, would be less than \$400 thousand. We also establish a liability for our medical claims incurred but not reported based on our historical claim

experience and a claim lag study prepared by our third-party claims processor. Although this accrual has not displayed substantial volatility in the past, our actual claim costs in the future could vary materially from our past historical trends. If an adjustment to the reserve is necessary in the future, we will adjust it accordingly in the period the determination is made.

Tax, Legal and Other Contingent Reserves We record reserves for certain legal, income tax (federal, state and local) or other contingencies when estimated future expenditures associated with such contingencies become probable and the amounts can be reasonably estimated. However, new information may become available, or circumstances (such as applicable laws and regulations) may change, which are difficult to forecast or predict thereby resulting in an adjustment in the amount required to be accrued for such matters in future periods.

Lease Accounting Adjustment

Based on certain views expressed in a letter of February 7, 2005 from the Office of the Chief Accountant of the Securities and Exchange Commission to the American Institute of Certified Public Accountants, we reviewed our accounting policies and practices associated with operating leases. Consistent with industry practices, we historically reported straight-line rental expense beginning on the lease commencement date. This had the effect of excluding the rent holiday associated with the pre-opening or build-out period of our stores from the calculation of the period over which we expensed rent. Following our review, we modified our accounting policies such that we begin recording rent expense on the date we take possession of or have the right to use the premises.

As a result of this adjustment, we recorded a one-time, non-cash, $3.9 million ($2.4 million, net of income tax) cumulative charge to earnings during the first quarter of 2005. The adjustment did not impact historical or future net cash flows or the timing of the payments under related leases. We believe that the new lease accounting policies will not have a material effect on future diluted earnings per share. Prior years financial statements were not restated as the impact of this issue was immaterial to previously reported results for any individual previous periods.

Results of Operations

The following table sets forth, for the periods indicated, selected statement of operations data, expressed as a percentage of net sales, as well as the number of stores open at the end of each period.

	Year Ended December 31,		
	2005	**2004**	**2003**
Net sales	100.0 %	100.0 %	100.0 %
Cost of sales	61.7	62.0	62.4
Gross profit	38.3	38.0	37.6
Selling, general and administrative expenses	27.9	26.4	25.5
Operating income	10.4	11.6	12.1
Loss on early extinguishment of debt			0.5
Net interest and other expense	0.1	0.2	1.0
Income tax expense	3.8	4.4	4.1
Net income	6.5 %	7.0 %	6.5 %
Number of stores open at end of period	732	662	577

We capitalize into inventory all merchandise costs and certain costs incurred to purchase, distribute and deliver merchandise to our stores in order to more accurately match the cost of merchandise with the timing of its sale. These costs are included in cost of sales when the merchandise is sold. Other cost of sales components include merchandise markdowns, shrink and damages, which are expensed as they are incurred

Selling, general and administrative expenses are comprised of wages and benefits, rent and occupancy costs, depreciation, advertising, miscellaneous store operating expenses and corporate office costs. Increases in dollar amounts of these expenses are attributable to increases in the number of stores and increases in variable expenses due to sales growth. Variable expenses include payroll and related benefits, advertising expense and other expenses such as credit card fees.

2005 Compared to 2004

Net sales increased $34.0 million or 3.8% to $931.8 million in 2005 from $897.8 million in 2004, of which, $68.6 million of the increase was attributable to sales from non-comparable new stores offset by a 4.0% decrease in comparable store sales from 2004. Comparable store transactions decreased 4.4% offset by an increase of 0.4% in comparable store average ticket. Our average annual sales per store decreased by $99,000 or 6.9% to $1.3 million in 2005. Comparable store sales and sales per store decreased primarily due to lower traffic levels than anticipated. Management believes traffic levels are lower due to the lower discretionary income availability of our customers due to the impact of higher gasoline and energy costs.

Gross profit increased $16.1 million or 4.7% to $357.3 million in 2005 compared to $341.2 million in 2004, of which, $12.9 million of the gross profit increase was directly attributable to an increase in our net sales. Our gross profit percentage increased to 38.3% in 2005 from 38.0% in 2004. This 0.3% increase in our gross profit percentage was primarily attributable to a 0.1% decrease in temporary and permanent markdowns, net of inventory shrink and a 0.2% improvement in the leveraging of our distribution and freight expenses.

Selling, general and administrative expenses increased $23.6 million or 10.0% to $260.7 million in 2005 from $237.1 million in the prior year. The increase was mostly attributable to the $3.9 million one-time, non-cash lease accounting adjustment taken in the first quarter of 2005 and a $15.8 million increase in store occupancy costs, store personnel costs, and store fixed asset depreciation expense primarily due to the expansion of our store base. As a percentage of sales these expenses increased 1.5% to 27.9% in 2005 from 26.4% in 2004. The increased percentage is primarily due to reduced expense leveraging given our negative comparable store sales for the year and includes a 0.4% increase in rent expense due to the lease accounting adjustment and a 1.0% increase related to store occupancy costs, store personnel costs and store fixed asset depreciation expense.

Net interest and other expense decreased $1.7 million to $526 thousand in 2005 compared to $2.3 million in 2004. This decrease was attributable to $600 thousand less interest expense due to lower average borrowings levels in 2005 than in 2004 and to $1.1 million in less deferred financing costs amortization due to the replacement of our revolving credit facility in December 2004 and less deferred financing costs required for amortization.

Income tax expense decreased $4.1 million to $35.1 million in 2005 from $39.2 million in 2004 due to decreased profitability. Our effective tax rate decreased to 36.5% in 2005 from 38.5% in 2004 primarily due to the net adjustment of tax reserves related to net favorable settlements with certain state taxing authorities and due to a change in our state tax planning strategies.

2004 Compared to 2003

Net sales increased $75.2 million or 9.1% to $897.8 million in 2004 from $822.6 million in 2003. This increase was attributable primarily to $88.7 in sales from non-comparable new stores offset by a 1.7% decrease in comparable store sales from 2003. Comparable store transactions decreased 2.5% offset by an increase of 0.8% in comparable store average ticket. Our average annual sales per store decreased by

$52,000 or 3.5% to $1.4 million in 2004. Comparable store sales and sales per store decreased primarily due to the impact in the third quarter of 2004 of severe storms on 33% of our store sales base and lower than expected sales on decorative accessories and seasonal products in the fourth quarter.

In the first quarter of 2004, we refined our methodology for calculating our comparable store sales, in light of changes to the timing of store openings during a quarter. Stores are now included in the same store calculation at the beginning of the quarter following the anniversary date of the store opening. Previously, stores were included in the same store calculation at the beginning of the quarter that contained the anniversary date of the store opening, since the majority of our store openings used to be only at the beginning of the respective quarter. Stores that relocate within the same geographic market are still considered same store for purposes of this computation. The number of days our stores are open may fluctuate from period to period.

Gross profit increased $31.7 million or 10.2% to $341.2 million in 2004 compared to $309.5 million in 2003, of which, $28.3 million of the increase was attributable to an increase in our net sales. Our gross profit percentage increased to 38.0% in 2004 from 37.6% in 2003. This 0.4% increase in our gross profit percentage was attributable to a 0.6% improvement in leveraging our distribution expenses offset by a 0.2% increase in the cost of our product, net of markdowns.

Selling, general and administrative expenses increased $27.0 million or 12.8% to $237.1 million in 2004 from $210.2 million in the prior year. The increase was mostly attributable to a $22.3 million increase in store occupancy costs, store personnel costs, and store fixed asset depreciation expense primarily due to the expansion of our store base. As a percentage of sales these expenses increased 0.9% to 26.4% in 2004 from 25.5% in 2003. The increased percentage is primarily due to reduced expense leveraging given our negative comparable store sales for the year and includes a 1.1% increase related to store occupancy costs, store personnel costs and store fixed asset depreciation expense offset by a 0.3% decrease in advertising expense.

Net interest and other expense, excluding the loss on early extinguishment of debt in 2003, decreased $6.0 million to $2.3 million in 2004 compared to $8.3 million in 2003. This decrease was primarily attributable to the redemption in the fourth quarter of 2003 of the $69 million Senior Subordinated Notes.

Income tax expense increased $5.6 million to $39.2 million in 2004 from $33.6 million in 2003 due to increased profitability.

Liquidity and Capital Resources

We have financed our operations with funds generated from operating activities and borrowings under our revolving credit facility. Our cash flow strategy during the last three years has been focused on funding our store growth and distribution improvements, reducing our debt and financing costs associated with our recapitalization in 1997 and payment of our first cash dividend. Our cash flows will continue to be utilized for the expansion of our business and payment of an annual cash dividend.

Net cash flows provided from operating activities in 2005, 2004 and 2003 were $38.7 million, $44.8 million and $79.4 million, respectively. In 2005, the decrease in net cash from operating activities is due to our negative comparable stores sales for the year and lower sales per store than anticipated and our $5 million increase in income tax payments, offset by our lower volume of inventory purchases. In 2004, the decrease in net cash from operating activities is due to the build-up of inventory to more historical levels and lower sales per store than planned especially in the fourth quarter of 2004. Cash and cash equivalents as of December 31, 2005, 2004 and 2003 were $43.5 million, $45.1 million and $23.5 million, respectively.

Capital expenditures, principally associated with new store openings and distribution center systems enhancements, were $16.1 million, $23.0 million and $17.3 million for 2005, 2004 and 2003, respectively. During each year, capital expenditures were primarily for new store openings, various distribution center equipment and improvements and corporate office equipment and improvements. In 2006, we expect to spend approximately $18 million for capital expenditures, primarily for new store openings. Capital expenditures will be financed with funds generated from operations and borrowings under our revolving credit facility.

During the second quarter of 2005, our board of directors approved the issuance of our first annual cash dividend of $0.65 per share of common stock. The cash dividend of $26.9 million was paid June 20, 2005 to 41.3 million shareholders of record on June 6, 2005. For 2006, we intend to pay a cash dividend of $0.80 per share of common stock to shareholders on March 30, 2006.

We have a $210 million revolving credit facility which expires December 2009. Any borrowing under the revolver will incur interest at LIBOR or the prime rate, depending on the term of the borrowing, plus an applicable margin. We incur commitment fees of up to 0.25% on the unused portion of the revolving credit facility. This rate is reduced or increased as our average total leverage ratio changes. Our indebtedness under the credit facility is secured by a lien on our inventory and cash accounts, as well as a pledge of our ownership interests in all of our subsidiaries.

We had no balances outstanding related to our revolving credit facility at December 31, 2005 and 2004 and had borrowing availability of $200.3 million at December 31, 2005. As of December 31, 2005, we had outstanding letters of credit of $9.7 million under the revolving credit facility, primarily for self-insurance purposes.

The new revolving credit facility contains certain restrictive covenants, which among other things, require us to comply with certain financial ratios covering maximum leverage, minimum fixed charge coverage and minimum interest coverage. Other restrictions affect our ability to incur liens or make certain other restricted payments, sell assets or merge or consolidate with any other person. As of December 31, 2005, we were in compliance with all covenants.

We anticipate that our net cash flows from operations and borrowings under our revolving credit facility will be sufficient to fund our working capital needs, planned capital expenditures, cash dividends and interest payments for the next twelve months.

Off-balance Sheet Arrangements

Tuesday Morning does not have any off-balance sheet arrangements, as defined in Regulation S-K Item 303(a)(4)(ii)(A)-(D), that have or are reasonably likely to have a current or future effect on Tuesday Morning s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Contractual Obligations

The following table summarizes our contractual obligations at December 31, 2005 and the effects such obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

	Payments Due by Period				
Contractual Obligations	**Total**	**< 1 Year**	**1-3 Years**	**3-5 Years**	**> 5 Years**
Non-cancelable operating leases	$ 192,466	$ 53,776	$ 85,250	$ 40,504	$ 12,936

We do not consider merchandise purchase orders to be contractual obligations due to designated cancellation dates on the face of the purchase order. We have no capital lease obligations or long-term debt at December 31, 2005.

Quarterly Results and Seasonality

The following tables set forth some of our quarterly financial data for the eight quarters ended December 31, 2005. The quarterly information is unaudited but has been prepared on the same basis as the audited financial statements included elsewhere in this Form 10-K. In our opinion, all necessary adjustments (consisting only of normal recurring adjustments) have been included to present fairly the unaudited quarterly results when read in conjunction with our consolidated financial statements and related notes included elsewhere in this Form 10-K. The results of operations for any quarter are not necessarily indicative of the results for any future period. (In thousands except for per share data and comparable store sales)

	Quarters Ended March 31, 2005	June 30, 2005	Sept. 30, 2005	Dec. 31, 2005
Net sales	$ 185,594	$ 218,756	$ 192,276	$ 335,201
Gross profit	72,558	81,418	74,699	128,606
Operating income (1)	10,436	16,746	13,312	56,051
Net income (1)	6,666	10,530	8,213	35,550
Basic earnings per share	$ 0.16	$ 0.26	$ 0.20	$ 0.86
Diluted earnings per share	$ 0.16	$ 0.25	$ 0.20	$ 0.85
Comparable store sales increase (decrease)	(0.3)%	(4.7)%	(4.4)%	(5.3)%

	Quarters Ended March 31, 2004	June 30, 2004	Sept. 30, 2004	Dec. 31, 2004
Net sales	$ 168,597	$ 210,697	$ 186,148	$ 332,399
Gross profit	66,012	76,390	68,623	130,193
Operating income	13,481	16,553	12,923	61,134
Net income	8,189	10,009	7,522	36,897
Basic earnings per share	$ 0.20	$ 0.24	$ 0.18	$ 0.90
Diluted earnings per share	$ 0.20	$ 0.24	$ 0.18	$ 0.88
Comparable store sales increase (decrease)	1.7 %	6.6 %	(4.0)%	(6.6)%

(1) Includes the lease accounting adjustment of $3.9 million ($2.4 million, net of income tax) which was recorded in the first quarter of 2005.

Our quarterly results of operations may fluctuate based upon such factors as the number and timing of store openings, the amount of net sales contributed by new and existing stores, the mix of merchandise sold, pricing, store closings or relocations, competitive factors and general economic and weather-related conditions. The timing of sales events could impact the weighting of sales between quarters. We expect to continue to experience seasonal fluctuations in our business, with a significant percentage of our net sales and operating income being generated in the fourth quarter, which includes the holiday selling season.

Inflation

In our opinion, inflation has not had a material effect on our results of operations in recent years. We cannot assure you that inflation will not materially affect us in the future.

Recent Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), *Share-Based Payment* (Statement 123(R)), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the time of grant. Pro forma disclosure is no longer an alternative.

Statement 123(R) must be adopted no later than January 1, 2006. Early adoption will be permitted in periods in which financial statements have not yet been issued. We adopted Statement 123(R) on January 1, 2006.

Statement 123(R) permits public companies to adopt its requirements using one of two methods: (1) a modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date; or, (2) a modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

We adopted the standard based on the modified prospective transition method.

As permitted by Statement 123, we currently account for share-based payments to employees using Opinion 25 s intrinsic value method and, as such, generally recognize no compensation cost for employee stock options. Accordingly, the adoption of Statement 123(R) s fair value method will have a significant impact on our result of operations, although it will have no impact on our overall financial position. The impact of adoption of Statement 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future and the model chosen to determine fair value for grants after January 1, 2006. However, had we adopted Statement 123(R) in prior periods based on our use of the Black-Scholes option pricing model, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net income and earnings per share in Note 1 of the notes to our consolidated financial statements included elsewhere in this Form 10-K. While Statement 123(R) permits entities to continue the use of the Black-Scholes option pricing model, Statement 123(R) also permits the use of a binomial model. Based on the research done by us on the alternative models available to value option grants, and in conjunction with the type and number of stock options we expect to issue in the future, we have determined that we will continue to use the Black-Scholes option pricing model for stock option valuation upon the adoption of Statement 123(R).

Statement 123(R) includes several modifications to the way that incomes taxes are provided for in the financial statements. The expense for stock option grants is only deductible for tax purposes at the time the taxable event takes place, which will cause variability in our effective tax rates recorded throughout each year. The expected variability in our effective tax rate is caused by Statement 123(R) s forbiddance of companies from predicting when these taxable events will take place. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While we cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized in prior periods for such excess tax deductions were $1.4 million, $1.5 million, and $4.1 million in 2005, 2004 and 2003, respectively.

In March 2005, the Financial Accounting Standards Board (FASB) issued Interpretation 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations*, an interpretation of FASB Statement

143, *Accounting for Asset Retirement Obligations*. FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The interpretation would require us to provide for an asset retirement obligation if any of our leases would require us to remove tenant improvements or our owned movable fixed assets. The guidance is effective for fiscal years ending after December 15, 2005, or our current year end, and would require us to record a liability for any asset retirement obligation adjusted for cumulative accretion to the date of adoption and a capitalized asset retirement cost, adjusted for accumulated depreciation, to be added to our property and equipment upon the date of adoption. Adoption of this guidance was not material to our financial position or results of operation.

In November of 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. The amendments made by Statement 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 23, 2004. We adopted this statement on January 1, 2006 and do not expect the adoption of this statement to have a material affect on our financial position or results of operation.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to various market risks, including changes in foreign currency exchange rates and interest rates. Market risk is the potential loss arising from adverse changes in market prices and rates, such as foreign currency exchange and interest rates. Based on our market risk sensitive instruments outstanding as of December 31, 2005, as described below, we have determined that there was no material market risk exposure to our consolidated financial position, results of operations or cash flows as of such date. We do not enter into derivatives or other financial instruments for trading or speculative purposes.

Foreign Currency Exchange Rates. We enter into foreign currency forward contracts with major financial institutions to manage and reduce the impact of changes in foreign currency exchange rates on contractual merchandise purchases with certain international vendors. During 2005, the only transactions we hedged were for inventory purchase orders placed with foreign vendors for which the purchase order had to be settled in the foreign vendor s currency. The periods for the forward foreign exchange contracts correspond to the periods of the hedged transactions. Gains and losses on forward foreign exchange contracts are reflected in the statement of income as cost of sales at the time the inventory is sold and were immaterial to us as a whole in 2005. At December 31, 2005, we had outstanding forward foreign currency contracts to purchase approximately $1,877,000 of US dollar equivalent Euros with maturities ranging between 20 and 118 days.

The estimated fair value of foreign currency contracts represents the amount required to enter into offsetting contracts with similar remaining maturities based on quoted market prices. At December 31, 2005, the difference between the fair value of all outstanding contracts and the face amount of such contracts was immaterial. A large fluctuation in exchange rates for these currencies could have a material affect on their fair value; however, because we only use these forward foreign currency contracts to hedge future inventory purchases at a fixed price in the vendor s foreign currency at the time the purchase order is made, any fluctuations in the exchange rate should not materially affect us.

The table below provides information about our forward foreign currency contracts at December 31, 2005 that are sensitive to foreign currency exchange rates and presents such information in U.S. dollar equivalents because that is our reporting currency. All the related contracts mature in 2006.

Expected Maturity
(U.S. dollar equivalent in thousands)

Currency	**Contract Amount**	**Exchange Rate**	**Fair Value**
Euro	$ 1,877,000	1.2115	$ 1,843,000

You can find more information about the accounting policies for our forward foreign currency contracts and our financial instruments in Notes 1 and 10 of the notes to our consolidated financial statements included elsewhere in this Form 10-K.

Interest Rates. We had no outstanding debt at December 31, 2005; however, we use our revolving credit facility to fund our operations as needed. We are exposed to financial market risk due to fluctuating interest rates on our revolving line of credit. Any borrowing under our revolver will incur interest at LIBOR or the prime rate depending on the term of the borrowing plus an applicable margin. During the twelve month period ended December 31, 2005, the LIBOR and Prime rates varied from 3.35% to 4.06% and 5.25% to 7.25%, respectively. We incur commitment fees of up to 0.25% on the unused portion of the revolving credit facility. This rate is reduced or increased as our leverage ratio changes. We do not hold any derivatives related to interest rate exposure for any of our debt facilities. You can find more information about our debt in Note 4 of the notes to our consolidated financial statements included elsewhere in this Form 10-K.

Item 8. Financial Statements and Supplementary Data

The following consolidated financial statements of Tuesday Morning and its subsidiaries and Report of Independent Auditors are included in this Form 10-K.

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Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

There were no disagreements with our auditors for the years ended December 31, 2005, 2004 and 2003, respectively.

Item 9A. Controls and Procedures

Disclosure Control Procedures

Based on our management s evaluation (with participation of our principal executive officer and our principal financial officer), our principal executive officer and our principal financial officer have concluded that our disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) were effective as of December 31, 2005 to ensure that information required to be disclosed by us in this Annual Report on Form 10-K was (1) recorded, processed, summarized and reported within the time periods specified in the Securities Exchange Commission s rules and forms and (2) accumulated and communicated to our management, including our principal executive and principal financial officers, to allow timely decisions regarding required disclosure.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met and, as set forth above, our chief executive officer and chief financial officer have concluded, based on their evaluation as of the end of the period covered by this report, that our disclosure controls and procedures were effective to provide reasonable assurance that the objectives of our disclosure control system were met.

Management s Annual Report on Internal Control Over Financial Reporting

Management of Tuesday Morning is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) or Rule 15(d)-15(f) under the Exchange Act. Tuesday Morning s internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Our management (with the participation of our principal executive officer and our principal financial officer) assessed the effectiveness of Tuesday Morning s internal control over financial reporting as of December 31, 2005. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. Based on our assessment, we believe that, as of December 31, 2005, Tuesday Morning s internal control over financial reporting is effective based on those criteria.

Management s assessment of the effectiveness of internal control over financial reporting as of December 31, 2005, has been audited by Ernst & Young, LLP, the independent registered public accounting firm who also audited the Tuesday Morning s consolidated financial statements included in this Annual Report on Form 10-K. Ernst & Young s attestation report on management s assessment of Tuesday Morning s internal control over financial reporting appears on page F-3 hereof.

Changes in Internal Control Over Financial Reporting

There were no changes in Tuesday Morning s internal control over financial reporting that occurred during Tuesday Morning s last fiscal quarter that have materially affected or are reasonably likely to materially affect Tuesday Morning s internal control over financial reporting.

Item 9B. Other Information

None.

Part III

Item 10. Directors and Executive Officers of the Registrant

The information required by this Item 10 is incorporated herein by reference to the disclosure found under the captions Directors, Executive Officers and Section 16(a) Beneficial Ownership Reporting Compliance in our definitive proxy statement to be filed pursuant to Regulation 14A of the Exchange Act in connection with Tuesday Morning s 2006 Annual Meeting of Stockholders.

We have adopted a Code of Ethics for Senior Financial Officers that establishes the ethical standards to be followed by the person serving as our Chief Executive Officer and President and the person serving as our Executive Vice President and Chief Financial Officer. We have also adopted a Code of Conduct that establishes the business conduct to be followed by all of our employees and members of our Board of Directors. Both are available on our website at *http://www.tuesdaymorning.com* under Investor Relations- Corporate Governance.

Item 11. Executive Compensation

The information required by this Item 11 is incorporated herein by reference to the disclosure found under the captions Directors, Executive Officers, Report of the Compensation Committee and Compensation Committee Interlocks and Insider Participation in our definitive proxy statement to be filed pursuant to Regulation 14A of the Exchange Act in connection with Tuesday Morning s 2006 Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item 12 is incorporated herein by reference to the disclosure found under the caption Beneficial Ownership of Common Stock in our definitive proxy statement to be filed pursuant to Regulation 14A of the Exchange Act in connection with Tuesday Morning s 2006 Annual Meeting of Stockholders.

Equity Compensation Plan Information

The following table provides information about our common stock that may be issued upon the exercise of options under equity compensation plans approved by stockholders at December 31, 2005. We do not have any equity compensation plans that were not approved by our stockholders.

Plan Category	Number of Securities to Be Issued Upon Exercise of Outstanding Options, Warrants and Rights (thousands) (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in column (a)) (thousands) (c)
Equity Compensation Plans Approved by Security Holders	2,016	$ 20.07	1,910
Equity Compensation Plans Not Approved by Security Holders			
Total	2,016	$ 20.07	1,910

Item 13. Certain Relationships and Related Transactions

The information required by this Item 13 is incorporated herein by reference to the disclosure found under the caption Certain Relationships and Related Transactions in our definitive proxy statement to be filed pursuant to Regulation 14A of the Exchange Act in connection with Tuesday Morning s 2006 Annual Meeting of Stockholders.

Item 14. Principal Accountant Fees and Services.

The information required by this Item 14 is incorporated herein by reference to the disclosure found under the caption Independent Registered Public Accounting Firm in our definitive proxy statement to be filed pursuant to Regulation 14A of the Exchange Act in connection with Tuesday Morning s 2006 Annual Meeting of Stockholders.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this Form 10-K.

(1) Financial Statements:

The list of financial statements required by this item is set forth in Item 8.

(2) Financial Statement Schedules:

All financial statement schedules called for under Regulation S-X are not required under the related instructions, are not material or are not applicable and, therefore, have been omitted or are included in the consolidated financial statements or notes thereto included elsewhere in this Form 10-K.

(3) Exhibits:

Exhibit No.	**Description**
3.1.1	Certificate of Incorporation of Tuesday Morning Corporation (the Company) (incorporated by reference to Exhibit 3.1 to the Company s Registration Statement on Form S-4 (File No. 333-46017) as filed with the Securities and Exchange Commission (the Commission) on February 10, 1998)
3.1.2	Certificate of Amendment to the Certificate of Incorporation of the Company (incorporated by reference to Exhibit 3.3 to the Company s Registration Statement on Form S-1/A (File No. 333-74365) as filed with the Commission on March 29, 1999)
3.1.3	Certificate of Amendment to the Certificate of Incorporation of the Company dated May 7, 1999 (incorporated by reference to Exhibit 3.1.3 to the Company s Form 10-Q (File No. 000-19658) as filed with the Commission on May 2, 2005)
3.2	Amended and Restated By-laws of the Company (incorporated by reference to Exhibit 3.7 to the Company s Registration Statement on Form S-4 (File No. 333-46017) as filed with the Commission on February 10, 1998)
10.1.1	Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.9 to the Company s Registration Statement on Form S-4 (File No. 333-46017) as filed with the Commission on February 10, 1998)
10.1.2	First Amendment to the Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.3 to the Company s Form 10-Q (File No. 000-19658) as filed with the Commission on August 1, 2005)
10.2	Stockholders Agreement, dated as of December 29, 1997, by and among the Company, Madison Dearborn Capital Partners II, L.P. and the executives listed on Schedule I attached thereto (incorporated by reference to Exhibit 10.11 to the Company s Registration Statement on Form S-4 (File No. 333-46017) as filed with the Commission on February 10, 1998)
10.3	1999 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.12 to the Company s Registration Statement on Form S-1 (File No. 333-74365) as filed with the Commission on March 12, 1999)
10.4	Employment Agreement, dated as of July 25, 2000, by and between the Company and Kathleen Mason (incorporated by reference to Exhibit 99.2 to the Company s Form 10-Q (File No. 000-19658) as filed with the Commission on November 7, 2000)
10.5.1	Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (incorporated by reference to Appendix B to the Company s Definitive 14A Proxy Statement (File No. 000-19658) as filed with the Commission on April 19, 2004)
10.5.2	First Amendment to the Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.4 to the Company s Form 10-Q (File No. 000-19658) as filed with the Commission on August 1, 2005)

10.6	Credit Agreement, dated as of December 22, 2004 by and among Tuesday Morning, Inc., Tuesday Morning Corporation, TMI Holdings, Inc., the lenders who are or may become a party to the agreement, Wachovia Bank, National Association, as Administrative Agent, Wells Fargo Bank, N.A. and LaSalle Bank National Association, as Co-Syndication Agents, U.S. Bank National Association and Sovereign Bank, as Co-Documentation Agents, Wachovia Capital Markets, LLC as a Co-Lead Arranger and Sole Book Manager, and Wells Fargo Bank, N.A. as a Co-Lead Arranger (incorporated by reference to Exhibit 10.6 to the Company s Form 10-K/A (File No. 000-19658) as filed with the Commission on February 24, 2006)
10.7	Form of Incentive Stock Option Agreement under the Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan and the Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company s Form 8-K (File No. 000-19658) as filed with the Commission on May 3, 2005)
10.8	Form of Nonqualified Stock Option Agreement under the Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan and the Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.2 to the Company s Form 8-K (File No. 000-19658) as filed with the Commission on May 3, 2005)
10.9	Bonus Agreement dated December 27, 2005 by and between Tuesday Morning Partners, Ltd. and John F. Reeves
10.10	Bonus Agreement dated December 27, 2005 by and between Tuesday Morning, Inc. and Loren K. Jensen
10.11	Description of Directors Compensation
21.1	Subsidiaries of the Company (incorporated by reference to Exhibit 21.1 to the Company s Form 10-K (File No. 000-19658) as filed with the Commission on March 9, 2005)
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification by the Chief Executive Officer of the Company Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by the Chief Financial Officer of the Company Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer of the Company Pursuant to 18 U.S.C. § 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Chief Financial Officer of the Company Pursuant to 18 U.S.C. § 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Management contract or compensatory plan or arrangement

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

TUESDAY MORNING CORPORATION

By: /s/ KATHLEEN MASON

Kathleen Mason

Date: March 1, 2006 — *Chief Executive Officer, President and Director*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ KATHLEEN MASON Kathleen Mason	Chief Executive Officer, President and Director (Principal Executive Officer)	March 1, 2006
/s/ LOREN K. JENSEN Loren K. Jensen	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 1, 2006
/s/ BENJAMIN D. CHERESKIN Benjamin D. Chereskin	Chairman of the Board	March 1, 2006
/s/ WILLIAM J. HUNCKLER, III William J. Hunckler, III	Director	March 1, 2006
/s/ ROBIN P. SELATI Robin P. Selati	Director	March 1, 2006
/s/ HENRY F. FRIGON Henry F. Frigon	Director	March 1, 2006
/s/ GILES H. BATEMAN Giles H. Bateman	Director	March 1, 2006

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Tuesday Morning Corporation

We have audited the accompanying consolidated balance sheets of Tuesday Morning Corporation as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Tuesday Morning Corporation at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Tuesday Morning Corporation s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2006, expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP
Dallas, TX
February 28, 2006

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of
Tuesday Morning Corporation

We have audited management s assessment, included in the accompanying Management s Annual Report on Internal Control Over Financial Reporting, that Tuesday Morning Corporation maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Tuesday Morning Corporation s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that Tuesday Morning Corporation maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Tuesday Morning Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria**.**

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Tuesday Morning Corporation as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2005 of Tuesday Morning Corporation and our report dated February 28, 2006 expressed an unqualified opinion thereon.

/s/ ERNST AND YOUNG LLP
Dallas, TX
February 28, 2006

Tuesday Morning Corporation
Consolidated Balance Sheets
(In thousands, except for share data)

	As of December 31, 2005	2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 43,547	$ 45,067
Inventories	230,639	189,132
Prepaid expenses and other current assets	7,258	5,169
Deferred income taxes	5,071	5,991
Total current assets	286,515	245,359
Property and equipment, net	87,786	86,332
Deferred financing costs	685	877
Other assets	4,941	3,552
Total Assets	$ 379,927	$ 336,120
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	74,975	72,722
Accrued liabilities	42,372	39,549
Income taxes payable	16,520	17,483
Total current liabilities	133,867	129,754
Long-term debt		
Deferred rent	4,431	165
Deferred income taxes	6,267	9,051
Total Liabilities	144,565	138,970
Commitments and contingencies		
Stockholders equity:		
Preferred stock, par value $0.01 per share, authorized 10,000,000 shares, none issued or outstanding		
Common stock, par value $.01 per share, authorized 100,000,000 shares; 41,369,922 and 41,101,965 shares issued and outstanding at December 31, 2005 and 2004, respectively	414	411
Additional paid-in capital	191,229	188,969
Retained earnings	43,763	7,745
Accumulated other comprehensive income (loss)	(44)	25
Total Stockholders Equity	235,362	197,150
Total Liabilities and Stockholders Equity	$ 379,927	$ 336,120

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

Tuesday Morning Corporation
Consolidated Statements of Income
(In thousands, except per share data)

	Years Ended December 31, 2005	2004	2003
Net sales	$ 931,827	$ 897,841	$ 822,646
Cost of sales	574,546	556,623	513,097
Gross profit	357,281	341,218	309,549
Selling, general and administrative expenses	260,736	237,127	210,158
Operating income	96,545	104,091	99,391
Other income (expense):			
Loss on early extinguishment of debt			(3,854)
Interest expense	(1,552)	(3,180)	(9,274)
Interest income	129	21	95
Other income (expense), net	897	884	896
	(526)	(2,275)	(12,137)
Income before income taxes	96,019	101,816	87,254
Income tax expense	35,060	39,199	33,593
Net income	$ 60,959	$ 62,617	$ 53,661
Earnings Per Share			
Net income per common share:			
Basic	$ 1.48	$ 1.53	$ 1.32
Diluted	$ 1.46	$ 1.50	$ 1.29
Weighted average number of common shares:			
Basic	41,264	41,046	40,513
Diluted	41,770	41,764	41,442
Dividends per common share	$ 0.65		

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

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Tuesday Morning Corporation
Consolidated Statements of Stockholders Equity
(In thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at December 31, 2002	40,224	$ 402	$ 177,118	$ (108,533)	$ 188	$ 69,175
Other comprehensive income						
Net income				53,661		53,661
Unrealized loss on foreign exchange contracts, net of tax					(86)	(86)
Total other comprehensive income				53,661	(86)	53,575
Shares issued in connection with employee stock option plan/stock purchase plan	600	6	2,943			2,949
Shares issued under secondary Offering, net	100	1	2,344			2,345
Tax benefit of employee stock options exercised			4,050			4,050
Balance at December 31, 2003	40,924	409	186,455	(54,872)	102	132,094
Other comprehensive income						
Net income				62,617		62,617
Unrealized loss on foreign exchange contracts, net of tax					(77)	(77)
Total other comprehensive income				62,617	(77)	62,540
Shares issued in connection with employee stock option plan/stock purchase plan	178	2	990			992
Other			68			68
Tax benefit of employee stock options exercised			1,456			1,456
Balance at December 31, 2004	41,102	411	188,969	7,745	25	197,150
Net income				60,959		60,959
Unrealized loss on foreign exchange contracts, net of tax					(69)	(69)
Total other comprehensive income				60,959	(69)	60,890
Shares issued in connection with employee stock option plan/stock purchase plan	268	3	2,709			2,712
Dividends declared			(1,913)	(24,941)		(26,854)
Other			59			59
Tax benefit of employee stock options exercised			1,405			1,405
Balance at December 31, 2005	41,370	$ 414	$ 191,229	$ 43,763	$ (44)	$ 235,362

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

Tuesday Morning Corporation
Consolidated Statements of Cash Flows
(In thousands)

	Years Ended December 31, 2005	2004	2003
Cash flows from operating activities:			
Net income	$ 60,959	$ 62,617	$ 53,661
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	14,606	11,570	9,883
Amortization of financing fees	171	1,295	702
Loss on early extinguishment of debt			3,854
Deferred income taxes	(1,864)	2,525	(1,196)
Tax benefit of employee stock option exercises	1,405	1,456	4,050
Other non-cash items	(10)	(9)	(75)
Change in operating assets and liabilities:			
Inventories	(41,507)	(46,109)	(8,076)
Prepaid and other current assets	(2,068)	(221)	(683)
Other assets	(1,389)	(2,553)	(156)
Accounts payable	2,253	6,631	7,016
Accrued liabilities	2,823	3,393	10,531
Deferred rent	4,266		
Income taxes payable	(963)	4,236	(118)
Total adjustments	(22,277)	(17,786)	25,732
Net cash provided by operating activities	38,682	44,831	79,393
Cash flows from investing activities:			
Capital expenditures	(16,060)	(23,027)	(17,273)
Net cash used in investing activities	(16,060)	(23,027)	(17,273)
Cash flows from financing activities:			
Payment of debt and mortgages			(75,758)
Payment of dividends to common stockholders	(26,854)		
Proceeds from exercise of common stock options and stock purchase plan purchases	2,712	992	2,949
Net proceeds from secondary offering			2,345
Payment of financing fees		(1,265)	(49)
Net cash used in financing activities	(24,142)	(273)	(70,513)
Net increase (decrease) in cash and cash equivalents	(1,520)	21,531	(8,393)
Cash and cash equivalents, beginning of period	45,067	23,536	31,929
Cash and cash equivalents, end of period	$ 43,547	$ 45,067	$ 23,536
Supplemental cash flow information:			
Interest paid	$ 1,303	$ 1,938	$ 8,919
Income taxes paid	36,463	31,422	31,186

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

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TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(All dollar amounts in thousands, except for per share amounts)

(1) NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

We operated 732 discount retail stores in 46 states at December 31, 2005 (662 and 577 stores at December 31, 2004 and 2003, respectively). We sell close-out home furnishings, gifts and related items, which we purchase at below wholesale prices. Our stores are open for periodic sales events, each of which lasts from four to five weeks.

(a) *Basis of Presentation* The accompanying consolidated financial statements include the accounts of Tuesday Morning Corporation, a Delaware corporation, and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

(b) *Cash and Cash Equivalents* Cash equivalents of $36,032 at December 31, 2005 and $31,184 at December 31, 2004 were invested in money market funds. We consider all short-term investments with original maturities of three months or less to be cash equivalents.

(c) *Inventories* Inventories, consisting of finished goods, are stated at the lower of cost or market using the retail inventory method for store inventory and the specific identification method for warehouse inventory. Amounts are removed from inventory based on the retail inventory method which applies a cost-to-retail ratio to our various retail deductions (sales, markdowns, shrink, etc.) to arrive at our cost of sales. Buying, distribution, freight costs and certain other general and administrative expenses are capitalized as part of inventory and are expensed as cost of sales as the related inventory is sold. We conduct semi-annual physical inventories to measure quantities on-hand and make appropriate adjustments to our financial statements. During periods for which physical observations do not occur, we utilize an estimate for recording shrinkage reserves, based on past historical trends of physical inventory results. These shrinkage reserves may require a favorable or unfavorable adjustment to actual results to the extent our subsequent actual physical inventories yield a different result. We use markdowns to promote the effective and timely sale of merchandise. Temporary markdowns are for a designated period of time with markdowns recorded based on quantities sold during the period. Permanent markdowns vary in timing throughout the year, but are charged to cost of sales immediately based on total quantities on-hand in the stores. We review all inventory on an aged basis at the end of each quarterly period to ensure all necessary price actions are taken or will be taken to adequately value our inventory at the lower of cost or market. These actions which involve actual or planned permanent markdowns are considered by management to be the appropriate prices to stimulate demand for the merchandise. Actual required permanent markdowns could differ materially from management s initial estimates based on future customer demand or economic conditions.

(d) *Property and Equipment* Property and equipment are stated at cost. Buildings, furniture, fixtures, leasehold improvements and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets as follows:

Estimated Useful Lives

Buildings	30 years
Furniture and fixtures	7 years
Leasehold improvements	Lease life
Equipment	5 to 10 years

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(1) NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Improvements to leased premises are amortized on a straight-line basis over the shorter of their useful lives or the term of the related lease. Upon sale or retirement of an asset, the related cost and accumulated depreciation are removed from our accounts and any gain or loss is recognized in income. Expenditures for maintenance, minor renewals and repairs are expensed as incurred, while major replacements and improvements are capitalized.

(e) *Deferred Financing Costs* Deferred financing costs represent fees paid in connection with obtaining bank and other long-term financing. These fees are amortized over the term of the related financing using the effective interest method.

(f) *Income Taxes* Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using statutory tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment. We file our annual federal income tax return on a consolidated basis. Furthermore, we record reserves for income tax contingencies when estimated future tax assessments become probable and the amounts can be reasonably estimated. However, new information may become available or applicable laws or regulations may change thereby resulting in a favorable or unfavorable adjustment to amounts recorded.

(g) Self-Insurance Reserves We have agreed to bear a portion of the annual cost to insure for workers compensation, general liability and medical claims. Amounts in excess of the designated risk levels are covered 100% by our insurance providers. We establish reserves for the potential remaining exposure on workers compensation and general liability claims based upon historical claims experience, severity factors and the use of loss development factors as determined by a third-party actuary. Our estimated reserves may be materially different from our future actual claim costs, and may require us to adjust our reserves in the future period that the determination is made. We also establish a liability for our medical claims incurred but not reported based on our historical claim experience and a claim lag study prepared by our third-party claims processor. Our actual health care costs in the future could vary materially from our past historical trends. If an adjustment to the reserve is necessary in the future, we will adjust it accordingly in the period the determination is made.

(h) *Revenue Recognition* Sales are recorded at the point of sale and conveyance of merchandise to customers at our stores. Sales are net of estimated returns and exclude sales tax.

(i) *Pre-opening Costs* Costs incurred prior to the date that new stores open are expensed as incurred.

(j) *Advertising* Costs for television, radio, newspaper and other media are expensed as the advertised events take place. Advertising expense for 2005, 2004 and 2003 was $34,371, $33,075 and $33,166, respectively. We do not receive money from vendors to support our advertising expenditures.

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(1) NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(k) *Use of Estimates* The preparation of the consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(l) *Foreign Currency Transactions* We enter into foreign currency forward exchange contracts with major financial institutions to manage and reduce the impact of fluctuations in foreign currency exchange rates on certain contractual merchandise purchases with international vendors between the order and payment dates, approximately 2 to 6 months. We do not utilize derivative financial instruments for trading or speculative purposes.

We account for our foreign currency forward contracts as cash flow hedges in accordance with Financial Accounting Standards Board (FASB) FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*. Changes in the fair value of the contracts that are considered to be effective are recorded in other comprehensive income until the hedged item is recorded in earnings. Effective cash flow hedges are reclassified out of other comprehensive income and into cost of sales when the hedged inventory is sold. All of our cash flow hedges are effective. The effect of foreign exchange contracts on our financial position is immaterial.

(m) *Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of* We periodically review long-lived assets, principally property and equipment and leasehold improvements, for impairment by comparing the carrying amount of the asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Impairment of long-lived assets has not had a material impact on our financial position, results of operations or liquidity for the years presented.

(n) *Stock Option Plan* We generally grant stock options to certain employees and members of our Board of Directors with stock option exercise prices equal to the fair market value of the shares on the date of the grant. We have elected to continue to apply the requirements of APB Opinion No. 25, *Accounting for Stock Issued to Employees* and provide the pro forma disclosure requirements of SFAS No. 148, *Accounting for Stock-Based Compensation, Transition and Disclosure*; therefore no material compensation expense for the stock option grants has been recognized.

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(1) NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Had we determined compensation cost based on the fair value at the grant date for our stock options under FASB Statement No. 123, our net income would have been reduced to the pro forma amounts indicated below:

	2005	2004	2003
Net income as reported	$ 60,959	$ 62,617	$ 53,661
Deduct: employee stock based compensation determined under fair value based methods for all awards, net of related tax effects	(3,909)	(3,662)	(2,547)
Pro forma net income	$ 57,050	$ 58,955	$ 51,114
Net income per common share			
Basic as reported	$ 1.48	$ 1.53	$ 1.32
Basic pro forma	1.38	1.44	1.26
Diluted as reported	1.46	1.50	1.29
Diluted pro forma	1.37	1.42	1.25

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for options granted in fiscal 2005, 2004 and 2003: the risk-free interest rate of 3.70%, 3.10% and 3.62% for 2005, 2004 and 2003, respectively; expected dividend yield of 2.0% for 2005 and zero for 2004 and 2003; expected term of 7.25 for 2005 and 7.5 years for 2004 and 2003 and expected volatility of 56%, 62% and 63% for 2005, 2004 and 2003, respectively. The weighted average fair value of options granted in 2005, 2004 and 2003 were $15.41, $19.86 and $14.75, respectively.

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), *Share-Based Payment* (Statement 123(R)), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the time of grant. Pro forma disclosure is no longer an alternative.

Statement 123(R) must be adopted no later than January 1, 2006. Early adoption will be permitted in periods in which financial statements have not yet been issued. We adopted Statement 123(R) on January 1, 2006.

Statement 123(R) permits public companies to adopt its requirements using one of two methods: (1) a modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date; or, (2) a modified retrospective method which includes the requirements of the modified prospective method

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(1) NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

We adopted the standard based on the modified prospective transition method.

As permitted by Statement 123, we currently account for share-based payments to employees using Opinion 25 s intrinsic value method and, as such, generally recognize no compensation cost for employee stock options. Accordingly, the adoption of Statement 123(R) s fair value method will have a significant impact on our result of operations, although it will have no impact on our overall financial position. The impact of adoption of Statement 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future and the model chosen to determine fair value for grants after January 1, 2006. However, had we adopted Statement 123(R) in prior periods based on our use of the Black-Scholes option pricing model, the impact of that standard would have approximated the impact of Statement 123 as described in the aforementioned disclosure of pro forma net income and earnings per share. While Statement 123(R) permits entities to continue the use of the Black-Scholes option pricing model, Statement 123(R) also permits the use of a binomial model. Based on the research done by us on the alternative models available to value option grants, and in conjunction with the type and number of stock options we except to issue in the future, we have determined that we will continue to use the Black-Scholes option pricing model for stock option valuation upon the adoption of Statement 123(R).

Statement 123(R) includes several modifications to the way that incomes taxes are provided for in the financial statements. The expense for stock option grants is only deductible for tax purposes at the time the taxable event takes place, which will cause variability in our effective tax rates recorded throughout each year. The expected variability in our effective tax rate is caused by Statement 123(R) s forbiddance of companies from predicting when these taxable events will take place. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While we cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized in prior periods for such excess tax deductions were $1,405, $1,456, and $4,050 in 2005, 2004 and 2003, respectively.

(o) *Net Income Per Common Share* Basic net income per common share for the years ended December 31, 2005, 2004 and 2003 was calculated by dividing net income by the weighted average number of common shares outstanding for each period. Diluted net income per common share for the years ended December 31, 2005, 2004 and 2003 was calculated by dividing net income by the weighted average number of common shares including the impact of dilutive common stock options outstanding. See Notes 7 and 12.

(p) *Recent Accounting Pronouncements* In November of 2003, the FASB issued FASB Statement No. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4. The amendments made by Statement 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(1) NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 23, 2004. We adopted this statement on January 1, 2006 and do not expect the adoption of this statement to have a material affect on our financial position or results of operation.

In March 2005, the Financial Accounting Standards Board (FASB) issued Interpretation 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations*, an interpretation of FASB Statement 143, *Accounting for Asset Retirement Obligations*. FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The interpretation would require us to provide for an asset retire obligation if in any of our leases would require us to remove tenant improvements or our owned movable fixed assets. The guidance is effective for fiscal years ending after December 15, 2005, or our current year end, and would require us to record a liability for any asset retirement obligation adjusted for cumulative accretion to the date of adoption and a capitalized asset retirement cost, adjusted for accumulated depreciation, to be added to our property and equipment upon the date of adoption. Adoption of this guidance was not material to our financial position or results of operation.

(q) *Other Comprehensive Income* Comprehensive income represents our change in equity (net assets), during a period, from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments or distributions by or to owners. The components of comprehensive income are reported in the Consolidated Statements of Stockholders Equity.

(r) *Segment Reporting* We operate as one business segment. Operations at December 31, 2005 consisted of 732 retail stores in 46 states. These stores have a uniform format, uniform hours, the same event calendar and carry substantially the same merchandise (quantities, styles and patterns may vary). All merchandise is priced uniformly throughout our stores and is distributed from our central distribution system.

(s) *Off-balance Sheet or Variable Interest Arrangements* We do not have off-balance sheet arrangements, transactions with unconsolidated, limited purpose or variable interest entities, nor do we have material transactions or commitments involving related persons or entities.

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(2) LEASE ACCOUNTING ADJUSTMENT

Based on certain views expressed in a letter of February 7, 2005 from the Office of the Chief Accountant of the Securities and Exchange Commission to the American Institute of Certified Public Accountants, we reviewed our accounting policies and practices associated with operating leases. Consistent with industry practices, we historically reported straight-line rental expense beginning on the lease commencement date. This had the effect of excluding the rent holiday associated with the pre-opening or build-out period of our stores from the calculation of the period over which we expensed rent. Following our review, we modified our accounting policies such that we begin recording rent expense on the date we take possession of or have the right to use the premises.

As a result of this adjustment, we recorded a one-time, non-cash, $3.9 million ($2.4 million, net of income tax) cumulative charge to earnings during the first quarter of 2005. The adjustment did not impact historical or future net cash flows or the timing of the payments under related leases. We believe that the new lease accounting policies will not have a material effect on future diluted earnings per share. Prior years financial statements were not restated as the impact of this issue was immaterial to previously reported results for any individual previous periods.

(3) PROPERTY AND EQUIPMENT

Property and equipment, net of accumulated depreciation, consisted of the following at December 31, 2005 and 2004:

	2005	**2004**
Land	$ 8,509	$ 8,509
Buildings	40,396	40,228
Furniture and fixtures	55,120	45,024
Equipment	53,898	51,058
Leasehold improvements	6,854	4,232
	164,777	149,051
Less accumulated depreciation	(76,991)	(62,719)
Net property and equipment	$ 87,786	$ 86,332

(4) DEBT

We have a $210 million revolving credit facility which expires in December 2009. Any borrowing under the revolver will incur interest at LIBOR or the prime rate, depending on the term of the borrowing, plus an applicable margin. We incur commitment fees of up to 0.25% on the unused portion of the revolving credit facility. This rate is reduced or increased as our leverage ratio changes. Our indebtedness under the credit facility is secured by a lien on our inventory and cash accounts, as well as a pledge of our ownership interests in all of our subsidiaries.

We had no balances outstanding related to our revolving credit facility at December 31, 2005 and 2004. Our availability under our revolving credit facility was $200.3 million and $202.1 million at December 31, 2005 and 2004, respectively. As of December 31, 2005, we had outstanding letters of credit of $9.7 million, primarily for self-insurance purposes.

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(4) DEBT (Continued)

The revolving credit facility contains certain restrictive covenants, which among other things, require us to comply with certain financial ratios covering maximum leverage, minimum fixed charge coverage and minimum interest coverage. Other restrictions affect our ability to incur liens or make certain other restricted payments, sale assets or merge or consolidate with any other person. As of December 31, 2005, we were in compliance with all covenants.

In 2003, we redeemed the entire $69 million aggregate principal amount of our outstanding 11% Senior Subordinated Notes due 2007 at a redemption price equal to 103.67% of the aggregate principal amount of the notes plus accrued and unpaid interest. We paid the notes, redemption premium and accrued interest in full with available cash on-hand. We incurred a pre-tax charge of $2.5 million representing the redemption premium and a non-cash write-off of $1.4 million in unamortized financing costs carried on the balance sheet.

(5) ACCRUED LIABILITIES

At December 31, 2005 and 2004, we had accrued liabilities consisting of the following:

	2005	2004
Sales tax	$ 6,351	$ 7,679
Self-Insurance Reserves	12,542	12,117
Wages & benefits	7,576	6,621
Property taxes	2,000	1,980
Other expenses	13,903	11,152
Total accrued liabilities	$ 42,372	$ 39,549

(6) INCOME TAXES

Income tax expense (benefit) for the years ended December 31, 2005, 2004 and 2003 consists of:

	Current	Deferred	Total
Year ended December 31, 2005			
Federal	$ 34,466	$ (1,796)	$ 32,670
State and local	2,458	(68)	2,390
Total	$ 36,924	$ (1,864)	$ 35,060
Year ended December 31, 2004			
Federal	$ 31,046	$ 2,251	$ 33,297
State and local	5,628	274	5,902
Total	$ 36,674	$ 2,525	$ 39,199
Year ended December 31, 2003			
Federal	$ 30,134	$ (1,099)	$ 29,035
State and local	4,655	(97)	4,558
Total	$ 34,789	$ (1,196)	$ 33,593

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(6) INCOME TAXES (Continued)

A reconciliation of the expected federal income tax expense at the statutory income tax rate to the actual tax expense follows (based upon a tax rate of 35%):

	2005	2004	2003
Expected federal income tax expense	$ 33,607	$ 35,636	$ 30,539
State income taxes, net of related federal tax benefit	1,372	3,920	2,963
Other, net	81	(357)	91
Total tax expense	$ 35,060	$ 39,199	$ 33,593

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 31, 2005 and 2004 were as follows:

	2005	2004
Deferred tax assets:		
Current:		
Other payroll and benefits	$ 1,157	$ 1,190
Inventory reserves	1,532	1,782
Self-insurance reserves	4,823	4,730
Other current liabilities	1,163	1,239
Noncurrent:		
Deferred rent	1,685	
Total gross deferred tax assets	$ 10,360	$ 8,941
Deferred tax liabilities:		
Current:		
Inventory costs	$ 1,794	$ 1,283
Prepaid supplies	1,810	1,667
Non-current:		
Property and equipment	7,952	9,051
Total gross deferred tax liabilities	11,556	12,001
Net deferred tax liability	$ 1,196	$ 3,060

We expect the deferred tax assets at December 31, 2005 to be fully recovered and the deferred tax liabilities at December 31, 2005 to be fully satisfied through the reversal of taxable temporary differences in future years as a result of normal business activities. Accordingly, no valuation allowances for deferred tax items were considered necessary as of December 31, 2005 or 2004.

(7) STOCK OPTIONS

We have established a 1997 Long-Term Equity Incentive Plan (the 1997 Plan) and a Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (the 2004 Plan) which allows our Board of Directors to grant stock options to directors, officers and key employees performing services for us. The 1997 and 2004 Plan authorizes grants of options to purchase up to 4,800,000 and 2,000,000 shares, respectively, of authorized, but unissued common stock. Stock options are granted with an exercise price,

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(7) STOCK OPTIONS (Continued)

terms and vesting determined by the Compensation Committee of the Board of Directors, with certain limitations.

Options granted under the 1997 and 2004 Plan vest over periods of four to five years and expire in ten years. The exercise prices of the options range between $0.20 and $35.23, which represents market value on the grant date of the shares of common stock into which such options are exercisable. At December 31, 2005, there were 14,998 and 1,895,000 additional shares available for grant under the 1997 Plan and 2004 Plan, respectively.

Following is a summary of transactions relating to the 1997 and 2004 Plan s options for the three years ended December 31, 2005:

	Number of Shares	Weighted-Average Exercise Price
Outstanding at December 31, 2002	1,814,178	$ 8.36
Exercised during year	(599,414)	4.84
Canceled during year	(39,541)	20.01
Granted during year	790,000	21.67
Outstanding at December 31, 2003	1,965,223	14.53
Exercised during year	(178,228)	5.52
Canceled during year	(24,930)	22.35
Granted during year	330,000	30.66
Outstanding at December 31, 2004	2,092,065	17.75
Exercised during year	(267,574)	10.44
Canceled during year	(159,177)	27.55
Granted during year	350,979	29.97
Outstanding at December 31, 2005	2,016,293	$ 20.07

As of December 31, 2005, 2004 and 2003, 1,242,772, 1,104,927 and 829,891, respectively, of options outstanding were exercisable.

The following table summarizes information about stock options outstanding at December 31, 2005.

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding (in thousands)	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price Per Share	Number Exercisable (in thousands)	Weighted Average Exercise Price Per Share
$ 0.20-$ 1.43	24	2.48	$ 0.91	24	$ 0.91
$ 7.97-$10.00	543	4.60	$ 9.76	541	$ 9.76
$13.35-$20.01	215	6.16	$ 16.96	134	$ 16.75
$20.04-$29.90	887	7.65	$ 23.11	462	$ 21.73
$30.18-$35.23	347	8.82	$ 31.68	82	$ 31.84
	2,016	6.81	$ 20.07	1,243	$ 16.24

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(8) OPERATING LEASES

We lease substantially all store locations under non-cancelable operating leases. Our leases generally are for a five year period with two five year renewal options and in very limited circumstances do our leases involve a tenant allowance for leasehold improvements. As disclosed in Note 2, we record rent expense ratably over the life of the lease beginning with the date we take possession of or have the right to use the premises, and if our leases provide for a tenant allowance, we record the landlord reimbursement as a liability and ratably amortize the liability as a reduction to rent expense over the lease term beginning with the date we take possession of or control the physical access to the premises. Leases for new stores also typically allow us the ability to terminate a lease after 24 to 36 months if the store does not achieve sales expectations or another location appears more desirable. Future minimum rental payments under leases are as follows:

Years Ending December 31,	
2006	$ 53,776
2007	47,180
2008	38,070
2009	26,321
2010	14,183
Thereafter	12,936
Total minimum rental payments	$ 192,466

Rental expense for 2005, 2004 and 2003 was $63,362, $52,405 and $43,940, respectively. Rent expense includes rent for store locations and warehouses. Rent based on sales is not material to our financial statements.

(9) 401(K) PROFIT SHARING PLAN AND STOCK PURCHASE PROGRAM

We have a 401(k) profit sharing plan for the benefit of our full-time, eligible employees after one year of service. Under the plan, eligible employees may request us to deduct and contribute from 1% to 20% of their salary to the plan. Subject to Internal Revenue Service Regulations, we match each participant s contribution up to 4% of participant s compensation. We expensed contributions of $801, $760 and $808 during the years ended December 31, 2005, 2004 and 2003, respectively.

We offer participation in a stock purchase program for full time employees after completion of 90 days of continuous employment. Under the plan, eligible employees may request us to deduct from 1% to 10% of their salary and receive a 25% match of their contribution up to $2,500 annually in whole dollars. The number of shares of common stock offered under the Plan is unlimited, and shares are acquired through open market transactions by an agent of the Plan. We expense our contributions as incurred. The contributions were immaterial for all reported years.

(10) FINANCIAL INSTRUMENTS

We had various forward foreign currency contracts outstanding at December 31, 2005 and 2004 with fair values of $33 and $22, respectively. Our risk that counterparties to these contracts may be unable to perform is minimized by limiting the counterparties to major financial institutions. The carrying value of our cash and cash equivalents approximates its fair value and the fair value of our forward foreign currency contracts were determined based on quoted market prices of comparable contracts.

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(11) LEGAL PROCEEDINGS

During 2001 and 2002, we were named as a defendant in three complaints filed in the Superior Court of California in and for the County of Los Angeles. The plaintiffs are seeking to certify a statewide class made up of some of our current and former employees, which they claim are owed compensation for overtime wages, penalties and interest. The plaintiffs are also seeking attorney s fees and costs. In October 2003, we entered into a settlement agreement with a sub-class of these plaintiffs consisting of manager-in-training and management trainees which was paid in November 2005 with no material impact to our financial statements. The remaining complaint relating to our salaried managers is still open and is awaiting a trial date. We are attempting to consolidate a similar lawsuit filed in Orange County, California in 2004 with this remaining manager complaint, but no agreement has been reached with the court. This case is still in discovery. We do not expect either of these complaints to have a material impact to our financial statements.

In December 2003, we were named as a defendant in a new lawsuit filed in the Superior Court of California, in and for the County of San Diego. The plaintiffs were alleging failure to pay for minimum reporting time, travel time, split-shift premiums, meal periods and other labor issues. We entered into a settlement agreement on July 7, 2005 with the plaintiffs. The settlement was paid in December 2005 with no material impact to our financial statements.

In June 2004, we were named as a defendant in a complaint filed in the U.S. District Court, Central District of California. The plaintiff, Thomas Kinkade Company (f/k/a/ Media Arts Group Inc.), is alleging copyright infringement and false advertisements on merchandise we sold in the second quarter of 2004. This lawsuit is currently set for trial in March 2006.

We intend to vigorously defend all pending actions. We do not believe these or any other legal proceedings pending or threatened against us would have a material adverse effect on our financial condition or results of operations.

(12) EARNINGS PER COMMON SHARE

The following table sets forth the computation of basic and diluted earnings per common share:

	Years Ended December 31,		
	2005	**2004**	**2003**
Basic Earnings Per Share:			
Net income	$ 60,959	$ 62,617	$ 53,661
Weighted average number of common shares outstanding	41,264	41,046	40,513
Basic earnings per common share	$ 1.48	$ 1.53	$ 1.32
Diluted Earnings Per Share:			
Net income	$ 60,959	$ 62,617	$ 53,661
Dilutive effect of employee stock options	506	718	929
Weighted average number of common shares outstanding	41,264	41,046	40,513
Weighted average number of common shares and dilutive effect of outstanding employee stock options	41,770	41,764	41,442
Diluted earnings per common share	$ 1.46	$ 1.50	$ 1.29

TUESDAY MORNING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All dollar amounts in thousands, except for per share amounts)

(12) EARNINGS PER COMMON SHARE (Continued)

Options to purchase common stock of 584,000 shares at prices ranging from $28.75 to $35.23, 150,000 shares at prices ranging from $31.84 to $34.15 and 115,000 shares at prices ranging from $26.93 to $32.06 were outstanding at December 31, 2005, 2004 and 2003, respectively. These shares were not included in the diluted earnings per share calculation because the assumed exercise of such options would have been anti-dilutive.

(13) QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

A summary of the unaudited quarterly results for 2005 and 2004 follows:

	Quarters Ended March 31, 2005 (in thousands, except per share data)	June 30, 2005	Sept. 30, 2005	Dec. 31, 2005
Net sales	$ 185,594	$ 218,756	$ 192,276	$ 335,201
Gross profit	72,558	81,418	74,699	128,606
Operating income(1)	10,436	16,746	13,312	56,051
Net income(1)	6,666	10,530	8,213	35,550
Basic earnings per share	$ 0.16	$ 0.26	$ 0.20	$ 0.86
Diluted earnings per share	$ 0.16	$ 0.25	$ 0.20	$ 0.85

	Quarters Ended March 31, 2004 (in thousands, except per share data)	June 30, 2004	Sept. 30, 2004	Dec. 31, 2004
Net sales	$ 168,597	$ 210,697	$ 186,148	$ 332,399
Gross profit	66,012	76,390	68,623	130,193
Operating income	13,481	16,553	12,923	61,134
Net income	8,189	10,009	7,522	36,897
Earnings Per Share Basic	$ 0.20	$ 0.24	$ 0.18	$ 0.90
Earnings Per Share Diluted	$ 0.20	$ 0.24	$ 0.18	$ 0.88

(1) Includes the lease accounting adjustment of $3.9 million ($2.4 million, net of income tax) which was recorded in the first quarter of 2005.

EXHIBIT INDEX

Exhibit No.	**Description**
3.1.1	Certificate of Incorporation of Tuesday Morning Corporation (the Company) (incorporated by reference to Exhibit 3.1 to the Company s Registration Statement on Form S-4 (File No. 333-46017) as filed with the Securities and Exchange Commission (the Commission) on February 10, 1998)
3.1.2	Certificate of Amendment to the Certificate of Incorporation of the Company (incorporated by reference to Exhibit 3.3 to the Company s Registration Statement on Form S-1/A (File No. 333-74365) as filed with the Commission on March 29, 1999)
3.1.3	Certificate of Amendment to the Certificate of Incorporation of the Company dated May 7, 1999 (incorporated by reference to Exhibit 3.1.3 to the Company s Form 10-Q (File No. 000-19658) as filed with the Commission on May 2, 2005)
3.2	Amended and Restated By-laws of the Company (incorporated by reference to Exhibit 3.7 to the Company s Registration Statement on Form S-4 (File No. 333-46017) as filed with the Commission on February 10, 1998)
10.1.1	Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.9 to the Company s Registration Statement on Form S-4 (File No. 333-46017) as filed with the Commission on February 10, 1998)
10.1.2	First Amendment to the Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.3 to the Company s Form 10-Q (File No. 000-19658) as filed with the Commission on August 1, 2005)
10.2	Stockholders Agreement, dated as of December 29, 1997, by and among the Company, Madison Dearborn Capital Partners II, L.P. and the executives listed on Schedule I attached thereto (incorporated by reference to Exhibit 10.11 to the Company s Registration Statement on Form S-4 (File No. 333-46017) as filed with the Commission on February 10, 1998)
10.3	1999 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.12 to the Company s Registration Statement on Form S-1 (File No. 333-74365) as filed with the Commission on March 12, 1999)
10.4	Employment Agreement, dated as of July 25, 2000, by and between the Company and Kathleen Mason (incorporated by reference to Exhibit 99.2 to the Company s Form 10-Q (File No. 000-19658) as filed with the Commission on November 7, 2000)
10.5.1	Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (incorporated by reference to Appendix B to the Company s Definitive 14A Proxy Statement (File No. 000-19658) as filed with the Commission on April 19, 2004)
10.5.2	First Amendment to the Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.4 to the Company s Form 10-Q (File No. 000-19658) as filed with the Commission on August 1, 2005)
10.6	Credit Agreement, dated as of December 22, 2004 by and among Tuesday Morning, Inc., Tuesday Morning Corporation, TMI Holdings, Inc., the lenders who are or may become a party to the agreement, Wachovia Bank, National Association, as Administrative Agent, Wells Fargo Bank, N.A. and LaSalle Bank National Association, as Co-Syndication Agents, U.S. Bank National Association and Sovereign Bank, as Co-Documentation Agents, Wachovia Capital Markets, LLC as a Co-Lead Arranger and Sole Book Manager, and Wells Fargo Bank, N.A. as a Co-Lead Arranger (incorporated by reference to Exhibit 10.6 to the Company s Form 10-K/A (File No. 000-19658) as filed with the Commission on February 24, 2006)
10.7	Form of Incentive Stock Option Agreement under the Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan and the Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company s Form 8-K (File No. 000-19658) as filed with the Commission on May 3, 2005)

10.8	Form of Nonqualified Stock Option Agreement under the Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan and the Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan (incorporated by reference to Exhibit 10.2 to the Company s Form 8-K (File No. 000-19658) as filed with the Commission on May 3, 2005)
10.9	Bonus Agreement dated December 27, 2005 by and between Tuesday Morning Partners, Ltd. and John F. Reeves
10.10	Bonus Agreement dated December 27, 2005 by and between Tuesday Morning, Inc. and Loren K. Jensen
10.11	Description of Directors Compensation
21.1	Subsidiaries of the Company (incorporated by reference to Exhibit 21.1 to the Company s Form 10-K (File No. 000-19658) as filed with the Commission on March 9, 2005)
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification by the Chief Executive Officer of the Company Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by the Chief Financial Officer of the Company Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer of the Company Pursuant to 18 U.S.C. § 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Chief Financial Officer of the Company Pursuant to 18 U.S.C. § 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Management contract or compensatory plan or arrangement