

WILLIAMS SONOMA INC  
Form 10-Q  
September 12, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended August 3, 2008.

or

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

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

Commission File Number: 001-14077

**WILLIAMS-SONOMA, INC.**

(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of incorporation or organization)

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

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

94109  
(Zip Code)

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

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of August 31, 2008, 105,631,632 shares of the registrant's Common Stock were outstanding.

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**FOR THE QUARTER ENDED AUGUST 3, 2008**  
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**Table of Contents****ITEM 1. FINANCIAL STATEMENTS****WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited)

<i>Dollars and shares in thousands, except per share amounts</i>	August 3, 2008	February 3, 2008	July 29, 2007
<b>ASSETS</b>			
Current assets			
Cash and cash equivalents	\$ 38,544	\$ 118,950	\$ 58,039
Accounts receivable	62,729	48,052	63,847
Merchandise inventories, net	656,641	693,661	651,262
Prepaid catalog expenses	50,087	54,907	69,488
Prepaid expenses	49,522	32,276	46,361
Deferred income taxes	91,808	91,843	70,986
Other assets	9,140	10,086	6,708
Total current assets	958,471	1,049,775	966,691
Property and equipment, net	980,857	981,075	948,415
Non-current deferred income taxes	47,355	44,997	35,087
Other assets	18,367	18,007	17,195
Total assets	\$ 2,005,050	\$ 2,093,854	\$ 1,967,388
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
Current liabilities			
Accounts payable	\$ 159,993	\$ 197,561	\$ 205,546
Accrued salaries, benefits and other	85,248	95,383	87,568
Customer deposits	200,554	201,743	200,560
Income taxes payable	12,882	83,984	2,786
Current portion of long-term debt	14,568	14,734	15,690
Other liabilities	16,772	18,129	20,541
Total current liabilities	490,017	611,534	532,691
Deferred rent and lease incentives	269,487	247,836	250,946
Long-term debt	10,050	11,238	12,548
Other long-term obligations	53,055	57,523	55,402
Total liabilities	822,609	928,131	851,587
Commitments and contingencies			
Shareholders' equity			
Preferred stock, \$.01 par value, 7,500 shares authorized, none issued	-	-	-
Common stock, \$.01 par value, 253,125 shares authorized, issued and outstanding: 105,584, 105,349 and 108,536 shares at August 3, 2008, February 3, 2008 and July 29, 2007, respectively	1,056	1,054	1,085
Additional paid-in capital	417,802	403,217	397,132
Retained earnings	749,483	746,201	704,034
Accumulated other comprehensive income	14,100	15,251	13,550
Total shareholders' equity	1,182,441	1,165,723	1,115,801
Total liabilities and shareholders' equity	\$ 2,005,050	\$ 2,093,854	\$ 1,967,388

*See Notes to Condensed Consolidated Financial Statements.*

**Table of Contents****WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

(Unaudited)

<i>Dollars and shares in thousands, except per share amounts</i>	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 3, 2008	July 29, 2007	August 3, 2008	July 29, 2007
Net revenues	\$ 819,621	\$ 859,396	\$ 1,601,405	\$ 1,675,447
Cost of goods sold	540,774	539,301	1,046,339	1,053,382
Gross margin	278,847	320,095	555,066	622,065
Selling, general and administrative expenses	253,424	277,227	512,760	550,755
Interest income	(187)	(1,031)	(763)	(3,501)
Interest expense	377	505	774	1,036
Earnings before income taxes	25,233	43,394	42,295	73,775
Income taxes	6,849	17,428	13,464	29,659
Net earnings	\$ 18,384	\$ 25,966	\$ 28,831	\$ 44,116
Basic earnings per share	\$ 0.17	\$ 0.24	\$ 0.27	\$ 0.40
Diluted earnings per share	\$ 0.17	\$ 0.23	\$ 0.27	\$ 0.39
Shares used in calculation of earnings per share:				
Basic	105,561	109,884	105,462	110,081
Diluted	107,010	112,022	107,088	112,339

*See Notes to Condensed Consolidated Financial Statements.*

**Table of Contents****WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

<i>Dollars in thousands</i>	Twenty-Six Weeks Ended	
	August 3, 2008	July 29, 2007
Cash flows from operating activities:		
Net earnings	\$ 28,831	\$ 44,116
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation and amortization	73,706	68,758
(Gain)/loss on sale/disposal/impairment of assets, net	(12,405)	2,748
Amortization of deferred lease incentives	(15,854)	(13,904)
Deferred income taxes	(2,859)	(2,741)
Tax benefit from exercise of stock-based compensation	854	3,114
Stock-based compensation expense	13,179	12,741
Other	(416)	-
Changes in:		
Accounts receivable	(15,383)	(14,488)
Merchandise inventories	36,837	(39,622)
Prepaid catalog expenses	4,821	(9,878)
Prepaid expenses and other assets	(16,563)	(17,145)
Accounts payable	(33,473)	(25,680)
Accrued salaries, benefits and other current and long-term liabilities	(15,948)	998
Customer deposits	(1,089)	12,515
Deferred rent and lease incentives	37,672	27,453
Income taxes payable	(71,098)	(90,213)
Net cash provided by (used in) operating activities	10,812	(41,228)
Cash flows from investing activities:		
Purchases of property and equipment	(112,721)	(90,368)
Proceeds from sale/disposal of assets	46,787	285
Proceeds from insurance reimbursement	632	-
Other	(152)	(605)
Net cash used in investing activities	(65,454)	(90,688)
Cash flows from financing activities:		
Repayments of long-term obligations	(1,354)	(437)
Net proceeds from exercise of stock options	132	26,358
Excess tax benefit from exercise of stock-based compensation	916	4,949
Payment of dividends	(24,970)	(23,881)
Repurchase of common stock	-	(95,468)
Net cash used in financing activities	(25,276)	(88,479)
Effect of exchange rates on cash and cash equivalents	(488)	3,005
Net decrease in cash and cash equivalents	(80,406)	(217,390)
Cash and cash equivalents at beginning of period	118,950	275,429
Cash and cash equivalents at end of period	\$ 38,544	\$ 58,039

*See Notes to Condensed Consolidated Financial Statements.*

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**WILLIAMS-SONOMA, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Twenty-Six Weeks Ended August 3, 2008 and July 29, 2007

(Unaudited)

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

These financial statements include Williams-Sonoma, Inc. and its wholly owned subsidiaries ( we, us or our ). The condensed consolidated balance sheets as of August 3, 2008 and July 29, 2007, the condensed consolidated statements of earnings and cash flows for the thirteen and twenty-six weeks ended August 3, 2008 and July 29, 2007 have been prepared by us, without audit. In our opinion, the financial statements include all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position at the balance sheet dates and the results of operations for the thirteen and twenty-six weeks then ended. Significant intercompany transactions and accounts have been eliminated. The balance sheet as of February 3, 2008, presented herein, has been derived from our audited balance sheet included in our Annual Report on Form 10-K for the fiscal year ended February 3, 2008.

The results of operations for the thirteen and twenty-six weeks ended August 3, 2008 are not necessarily indicative of the operating results of the full year.

Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended February 3, 2008.

**NOTE B. ACCOUNTING POLICIES**

*Recent Accounting Pronouncements*

On February 4, 2008, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements*, for all financial assets and liabilities. SFAS No. 157 establishes a standard definition for fair value, provides a framework under generally accepted accounting principles for measuring fair value and expands disclosure requirements for fair value measurements. In December 2007, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position ( FSP ) No. 157-b, *Effective Date of FASB No. 157*, which delayed the effective date of SFAS No. 157 for all nonfinancial assets and liabilities (except those recognized or disclosed at fair value in the financial statements on a recurring basis) to annual reporting periods beginning after November 15, 2008. We do not have significant financial assets and liabilities or nonfinancial assets and liabilities recognized or disclosed at fair value on a recurring basis and, as such, the adoption of SFAS No. 157 did not have a material impact on our consolidated financial position, results of operations or cash flows. Further, we do not expect the adoption of FSP No. 157-b to have a material impact on our consolidated financial position, results of operations or cash flows.

On February 4, 2008, we adopted the provisions of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The adoption of SFAS No. 159 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* ( SFAS 141(R) ), which will change the accounting for business combinations. Under SFAS 141(R), an acquiring entity will be

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required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition date fair value with limited exceptions. SFAS 141(R) will change the accounting treatment for certain specific acquisition-related items, including expensing acquisition-related costs as incurred, valuing non-controlling interests (minority interests) at fair value at the acquisition date, and expensing restructuring costs associated with an acquired business. SFAS 141(R) applies prospectively, with limited exceptions, to business combinations for which the acquisition date is on or after the first fiscal period beginning on or after December 15, 2008. Early adoption is not permitted. Generally, the effect of SFAS 141(R) will depend on future acquisitions and, as such, we do not currently expect the adoption of this Statement to have a material impact on our consolidated financial position, results of operations or cash flows.

**NOTE C. STOCK-BASED AND OTHER LONG-TERM INCENTIVE COMPENSATION**

We provide long-term compensation to our employees through various equity and cash award programs.

*Equity Award Programs*

Our Amended and Restated 2001 Long-Term Incentive Plan (the *Plan*) provides for grants of incentive stock options, nonqualified stock options, stock-settled stock appreciation rights (collectively, *option awards*), restricted stock awards, restricted stock units, deferred stock awards (collectively, *stock awards*) and dividend equivalents up to an aggregate of 15,959,903 shares. As of August 3, 2008, there were approximately 5,337,000 shares available for future grant. Awards may be granted under the Plan to officers, employees and non-employee Board members of the company or any parent or subsidiary. Annual grants are limited to 1,000,000 shares covered by option awards and 400,000 shares covered by stock awards on a per person basis. All grants of option awards made under the Plan have a maximum term of ten years, except incentive stock options that may be issued to 10% shareholders, which have a maximum term of five years. The exercise price of these option awards is not less than 100% of the closing price of our stock on the day prior to the grant date or not less than 110% of such closing price for an incentive stock option granted to a 10% shareholder. Option awards granted to employees generally vest over five years. Stock awards granted to employees generally vest over a period of three to five years for service based awards, and four and five years for performance based awards. Certain option and stock awards contain vesting acceleration clauses in the event of a merger or similar corporate event. Option and stock awards granted to non-employee Board members generally vest in one year. Non-employee Board members automatically receive stock awards on the date of their initial election to the Board and annually thereafter on the date of the annual meeting of shareholders (so long as they continue to serve as a non-employee Board member). Shares issued as a result of award exercises will be funded with the issuance of new shares.

*Stock-Based Compensation Expense*

We account for stock-based compensation arrangements in accordance with SFAS No. 123R, *Share-Based Payment*, which requires us to measure and record compensation expense in our consolidated financial statements for all employee stock-based awards using a fair value method.

During the thirteen and twenty-six weeks ended August 3, 2008, we recognized total stock-based compensation expense, as a component of selling, general and administrative expenses, of \$6,622,000 (\$4,096,000 for option awards and \$2,526,000 for stock awards) and \$13,179,000 (\$9,111,000 for option awards and \$4,068,000 for stock awards), respectively. During the thirteen and twenty-six weeks ended July 29, 2007, we recognized total stock-based compensation expense of \$6,731,000 and \$12,741,000, respectively.



**Table of Contents***Stock Options*

The following table summarizes our stock option activity during the twenty-six weeks ended August 3, 2008:

	Shares
Balance at February 3, 2008	6,631,149
Granted <sup>1</sup>	-
Exercised	(416,782)
Canceled	(210,180)
Balance at August 3, 2008	6,004,187
Vested at August 3, 2008	5,398,987
Vested plus expected to vest at August 3, 2008	5,920,110

<sup>1</sup> In fiscal 2006, we began issuing stock-settled stock appreciation rights in lieu of stock option grants. Therefore, no stock options have been granted during the twenty-six weeks ended August 3, 2008. See the stock-settled stock appreciation rights table below.

*Stock-Settled Stock Appreciation Rights*

The following table summarizes our stock-settled stock appreciation rights activity during the twenty-six weeks ended August 3, 2008:

	Shares
Balance at February 3, 2008	3,286,470
Granted (weighted average fair value of \$8.63)	17,000
Converted	-
Canceled	(165,820)
Balance at August 3, 2008	3,137,650
Vested at August 3, 2008	742,488
Vested plus expected to vest at August 3, 2008	2,700,481

The weighted-average assumptions associated with option awards issued during the thirteen and twenty-six weeks ended August 3, 2008 and July 29, 2007 are as follows:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 3, 2008 <sup>1</sup>	July 29, 2007	August 3, 2008	July 29, 2007
Expected term (years)	-	5.0	5.1	5.0
Expected volatility	-	33.3%	41.5%	33.2%
Risk-free interest rate	-	4.6%	2.9%	4.5%
Dividend yield	-	1%	1.5%	1%

<sup>1</sup>There were no option awards issued during the thirteen weeks ended August 3, 2008.

**Table of Contents***Restricted Stock Units*

The following table summarizes our restricted stock unit activity during the twenty-six weeks ended August 3, 2008:

	Shares
Balance at February 3, 2008	831,800
Granted	473,464
Released	(15,900)
Canceled	(47,671)
Balance at August 3, 2008	1,241,693
Vested at August 3, 2008	-
Expected to vest at August 3, 2008	1,099,677
<i>Other Long-Term Incentive Awards</i>	

Beginning in fiscal 2008, we began issuing long-term cash-based awards to certain employees, in lieu of option awards. The cash award allows the recipient to receive a fixed cash payment upon vesting, which typically occurs at the end of a four-year service period. Compensation expense for these cash awards is recorded on a straight-line basis over the term of the award based on the fixed value of the award, adjusted for the percentage of the awards expected to be issued on the vest date. During the twenty-six weeks ended August 3, 2008, we issued cash awards with a fair value of \$4,509,000 to employees that vest over four years. The liability for cash awards expected to be issued on the vest date is recorded within other long-term liabilities. No cash awards were issued during fiscal 2007.

**NOTE D. BORROWING ARRANGEMENTS***Credit Facility*

As of August 3, 2008, we have a credit facility that provides for a \$300,000,000 unsecured revolving line of credit that may be used for loans or letters of credit and contains certain financial covenants, including a maximum leverage ratio (funded debt adjusted for lease and rent expense to EBITDAR), and covenants limiting our ability to dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens and make investments. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the credit facility of up to \$200,000,000, to provide for a total of \$500,000,000 of unsecured revolving credit. The credit facility contains events of default that include, among others, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, bankruptcy and insolvency events, material judgments, cross defaults to certain other indebtedness and events constituting a change of control. The occurrence of an event of default will increase the applicable rate of interest by 2.0% and could result in the acceleration of our obligations under the credit facility and an obligation of any or all of our U.S. subsidiaries to pay the full amount of our obligations under the credit facility. The credit facility matures on October 4, 2011, at which time all outstanding borrowings must be repaid and all outstanding letters of credit must be cash collateralized.

We may elect interest rates calculated at Bank of America's prime rate (or, if greater, the average rate on overnight federal funds plus one-half of one percent) or LIBOR plus a margin based on our leverage ratio. As of May 4, 2008, an aggregate of \$61,000,000 was outstanding under our credit facility. All outstanding balances were fully repaid during the thirteen weeks ended August 3, 2008. No amounts were borrowed under the line of credit facility during the thirteen or twenty-six weeks ended July 29, 2007. However, as of August 3, 2008, \$36,229,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. The standby letters of credit were issued to secure the liabilities associated with workers' compensation, other insurance

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programs and certain debt transactions. As of August 3, 2008, we were in compliance with our financial covenants under the credit facility.

*Letter of Credit Facilities*

On September 5, 2008, we amended our five unsecured commercial letter of credit reimbursement facilities, each of which expires on September 4, 2009, to decrease the aggregate credit available under all letter of credit facilities to \$165,000,000 as a result of negotiating wire payment terms with certain foreign vendors. The letter of credit facilities contain substantially similar covenants and provide for substantially similar events of default as the credit facility. Interest on amounts outstanding under the letter of credit facilities accrues at the lender's prime rate (or if greater, the average rate on overnight federal funds plus one-half of one percent). As of August 3, 2008, an aggregate of \$81,480,000 was outstanding under the letter of credit facilities. Such letters of credit represent only a future commitment to fund inventory purchases to which we had not taken legal title as of August 3, 2008. The latest expiration possible for any future letters of credit issued under the facilities is February 1, 2010.

**NOTE E. COMPREHENSIVE INCOME**

Comprehensive income for the thirteen and twenty-six weeks ended August 3, 2008 and July 29, 2007 was as follows:

<i>Dollars in thousands</i>	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 3, 2008	July 29, 2007	August 3, 2008	July 29, 2007
Net earnings	\$ 18,384	\$ 25,966	\$ 28,831	\$ 44,116
Other comprehensive (loss) income -				
Foreign currency translation adjustment	(381)	2,983	(1,144)	5,778
Net unrealized loss on investment	(3)	(3)	(6)	(12)
Comprehensive income	\$ 18,000	\$ 28,946	\$ 27,681	\$ 49,882

**NOTE F. EARNINGS PER SHARE**

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

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

<i>Dollars and amounts in thousands, except per share amounts</i>	Net Earnings	Weighted Average Shares	Per Share Amount
<b>Thirteen weeks ended August 3, 2008</b>			
Basic	\$ 18,384	105,561	\$ 0.17
Effect of dilutive stock-based awards	-	1,449	
Diluted	\$ 18,384	107,010	\$ 0.17
<b>Thirteen weeks ended July 29, 2007</b>			
Basic	\$ 25,966	109,884	\$ 0.24
Effect of dilutive stock-based awards	-	2,138	
Diluted	\$ 25,966	112,022	\$ 0.23
<b>Twenty-six weeks ended August 3, 2008</b>			
Basic	\$ 28,831	105,462	\$ 0.27
Effect of dilutive stock-based awards	-	1,626	
Diluted	\$ 28,831	107,088	\$ 0.27
<b>Twenty-six weeks ended July 29, 2007</b>			
Basic	\$ 44,116	110,081	\$ 0.40
Effect of dilutive stock-based awards	-	2,258	
Diluted	\$ 44,116	112,339	\$ 0.39

Stock-based awards of 6,438,000 and 4,957,000 for the thirteen weeks ended and 6,054,000 and 4,922,000 for the twenty-six weeks ended August 3, 2008 and July 29, 2007, respectively, were not included in the computation of diluted earnings per share, as their inclusion would be anti-dilutive.

**NOTE G. LEGAL PROCEEDINGS**

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

**NOTE H. SEGMENT REPORTING**

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

These reportable segments are strategic business units that offer similar home-centered products. They are managed separately because the business units utilize two distinct distribution and marketing strategies. Our

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operating segments are aggregated at the channel level for reporting purposes due to the fact that we do not maintain fully allocated income statements at the brand level and our brands are interdependent for economies of scale. As a result, material financial decisions related to the brands are made at the channel level. Furthermore, it is not practicable for us to report revenue by product group.

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

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

**Segment Information**

<i>Dollars in thousands</i>	Direct-to-			Total
	Retail	Customer	Unallocated	
<b>Thirteen weeks ended August 3, 2008</b>				
Net revenues <sup>1</sup>	\$ 463,239	\$ 356,382	-	\$ 819,621
Depreciation and amortization expense	24,654	5,237	\$ 6,683	36,574
Earnings (loss) before income taxes <sup>2</sup>	6,476	52,573	(33,816)	25,233
Capital expenditures	44,815	5,843	8,582	59,240
<b>Thirteen weeks ended July 29, 2007</b>				
Net revenues <sup>1</sup>	\$ 486,976	\$ 372,420	-	\$ 859,396
Depreciation and amortization expense	23,351	4,727	\$ 6,255	34,333
Earnings (loss) before income taxes	37,412	57,889	(51,907)	43,394
Capital expenditures	35,397	7,165	15,946	58,508
<b>Twenty-six weeks ended August 3, 2008</b>				
Net revenues <sup>1</sup>	\$ 896,790	\$ 704,615	-	\$ 1,601,405
Depreciation and amortization expense	50,073	10,219	\$ 13,414	73,706
Earnings (loss) before income taxes <sup>2,3</sup>	24,445	102,177	(84,327)	42,295
Assets <sup>4</sup>	1,184,705	339,735	480,610	2,005,050
Capital expenditures	88,383	9,551	14,787	112,721
<b>Twenty-six weeks ended July 29, 2007</b>				
Net revenues <sup>1</sup>	\$ 940,352	\$ 735,095	-	\$ 1,675,447
Depreciation and amortization expense	46,562	9,762	\$ 12,434	68,758
Earnings (loss) before income taxes	61,102	114,024	(101,351)	73,775
Assets <sup>4</sup>	1,103,600	361,657	502,131	1,967,388
Capital expenditures	56,356	8,416	25,596	90,368

<sup>1</sup> Includes revenues in the retail channel of \$20.3 million and \$17.7 million for the thirteen weeks ended August 3, 2008 and July 29, 2007, respectively, and \$38.4 million and \$33.9 million for the twenty-six weeks ended August 3, 2008 and July 29, 2007, respectively, related to our foreign operations.

<sup>2</sup> Unallocated costs before income taxes include a benefit of approximately \$16.0 million related to a gain on the sale of a corporate aircraft.

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<sup>3</sup> Includes a benefit in the retail channel of approximately \$9.4 million related to an incentive payment received from a landlord to compensate us for terminating a store lease prior to its expiration, partially offset by accelerated depreciation of \$1.1 million related to the early termination of this lease.

<sup>4</sup> Includes \$31.9 million and \$25.2 million of long-term assets as of August 3, 2008 and July 29, 2007, respectively, related to our foreign operations.

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**NOTE I. RELATED PARTY TRANSACTION**

On May 16, 2008, we completed two transactions relating to our corporate aircraft. First, we were able to take advantage of a robust corporate aircraft market and sold our Bombardier Global Express airplane for approximately \$46,787,000 in cash (a net after-tax cash benefit of approximately \$29,000,000) to an unrelated third party. This resulted in a gain on sale of asset of approximately \$16,000,000, or \$0.09 per diluted share, in the second quarter of fiscal 2008. Second, in order to address our ongoing aircraft needs, we entered into an Aircraft Lease Agreement (the Lease Agreement ) with a limited liability company (the LLC ) owned by W. Howard Lester, our Chief Executive Officer, Chairman of the Board of Directors and a significant shareholder, for use of a Bombardier Global 5000 owned by the LLC. These transactions were approved by our Board of Directors.

Under the terms of the Lease Agreement, in exchange for use of the aircraft, we will pay the LLC \$375,000 for each of the thirty-six months of the lease term through May 15, 2011. We are also responsible for all use-related costs associated with the aircraft, including fixed costs such as crew salaries and benefits, insurance and hangar costs, and all direct operating costs. Closing costs associated with the Lease Agreement were divided evenly between us and the LLC, and each party paid its own attorney and advisor fees. The Lease Agreement is subject to early termination by either party, with 90 days prior written notice, if Mr. Lester retires or otherwise withdraws from active management of the company.

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

**FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they do not fully materialize or prove incorrect, could cause our business and results of operations to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include projections of earnings, revenues or financial items, including the impact of accounting changes and our expected effective tax rate, statements of the plans, strategies and objectives of management for future operations, statements related to the future performance of our brands, statements related to macroeconomic and retail trends, statements related to seasonal marketing and merchandising, statements related to the resiliency of the Williams-Sonoma Home brand, statements related to our returns, replacements and damages reductions initiative, statements related to our catalog circulation strategy, statements related to improved seasonal sales in the Williams-Sonoma brand, statements related to reducing inventories and capital expenditures, statements related to reducing costs, statements related to reducing retail leased square footage growth in 2009, statements related to reducing capital spending in 2009, statements related to reducing inventory levels in 2009, statements about trends in cost of goods sold as a percentage of net revenues, statements related to declining catalog advertising costs in 2008, statements related to the adequacy and use of our available cash, including the payment of a dividend, statements related to our projected capital expenditures, statements related to our stock repurchase program, and statements of belief and statements of assumptions underlying any of the foregoing. You can identify these and other forward-looking statements by the use of words such as may, should, expects, plans, anticipates, believes, estimates, predicts, intends, continue, or the negative of such terms, or other comparable terminology.

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

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**OVERVIEW**

We are a specialty retailer of products for the home. The retail segment of our business sells our products through our five retail store concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, West Elm and Williams-Sonoma Home). The direct-to-customer segment of our business sells similar products through our seven direct mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed and Bath, PBteen, West Elm and Williams-Sonoma Home) and six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and wshome.com). Based on net revenues in fiscal 2007, retail net revenues accounted for 57.8% of our business and direct-to-customer net revenues accounted for 42.2% of our business. Based on their contribution to our net revenues in fiscal 2007, the core brands in both the retail and direct-to-customer channels are: Pottery Barn, which sells casual home furnishings; Williams-Sonoma, which sells cooking and entertaining essentials; and Pottery Barn Kids, which sells stylish children's furnishings.

The following discussion and analysis of financial condition, results of operations, and liquidity and capital resources should be read in conjunction with our condensed consolidated financial statements and the notes thereto.

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

*Second Quarter of Fiscal 2008 Financial Results*

During the second quarter of fiscal 2008, we continued to see significant deterioration in the macroeconomic environment, resulting in a net revenue decrease of 4.6% to \$819,621,000 from \$859,396,000 in the second quarter of fiscal 2007, and progressively declining comparable store sales. This net revenue decline was primarily driven by decreases in the Pottery Barn, Pottery Barn Kids and Williams-Sonoma Home brands, partially offset by increases in the West Elm, PBteen and Williams-Sonoma brands.

Including a \$0.09 per diluted share benefit related to a gain on the sale of a corporate aircraft, diluted earnings per share for the second quarter of fiscal 2008 decreased 26.1% to \$0.17 per diluted share compared to \$0.23 per diluted share in the second quarter of fiscal 2007.

Retail net revenues in the second quarter of fiscal 2008 decreased \$23,737,000, or 4.9%, compared to the second quarter of fiscal 2007. This decrease was driven by an 11.7% reduction in comparable store sales, partially offset by an 11.0% year-over-year increase in retail leased square footage, including 33 net new stores. Net revenues decreased in the Pottery Barn and Pottery Barn Kids brands, partially offset by increases in the West Elm, Williams-Sonoma Home and Williams-Sonoma brands.

Direct-to-customer net revenues in the second quarter of fiscal 2008 decreased \$16,038,000, or 4.3%, compared to the second quarter of fiscal 2007. This decrease was driven by declining net revenues in the Pottery Barn, Pottery Barn Kids and Williams-Sonoma Home brands, partially offset by increasing net revenues in the PBteen, West Elm and Williams-Sonoma brands. This decrease was also impacted by a decrease in catalog and page circulation of 20.5% and 31.1%, respectively (consistent with our catalog circulation optimization strategy), as well as an estimated \$2,600,000 negative impact associated with a voluntary product recall in the Pottery Barn brand. Net revenues generated in our Internet business, which continued to be our fastest growing shopping channel, increased 11.7% to \$265,130,000 in the second quarter of fiscal 2008 compared to \$237,379,000 in the second quarter of fiscal 2007.

In our core brands, net revenues in the second quarter of fiscal 2008 decreased 7.6%, primarily driven by decreases in the Pottery Barn and Pottery Barn Kids brands, partially offset by an increase in the Williams-Sonoma brand. In the Pottery Barn brand, net revenues in the second quarter decreased 11.5% with declining trends throughout the quarter, partially driven by reductions in catalog circulation and a voluntary product recall.



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While we were generally encouraged by the consumer response to overall newness in the brand, it was not strong enough to offset the significant deterioration in the overall macroeconomic environment. Retail was particularly challenging with comparable store sales decreasing 16.0%, a directional trend that we expect will continue for the remainder of the year. In the Pottery Barn Kids brand, net revenues in the second quarter of fiscal 2008 decreased 8.1% primarily driven by a comparable store sales decrease of 13.5% and reductions in catalog circulation. We continue to believe that the macroeconomic environment is having a significant impact on this brand as well. Retail performance also continued to worsen during the quarter, a directional trend that we expect will continue for the remainder of the year. In the Williams-Sonoma brand, net revenues in the second quarter increased 1%. Comparable store sales, however, decreased 4.5%, but were more than offset by incremental revenues from new and expanded stores and higher traffic in e-commerce. These results were driven by the successful marketing and merchandising of seasonal events, which is encouraging as we enter the highly event-driven back half of the year.

In our emerging brands (West Elm, PBteen and Williams-Sonoma Home), net revenues in the second quarter of fiscal 2008 increased 15.9%, despite the softening in the overall economy, driven primarily by positive growth in the West Elm and PBteen brands, partially offset by a decrease in net revenues in the Williams-Sonoma Home brand. In the West Elm brand, net revenue growth in the second quarter was driven by incremental sales from new stores and increased traffic in e-commerce, partially offset by weaker sales in existing stores. In the PBteen brand, net revenues increased 25.1% during the quarter, delivering the best year-over-year net revenue growth in the company. All key merchandising categories saw strong growth during the quarter, however, consistent with our core brands, we also began to see a decline in the PBteen growth rate throughout the quarter as the macroeconomic environment began to impact the PBteen brand. In the Williams-Sonoma Home brand, despite a decrease in net revenues in the second quarter, we continued to make progress on our brand building initiatives and continue to believe that Williams-Sonoma Home will be more resilient than our other home furnishings brands due to its target demographic and relatively small store base.

From a merchandise inventory perspective, as of August 3, 2008, we held \$656,641,000 in merchandise inventories compared to \$651,262,000 at July 29, 2007 for a net increase of \$5,379,000. This increase in merchandise inventories was primarily attributable to an approximate \$33,000,000 year-over-year increase in fixed investments for new and remodeled stores; an approximate \$8,000,000 increase in the Williams-Sonoma brand due to cost increases and the impact of a change in the mix of our goods, offset by lower units; and an approximate \$36,000,000 decrease in the Pottery Barn and Pottery Barn Kids brands due to lower units, partially offset by cost increases and a change in the mix of our goods. Inventories in the emerging brands, excluding new stores, were virtually flat at the end of the quarter. Despite this year-over-year increase, merchandise inventories decreased approximately \$37,020,000 from our fiscal 2007 year-end balance of \$693,661,000 at February 3, 2008.

In addition, our prepaid catalog expenses decreased \$19,401,000 to \$50,087,000 as of August 3, 2008 from \$69,488,000 as of July 29, 2007. This decrease was primarily driven by a significant reduction in catalog circulation related to our catalog circulation optimization strategy, partially offset by cost increases in paper and postage.

*Second Quarter of Fiscal 2008 Operational Results*

Throughout this year, we have consistently focused on improving our merchandising, our inventory planning, our marketing efficiency and our supply chain operations.

In our supply chain, we continued to see a significant benefit from our returns, replacements and damages initiative. This has been a key initiative for us, and we are currently taking additional steps to further reduce our costs in this area by assuming a greater level of direct control over our furniture operations in Asia.

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In direct marketing, we continued to implement our catalog circulation optimization strategy by strategically decreasing catalog circulation, which has had a positive impact on earnings. Based on these results, we will continue to look for ways to expand this strategy over the next several quarters.

*Fiscal 2008*

As we look forward to the balance of the year, we are increasingly concerned about the downward trends we have seen in the macroeconomic environment and, more importantly, in our brands. Due to this concern, it is difficult for us to predict how the consumer will respond in the back half of the year. Our assumption is that these trends will continue in the future, with the exception of the Williams-Sonoma brand, where we believe that seasonal relevance will drive improved sales despite a weak economy. Accordingly, we are projecting our fiscal 2008 revenues to decline in the range of 7.8% to 9.5% and our annual diluted earnings per share for fiscal 2008 to decline in the range of 34.7% to 41.5%, to \$1.03 to \$1.15 per diluted share versus fiscal 2007.

For the remainder of fiscal 2008, we plan to focus on profitable growth and maintaining a strong balance sheet, including reducing inventories and capital expenditures. We will also focus on aggressively reducing costs to the extent it does not affect service levels to our customers.

Consistent with our economic perspective on 2008, we are also looking forward to 2009 with a very cautious outlook. Accordingly, the longer-term decisions we are making are reflective of that sentiment, particularly in the areas of retail leased square footage growth, capital spending, and inventory. Therefore, in 2009, we are currently targeting a reduction in retail leased square footage growth from 7% to 7.5% in 2008 to 4% to 5% in 2009; a reduction in capital spending from \$200 million to \$220 million in 2008 to \$145 million to \$170 million in 2009; and a continued reduction in inventory levels through managed inventory receipt flow and inventory turn optimization initiatives.

**Results of Operations****NET REVENUES**

Net revenues consist of retail sales, direct-to-customer sales and shipping fees. Retail sales include sales of merchandise to customers at our retail stores. Direct-to-customer sales include sales of merchandise to customers through our catalogs and the Internet. Shipping fees consist of revenue received from customers for delivery of merchandise. Revenues are net of sales returns and other discounts.

The following table summarizes our net revenues for the thirteen weeks ended August 3, 2008 ( second quarter of fiscal 2008 ) and July 29, 2007 ( second quarter of fiscal 2007 ), and the twenty-six weeks ended August 3, 2008 ( year-to-date 2008 ) and July 29, 2007 ( year-to-date 2007 ):

<i>Dollars in thousands</i>	Thirteen Weeks Ended				Twenty-Six Weeks Ended			
	August 3, 2008	% Total	July 29, 2007	% Total	August 3, 2008	% Total	July 29, 2007	% Total
Retail revenues	\$ 463,239	56.5%	\$ 486,976	56.7%	\$ 896,790	56.0%	\$ 940,352	56.1%
Direct-to-customer revenues	356,382	43.5%	372,420	43.3%	704,615	44.0%	735,095	43.9%
<b>Net revenues</b>	<b>\$ 819,621</b>	<b>100.0%</b>	<b>\$ 859,396</b>	<b>100.0%</b>	<b>\$ 1,601,405</b>	<b>100.0%</b>	<b>\$ 1,675,447</b>	<b>100.0%</b>

Net revenues for the second quarter of fiscal 2008 decreased by \$39,775,000, or 4.6%, compared to the second quarter of fiscal 2007. This decrease was driven by an 11.7% reduction in comparable store sales, and a decrease in catalog and page circulation of 20.5% and 31.1%, respectively (consistent with our catalog circulation optimization strategy), partially offset by an 11.0% year-over-year increase in retail leased square footage,

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including 33 net new stores. Net revenues decreased in the Pottery Barn, Pottery Barn Kids and Williams-Sonoma Home brands, partially offset by increases in the West Elm, PBteen and Williams-Sonoma brands.

Net revenues for year-to-date 2008 decreased by \$74,042,000, or 4.4%, compared to year-to-date 2007. This decrease was driven by a 10.4% reduction in comparable store sales and a decrease in catalog and page circulation of 18.4% and 28.1%, respectively (consistent with our catalog circulation optimization strategy), partially offset by an 11.0% year-over-year increase in retail leased square footage, including 33 net new stores. Net revenues decreased in the Pottery Barn, Pottery Barn Kids, Williams-Sonoma and Williams-Sonoma Home brands, partially offset by increases in the PBteen and West Elm brands.

**RETAIL REVENUES AND OTHER DATA**

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 3,	July 29,	August 3,	July 29,
<i>Dollars in thousands</i>	2008	2007	2008	2007
Retail revenues	\$ 463,239	\$ 486,976	\$ 896,790	\$ 940,352
Percent (decrease) increase in retail revenues	(4.9%)	5.1%	(4.6%)	4.8%
Percent (decrease) increase in comparable store sales	(11.7%)	1.2%	(10.4%)	0.2%
Number of stores - beginning of period	603	584	600	588
Number of new stores	8	2	15	4
Number of new stores due to remodeling <sup>1</sup>	11	8	13	9
Number of closed stores due to remodeling <sup>1</sup>	(7)	(12)	(12)	(18)
Number of permanently closed stores	(2)	(2)	(3)	(3)
Number of stores - end of period	613	580	613	580
Store selling square footage at period-end	3,713,000	3,343,000	3,713,000	3,343,000
Store leased square footage ( LSF ) at period-end	5,959,000	5,370,000	5,959,000	5,370,000

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

	Store Count			Store Count		Avg. LSF	Avg. LSF
	May 4,			August 3,		Per Store	Per Store
	2008	Openings	Closings	2008	2007	August 3,	July 29,
Williams-Sonoma	256	9	(5)	260	252	6,200	6,000
Pottery Barn	198	6	(4)	200	190	12,700	12,100
Pottery Barn Kids	94	1	-	95	91	7,900	7,900
West Elm	29	3	-	32	23	17,400	17,500
Williams-Sonoma Home	9	-	-	9	8	14,300	14,200
Outlets	17	-	-	17	16	21,300	20,500
Total	603	19	(9)	613	580	9,700	9,300

Retail net revenues in the second quarter of fiscal 2008 decreased \$23,737,000, or 4.9%, compared to the second quarter of fiscal 2007. This decrease was driven by an 11.7% reduction in comparable store sales, partially offset by an 11.0% year-over-year increase in retail leased square footage, including 33 net new stores. Net revenues decreased in the Pottery Barn and Pottery Barn Kids brands, partially offset by increases in the West Elm, Williams-Sonoma Home and Williams-Sonoma brands.

Retail net revenues for year-to-date 2008 decreased by \$43,562,000, or 4.6%, compared to year-to-date 2007 due to a 10.4% reduction in comparable store sales, partially offset by an 11.0% year-over-year increase in retail leased square footage, including 33 net new stores. Net revenues decreased in the Pottery Barn, Pottery Barn



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Kids and Williams-Sonoma brands, partially offset by increases in the West Elm and Williams-Sonoma Home brands.

*Comparable Store Sales*

Comparable stores are defined as those stores in which gross square footage did not change by more than 20% in the previous 12 months and which have been open for at least 12 consecutive months without closure for seven or more consecutive days. By measuring the year-over-year sales of merchandise in the stores that have a history of being open for a full comparable 12 months or more, we can better gauge how the core store base is performing since it excludes new store openings, store remodelings, expansions and closings. Comparable stores exclude new retail concepts until such time as we believe that comparable store results in those concepts are meaningful to evaluating the performance of the retail strategy. In both fiscal 2008 and fiscal 2007, we excluded West Elm and Williams-Sonoma Home.

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

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 3,	July 29,	August 3,	July 29,
<i>Percent (decrease) increase in comparable store sales</i>	2008	2007	2008	2007
Williams-Sonoma	(4.5%)	1.1%	(4.6%)	0.3%
Pottery Barn	(16.0%)	1.8%	(13.3%)	0.3%
Pottery Barn Kids	(13.5%)	(3.8%)	(12.3%)	(3.8%)
Outlets	(12.6%)	9.0%	(12.8%)	9.2%
Total	(11.7%)	1.2%	(10.4%)	0.2%

Various factors affect comparable store sales, including the number, size and location of stores we open, close, remodel or expand in any period, the general retail sales environment, consumer preferences and buying trends, changes in sales mix between distribution channels, our ability to efficiently source and distribute products, changes in our merchandise mix, competition (including competitive promotional activity), current local and global economic conditions, the timing of our releases of new merchandise and promotional events, the success of marketing programs, the cannibalization of existing store sales by our new stores, changes in our catalog circulation strategies, continued strength in our Internet business and fluctuation in foreign exchange rates. Among other things, weather conditions can affect comparable store sales because inclement weather can alter consumer behavior or require us to close certain stores temporarily and thus reduce store traffic. Even if stores are not closed, many customers may decide to avoid going to stores in bad weather. These factors have caused our comparable store sales to fluctuate significantly in the past on an annual, quarterly and monthly basis and, as a result, we expect that comparable store sales will continue to fluctuate in the future.

**DIRECT-TO-CUSTOMER REVENUES**

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 3,	July 29,	August 3,	July 29,
<i>Dollars in thousands</i>	2008	2007	2008	2007
Catalog revenues <sup>1</sup>	\$ 91,252	\$ 135,041	\$ 187,964	\$ 266,252
Internet revenues <sup>1</sup>	265,130	237,379	516,651	468,843
Total direct-to-customer revenues <sup>1</sup>	\$ 356,382	\$ 372,420	\$ 704,615	\$ 735,095
Percent (decrease) increase in direct-to-customer revenues	(4.3%)	2.8%	(4.1%)	1.7%
Percent (decrease) increase in number of catalogs circulated	(20.5%)	8.6%	(18.4%)	2.4%
Percent (decrease) increase in number of pages circulated	(31.1%)	9.2%	(28.1%)	7.4%

<sup>1</sup>Approximately 60% of our company-wide non-gift registry Internet revenues are driven by customers who recently received a catalog and approximately 40% are incremental to the direct-to-customer channel.

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Direct-to-customer net revenues in the second quarter of fiscal 2008 decreased \$16,038,000, or 4.3%, compared to the second quarter of fiscal 2007. This decrease was driven by declining net revenues in the Pottery Barn, Pottery Barn Kids and Williams-Sonoma Home brands, partially offset by increasing net revenues in the PBteen, West Elm and Williams-Sonoma brands. This decrease was also impacted by a decrease in catalog and page circulation of 20.5% and 31.1%, respectively (consistent with our catalog circulation optimization strategy), as well as an estimated \$2,600,000 negative impact associated with a voluntary product recall in the Pottery Barn brand. Net revenues generated in our Internet business, which continued to be our fastest growing shopping channel, increased 11.7% to \$265,130,000 in the second quarter of fiscal 2008 compared to \$237,379,000 in the second quarter of fiscal 2007.

Direct-to-customer net revenues for year-to-date 2008 decreased \$30,480,000, or 4.1%, compared to year-to-date 2007. This decrease was driven by declining net revenues in the Pottery Barn, Pottery Barn Kids and Williams-Sonoma Home brands, partially offset by increasing net revenues in the PBteen, West Elm and Williams-Sonoma brands. This decrease was also impacted by a decrease in catalog and page circulation of 18.4% and 28.1%, respectively (consistent with our catalog circulation optimization strategy), as well as an estimated \$2,600,000 negative impact associated with a voluntary product recall in the Pottery Barn brand. Net revenues generated in our Internet business, which continued to be our fastest growing shopping channel, increased 10.2% to \$516,651,000 for year-to-date 2008 compared to \$468,843,000 for year-to-date 2007.

**COST OF GOODS SOLD**

	Thirteen Weeks Ended				Twenty-Six Weeks Ended			
	August 3, 2008	% Net Revenues	July 29, 2007	% Net Revenues	August 3, 2008	% Net Revenues	July 29, 2007	% Net Revenues
<i>Dollars in thousands</i>								
Cost of goods sold	\$ 540,774	66.0%	\$ 539,301	62.8%	\$ 1,046,339	65.3%	\$ 1,053,382	62.9%

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

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

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

*Second Quarter of Fiscal 2008 vs. Second Quarter of Fiscal 2007*

Cost of goods sold increased by \$1,473,000, or 0.3%, in the second quarter of fiscal 2008 compared to the second quarter of fiscal 2007. Cost of goods sold as a percentage of net revenues increased to 66.0% in the second quarter of fiscal 2008 from 62.8% in the second quarter of fiscal 2007. This increase as a percentage of net revenues was primarily driven by an increase in cost of merchandise sold, including increased markdowns, the deleverage of fixed occupancy expenses due to declining sales and an increase in inventory related reserves, partially offset by the favorable benefit of the company's ongoing replacement and damages initiatives.

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In the retail channel, cost of goods sold as a percentage of net revenues increased 450 basis points in the second quarter of fiscal 2008 compared to the second quarter of fiscal 2007. This increase as a percentage of net revenues primarily resulted from the deleverage of fixed occupancy expenses due to declining sales, an increase in cost of merchandise sold, including increased markdowns and an increase in inventory related reserves, partially offset by the favorable benefit of the company's ongoing replacement and damages initiatives.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues increased 150 basis points in the second quarter of 2008 compared to the second quarter of 2007. This increase as a percentage of net revenues primarily resulted from an increase in cost of merchandise sold, including increased markdowns, the deleverage of fixed occupancy expenses due to declining sales and an increase in inventory related reserves, partially offset by the favorable benefit of the company's ongoing replacement and damages initiatives.

*Year-to-Date 2008 vs. Year-to-Date 2007*

Cost of goods sold for year-to-date 2008 decreased by \$7,043,000, or 0.7%, compared to year-to-date 2007. Cost of goods sold as a percentage of net revenues increased to 65.3% for year-to-date 2008 from 62.9% for year-to-date 2007. This increase as a percentage of net revenues was primarily driven by the deleverage of fixed occupancy expenses due to declining sales and an increase in cost of merchandise sold, including increased markdowns, partially offset by the favorable benefit of the company's ongoing replacement and damages initiatives. For the remainder of fiscal 2008, as compared to prior year, we expect these trends to continue.

In the retail channel, cost of goods sold as a percentage of net revenues increased 370 basis points for year-to-date 2008 compared to year-to-date 2007. This increase as a percentage of net revenues primarily resulted from the deleverage of fixed occupancy expenses due to declining sales, an increase in cost of merchandise sold, including increased markdowns and an increase in inventory related reserves, partially offset by the favorable benefit of the company's ongoing replacement and damages initiatives.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues increased 90 basis points for year-to-date 2008 compared to year-to-date 2007. This increase as a percentage of net revenues primarily resulted from an increase in cost of merchandise sold, including increased markdowns and the deleverage of fixed occupancy expenses due to declining sales, partially offset by the favorable benefit of the company's ongoing replacement and damages initiatives and a reduction in customer shipping costs.

**SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

<i>Dollars in thousands</i>	Thirteen Weeks Ended				Twenty-Six Weeks Ended			
	August 3, 2008	% Net Revenues	July 29, 2007	% Net Revenues	August 3, 2008	% Net Revenues	July 29, 2007	% Net Revenues
Selling, general and administrative expenses	\$ 253,424	30.9%	\$ 277,227	32.3%	\$ 512,760	32.0%	\$ 550,755	32.9%

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

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

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### *Second Quarter of Fiscal 2008 vs. Second Quarter of Fiscal 2007*

Selling, general and administrative expenses decreased by \$23,803,000, or 8.6%, in the second quarter of fiscal 2008 compared to the second quarter of fiscal 2007. Selling, general and administrative expenses as a percentage of net revenues decreased to 30.9% in the second quarter of fiscal 2008 from 32.3% in the second quarter of fiscal 2007. This decrease as a percentage of net revenues was primarily due to a benefit of approximately \$16,000,000 related to a gain on the sale of a corporate aircraft and reduced advertising costs due to the rollout of our catalog circulation optimization strategy, partially offset by deleverage of our employment costs due to declining sales.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues increased 180 basis points in the second quarter of fiscal 2008 compared to the second quarter of fiscal 2007. This increase as a percentage of net revenues was primarily due to deleverage of our employment costs due to declining sales and an increase in other general expenses.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased 70 basis points in the second quarter of fiscal 2008 compared to the second quarter of fiscal 2007. This decrease as a percentage of net revenues was primarily driven by reduced advertising costs due to the rollout of our catalog circulation optimization strategy, partially offset by deleverage of our employment costs due to declining sales.

### *Year-to-Date 2008 vs. Year-to-Date 2007*

Selling, general and administrative expenses for year-to-date 2008 decreased by \$37,995,000, or 6.9%, compared to year-to-date 2007. Selling, general and administrative expenses as a percentage of net revenues decreased to 32.0% for year-to-date 2008 from 32.9% for year-to-date 2007. This decrease as a percentage of net revenues was primarily driven by a benefit of approximately \$16,000,000 related to a gain on the sale of a corporate aircraft, a benefit of approximately \$9,350,000 related to an incentive payment received from a landlord to compensate us for terminating a store lease prior to its expiration, partially offset by deleverage of our employment costs due to declining sales. Although total advertising costs as a percentage of net revenues were relatively flat for year-to-date 2008 compared to year-to-date 2007, we saw a reduction in catalog advertising costs due to the second quarter of fiscal 2008 rollout of our catalog circulation optimization strategy. We expect to see catalog advertising costs continue to decline throughout the remainder of fiscal 2008.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues increased 10 basis points for year-to-date 2008 compared to year-to-date 2007. This increase as a percentage of net revenues was primarily driven by deleverage of our employment costs due to declining sales, partially offset by the incentive payment received from a landlord to compensate us for terminating a store lease prior to its expiration.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues increased 20 basis points for year-to-date 2008 compared to year-to-date 2007. This increase as a percentage of net revenues was primarily driven by deleverage of our employment costs due to declining sales. Although total advertising costs as a percentage of direct-to-customer net revenues were relatively flat for year-to-date 2008 compared to year-to-date 2007, we saw a reduction in catalog advertising costs due to the second quarter of fiscal 2008 rollout of our catalog circulation optimization strategy. We expect to see catalog advertising costs continue to decline throughout the remainder of fiscal 2008.

## **INTEREST INCOME**

Interest income was \$187,000 in the second quarter of fiscal 2008, compared to \$1,031,000 in the second quarter



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of fiscal 2007, and is comprised primarily of income from short-term investments classified as cash and cash equivalents. For year-to-date 2008, interest income was \$763,000 compared to \$3,501,000 for year-to-date 2007. The decrease in interest income during the second quarter of fiscal 2008 and year-to-date 2008 compared to the second quarter of fiscal 2007 and year-to-date 2007 resulted from lower average cash balances and lower average interest rates associated with these investments during fiscal 2008 compared to fiscal 2007, after returning approximately \$144,862,000 to our shareholders through share repurchases and dividends over the past 12 months.

### **INCOME TAXES**

Our effective tax rate was 27.1% and 40.2% for the second quarter of fiscal 2008 and the second quarter of fiscal 2007, respectively, and 31.8% and 40.2% for year-to-date 2008 and year-to-date 2007, respectively. The decrease in the effective tax rate during the second quarter of 2008 and year-to-date 2008 was primarily due to certain favorable income tax resolutions in fiscal 2008. We expect our effective tax rate to be in the range of 37.2% to 37.6% in fiscal 2008. Throughout the year, we expect that there could be ongoing variability in our quarterly tax rates as taxable events occur and exposures are re-evaluated.

### **LIQUIDITY AND CAPITAL RESOURCES**

As of August 3, 2008, we held \$38,544,000 in cash and cash equivalent funds. As is consistent with our industry, our cash balances are seasonal in nature, with the fourth quarter representing a significantly higher level of cash than other periods.

Throughout the fiscal year, we utilize our cash balances to build our inventory levels in preparation for our fourth quarter holiday sales. In fiscal 2008, we plan to utilize our cash resources to fund our inventory and inventory related purchases, catalog advertising and marketing initiatives, purchases of property and equipment and dividend payments. In addition to the current cash balances on-hand, we have a \$300,000,000 credit facility available as of August 3, 2008 that may be used for loans or letters of credit. Prior to April 4, 2011, we may, upon notice to the lenders, request an increase in the credit facility of up to \$200,000,000, to provide for a total of \$500,000,000 of unsecured revolving credit. As of August 3, 2008, no amounts were outstanding under our credit facility. However, as of August 3, 2008, \$36,229,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. We believe our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations over the next 12 months.

For year-to-date 2008, net cash provided by operating activities was \$10,812,000 compared to net cash used in operating activities of \$41,228,000 for year-to-date 2007. Net cash provided by operating activities for year-to-date 2008 was primarily attributable to an increase in deferred rent and lease incentives and a decrease in merchandise inventories, partially offset by the payment of income taxes and a decrease in accounts payable due to the timing of payments.

For year-to-date 2008, net cash used in investing activities was \$65,454,000 compared to net cash used in investing activities of \$90,688,000 for year-to-date 2007. For year-to-date 2008, purchases of property and equipment were \$112,721,000, comprised of \$78,208,000 for stores, \$26,189,000 for systems development projects (including e-commerce websites) and \$8,324,000 for distribution, facility infrastructure and other projects. Net cash used in investing activities was partially offset by proceeds from the sale of a corporate aircraft of \$46,787,000.

In fiscal 2008, we anticipate investing \$200,000,000 to \$220,000,000 in the purchase of property and equipment, primarily for the construction of 30 new stores and 24 remodeled or expanded stores, systems development projects (including e-commerce websites), and distribution, facility infrastructure and other projects.

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For year-to-date 2008, net cash used in financing activities was \$25,276,000 compared to net cash used in financing activities of \$88,479,000 for year-to-date 2007. Net cash used in financing activities for year-to-date 2008 was primarily due to the payment of dividends.

*Related Party Transaction*

On May 16, 2008, we completed two transactions relating to our corporate aircraft. First, we were able to take advantage of a robust corporate aircraft market and sold our Bombardier Global Express airplane for approximately \$46,787,000 in cash (a net after-tax cash benefit of approximately \$29,000,000) to an unrelated third party. This resulted in a gain on sale of asset of approximately \$16,000,000, or \$0.09 per diluted share, in the second quarter of fiscal 2008. Second, in order to address our ongoing aircraft needs, we entered into an Aircraft Lease Agreement (the Lease Agreement ) with a limited liability company (the LLC ) owned by W. Howard Lester, our Chief Executive Officer, Chairman of the Board of Directors and a significant shareholder, for use of a Bombardier Global 5000 owned by the LLC. These transactions were approved by our Board of Directors.

Under the terms of the Lease Agreement, in exchange for use of the aircraft, we will pay the LLC \$375,000 for each of the thirty-six months of the lease term through May 15, 2011. We are also responsible for all use-related costs associated with the aircraft, including fixed costs such as crew salaries and benefits, insurance and hangar costs, and all direct operating costs. Closing costs associated with the Lease Agreement were divided evenly between us and the LLC, and each party paid its own attorney and advisor fees. The Lease Agreement is subject to early termination by either party, with 90 days prior written notice, if Mr. Lester retires or otherwise withdraws from active management of the company.

*Stock Repurchase Program*

In January 2008, the Board of Directors authorized the repurchase of up to \$150,000,000 of our common stock through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. The stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

During the second quarter of fiscal 2008, no shares of our common stock were repurchased and \$150,000,000 of our common stock remains available for repurchase.

*Dividend Policy*

In March 2008, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.115 to \$0.12 per common share. The indicated annual cash dividend, subject to capital availability, is \$0.48 per common share or approximately \$51,000,000 in fiscal 2008. Our quarterly cash dividend could be reduced or discontinued at any time.

*Critical Accounting Policies*

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. The estimates and assumptions are evaluated on an ongoing basis and are based on historical experience and various other factors that we believe to be reasonable

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under the circumstances. Actual results may differ significantly from these estimates. There have been no significant changes to the policies as discussed in our Annual Report on Form 10-K for the year ended February 3, 2008.

### *Impact of Inflation*

The impact of inflation on results of operations was not significant for year-to-date 2008 or year-to-date 2007.

### *Seasonality*

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

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

We are exposed to market risks, which include changes in U.S. interest rates, foreign currency exchange rates, including the devaluation of the U.S. dollar and the effects of rising prices in the foreign countries in which we do business. We do not engage in financial transactions for trading or speculative purposes.

### *Interest Rate Risk*

As of August 3, 2008, we have three debt instruments with variable interest rates which subject us to risks associated with changes in interest rates (the interest payable on our credit facility, our Mississippi industrial development bond and the bond-related debt associated with one of our Memphis-based distribution facilities). As of August 3, 2008, the total outstanding principal balance on these instruments was \$13,805,000 (with a weighted average interest rate of approximately 2.7%). If interest rates on these existing variable rate debt instruments rose 27 basis points (an approximate 10% increase in the associated variable rates as of August 3, 2008), our results from operations and cash flows would not be materially affected.

In addition, we have fixed and variable income investments consisting of short-term investments classified as cash and cash equivalents, which are also affected by changes in market interest rates. As of August 3, 2008, our investments, made solely in money market funds, are stated at cost and approximate their fair values. An increase in interest rates of 10% would have an immaterial effect on the value of these investments. Declines in interest rates would, however, decrease the income derived from these investments.

### *Foreign Currency Risks*

We purchase a significant amount of inventory from vendors outside of the U.S. in transactions that are denominated in U.S. dollars. Approximately 5% of our international purchase transactions are in currencies other than the U.S. dollar, primarily the euro. Any currency risks related to these international purchase transactions were not significant to us during the year-to-date 2008 and year-to-date 2007. However, since we pay for the majority of our international purchases in U.S. dollars, a decline in the U.S. dollar relative to other foreign currencies would subject us to risks associated with increased purchasing costs from our vendors in their effort to offset any lost profits associated with any currency devaluation. We cannot predict with certainty the effect these increased costs associated with any currency devaluation may have on our financial statements or results of operations.

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In addition, as of August 3, 2008, we have 15 retail stores in Canada and limited operations in both Europe and Asia, each of which expose us to market risk associated with foreign currency exchange rate fluctuations. Although these exchange rate fluctuations have not been material to us in the past, we may enter into foreign currency contracts in the future to minimize any currency remeasurement risk associated with the intercompany assets and liabilities of our subsidiaries. We did not enter into any foreign currency contracts during year-to-date 2008 or year-to-date 2007.

**ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures*

As of August 3, 2008, an evaluation was performed by management, with the participation of our Chief Executive Officer ( CEO ) and our Executive Vice President, Chief Operating and Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow timely discussions regarding required disclosures, and that such information is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

*Changes in Internal Control Over Financial Reporting*

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

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

A description of the risks and uncertainties associated with our business is set forth below. You should carefully consider such risks and uncertainties, together with the other information contained in this report and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.

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

Our success depends, in large part, upon our ability to identify and analyze factors affecting our business and to anticipate and respond in a timely manner to changing merchandise trends and customer demands. For example, in the specialty home products business, style and color trends are constantly evolving. Consumer preferences cannot be predicted with certainty and may change between selling seasons. Changes in customer preferences and buying trends may also affect our brands differently. We must be able to stay current with preferences and trends in our brands and address the customer tastes for each of our target customer demographics. We must also

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be able to identify and adjust the customer offerings in our brands to cater to customer demands. For example, a change in customer preferences for children's room furnishings may not correlate to a similar change in buying trends for other home furnishings. If we misjudge either the market for our merchandise or our customers' purchasing habits, our sales may decline significantly, and we may be required to mark down certain products to sell the resulting excess inventory or to sell such inventory through our outlet stores or other liquidation channels at prices which are significantly lower than our retail prices, either of which would negatively impact our business and operating results.

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

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

Our business depends on consumer demand for our products and, consequently, is sensitive to a number of factors that influence consumer spending, including general economic conditions, disposable consumer income, fuel prices, recession and fears of recession, war and fears of war, inclement weather, consumer debt, conditions in the housing market, interest rates, sales tax rates and rate increases, inflation, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. In particular, an economic downturn leads to decreased discretionary spending, which adversely impacts the specialty retail business. These factors may also affect our various brands and channels differently. Adverse changes in factors affecting discretionary consumer spending could reduce consumer demand for our products, thus reducing our sales and harming our business and operating results.

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

The specialty retail and direct-to-customer business is highly competitive. Our specialty retail stores, mail order catalogs and e-commerce websites compete with other retail stores, other mail order catalogs and other e-commerce websites that market lines of merchandise similar to ours. We compete with national, regional and local businesses utilizing a similar retail store strategy, as well as traditional furniture stores, department stores and specialty stores. The substantial sales growth in the direct-to-customer industry within the last decade has encouraged the entry of many new competitors and an increase in competition from established companies.

The competitive challenges facing us include:

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

maintaining favorable brand recognition and achieving customer perception of value;

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

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

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

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

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

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

Any inability to acquire suitable merchandise on acceptable terms or the loss of one or more of our key agents or vendors could have a negative effect on our business and operating results because we would be missing products that we felt were important to our assortment, unless and until alternative supply arrangements are secured. We may not be able to develop relationships with new agents or vendors, and products from alternative sources, if any, may be of a lesser quality and/or more expensive than those we currently purchase.

In addition, we are subject to certain risks, including availability of raw materials, labor disputes, union organizing activities, vendor financial liquidity, inclement weather, natural disasters, and general economic and political conditions that could limit our vendors' ability to provide us with quality merchandise on a timely basis and at a price that is commercially acceptable. For these or other reasons, one or more of our vendors might not adhere to our quality control standards, and we might not identify the deficiency before merchandise ships to our stores or customers. In addition, our vendors may have difficulty adjusting to our changing demands and growing business. Our vendors' failure to manufacture or import quality merchandise in a timely and effective manner could damage our reputation and brands, and could lead to an increase in customer litigation against us and an attendant increase in our routine litigation costs. Further, any merchandise that does not meet our quality standards could become subject to a recall, which would damage our reputation and brands, and harm our business.

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

In fiscal 2007, we sourced our products from vendors in 43 countries outside of the United States. Approximately 60% of our merchandise purchases were foreign-sourced, primarily from Asia and Europe. Our dependence on foreign vendors means that we may be affected by declines in the relative value of the U.S. dollar to other foreign currencies. For example, any upward valuation in the Chinese yuan, the euro, or any other foreign currency against the U.S. dollar may result in higher costs to us for those goods. Although approximately 95% of our foreign purchases of merchandise are negotiated and paid for in U.S. dollars, declines in foreign currencies and currency exchange rates might negatively affect the profitability and business prospects of one or more of our foreign vendors. This, in turn, might cause such foreign vendors to demand higher prices for merchandise in their effort to offset any lost profits associated with any currency devaluation, delay merchandise shipments to us, or discontinue selling to us, any of which could ultimately reduce our sales or increase our costs.

We are also subject to other risks and uncertainties associated with changing economic and political conditions in foreign countries. These risks and uncertainties include import duties and quotas, concerns over anti-dumping, work stoppages, economic uncertainties (including inflation), foreign government regulations, employment matters, wars and fears of war, political unrest, natural disasters and other trade restrictions. We cannot predict

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whether any of the countries in which our products are currently manufactured or may be manufactured in the future will be subject to trade restrictions imposed by the U.S. or foreign governments or the likelihood, type or effect of any such restrictions. Any event causing a disruption or delay of imports from foreign vendors, including the imposition of additional import restrictions, restrictions on the transfer of funds and/or increased tariffs or quotas, or both, could increase the cost or reduce the supply of merchandise available to us and adversely affect our business, financial condition and operating results. Furthermore, some or all of our foreign vendors' operations may be adversely affected by political and financial instability resulting in the disruption of trade from exporting countries, restrictions on the transfer of funds and/or other trade disruptions. Our overseas operations in Europe and Asia could also be affected by changing economic and political conditions in foreign countries, which could have a negative effect on our business, financial condition and operating results.

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

Our overseas operations are subject to certain U.S. laws applicable to us, including the Foreign Corrupt Practices Act. We must ensure that the employees in our overseas operations comply with these laws. If any of our overseas operations, or our employees or agents, violates such U.S. laws, we could become subject to sanctions, which could negatively affect our business and operating results.

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

In each of the past three fiscal years, the majority of our net revenues have been generated by our retail stores. Our ability to open additional stores successfully will depend upon a number of factors, including:

- our identification and availability of suitable store locations;
- our success in negotiating leases on acceptable terms;
- our ability to secure required governmental permits and approvals;
- our hiring and training of skilled store operating personnel, especially management;
- the availability of financing on acceptable terms, if at all; and

general economic conditions.

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

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

The success of our business depends on our ability to timely and effectively deliver merchandise to our stores and customers. We cannot control all of the various factors that might affect our fulfillment rates in direct-to-customer sales and timely and effective merchandise delivery to our stores. We rely upon third party carriers for our merchandise shipments and reliable data regarding the timing of those shipments, including shipments to our customers and to and from all of our stores. In addition, we are heavily dependent upon two carriers for the delivery of our merchandise to our customers. Accordingly, we are subject to the risks, including labor disputes, union organizing activity, inclement weather, natural disasters and possible acts of terrorism associated with such carriers' ability to provide delivery services to meet our shipping needs. Failure to deliver merchandise in a timely and effective manner could damage our reputation and brands. In addition, fuel costs have increased substantially and airline and other transportation companies struggle to operate profitably, which could lead to increased fulfillment expenses. The increased fulfillment costs could negatively affect our business and operating results by increasing our transportation costs and decreasing the efficiency of our shipments.

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

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

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

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

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

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

Our success depends upon our ability to increase sales at our existing stores. Various factors affect comparable store sales, including the number, size and location of stores we open, close, remodel or expand in any period, the general retail sales environment, consumer preferences and buying trends, changes in sales mix among distribution channels, our ability to efficiently source and distribute products, changes in our merchandise mix, competition (including competitive promotional activity), current local and global economic conditions, the timing of our releases of new merchandise and promotional events, the success of marketing programs, the cannibalization of existing store sales by our new stores, increased catalog circulation, continued strength in our



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Internet business and fluctuation in foreign exchange rates. Among other things, weather conditions can affect comparable store sales because inclement weather can alter consumer behavior or require us to close certain stores temporarily and thus reduce store traffic. Even if stores are not closed, many customers may decide to avoid going to stores in bad weather. These factors have caused and may continue to cause our comparable store sales results to differ materially from prior periods and from earnings guidance we have provided.

Our comparable store sales have fluctuated significantly in the past on an annual, quarterly and monthly basis, and we expect that comparable store sales will continue to fluctuate in the future. Past comparable store sales are no indication of future results, and comparable store sales may decrease in the future. Our ability to maintain and improve our comparable store sales results depends, in large part, on maintaining and improving our forecasting of customer demand and buying trends, selecting effective marketing techniques, providing an appropriate mix of merchandise for our broad and diverse customer base and using effective pricing strategies. Any failure to meet the comparable store sales expectations of investors and securities analysts in one or more future periods could significantly reduce the market price of our common stock.

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

Catalog mailings are an important component of our business. Postal rate increases, paper costs, printing costs and other catalog distribution costs affect the cost of our catalog mailings. We rely on discounts from the basic postal rate structure, which could be changed or discontinued at any time. Our cost of paper has fluctuated significantly during the past three fiscal years, and our paper costs are expected to increase in the future. Future increases in postal rates, paper costs or printing costs would have a negative impact on our operating results to the extent that we are unable to offset such increases by raising prices or by implementing more efficient printing, mailing, delivery and order fulfillment systems.

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

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

Our Internet business constitutes a significant part of our sales success. The success of our Internet business depends, in part, on factors over which we have limited control. We must successfully respond to changing consumer preferences and buying trends relating to Internet usage. We are also vulnerable to certain additional risks and uncertainties associated with the Internet, including changes in required technology interfaces, website downtime and other technical failures, costs and technical issues as we upgrade our website software, computer viruses, changes in applicable federal and state regulation, security breaches and consumer privacy concerns. In addition, we must keep up to date with competitive technology trends, including the use of improved technology, creative user interfaces and other Internet marketing tools, which may increase costs and which may not succeed in increasing sales or attracting customers. Our failure to successfully respond to these risks and uncertainties might adversely affect the sales in our Internet business, as well as damage our reputation and brands.

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

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

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

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

*If we are unable to introduce new brands and brand extensions successfully, or to reposition existing brands, we may not be able to grow our business.*

We have in the past and may in the future introduce new brands and brand extensions, or reposition existing brands. Our newest brands West Elm, PBteen and Williams-Sonoma Home and any other new brands, however, may not be successful growth vehicles. In January 2006, we announced our decision to transition the merchandising strategies of our Hold Everything brand into our other existing brands. Further, if we devote time and resources to new brands, brand extensions or brand repositioning, and those businesses are not as successful as we planned, then we risk damaging our overall business results. Alternatively, if our new brands, brand extensions or repositioned brands prove to be very successful, we risk hurting our other existing brands through the potential migration of existing brand customers to the new businesses. In addition, we may not be able to introduce new brands and brand extensions, or to reposition brands, in a manner that improves our overall business and operating results.

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

We believe that commercial insurance coverage is prudent in certain areas for risk management. Insurance costs may increase substantially in the future and may be affected by natural catastrophes, fear of terrorism and financial irregularities and other fraud at publicly-traded companies. In addition, for certain types or levels of risk, such as risks associated with earthquakes, hurricanes or terrorist attacks, we may determine that we cannot obtain commercial insurance at acceptable prices, if at all. Therefore, we may choose to forego or limit our purchase of relevant commercial insurance, choosing instead to self-insure one or more types or levels of risks. We are primarily self-insured for workers compensation, employee health benefits and product and general liability claims. If we suffer a substantial loss that is not covered by commercial insurance or our self-insurance reserves, the loss and attendant expenses could harm our business and operating results. In addition, exposures exist for which no insurance may be available and for which we have not reserved.

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

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

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

We are involved in lawsuits, claims and proceedings incident to the ordinary course of our business. Litigation is inherently unpredictable. Any claims against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources. There are an increasing number of cases being filed against companies generally, including a growing number of business method patent infringement lawsuits. The plaintiff in each case claims to hold a patent that covers certain technology or methodologies, which are allegedly infringed by the operation of the defendants' business. We are currently a defendant in such patent infringement cases and may be named in others in the future, as part of an industry-wide trend. There has also been a rise in lawsuits against companies like us that collect personal information from customers. The cost of defending such claims or the ultimate resolution of such claims may harm our business and operating results.

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

To be successful, we need to manage our operating costs and continue to look for opportunities to reduce costs. We recognize that we may need to increase the number of our employees, especially during peak sales seasons, and incur other expenses to support new brands and brand extensions, as well as the opening of new stores and direct-to-customer growth of our existing brands. From time to time, we may also experience union organizing activity in currently non-union facilities. Union organizing activity may result in work slowdowns or stoppages and higher labor costs. In addition, there appears to be a growing number of wage-and-hour lawsuits against retail companies, especially in California.

We contract with various agencies to provide us with qualified personnel for our workforce. Any negative publicity regarding these agencies, such as in connection with immigration issues or employment practices, could damage our reputation, disrupt our ability to obtain needed labor or result in financial harm to our business, including the potential loss of business-related financial incentives in the jurisdictions where we operate.

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

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

Our success depends, in part, on our ability to source and distribute merchandise efficiently through appropriate systems and procedures. We are in the process of substantially modifying our information technology systems,

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including design, sourcing, merchandise planning and forecasting, purchase order and inventory management, customer order management, and pricing and promotions management. Modifications will involve updating or replacing legacy systems with successor systems during the course of several years. There are inherent risks associated with replacing our core systems, including supply chain and merchandising systems disruptions that affect our ability to get the correct products into the appropriate stores and delivered to customers. We may not successfully launch these new systems, or the launch of such systems may result in disruptions to our business operations. In addition, changes to any of our software implementation strategies could result in the impairment of software-related assets. We are also subject to the risks associated with the ability of our vendors to provide information technology solutions to meet our needs. Any disruptions could negatively impact our business and operating results.

*We outsource certain aspects of our business to third party vendors that subject us to risks, including disruptions in our business and increased costs.*

We outsource certain aspects of our business to third party vendors that subject us to risks of disruptions in our business as well as increased costs. For example, we have engaged IBM to host and manage certain aspects of our data center information technology infrastructure. Accordingly, we are subject to the risks associated with IBM's ability to provide information technology services to meet our needs. Our operations will depend significantly upon our ability to make our servers, software applications and websites available and to protect our data from damage or interruption from human error, computer viruses, intentional acts of vandalism, labor disputes, natural disasters and similar events. If the cost of IBM hosting and managing certain aspects of our data center information technology infrastructure is more than expected, or if IBM or we are unable to adequately protect our data and information is lost or our ability to deliver our services is interrupted, then our business and operating results may be negatively impacted.

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

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

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

Our quarterly results have fluctuated in the past and may fluctuate in the future, depending upon a variety of factors, including shifts in the timing of holiday selling seasons, including Valentine's Day, Easter, Halloween, Thanksgiving and Christmas. A significant portion of our revenues and net earnings has been realized during the period from October through December each year. In anticipation of increased holiday sales activity, we incur certain significant incremental expenses prior to and during peak selling seasons, particularly October through December, including fixed catalog production and mailing costs and the costs associated with hiring a substantial number of temporary employees to supplement our existing workforce. If, for any reason, we were to realize significantly lower-than-expected revenues or net earnings during the October through December selling season or during any of our other holiday selling seasons, our business and operating results would be harmed.

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*We may require external funding sources for operating funds, which may cost more than we expect and negatively impact our expenses and operating results.*

We regularly review and evaluate our liquidity and capital needs. We currently believe that our available cash, cash equivalents, cash flow from operations and cash available under our existing credit facilities will be sufficient to finance our operations and expected capital requirements for at least the next 12 months. However, as we continue to grow, we might experience peak periods for our cash needs during the course of our fiscal year, and we might need additional external funding to support our operations. Although we believe we would have access to additional debt and/or capital market funding if needed, such funds may not be available to us on acceptable terms. If the cost of such funds is greater than expected, it could adversely affect our expenses and our operating results.

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

In January 2008, the Board of Directors authorized the repurchase of up to \$150,000,000 of the company's common stock. In March 2008, our Board of Directors authorized an increase in our quarterly cash dividend from \$0.115 to \$0.12 per common share. The share repurchase and dividend programs require the use of a significant portion of our cash earnings. As a result, we may not retain a sufficient amount of cash to finance growth opportunities, new product development initiatives and unanticipated capital expenditures or to fund our operations. Our Board of Directors may, at its discretion, decrease the intended level of dividends or entirely discontinue the payment of dividends at any time. The stock repurchase program does not have an expiration date and may be limited or terminated at any time. Our ability to pay dividends and repurchase shares will depend on our ability to generate sufficient cash flows from operations in the future. This ability may be subject to certain economic, financial, competitive and other factors that are beyond our control. Any failure to pay dividends or repurchase shares after we have announced our intention to do so may negatively impact our reputation and investor confidence in us and negatively impact our stock price.

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

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

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

Changes to existing accounting rules or regulations may impact our future operating results. For example, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, which we adopted on January 29, 2007. The adoption of FIN 48 resulted in the recognition of an \$11,684,000 increase in the liability for tax contingencies, which was accounted for as a reduction to retained earnings, and had an approximate net 40 basis point negative impact on our effective tax rate in fiscal 2007. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective. Other new accounting rules or regulations and varying interpretations of existing accounting rules or regulations have occurred and may occur.

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in the future. Future changes to accounting rules or regulations or the questioning of current accounting practices may adversely affect our operating results.

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

We make certain estimates and projections in connection with impairment analyses for certain of our store locations and other property and equipment in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. For example, we review for impairment all stores for which current cash flows from operations are either negative or nominal, or the construction costs are significantly in excess of the amount originally expected. An impairment charge is required when the carrying value of the asset exceeds the undiscounted future cash flows over the life of the lease. These calculations require us to make a number of estimates and projections of future results, often up to 20 years into the future. If these estimates or projections change or prove incorrect, we may be, and have been, required to record impairment charges on certain store locations and other property and equipment. If these impairment charges are significant, our operating results would be adversely affected.

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

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

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

We are subject to income taxes in many U.S. and certain foreign jurisdictions. We record tax expense based on our estimates of future payments, which include reserves for estimates of probable settlements of foreign and domestic tax audits. At any one time, many tax years are subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. As a result, we expect that throughout the year there could be on-going variability in our quarterly tax rates as taxable events occur and exposures are evaluated. Further, our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings or by changes to existing accounting rules or regulations. For example, the adoption of FIN 48 had an approximate net 40 basis point negative impact on our effective tax rate in fiscal 2007.

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

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

In addition, our main offices are located in the San Francisco Bay Area, where competition for personnel with retail and technology skills is intense. If we fail to identify, attract, retain and motivate these skilled personnel, our business may be harmed. Further, in the event we need to hire additional personnel, we may experience

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difficulties in attracting and successfully hiring such individuals due to significant competition for highly skilled personnel in our market.

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

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

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

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

Information required by this Item is contained in the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the heading "Stock Repurchase Program" within Part I of this Form 10-Q.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Our Annual Meeting of Shareholders was held on June 11, 2008. At this meeting, the shareholders took the following actions:

(I) The shareholders elected each of the following persons by the vote indicated to serve as a member of our Board of Directors until the next Annual Meeting of Shareholders or until his successor is elected and qualified:

<b>Name</b>	<b>For</b>	<b>Withheld</b>
W. Howard Lester	98,007,995	852,084
Adrian D.P. Bellamy	97,975,950	884,129
Patrick J. Connolly	98,559,010	301,069
Adrian T. Dillon	98,558,280	301,799
Anthony A. Greener	98,497,282	362,797
Ted W. Hall	98,554,636	305,443
Michael R. Lynch	98,523,804	336,275
Richard T. Robertson	98,559,005	301,074
David B. Zenoff	98,503,710	356,369

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(II) The shareholders ratified, by the vote indicated, the selection of Deloitte & Touche LLP as our independent registered public accounting firm for the fiscal year ending February 1, 2009:

<b>For</b>	<b>Against</b>	<b>Abstain</b>	<b>Broker Non-Vote</b>
98,257,737	585,213	17,129	0

(III) The shareholders approved, by the vote indicated, the Equity Award Exchange Program:

<b>For</b>	<b>Against</b>	<b>Abstain</b>	<b>Broker Non-Vote</b>
62,278,110	18,849,848	103,315	17,628,806

**ITEM 6. EXHIBITS**

(a) Exhibits

<b>Exhibit Number</b>	<b>Exhibit Description</b>
10.1	Amended and Restated Williams-Sonoma, Inc. 2001 Long-Term Incentive Plan
10.2	Aircraft Sale Agreements between the Company and Aero Toy Store, Inc. dated May 13, 2008 and May 16, 2008
10.3	Aircraft Lease Agreement between WHL Management LLC and the Company dated May 16, 2008
31.1	Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.2	Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
32.1	Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



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**SIGNATURE**

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

WILLIAMS-SONOMA, INC.

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

Date: September 12, 2008