

Zumiez Inc  
Form 10-Q  
June 01, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C.

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MAY 5, 2007**

OR

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

Commission file number 000-51300

**ZUMIEZ INC.**

(Exact name of registrant as specified in its charter)

**Washington**  
(State or other jurisdiction of  
incorporation or organization)

**91-1040022**  
(I.R.S. Employer Identification No.)

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

(Address of principal executive offices) (Zip Code)

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Number of shares of Common Stock outstanding as of June 1, 2007 was 28,381,694 shares.



ZUMIEZ INC.

FORM 10-Q

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

	May 5, 2007	February 3, 2007
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 5,827	\$ 8,161
Marketable Securities	32,144	43,816
Receivables	10,980	5,223
Inventory	50,285	42,157
Prepaid expenses and other	3,603	3,593
Deferred tax assets	1,619	1,551
<b>Total current assets</b>	<b>104,458</b>	<b>104,501</b>
Leasehold improvements and equipment, net	55,474	49,889
Goodwill	12,904	12,904
<b>Total long-term assets</b>	<b>68,378</b>	<b>62,793</b>
<b>Total assets</b>	<b>\$ 172,836</b>	<b>\$ 167,294</b>
<b>Liabilities and Shareholders Equity</b>		
<b>Current liabilities</b>		
Trade accounts payable	\$ 28,430	\$ 24,164
Book overdraft	2,756	6,083
Accrued payroll and payroll taxes	3,750	4,784
Income taxes payable		6,598
Current portion of deferred rent and tenant allowances	1,584	1,377
Other accrued liabilities	6,227	6,566
<b>Total current liabilities</b>	<b>42,747</b>	<b>49,572</b>
Long-term deferred rent and tenant allowances, less current portion	14,084	12,069
Deferred tax liabilities	227	841
<b>Total long-term liabilities</b>	<b>14,311</b>	<b>12,910</b>
Commitments and contingencies		
<b>Shareholders equity</b>		
Preferred stock, no par value, 40,000,000 shares authorized; none issued and outstanding		
Common stock, no par value, 100,000,000 shares authorized; 28,381,694 shares issued and outstanding at May 5, 2007 and 27,880,512 shares issued and outstanding at February 3, 2007.	54,657	45,311
Accumulated other comprehensive loss	(11	) (14
Retained earnings	61,132	59,515
<b>Total shareholders equity</b>	<b>115,778</b>	<b>104,812</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 172,836</b>	<b>\$ 167,294</b>

See accompanying notes to condensed consolidated financial statements

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

	<b>Three Months Ended</b>	
	<b>May 5, 2007</b>	<b>April 29, 2006</b>
Net sales	\$ 68,791	\$ 47,785
Cost of goods sold	46,976	32,519
<b>Gross profit</b>	<b>21,815</b>	<b>15,266</b>
Selling, general and administrative expenses	19,632	13,796
<b>Operating profit</b>	<b>2,183</b>	<b>1,470</b>
Interest income, net	426	352
Other income (expense), net	(1 )	
<b>Earnings before income taxes</b>	<b>2,608</b>	<b>1,822</b>
Provision for income taxes	991	713
<b>Net income</b>	<b>\$ 1,617</b>	<b>\$ 1,109</b>
Basic net income per share	\$ 0.06	\$ 0.04
Diluted net income per share	\$ 0.06	\$ 0.04
Weighted average shares outstanding, Basic	27,975,278	27,272,799
Weighted average shares outstanding, Diluted	29,008,312	28,631,942

See accompanying notes to condensed consolidated financial statements

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

	Common Stock Shares	Amount	Other Comprehensive Loss	Retained Earnings	Total
<b>Balance at February 3, 2007</b>	27,881	\$ 45,311	\$ (14 )	\$ 59,515	\$ 104,812
Common shares issued including tax benefit of \$7,247	501	8,539			8,539
Stock-based compensation expense		807			807
Unrealized gains, net			3		3
Net income				1,617	1,617
<b>Balance at May 5, 2007</b>	28,382	\$ 54,657	\$ (11 )	\$ 61,132	\$ 115,778

See accompanying notes to condensed consolidated financial statements

**ZUMIEZ INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(Unaudited)

	Three Months Ended May 5, 2007	April 29, 2006
<b>Cash flows from operating activities</b>		
Net income	\$ 1,617	\$ 1,109
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	3,220	2,259
Deferred tax benefit	(682 )	(436 )
Stock compensation expense	807	337
Loss on disposal of fixed assets	11	1
Excess tax benefit from stock options	(7,247 )	(972 )
Changes in operating assets and liabilities		
Receivables	(5,757 )	(123 )
Inventory	(6,331 )	(8,370 )
Prepaid expenses and other	(10 )	375
Trade accounts payable	2,469	3,371
Accrued payroll and payroll taxes	(1,034 )	(1,077 )
Income taxes payable	649	(2,266 )
Other accrued liabilities	(338 )	2,981
Deferred rent	(352 )	19
<b>Net cash used in operating activities</b>	<b>(12,978 )</b>	<b>(2,792 )</b>
<b>Cash flows from investing activities</b>		
Additions to leasehold improvements and equipment	(6,197 )	(3,546 )
Purchases of marketable securities	(24,876 )	(36,242 )
Sales and maturities of marketable securities	36,506	38,201
<b>Net cash provided by (used in) investing activities</b>	<b>5,433</b>	<b>(1,587 )</b>
<b>Cash flows from financing activities</b>		
Change in book overdraft	(3,327 )	
Proceeds from exercise of stock options	1,291	440
Excess tax benefit from stock options	7,247	972
<b>Net cash provided by financing activities</b>	<b>5,211</b>	<b>1,412</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(2,334 )</b>	<b>(2,967 )</b>
<b>Cash and cash equivalents, Beginning of period</b>	<b>8,161</b>	<b>4,737</b>
<b>Cash and cash equivalents, End of period</b>	<b>\$ 5,827</b>	<b>\$ 1,770</b>
<b>Supplemental disclosure of cash flow information</b>		
Cash paid during the period for interest	\$ 1	\$
Cash paid during the period for income taxes	7,020	3,497

See accompanying notes to condensed consolidated financial statements

ZUMIEZ INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the condensed consolidated balance sheet as of May 5, 2007, the condensed consolidated statement of operations for the three-months ended May 5, 2007 and April 29, 2006, and the condensed consolidated statement of cash flows for the three-months ended May 5, 2007 and April 29, 2006.

The financial data at February 3, 2007 is derived from audited financial statements which are included in the Company's Annual Report on Form 10-K for the year ended February 3, 2007, and should be read in conjunction with the audited financial statements and notes thereto. Interim results are not necessarily indicative of results for the full year.

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

**Reclassifications** Certain prior-period balances may have been reclassified to conform to the current period presentation. These reclassifications had no impact on revenue, net income (loss), assets or liabilities in either period presented.

**Use of Estimates** The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. These estimates can also affect supplemental information disclosed by the Company, including information about contingencies, risk, and financial condition. In preparing the financial statements, the Company makes routine estimates and judgments in determining the net realizable value of accounts receivable, inventory, fixed assets, and prepaid assets. Some of the more significant estimates include the allowance for sales returns, the reserve for inventory valuation estimates and the expected useful lives of fixed assets. Actual results could differ from those estimates. The results of operations for the three months ending May 5, 2007 are not necessarily indicative of the results that might be expected for fiscal 2007. For further information, refer to the Company's financial statements and notes included in the Company's Form 10-K filed on March 27, 2007.

**Nature of Business** The Company is a leading specialty retailer of action sports related apparel, footwear, equipment and accessories operating under the Zumiez brand name. As of May 5, 2007, the Company operated 254 stores primarily located in shopping malls, giving the Company a presence in 25 states. The Company's stores cater to young men and women between the ages of 12 and 24 who seek brands representing a lifestyle centered on activities that include skateboarding, surfing, snowboarding, bicycle motocross (or BMX ) and motocross. The Company supports the action sports lifestyle and promotes its brand through a multi-faceted marketing approach that is designed to integrate its brand image with its customers' interests. In addition, the Company operates a website which sells merchandise online and provides content and a community for its target customers. The Company, based in Everett, WA, was formed in August 1978 and operates within one reportable segment.



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**Fiscal Year** The Company uses a fiscal calendar widely used by the retail industry which results in a fiscal year consisting of a 52- or 53- week period ending on the Saturday closest to January 31. Each fiscal year consists of four 13-week quarters, with an extra week added to the fourth quarter every five or six years. Fiscal 2006 was the 53-week period ended February 3, 2007. The first three months of fiscal 2007 was the 13-week period ended May 5, 2007. The first three months of fiscal 2006 was the 13-week period ended April 29, 2006. Fiscal 2007 is the 52-week period ending February 2, 2008.

**Stock Split** On April 14, 2005, the Company's Board of Directors and shareholders approved an amendment to the Company's Certificate of Incorporation to effect a 1 for 258.6485 split of the Company's common stock (the Stock Split). The Stock Split became effective on April 20, 2005. All reference to shares in the financial statements and the accompanying notes, including but not limited to the number of shares and per share amounts, unless otherwise noted, have been adjusted to reflect the Stock Split on a retroactive basis. Previously awarded stock options in the Company's common stock have been retroactively adjusted to reflect the Stock Split. On March 15, 2006, the Company's Board of Directors approved a two for one stock split of the Company's common stock that was affected by a share dividend and became effective April 19, 2006. All reference to shares in the financial statements and the accompanying notes, including but not limited to the number of shares and per share amounts, unless otherwise noted, have been adjusted to reflect the stock split on a retroactive basis. Previously awarded stock options in the Company's common stock have been retroactively adjusted to reflect the stock split.

**Reincorporation** On April 29, 2005, the Company reincorporated in the State of Washington from the State of Delaware. In

connection with the reincorporation, the Company filed new articles of incorporation and adopted new bylaws. The new articles of incorporation changed the Company's common stock from \$0.01 par value per share to no par value per share and increased the Company's authorized capital stock.

**Initial Public Offering** In May 2005, the Company completed an initial public offering of its common stock in which the Company sold 3,750,000 shares and the Company's selling shareholders sold 3,437,500 shares. Net proceeds from the offering received by the Company totaled approximately \$29.2 million, after payment of underwriters' commissions and offering expenses. The Company did not receive any of the proceeds from the sale of shares of its common stock by the selling shareholders. Prior to this initial public offering, the Company was a majority owned subsidiary of Zumiez Holdings LLC (the "Parent"), a holding company with no operating activities.

## 2. Summary of Significant Accounting Policies

Information regarding the Company's significant accounting policies is contained in Note 2, "Summary of Significant Accounting Policies," to the financial statements in the Company's Form 10-K filed on March 27, 2007. Presented below in this and the following notes is supplemental information that should be read in conjunction with "Notes to Financial Statements" in that annual report.

**Marketable Securities** At May 5, 2007, marketable securities, classified as available for sale, were \$32.1 million and consisted of municipal and U.S. agency debt instruments with original maturities over 90 days. The portfolio is carried at market value with net unrealized gains and losses recorded as other comprehensive income (loss).

**Stock Compensation** Effective January 29, 2006 the Company adopted the fair value method of accounting for stock-based compensation arrangements in accordance with Financial Accounting Standards Board ("FASB") Statement No. 123(R), *Share-Based Payment* ("SFAS No. 123(R)"), using the modified prospective method of transition. Under the provisions of SFAS No. 123(R), the estimated fair value of share based awards granted under the 2005 Stock Incentive Plan is recognized as compensation expense over the vesting period. Using the modified prospective method, compensation expense is recognized beginning with the effective date of adoption of SFAS No. 123(R) for all share based payments (i) granted after the effective date of adoption and (ii) granted prior to the effective date of adoption and after the Company's initial public offering on May 5, 2005.

Prior to January 29, 2006, the Company accounted for stock-based employee compensation plans using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), and its related interpretations. Under the provisions of APB 25, no compensation expense was recognized when stock options were granted with exercise prices equal to or greater than market value on the date of grant. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the valuation techniques previously utilized for options in footnote disclosures required under SFAS No. 123, *Accounting for Stock Based Compensation*. The expected option term is estimated using "SAB 107 Simplified Method for Estimating Expected Term" for plain vanilla options. The expected volatility of the Company's stock price is based upon the historical volatility of our stock from the initial public offering date of May 5, 2005 through the end of our most recent fiscal year ended February 3, 2007. The risk-free interest rate is based upon the current yield on U.S. Treasury securities having a term similar to the expected option term. Dividend yield is estimated at zero because the Company does not anticipate paying dividends in the foreseeable future.

The fair values of the options granted after the effective date were estimated using the Black-Scholes valuation model with the assumptions from the table below:

	<b>Quarter Ended May 5, 2007</b>	
Dividend yield		%
Volatility rate	37.00	%
Forfeiture rate	10.00	%
Average expected life (in years):		
Expected lives - Eight years	6.38	
Expected lives - Five years	6.00	
Average risk-free interest rate:	4.43	%

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The following table summarizes the Company's stock option activity for the quarter ended May 5, 2007 (in thousands except weighted-average exercise price):

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	Number of Options	Weighted-Average Exercise Price
Options outstanding at February 3, 2007	2,675	\$ 6.76
Options granted during the quarter	384	35.85
Options exercised during the quarter	(501 )	1.80
Options forfeited during the quarter	(101 )	13.12
Options outstanding at May 5, 2007	2,457	12.00
Options exercisable at May 5, 2007	766	3.34

The Company recorded \$806,665 and \$337,104 of total stock-based compensation expense for the three-month periods ended May 5, 2007 and April 29, 2006, respectively, of which \$127,759 and \$0 was attributable to the Board of Directors as required by the provisions of SFAS No. 123(R). The stock-based compensation expense is calculated on an accelerated method over the vesting periods of the related options. This charge had no impact on the Company's reported cash flows. For both of the three-month periods ended April 29, 2006 and May 5, 2007, the Company recorded approximately \$41,000 in stock compensation expense pursuant to APB 25. Under the modified prospective method of transition under SFAS No. 123(R), the Company is not required to restate its prior period financial statements to reflect expensing of share-based compensation under SFAS No. 123(R). At May 5, 2007 and February 3, 2007, there was approximately \$9.4 million and \$ 4.6 million, respectively, of total unrecognized compensation cost related to unvested stock options of which \$414,856 and \$542,615, respectively, was attributable to the Board of Directors. This cost is expected to be recognized over a weighted-average period of approximately eight years.

The Company accounts for unvested stock-based employee compensation arrangements granted prior to the initial public offering on the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion ( APB ) No. 25, Accounting for Stock Issued to Employees and related amendments and interpretations. For these awards, the Company complies with the disclosure provisions of Statement of Financial Accounting Standards No. 123 ( SFAS 123 ), Accounting for Stock-Based Compensation.

If the computed fair values of the awards had been amortized to expense over the vesting period of the awards, pro forma net income (loss) and net income (loss) per share would have been reduced to the pro forma amounts indicated in the following table (in thousands, except per share amounts):

	For the Three Months Ended	
	May 5, 2007	April 29, 2006
Net income, as reported	\$ 1,617	\$ 1,109
Add: Stock-based compensation expense, as reported, net of tax	500	205
Deduct: Stock-based employee compensation expense determined under fair-value-based method, net of tax	(531 )	(237 )
Pro forma net income	1,586	1,077
Net income per share:		
Basic-as reported	\$ 0.06	\$ 0.04
Basic pro forma	\$ 0.06	\$ 0.04
Diluted as reported	\$ 0.06	\$ 0.04
Diluted pro forma	\$ 0.06	\$ 0.04

**Goodwill** In accordance with Statement of Financial Accounting Standards No. 142, *Accounting for Goodwill and Other Intangible Assets* ( SFAS No. 142 ), the Company does not amortize goodwill derived from purchase business combinations. The Company evaluates the recoverability of goodwill annually based on a two-step impairment test. The first step compares the fair value of each reporting unit with its carrying amount, including goodwill. If the carrying amount exceeds fair value, then the second step of the impairment test is performed to measure the amount of any impairment loss. Additional impairment assessments may be performed on an interim basis if the Company encounters events or changes in circumstances that would indicate that, more likely than not, the book value of goodwill has been impaired. There was no impairment of Goodwill in the 2006 fiscal year or for the fiscal quarter ended May 5, 2007.

**Recent accounting pronouncements** In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, *Inventory Costs an Amendment of ARB No. 43, Chapter 4*. This statement clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and spoilage, requiring these items be recognized as current-period charges. In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement are effective for inventory costs incurred during fiscal years beginning after June 15, 2005 and became effective for the Company beginning in fiscal 2006. The effect of adopting this statement has not been significant to the Company's financial position and results of operations.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*.

This Statement requires retrospective application to prior periods financial statements of changes in accounting principle. The provisions of this statement became effective for fiscal periods beginning after December 15, 2005. The standard dictates that changes in accounting principle that are a result of a new pronouncement shall be subject to the reporting provisions of that pronouncement if they exist.

In June 2005 EITF 05-6, *Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination*, was ratified by the FASB. The EITF reached a consensus on two issues, that leasehold improvements acquired in a business combination should be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date of acquisition, and that leasehold improvements that are placed in service significantly after and not contemplated at or near the beginning of the lease term should be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date the leasehold improvements are purchased. The consensus should be applied to leasehold improvements that are purchased or acquired in reporting periods beginning after the FASB ratification on June 29, 2005. On September 28, 2005 the FASB ratified a modification to clarify that the application does not apply to preexisting leasehold improvements. The Company amortizes leasehold improvements per the guidance set forth in this consensus.

In June 2006, the FASB issued Interpretation ( FIN ) No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes ( FIN 48 )*, on January 1, 2007. The adoption of FIN No. 48 did not have a material effect on the Company’s consolidated financial position or results of operations for the quarter ended May 5, 2007.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company does not expect the adoption of SFAS No. 157 to have a material effect on the Company’s consolidated financial position or results of operations.

In September 2006 The SEC released Staff Accounting Bulletin ( SAB ) No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*. SAB 108 provides guidance on how the effects of the carryover or reversal of prior year financial statement misstatements should be considered in quantifying a current year misstatement. The Company adopted the guidance in SAB 108 beginning in the fourth quarter of fiscal year 2006. The adoption of SAB 108 did not have a material impact on the Company’s consolidated financial position or consolidated results of operations for the quarter ended May 5, 2007.

In June 2006 EITF 06-3 *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement*, was ratified by the FASB. The EITF reached a consensus on how taxes assessed by a governmental authority should be presented on the income statement. The EITF reached a consensus that the disclosures required under this Issue should be applied retrospectively to interim and annual financial statements for all periods presented, if those amounts are significant. Other wise the consensuses in this issue should be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006. The Company believes that EITF 06-3 did not have a material impact on the Company’s consolidated financial position or results of operations for the fiscal quarter ended May 5, 2007.

### 3. Commitments and Contingencies

**Leases** The Company is committed under operating leases for its entire retail store locations. In addition to minimum future lease payments, all store leases provide for additional rental payments based on sales, as well as common area maintenance charges. Total rent expense, base rent and contingent rent for the three month periods ended May 5, 2007 and April 29, 2006 (in thousands) are as follows:

	<b>Three Months Ended</b>	
	<b>May 5, 2007</b>	<b>April 29, 2006</b>
Base Rent Expense	\$ 5,704	\$ 3,462
Contingent Rent Expense	3,620	2,495
Total Rent Expense	\$ 9,324	\$ 5,957

**Litigation** The Company is involved from time to time in litigation incidental to its business and the Company may make provisions for potential litigation losses relating thereto. The Company follows SFAS 5, *Accounting for*

*Contingencies* when assessing pending or potential litigation. Management believes, after considering a number of factors and the nature of the contingencies to which the Company is subject, that the outcome of these contingencies will not have a material adverse effect upon the results of operations or financial condition of the Company.

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**Insurance Reserves** The Company is responsible for medical insurance claims up to a specified aggregate amount. The Company maintains a reserve for estimated medical insurance claims based on historical claims experience and other estimated assumptions. The Company follows SFAS 5, *Accounting for Contingencies* when assessing pending or potential claims.

**4. Net Income Per Share, Basic and Diluted** The Company calculates net income per share in accordance with SFAS No. 128, *Earnings Per Share*, as amended by SFAS No. 123(R). Basic net income per share is based on the weighted average number of common shares outstanding during the period. Diluted net income per share is based on the weighted average number of common shares and common share equivalents outstanding during the period. Common share equivalents included in the computation represent shares issuable upon assumed exercise of outstanding stock options. Potentially anti-dilutive securities not included in the calculation of diluted earnings per share include options to purchase common stock where the option exercise price is greater than the average market price of the Company's common stock. There were no potentially anti-dilutive shares of common stock for three months ended May 5, 2007 and April 29, 2006, respectively.

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

	<b>Three Months Ended</b>	
	<b>May 5, 2007</b>	<b>April 29, 2006</b>
Net income	\$ 1,617	\$ 1,109
Weighted average common shares for basic net income per share	27,975,278	27,272,799
Dilutive effect of stock options	1,033,034	1,359,143
Weighted average common shares for diluted net income per share	29,008,312	28,631,942
Basic net income per share	\$ 0.06	\$ 0.04
Diluted net income per share	\$ 0.06	\$ 0.04

**5. Goodwill** In connection with the acquisition of Fast Forward on June 24, 2006 the Company recorded goodwill in accordance with SFAS 141 *Business Combinations*. The Company recorded \$12.9 million of goodwill as the excess of the purchase price of \$15.3 million over the fair value of the net amounts assigned to assets acquired and liabilities assumed. In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, the Company will continue to assess, in accordance with our Goodwill policy as stated in Note 2, whether goodwill is impaired.

#### 7. Business Acquisitions

In June, 2006, we completed the acquisition of 100% of the ownership of Action Concepts Fast Forward, Ltd. (a limited partnership) (Fast Forward), an apparel and accessory retail sales company which operated 20 stores (17 in Texas, 2 in Oklahoma and 1 in California). The ability to expand operations into Texas with a full complement of stores at one time was the primary reason for the acquisition. Total costs of the acquisition were \$15.3 million and were paid in cash plus assumption of liabilities. The Company completed an independent appraisal to determine the final allocation of the purchase price. The following table summarizes the allocation of fair values of the assets acquired and liabilities assumed (in thousands):

Cash in stores	\$ 15
Prepaid expenses	143
Other current assets	168
Merchandise inventory	4,227
Property & equipment	1,819
Goodwill	12,904
Checks drawn in excess of bank balance	(608)
Accounts payable	(1,712)
Short-term debt	(732)
Other current liabilities	(957)
Fair value of net assets acquired, including Goodwill	\$ 15,267



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The transaction was accounted for under the purchase method of accounting and, accordingly, the purchased assets and assumed liabilities were recorded at their estimated fair values. The preliminary purchase price allocation resulted in an excess of purchase

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price over net tangible assets acquired of \$12.9 million. All of the excess of purchase price over net tangible assets acquired was attributed to goodwill, which is not subject to amortization for book purposes. The Company will amortize the goodwill for tax purposes utilizing the 338(h)(10) Federal tax code election. At May 5, 2007, \$250,000 was held in escrow and due for payment to either the Company or the ownership of Action Concepts Fast Forward, Ltd. dependent on future claims. This amount has not been reflected in the purchase price of the related acquisition, but will be reflected in the allocable cost of the acquisition at the time of determination of the contingencies and ultimate distribution to the sellers in accordance with Paragraph 46 of SFAS 141, Business Combinations.

The condensed consolidated statement of operations for the period ended May 5, 2007, includes the operating results of Fast Forward from the quarter then ended. The following summarized unaudited pro forma information (in thousands) assumes the acquisition of Fast Forward had occurred at the beginning of the period presented. The pro forma information does not purport to indicate what would have occurred had the acquisition been made at the beginning of the period presented, nor of the results which may occur in the future.

Pro Forma Information (Unaudited)	For the Three Month Period Ended	
	May 5, 2007	April 29, 2006
Net Sales	\$ 68,791	\$ 53,213
Net Income	1,617	677
Basic Earnings Per Share	\$ 0.06	\$ 0.02
Diluted Earnings Per Share	\$ 0.06	\$ 0.02

The Company incurred transaction expenses of approximately \$663,000 related to the employee severance and transition expense of the acquisition. To date, this amount has been paid in full. In addition, the company has a reserve of \$117,000 as of May 5, 2007 for the potential clearance of discontinued merchandise from Fast Forward locations and raw materials that may not be consumed. These costs were accounted for under Emerging Issues Task Force (EITF) 95-3 *Recognition of Liabilities in Connection with a Purchase Business Combination*.

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

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this quarterly report. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those discussed in the section entitled Risk Factors in our Form 10-K filed with the SEC on March 27, 2007 and in this Form 10-Q.*

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

## **Overview**

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

In May 2005, we completed an initial public offering of our common stock in which we sold 3,750,000 shares and our selling shareholders sold 3,437,500 shares. Net proceeds received by us from the offering totaled approximately \$29.2 million, after payment of underwriters' commissions and offering expenses. We did not receive any of the proceeds from the sale of shares of our common stock by the selling shareholders.

In November 2005, a secondary public offering of 5,462,500 shares of our common stock was completed by certain of our shareholders. We did not receive any of the proceeds from the offering.

In June 2006, a secondary public offering of 1,609,090 shares of common stock was completed by certain of our shareholders. We did not receive any of the proceeds from the offering.

In June, 2006, we completed the acquisition of 100% of the ownership of Action Concepts Fast Forward, Ltd. (a limited partnership) (Fast Forward), an apparel and accessory retail sales company which operated 20 stores (17 in Texas, 2 in Oklahoma and 1 in California). The ability to expand operations into Texas with a full complement of stores at one time was the primary reason for the acquisition.

## **General**

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

We report comparable store sales based on net sales, and stores are included in our comparable store sales beginning on the first anniversary of their first day of operation. Changes in our comparable store sales between two periods are based on net sales of stores which were in operation during both of the two periods being compared and, if a store is included in the calculation of comparable store sales for only a portion of one of the two periods being compared, then that store is included in the calculation for only the comparable portion of the other period. When additional square footage is added to a store that is included in comparable store sales, the store remains in comparable store sales. The 20 stores that we recently acquired in the Fast Forward transaction are being treated as new stores and will move into our comparable store base according to our current reporting method, and will be a comparable store on the first anniversary of the acquisition date, June 24, 2007. There may be variations in the way in which some of our competitors and other apparel retailers calculate comparable or same store sales. As a result, data regarding our comparable store sales may not be comparable to similar data made available by our competitors or other retailers.

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

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

## **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in conformity with generally accepted accounting principles in the United States (GAAP). In preparing financial statements in accordance with GAAP, we are required to make estimates and assumptions that have an impact on the assets, liabilities, revenue and expense amounts reported. These estimates can also affect supplemental information disclosed by us, including information about contingencies, risk, and financial condition. We believe, given current facts and circumstances that our estimates and assumptions are reasonable, adhere to GAAP, and are consistently applied. Inherent in the nature of an estimate or assumption is the fact that actual results may differ from estimates and estimates

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may vary as new facts and circumstances arise. In preparing the financial statements, we make routine estimates and judgments in determining the net realizable value of accounts receivable, inventory, fixed assets, and prepaid expenses. We believe our most critical accounting estimates and assumptions are in the following areas:

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

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upwards based on actual sales experience.

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

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

*Impairment of Long-Lived Assets.* We account for long-lived assets in accordance with the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is determined by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered impaired, the impairment recognized is measured by comparing projected individual store discounted cash flow to the asset carrying values. Declines in projected store cash flow could result in the impairment of assets.

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

Significant management judgment is required in determining the provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against net deferred tax assets. Based on our history of operating earnings, no valuation allowance has been recorded as of May 5, 2007. In the event that actual results differ from these estimates, or these estimates are adjusted in future periods, a valuation allowance may need to be established, which could impact our financial position and results of operations. As described in Note 2 to the financial statements, *Recent Accounting Pronouncements* the Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), on January 1, 2007. The adoption of FIN No. 48 did not have a material effect on the Company's consolidated financial position or results of operations for the period ended May 5, 2007.

Provisions for income taxes are based on numerous factors that are subject to audit by the Internal Revenue Service and the tax authorities in the various jurisdictions in which we do business.

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

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Prior to January 29, 2006, we accounted for stock-based employee compensation plans using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and its related interpretations. Under the provisions of APB 25, no compensation expense was recognized when stock options were granted with exercise prices equal to or greater than market value on the date of grant. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the valuation techniques previously utilized for options in footnote disclosures required under SFAS No. 123, *Accounting for Stock Based Compensation*. We recorded \$806,665 and \$337,104 of total stock-based compensation expense for the three month periods ended May 5, 2007 and April 29, 2006, respectively of which \$127,759 and \$0 was attributable to the Board of Directors, respectively as required by the provisions of SFAS No. 123(R). The stock-based compensation expense is calculated on an accelerated method over the vesting periods of the related options. This charge had no impact on our reported cash flows. For both of the periods ended May 5, 2007 and April 29, 2006, we recorded approximately \$41,000, respectively in stock compensation expense pursuant to APB 25. Under the modified prospective method of transition under SFAS No. 123(R), we are not required to restate its prior period financial statements to reflect expensing of share-based compensation under SFAS No. 123(R).

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At May 5, 2007 and February 3 2007, there was approximately \$9.4 million and \$4.6 million of total unrecognized compensation cost related to unvested stock options of which \$414,856 and \$524,530 was attributable to the Zumiez Board of Directors. This cost is expected to be recognized on a weighted-average basis over a period of approximately eight years.

We account for unvested stock-based employee compensation arrangements granted prior to the initial public offering on the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion ( APB ) No. 25, *Accounting for Stock Issued to Employees* and related amendments and interpretations. For these awards, we comply with the disclosure provisions of Statement of Financial Accounting Standards No. 123 ( SFAS 123 ), *Accounting for Stock-Based Compensation*.

### Results of Operations

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

	<b>Three Months Ended</b>			
	<b>May 5, 2007</b>	%	<b>April 29, 2006</b>	%
Net sales	100.0	%	100.0	%
Cost of goods sold	68.3		68.0	
Gross profit	31.7		32.0	
Selling, general and administrative expenses	28.5		28.9	
Operating profit	3.2		3.1	
Interest income, net	0.6		0.7	
Other income	0.0			
Earnings before income taxes	3.8		3.8	
Provision for income taxes	1.4		1.5	
Net income	2.4	%	2.3	%

### Three Months (13 weeks) Ended May 5, 2007 Compared With Three Months (13 weeks) Ended April 29, 2006

#### *Net Sales*

Net sales increased to \$68.8 million for the three months ended May 5, 2007 from \$47.8 million for the three months ended April 29, 2006, an increase of \$21.0 million, or 44.0%. Comparable store net sales increased by 11.3% for the three months ended May 5, 2007 compared to the three months ended April 29, 2006, and 19.7% for the three months ended April 29, 2006 compared to the three months ended April 30, 2005. The increase in total net sales was due to an increase in comparable store net sales of approximately \$5.5 million and an increase in net sales from non-comparable stores of approximately \$15.5 million. The increase in non-comparable store net sales was primarily due to the opening of 75 new and acquired stores subsequent to April 29, 2006. The increase in comparable stores was primarily due to higher net sales of men's apparel and skate hardgoods. For information as to how we define comparable stores, see *General* above.

#### *Gross Profit*

Gross profit for the three months ended May 5, 2007 was \$21.8 million compared with \$15.3 million for the three months ended April 29, 2006, an increase of \$6.5 million, or 42.9%. As a percentage of net sales, gross margin decreased to 31.7% for the three months ended May 5, 2007 from 32.0% for the three months ended April 29, 2006. The decrease in gross margin as a percentage of net sales was due to higher store occupancy costs as a result of a higher proportion of new and maturing stores and an increase in stock based compensation largely offset by improved product margins.

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

Selling, general and administrative, or SG&A, expenses in the three months ended May 5, 2007 were \$19.6 million compared with \$13.8 million in the three months ended April 29, 2006, an increase of \$5.8 million, or 42.3%. This increase was primarily the result of costs associated with operating new stores as well as increases in infrastructure and administrative staff to support our growth. As a percentage of net sales, SG&A expenses decreased to 28.5% in the three months ended May 5, 2007 from 28.9% in the three months ended April 29, 2006. The decrease in SG&A expenses as a percentage of net sales was primarily attributable to improved leverage on fixed operating expenses and store payroll, partially offset by an increase in stock based compensation expense. We expect that our SG&A expenses as a percentage of net sales will be lower in fiscal 2007 than in fiscal 2006, although there can be no assurance in this regard.

***Operating Profit***

As a result of the above factors, operating profit increased to \$2.2 million in the three months ended May 5, 2007 compared with \$1.5 million in the three months ended April 29, 2006. As a percentage of net sales, operating profit was 3.2% in the three months ended May 5, 2007 compared with 3.1% in the three months ended April 29, 2006.

***Provision for Income Taxes***

Provision for income taxes was \$1.0 million for the three months ended May 5, 2007 compared with \$0.7 million for the three months ended April 29, 2006.

***Net Income***

Net income increased to \$1.6 million in the three months ended May 5, 2007 from \$1.1 million in the three months ended April 29,



2006. As a percentage of net sales, net income was 2.4% in the three months ended May 5, 2007 compared with 2.3% in the three months ended April 29, 2006.

### Liquidity and Capital Resources

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

The Registration Statement (SEC File No. 333-122865) for our initial public offering was declared effective by the Securities and Exchange Commission on May 5, 2005. We and the selling shareholders sold 3,750,000 shares and 3,437,500 shares of common stock, respectively, in the offering at a public offering price of \$9.00 per share (on a split-adjusted basis), for aggregate gross proceeds of approximately \$33.8 million and \$30.9 million, respectively. In connection with this offering we paid underwriters' commissions of approximately \$2.4 million and incurred offering expenses of approximately \$1.7 million. After deducting the underwriters' commissions and the offering expenses, we received net proceeds of approximately \$29.2 million from the offering. We did not receive any of the proceeds from the sale of the shares offered by the selling shareholders.

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

Our capital requirements include construction and fixture costs related to the opening of new stores and for maintenance and remodeling expenditures for existing stores. Future capital requirements will depend on many factors, including the pace of new store openings, the availability of suitable locations for new stores, and the nature of arrangements negotiated with landlords. In that regard, our net investment to open a new store has varied significantly in the past due to a number of factors, including the geographic location and size of the new store, and is likely to vary significantly in the future. During fiscal 2007, we expect to spend approximately \$24.4 million on capital expenditures, a majority of which will relate to leasehold improvements and fixtures for the 50 total new stores we plan to open in fiscal 2007, and a smaller amount will relate to equipment, systems and improvements for our distribution center and support infrastructure. However, there can be no assurance that the number of stores that we actually open in fiscal 2007 will not be different from the number of stores we plan to open, or that actual fiscal 2007 capital expenditures will not differ from this expected amount.

We expect cash flows from operations and available borrowings under our revolving credit facility will be sufficient to meet our foreseeable cash requirements for operations and planned capital expenditures for at least the next twelve months. Beyond this time frame, if these sources are not sufficient to meet our capital requirements, then we will be required to obtain additional equity or debt financing in the future. There can be no assurance that equity or debt financing will be available to us when we need it or, if available, that the terms will be satisfactory to us and not dilutive to our then-current shareholders.

Net cash used in operating activities in the three months ended May 5, 2007 was \$12.7 million primarily related to an increase in inventory and receivable levels and \$1.8 million in the three months ended April 29, 2006 primarily related to an increase in inventory levels.

Net cash provided by investing activities was \$5.4 million in the three months ended May 5, 2007, related to the net sales of marketable securities partially offset by capital expenditures for new store openings and existing store renovations, and net cash used of \$1.6 million in the three months ended April 29, 2006, related to capital expenditures for new store openings and existing store renovations partially offset by net sales of marketable securities.

Net cash provided by financing activities in the three months ended May 5, 2007 was \$5.0 million, related to proceeds received from exercise of stock options and the related tax benefit partially offset by use of bank funds, and \$0.4 million in the three months ended April 29, 2006, related to proceeds received from exercise of stock options.

We have a secured revolving credit facility with Wells Fargo HSBC Trade Bank, N.A. The Credit Agreement provides us with a senior revolving credit facility through August 30, 2009 of up to \$25.0 million. This facility replaces our \$20.0 million secured revolving credit facility with Bank of America, N.A., which terminated effective August 31, 2006. The secured revolving credit facility provides for the issuance of Standby Commercial Letters of Credit in an amount not to exceed \$5.0 million outstanding at any time and with a term not to exceed 365 days, although the amount of borrowings available at any time under our revolving credit facility is reduced by the amount of Standby Letters of Credit outstanding at that time. There were no outstanding borrowings under the revolving credit facility at May 5, 2007 or February 3, 2007. The Company had open letters of credit of \$1.7 million at May 5, 2007 and \$711,049 at February 3, 2007. The revolving credit facility bears

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interest at floating rates based on the lower of the prime rate (8.25% at May 5, 2007) minus 0.50% or the LIBOR rate (5.30% at May 5, 2007), plus 1.00% for advances over \$500,000 for a minimum of 30 days and a maximum of 180 days. The revolving credit facility also contains financial covenants that require us to meet certain specified financial ratios, including, minimum net income after taxes, total liabilities divided by tangible net worth and quick ratio. Our obligations under the revolving credit facility are secured by almost all of our personal property, including, among other things, our inventory, equipment and fixtures. We must also provide financial information and statements to our lender. We were

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in compliance with all such covenants at May 5, 2007.

### Contractual Obligations and Commercial Commitments

There were no material changes outside the ordinary course of business in our contractual obligations during the quarter ended May 5, 2007. Our operating lease obligations are not recognized as liabilities in the financial statements. The following table summarizes the total amount of future payments (in thousands) due under certain of our contractual obligations at May 5, 2007:

Contractual Obligations	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Operating Lease Obligations	\$ 175,700	\$ 16,595	\$ 43,819	\$ 41,611	\$ 73,675
Purchase Obligations	89,440	89,440			
Letters of Credit	1,651	1,651			
	\$ 266,791	\$ 107,686	\$ 43,819	\$ 41,611	\$ 73,675

We occupy our retail stores and combined home office and distribution center under operating leases generally with terms of seven to ten years. Some of our leases have early cancellation clauses, which permit the lease to be terminated by us if certain sales levels are not met in specific periods. Some leases contain renewal options for periods ranging from one to five years under substantially the same terms and conditions as the original leases. In addition to future minimum lease payments, substantially all of our store leases provide for additional rental payments (or percentage rent ) if sales at the respective stores exceed specified levels, as well as the payment of common area maintenance charges and real estate taxes. Amounts in the above table do not include percentage rent, common area maintenance charges or real estate taxes. Most of our lease agreements have defined escalating rent provisions, which we have straight-lined over the term of the lease, including any lease renewals deemed to be probable. For certain locations, we receive cash tenant allowances and we have reported these amounts as a deferred liability which is amortized to rent expense over the term of the lease, including any lease renewals deemed to be probable. Rent expense, including common area maintenance and other occupancy costs, was \$9.3 million, \$6.0 million for the three months ended May 5, 2007 and April 29, 2006, respectively.

At May 5, 2007, we had outstanding purchase orders to acquire merchandise from vendors of approximately \$89 million. We have an option to cancel these commitments with no notice prior to shipment. At May 5, 2007, we had approximately \$1.7 million of letters of credit outstanding.

### Off-Balance Sheet Obligations

Our only off-balance sheet contractual obligations and commercial commitments as of May 5, 2007 related to operating lease obligations and letters of credit. We have excluded these items from our balance sheet in accordance with generally accepted accounting principles. We presently do not have any non-cancelable purchase commitments. At May 5, 2007, we had outstanding purchase orders to acquire merchandise from vendors for approximately \$89 million. These purchases are expected to be financed by cash flows from operations and borrowings under our revolving credit facility. We have an option to cancel these commitments with no notice prior to shipment. At May 5, 2007, we had \$1.7 million of letters of credit outstanding under our revolving credit facility.

### Impact of Inflation

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

### Risk Factors

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- the timing of new store openings and the relative proportion of our new stores to mature stores;
- the successful integration of any new stores that we acquire and the absence of any unanticipated liabilities in connection therewith;
- fashion trends and changes in consumer preferences;
- calendar shifts of holiday or seasonal periods;
- changes in our merchandise mix;
- timing of promotional events;
- general economic conditions and, in particular, the retail sales environment;
- actions by competitors or mall anchor tenants;
- weather conditions;
- the level of pre-opening expenses associated with our new stores; and
- inventory shrinkage beyond our historical average rates.

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

We may from time to time acquire other retail stores, individually or in groups, or businesses. In particular, in June 2006 we completed the acquisition of the Fast Forward sporting goods store chain. We may experience difficulties in assimilating any stores or businesses we may acquire, including the Fast Forward operations, and any such acquisitions may also result in the diversion of our capital and our management's attention from other business issues and opportunities. We may not be able to successfully integrate any stores or businesses that we may acquire, including their facilities, personnel, financial systems, distribution, operations and general operating procedures. If we fail to successfully integrate acquisitions or if such acquisitions fail to provide the benefits that we expect to receive, we could experience increased costs and other operating inefficiencies, which could have an adverse effect on our results of operations and financial performance.

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

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

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

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

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

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

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

***Our Chief Financial Officer has recently resigned and if we continue to lose key management or are unable to attract and retain the talent required for our business, our financial performance could suffer.***

Our performance depends largely on the efforts and abilities of our senior management, including our Co-Founder and Chairman, Thomas D. Champion, our President and Chief Executive Officer, Richard M. Brooks, and our General Merchandising Manager, Lynn K. Kilbourne. We recently announced the resignation of our Chief Financial Officer, Brenda I. Morris for personal reasons effective in April, 2007. While we are in the process of recruiting a new Chief Financial Officer, no assurances can be given that we will be successful in finding a suitable replacement in a timely fashion or that we will not incur greater costs than expected to attract a new Chief Financial Officer. Competition for

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highly qualified senior management personnel is intense, and we expect that replacement of our Chief Financial Officer could be costly, time consuming, and could distract our management team from running the Company's business. Until a suitable replacement can be found, our Chief Executive Officer will have responsibility as our principal accounting and financial officer. None of our employees, except Mr. Brooks, has an employment agreement with us and we do not plan to obtain key person life insurance covering any of our employees. If we lose the services of one or more of our key executives, we may not be able to successfully manage our business or achieve our growth objectives. As our business grows, we will need to attract and retain additional qualified management personnel in a timely manner and we may not be able to do so.

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

Our success depends in part upon our ability to attract, motivate and retain a sufficient number of qualified employees, including regional managers, district managers, store managers and store associates, who understand and appreciate our corporate culture based on a passion for the action sports lifestyle and are able to adequately represent this culture to our customers. Qualified individuals of the requisite caliber, skills and number needed to fill these positions may be in short supply in some areas, and the employee turnover rate in the retail industry is high. Competition for qualified employees could require us to pay higher wages to attract a sufficient number of suitable employees. If we are unable to hire and retain store managers and store associates capable of consistently providing a high level of customer service, as demonstrated by their enthusiasm for our culture and knowledge of our merchandise, our ability to open new stores may be impaired and the performance of our existing and new stores could be materially adversely affected. We are also dependent upon temporary personnel to adequately staff our stores and distribution center, particularly during busy periods such as the back-to-school and winter holiday seasons. There can be no assurance that we will receive adequate assistance from our temporary personnel, or that there will be sufficient sources of temporary personnel. Although none of our employees is currently covered by collective bargaining agreements, we cannot guarantee that our employees will not elect to be represented by labor unions in the future, which could increase our labor costs and could subject us to the risk of work stoppages and strikes. Any such failure to meet our staffing needs, any material increases in employee turnover rates, any increases in labor costs or any work stoppages or interruptions or strikes could have a material adverse effect on our business or results of operations.

***Our operations, including our sole distribution center, are concentrated in the western United States, which makes us susceptible to adverse conditions in this region.***

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

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

We do not own any of our retail stores or our combined home office and distribution center, but instead we lease all of these facilities under operating leases. Payments under these operating leases account for a significant portion of our operating expenses. For example, total rental expense, including additional rental payments (or percentage rent) based on sales of some of the stores, common area maintenance charges and real estate taxes, under operating leases was \$9.3 million and \$6.0 million for three months ended May 5, 2007 and April 29, 2006, respectively and \$17.1 million, \$22.2 million and \$31.9 million for fiscal 2004, 2005, and 2006 respectively. As of May 5, 2007 we were a party to operating leases requiring future minimum lease payments aggregating approximately \$102.0 million through fiscal year 2011 and approximately \$73.7 million thereafter. In addition, substantially all of our store leases provide for additional rental payments based on sales of the respective stores, as well as common area maintenance charges, and require that we pay real estate taxes, none of which is included in the amount of future minimum lease payments. We expect that any new stores we open will also be leased by us under operating leases, which will further increase our operating lease expenses.

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

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

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

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

We have a \$25 million revolving credit facility with Wells Fargo HSBC Trade Bank, N.A., which we use for inventory financing and other general corporate purposes, that contains a number of restrictions and covenants that generally limit our ability to enter into certain transactions. In addition, our obligations under the revolving credit facility are secured by almost all of our personal property, including, among other things, our inventory, equipment and fixtures. Our revolving credit facility also contains financial covenants that require us to meet certain specified financial ratios, including minimum net income after taxes, total liabilities divided by tangible net worth and quick ratio. Our ability to comply with these ratios may be affected by events beyond our control.

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

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

***Our business could suffer as a result of United Parcel Service being unable to distribute our merchandise.***

We rely upon United Parcel Service for our product shipments, including shipments to, from and between our stores. Accordingly, we are subject to risks, including employee strikes and inclement weather, which may affect United Parcel Service's ability to meet our shipping needs. Among other things, any circumstances that require us to use other delivery services for all or a portion of our shipments could result in increased costs and delayed deliveries and could harm our business materially. In addition, although we have a contract with United Parcel Service that expires in June 2008, United Parcel Service has the right to terminate the contract upon 30 days written notice. Although the contract with United Parcel Service provides certain discounts from the shipment rates in effect at the time of shipment, the contract does not limit United Parcel Service's ability to raise the shipment rates at any time. Accordingly, we are subject to the risk that United Parcel Service may increase the rates they charge, that United Parcel Service may terminate their contract with us, that United Parcel Service may decrease the rate discounts provided to us when an existing contract is renewed or that we may be unable to agree on the terms of a new contract with United Parcel Service, any of which could materially adversely affect our operating results.

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

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

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

Sales from private label merchandise accounted for 14.3% of our net sales in fiscal year 2006. We may take steps to increase the percentage of net sales of private label merchandise in the future, although there can be no assurance that we will be able to achieve increases in private label merchandise sales as a percentage of net sales. Because our private label merchandise generally carries higher gross margins than other merchandise, our failure to anticipate, identify and react in a timely manner to fashion trends with our private label merchandise, particularly if the percentage of net sales derived from private label merchandise increases, may have a material adverse effect on our comparable store sales, financial condition and results of operations.

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

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

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

Over the past several years, we have made improvements to our existing hardware and software systems, as well as implemented new systems. If these or any other information systems and software do not work effectively, this could adversely impact the promptness and accuracy of our transaction processing, financial accounting and reporting and our ability to manage our business and properly forecast operating results and cash requirements. To manage the anticipated growth of our operations and personnel, we may need to continue to improve our operational and financial systems, transaction processing, procedures and controls, and in doing so could incur substantial additional expenses which could impact our financial results. In addition, as discussed below, we continue to be required to improve our financial and managerial controls, reporting systems and procedures to comply with Section 404 of the Sarbanes-Oxley Act of 2002.

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

We believe that our trademarks and domain names are valuable assets that are critical to our success. The unauthorized use or other misappropriation of our trademarks or domain names could diminish the value of the Zumiez brand, our store concept, our private label brands or our goodwill and cause a decline in our net sales. At this time, we have or are in the process of securing protection for our trademarks and domain names in all jurisdictions, except for some marks outside of the United States. Therefore, we may not be able to prevent other persons from using our trademarks or domain names outside of the United States, which also could materially adversely affect our business. We are also subject to the risk that we may infringe on the intellectual property rights of third parties. Any infringement or other intellectual property claim made against us, whether or not it has merit, could be time-consuming, result in costly litigation, cause product delays or require us to pay royalties or license fees. As a result, any such claim could have a material adverse effect on our operating results.

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

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

***The outcome of litigation could have a material adverse effect on our business.***

We are involved, from time to time, in litigation incidental to our business. Management believes, after considering a number of factors and the nature of the legal proceedings to which we are subject, that the outcome of current litigation is not expected to have a material adverse effect upon our results of operations or financial condition. However, management's assessment of our current litigation could change in light of the discovery of facts not presently known to us or determinations by judges, juries or other finders of fact that are not in accord with management's evaluation of the possible liability or outcome of such litigation. As a result, there can be no assurance that the actual outcome of pending or future litigation will not have a material adverse effect on our results of operations or financial condition.

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

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

- diversion of traffic and sales from our stores;
- liability for online content; and
- risks related to the computer systems that operate our website and related support systems, including computer viruses and electronic break-ins and similar disruptions.

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

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

We completed our initial public offering in May 2005 and we have incurred and will continue to incur significant legal, accounting, insurance and other expenses as a result of being a public company. The Sarbanes-Oxley Act of 2002, as well as related rules implemented by the SEC and The Nasdaq Stock Market, has required changes in corporate governance practices of public companies. Compliance with these laws, rules and regulations, including compliance with Section 404 of the Sarbanes-Oxley Act as discussed in the following risk factor, have caused and will cause us to incur significant costs and expenses, including legal and accounting costs, and have made some activities more time-consuming and costly. These laws, rules and regulations have made it more expensive for us to obtain director and officer liability insurance, and we have been required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. As a result, it

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may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as officers. As a result of the foregoing, we have and we expect to incur significant legal, accounting, insurance and certain other expenses on an ongoing basis, which will negatively impact our financial performance and could have a material adverse effect on our results of operations and financial condition.

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

Reporting obligations as a public company and our anticipated growth are likely to place a considerable strain on our financial and management systems, processes and controls, as well as on our personnel. In addition, we are required to document and test our internal controls over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 so that our management can certify as to the effectiveness of our internal controls and our independent registered public accounting firm can render an opinion on management's assessment and on the effectiveness of our internal control over financial reporting for our annual report for fiscal 2007 and thereafter on an annual basis. This process requires us to document our internal controls over financial reporting and to potentially make significant changes thereto, if applicable. As a result, we may be required to improve our financial and managerial controls,

reporting systems and procedures, to incur substantial expenses to test our systems and to make such improvements and to hire additional personnel. If our management is ever unable to certify the effectiveness of our internal controls or if our independent registered public accounting firm cannot render an opinion on management's assessment and on the effectiveness of our internal control over financial reporting, or if material weaknesses in our internal controls is ever identified, we could be subject to regulatory scrutiny and a loss of public confidence, which could have a material adverse effect on our business and our stock price. In addition, if we do not maintain adequate financial and management personnel, processes and controls, we may not be able to accurately report our financial performance on a timely basis, which could cause a decline in our stock price and adversely affect our ability to raise capital.

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

During different times of the year, due to the seasonality of our business, we have borrowed under our revolving credit facility. To the extent we borrow under our revolving credit facility, which bears interests at floating rates based either on the prime rate or LIBOR, we are exposed to market risk related to changes in interest rates. At May 5, 2007, we had no borrowings outstanding under our credit facility. We are not a party to any derivative financial instruments.

### **Item 4: Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures.* We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Securities Exchange Act Rule 13a-15(e)). Based on this evaluation, our CEO and CFO concluded that, as of May 5, 2007, our disclosure controls and procedures were effective. Effective as of April 26, 2007, our CEO has also been serving as the Company's acting CFO.

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

*Changes in Internal Control Over Financial Reporting.* There has been no change in our internal control over financial reporting (as defined in Securities Exchange Act Rule 13a-15(f)) during the quarter ended May 5, 2007 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**

We are involved from time to time in litigation incidental to our business. We believe that the outcome of current litigation is not expected to have a material adverse effect on our results of operations or financial condition.

See Note 4 to the Notes to Consolidated Financial Statements found in Item 1 of this Form 10-Q (listed under Litigation under Commitments and Contingencies).

### **Item 1A. Risk Factors**

Please refer to the Risk Factors set forth in Item 2 of Part I of this Form 10-Q as well as the risk factors previously disclosed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended February 3, 2007.

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

None

### **Item 3. Defaults Upon Senior Securities**

None.

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

None

**Item 5. Other Information**

On March 13, 2007, the compensation committee of our board of directors approved changes to the annual base salaries for our executive officers. Effective as of the first payroll period for the beginning of fiscal 2007, our executive officers will receive the annual base salaries set forth below:

Executive Officer	2006 Base Salary
Richard M. Brooks, President and CEO	\$ 250,000
Thomas D. Campion, Chairman of the Board	\$ 250,000
Lynn K. Kilbourne, Executive Vice President & General Merchandise Manager	\$ 250,000
Ford K. Wright, Executive Vice President of Stores	\$ 200,000

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Item 6. Exhibits

Exhibits

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

**SIGNATURE**

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

ZUMIEZ INC.

By: /s/ RICHARD M. BROOKS  
Richard M. Brooks  
Chief Financial Officer

Dated: June 1, 2007