

WILLIAMS SONOMA INC  
Form 10-Q  
September 12, 2014  
Table of Contents

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

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended August 3, 2014.**

**or**

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

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

**Commission File Number: 001-14077**

**WILLIAMS-SONOMA, INC.**

**(Exact name of registrant as specified in its charter)**

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

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

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

**94109**  
**(Zip Code)**

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

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

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of August 31, 2014, 93,299,192 shares of the registrant's Common Stock were outstanding.

**Table of Contents**

**WILLIAMS-SONOMA, INC.**

**REPORT ON FORM 10-Q**

**FOR THE QUARTER ENDED AUGUST 3, 2014**

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

|  | PAGE |
|--|------|
| Item 1. <u>Financial Statements</u>  | 2    |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 12   |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>                            | 19   |
| Item 4. <u>Controls and Procedures</u>   | 20   |

**PART II. OTHER INFORMATION**

|  |    |
|--|----|
| Item 1. <u>Legal Proceedings</u>   | 20 |
| Item 1A. <u>Risk Factors</u>   | 20 |
| Item 2. <u>Unregistered Sales of Equity Securities And Use of Proceeds</u> | 20 |
| Item 3. <u>Defaults Upon Senior Securities</u>                             | 21 |
| Item 4. <u>Mine Safety Disclosures</u>                                     | 21 |
| Item 5. <u>Other Information</u>   | 21 |
| Item 6. <u>Exhibits</u>  | 21 |

**Table of Contents****ITEM 1. FINANCIAL STATEMENTS****WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

(Unaudited)

| <i>Dollars and shares in thousands, except per share amounts</i> | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|--|----------------------|-------------------|------------------------|-------------------|
|  | August 3,<br>2014    | August 4,<br>2013 | August 3,<br>2014      | August 4,<br>2013 |
| Net revenues   | \$ 1,039,102         | \$ 982,209        | \$ 2,013,432           | \$ 1,870,017      |
| Cost of goods sold   | 657,004              | 613,285           | 1,262,926              | 1,166,908         |
| Gross profit   | 382,098              | 368,924           | 750,506                | 703,109           |
| Selling, general and administrative expenses                     | 296,762              | 290,838           | 590,844                | 561,240           |
| Operating income   | 85,336               | 78,086            | 159,662                | 141,869           |
| Interest expense (income), net                                   | 40                   | (125)             | (29)                   | (314)             |
| Earnings before income taxes                                     | 85,296               | 78,211            | 159,691                | 142,183           |
| Income taxes   | 34,549               | 29,292            | 62,782                 | 53,798            |
| Net earnings   | \$ 50,747            | \$ 48,919         | \$ 96,909              | \$ 88,385         |
| Basic earnings per share   | \$ 0.54              | \$ 0.50           | \$ 1.03                | \$ 0.91           |
| Diluted earnings per share                                       | \$ 0.53              | \$ 0.49           | \$ 1.01                | \$ 0.89           |
| Shares used in calculation of earnings per share:                |                      |                   |                        |                   |
| Basic  | 93,979               | 96,892            | 94,010                 | 97,470            |
| Diluted  | 95,839               | 98,957            | 95,714                 | 99,365            |

*See Notes to Condensed Consolidated Financial Statements.***WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited)

| <i>Dollars in thousands</i>   | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|---|----------------------|-------------------|------------------------|-------------------|
|   | August 3,<br>2014    | August 4,<br>2013 | August 3,<br>2014      | August 4,<br>2013 |
| Net earnings  | \$ 50,747            | \$ 48,919         | \$ 96,909              | \$ 88,385         |
| Other comprehensive income (loss):  |                      |                   |                        |                   |
| Foreign currency translation adjustments  | 545                  | (3,148)           | 1,943                  | (4,496)           |
| Changes in fair value of derivative financial instruments,<br>net of tax              | 91                   | 292               | (207)                  | 123               |
| Reclassification adjustment for realized gains on<br>derivative financial instruments | (287)                | 0                 | (520)                  | 0                 |
| Comprehensive income  | \$ 51,096            | \$ 46,063         | \$ 98,125              | \$ 84,012         |

*See Notes to Condensed Consolidated Financial Statements.*

**Table of Contents****WILLIAMS-SONOMA, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited)

| <i>Dollars and shares in thousands, except per share amounts</i>   | August 3,<br>2014 | February 2,<br>2014 | August 4,<br>2013 |
|--|-------------------|---------------------|-------------------|
| <b>ASSETS</b>  |                   |                     |                   |
| Current assets   |                   |                     |                   |
| Cash and cash equivalents  | \$ 70,574         | \$ 330,121          | \$ 205,364        |
| Restricted cash  | 0                 | 14,289              | 16,967            |
| Accounts receivable, net   | 69,653            | 60,330              | 62,808            |
| Merchandise inventories, net   | 894,860           | 813,160             | 736,871           |
| Prepaid catalog expenses   | 39,072            | 33,556              | 37,266            |
| Prepaid expenses   | 55,892            | 35,309              | 61,725            |
| Deferred income taxes, net   | 121,527           | 121,486             | 99,699            |
| Other assets   | 9,772             | 10,852              | 11,029            |
| Total current assets   | 1,261,350         | 1,419,103           | 1,231,729         |
| Property and equipment, net  | 849,255           | 849,293             | 829,951           |
| Non-current deferred income taxes, net   | 856               | 13,824              | 7,509             |
| Other assets, net  | 52,087            | 54,514              | 54,989            |
| Total assets   | \$ 2,163,548      | \$ 2,336,734        | \$ 2,124,178      |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                   |                     |                   |
| Current liabilities  |                   |                     |                   |
| Accounts payable   | \$ 336,470        | \$ 404,791          | \$ 318,532        |
| Accrued salaries, benefits and other   | 101,818           | 138,181             | 95,762            |
| Customer deposits  | 251,146           | 228,193             | 225,822           |
| Income taxes payable   | 14,604            | 49,365              | 2,955             |
| Current portion of long-term debt  | 1,968             | 1,785               | 1,817             |
| Other liabilities  | 44,713            | 38,781              | 35,531            |
| Total current liabilities  | 750,719           | 861,096             | 680,419           |
| Deferred rent and lease incentives   | 171,193           | 157,856             | 170,817           |
| Long-term debt   | 0                 | 1,968               | 1,968             |
| Other long-term obligations  | 63,227            | 59,812              | 51,599            |
| Total liabilities  | 985,139           | 1,080,732           | 904,803           |
| Commitments and contingencies  |                   |                     |                   |
| Stockholders equity  |                   |                     |                   |
| Preferred stock: \$.01 par value; 7,500 shares authorized; none issued   | 0                 | 0                   | 0                 |
| Common stock: \$.01 par value; 253,125 shares authorized; 93,414, 94,049 and 95,839 shares issued and outstanding at August 3, 2014, February 2, 2014 and August 4, 2013, respectively | 934               | 941                 | 959               |
| Additional paid-in capital   | 514,464           | 522,595             | 513,246           |
| Retained earnings  | 657,721           | 729,043             | 699,012           |
| Accumulated other comprehensive income   | 7,741             | 6,524               | 9,260             |
| Treasury stock, at cost  | (2,451)           | (3,101)             | (3,102)           |

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|  |              |              |              |
|--|--------------|--------------|--------------|
| Total stockholders' equity                 | 1,178,409    | 1,256,002    | 1,219,375    |
| Total liabilities and stockholders' equity | \$ 2,163,548 | \$ 2,336,734 | \$ 2,124,178 |

*See Notes to Condensed Consolidated Financial Statements.*

Table of Contents

## WILLIAMS-SONOMA, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

|   | Twenty-Six Weeks Ended |           |
|---|------------------------|-----------|
|   | August 3,              | August 4, |
| <i>Dollars in thousands</i>   | 2014                   | 2013      |
| Cash flows from operating activities:   |                        |           |
| Net earnings  | \$ 96,909              | \$ 88,385 |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: |                        |           |
| Depreciation and amortization   | 79,332                 | 73,832    |
| Loss on sale/disposal/impairment of assets  | 952                    | 1,233     |
| Amortization of deferred lease incentives   | (12,483)               | (12,621)  |
| Deferred income taxes   | (8,326)                | (6,937)   |
| Tax benefit related to stock-based awards   | 46,174                 | 11,733    |
| Excess tax benefit related to stock-based awards  | (22,911)               | (5,173)   |
| Stock-based compensation expense  | 22,191                 | 18,472    |
| Other   | 305                    | 0         |
| Changes in:   |                        |           |
| Accounts receivable   | (4,227)                | (1,284)   |
| Merchandise inventories   | (80,158)               | (97,653)  |
| Prepaid catalog expenses  | (5,516)                | (35)      |
| Prepaid expenses and other assets   | (18,043)               | (40,191)  |
| Accounts payable  | (60,527)               | 52,336    |
| Accrued salaries, benefits and other current and long-term liabilities                        | (28,981)               | (10,677)  |
| Customer deposits   | 22,767                 | 18,710    |
| Deferred rent and lease incentives  | 17,516                 | 12,823    |
| Income taxes payable  | (34,757)               | (38,890)  |
| Net cash provided by operating activities   | 10,217                 | 64,063    |
| Cash flows from investing activities:   |                        |           |
| Purchases of property and equipment   | (83,519)               | (97,777)  |
| Restricted cash receipts (deposits)   | 14,289                 | (912)     |
| Other   | 282                    | 1,274     |
| Net cash used in investing activities   | (68,948)               | (97,415)  |
| Cash flows from financing activities:   |                        |           |
| Repurchase of common stock  | (112,054)              | (131,006) |
| Payment of dividends  | (63,996)               | (52,196)  |
| Tax withholdings related to stock-based awards  | (49,434)               | (11,135)  |
| Excess tax benefit related to stock-based awards  | 22,911                 | 5,173     |
| Net proceeds related to stock-based awards  | 3,471                  | 6,541     |
| Repayments of long-term obligations   | (1,785)                | (1,692)   |
| Other   | (6)                    | 0         |



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|   |           |            |
|---|-----------|------------|
| Net cash used in financing activities                 | (200,893) | (184,315)  |
| Effect of exchange rates on cash and cash equivalents | 77        | (1,524)    |
| Net decrease in cash and cash equivalents             | (259,547) | (219,191)  |
| Cash and cash equivalents at beginning of period      | 330,121   | 424,555    |
| Cash and cash equivalents at end of period            | \$ 70,574 | \$ 205,364 |

*See Notes to Condensed Consolidated Financial Statements.*

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**Table of Contents**

**WILLIAMS-SONOMA, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Twenty-Six Weeks Ended August 3, 2014 and August 4, 2013

(Unaudited)

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

These financial statements include Williams-Sonoma, Inc. and its wholly owned subsidiaries ( we, us or our ). The Condensed Consolidated Balance Sheets as of August 3, 2014 and August 4, 2013, the Condensed Consolidated Statements of Earnings and the Condensed Consolidated Statements of Comprehensive Income for the thirteen and twenty-six weeks then ended, and the Condensed Consolidated Statements of Cash Flows for the twenty-six weeks then ended, have been prepared by us, without audit. In our opinion, the financial statements include all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position at the balance sheet dates and the results of operations for the thirteen and twenty-six weeks then ended. Intercompany transactions and accounts have been eliminated. The balance sheet as of February 2, 2014, presented herein, has been derived from our audited Consolidated Balance Sheet included in our Annual Report on Form 10-K for the fiscal year ended February 2, 2014.

The results of operations for the thirteen and twenty-six weeks ended August 3, 2014 are not necessarily indicative of the operating results of the full year.

Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended February 2, 2014.

*New Accounting Pronouncements*

In May 2014, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2014-09, *Revenue from Contracts with Customers*, to clarify the principles of recognizing revenue and create common revenue recognition guidance between U.S. GAAP and International Financial Reporting Standards. This ASU is effective retrospectively for fiscal years and interim periods within those years beginning after December 15, 2016. We are currently assessing the potential impact of this ASU on our Condensed Consolidated Financial Statements.

**NOTE B. STOCK-BASED COMPENSATION**

*Equity Award Programs*

Our Amended and Restated 2001 Long-Term Incentive Plan (the Plan ) provides for grants of incentive stock options, nonqualified stock options, stock-settled stock appreciation rights (collectively, option awards ), restricted stock awards, restricted stock units (including those that are performance based), deferred stock awards (collectively, stock awards ) and dividend equivalents up to an aggregate of 25,760,000 shares. As of August 3, 2014, there were approximately 4,437,000 shares available for future grant. Awards may be granted under the Plan to officers, employees and non-employee members of the board of directors of the company (the Board ) or any parent or subsidiary. Annual grants are limited to 1,000,000 shares covered by option awards and 400,000 shares covered by

stock awards on a per person basis. All grants of option awards made under the Plan have a maximum term of seven years. The exercise price of these option awards is not less than 100% of the closing price of our stock on the day prior to the grant date. Option awards and stock-awards granted to employees generally vest over a period of four years for service-based awards, and three years for certain performance-based awards. Certain option awards, stock awards and other agreements contain vesting acceleration clauses resulting from events including, but not limited to, retirement, merger or a similar corporate event. Option and stock awards granted to non-employee Board members generally vest in one year.

**Table of Contents**

Non-employee Board members automatically receive stock awards on the date of their initial election to the Board and annually thereafter on the date of the annual meeting of stockholders (so long as they continue to serve as a non-employee Board member). Shares issued as a result of award exercises or releases are primarily funded with the issuance of new shares.

*Stock-Based Compensation Expense*

We measure and record stock-based compensation expense for all employee stock-based awards using a fair value method. During the thirteen and twenty-six weeks ended August 3, 2014, we recognized total stock-based compensation expense, as a component of selling, general and administrative expenses, of \$9,823,000 and \$22,191,000, respectively. During the thirteen and twenty-six weeks ended August 4, 2013, we recognized total stock-based compensation expense of \$9,481,000 and \$18,472,000, respectively.

*Stock Options*

The following table summarizes our stock option activity during the twenty-six weeks ended August 3, 2014:

|   | Shares    |
|---|-----------|
| Balance at February 2, 2014             | 222,488   |
| Granted                                 | 0         |
| Exercised                               | (100,988) |
| Cancelled                               | 0         |
| Balance at August 3, 2014 (100% vested) | 121,500   |

*Stock-Settled Stock Appreciation Rights*

The following table summarizes our stock-settled stock appreciation right activity during the twenty-six weeks ended August 3, 2014:

|  | Shares    |
|--|-----------|
| Balance at February 2, 2014                    | 1,859,762 |
| Granted  | 0         |
| Converted into common stock                    | (504,087) |
| Cancelled                                      | (17,566)  |
| Balance at August 3, 2014                      | 1,338,109 |
| Vested at August 3, 2014                       | 1,041,455 |
| Vested plus expected to vest at August 3, 2014 | 1,217,066 |

*Restricted Stock Units*

The following table summarizes our restricted stock unit activity during the twenty-six weeks ended August 3, 2014:

|                             | Shares    |
|-----------------------------|-----------|
| Balance at February 2, 2014 | 3,079,651 |

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|  |             |
|--|-------------|
| Granted  | 872,177     |
| Released                                       | (1,414,406) |
| Cancelled                                      | (123,562)   |
| Balance at August 3, 2014                      | 2,413,860   |
| Vested plus expected to vest at August 3, 2014 | 1,570,053   |

**Table of Contents****NOTE C. EARNINGS PER SHARE**

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

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

| <i>Dollars and amounts in thousands, except per share amounts</i> | Net Earnings | Weighted<br>Average Shares | Earnings<br>Per Share |
|---|--------------|----------------------------|-----------------------|
| <b>Thirteen weeks ended August 3, 2014</b>                        |              |                            |                       |
| Basic   | \$ 50,747    | 93,979                     | \$ 0.54               |
| Effect of dilutive stock-based awards                             |              | 1,860                      |                       |
| Diluted   | \$ 50,747    | 95,839                     | \$ 0.53               |
| <b>Thirteen weeks ended August 4, 2013</b>                        |              |                            |                       |
| Basic   | \$ 48,919    | 96,892                     | \$ 0.50               |
| Effect of dilutive stock-based awards                             |              | 2,065                      |                       |
| Diluted   | \$ 48,919    | 98,957                     | \$ 0.49               |
| <b>Twenty-six weeks ended August 3, 2014</b>                      |              |                            |                       |
| Basic   | \$ 96,909    | 94,010                     | \$ 1.03               |
| Effect of dilutive stock-based awards                             |              | 1,704                      |                       |
| Diluted   | \$ 96,909    | 95,714                     | \$ 1.01               |
| <b>Twenty-six weeks ended August 4, 2013</b>                      |              |                            |                       |
| Basic   | \$ 88,385    | 97,470                     | \$ 0.91               |
| Effect of dilutive stock-based awards                             |              | 1,895                      |                       |
| Diluted   | \$ 88,385    | 99,365                     | \$ 0.89               |

There were no stock-based awards excluded from the computation of diluted earnings per share for the thirteen weeks ended August 3, 2014 and August 4, 2013 and the twenty-six weeks ended August 3, 2014. Stock-based awards of 133,000 for the twenty-six weeks ended August 4, 2013, were excluded from the computation of diluted earnings per share, as their inclusion would be anti-dilutive.

**NOTE D. SEGMENT REPORTING**

We have two reportable segments, direct-to-customer and retail. The direct-to-customer segment has seven merchandising concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, West Elm, PBteen, Rejuvenation and Mark and Graham) which sell our products through our e-commerce websites and direct-mail catalogs. Our direct-to-customer merchandising concepts are operating segments, which have been aggregated into one reportable segment, direct-to-customer. The retail segment has five merchandising concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, West Elm and Rejuvenation) which sell our products through our retail stores. Our retail merchandising concepts are operating segments, which have been aggregated into one reportable segment, retail. Management's expectation is that the overall economic characteristics of each of our operating segments will be similar over time based on management's judgment that the operating segments have had similar historical economic characteristics and are expected to have similar long-term financial performance in the future.

These reportable segments are strategic business units that offer similar home-centered products. They are managed separately because the business units utilize two distinct distribution and marketing strategies. Based on management's best estimate, our operating segments include allocations of certain expenses, including advertising

**Table of Contents**

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

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

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

**Segment Information**

| <i>Dollars in thousands</i>                  | Direct-to-<br>Customer | Retail     | Unallocated | Total        |
|--|------------------------|------------|-------------|--------------|
| <b>Thirteen weeks ended August 3, 2014</b>   |                        |            |             |              |
| Net revenues <sup>1</sup>                    | \$ 522,589             | \$ 516,513 | \$ 0        | \$ 1,039,102 |
| Depreciation and amortization expense        | 7,730                  | 20,358     | 12,614      | 40,702       |
| Operating income (loss)                      | 120,612                | 37,058     | (72,334)    | 85,336       |
| Capital expenditures                         | 13,398                 | 19,548     | 12,454      | 45,400       |
| <b>Thirteen weeks ended August 4, 2013</b>   |                        |            |             |              |
| Net revenues <sup>1</sup>                    | \$ 477,657             | \$ 504,552 | \$ 0        | \$ 982,209   |
| Depreciation and amortization expense        | 6,096                  | 19,535     | 11,592      | 37,223       |
| Operating income (loss)                      | 114,491                | 34,609     | (71,014)    | 78,086       |
| Capital expenditures                         | 9,993                  | 24,428     | 15,912      | 50,333       |
| <b>Twenty-six weeks ended August 3, 2014</b> |                        |            |             |              |
| Net revenues <sup>1</sup>                    | \$ 1,013,878           | \$ 999,554 | \$ 0        | \$ 2,013,432 |
| Depreciation and amortization expense        | 15,137                 | 39,718     | 24,477      | 79,332       |
| Operating income (loss)                      | 241,748                | 67,254     | (149,340)   | 159,662      |
| Assets <sup>2</sup>                          | 588,234                | 974,474    | 600,840     | 2,163,548    |
| Capital expenditures                         | 22,875                 | 34,248     | 26,396      | 83,519       |
| <b>Twenty-six weeks ended August 4, 2013</b> |                        |            |             |              |
| Net revenues <sup>1</sup>                    | \$ 896,741             | \$ 973,276 | \$ 0        | \$ 1,870,017 |
| Depreciation and amortization expense        | 12,922                 | 38,752     | 22,158      | 73,832       |
| Operating income (loss)                      | 210,432                | 68,625     | (137,188)   | 141,869      |
| Assets <sup>2</sup>                          | 470,792                | 937,720    | 715,666     | 2,124,178    |
| Capital expenditures                         | 19,699                 | 45,150     | 32,928      | 97,777       |

<sup>1</sup> Includes net revenues of approximately \$55.4 million and \$50.4 million for the thirteen weeks ended August 3, 2014 and August 4, 2013, respectively, and \$106.5 million and \$98.5 million for the twenty-six weeks ended August 3, 2014 and August 4, 2013, respectively, related to our foreign operations.

<sup>2</sup>



*Includes approximately \$62.2 million and \$55.5 million of long-term assets as of August 3, 2014 and August 4, 2013, respectively, related to our foreign operations.*

**NOTE E. COMMITMENTS AND CONTINGENCIES**

We are involved in lawsuits, claims and proceedings incident to the ordinary course of our business. These disputes, which are not currently material, are increasing in number as our business expands and our company

## **Table of Contents**

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

## **NOTE F. STOCK REPURCHASE PROGRAM AND DIVIDEND**

### *Stock Repurchase Program*

During the thirteen weeks ended August 3, 2014, we repurchased 847,946 shares of our common stock at an average cost of \$69.28 per share for a total cost of approximately \$58,745,000. During the twenty-six weeks ended August 3, 2014, we repurchased 1,688,707 shares of our common stock at an average cost of \$66.35 per share for a total cost of approximately \$112,054,000. As of August 3, 2014, we held treasury stock of \$2,451,000 which represents the cost of shares available for issuance in certain foreign jurisdictions as a result of future stock award exercises or releases.

During the thirteen weeks ended August 4, 2013, we repurchased 1,613,943 shares of our common stock at an average cost of \$55.66 per share for a total cost of \$89,832,000. During the twenty-six weeks ended August 4, 2013, we repurchased 2,414,825 shares of our common stock at an average cost of \$54.25 per share for a total cost of \$131,006,000.

Stock repurchases under this program may be made through open market and privately negotiated transactions at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. This stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

### *Dividend*

We declared cash dividends of \$0.33 and \$0.31 per common share for the thirteen weeks ended August 3, 2014 and August 4, 2013, respectively. We declared cash dividends of \$0.66 and \$0.62 per common share for the twenty-six weeks ended August 3, 2014 and August 4, 2013, respectively.

## **NOTE G. DERIVATIVE FINANCIAL INSTRUMENTS**

Substantially all of our purchases and sales are denominated in U.S. dollars, which limits our exposure to foreign currency exchange rate fluctuations. However, we are exposed to foreign currency exchange risk related to the transactions of our foreign subsidiaries. While the impact of foreign currency exchange rate fluctuations was not significant in the second quarter of fiscal 2014, as we continue to expand globally, the foreign currency exchange risk related to the transactions of our foreign subsidiaries will increase. To mitigate this risk, we hedge a portion of our foreign currency exposure with foreign currency forward contracts in accordance with our risk management policies. We do not enter into such contracts for speculative purposes.

The assets or liabilities associated with the derivative instruments are measured at fair value and recorded in either other current assets or other current liabilities. As discussed below, the accounting for gains and losses resulting from changes in fair value depends on whether the derivative instrument is designated as a hedge and qualifies for hedge accounting in accordance with the Financial Accounting Standards Board Accounting Standard Codification ( ASC ) 815, *Derivatives and Hedging*.



**Table of Contents***Cash Flow Hedges*

We enter into foreign currency forward contracts designated as cash flow hedges for forecasted inventory purchases in U.S. dollars by our foreign subsidiaries. These hedges generally have terms of up to 12 months. The hedges are designed to offset changes to future cash flows on hedged transactions. We record the effective portion of changes in the fair value of our cash flow hedges in other comprehensive income ( OCI ) until the earlier of either the hedged forecasted inventory purchase occurs or the respective contracts reach maturity. Subsequently, as the inventory is sold to the customer, we reclassify the amounts previously recorded in OCI to cost of goods sold. Changes in the fair value of the forward contract related to interest charges or forward points are excluded from the assessment and measurement of hedge effectiveness and are recorded immediately in other income (expense), net. Based on the rates in effect as of August 3, 2014, we expect to reclassify a net gain of approximately \$19,000 from OCI to cost of goods sold over the next 12 months.

We also enter into non-designated foreign currency contracts to reduce the exchange risk associated with our assets and liabilities denominated in a foreign currency. Any foreign exchange gains (losses) related to these contracts are recognized in other income (expense), net.

As of August 3, 2014, and August 4, 2013, we had foreign currency forward contracts outstanding (in U.S. dollars) as follows:

| <i>Dollars in thousands</i>                               | August 3, 2014 | August 4, 2013 |
|---|----------------|----------------|
| Contracts to sell Canadian dollars and buy U.S. dollars   |                |                |
| Contracts designated as cash flow hedges                  | \$ 24,400      | \$ 19,400      |
| Contracts not designated as cash flow hedges <sup>1</sup> | \$ 0           | \$ 3,800       |
| Contracts to sell Australian dollars and buy U.S. dollars |                |                |
| Contracts not designated as cash flow hedges              | \$ 10,410      | \$ 5,000       |

<sup>1</sup>These contracts are no longer designated as cash flow hedges as the related inventory purchases have occurred. Hedge effectiveness is evaluated prospectively at inception, on an ongoing basis, as well as retrospectively using regression analysis. Any measureable ineffectiveness of the hedge is recorded in other income (expense), net. No gain or loss was recognized for cash flow hedges due to hedge ineffectiveness and all hedges were deemed effective for assessment purposes for the thirteen and twenty-six weeks ended August 3, 2014 and August 4, 2013.

The effect of derivative instruments in our Condensed Consolidated Financial Statements, pre-tax, was as follows:

| <i>Dollars in thousands</i>  | Thirteen<br>Weeks Ended<br>August 3, 2014 | Thirteen<br>Weeks Ended<br>August 4, 2013 | Twenty-Six<br>Weeks Ended<br>August 3, 2014 | Twenty-Six<br>Weeks Ended<br>August 4, 2013 |
|--|---|---|---|---|
| Net gain (loss) recognized in OCI                                      | \$ 22                                     | \$ 292                                    | \$ (202)                                    | \$ 123                                      |
| Net gain reclassified from OCI into cost of goods sold                 | 287                                       | 0   | 520   | 0   |
| Net foreign exchange gain (loss) recognized in other income (expense): |   |   |   |   |

|  |      |      |      |      |
|--|------|------|------|------|
| Instruments designated as cash flow hedges <sup>1</sup>                    | (53) | (29) | (87) | (42) |
| Instruments not designated or de-designated during the period <sup>2</sup> | 36   | 222  | 620  | 222  |

<sup>1</sup> Changes in fair value of the forward contract related to interest charges or forward points.

<sup>2</sup> Changes in fair value subsequent to de-designation for instruments no longer designated as cash flow hedges, and changes in fair value related to instruments not designated as cash flow hedges.

The fair values of our derivative financial instruments are presented below. All fair values for these derivatives were measured using Level 2 inputs as defined by the fair value hierarchy described in Note H.

**Table of Contents**

| <i>Dollars in thousands</i>                               | Balance sheet location    | August 3, 2014 | August 4, 2013 |
|---|---------------------------|----------------|----------------|
| <b>Derivatives designated as hedging instruments:</b>     |                           |                |                |
| Cash flow hedge foreign currency forward contracts        | Other current assets      | \$ 150         | \$ 107         |
| Cash flow hedge foreign currency forward contracts        | Other current liabilities | (198)          | (48)           |
| Total   |                           | \$ (48)        | \$ 59          |
| <b>Derivatives not designated as hedging instruments:</b> |                           |                |                |
| Foreign currency forward contracts                        | Other current assets      | \$ 0           | \$ 204         |
| Foreign currency forward contracts                        | Other current liabilities | (16)           | 0              |
| Total   |                           | \$ (16)        | \$ 204         |

We record all derivative assets and liabilities on a gross basis. They do not meet the balance sheet netting criteria as discussed in ASC 210, *Balance Sheet*, because we do not have master netting agreements established with our derivative counterparties that would allow for net settlement.

Amounts recorded within accumulated other comprehensive income ( AOCI ) associated with our derivative instruments were as follows:

| <i>Dollars in thousands</i>                           | Thirteen<br>Weeks Ended<br>August 3, 2014 | Thirteen<br>Weeks Ended<br>August 4, 2013 | Twenty-Six<br>Weeks Ended<br>August 3, 2014 | Twenty-Six<br>Weeks Ended<br>August 4, 2013 |
|---|---|---|---|---|
| AOCI beginning balance amount of gain (loss)          | \$ 284                                    | \$ (169)                                  | \$ 741                                      | \$ 0  |
| Amounts recognized in OCI before reclassifications    | 22  | 292                                       | (202)                                       | 123   |
| Amounts reclassified from OCI into cost of goods sold | (287)                                     | 0   | (520)                                       | 0   |
| AOCI ending balance amount of gain                    | \$ 19                                     | \$ 123                                    | \$ 19                                       | \$ 123                                      |

**NOTE H. FAIR VALUE MEASUREMENTS**

Fair value is the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

We determine the fair value of financial and non-financial assets and liabilities using the fair value hierarchy established by ASC 820, *Fair Value Measurement*, which defines three levels of inputs that may be used to measure fair value, as follows:

Level 1: inputs which include quoted prices in active markets for identical assets or liabilities;

Level 2: inputs which include observable inputs other than Level 1 inputs, such as quoted prices in active markets for similar assets or liabilities; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability; and

Level 3: inputs which include unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the underlying asset or liability.

The fair values of our cash and cash equivalents are based on Level 1 inputs, which include quoted prices in active markets for identical assets.

*Foreign Currency Derivatives and Hedging Instruments*

We use the income approach to value our derivatives using observable Level 2 market data at the measurement date and standard valuation techniques to convert future amounts to a single present value amount, assuming that participants are motivated but not compelled to transact. Level 2 inputs are limited to quoted prices that are

## **Table of Contents**

observable for the assets and liabilities, which include interest rates and credit risk ratings. We use mid-market pricing as a practical expedient for fair value measurements. Key inputs for currency derivatives are the spot rates, forward rates, interest rates and credit derivative market rates.

The counterparties associated with our foreign currency forward contracts are large credit-worthy financial institutions, and the derivatives transacted with these entities are relatively short in duration, therefore, we do not consider counterparty concentration and non-performance to be material risks at this time. Both we and our counterparties are expected to perform under the contractual terms of the instruments. None of the derivative contracts entered into are subject to credit risk-related contingent features or collateral requirements. Our policy is to present the fair value of our foreign currency derivatives on a gross basis in our Balance Sheet as these instruments are not subject to legal right of offset or other netting arrangements with our counterparties.

There were no transfers between Level 1 and Level 2 categories during the thirteen and twenty-six weeks ended August 3, 2014.

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

### **FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they do not fully materialize or are proven incorrect, could cause our business and results of operations to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include statements related to: our beliefs regarding the resolution of current lawsuits, claims and proceedings; our three year stock repurchase program; our expectations regarding our cash flow hedges and foreign currency risks; our planned use of cash; our compliance with our financial covenants; our belief that our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations over the next 12 months; our plans to expand our operations globally; and our beliefs regarding seasonal patterns associated with our business, as well as statements of belief and statements of assumptions underlying any of the foregoing. You can identify these and other forward-looking statements by the use of words such as *may*, *should*, *expects*, *plans*, *anticipates*, *believes*, *estimates*, *predicts*, *intends*, *potential*, *continue*, or the negative other comparable terminology. The risks, uncertainties and assumptions referred to above that could cause our results to differ materially from the results expressed or implied by such forward-looking statements include, but are not limited to, those discussed under the heading *Risk Factors* in this document and our Annual Report on Form 10-K for the year ended February 2, 2014, and the risks, uncertainties and assumptions discussed from time to time in our other public filings and public announcements. All forward-looking statements included in this document are based on information available to us as of the date hereof, and we assume no obligation to update these forward-looking statements.

### **OVERVIEW**

Williams-Sonoma, Inc. is a specialty retailer of high-quality products for the home. These products, representing eight distinct merchandise strategies *Williams-Sonoma*, *Pottery Barn*, *Pottery Barn Kids*, *West Elm*, *PBteen*, *Williams-Sonoma Home*, *Rejuvenation*, and *Mark and Graham* are marketed through e-commerce websites, direct mail catalogs and 589 stores. Williams-Sonoma, Inc. currently operates in the United States, Canada, Australia and the United Kingdom, offers international shipping to customers worldwide, and has unaffiliated franchisees that operate stores in the Middle East and the Philippines.



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The following discussion and analysis of financial condition, results of operations, and liquidity and capital resources for the thirteen weeks ended August 3, 2014 ( second quarter of fiscal 2014 ), as compared to the thirteen weeks ended August 4, 2013 ( second quarter of fiscal 2013 ) and the twenty-six weeks ended August 3, 2014 ( year-to-date 2014 ), as compared to the twenty-six weeks ended August 4, 2013 ( year-to-date 2013 ), should be read in conjunction with our Condensed Consolidated Financial Statements and the notes thereto.

## **Table of Contents**

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

### *Second Quarter of Fiscal 2014 Financial Results*

In the second quarter of fiscal 2014, our net revenues increased 5.8% to \$1,039,102,000, compared to \$982,209,000 in the second quarter of fiscal 2013, with comparable brand revenue growth of 5.7%. Diluted earnings per share in the second quarter of fiscal 2014 increased to \$0.53, versus \$0.49 in the second quarter of fiscal 2013, and we returned \$89,850,000 to our stockholders through stock repurchases and dividends.

Direct-to-customer net revenues in the second quarter of fiscal 2014 increased \$44,932,000, or 9.4%, compared to the second quarter of fiscal 2013, primarily driven by West Elm, Pottery Barn, Williams-Sonoma, and Pottery Barn Kids. Direct-to-customer net revenues generated 50% of our total company net revenues in the second quarter of fiscal 2014 compared to 49% in the second quarter of fiscal 2013.

Retail net revenues in the second quarter of fiscal 2014 increased \$11,961,000, or 2.4%, compared to the second quarter of fiscal 2013, primarily driven by West Elm and Pottery Barn, partially offset by a decrease in Williams-Sonoma.

In Pottery Barn, our largest brand, comparable brand revenues increased 4.4% in the second quarter of fiscal 2014 on top of an increase of 9.9% in the second quarter of fiscal 2013, driven by furniture with strong performance across our upholstery and outdoor furniture collections. In the Williams-Sonoma brand, comparable brand revenues increased 3.4% in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013, with strong performance in the cutlery, tabletop, electrics, cookware and food product categories. In West Elm, comparable brand revenues increased 16.7% in the second quarter of fiscal 2014 on top of 16.5% in the second quarter of fiscal 2013. Brand growth continued to be broad-based across many categories. In Pottery Barn Kids, comparable brand revenues increased 5.6% in the second quarter of fiscal 2014 on top of 8.2% in the second quarter of fiscal 2013. The introduction of new furniture collections was a key contributor to this growth. In PBteen, comparable brand revenues decreased 1.0% in the second quarter of fiscal 2014 on top of an increase of 16.3% in the second quarter of fiscal 2013. Although furniture demand remained strong, our net revenues were primarily impacted by increased backorders in furniture due to the recent political unrest in Vietnam, as well as a decrease in net revenues in our dorm and gear product categories.

### *Results of Operations*

#### **NET REVENUES**

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

**Table of Contents**

The following table summarizes our net revenues for the second quarter of fiscal 2014 and fiscal 2013, and year-to-date 2014 and 2013:

| <i>Dollars in thousands</i>     | Thirteen Weeks Ended |         |                   |         | Twenty-Six Weeks Ended |         |                   |         |
|---------------------------------|----------------------|---------|-------------------|---------|------------------------|---------|-------------------|---------|
|                                 | August 3,<br>2014    | % Total | August 4,<br>2013 | % Total | August 3,<br>2014      | % Total | August 4,<br>2013 | % Total |
| Direct-to-customer net revenues | \$ 522,589           | 50.3%   | \$ 477,657        | 48.6%   | \$ 1,013,878           | 50.4%   | \$ 896,741        | 48.0%   |
| Retail net revenues             | 516,513              | 49.7%   | 504,552           | 51.4%   | 999,554                | 49.6%   | 973,276           | 52.0%   |
| Net revenues                    | \$ 1,039,102         | 100.0%  | \$ 982,209        | 100.0%  | \$ 2,013,432           | 100.0%  | \$ 1,870,017      | 100.0%  |

Net revenues in the second quarter of fiscal 2014 increased by \$56,893,000, or 5.8%, compared to the second quarter of fiscal 2013, with comparable brand revenue growth of 5.7%. This increase was primarily driven by the West Elm and Pottery Barn brands.

Net revenues for year-to-date 2014 increased by \$143,415,000, or 7.7%, compared to year-to-date 2013, with comparable brand revenue growth of 7.8%. This increase was primarily driven by the Pottery Barn and West Elm brands.

*Comparable Brand Revenue Growth*

Comparable brand revenues include retail comparable store sales and direct-to-customer sales, as well as shipping fees, sales returns and other discounts associated with current period sales. Outlet comparable store net revenues are included in their respective brands. Sales related to our international franchised stores have been excluded as these stores are not operated by us. Comparable stores are defined as permanent stores in which gross square footage did not change by more than 20% in the previous 12 months and which have been open for at least 12 consecutive months without closure for seven or more consecutive days.

Percentages represent changes in comparable brand revenues compared to the same period in the prior year.

| <i>Comparable brand revenue growth (decline)</i> | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|--|----------------------|-------------------|------------------------|-------------------|
|  | August 3,<br>2014    | August 4,<br>2013 | August 3,<br>2014      | August 4,<br>2013 |
| Pottery Barn                                     | 4.4%                 | 9.9%              | 7.0%                   | 8.8%              |
| Williams-Sonoma                                  | 3.4%                 | (0.4%)            | 4.7%                   | 0.7%              |
| Pottery Barn Kids                                | 5.6%                 | 8.2%              | 6.8%                   | 7.6%              |
| West Elm   | 16.7%                | 16.5%             | 17.7%                  | 14.2%             |
| PBteen   | (1.0%)               | 16.3%             | 4.2%                   | 16.2%             |
| Williams-Sonoma, Inc.                            | 5.7%                 | 8.4%              | 7.8%                   | 7.8%              |

**DIRECT-TO-CUSTOMER NET REVENUES**

| <i>Dollars in thousands</i>           | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|---------------------------------------|----------------------|-------------------|------------------------|-------------------|
|                                       | August 3,<br>2014    | August 4,<br>2013 | August 3,<br>2014      | August 4,<br>2013 |
| Direct-to-customer net revenues       | \$ 522,589           | \$ 477,657        | \$ 1,013,878           | \$ 896,741        |
| Direct-to-customer net revenue growth | 9.4%                 | 15.3%             | 13.1%                  | 13.7%             |

Direct-to-customer net revenues in the second quarter of fiscal 2014 increased \$44,932,000, or 9.4%, compared to the second quarter of fiscal 2013, primarily driven by West Elm, Pottery Barn, Williams-Sonoma, and Pottery Barn Kids. Direct-to-customer net revenues generated 50% of our total company net revenues in the second quarter of fiscal 2014 compared to 49% in the second quarter of fiscal 2013.

Direct-to-customer net revenues for year-to-date 2014 increased \$117,137,000, or 13.1%, compared to year-to-date 2013, with increases across all brands. This growth was primarily led by Pottery Barn, West Elm, Williams-Sonoma, and Pottery Barn Kids.

**Table of Contents****RETAIL NET REVENUES AND OTHER DATA**

| <i>Dollars in thousands</i>                       | Thirteen Weeks Ended |                   | Twenty-Six Weeks Ended |                   |
|---|----------------------|-------------------|------------------------|-------------------|
|   | August 3,<br>2014    | August 4,<br>2013 | August 3,<br>2014      | August 4,<br>2013 |
| Retail net revenues                               | \$ 516,513           | \$ 504,552        | \$ 999,554             | \$ 973,276        |
| Retail net revenue growth                         | 2.4%                 | 9.7%              | 2.7%                   | 7.8%              |
| Store count - beginning of period                 | 589                  | 587               | 585                    | 581               |
| Store openings                                    | 2                    | 5                 | 9                      | 16                |
| Store closings                                    | (2)                  | (2)               | (5)                    | (7)               |
| Store count - end of period <sup>1, 2</sup>       | 589                  | 590               | 589                    | 590               |
| Store selling square footage at period-end        | 3,598,000            | 3,600,000         | 3,598,000              | 3,600,000         |
| Store leased square footage ( LSF ) at period-end | 5,843,000            | 5,863,000         | 5,843,000              | 5,863,000         |

<sup>1</sup> Included in the fiscal 2014 numbers above are 5 stores in Australia and 1 West Elm store in the United Kingdom.

<sup>2</sup> Included in the fiscal 2013 numbers above are 4 stores in Australia.

|                   | Store Count    |          |          |                   | Avg. LSF Per Store |                   |                   |
|-------------------|----------------|----------|----------|-------------------|--------------------|-------------------|-------------------|
|                   | May 4,<br>2014 | Openings | Closings | August 3,<br>2014 | August 4,<br>2013  | August 3,<br>2014 | August 4,<br>2013 |
| Williams-Sonoma   | 248            |          | (1)      | 247               | 253                | 6,600             | 6,600             |
| Pottery Barn      | 195            |          |          | 195               | 196                | 13,700            | 13,800            |
| Pottery Barn Kids | 84             | 1        | (1)      | 84                | 86                 | 7,700             | 8,000             |
| West Elm          | 58             | 1        |          | 59                | 51                 | 14,000            | 14,600            |
| Rejuvenation      | 4              |          |          | 4                 | 4                  | 13,200            | 13,200            |
| Total             | 589            | 2        | (2)      | 589               | 590                | 9,900             | 9,900             |

Retail net revenues in the second quarter of fiscal 2014 increased \$11,961,000, or 2.4%, compared to the second quarter of fiscal 2013, primarily driven by West Elm and Pottery Barn, partially offset by a decrease in Williams-Sonoma.

Retail net revenues for year-to-date 2014 increased \$26,278,000, or 2.7%, compared to year-to-date 2013, primarily driven by West Elm and Pottery Barn, partially offset by a decrease in our international franchise operations and Williams-Sonoma.

**COST OF GOODS SOLD**

| <i>Dollars in thousands</i> | Thirteen Weeks Ended |                   |                   |                   | Twenty-Six Weeks Ended |                   |                   |                   |
|-----------------------------|----------------------|-------------------|-------------------|-------------------|------------------------|-------------------|-------------------|-------------------|
|                             | August 3,<br>2014    | % Net<br>Revenues | August 4,<br>2013 | % Net<br>Revenues | August 3,<br>2014      | % Net<br>Revenues | August 4,<br>2013 | % Net<br>Revenues |
|                             | \$ 657,004           | 63.2%             | \$ 613,285        | 62.4%             | \$ 1,262,926           | 62.7%             | \$ 1,166,908      | 62.4%             |

Cost of goods  
sold<sup>1</sup>

<sup>1</sup> Includes total occupancy expenses of \$148,142,000 and \$138,068,000 for the second quarter of fiscal 2014 and second quarter of fiscal 2013, respectively, and \$294,581,000 and \$271,072,000 for year-to-date 2014 and year-to-date 2013, respectively.

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

**Table of Contents**

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

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

*Second Quarter of Fiscal 2014 vs. Second Quarter of Fiscal 2013*

Cost of goods sold increased by \$43,719,000, or 7.1%, in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013. Cost of goods sold as a percentage of net revenues increased to 63.2% in the second quarter of fiscal 2014 from 62.4% in the second quarter of fiscal 2013. This increase was primarily driven by lower selling margins and occupancy deleverage.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues increased in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 primarily driven by lower selling margins and occupancy deleverage.

In the retail channel, cost of goods sold as a percentage of net revenues increased in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 primarily driven by occupancy deleverage.

*Year-to-Date 2014 vs. Year-to-Date 2013*

Cost of goods sold for year-to-date 2014 increased by \$96,018,000, or 8.2%, compared to year-to-date 2013. Cost of goods sold as a percentage of net revenues increased to 62.7% for year-to-date 2014 from 62.4% for year-to-date 2013. This increase was primarily driven by lower selling margins and occupancy deleverage.

In the direct-to-customer channel, cost of goods sold as a percentage of net revenues increased for year-to-date 2014 compared to year-to-date 2013 primarily driven by lower selling margins and occupancy deleverage.

In the retail channel, cost of goods sold as a percentage of net revenues increased for year-to-date 2014 compared to year-to-date 2013 primarily driven by occupancy deleverage, partially offset by higher selling margins.

**SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

|  | Thirteen Weeks Ended |                | Twenty-Six Weeks Ended |                |                |                |                |                |
|--|----------------------|----------------|------------------------|----------------|----------------|----------------|----------------|----------------|
|  | August 3, 2014       | % Net Revenues | August 4, 2013         | % Net Revenues | August 3, 2014 | % Net Revenues | August 4, 2013 | % Net Revenues |
| <i>Dollars in thousands</i>                  |                      |                |                        |                |                |                |                |                |
| Selling, general and administrative expenses | \$ 296,762           | 28.6%          | \$ 290,838             | 29.6%          | \$ 590,844     | 29.3%          | \$ 561,240     | 30.0%          |

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

and other general expenses.



## **Table of Contents**

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

### *Second Quarter of Fiscal 2014 vs. Second Quarter of Fiscal 2013*

Selling, general and administrative expenses increased by \$5,924,000, or 2.0%, in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013. Selling, general and administrative expenses as a percentage of net revenues decreased to 28.6% in the second quarter of fiscal 2014 from 29.6% in the second quarter of fiscal 2013. This decrease as a percentage of net revenues was primarily driven by lower general expenses and advertising efficiency.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 primarily driven by advertising efficiency, partially offset by the deleverage of employment costs.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues decreased in the second quarter of fiscal 2014 compared to the second quarter of fiscal 2013 primarily driven by lower general expenses, partially offset by the deleverage of employment costs.

### *Year-to-Date 2014 vs. Year-to-Date 2013*

Selling, general and administrative expenses for year-to-date 2014 increased by \$29,604,000, or 5.3%, compared to year-to-date 2013. Selling, general and administrative expenses as a percentage of net revenues decreased to 29.3% for year-to-date 2014 from 30.0% for year-to-date 2013. This decrease was primarily driven by advertising efficiency and the leverage of general expenses.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of net revenues decreased for year-to-date 2014 compared to year-to-date 2013 primarily driven by advertising efficiency.

In the retail channel, selling, general and administrative expenses as a percentage of net revenues increased for year-to-date 2014 compared to year-to-date 2013 primarily driven by the deleverage of employment costs, partially offset by the leverage of general expenses.

## **INCOME TAXES**

Our effective tax rate was 39.3% for year-to-date 2014 compared to 37.8% for year-to-date 2013, reflecting certain unfavorable income tax matters.

## **LIQUIDITY AND CAPITAL RESOURCES**

As of August 3, 2014, we held \$70,574,000 in cash and cash equivalent funds, the majority of which is held in demand deposit accounts, including \$60,937,000 held by our foreign subsidiaries. As is consistent within our industry, our cash balances are seasonal in nature, with the fourth quarter historically representing a significantly higher level of cash than other periods.

Throughout the fiscal year, we utilize our cash balances to build our inventory levels in preparation for our fourth quarter holiday sales. In fiscal 2014, we plan to use our cash resources to fund our inventory and inventory related purchases, advertising and marketing initiatives, stock repurchases and dividend payments and purchases of property and equipment. In addition to our cash balances on hand, we have a \$300,000,000 unsecured revolving line of credit ( credit facility ) that may be used for loans or letters of credit. Prior to December 22, 2016, we

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**Table of Contents**

may, upon notice to the lenders, request an increase in the credit facility of up to \$200,000,000 to provide for a total of \$500,000,000 of unsecured revolving credit. During the thirteen and twenty-six weeks ended August 3, 2014 and August 4, 2013, we had no borrowings under the credit facility, and no amounts were outstanding as of August 3, 2014 or August 4, 2013. During the quarter, we redeemed restricted cash deposits of \$14,289,000 previously held under collateralized trust agreements. These deposits, which secured potential liabilities associated with our workers compensation and other insurance programs, were replaced with standby letters of credit upon redemption. As of August 3, 2014, a total of \$17,440,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. Additionally, as of August 3, 2014, we had three unsecured letter of credit reimbursement facilities for a total of \$70,000,000, of which an aggregate of \$9,065,000 was outstanding. On August 29, 2014, we renewed all three of our letter of credit facilities for an aggregate of \$70,000,000, and each of these facilities now matures on August 28, 2015. These letter of credit facilities represent only a future commitment to fund inventory purchases to which we had not taken legal title. We are currently in compliance with all of our financial covenants and, based on our current projections, we expect to remain in compliance throughout fiscal 2014. We believe our cash on hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations over the next 12 months.

*Cash Flows from Operating Activities*

For year-to-date 2014, net cash provided by operating activities was \$10,217,000 compared to \$64,063,000 for year-to-date 2013. For year-to-date 2014, net cash provided by operating activities was primarily attributable to net earnings adjusted for non-cash items, partially offset by an increase in merchandise inventories as well as a decrease in accounts payable, income taxes payable, and accrued liabilities, due to the timing of payments. This represents a decrease in net cash provided by operating activities, compared to year-to-date 2013, primarily due to a decrease in both accounts payable and accrued liabilities resulting from the timing of payments, partially offset by an increase in net earnings adjusted for non-cash items.

*Cash Flows from Investing Activities*

For year-to-date 2014, net cash used in investing activities was \$68,948,000 compared to \$97,415,000 for year-to-date 2013, and was primarily attributable to purchases of property and equipment, partially offset by the redemption of restricted cash deposits we previously held under collateralized trust agreements. Net cash used compared to year-to-date 2013 decreased primarily due to the redemption of restricted cash and a decrease in purchases of property and equipment.

*Cash Flows from Financing Activities*

For year-to-date 2014, net cash used in financing activities was \$200,893,000 compared to \$184,315,000 for year-to-date 2013. For year-to-date 2014, net cash used in financing activities was primarily attributable to repurchases of common stock, the payment of dividends and tax withholding payments related to stock-based awards. Net cash used compared to year-to-date 2013 increased primarily due to an increase in tax withholding payments related to stock-based awards.

*Stock Repurchase Program and Dividend*

See Note F to our Condensed Consolidated Financial Statements, *Stock Repurchase Program and Dividend*, within Item 1 of this Quarterly Report on Form 10-Q for further information.

*Critical Accounting Policies*

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and

## **Table of Contents**

expenses and related disclosures of contingent assets and liabilities. The estimates and assumptions are evaluated on an ongoing basis and are based on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results may differ significantly from these estimates. During the second quarter of fiscal 2014, there have been no significant changes to the critical accounting policies discussed in our Annual Report on Form 10-K for the year ended February 2, 2014.

### *Seasonality*

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

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

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

### *Interest Rate Risk*

Our line of credit facility is the only instrument we hold with a variable interest rate which could, if drawn upon, subject us to risks associated with changes in that interest rate. As of August 3, 2014, there were no amounts outstanding under our credit facility.

In addition, we have fixed and variable income investments consisting of short-term investments classified as cash and cash equivalents, which are also affected by changes in market interest rates. As of August 3, 2014, our investments, made primarily in demand deposit accounts are stated at cost and approximate their fair values.

### *Foreign Currency Risks*

We purchase a significant amount of inventory from vendors outside of the U.S. in transactions that are denominated in U.S. dollars. Approximately 2% of our international purchase transactions are in currencies other than the U.S. dollar, primarily the euro. Any currency risks related to these international purchase transactions were not significant to us during the second quarter of fiscal 2014 or the second quarter of fiscal 2013. Since we pay for the majority of our international purchases in U.S. dollars, however, a decline in the U.S. dollar relative to other foreign currencies would subject us to risks associated with increased purchasing costs from our vendors in their effort to offset any lost profits associated with any currency devaluation. We cannot predict with certainty the effect these increased costs may have on our financial statements or results of operations.

In addition, our retail stores in Canada, Australia and the United Kingdom, and operations throughout Asia and Europe, expose us to market risk associated with foreign currency exchange rate fluctuations. Substantially all of our purchases and sales are denominated in U.S. dollars, which limits our exposure to this risk. While the impact of foreign currency exchange rate fluctuations was not significant in the second quarter of fiscal 2014, as we continue to expand globally, the foreign currency exchange risk related to the transactions of our foreign subsidiaries will

increase. To mitigate this risk, we hedge a portion of our foreign currency exposure with foreign currency forward contracts in accordance with our risk management policies (see Note G to our Condensed Consolidated Financial Statements).

**Table of Contents****ITEM 4. CONTROLS AND PROCEDURES***Evaluation of Disclosure Controls and Procedures*

As of August 3, 2014, an evaluation was performed by management, with the participation of our Chief Executive Officer ( CEO ) and our Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow for timely discussions regarding required disclosures, and that such information is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

*Changes in Internal Control Over Financial Reporting*

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

**PART II - OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

See Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended February 2, 2014 for a description of the risks and uncertainties associated with our business. There were no material changes to such risk factors in the current quarterly reporting period.

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

The following table provides information as of August 3, 2014 with respect to shares of common stock we repurchased during the second quarter of fiscal 2014. For additional information, please see Note F to our Condensed Consolidated Financial Statements within Part I of this Form 10-Q.

| Fiscal period                   | Total Number<br>of Shares<br>Purchased <sup>1</sup> | Average Price<br>Paid Per Share | Total Number of<br>Shares Purchased as<br>Part of a Publicly<br>Announced Program | Maximum Dollar Value<br>of Shares That May Yet<br>Be Purchased Under the<br>Program |
|---------------------------------|---|---------------------------------|---|---|
| May 5, 2014 to June 1, 2014     | 115,830   | 64.57                           | 115,830   | 450,434,000   |
| June 2, 2014 to June 29, 2014   | 451,953   | 69.33                           | 451,953   | 419,101,000   |
| June 30, 2014 to August 3, 2014 | 280,163   | 71.15                           | 280,163   | 399,168,000   |
| Total                           | 847,946   | 69.28                           | 847,946   | 399,168,000   |

<sup>1</sup>*In March 2013, our Board of Directors announced a \$750,000,000 stock repurchase program. Stock repurchases under this program may be made through open market and privately negotiated transactions at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability and other market conditions. This stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.*



**Table of Contents**

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

(a) Exhibits

| Exhibit Number | Exhibit Description  |
|----------------|--|
| 31.1           | Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended                 |
| 31.2           | Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended                 |
| 32.1           | Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2           | Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101.INS        | XBRL Instance Document   |
| 101.SCH        | XBRL Taxonomy Extension Schema Document  |
| 101.CAL        | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF        | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB        | XBRL Taxonomy Extension Label Linkbase Document  |
| 101.PRE        | XBRL Taxonomy Extension Presentation Linkbase Document   |

**Table of Contents**

**SIGNATURE**

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

WILLIAMS-SONOMA, INC.

By: /s/ Julie P. Whalen  
Julie P. Whalen  
Chief Financial Officer

Date: September 12, 2014