KIRKLAND'S, INC
Form 10-Q
December 08, 2011

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

þ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended October 29, 2011 , or

o **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from __________ to__________.

Commission file number: 000-49885
KIRKLAND S, INC.
(Exact name of registrant as specified in its charter)

Tennessee (State or other jurisdiction of incorporation or organization)	**62-1287151** (IRS Employer Identification No.)
2501 McGavock Pike, Suite 1000 **Nashville, Tennessee** (Address of principal executive offices)	**37214** (Zip Code)

Registrant s telephone number, including area code: **(615) 872-4800**

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 þ NO o

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 þ NO o

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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Stock, no par value 19,450,980 shares outstanding as of December 2, 2011.

KIRKLAND S, INC.
TABLE OF CONTENTS

2

Table of Contents

KIRKLAND S, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(in thousands, except share data)

	October 29, 2011	January 29, 2011	October 30, 2010
ASSETS			
Current assets:			
Cash and cash equivalents	$ 60,343	$ 91,222	$ 58,831
Inventories, net	59,940	44,452	56,851
Income taxes receivable	2,664		3,332
Prepaid expenses and other current assets	11,176	7,468	8,321
Deferred income taxes	2,174	3,528	4,013
Total current assets	136,297	146,670	131,348
Property and equipment, net	58,366	46,231	45,125
Non-current deferred income taxes	2,412	1,440	3,656
Other assets	1,176	736	684
Total assets	$ 198,251	$ 195,077	$ 180,813
LIABILITIES AND SHAREHOLDERS EQUITY			
Current liabilities:			
Accounts payable	$ 24,975	$ 20,236	$ 25,923
Income taxes payable		1,289	
Accrued expenses and other	21,145	24,364	21,625
Total current liabilities	46,120	45,889	47,548
Deferred rent	30,578	27,259	27,001
Other liabilities	4,445	3,640	3,331
Total liabilities	81,143	76,788	77,880
Shareholders equity:			
Common stock, no par value; 100,000,000 shares authorized; 19,542,449, 19,910,963 and 19,891,346 shares issued and outstanding at October 29, 2011, January 29, 2011 and October 30, 2010, respectively	149,256	146,747	145,773
Accumulated deficit	(32,148)	(28,458)	(42,840)
Total shareholders equity	117,108	118,289	102,933
Total liabilities and shareholders equity	$ 198,251	$ 195,077	$ 180,813

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

3

Table of Contents

KIRKLAND S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)
(in thousands, except per share data)

	13-Week Period Ended		39-Week Period Ended	
	October 29, 2011	**October 30, 2010**	**October 29, 2011**	**October 30, 2010**
Net sales	$ 97,071	$ 92,725	$ 281,175	$ 275,694
Cost of sales (exclusive of depreciation as shown below)	60,938	56,732	176,109	164,243
Gross profit	36,133	35,993	105,066	111,451
Operating expenses:				
Compensation and benefits	18,828	18,337	55,187	53,228
Other operating expenses	12,467	10,744	34,541	29,146
Depreciation	2,914	3,146	8,888	9,294
Total operating expenses	34,209	32,227	98,616	91,668
Operating income	1,924	3,766	6,450	19,783
Interest expense, net	55	33	125	101
Other income, net	(51)	(62)	(126)	(249)
Income before income taxes	1,920	3,795	6,451	19,931
Income tax provision	673	1,516	2,514	7,882
Net income	$ 1,247	$ 2,279	$ 3,937	$ 12,049
Earnings per share:				
Basic	$ 0.06	$ 0.11	$ 0.20	$ 0.61
Diluted	$ 0.06	$ 0.11	$ 0.19	$ 0.59
Weighted average shares for basic earnings per share	19,918	19,889	19,930	19,839
Effect of dilutive stock equivalents	286	633	568	749
Adjusted weighted average shares for diluted earnings per share	20,204	20,522	20,498	20,588

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

Table of Contents

KIRKLAND S, INC.
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)
(in thousands, except share data)

	Common Stock		Accumulated	Total Shareholders
	Shares	Amount	Deficit	Equity
Balance at January 29, 2011	19,910,963	$ 146,747	$ (28,458)	$ 118,289
Exercise of employee stock options and employee stock purchases	172,388	422		422
Tax benefit from exercise of stock options and vesting of restricted stock		1,177		1,177
Net share settlement of stock options and restricted stock	(111,538)	(1,142)		(1,142)
Restricted stock issued	408,439			
Stock-based compensation expense		2,382		2,382
Repurchase and retirement of common stock	(837,803)	(330)	(7,627)	(7,957)
Net income			3,937	3,937
Balance at October 29, 2011	19,542,449	$ 149,256	$ (32,148)	$ 117,108

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

Table of Contents

KIRKLAND S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

	39-Week Period Ended October 29, 2011	October 30, 2010
Cash flows from operating activities:		
Net income	$ 3,937	$ 12,049
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation of property and equipment	8,888	9,294
Amortization of landlord construction allowances	(3,530)	(4,727)
Amortization of debt issue costs	33	20
Loss on disposal of property and equipment	152	247
Cash received for landlord construction allowances	6,849	6,329
Stock-based compensation expense	2,382	1,850
Excess tax benefits from exercise of stock options and restricted stock	(1,177)	(460)
Deferred income taxes	382	278
Changes in assets and liabilities:		
Inventories, net	(15,488)	(17,496)
Prepaid expenses and other current assets	(3,708)	(3,990)
Other noncurrent assets	(186)	(64)
Accounts payable	4,739	10,334
Income taxes payable	(2,776)	(9,959)
Accrued expenses and other current and noncurrent liabilities	(2,414)	(4,025)
Net cash used in operating activities	(1,917)	(320)
Cash flows from investing activities:		
Disposal of property and equipment		(37)
Capital expenditures	(21,175)	(17,773)
Net cash used in investing activities	(21,175)	(17,810)
Cash flows from financing activities:		
Refinancing costs	(287)	
Excess tax benefits from exercise of stock options and restricted stock	1,177	460
Cash used in net share settlement of stock options and restricted stock	(1,142)	(239)
Exercise of stock options and employee stock purchases	422	328
Repurchase and retirement of common stock	(7,957)	
Net cash provided by (used in) financing activities	(7,787)	549
Cash and cash equivalents:		
Net decrease	(30,879)	(17,581)
Beginning of the period	91,222	76,412
End of the period	$ 60,343	$ 58,831

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

KIRKLAND S, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 Basis of Presentation

Kirkland s, Inc. (the Company) is a specialty retailer of home décor with 301 stores in 30 states as of October 29, 2011. The consolidated financial statements of the Company include the accounts of the Company and its wholly-owned subsidiaries, Kirkland s Stores, Inc., Kirkland s DC, Inc., Kirkland s Texas, LLC, and Kirklands.com, LLC. Significant intercompany accounts and transactions have been eliminated.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, including normal recurring adjustments, considered necessary for a fair presentation have been included. These financial statements should be read in conjunction with the audited financial statements included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 14, 2011.

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from the estimates and assumptions used.

Changes in estimates are recognized in the period when new information becomes available to management. Areas where the nature of the estimate makes it reasonably possible that actual results could materially differ from amounts estimated include: impairment assessments on long-lived assets, inventory reserves, self-insurance reserves, income tax liabilities, stock-based compensation, gift certificate and gift card breakage, customer loyalty program accruals and contingent liabilities.

It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than those at fiscal year end. In addition, because of seasonality factors, the results of the Company s operations for the 13-week and 39-week periods ended October 29, 2011 are not indicative of the results to be expected for any other interim period or for the entire fiscal year. The Company s fiscal year ends on the Saturday closest to January 31, resulting in years of either 52 or 53 weeks. All references to a fiscal year refer to the fiscal year ending on the Saturday closest to January 31 of the following year.

Note 2 Income Taxes

An estimate of the annual effective tax rate is used at each interim period based on the facts and circumstances available at that time, while the actual effective tax rate is calculated at year-end. For the 13-week period ended October 29, 2011, the Company recorded an income tax expense of 35.1% of income before income taxes. In the prior year period, the Company recorded income tax expense of 40.0% of income before income taxes. For the 39-week period ended October 29, 2011, the Company recorded income tax expense of 39.0% of income before income taxes. In the prior year period, the Company recorded income tax expense of 39.5% of income before income taxes.

Note 3 Earnings Per Share

Basic earnings per share is computed by dividing net income or loss by the weighted average number of shares outstanding during each period presented, which excludes non-vested restricted stock. Diluted earnings per share is computed by dividing net income by the weighted average number of shares outstanding plus the dilutive effect of stock equivalents outstanding during the applicable periods using the treasury stock method. Diluted earnings per share reflects the potential dilution that could occur if options to purchase stock were exercised into common stock or restricted stock units became vested. Stock options that would have been antidilutive were not included in the computation of diluted earnings per share. The amount of shares excluded from the computation due to their antidilutive effect were 955,000 and 368,000 for the 13-week periods ended October 29, 2011, and October 30, 2010, and 545,000 and 161,000 for the 39-week periods ended October 29, 2011, and October 30, 2010, respectively.

Note 4 Commitments and Contingencies

The Company is party to pending legal proceedings and claims. Although the outcome of such proceedings and claims cannot be determined with certainty, the Company s management is of the opinion that it is unlikely that these proceedings and claims will have a material effect on the financial condition, operating results or cash flows of the Company.

Table of Contents

Note 5 Stock-Based Compensation

The Company maintains equity incentive plans under which it may grant non-qualified stock options, incentive stock options, restricted stock units, or stock appreciation rights to employees, non-employee directors and consultants.

The Company granted 172,500 stock options and 89,000 restricted stock units during the 39-week period ended October 29, 2011. This compares to 225,000 stock options and 114,000 restricted stock units granted in the 39-week period ended October 30, 2010. Total stock-based compensation expense (a component of compensation and benefits) was $733,000 for the 13-week period ended October 29, 2011, and $2.4 million for the 39-week period ended October 29, 2011, compared to $798,000 and $1.9 million, respectively, for the comparable prior year periods.

Note 6 Stock Repurchase Program

On August 19, 2011, the Company announced that its Board of Directors authorized a stock repurchase plan providing for the purchase in the aggregate of up to $40 million of the Company s outstanding common stock from time to time until February 2013. Through October 29, 2011, the Company had repurchased and retired a total of approximately 838,000 shares at an aggregate cost of $8.0 million. As of October 29, 2011, the Company had $32.0 million remaining under the Board s authorization to repurchase its common stock. Subsequent to October 29, 2011, the Company has repurchased and retired approximately 170,000 shares of common stock at an aggregate cost of $2.0 million.

Note 7 Related Party Transactions

In July 2009, the Company entered into an agreement with a related party vendor to purchase merchandise inventory. The vendor is considered a related party for financial reporting purposes because one of its principals is the spouse of the Company s Vice President of Merchandising.

During the third quarter of fiscal 2011 and 2010, purchases from this vendor totaled approximately $7.1 million, or 12% of total merchandise purchases, and $6.0 million, or 11% of total merchandise purchases, respectively. During the 39-week periods ended October 29, 2011, and October 30, 2010, purchases from this vendor totaled approximately $17.0 million, or 11% of total merchandise purchases, and $15.4 million, or 11% of total merchandise purchases, respectively. Payable amounts outstanding to this vendor were approximately $2.2 million and $2.7 million as of October 29, 2011 and October 30, 2010, respectively. The Company s payable terms with this vendor are consistent with the terms offered by other vendors in the ordinary course of business.

Note 8 Amended Credit Facility

On August 19, 2011, the Company entered into an Amended and Restated Credit Agreement, dated as of August 19, 2011 (the Credit Agreement), with Bank of America, N.A. as administrative agent and collateral agent, and the lenders named therein (the Lenders). The Credit Agreement increases the Company s senior secured revolving credit facility from $45 million to $50 million and extends its maturity date to August 2016. Borrowings under the facility will bear interest at an annual rate equal to LIBOR plus a margin ranging from 175 to 225 basis points with no LIBOR floor. The Company will also pay the banks a fee of 0.375% per annum on the unused portion of the facility.

Pursuant to the Credit Agreement, borrowings are subject to certain customary conditions and contain customary events of default, including, without limitation, failure to make payments, a cross-default to certain other debt, breaches of covenants, breaches of representations and warranties, a change in control, certain monetary judgments and bankruptcy and ERISA events. Upon any such event of default, the principal amount of any unpaid loans and all other obligations under the Credit Agreement may be declared immediately due and payable. The maximum availability under the facility is limited by a borrowing base formula which consists of a percentage of eligible inventory and eligible credit card receivables, less reserves.

Also on August 19, 2011, the Company entered into an Amended and Restated Security Agreement, dated as of August 19, 2011 (the Security Agreement), with its Lenders. Pursuant to the Security Agreement, the Company pledged and granted to the administrative agent, for the benefit of itself and the secured parties specified therein, a lien on and security interest in all of the rights, title and interest in substantially all of the assets of the Company to secure the payment and performance of the obligations under the Credit Agreement.

Table of Contents

The Company and its subsidiaries entered into the Credit Agreement and the Security Agreement to amend and restate the previous Loan and Security Agreement, dated as of October 4, 2004 (the Loan and Security Agreement) and amended on August 6, 2007, by and among the Company and its Lenders. The Loan and Security Agreement and the amendment thereto have been previously filed with the Securities Exchange Commission.

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

Forward Looking Statements

This Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to provide an understanding of our financial condition, change in financial condition, cash flow, liquidity and results of operations. The following MD&A discussion should be read in conjunction with the condensed consolidated financial statements and notes to those statements that appear elsewhere in this Form 10-Q and in the Company s Annual Report on Form 10-K. The following discussion contains forward-looking statements that reflect the Company s plans, estimates and beliefs. The Company s actual results could differ materially from those discussed or referred to in the forward-looking statements. Factors that could cause or contribute to any differences include, but are not limited to, those discussed under the caption, Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995 and under Part II, Item 1A Risk Factors .

General

We are a specialty retailer of home décor in the United States, operating 301 stores in 30 states as of October 29, 2011. Our stores present a broad selection of distinctive merchandise, including framed art, mirrors, wall décor, candles and related items, lamps, decorative accessories, accent furniture, textiles, garden-related accessories and artificial floral products. Our stores also offer an extensive assortment of holiday merchandise during seasonal periods as well as items carried throughout the year suitable for gift-giving. In addition, we sometimes use innovative design and packaging to market home décor items as gifts. We provide our predominantly female customers an engaging shopping experience characterized by a diverse, ever-changing merchandise selection at prices which provide the customer discernable value. Our stores offer a unique combination of style and value that has led to our emergence as a recognized name in home décor and has enabled us to develop a strong customer franchise.

During the 13-week period ended October 29, 2011, we opened 13 new stores and closed six stores. The following table summarizes our stores and square footage under lease by venue type:

	Stores				Square Footage		Average Store Size	
	10/29/11		10/30/10		10/29/11	10/30/10	10/29/11	10/30/10
Mall	51	17%	61	21%	255,250	292,000	5,005	4,787
Off-Mall	250	83%	235	79%	1,783,702	1,582,524	7,135	6,734
Total	301	100%	296	100%	2,038,952	1,874,524	6,774	6,333

13-Week Period Ended October 29, 2011 Compared to the 13-Week Period Ended October 30, 2010

Results of operations. The table below sets forth selected results of our operations in dollars and expressed as a percentage of net sales for the periods indicated (dollars in thousands):

	13-Week Period Ended					
	October 29, 2011		October 30, 2010		Change	
	$	%	$	%	$	%
Net sales	$ 97,071	100.0%	$ 92,725	100.0%	$ 4,346	4.7%
Cost of sales	60,938	62.8%	56,732	61.2%	4,206	7.4%
Gross profit	36,133	37.2%	35,993	38.8%	140	0.4%
Operating expenses:						
Compensation and benefits	18,828	19.4%	18,337	19.8%	491	2.7%

Other operating expenses	12,467	12.8%	10,744	11.6%	1,723	16.0%
Depreciation	2,914	3.0%	3,146	3.4%	(232)	(7.4%)
Total operating expenses	34,209	35.2%	32,227	34.8%	1,982	6.2%
Operating income	1,924	2.0%	3,766	4.1%	(1,842)	(48.9%)
Interest expense, net	55	0.1%	33	0.0%	22	66.7%
Other income, net	(51)	(0.1%)	(62)	(0.1%)	11	(17.7%)
Income before income taxes	1,920	2.0%	3,795	4.1%	(1,875)	(49.4%)
Income tax provision	673	0.7%	1,516	1.6%	(843)	(55.6%)
Net income	$ 1,247	1.3%	$ 2,279	2.5%	$ (1,032)	(45.3%)

Table of Contents

Net sales. Net sales increased 4.7% to $97.1 million for the third fiscal quarter of 2011 compared to $92.7 million for the prior year period. The impact of net new store growth accounted for an increase in sales of $5.3 million. E-Commerce sales of approximately $2 million also contributed to the increase over the prior year. These increases in net sales were offset by a decline in comparable store sales of 3.6%, accounting for a $2.9 million decline versus the prior year quarter. Comparable store sales decreased 2.4% in the prior year period. The comparable store sales decrease was primarily due to a decrease in the number of transactions, partially offset by a slight increase in the average ticket. The decrease in transactions was due to a 3% decrease in customer traffic count and a 1% decline in the conversion rate. The increase in the average ticket was the result of a 3% increase in items per transaction, partly offset by a decline in the average retail selling price. Merchandise categories showing a positive comparable store sales performance were art, furniture, floral, textiles and gift. Merchandise categories contributing most to the comparable store sales decline were alternative wall décor, decorative accessories and frames.

Gross profit. Gross profit as a percentage of total revenue decreased from 38.8% in the third quarter of 2010 to 37.2% in the third quarter of 2011. Merchandise margins decreased from 53.7% in the third quarter of fiscal 2010 to 53.4% in the third quarter of fiscal 2011. Merchandise margin is calculated as net sales minus product cost of sales (including inbound freight), inventory shrinkage, and loyalty reward program expense. Merchandise margin excludes outbound freight, store occupancy and central distribution costs. The decrease in merchandise margin during the third quarter of 2011 was due to higher rates of promotional activity and markdowns partially offset by lower ocean freight costs. Store occupancy costs as a percentage of net sales increased 0.4% versus the prior year quarter. This increase resulted primarily from the decline in comparable store sales and a reduction in the number of renegotiated leases versus the prior year. Outbound freight costs and central distribution expenses increased 0.9% as a percentage of sales primarily due to comparable store sales deleverage and an increase in diesel fuel costs as well as shipping and packaging costs associated with E-commerce, which went live during the fourth quarter of fiscal 2010.

Compensation and benefits. At the store-level and corporate level, the compensation and benefits expense ratio decreased for the third quarter of fiscal 2011 as compared to the third quarter of fiscal 2010 primarily due to lower store and corporate bonus accruals as well as a decrease in stock compensation expense.

Other operating expenses. Other operating expenses increased as a percentage of net sales for the third quarter of fiscal 2011. This was primarily the result of negative comparable store sales performance as well as increases in marketing and information technology-related expenses in the third quarter of fiscal 2011 as compared to the prior year period.

Depreciation. The decrease in depreciation as a percentage of sales versus the prior year quarter reflects the impact of lease extensions during the preceding twelve months for store locations in which the majority of the fixed assets had been fully depreciated.

Income tax expense. We recorded an income tax expense of approximately $673,000, or 35.1% of pre-tax income during the third quarter of fiscal 2011, versus income tax expense of approximately $1.5 million, or 40.0% of pre-tax income, in the prior year quarter.

Net income and earnings per share. As a result of the foregoing, we reported net income of $1.2 million, or $0.06 per diluted share, for the third quarter of fiscal 2011 as compared to net income of $2.3 million, or $0.11 per share, for the third quarter of fiscal 2010.

Table of Contents

39-Week Period Ended October 29, 2011 Compared to the 39-Week Period Ended October 30, 2010

Results of operations. The table below sets forth selected results of our operations in dollars and expressed as a percentage of net sales for the periods indicated (dollars in thousands):

	39-Week Period Ended					
	October 29, 2011		October 30, 2010		Change	
	$	%	$	%	$	%
Net sales	$ 281,175	100.0%	$ 275,694	100.0%	5,481	2.0%
Cost of sales	176,109	62.6%	164,243	59.6%	11,866	7.2%
Gross profit	105,066	37.4%	111,451	40.4%	(6,385)	(5.7%)
Operating expenses:						
Compensation and benefits	55,187	19.6%	53,228	19.3%	1,959	3.7%
Other operating expenses	34,541	12.3%	29,146	10.6%	5,395	18.5%
Depreciation	8,888	3.2%	9,294	3.4%	(406)	(4.4%)
Total operating expenses	98,616	35.1%	91,668	33.2%	6,948	7.6%
Operating income	6,450	2.3%	19,783	7.2%	(13,333)	(67.4%)
Interest expense, net	125	0.0%	101	0.0%	24	23.8%
Other income, net	(126)	(0.0%)	(249)	(0.1%)	123	(49.4%)
Income before income taxes	6,451	2.3%	19,931	7.2%	(13,480)	(67.6%)
Income tax expense	2,514	0.9%	7,882	2.9%	(5,368)	(68.1%)
Net income	$ 3,937	1.4%	$ 12,049	4.4%	$ (8,112)	(67.3%)

Net sales. Net sales increased 2.0% to $281.2 million for the first three quarters of fiscal 2011 from $275.7 million for the prior year period. The impact of net new store growth accounted for an increase in net sales of $17.3 million. E-Commerce sales of $4.9 million also contributed to the increase over the prior year period. These increases in net sales were offset by a decline in comparable store sales of 6.7%, which accounted for a $16.7 million decline versus the prior year period. Comparable store sales increased 3.5% in the prior year period. The comparable store sales decrease was primarily due to a decline in number of transactions and a decrease in the average ticket. The decline in transactions resulted from lower traffic counts and a decline in the conversion rate. The decrease in average ticket was the result of lower average retail selling price, partially offset by an increase in items per transaction. Categories contributing most to the comparable store sales decline were alternative wall décor, decorative accessories, frames and mirrors.

Gross profit. Gross profit as a percentage of total revenue decreased from 40.4% in the first three quarters of fiscal 2010 to 37.4% in the first three quarters of fiscal 2011. The decrease in gross profit as a percentage of total revenue was primarily driven by a decline in merchandise margins, which decreased from 54.6% in the first three quarters of fiscal 2010 to 52.9% in the first three quarters of fiscal 2011. The decrease in merchandise margin was the result of higher rates of promotional activity and markdowns, particularly during the second quarter, as well as higher inbound freight costs. Store occupancy costs as a percentage of net sales increased 0.5%. This increase resulted primarily from the decline in comparable stores sales. Outbound freight costs and central distribution expenses also increased as a percentage of sales primarily due to deleverage, an increase in diesel fuel costs, and shipping and packaging costs associated with E-commerce which went live during the fourth quarter of fiscal 2010.

Compensation and benefits. At the store-level, the compensation and benefits expense ratio increased for the first three quarters of fiscal 2011 as compared to the first three quarters of 2010 primarily due to the negative comparable store sales performance. At the corporate level, the compensation and benefits ratio was flat for the first three quarters of 2011 as compared to the first three quarters of 2010, reflecting a decrease in performance bonus accruals.

Other operating expenses. Other operating expenses increased as a percentage of net sales for the first three quarters of fiscal 2011. This was primarily the result of increases in advertising, utilities, legal fees, credit card processing fees, and insurance expenses in the first three quarters of fiscal 2011 as compared to the prior year period.

Depreciation. The decrease in depreciation as a percentage of sales versus the prior year period reflects the impact of lease extensions during the preceding twelve months for store locations in which the majority of the fixed assets had been fully depreciated.

Income tax expense. We recorded income tax expense of approximately $2.5 million, or 39.0% of pre-tax income during the first three quarters of fiscal 2011, versus approximately $7.9 million, or 39.5% of pre-tax income, during the prior year period.

Net income and earnings per share. As a result of the foregoing, we reported net income of $3.9 million, or $0.19 per diluted share, for the first three quarters of fiscal 2011 as compared to net income of $12.0 million, or $0.59 per share, for the first three quarters of fiscal 2010.

Liquidity and Capital Resources

Our principal capital requirements are for working capital and capital expenditures. Working capital consists mainly of merchandise inventories offset by accounts payable, which typically reach their peak by the end of the third quarter of each fiscal year. Capital expenditures primarily relate to new store openings; existing store expansions, remodels or relocations; and purchases of equipment or information technology assets for our stores, distribution facilities and corporate headquarters. Historically, we have funded our working capital and capital expenditure requirements with internally generated cash and borrowings under our credit facility.

Cash flows from operating activities. Net cash used in operating activities was $1.9 million and $320,000 for the first three quarters of fiscal 2011 and fiscal 2010, respectively. Cash flows from operating activities depend heavily on operating performance, changes in working capital and the timing and amount of payments for income taxes. The change in the amount of cash used in operations as compared to the prior year period was primarily the result of the decline in our operating performance versus the prior year and an increase in working capital, excluding cash. These factors were partially offset by a decrease in income taxes paid. Cash tax payments for the first three quarters of fiscal 2011 totaled approximately $6.1 million compared to $9.1 million in the prior year period.

Cash flows from investing activities. Net cash used in investing activities for the first three quarters of fiscal 2011 consisted of $21.2 million in capital expenditures as compared to $17.8 million for the prior year period. The capital expenditures primarily related to the construction of thirteen new stores and the continuation of several information technology projects.

Cash flows from financing activities. Net cash used in financing activities was approximately $7.8 million for the first three quarters of fiscal 2011, and was primarily related to repurchase and retirement of common stock. Net cash provided by financing activities was $549,000 for the first three quarters of fiscal 2010, and was related to the exercise of employee stock options, the vesting of restricted stock units, employee stock purchases, and the related tax benefits.

Revolving credit facility. On August 19, 2011, we entered into an Amended and Restated Credit Agreement, dated as of August 19, 2011 (the Credit Agreement), with Bank of America, N.A. as administrative agent and collateral agent, and the lenders named therein (the Lenders). The Credit Agreement increases our senior secured revolving credit facility from $45 million to $50 million and extends the maturity date to August 2016. Borrowings under the facility will bear interest at an annual rate equal to LIBOR plus a margin ranging from 175 to 225 basis points with no LIBOR floor. We will also pay the banks a fee of 0.375% per annum on the unused portion of the facility.

Pursuant to the Credit Agreement, borrowings are subject to certain customary conditions and contain customary events of default, including, without limitation, failure to make payments, a cross-default to certain other debt, breaches of covenants, breaches of representations and warranties, a change in control, certain monetary judgments and bankruptcy and ERISA events. Upon any such event of default, the principal amount of any unpaid loans and all other obligations under the Credit Agreement may be declared immediately due and payable. The maximum availability under the facility is limited by a borrowing base formula which consists of a percentage of eligible inventory and eligible credit card receivables, less reserves.

Also on August 19, 2011, we entered into an Amended and Restated Security Agreement, dated as of August 19, 2011 (the Amended and Restated Security Agreement), with our Lenders. Pursuant to the Security Agreement, we pledged and granted to the administrative agent, for the benefit of itself and the secured parties specified therein, a lien on and security interest in all of the rights, title and interest in substantially all of our assets to secure the payment and performance of the obligations under the Credit Agreement.

We entered into the Credit Agreement and the Security Agreement to amend and restate the previous Loan and Security Agreement, dated as of October 4, 2004 (the Loan and Security Agreement) and amended on August 6, 2007, between us and the Lenders. The Loan and Security Agreement and the amendment thereto have been previously filed with the Securities Exchange Commission.

As of October 29, 2011, we were in compliance with the covenants in the facility and there were no outstanding borrowings under the credit facility, with approximately $47 million available for borrowing. We do not anticipate any borrowings under the credit facility during fiscal 2011.

12

Table of Contents

At October 29, 2011, our balance of cash and cash equivalents was approximately $60.3 million and the borrowing availability under our facility was $47 million. We believe that the combination of our cash balances, line of credit availability and cash flow from operations will be sufficient to fund our planned capital expenditures and working capital requirements for at least the next twelve months.

Share Repurchase Authorization. On August 19, 2011, the Company announced that its Board of Directors authorized a stock repurchase plan providing for the purchase in the aggregate of up to $40 million of the Company s outstanding common stock from time to time until February 2013. Through October 29, 2011, the Company had repurchased and retired a total of approximately 838,000 shares at an aggregate cost of $8.0 million. As of October 29, 2011, the Company had $32.0 million remaining under the Board s authorization to repurchase its common stock. Subsequent to October 29, 2011, the Company has repurchased and retired approximately 170,000 shares of common stock at an aggregate cost of $2.0 million.

Related Party Transactions

In July 2009, the Company entered into a Vendor Agreement with a related party vendor to purchase merchandise inventory. The vendor is considered a related party because one of its principals is the spouse of the Company s Vice President of Merchandising.

During the third quarter of fiscal 2011 and 2010, the Company s purchases from this vendor totaled approximately $7.1 million, or 12% of total merchandise purchases, and $6.0 million, or 11% of total merchandise purchases, respectively. During the 39-week periods ended October 29, 2011 and October 30, 2010, purchases from this vendor totaled approximately $17.0 million, or 11% of total merchandise purchases, and $15.4 million, or 11% of total merchandise purchases, respectively. Payable amounts outstanding to this vendor were approximately $2.2 million and $2.7 million as of October 29, 2011 and October 30, 2010, respectively. The Company s payable terms with this vendor are consistent with the terms offered by other vendors in the ordinary course of business.

Significant Contractual Obligations and Commercial Commitments

Construction commitments

The Company had commitments for new store construction projects totaling approximately $1.4 million at October 29, 2011.

Critical Accounting Policies and Estimates

There have been no significant changes to our critical accounting policies during fiscal 2011. Refer to our Annual Report on Form 10-K for the fiscal year ended January 29, 2011, for a summary of our critical accounting policies.

Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995

The following information is provided pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Certain statements under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-Q are forward-looking statements made pursuant to these provisions. Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that does not directly relate to any historical or current fact. Words such as should, likely to, forecasts, strategy, goal, anticipates, believes, expects, estimates, intends, plans, projects, and sin identify such forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from the results projected in such statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

The factors listed below in Part II, Item A1 of this report under the heading Risk Factors and in the other sections of this Form 10-Q provide examples of risks, uncertainties and events that could cause our actual results to differ materially from the expectations expressed in our forward-looking statements.

These forward-looking statements speak only as of the date of this report and, except as required by law, we undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this report.

Table of Contents

We caution readers that the following important factors, among others, have in some past cases, affected and could in the future affect our actual results of operations and cause our actual results to differ materially from the results expressed in any forward-looking statements made by us or on our behalf.

If We Do Not Generate Sufficient Cash Flow, We May Not Be Able to Implement Our Growth Strategy.

If We Are Unable to Profitably Open and Operate New Stores, We May Not Be Able to Adequately Execute Our Growth Strategy, Resulting in a Decrease in Net Sales and Net Income.

Our Success Depends Upon our Marketing, Advertising and Promotional Efforts. If We are Unable to Implement Them Successfully, or if Our Competitors are More Effective Than We are, Our Revenue May Be Adversely Affected.

Weather Conditions Could Adversely Affect Our Sales and/or Profitability by Affecting Consumer Shopping Patterns.

Our Performance May Be Affected by General Economic Conditions.

We May Not Be Able to Successfully Anticipate Consumer Trends and Our Failure to Do So May Lead to Loss of Consumer Acceptance of Our Products Resulting in Reduced Net Sales.

Our Freight Costs and thus Our Cost of Goods Sold are Impacted by Changes in Fuel Prices.

New Legal Requirements Could Adversely Affect Our Operating Results.

The Market Price for Our Common Stock Might Be Volatile and Could Result in a Decline in the Value of Your Investment.

Our Comparable Store Net Sales Fluctuate Due to a Variety of Factors.

Failure to Protect the Integrity and Security of Individually Identifiable Data of Our Customers and Employees Could Expose Us to Litigation and Damage Our Reputation.

We Face an Extremely Competitive Specialty Retail Business Market, and Such Competition Could Result in a Reduction of Our Prices and a Loss of Our Market Share.

We Depend on a Number of Vendors to Supply Our Merchandise, and Any Delay in Merchandise Deliveries from Certain Vendors May Lead to a Decline in Inventory Which Could Result in a Loss of Net Sales.

We Are Dependent on Foreign Imports for a Significant Portion of Our Merchandise, and Any Changes in the Trading Relations and Conditions Between the United States and the Relevant Foreign Countries May Lead to a Decline in Inventory Resulting in a Decline in Net Sales, or an Increase in the Cost of Sales Resulting in Reduced Gross Profit.

Our Success Is Highly Dependent on Our Planning and Control Processes and Our Supply Chain, and Any Disruption in or Failure to Continue to Improve These Processes May Result in a Loss of Net Sales and Net Income.

Our Business Is Highly Seasonal and Our Fourth Quarter Contributes a Disproportionate Amount of Our Net Sales, Net Income and Cash Flow, and Any Factors Negatively Impacting Us During Our Fourth Quarter

Could Reduce Our Net Sales, Net Income and Cash Flow, Leaving Us with Excess Inventory and Making It More Difficult for Us to Finance Our Capital Requirements.

We May Experience Significant Variations in Our Quarterly Results.

Our Hardware and Software Systems Are Vulnerable to Damage that Could Harm Our Business.

We Depend on Key Personnel, and if We Lose the Services of Any Member of Our Senior Management Team, We May Not Be Able to Run Our Business Effectively.

Table of Contents

Our Charter and Bylaw Provisions and Certain Provisions of Tennessee Law May Make It Difficult in Some Respects to Cause a Change in Control of Kirkland s and Replace Incumbent Management.

Concentration of Ownership among Our Existing Directors, Executive Officers, and Their Affiliates May Prevent New Investors from Influencing Significant Corporate Decisions.

If We Fail to Maintain an Effective System of Internal Control, We May Not Be Able to Accurately Report Our Financial Results.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company does not utilize financial instruments for trading or other speculative purposes, nor does it utilize leveraged financial instruments. There have been no material changes in the market risk factors from those disclosed in the Company s Form 10-K for the year ended January 29, 2011.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures*. Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15(d)-(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act) have concluded that as of October 29, 2011 our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by the Company in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

(b) *Change in internal controls over financial reporting*. There have been no changes in internal controls over financial reporting identified in connection with the foregoing evaluation that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved in various routine legal proceedings incidental to the conduct of our business. We believe any resulting liability from existing legal proceedings, individually or in the aggregate, will not have a material adverse effect on our operations or financial condition.

ITEM 1A. RISK FACTORS

In addition to factors set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995, in Part I Item 2 of this report, you should carefully consider the factors discussed in Part I, Item 1A Risk Factors in our Annual Report on Form 10-K for the fiscal year ended January 29, 2011, which factors could materially affect our business, financial condition or future results. The risks described in this report and in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

As of the date of this filing, there have been no material changes in our risk factors from those disclosed in Part I, Item 1A, of our Annual Report on Form 10-K for the fiscal year ended January 29, 2011.

Table of Contents

ITEM 6. EXHIBITS

(a) Exhibits.

Exhibit No.	Description of Document
31.1	Certification of the President and Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
31.2	Certification of the Senior Vice President and Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
32.1	Certification of the President and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of the Senior Vice President and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101	The following materials from our Quarterly Report on Form 10-Q for the quarter ended October 29, 2011 are furnished herewith, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Condensed Consolidated Statements of Shareholders Equity; (iv) the Condensed Consolidated Statements of Cash Flows, and (iv) the Notes to Condensed Consolidated Financial Statements, tagged as blocks of text

Table of Contents

SIGNATURES

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 hereunto duly authorized.

	KIRKLAND S, INC.
Date: December 8, 2011	/s/ Robert E. Alderson Robert E. Alderson President and Chief Executive Officer (Principal Executive Officer)
Date: December 8, 2011	/s/ W. Michael Madden W. Michael Madden Senior Vice President and Chief Financial Officer (Principal Financial Officer and Accounting Officer)

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description of Document
31.1	Certification of the President and Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
31.2	Certification of the Senior Vice President and Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
32.1	Certification of the President and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of the Senior Vice President and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101	The following materials from our Quarterly Report on Form 10-Q for the quarter ended October 29, 2011 are furnished herewith, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Condensed Consolidated Statements of Shareholders Equity; (iv) the Condensed Consolidated Statements of Cash Flows, and (iv) the Notes to Condensed Consolidated Financial Statements, tagged as blocks of text