

BEBE STORES INC
Form 10-Q
May 11, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities
Exchange Act of 1934**

For the quarterly period ended April 1, 2006

OR

**Transition Report Pursuant to Section 13 or 15(d) of the Securities
Exchange Act of 1934**

Commission File Number 0-24395

bebe stores, inc.

(Exact name of registrant as specified in its charter)

California
(State or Jurisdiction of
Incorporation or Organization)

94-2450490
(IRS Employer
Identification Number)

**400 Valley Drive
Brisbane, California 94005**
(Address of principal executive offices)

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Telephone: (415) 715-3900

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act). Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuers of common stock, as of the latest practicable date.

COMMON STOCK, PAR VALUE OF \$0.001 PER SHARE, 91,595,639 SHARES
OUTSTANDING AS OF APRIL 27, 2006

bebe stores, inc.

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PART I. FINANCIAL INFORMATION**ITEM 1. Condensed Consolidated Financial Statements****bebe stores, inc.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share data)****(unaudited)**

	As of April 1, 2006		As of July 2, 2005		As of April 2, 2005
Assets:					
Current assets:					
Cash and equivalents	\$ 47,411	\$	27,072	\$	35,581
Short-term marketable securities	264,280		241,604		220,602
Receivables (net of allowance of \$1,141, \$843 and \$799)	6,080		6,547		3,817
Inventories	40,047		31,785		31,513
Prepaid and other	21,198		12,599		18,063
Total current assets	379,016		319,607		309,576
Property and equipment, net	81,576		77,753		72,331
Long-term marketable securities			2,000		2,000
Other assets	12,035		8,186		5,670
Total assets	\$ 472,627	\$	407,546	\$	389,577
Liabilities and Shareholders Equity:					
Current liabilities:					
Accounts payable	\$ 26,393	\$	20,682	\$	27,067
Accrued liabilities	26,611		23,041		22,778
Current portion of capital lease liability	266		167		
Total current liabilities	53,270		43,890		49,845
Long-term portion of capital lease liability	311		226		
Deferred rent and other lease incentives	32,681		30,187		28,919
Total liabilities	86,262		74,303		78,764
Commitments and contingencies					
Shareholders equity:					
Preferred stock-authorized 1,000,000 shares at \$0.001 par value per share; no shares issued and outstanding					
Common stock-authorized 135,000,000 shares at \$0.001 par value per share; issued and outstanding 91,584,334, 91,127,616 and 90,681,415 shares					
	92		91		91
Additional paid-in capital	92,081		80,526		73,942
Deferred compensation			(35)		(61)
Accumulated other comprehensive income	1,552		971		1,030
Retained earnings	292,640		251,690		235,811
Total shareholders equity	386,365		333,243		310,813
Total liabilities and shareholders equity	\$ 472,627	\$	407,546	\$	389,577

See accompanying notes to condensed consolidated financial statements.

bebe stores, inc.
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS
(In thousands, except per share data)
(unaudited)

	Three Months Ended		Nine Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
Net sales	\$ 132,812	\$ 116,862	\$ 426,862	\$ 372,590
Cost of sales, including production and occupancy	70,576	62,183	217,284	189,463
Gross profit	62,236	54,679	209,578	183,127
Selling, general and administrative expenses	44,721	37,842	133,886	110,655
Income from operations	17,515	16,837	75,692	72,472
Interest and other income, net	2,814	1,117	7,174	3,027
Earnings before income taxes	20,329	17,954	82,866	75,499
Provision for income taxes	7,030	6,823	30,985	28,690
Net earnings	\$ 13,299	\$ 11,131	\$ 51,881	\$ 46,809
Basic earnings per share	\$ 0.15	\$ 0.12	\$ 0.57	\$ 0.52
Diluted earnings per share	\$ 0.14	\$ 0.12	\$ 0.55	\$ 0.50
Basic weighted average shares outstanding	91,445	90,199	91,274	89,210
Diluted weighted average shares outstanding	93,762	94,048	93,769	92,790

See accompanying notes to condensed consolidated financial statements.

bebe stores, inc.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(unaudited)

	Nine Months Ended	
	April 1, 2006	April 2, 2005
Cash flows from operating activities:		
Net earnings	\$ 51,881	\$ 46,809
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Non-cash compensation expense	6,912	637
Depreciation and amortization	11,659	9,912
Net loss on disposal of property	149	304
Deferred rent and other lease incentives	2,460	6,353
Deferred income taxes	(3,564)	(1,217)
Changes in operating assets and liabilities:		
Receivables	876	(859)
Inventories	(8,224)	(5,936)
Prepaid expenses and other assets	(9,026)	(6,785)
Accounts payable	5,707	12,590
Accrued liabilities	499	9,721
Net cash provided by operating activities	59,329	71,529
Cash flows from investing activities:		
Purchase of property and equipment	(15,733)	(15,891)
Purchase of marketable securities	(235,748)	(217,624)
Proceeds from sales of marketable securities	215,278	163,097
Net cash used by investing activities	(36,203)	(70,418)
Cash flows from financing activities:		
Net proceeds from issuance of common stock	3,005	13,706
Tax benefit on options exercised	1,674	
Cash dividends paid	(7,299)	(5,975)
Other	(192)	
Net cash provided (used) by financing activities	(2,812)	7,731
Net increase in cash and equivalents	20,314	8,842
Effect of exchange rates on cash	25	684
Cash and equivalents:		
Beginning of period	27,072	26,055
End of period	\$ 47,411	\$ 35,581

See accompanying notes to condensed consolidated financial statements.

bebe stores, inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

INTERIM FINANCIAL STATEMENTS

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The accompanying condensed consolidated balance sheets of bebe stores, inc. as of April 1, 2006 and April 2, 2005, the condensed consolidated statements of earnings for the three and nine months ended April 1, 2006 and April 2, 2005 and the condensed consolidated statements of cash flows for the nine months ended April 1, 2006 and April 2, 2005 have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, without audit. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for annual financial statements. Therefore, these condensed consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended July 2, 2005.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary to present fairly the financial position at the balance sheet dates and the results of earnings for the three and nine months then ended have been included. The condensed consolidated balance sheet at July 2, 2005, presented herein, was derived from the audited balance sheet included in the Form 10-K for the fiscal year ended July 2, 2005.

Our business is affected by the pattern of seasonality common to most retail apparel businesses. The results for the periods presented are not necessarily indicative of future financial results.

FISCAL YEAR

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Beginning on July 1, 2004, the Company changed their fiscal year to a 52/53 week year, each period ending on the first Saturday after June 30. Fiscal years 2005, 2006 and 2007 include 52, 52 and 53 weeks, respectively.

Beginning on July 1, 2004, the Company changed their fiscal year to a 52/53 week year, each period ending on the

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The three-month periods ending April 1, 2006 and April 2, 2005 both include 91 days. The nine-month period ending April 1, 2006 began on July 3, 2005 and included 273 days. The nine-month period ending April 2, 2005 began on July 1, 2004 and included 276 days.

The three-month periods ending April 1, 2006 and April 2, 2005 both include 91 days. The nine-month period ending

INVENTORIES

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The company's inventories consist of:

	April 1, 2006	As of July 2, 2005 (In thousands)	April 2, 2005
Raw materials	\$ 8,920	\$ 7,302	\$ 7,204
Merchandise available for sale	31,127	24,483	24,309
Inventories	\$ 40,047	\$ 31,785	\$ 31,513

EARNINGS PER SHARE

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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 reflects the potential dilution that could occur from common shares issuable through the exercise of dilutive stock options.

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

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	Three Months Ended		Nine Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
	(In thousands)			
Basic weighted average number of shares outstanding	91,445	90,199	91,274	89,210
Incremental shares from assumed issuance of stock options	2,317	3,849	2,495	3,580
Diluted weighted average number of shares outstanding	93,762	94,048	93,769	92,790

The number of incremental shares from the assumed issuance of stock options is calculated applying the treasury stock method.

Excluded from the computation of the number of diluted weighted average shares outstanding were antidilutive options of approximately 1,458,000 and 105,000 for the three months ended April 1, 2006 and April 2, 2005, respectively, and approximately 1,225,000 and 252,000 for the nine months ended April 1, 2006 and April 2, 2005, respectively.

COMPREHENSIVE INCOME

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Comprehensive income consists of net income and other comprehensive income (income, expenses, gains and losses that bypass the income statement and are reported directly as a separate component of equity). The Company's comprehensive income consists of net income and foreign currency translation adjustments for all periods presented.

	Three Months Ended		Nine Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
	(In thousands)			
Net income	13,299	11,131	51,881	46,809
Other comprehensive income (loss)	(71)	(96)	581	734
Total comprehensive income	13,228	11,035	52,462	47,543

CREDIT FACILITIES

The Company has an unsecured commercial line of credit agreement with a bank, which provides for borrowings and issuance of letters of credit up to a combined total of \$25.0 million and expires on March 31, 2009. The outstanding balance bears interest at either the bank's reference rate (which was 7.75% as of April 1, 2006) or the LIBOR rate plus 1.75 percentage points. As of April 1, 2006, there were no outstanding cash borrowings, and there was \$3.5 million of letters of credit outstanding.

This credit facility requires the Company to comply with certain financial covenants, including amounts for minimum tangible net worth, unencumbered liquid assets and profitability, and certain restrictions on making loans and investments.

STOCK-BASED COMPENSATION

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The 1997 Stock Plan as amended (the "Stock Plan") provides for the grant of incentive stock options, non-qualified stock options, stock purchase rights, stock awards and restricted stock units ("RSU"). Although the Stock Plan allows for stock options and related awards to be granted at prices below fair market value, the Company has historically granted such options at the fair market value of the stock on the date of grant. Stock options and related awards have a maximum term of ten years. Options and restricted stock units granted to employees generally vest over four years with 20% of the award vested in each of the first and second years and 30% vested in each of the remaining two years. Options granted to Directors generally vest over four years with 20% of the award vested in each of the first and second years and 30% vested in each of the remaining two years. Restricted stock units awarded to Directors

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generally vest over a period of one year from the date of grant. As of April 1, 2006, the Company has reserved 19,613,750 shares of common stock for issuance under the Stock Plan and there were 1,572,368 shares available for future grant.

Prior to July 3, 2005, the Company accounted for stock-based awards granted to employees and non-employee Directors under the Stock Plan in accordance with the measurement and recognition provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, Financial Accounting Standards Board (FASB) Statement No. 123 Accounting for Stock-Based Compensation, and complied with the disclosure provisions of FASB Statement No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an Amendment of FASB Statement No. 123.

Effective July 3, 2005, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), Share-Based Payment, using the modified prospective transition method. Under this transition method, compensation cost in 2006 includes the portion vesting in the period for (1) all share-based payments granted prior to, but not vested as of July 2, 2005, based on the grant date fair value estimated in accordance with the original provisions of FASB Statement No. 123 and (2) all share-based payments granted subsequent to July 2, 2005, based on the grant date fair value estimated in accordance with the provisions of FASB Statement No. 123(R). Results for prior periods have not been restated.

The Company recognized share-based compensation expense of \$2.1 million (\$0.01 per diluted share, after related tax benefit of \$0.7 million) in the three months ended April 1, 2006 as a component of selling, general and administrative expenses. The Company recognized share-based compensation expense of \$6.9 million (\$0.04 per diluted share, after related tax benefit of \$2.6 million) in the nine months ended April 1, 2006 as a component of selling, general and administrative expenses. As of April 1, 2006, there was \$27.1 million (before any related tax benefit) of total unrecognized compensation cost related to nonvested share-based compensation that is expected to be recognized over a weighted-average period of 2.0 years.

Prior to the adoption of FASB Statement No. 123(R), the Company presented all benefits of tax deductions resulting from the exercise of share-based compensation as operating cash flows in the Statements of Cash Flows. FASB Statement No. 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. For the nine months ended April 1, 2006, the Company reported \$1.7 million of excess tax benefits as a financing cash inflow.

The fair value of each option grant was estimated on the date of the grant using the Black-Scholes valuation model. The expected life of the options represents the period of time the options are expected to be outstanding and is based on historical trends. For the three and nine months ended April 1, 2005, expected stock price volatility is based on an average of the historical volatility of the Company's stock for a period approximating the expected life and the implied volatility based on traded options of the Company's stock. For the three and nine months ended April 2, 2005, expected stock price volatility was based on historical volatility only. The expected dividend yield is based on the Company's most recent annual dividend payout. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and has a term that approximates the expected life.

The following table presents the weighted average assumptions used in the option pricing model for the stock options granted in the three and nine months ended April 1, 2006 and April 2, 2005:

Three Months Ended		Nine Months Ended	
April 1, 2006	April 2, 2005 (Pro forma)	April 1, 2006	April 2, 2005 (Pro forma)

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Expected dividend rate	0.9%	0.4%	0.9%	0.6%
Volatility	49.2%	69.7%	52.9%	72.4%
Risk-free interest rate	4.4%	3.4%	4.2%	3.5%
Expected lives (years)	4.4	5.8	4.4	5.9
Fair value per option granted	\$ 7.37	\$ 12.66	\$ 7.90	\$ 9.67

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Had stock-based employee compensation expense been determined based upon the fair values at the grant dates for awards under the Company's stock plan in accordance with FASB Statement No. 123 in the three and nine months ended April 2, 2005, the Company's pro forma net earnings, basic and diluted earnings per common share would have been as follows:

	Three Months Ended		Nine Months Ended	
	April 2, 2005		April 2, 2005	
	(In thousands, except per share amounts)			
Net income, as reported	\$	11,131	\$	46,809
Add: Stock-based employee compensation expense included in reported net income, net of income tax		341		395
Deduct: Stock-based employee compensation determined under the fair value method, net of income tax		(2,057)		(5,299)
Net income, pro forma	\$	9,415	\$	41,905
Basic EPS, as reported	\$	0.12	\$	0.52
Basic EPS, pro forma	\$	0.10	\$	0.47
Diluted EPS, as reported	\$	0.12	\$	0.50
Diluted EPS, pro forma	\$	0.10	\$	0.45

The following table summarizes stock option activity during the nine months ended April 1, 2006:

	Options (In thousands)	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (In thousands)
Outstanding, July 2, 2005	7,663	\$ 8.48		
Granted	729	17.31		
Exercised	(448)	6.40		
Cancelled	(416)	8.18		
Outstanding, April 1, 2006	7,528	\$ 9.47	7.50	\$ 68,724
Exercisable, April 1, 2006	2,766	\$ 6.80	6.33	\$ 32,213

Intrinsic value for stock options is defined as the difference between the current market value and the grant price. For the nine months ended April 1, 2006, the total intrinsic value of stock options exercised was \$5.5 million. Cash received from stock options exercised during the nine months ended April 1, 2006 was \$2.9 million and the actual tax benefit realized for tax deductions from stock options exercised totaled \$5.4 million.

The following table summarizes RSU activity during the nine months ended April 1, 2006:

	Shares (In thousands)		Weighted Average Grant Date Fair Value Per Share
Nonvested, July 2, 2005	6	\$	15.60
Vested	(6)	\$	15.60
Granted	24	\$	15.17
Nonvested, April 1, 2006	24	\$	15.15

LEGAL MATTERS

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A former candidate for an executive position sued the Company and two other named defendants in a First Amended Complaint, filed November 9, 2004 in the Superior Court of the State of California, County of San Francisco (case No. CGC-04-435517), seeking unspecified monetary damages and other equitable relief. This case was dismissed with prejudice with no liability to the Company.

A former employee sued the Company in a complaint filed on April 28, 2005 in the United States District Court for the Northern District of California (case No. C05-0177-MHP) alleging violations under the Fair Labor Standards Act, specifically that the Company obligated her to buy and wear its brand clothing as a uniform, without reimbursement or credit, and the net effect of deducting the value of such required purchases from her wages would often result in her not being paid minimum wages. The plaintiff purports to bring the action also on behalf of a class of hourly, non-managerial employees who are similarly situated. The lawsuit seeks compensatory, statutory and injunctive relief. The Company believes that the plaintiff's claims are without merit, and will continue to vigorously defend this matter.

In addition to the above, the Company is also involved in various other legal proceedings arising in the normal course of business. None of these matters, or their ultimate resolution, are expected, individually or in the aggregate, to have a material adverse effect on the Company's business, financial condition or results of operations.

The Company intends to defend itself vigorously against these claims. However, the results of any litigation are inherently uncertain. The Company cannot assure you that it will be able to successfully defend itself in these lawsuits. Where required, and/or otherwise appropriate, the Company makes an estimate of potential liabilities that management believes are reasonable. Any estimates are revised as further information becomes available.

RECENT ACCOUNTING PRONOUNCEMENT

In March 2005, the FASB issued FASB Interpretation (FIN) 47, Accounting for Conditional Asset Retirement Obligations. FIN 47 clarifies that the term "conditional asset retirement obligation" as used in FASB Statement No. 143, Accounting for Asset Retirement Obligations, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. FIN 47 is effective for fiscal years ending on or after December 15, 2005. The Company does not believe that the adoption of FIN 47 will have a material impact on its financial position or results of operations.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements. Statements that are predictive in nature, that depend upon or refer to future events or conditions or that include words such as "expects," "anticipates," "intends," "plans," "believes," "estimates," "thinks," and similar expressions are forward-looking statements. Forward looking statements include statements about our expected results of operations, capital expenditures and store openings. Although we believe that these statements are based upon reasonable assumptions, we cannot ensure that our goals will be achieved. These forward-looking statements are made as of the date of this Form 10-Q, and we assume no obligation to update or revise them or provide reasons why actual results may differ. Factors that might cause such a difference include, but are not limited to, our ability to respond to changing fashion trends, miscalculation of the demand for our products, disruption in supply, difficulties in manufacturing, effective management of our growth, the success of future store openings, decline in comparable store sales performance, ongoing competitive pressures in the apparel industry, changes in the level of consumer spending or preferences in apparel, our ability to attract and retain key management personnel, adverse economic conditions, and/or other factors discussed in "Risks That May Affect Results" and elsewhere in this Form 10-Q.

OVERVIEW

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We design, develop and produce a distinctive line of contemporary women's apparel and accessories. While we attract a broad audience, our target customer is a 21 to 35-year-old woman who seeks current fashion trends to suit her lifestyle. The bebe look, appeals to a hip, sexy, sophisticated, body-conscious woman who takes pride in her appearance. The bebe customer expects value in the form of current fashion and high quality at a competitive price.

Our distinctive product offering includes a full range of separates, tops, dresses, active wear and accessories in the following lifestyle categories: career, evening, casual and active. We design and develop the majority of our merchandise in-house, which is manufactured to our specifications. The remainder of our merchandise is sourced directly from third party manufacturers' lines.

We market our products under the bebe, BEBE SPORT and bebe O brand names through our 228 retail stores, of which 173 are bebe stores, 35 are BEBE SPORT stores, and 20 are bebe outlet stores. These stores are located in 32 states, the District of Columbia, Puerto Rico and Canada. In addition, we have an on-line store at www.bebe.com and our licensees operate 15 international stores. During the three-month period ended April 1, 2006, we did not open or close any stores. During the nine-month period ended April 1, 2006, we opened 16 stores, including 8 bebe stores, 5 BEBE SPORT stores, and 3 bebe outlet stores. We also closed 1 bebe store and 1 BEBE SPORT store. We expect to open 34 stores, including 19 bebe stores, 12 BEBE SPORT stores and 3 outlet stores during the year. We also plan to renovate, relocate or expand approximately 11 existing stores and close 3 stores, resulting in square footage growth of approximately 16%.

bebe stores. The Company was founded by Manny Mashouf, Chairman of the Board. We opened our first store in San Francisco, California in 1976, which was also the year we incorporated.

BEBE SPORT stores. The Company launched BEBE SPORT during fiscal 2003 to address the active lifestyle needs of the bebe customer. The BEBE SPORT collection includes sportswear, tops, sweaters, outerwear and accessories.

bebe outlet stores. The Company utilizes the outlets as a clearance vehicle for merchandise from retail stores. In addition, the inventory includes a strong presentation of bebe logo merchandise and special cuts, produced under the bebe O label, produced exclusively for the outlet stores.

On-line store. bebe.com is an extension of the bebe store experience and provides a complete assortment of bebe and BEBE SPORT merchandise. It is also used as an advertising vehicle to communicate with our customers.

Direct to consumer. The Company launched a direct mail marketing program in fiscal 2005 and plans to increase the circulation and frequency of mailings during fiscal 2006. We effectively communicate our brand strategy to our best customers through direct to consumer marketing.

Neda by bebe. The Company announced its new accessory concept, Neda by bebe, in November 2005 and plans to open its first store in September 2006. Neda by bebe will offer distinctly designed shoes, handbags and accessories.

CRITICAL ACCOUNTING POLICIES

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Management's Discussion and Analysis of Financial Condition and Results of Operations are based upon our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America.

The preparation of these financial statements requires the appropriate application of certain accounting policies, many of which require us to make estimates and assumptions about future events and their impact on amounts reported in our financial statements and related notes. Since future events and their impact cannot be determined with certainty, the actual results may differ from our estimates. Such differences could be material to the financial statements. We believe our application of accounting policies, and the estimates inherently required therein, are reasonable. These accounting policies and estimates are constantly reevaluated, and adjustments are made when facts and circumstances dictate a change. Our accounting policies are more fully described in Note 1 to the consolidated financial statements in our annual report on Form 10-K for the year ended July 2, 2005.

We have identified certain critical accounting policies, which are described below:

Revenue recognition. We recognize revenue at the time the products are received by the customers in accordance with the provisions of Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements as amended by SAB No. 104, Revenue Recognition. Revenue is recognized for store sales at the point at which the customer receives and pays for the merchandise at the register. For on-line sales, revenue is recognized at the time the customer receives the product. We estimate and defer revenue and the related product costs for shipments that are in transit to the customer. Customers typically receive goods within a few days of shipment. Amounts related to shipping billed to customers are reflected in net sales and the related costs are reflected in cost of goods sold.

We record a reserve for estimated product returns based on historical return trends. As of April 1, 2006 and April 2, 2005 the reserve was \$1,046,000 and \$1,005,000, respectively. If actual returns are greater than those projected, additional sales returns may be recorded in the future.

Discounts offered to customers consist primarily of point of sale markdowns and are recorded at the time of the related sale as a reduction of revenue.

The value of points and rewards earned by our loyalty program members are included as a liability and a reduction of revenue at the time the points and rewards are earned based on historical conversion and redemption rates. The associated revenue is recognized when the rewards are redeemed or expire.

Gift certificates sold are carried as a liability and revenue is recognized when the gift certificate is redeemed. Similarly, customers may receive a store credit in exchange for returned goods. Store credits are carried as a liability until redeemed.

Royalty revenue from product licensees is recorded as earned.

Inventories. Our inventories are stated at the lower of weighted average cost or market. Market is determined based on the estimated net realizable value, which is generally the merchandise selling price. To ensure that our raw material is

properly valued we age the fabric inventory and record a reserve in accordance with our established policy, which is based on historical experience. To ensure our finished goods inventory is properly valued we review the age and turnover of our inventory and record a reserve if the selling price is marked down below cost. These assumptions can have an impact on current and future operating results and financial position. We estimate shrinkage for the period between the last physical count and balance sheet date based on historic shrinkage trends.

Long-lived assets. We review long-lived assets for impairment whenever events or changes in circumstances, such as store closures or poor performing stores, indicate that the carrying value of an asset may not be recoverable. If the undiscounted cash flows from the long-lived assets are less than the carrying value we record an

impairment charge equal to the difference between the carrying value and the asset's fair value. In addition, at the time a decision is made to close a store, we record an impairment charge, if appropriate, or accelerate depreciation over the revised useful life of the asset. Historically, our impairment charges have been immaterial. During the nine months ended April 1, 2006 and April 2, 2005, we recorded impairment charges of approximately \$73,000 and \$112,000, respectively, for poor performing stores for which the carrying value of the assets will not be recovered. We believe at this time that the long-lived assets' carrying values and useful lives continue to be appropriate.

Accrued Litigation. We accrue estimates of probable liabilities associated with lawsuits and claims. The results of any litigation are inherently uncertain. As information becomes available, we assess the potential liabilities related to pending litigation and may revise our estimates as necessary. Such revisions of estimates could materially impact the results of operations and financial position.

Self-Insurance. We use a combination of insurance and self insurance for employee related health care benefits. We record self insurance liabilities based on claims filed and an estimate of those claims incurred but not reported. Any projection of losses concerning our liability is subject to a high degree of variability. Among the causes of this variability are unpredictable external factors such as future inflation rates, changes in severity, benefit level changes, medical costs and claim settlement patterns. Should a different amount of claims occur compared to what was estimated or costs of the claims increase or decrease beyond what was anticipated, reserves may need to be adjusted in the future.

Income Taxes. We accrue liabilities for estimates of probable settlements of domestic and foreign tax audits. At any one time, many tax years may be subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. Our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings. We also record a valuation allowance against our deferred tax assets arising from foreign tax credit carryforwards as the utilization of these credits is not assured.

RECENT ACCOUNTING PRONOUNCEMENT

In March 2005, the FASB issued FASB Interpretation (FIN) 47, Accounting for Conditional Asset Retirement Obligations. FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, Accounting for Asset Retirement Obligations, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. FIN 47 is effective for fiscal years ending on or after December 15, 2005. The Company does not believe that the adoption of FIN 47 will have a material impact on its financial position or results of operations.

RESULTS OF OPERATIONS

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Beginning on July 1, 2004, the Company changed their fiscal year to a 52/53 week year, each period ending on the first Saturday after June 30. Fiscal years 2005, 2006 and 2007 include 52, 52 and 53 weeks, respectively.

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The three-month periods ending April 1, 2006 and April 2, 2005 both include 91 days. The nine-month period ending April 1, 2006 began on July 3, 2005 and included 273 days. The nine-month period ending April 2, 2005 began on July 1, 2004 and included 276 days.

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The following table sets forth certain financial data as a percentage of net sales for the periods indicated:

	Three Months Ended		Nine Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales, including production and occupancy (1)	53.1	53.2	50.9	50.9
Gross profit	46.9	46.8	49.1	49.1
Selling, general and administrative expenses expenses (2)	33.7	32.4	31.4	29.6
Income from operations	13.2	14.4	17.7	19.5
Interest and other income, net	2.1	1.0	1.7	0.8
Earnings before income taxes	15.3	15.4	19.4	20.3
Provision for income taxes	5.3	5.9	7.2	7.7
Net earnings	10.0%	9.5%	12.2%	12.6%

(1) Cost of sales includes the cost of merchandise, occupancy costs and production costs.

(2) Selling, general and administrative expenses primarily consist of non-occupancy store costs, corporate overhead and advertising costs.

Net Sales. Net sales increased to \$132.8 million during the three months ended April 1, 2006 from \$116.9 million in the comparable period of the prior year, an increase of \$15.9 million, or 13.6%. During the three-month period, an increase in comparable store sales of 4.7% versus the prior year contributed \$4.9 million to the increase in sales. The remaining increase in sales of \$11.0 million was generated by stores not included in the comparable store sales base and year over year increases in on-line sales and wholesale sales to international licensees.

For the nine months ended April 1, 2006, net sales increased to \$426.9 million from \$372.6 million in the comparable period of the prior year, an increase of \$54.3 million, or 14.6%. During the nine-month period, an increase in comparable store sales of 7.1% versus the prior year contributed \$23.2 million to the increase in sales. The remaining increase in sales of \$31.1 million was generated by stores not included in the comparable store sales base and year over year increases in on-line sales and wholesale sales to international licensees. Net sales include a reduction of \$1.7 million associated with the customer loyalty program in the current year compared to \$0 for the comparable period of the prior year.

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	Three Months Ended		Nine Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
Net sales (In thousands)	\$ 132,812	\$ 116,862	\$ 426,862	\$ 372,590
Total net sales increase percentage	13.6%	39.7%	14.6%	33.4%
Comparable store sales increase percentage	4.7%	28.5%	7.1%	23.0%
Net sales per average square foot (1)	\$ 158	\$ 158	\$ 528	\$ 511
Square footage at end of period (In thousands)	829	736	829	736
Number of store locations:				
Beginning of period	228	206	214	199
New store locations	0	3	16	11
Closed store locations	0	3	2	4
Number of stores open at end of period	228	206	228	206

(1) Net sales per average square foot is calculated using net store sales and a monthly average store square footage.

Gross Profit. Gross profit increased to \$62.2 million during the three months ended April 1, 2006 from \$54.7 million for the comparable period of the prior year, an increase of \$7.5 million, or 13.7%. As a percentage of net sales, gross profit increased to 46.9% for the three-month period ended April 1, 2006 from 46.8% in the comparable period of the prior year. The increase in gross profit as a percentage of net sales from the prior year of 0.1% resulted primarily from a cumulative, non-cash adjustment of \$3.2 million related to lease accounting in the prior year, partially offset by lower merchandise margins in the current year.

Gross profit increased to \$209.6 million during the nine months ended April 1, 2006 from \$183.1 million for the comparable period of the prior year, an increase of \$26.5 million, or 14.5%. As a percentage of net sales, gross profit was 49.1% for both of the nine-month periods ended April 1, 2006 and April 2, 2005. Gross profit as a percentage of net sales was flat with the prior year, primarily due to a cumulative, non-cash adjustment of \$3.2 million related to lease accounting in the prior year, offset by lower merchandise margins in the current year.

Selling, General and Administrative Expenses. Selling, general and administrative expenses, which primarily consist of non-occupancy store costs, corporate overhead and advertising costs, increased to \$44.7 million during the three months ended April 1, 2006 from \$37.8 million in the comparable period of the prior year, an increase of \$6.9 million, or 18.3%. As a percentage of net sales, these expenses increased to 33.7% during the three-month period from 32.4% in the comparable period of the prior year. For the nine months ended April 1, 2006, selling, general and administrative expenses increased to \$133.9 million from \$110.7 million in the comparable period of the prior year, an increase of \$23.2 million, or 21.0%. As a percentage of net sales, these expenses increased to 31.4% during the nine-month period from 29.6% in the comparable period of the prior year. This increase as a percentage of net sales was primarily due to a charge of \$2.1 million (1.6% of net sales) and \$6.9 million (1.6% of net sales) related to the expensing of stock-based compensation, due to the recent adoption of FASB Statement No. 123(R), for the three and nine month periods ended April 2, 2006, respectively. Increased advertising also contributed to the increase, offset by reductions in compensation and lower variable expenses.

Interest and Other Income, Net. We generated \$2.5 million of interest income during the three months ended April 1, 2006 compared to \$1.1 million in the comparable period of the prior year. For the nine months ended April 1, 2006, we generated \$6.3 million of interest income compared to \$3.0 million in the comparable period of the prior year. The increases are the result of higher average cash equivalent and marketable securities balances and higher interest rates.

The three-month periods ending April 1, 2006 and April 2, 2005 both include 91 days. The nine-month periods ending

Provision for Income Taxes. The effective tax rate decreased to 34.6% and 37.4% for the three and nine month periods ended April 1, 2006, respectively, from 38.0% for the comparable periods in the prior year, primarily due to a cumulative adjustment of permanent and temporary differences and an increase in tax exempt interest income, offset by compensation expense associated with incentive stock options. Due to the timing of when an incentive stock option is

exercised and sold and the level of earnings, the effective tax rate is expected to fluctuate from quarter to quarter under FASB Statement No. 123(R).

Seasonality of Business and Quarterly Results

Our business varies with general seasonal trends that are characteristic of the retail and apparel industries. As a result, our typical store generates a higher percentage of our annual net sales and profitability in the second quarter of our fiscal year (which includes the holiday selling season) compared to the other quarters of our fiscal year. If for any reason our sales were below seasonal norms during the second quarter of our fiscal year, our annual operating results would be negatively impacted. Because of the seasonality of our business, results for any quarter are not necessarily indicative of results that may be achieved for a full fiscal year.

LIQUIDITY AND CAPITAL RESOURCES

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Our working capital requirements vary widely throughout the year and generally peak during the first and second fiscal quarters. At April 1, 2006, we had \$311.7 million of cash and equivalents and short-term marketable securities on hand. In addition, we had a revolving line of credit, under which we could borrow or issue letters of credit up to a combined total of \$25.0 million. As of April 1, 2006, there were no outstanding cash borrowings under the line of credit, and there was \$3.5 million of letters of credit outstanding.

Net cash provided by operating activities for the nine months ended April 1, 2006 was \$59.3 million versus \$71.5 million for the nine months ended April 2, 2005. Cash provided by operating activities for these periods was primarily generated by earnings adjusted for depreciation, non-cash compensation expense, deferred rent, deferred income taxes and changes in working capital. The decrease in cash provided by operating activities in the current year as compared to the prior year is primarily due to the timing of payments and inventory receipts. In addition, the nine months ended April 2, 2005 include an increase in deferred rent of \$3.8 million, resulting primarily from lease accounting adjustments.

Net cash used by investing activities for the nine months ended April 1, 2006 was \$36.2 million, primarily for the purchases of marketable securities and expenditures related to the opening of 16 new stores, the relocation and expansion of existing stores, improvements made to our production facility and design studio and investments in technology. For the nine-month period ended April 2, 2005, \$70.4 million was used primarily for the purchases of marketable securities and expenditures related to the opening of 11 new stores, the relocation and expansion of existing stores and improvements made to our new production facility and design studio. The decrease in cash used by investing activities in the current year as compared to the prior year is primarily due to a decrease in net purchases of marketable securities. We expect to open approximately 34 stores during fiscal 2006 and estimate that total capital expenditures will be approximately \$33.0 million.

Net cash used by financing activities was \$2.8 million for the nine months ended April 1, 2006, resulting from the payment of two quarterly cash dividends totaling \$7.3 million, partially offset by proceeds from stock option exercises. Net cash provided by financing activities was \$7.7 million for the nine months ended April 2, 2005, and was derived from proceeds from stock option exercises, partially offset by the payment of three quarterly cash dividends totaling \$6.0 million.

We believe that our cash on hand, together with our cash flows from operations, will be sufficient to meet our capital and operating requirements for at least the next twelve months. Our future capital requirements, however, will depend on numerous factors, including without limitation, the size and number of new and expanded stores and/or store concepts, investment costs for management information systems, potential acquisitions and/or joint ventures, repurchase of stock and future results of operations.

Inflation

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We do not believe that inflation has had a material effect on the results of operations in the recent past. However, we cannot assure that our business will not be affected by inflation in the future.

RISKS THAT MAY AFFECT RESULTS

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Factors that might cause our actual results to differ materially from the forward looking statements discussed elsewhere in this report, as well as affect our ability to achieve our financial and other goals, include, but are not limited to, the following:

RISKS RELATING TO OUR BUSINESS:

1. The success of our business depends in large part on our ability to identify fashion trends as well as to react to changing customer demand in a timely manner. Consequently, we depend in part upon the customer response to the creative efforts of our merchandising, design and marketing teams and their ability to anticipate trends and fashions that will appeal to our consumer base. If we miscalculate our customers' product preferences or the demand for our products, we may be faced with excess inventory. Historically, this type of occurrence has resulted in excess fabric for some products and markdowns and/or write-offs, which has impaired our profitability, and may do so in the future. Similarly, any failure on our part to anticipate, identify and respond effectively to changing consumer demands and fashion trends will adversely affect our sales.

2. If we are unable to obtain raw materials, unable to find manufacturing facilities or our manufacturers perform unacceptably, our sales may be negatively affected and our financial condition may be harmed. We do not own any manufacturing facilities and therefore depend on contractors and third parties to manufacture our products. We place all of our orders for production of merchandise and raw materials by purchase order and do not have any long-term contracts with any manufacturer or supplier. If we fail to maintain favorable relationships with our manufacturers and suppliers or are unable to obtain sufficient quantities of quality raw materials on commercially reasonable terms, it could harm our business and results of operations. We cannot assure you that contractors and third party manufacturers (1) will not supply similar products to our competitors, (2) will not stop supplying products to us completely, or (3) will supply products in a timely manner. Untimely receipt of products may result in markdowns which would have a negative impact on earnings. Furthermore, we have received in the past, and may receive in the future, shipments of products from manufacturers that fail to conform to our quality control standards. In such event, unless we are able to obtain replacement products in a timely manner, we may lose sales. Certain of our third party manufacturers store our raw materials. In the event our inventory was damaged or destroyed and we were unable to obtain replacement raw materials, our earnings may be negatively impacted.

3. Our success depends on our ability to attract and retain key employees in order to support our existing business and future expansion. From time to time we actively recruit qualified candidates to fill key executive positions from within the Company. There is substantial competition for experienced personnel, which we expect will continue. We compete for experienced personnel with companies who have greater financial resources than we do. In the past, we have experienced significant turnover of our executive management team and retail store personnel. We made a strategic decision to move our bebe merchant team from our Brisbane headquarters to our Los Angeles studio to join our design and production teams in July 2006. We cannot assure you that we will not experience turnover as a result of this relocation. We are also exposed to employment practice litigation due to the large number of employees and high turnover of our sales associates. If we fail to attract, motivate, and retain qualified personnel, it could harm our business and limit our ability to expand.

In addition, we depend upon the expertise and execution of our key employees, particularly Manny Mashouf, the founder, Chairman of the Board and majority shareholder, and Gregory Scott, our Chief Executive Officer and member of the Board of Directors. If we lose the services of Mr. Mashouf, Mr. Scott, or any key officers or employees, it could harm our business and results of operations.

4. If we are not able to successfully expand our bebe and BEBE SPORT stores our revenue base and earnings may be impaired. We believe that there is opportunity to expand the number of bebe and BEBE SPORT stores in new and existing markets. For fiscal 2006, we plan to grow our operations in a controlled manner, primarily through the opening of new stores. As part of our growth strategy, we will also open larger bebe stores and accessory shop in shops. In addition, we have recently introduced a new accessory concept, Neda by bebe, and plan to open the first Neda by bebe store in the fall of fiscal 2007. If these stores are not successful, our financial condition may be harmed.

5. There can be no assurance that future store openings will be successful and new store openings may impact existing stores. We expect to open 34 stores in fiscal 2006, of which 19 will be bebe stores, 12 will be BEBE SPORT stores and 3 will be bebe outlet stores. In the past, we have closed stores as a result of poor performance, and there can be no assurance that the stores that we plan to open in fiscal 2006, or any other stores that we might open in the future, will be successful or that our overall operating profit will increase as a result of opening these stores. During fiscal 2006, we anticipate closing 3 stores and during fiscal 2005, we closed 6 stores. Most of our new store openings in fiscal 2006 will be in existing markets. These openings may affect the existing stores net sales and profitability. Our failure to predict accurately the demographic or retail environment at any future store location could have a material adverse effect on our business, financial condition and results of operations.

6. We are subject to risks associated with our on-line sales. We operate an on-line store at *www.bebe.com* to sell our merchandise, which we migrated to a third party platform in February 2006. Although our online sales encompass a relatively small percentage of our total sales, our on-line operations are subject to numerous risks, including unanticipated operating problems, reliance on third-party computer hardware and software providers, system failures and the need to invest in additional computer systems. The on-line operations also involve other risks that could have an impact on our results of operations including, but not limited to, diversion of sales from our other stores, rapid technological change, liability for online content, credit card fraud, risks related to the failure of the computer systems that operate the website and its related support systems. In addition, with the migration to a third party we no longer have direct control of certain aspects of our on-line business. There can be no assurance that our on-line store will continue to achieve sales and profitability growth or even remain at its current level.

7. Any serious disruption at our major facilities could have a harmful effect on our business. We currently operate a corporate office in Brisbane, California, a distribution facility in Benicia, California, and a design studio and production facility in Los Angeles, California. Any serious disruption at these facilities whether due to construction, relocation, fire, earthquake, terrorist acts or otherwise would harm our operations and could have a harmful effect on our business and results of operations. Furthermore, we have little experience operating essential functions away from our main corporate offices and are uncertain what effect operating such satellite facilities might have on business, personnel and results of operations.

8. We rely on information technology, the disruption of which could adversely impact our business. We rely on various management information systems to manage our operations and regularly make investments to upgrade, enhance or replace such systems. For example, in the first and second quarters of fiscal year 2006, we launched and rolled out a customer loyalty program to be used in conjunction with our direct marketing initiatives. In the fall of fiscal year 2007 we plan to implement an enhanced production system supporting our design, manufacturing and merchandising needs. We cannot assure you that we will be successful with the implementation of these and other new systems. Any delays or difficulties in transitioning to new systems, or in integrating them with our current systems, or any other disruptions affecting any of our management information systems, could have a material adverse impact on our business, financial condition and results of operations.

9. We face significant competition in the retail and apparel industry, which could harm our sales and profitability. The retail and apparel industries are highly competitive and are characterized by low barriers to entry. Key competitors include, but are not limited to Arden B, BCBG, Express, Guess, and the t.b.d. and Savvy Departments within Nordstrom. We expect competition in our markets to increase. The primary competitive factors in our markets are: brand name recognition, sourcing, product styling, quality, presentation and pricing, timeliness of product development and delivery, store ambiance, customer service and convenience.

We compete with traditional department stores, specialty store retailers, business to consumer websites, off-price retailers and direct marketers for, among other things, raw materials, market share, retail space, finished goods, sourcing and personnel. Because many of these competitors are larger and have substantially greater financial, distribution and marketing resources than we do, we may lack the resources to adequately compete with them. If we fail to compete in any way, it could harm our business, financial condition and results of operations.

10. Purchases of the merchandise we sell are generally discretionary and are therefore particularly susceptible to economic conditions. The outlook for the United States economy is uncertain and is directly affected by factors that are beyond our control. Such factors include disposable consumer income, oil prices, recession and fears of recession, war and fears of war, inclement weather, consumer debt, interest rates, sales tax rates, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. Consumers are generally more willing to make discretionary purchases, including purchases of fashion products, during periods in which favorable economic conditions prevail. If economic conditions change, our business, financial condition and results of operations could be adversely affected. We cannot predict the indirect effects such as rising oil and freight prices, consumer spending or other economic factors that natural disasters will have on our results of operations.

11. Our business could be adversely impacted by unfavorable international conditions. Our sales and operating results are, and will continue to be, affected by international social, political, legal and economic conditions. In particular, our business could be adversely impacted by instability or changes resulting in the disruption of trade with the countries in which our contractors, suppliers or customers are located, significant fluctuations in the value of the dollar against foreign currencies or restrictions on the transfer of funds, or additional trade restrictions imposed by the United States and other

foreign governments. Trade restrictions, including increased tariffs or quotas, embargoes, and customs restrictions could increase the cost or reduce the supply of merchandise available to us and adversely affect our financial condition and results of operations.

12. If we are not able to successfully protect our intellectual property our ability to capitalize on the value of our brand name may be impaired. Even though we take actions to establish, register and protect our trademarks and other proprietary rights, we cannot assure you that we will be successful or that others will not imitate our products or infringe upon our intellectual property rights. In addition, there is no assurance that others will not resist or seek to block the sale of our products as infringements of their trademark and proprietary rights.

We are seeking to register our trademarks domestically and internationally. Obstacles may exist that may prevent us from obtaining a trademark for the bebe name or related names in certain jurisdictions and/or classes of use. We may not be able to register certain trademarks or purchase the right or obtain a license to use the bebe name or related names on commercially reasonable terms. If we fail to obtain trademark, ownership or license the requisite rights, it would limit our ability to expand. Furthermore, if we do not demonstrate use of our trademarks, our existing trademark rights may lapse over time. In some jurisdictions, despite successful registration of our trademarks, third parties may allege infringement and bring actions against us. In addition, if our licensees fail to use our intellectual property correctly, the reputation and value associated with our trademarks may be diluted.

13. If an independent manufacturer violates labor or other laws, or is accused of violating any such laws, or if their labor practices diverge from those generally accepted as ethical, it could harm our business and brand image. While we maintain a policy to monitor the operations of our independent manufacturers by having an independent firm inspect these manufacturing sites, and all manufacturers are contractually required to comply with such labor practices, we cannot control the actions or the public's perceptions of such manufacturers, nor can we assure that these manufacturers will conduct their businesses using ethical or legal labor practices. While we do not control their employees' employment conditions or the manufacturers' business practices, and the manufacturers act in their own interest, they may act in a manner that results in negative public perceptions of us and/or employee allegations, and courts may or may not determine that we are jointly liable in such cases.

RISKS RELATING TO OUR COMMON STOCK:

1. Our stock price may fluctuate because of the small number of shares that can be publicly traded and the low average daily trading volumes. The vast majority of our outstanding shares of our common stock are subject to trading restrictions. As of April 1, 2006, approximately 25,000,000 shares of our common stock were available to be publicly traded, and as a result, our average daily trading volumes are relatively low, and our stock price is vulnerable to market swings due to large purchases, sales and short sales of our common stock.

2. Our operating results are subject to seasonal and quarterly fluctuations, which could adversely affect the market price of our common stock. Our business varies with general seasonal trends that are characteristic of the retail and apparel industries. As a result, our stores typically generate a higher percentage of our annual net sales and profitability in the second quarter of our fiscal year (which includes the holiday selling season) compared to other quarters. Such seasonal and quarterly fluctuations could adversely affect the market price of our common stock.

3. Because a principal shareholder controls the company, other shareholders may not be able to influence the direction the company takes. As of April 1, 2006, Manny Mashouf, the Chairman of the Board, beneficially owned approximately 74% of the outstanding shares of our common stock. As a result, he alone can control the election of directors and the outcome of all issues submitted to the shareholders. This may make it more difficult for a third party to acquire shares, may discourage acquisition bids, and could limit the price that certain investors might be willing to pay for shares of common stock. This concentration of stock ownership may have the effect of delaying, deferring or preventing a change in control of our company.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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We are exposed to market risks, which include changes in U.S. interest rates and, to a lesser extent, foreign exchange rates. We do not engage in financial transactions for trading or speculative purposes.

Interest Rate Risk

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We currently maintain a portfolio of variable interest rate investments consisting of cash equivalents and short-term marketable securities. Marketable securities are comprised of closed-end variable interest rate funds that invest primarily in tax-exempt municipal bonds. Due to the variable nature of these investments, their value is typically not subject to market rate changes. According to our investment policy, we may invest in taxable and tax exempt instruments. In addition, the policy establishes limits on credit quality, maturity, issuer and type of instrument. Marketable securities are classified as available for sale. We do not use derivative financial instruments in our investment portfolio.

All highly liquid investments with a maturity of three months or less at the date of purchase are considered to be cash equivalents. The remaining investments are considered short-term marketable securities if original maturities range between four and twelve months or long-term marketable securities if original maturities are over twelve months.

The following table lists our cash equivalents and short-term marketable securities at April 1, 2006:

	Book Value	Fair Value
	(Dollars in thousands)	
Cash equivalents	\$ 31,757	\$ 31,757
Weighted average interest rate	2.61%	
Short-term marketable securities	264,280	264,280
Weighted average interest rate	3.32%	
Total	\$ 296,037	\$ 296,037

The interest payable on our bank line of credit is based on variable interest rates and therefore affected by changes in market interest rates. As we have no outstanding cash borrowings, if interest rates rose significantly, our results from operations and cash flows would not be affected.

Foreign Currency Risks

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We enter into a significant amount of purchase obligations outside of the United States, substantially all of which are settled in U.S. Dollars and, therefore, have only minimal exposure to foreign currency exchange risks. We also operate a subsidiary for which the functional currency is the Canadian Dollar. Fluctuations in exchange rates therefore impact our financial condition and results of operations, as reported in U.S. Dollars.

To date, we have not experienced any significant negative impact as a result of fluctuations in foreign currency markets. We do not hedge against foreign currency risks and believe that foreign currency exchange risk is immaterial.

ITEM 4. CONTROLS AND PROCEDURES

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(a) Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

(b) There has been no change in our internal control over financial reporting during the quarter ended April 1, 2006 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

A former candidate for an executive position sued the Company and two other named defendants in a First Amended Complaint, filed November 9, 2004 in the Superior Court of the State of California, County of San Francisco (case No. CGC-04-435517), seeking unspecified monetary damages and other equitable relief. This case was dismissed with prejudice with no liability to the Company.

A former employee sued the Company in a complaint filed on April 28, 2005 in the United States District Court for the Northern District of California (case No. C05-0177-MHP) alleging violations under the Fair Labor Standards Act, specifically that the Company obligated her to buy and wear its brand clothing as a uniform, without reimbursement or credit, and the net effect of deducting the value of such required purchases from her wages would often result in her not being paid minimum wages. The plaintiff purports to bring the action also on behalf of a class of hourly, non-managerial employees who are similarly situated. The lawsuit seeks compensatory, statutory and injunctive relief. The Company believes that the plaintiff's claims are without merit, and will continue to vigorously defend this matter.

In addition to the above, the Company is also involved in various other legal proceedings arising in the normal course of business. None of these matters, or their ultimate resolution, are expected, individually or in the aggregate, to have a material adverse effect on the Company's business, financial condition or results of operations.

The Company intends to defend itself vigorously against these claims. However, the results of any litigation are inherently uncertain. The Company cannot assure you that it will be able to successfully defend itself in these lawsuits. Where required, and/or otherwise appropriate, the Company makes an estimate of potential liabilities that management believes are reasonable. Any estimates are revised as further information becomes available.

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

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS

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(a) Exhibits. The following is a list of exhibits filed as part of this Report on Form 10-Q.

Exhibit	Description
31.1	Section 302 Certification of Chief Executive Officer.
31.2	Section 302 Certification of Chief Financial Officer.
32.1	Section 906 Certification of Chief Executive Officer.
32.2	Section 906 Certification of Chief Financial Officer.

SIGNATURE

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

Dated May 11, 2006

bebe stores, inc.

/s/ Walter Parks
Walter Parks, Chief Financial Officer

EXHIBIT INDEX

Exhibit Number	Description
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1	Section 906 Certification of Chief Executive Officer
32.2	Section 906 Certification of Chief Financial Officer