

WILLIAMS SONOMA INC
Form 10-Q
September 08, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 30, 2006.

or

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

For the transition period from _____ to _____

Commission File Number: 001-14077

WILLIAMS-SONOMA, INC.

(Exact name of registrant as specified in its charter)

California
(State or other jurisdiction of incorporation or organization)

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

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

94109
(Zip Code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of August 27, 2006, 113,469,199 shares of the registrant's Common Stock were outstanding.

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WILLIAMS-SONOMA, INC.
REPORT ON FORM 10-Q
FOR THE QUARTER ENDED JULY 30, 2006

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

(Unaudited)

| <i>Dollars and shares in thousands, except per share amounts</i> | July 30, 2006 | January 29, 2006 | July 31, 2005 |
|--|------------------|---------------------|------------------|
| ASSETS | | | |
| Current assets | | | |
| Cash and cash equivalents | \$ 187,377 | \$ 360,982 | \$ 153,854 |
| Accounts receivable net | 74,527 | 51,020 | 46,791 |
| Merchandise inventories net | 565,691 | 520,292 | 521,459 |
| Prepaid catalog expenses | 64,059 | 53,925 | 55,300 |
| Prepaid expenses | 35,440 | 31,847 | 39,016 |
| Deferred income taxes | 57,279 | 57,267 | 39,023 |
| Other assets | 6,710 | 7,831 | 5,281 |
| Total current assets | 991,083 | 1,083,164 | 860,724 |
| Property and equipment net | 900,565 | 880,305 | 869,021 |
| Other assets net | 18,563 | 18,151 | 21,893 |
| Total assets | \$ 1,910,211 | \$ 1,981,620 | \$ 1,751,638 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | |
| Current liabilities | | | |
| Accounts payable | \$ 188,331 | \$ 196,074 | \$ 167,834 |
| Accrued salaries, benefits and other | 82,908 | 93,434 | 75,804 |
| Customer deposits | 174,710 | 172,775 | 164,594 |
| Income taxes payable | 10,183 | 83,589 | - |
| Current portion of long-term debt | 16,186 | 18,864 | 25,223 |
| Other liabilities | 23,915 | 25,656 | 19,132 |
| Total current liabilities | 496,233 | 590,392 | 452,587 |
| Deferred rent and lease incentives | 241,819 | 218,254 | 213,204 |
| Long-term debt | 14,037 | 14,490 | 16,023 |
| Deferred income tax liabilities | 12,371 | 18,455 | 21,052 |
| Other long-term obligations | 15,958 | 14,711 | 13,107 |
| Total liabilities | 780,418 | 856,302 | 715,973 |
| Commitments and contingencies | | | |
| Shareholders' equity | | | |
| Preferred stock, \$.01 par value, 7,500 shares authorized, none issued | - | - | - |
| Common stock, \$.01 par value, 253,125 shares authorized, issued and outstanding: 113,451, 114,779 and 116,424 shares at July 30, 2006, January 29, 2006 and July 31, 2005, respectively | 1,135 | 1,148 | 1,164 |
| Additional paid-in capital | 352,896 | 325,146 | 318,416 |
| Retained earnings | 766,641 | 791,329 | 710,041 |
| Accumulated other comprehensive income | 9,121 | 7,695 | 6,044 |
| Total shareholders' equity | 1,129,793 | 1,125,318 | 1,035,665 |
| Total liabilities and shareholders' equity | \$ 1,910,211 | \$ 1,981,620 | \$ 1,751,638 |

See Notes to Condensed Consolidated Financial Statements.

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

(Unaudited)

| | Thirteen Weeks Ended | | Twenty-Six Weeks Ended | |
|--|----------------------|------------------|------------------------|------------------|
| | July 30, 2006 | July 31, 2005 | July 30, 2006 | July 31, 2005 |
| <i>Dollars and shares in thousands, except per share amounts</i> | | | | |
| Net revenues | \$ 825,536 | \$ 776,239 | \$ 1,619,822 | \$ 1,496,927 |
| Cost of goods sold | 510,976 | 481,404 | 999,841 | 917,170 |
| Gross margin | 314,560 | 294,835 | 619,981 | 579,757 |
| Selling, general and administrative expenses | 260,312 | 245,628 | 531,043 | 486,847 |
| Interest income | (4,056) | (881) | (7,378) | (1,984) |
| Interest expense | 542 | 487 | 1,069 | 969 |
| Earnings before income taxes | 57,762 | 49,601 | 95,247 | 93,925 |
| Income taxes | 22,199 | 18,778 | 36,585 | 36,929 |
| Net earnings | \$ 35,563 | \$ 30,823 | \$ 58,662 | \$ 56,996 |
| Basic earnings per share | \$ 0.31 | \$ 0.27 | \$ 0.51 | \$ 0.49 |
| Diluted earnings per share | \$ 0.30 | \$ 0.26 | \$ 0.50 | \$ 0.48 |
| Shares used in calculation of earnings per share: | | | | |
| Basic | 115,026 | 115,978 | 114,672 | 115,661 |
| Diluted | 117,724 | 118,886 | 117,515 | 118,419 |

See Notes to Condensed Consolidated Financial Statements.

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

(Unaudited)

| | Twenty-Six Weeks Ended | |
|---|------------------------|------------------|
| | July 30, 2006 | July 31, 2005 |
| <i>Dollars in thousands</i> | | |
| Cash flows from operating activities: | | |
| Net earnings | \$ 58,662 | \$ 56,996 |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 65,830 | 60,759 |
| Net loss on disposal of assets | 2,127 | 1,139 |
| Amortization of deferred lease incentives | (14,286) | (12,095) |
| Deferred income taxes | (6,079) | - |
| Tax benefit from exercise of stock-based compensation | 3,872 | 12,261 |
| Stock-based compensation expense | 16,886 | - |
| Changes in: | | |
| Accounts receivable | (23,491) | (3,772) |
| Merchandise inventories | (45,327) | (68,978) |
| Prepaid catalog expenses | (10,134) | (1,779) |
| Prepaid expenses and other assets | (3,003) | 753 |
| Accounts payable | (22,510) | (5,976) |
| Accrued salaries, benefits and other | (11,048) | (9,683) |
| Customer deposits | 1,900 | 16,034 |
| Deferred rent and lease incentives | 37,763 | 11,706 |
| Income taxes payable | (73,443) | (72,050) |
| Net cash used in operating activities | (22,281) | (14,685) |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (84,481) | (77,142) |
| Net cash used in investing activities | (84,481) | (77,142) |
| Cash flows from financing activities: | | |
| Repayments of long-term obligations | (3,130) | (1,343) |
| Proceeds from exercise of stock-based compensation | 9,581 | 20,259 |
| Excess tax benefit from exercise of stock-based compensation | 2,541 | - |
| Repurchase of common stock | (65,430) | (12,387) |
| Payment of dividends | (11,591) | - |
| Credit facility renewal costs | - | (654) |
| Net cash (used in) provided by financing activities | (68,029) | 5,875 |
| Effect of exchange rates on cash and cash equivalents | 1,186 | 596 |
| Net decrease in cash and cash equivalents | (173,605) | (85,356) |
| Cash and cash equivalents at beginning of period | 360,982 | 239,210 |
| Cash and cash equivalents at end of period | \$ 187,377 | \$ 153,854 |

See Notes to Condensed Consolidated Financial Statements.

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WILLIAMS-SONOMA, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Thirteen and Twenty-Six Weeks Ended July 30, 2006 and July 31, 2005

(Unaudited)

NOTE A. FINANCIAL STATEMENTS - BASIS OF PRESENTATION

These financial statements include Williams-Sonoma, Inc. and its wholly owned subsidiaries (we, us or our). The condensed consolidated balance sheets as of July 30, 2006 and July 31, 2005, the condensed consolidated statements of earnings for the thirteen and twenty-six weeks ended July 30, 2006 and July 31, 2005, and the condensed consolidated statements of cash flows for the twenty-six weeks ended July 30, 2006 and July 31, 2005 have been prepared by us, without audit. In our opinion, the financial statements include all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position at the balance sheet dates and the results of operations for the thirteen and twenty-six weeks then ended. Significant intercompany transactions and accounts have been eliminated. The balance sheet as of January 29, 2006, presented herein, has been derived from our audited balance sheet included in our Annual Report on Form 10-K for the fiscal year ended January 29, 2006.

In January 2006, we decided to transition the merchandising strategies of our Hold Everything brand into our other existing brands by the end of fiscal 2006. In connection with this transition, we incurred a pre-tax charge of approximately \$13,500,000, or \$0.07 per diluted share, in the fourth quarter of fiscal 2005. In the second quarter of fiscal 2006, we incurred an additional charge of approximately \$961,000, or less than \$0.01 per diluted share. Of this pre-tax charge, approximately \$732,000 is included in cost of goods sold and approximately \$229,000 is included in selling, general and administrative expenses. For the twenty-six weeks ended July 30, 2006, we incurred a total charge of \$4,134,000, or \$0.02 per diluted share. Of this pre-tax charge, approximately \$2,426,000 is included in cost of goods sold and approximately \$1,708,000 is included in selling, general and administrative expenses. All of our Hold Everything retail stores were closed during the first quarter of fiscal 2006. The final phase of our operational shutdown was completed in the second quarter of fiscal 2006, with our final Hold Everything catalog mailed on May 16, 2006 and our website ceasing operations on June 30, 2006. Our Outlet stores are being used for the final clearance of inventory and the merchandising categories the brand represented are being transitioned into our other brands.

The results of operations for the thirteen and twenty-six weeks ended July 30, 2006 are not necessarily indicative of the operating results of the full year.

Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 29, 2006.

NOTE B. ACCOUNTING POLICIES

Customer Deposits

During the second quarter of fiscal 2006, we completed an analysis of our historical gift certificate and gift card redemption patterns, which included an independent actuarial study based on our historical redemption data. As a result of this analysis, we concluded that the likelihood of our gift certificates and gift cards being redeemed beyond four years from the date of issuance is remote. As a result, we have changed our estimate of the elapsed time for recording income associated with unredeemed gift certificates and gift cards to four years from our prior estimate of seven years. This change in estimate resulted in the recording of income in selling, general and administrative expense of approximately \$12,400,000.

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Recent Accounting Pronouncements

On January 30, 2006, we adopted Financial Accounting Standards Board (FASB) Staff Position (FSP) No. FAS 13-1, Accounting for Rental Costs Incurred During a Construction Period, which requires us to expense all rental costs associated with our operating leases that are incurred during a construction period. The adoption of this Staff Position resulted in after-tax occupancy expense being recorded as a component of cost of goods sold of approximately \$529,000 and \$863,000 in the thirteen and twenty-six weeks ended July 30, 2006, respectively, or less than \$0.01 per diluted share.

In June 2006, the FASB issued FASB Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. We will adopt the provisions of FIN 48 beginning in the first quarter of fiscal 2007. We are currently in the process of determining the effect, if any, the adoption of FIN 48 will have on our consolidated financial statements.

NOTE C. STOCK-BASED COMPENSATION

We maintain the 1993 Stock Option Plan (the 1993 Plan), as amended, the 2000 Nonqualified Stock Option Plan (the 2000 Plan), as amended, and the Amended and Restated 2001 Long-Term Incentive Plan (the 2001 Plan) (collectively the Plans), to award stock options and stock-settled stock appreciation rights (collectively stock awards) and other forms of equity compensation, including restricted stock and restricted stock units, to our key employees and Board members and those of any parent or subsidiary. All stock award grants have a maximum term of ten years, except incentive stock options issued to shareholders with greater than 10% of the voting power of all of our stock, which have a maximum term of five years. The exercise price is not less than 100% of the fair market value of our stock on the date of the stock award grant or not less than 110% of such fair market value for an incentive stock option granted to a 10% shareholder. Shares issued as a result of stock award exercises will be funded with the issuance of new shares. Stock awards granted to employees generally vest over five years. Stock awards granted to non-employee Board members generally vest in one year. In May 2006, our shareholders approved the amendment and restatement of our 2001 Plan to increase the shares issuable under the Plan by 6,000,000 shares and to include in the 2001 Plan shares that remained available under the 1993 Plan and 2000 Plan as well as shares subject to outstanding options under these plans that subsequently expire unexercised. The 1993 Plan and the 2000 Plan will no longer be used to grant future awards. The Plans now provide for grants of stock awards, restricted stock or restricted stock units, dividend equivalents, deferred stock awards and other equity compensation awards up to an aggregate of 34,500,000 shares. As of July 30, 2006, there were 7,537,000 shares available for future grant.

Effective January 30, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment, which requires us to measure and record compensation expense in our consolidated financial statements for all employee stock-based awards using a fair value method. Accordingly, at the beginning of fiscal 2006, we began recording compensation expense for all stock-based awards under the modified prospective transition method.

Prior to January 30, 2006, we accounted for stock-based awards granted to employees using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations. Accordingly, no compensation expense was recognized prior to fiscal 2006 for stock awards with an exercise price equal to the fair value on the date of grant.

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The following table illustrates the effect on net earnings and earnings per share as if we had applied the fair value recognition provisions of SFAS No. 123, as amended by SFAS No. 148, to all of our stock-based compensation arrangements for the thirteen and twenty-six weeks ended July 31, 2005:

| | <u>Thirteen Weeks Ended</u> | <u>Twenty-Six Weeks Ended</u> |
|--|-----------------------------|-------------------------------|
| | July 31, | July 31, |
| | 2005 | 2005 |
| <i>Dollars in thousands, except per share amounts</i> | | |
| Net earnings, as reported | \$ 30,823 | \$ 56,996 |
| Deduct: Total stock-based employee compensation expense Determined under fair value method for | | |
| all awards, net of related tax effect | (4,217) | (7,901) |
| Pro forma net earnings | \$ 26,606 | \$ 49,095 |
| Basic earnings per share | | |
| As reported | \$ 0.27 | \$ 0.49 |
| Pro forma | 0.23 | 0.42 |
| Diluted earnings per share | | |
| As reported | \$ 0.26 | \$ 0.48 |
| Pro forma | 0.23 | 0.42 |

As a result of adopting SFAS No. 123R, during the thirteen and twenty-six weeks ended July 30, 2006, our compensation expense recognized was based on the following:

- q Stock Awards: Amortization related to the remaining unvested portion of all stock awards granted prior to January 30, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123, as amended by SFAS No. 148, and all new stock awards granted during the thirteen and twenty-six weeks ended July 30, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R;
- q Restricted Stock Units: Amortization related to the remaining unvested portion of all restricted stock units granted prior to January 30, 2006 based on the market value of our stock on the date of grant.

Stock Awards

During the thirteen and twenty-six weeks ended July 30, 2006, we granted 166,850 and 1,183,150 stock awards, respectively.

The following table summarizes our stock award activity during the twenty-six weeks ended July 30, 2006:

| Shares | Weighted | Weighted | Intrinsic |
|--------|----------|----------|--------------------|
| | Average | Average | Value ¹ |

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| | | Average Exercise Price | Contractual Term Remaining (In Years) | |
|--|------------|---------------------------|---|---------------|
| Balance at January 29, 2006 | 10,309,909 | \$ 22.63 | | |
| Granted (weighted average fair value of \$13.98) | 1,183,150 | 40.31 | | |
| Exercised | (691,480) | 13.86 | | \$ 17,738,000 |
| Canceled | (294,899) | 33.43 | | |
| Balance at July 30, 2006 | 10,506,680 | \$ 24.90 | 6.10 | \$ 98,140,000 |
| Exercisable at July 30, 2006 | 6,729,812 | \$ 18.82 | 4.77 | \$ 92,528,000 |

¹ Intrinsic value is defined as the difference between the current market value and the grant price.

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The fair value of each stock award was estimated on the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions:

- q **Expected term** For the thirteen and twenty-six weeks ended July 30, 2006, the expected term of the awards represents the period of time between the grant date of the award and the time the award is either exercised or canceled including an estimate for those awards still outstanding. For the thirteen and twenty-six weeks ended July 31, 2005, the expected term of the awards represents only the period of time between the grant date of the award and the time the award is either exercised or canceled.
- q **Expected volatility** For the thirteen and twenty-six weeks ended July 30, 2006, the expected volatility is based on an average of the historical volatility of our stock price, for a period approximating our expected term, and the implied volatility based on externally traded options of our stock that were entered into during the quarter. For the thirteen and twenty-six weeks ended July 31, 2005, the expected volatility was based only on the historical volatility of our stock price.
- q **Risk-free interest rate** The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and with a maturity that approximates the expected term.
- q **Dividend yield** The dividend yield is based on the initiation of our quarterly cash dividend, authorized by our Board of Directors in March 2006, and its anticipated dividend payout over the expected term of the award.

The weighted average assumptions for the thirteen and twenty-six weeks ended July 30, 2006 and July 31, 2005 are as follows:

| | Thirteen Weeks Ended | | Twenty-Six Weeks Ended | |
|-------------------------|----------------------|------------------|------------------------|------------------|
| | July 30, 2006 | July 31, 2005 | July 30, 2006 | July 31, 2005 |
| Expected term (years) | 5.0 | 6.5 | 5.0 | 6.5 |
| Expected volatility | 33.2% | 59.5% | 34.5% | 59.7% |
| Risk-free interest rate | 4.9% | 3.9% | 4.7% | 3.9% |
| Dividend yield | 1% | - | 1% | - |

The total after-tax expense recognized during the thirteen and twenty-six weeks ended July 30, 2006 on all stock awards was \$4,523,000 and \$8,387,000, respectively, leaving a remaining unamortized balance as of July 30, 2006 of \$50,215,000 (net of estimated forfeitures), which we expect to be recognized on a straight-line basis over an average remaining life of approximately two years.

Restricted Stock Units

In January 2006, we issued 840,000 restricted stock units of our common stock. The fair market value of all restricted stock units awarded was based on a stock price of \$42.18 per unit for a total value of \$35,431,200. This balance is being amortized on a straight-line basis over the vesting period, with fifty percent of the restricted stock units vesting on January 31, 2010, and the remaining fifty percent vesting on January 31, 2011 based upon the employees' continued employment throughout the vesting period.

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The following table summarizes restricted stock unit activity during the twenty-six weeks ended July 30, 2006:

| | Shares | Intrinsic Value ¹ |
|--------------------------------------|----------|------------------------------|
| Unvested balance at January 29, 2006 | 840,000 | |
| Granted | - | |
| Vested | - | |
| Canceled | (20,000) | |
| Unvested balance at July 30, 2006 | 820,000 | \$ 26,429,000 |

¹ *Intrinsic value for restricted stock units is defined as the current market value.*

The total after-tax expense recognized during the thirteen and twenty-six weeks ended July 30, 2006 on all restricted stock units was \$981,000 and \$1,999,000, respectively, leaving a remaining unamortized balance as of July 30, 2006 of \$25,818,000 (net of estimated forfeitures), which we expect to be recognized on a straight-line basis over an average remaining life of approximately four years.

Total Stock-Based Compensation Expense

For the thirteen and twenty-six weeks ended July 30, 2006, we recognized total stock-based compensation expense (net of tax), including the impact of SFAS No. 123R and the expense associated with the issuance of restricted stock units, as a component of selling, general and administrative expense, of \$5,504,000 and \$10,386,000, respectively, or approximately \$0.05 and \$0.09 per diluted share, respectively.

Tax Effect

Prior to the adoption of SFAS No. 123R, we presented all tax benefits resulting from the exercise of stock-based awards as operating cash flows in the Condensed Consolidated Statements of Cash Flows. SFAS No. 123R now requires that cash flows resulting from tax deductions in excess of the cumulative compensation cost recognized for stock-based compensation awards exercised be classified as financing cash flows. For the thirteen and twenty-six weeks ended July 30, 2006, cash received from stock-based awards exercised was \$3,376,000 and \$9,581,000, respectively, and the tax benefit associated with such exercises totaled \$3,297,000 and \$6,690,000, respectively.

NOTE D. BORROWING ARRANGEMENTS*Credit Facility*

As of July 30, 2006, we have a credit facility that provides for a \$300,000,000 unsecured revolving line of credit that may be used for loans or letters of credit and contains certain financial covenants, including a maximum leverage ratio (funded debt adjusted for lease and rent expense to EBITDAR), and a minimum fixed charge coverage ratio. Prior to August 22, 2009, we may, upon notice to the lenders, request an increase in the credit facility of up to \$100,000,000, to provide for a total of \$400,000,000 of unsecured revolving credit. The credit facility contains events of

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default that include, among others, non-payment of principal, interest or fees, inaccuracy of representations and warranties, violation of covenants, bankruptcy and insolvency events, material judgments, cross defaults to certain other indebtedness and events constituting a change of control. The occurrence of an event of default will increase the applicable rate of interest by 2.0% and could result in the acceleration of our obligations under the credit facility, and an obligation of any or all of our U.S. subsidiaries to pay the full amount of our obligations under the credit facility. The credit facility matures on February 22, 2010, at which time all outstanding borrowings must be repaid and all outstanding letters of credit must be cash collateralized.

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We may elect interest rates calculated at Bank of America's prime rate (or, if greater, the average rate on overnight federal funds plus one-half of one percent) or LIBOR plus a margin based on our leverage ratio. During the twenty-six weeks ended July 30, 2006 and July 31, 2005, no amounts were borrowed under the credit facility. However, as of July 30, 2006, \$35,973,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. The standby letters of credit were issued to secure the liabilities associated with workers' compensation, other insurance programs and certain debt transactions. As of July 30, 2006, we were in compliance with our financial covenants under the credit facility.

Letter of Credit Facilities

We have three unsecured commercial letter of credit reimbursement facilities for an aggregate of \$145,000,000, each of which expires on September 9, 2006. As of July 30, 2006, an aggregate of \$124,731,000 was outstanding under the letter of credit facilities. Such letters of credit represent only a future commitment to fund inventory purchases to which we had not taken legal title as of July 30, 2006. On September 8, 2006, we amended the commercial letters of credit reimbursement facilities to include five unsecured facilities for an aggregate of \$165,000,000 expiring on September 8, 2007. The latest expiration possible for any future letters of credit issued under the amended facilities is now February 5, 2008.

NOTE E. COMPREHENSIVE INCOME

Comprehensive income for the thirteen and twenty-six weeks ended July 30, 2006 and July 31, 2005 was as follows:

| | Thirteen Weeks Ended | | Twenty-Six Weeks Ended | |
|--|----------------------|------------------|------------------------|------------------|
| | July 30, 2006 | July 31, 2005 | July 30, 2006 | July 31, 2005 |
| <i>Dollars in thousands</i> | | | | |
| Net earnings | \$ 35,563 | \$ 30,823 | \$ 58,662 | \$ 56,996 |
| Other comprehensive (loss) income - foreign currency translation adjustment | (443) | 746 | 1,426 | 874 |
| Comprehensive income | \$ 35,120 | \$ 31,569 | \$ 60,088 | \$ 57,870 |

NOTE F. EARNINGS PER SHARE

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

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

| <i>Dollars and amounts in thousands, except per share amounts</i> | Net Earnings | Weighted Average Shares | Per Share Amount |
|---|--------------|-------------------------|------------------|
| Thirteen weeks ended July 30, 2006 | | | |
| Basic | \$ 35,563 | 115,026 | \$ 0.31 |
| Effect of dilutive stock-based awards | - | 2,698 | |
| Diluted | \$ 35,563 | 117,724 | \$ 0.30 |
| Thirteen weeks ended July 31, 2005 | | | |
| Basic | \$ 30,823 | 115,978 | \$ 0.27 |
| Effect of dilutive stock-based awards | - | 2,908 | |
| Diluted | \$ 30,823 | 118,886 | \$ 0.26 |
| Twenty-Six weeks ended July 30, 2006 | | | |
| Basic | \$ 58,662 | 114,672 | \$ 0.51 |
| Effect of dilutive stock-based awards | - | 2,843 | |
| Diluted | \$ 58,662 | 117,515 | \$ 0.50 |
| Twenty-Six weeks ended July 31, 2005 | | | |
| Basic | \$ 56,996 | 115,661 | \$ 0.49 |
| Effect of dilutive stock-based awards | - | 2,758 | |
| Diluted | \$ 56,996 | 118,419 | \$ 0.48 |

Stock-based awards outstanding with an exercise price greater than the average market price of common shares were 2,588,000 and 121,000 for the thirteen weeks ended and 2,538,000 and 1,368,000 for the twenty-six weeks ended July 30, 2006 and July 31, 2005, respectively, and were not included in the computation of diluted earnings per share, as their inclusion would be anti-dilutive.

NOTE G. LEGAL PROCEEDINGS

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

NOTE H. SEGMENT REPORTING

We have two reportable segments, retail and direct-to-customer. The retail segment has six merchandising concepts which sell products for the home (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Hold Everything, West Elm and Williams-Sonoma Home). The six retail merchandising concepts are operating segments, which have been aggregated into one reportable segment, retail. The direct-to-customer segment has seven merchandising concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, PBteen, Hold Everything, West Elm and Williams-Sonoma Home) and sells similar products through our eight direct-mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed + Bath, PBteen, Hold Everything, West Elm and Williams-Sonoma Home) and six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and holdeverything.com). All of our Hold Everything retail stores were closed during the first quarter of fiscal 2006. The final phase of our operational shutdown was completed in the second quarter of fiscal 2006, with our final Hold Everything catalog mailed on May 16, 2006 and our website ceasing operations on June 30, 2006. Management's expectation is that the overall economics of each of our major concepts within each reportable segment will be similar over time.

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These reportable segments are strategic business units that offer similar home-centered products. They are managed separately because the business units utilize two distinct distribution and marketing strategies. It is not practicable for us to report revenue by product group.

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

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

Segment Information

| <i>Dollars in thousands</i> | Direct-to- | | | Total |
|--|---------------------|------------|-------------|--------------|
| | Retail ¹ | Customer | Unallocated | |
| Thirteen weeks ended July 30, 2006 | | | | |
| Net revenues | \$ 463,372 | \$ 362,164 | - | \$ 825,536 |
| Depreciation and amortization expense | 22,210 | 4,910 | \$ 5,757 | 32,877 |
| Earnings (loss) before income taxes ² | 41,086 | 51,551 | (34,875) | 57,762 |
| Capital expenditures | | | | |
| | 29,523 | 7,013 | 8,930 | 45,466 |
| Thirteen weeks ended July 31, 2005 | | | | |
| Net revenues | \$ 434,147 | \$ 342,092 | - | \$ 776,239 |
| Depreciation and amortization expense | 20,399 | 4,431 | \$ 5,779 | 30,609 |
| Earnings (loss) before income taxes | 39,247 | 49,937 | (39,583) | 49,601 |
| Capital expenditures | | | | |
| | 26,174 | 7,787 | 8,816 | 42,777 |
| Twenty-Six weeks ended July 30, 2006 | | | | |
| Net revenues | \$ 897,281 | \$ 722,541 | - | \$ 1,619,822 |
| Depreciation and amortization expense | 45,147 | 9,464 | \$ 11,219 | 65,830 |
| Earnings (loss) before income taxes ² | 75,756 | 103,207 | (83,716) | 95,247 |
| Assets³ | | | | |
| | 1,055,754 | 329,322 | 525,135 | 1,910,211 |
| Capital expenditures | | | | |
| | 53,738 | 14,941 | 15,802 | 84,481 |
| Twenty-Six weeks ended July 31, 2005 | | | | |
| Net revenues | \$ 831,335 | \$ 665,592 | - | \$ 1,496,927 |
| Depreciation and amortization expense | 40,755 | 8,870 | \$ 11,134 | 60,759 |
| Earnings (loss) before income taxes | 77,728 | 97,270 | (81,073) | 93,925 |
| Assets³ | | | | |
| | 949,886 | 323,777 | 477,975 | 1,751,638 |
| Capital expenditures | | | | |
| | 46,378 | 14,147 | 16,617 | 77,142 |

¹ Includes revenues of \$17.0 million and \$12.2 million for the thirteen weeks ended July 30, 2006 and July 31, 2005, respectively, and \$32.1 million and \$22.8 million for the twenty-six weeks ended July 30, 2006 and July 31, 2005, respectively, related to our foreign operations.

² Includes \$0.5 million and \$0.4 million in the retail and direct-to-customer segments, respectively, for the thirteen weeks ended July 30, 2006, and \$2.2 million, \$1.6 million and \$0.3 million in the retail, direct-to-customer and corporate unallocated segments, respectively, for the twenty-six weeks ended July 30, 2006, related to the transitioning of the merchandising strategies of our Hold Everything brand into our other existing brands.

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³ Includes \$25.3 million and \$24.7 million of long-term assets as of July 30, 2006 and July 31, 2005, respectively, related to our foreign operations.

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NOTE I. SUBSEQUENT EVENT

In August 2006, our Board of Directors authorized a stock repurchase program to acquire up to 5,000,000 shares of our outstanding common stock. Stock repurchases under this program may be made through open market and privately negotiated transactions at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements and other market conditions. The stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

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

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they do not fully materialize or prove incorrect, could cause our business and results of operations to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include projections of earnings, revenues or financial items, including the impact of accounting changes, statements of the plans, strategies and objectives of management for future operations, statements related to the future performance of our brands, statements related to refining our merchandising strategies, statements related to our plans to increase retail leased square footage, statements related to expanding catalog circulation, statements related to increasing electronic direct marketing and paid search, statements relating to upgrading functionality on our e-commerce websites, statements relating to implementing the ability to issue and redeem gift cards in our direct-to-customer channel, statements related to implementing initiatives throughout the supply chain to reduce returns, replacements and damages, statements relating to enhancing our daily store replenishment program, statements relating to leveraging the in-sourced east coast furniture hub to enhance the furniture delivery experience for our customers and reduce our furniture delivery costs, statements related to implementing new marketing initiatives and expanding on-line and electronic direct marketing initiatives, statements related to our plans to open new retail stores, statements related to transitioning our Hold Everything brand, statements related to the use of our available cash, including the payment of a dividend, statements related to our projected capital expenditures, statements related to our stock repurchase program, and statements of belief and statements of assumptions underlying any of the foregoing. You can identify these and other forward-looking statements by the use of words such as may, should, expects, plans, anticipates, believes, estimates, predicts, potential, continue, or the negative of such terms, or other comparable terminology.

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

OVERVIEW

We are a specialty retailer of products for the home. The retail segment of our business sells our products through our six retail store concepts (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Hold Everything, West Elm and Williams-Sonoma Home). The direct-to-customer segment of our business sells similar products through our eight direct-mail catalogs (Williams-Sonoma, Pottery Barn, Pottery Barn Kids, Pottery Barn Bed + Bath, PBteen, Hold Everything, West Elm and Williams-Sonoma Home) and six e-commerce websites (williams-sonoma.com, potterybarn.com, potterybarnkids.com, pbteen.com, westelm.com and holdeverything.com). All of our Hold Everything retail stores were closed during the first quarter of fiscal 2006. The final phase of our operational shutdown was completed in the second quarter of fiscal 2006, with our final Hold Everything catalog mailed on May 16, 2006 and our website ceasing operations on June 30, 2006. Based on net revenues in fiscal 2005, retail net revenues accounted for 57.4% of our business and direct-to-customer net revenues accounted for 42.6% of our business. Based on their contribution to our net revenues in fiscal 2005 (representing approximately 90%), the core brands in both retail and direct-to-customer are: Pottery Barn, which sells casual home furnishings; Williams-Sonoma, which sells cookware essentials; and Pottery Barn Kids, which sells stylish children's furnishings. The following discussion and analysis of financial condition, results of operations, and liquidity and capital resources should be read in conjunction with our condensed consolidated financial statements and the notes thereto.

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Second Quarter of Fiscal 2006 Financial Results

In the second quarter of fiscal 2006, our net revenues increased 6.4% to \$825,536,000 from \$776,239,000 in the second quarter of fiscal 2005 primarily driven by increases in the Pottery Barn Kids, Pottery Barn, West Elm and Williams-Sonoma brands. Despite this increase in revenues during the quarter, we are seeing an overall softening in our consumer demand, primarily in our Pottery Barn brand.

During the quarter, we experienced several unusual business events, including unredeemed gift certificate income due to a change in estimate, litigation settlement income, expense associated with the departure of our Chief Executive Officer and the expense associated with the Hold Everything transition. Including a \$0.01 per diluted share net benefit from these unusual business events and the implementation of two new accounting pronouncements (SFAS No. 123R, Share-Based Payment and Financial Accounting Standards (FAS) FSP 13-1, Accounting for Rental Costs Incurred During a Construction Period), diluted earnings per share for the second quarter of fiscal 2006 increased 15.4% to \$0.30 per diluted share versus \$0.26 per diluted share in the second quarter of fiscal 2005.

In our retail channel, net revenues increased 6.7% during the second quarter of fiscal 2006 versus the second quarter of fiscal 2005. This increase was primarily driven by a year-over-year increase in retail leased square footage of 7.5%, including 14 net new stores, and a comparable store sales increase of 1.2%. Net revenues generated in the West Elm, Pottery Barn Kids, Williams-Sonoma, Williams-Sonoma Home and Pottery Barn brands were the primary contributors to this year-over-year net revenues increase.

In our direct-to-customer channel, net revenues increased 5.9% during the second quarter of fiscal 2006 versus the second quarter of fiscal 2005. This year-over-year increase was primarily driven by net revenues generated in the Pottery Barn Kids, Pottery Barn, PBteen, West Elm and Williams-Sonoma brands due to an overall increase in page circulation and continued strength in our Internet business, resulting from our expanded efforts associated with electronic direct marketing and our on-line advertising initiatives. All brands in the direct-to-customer channel delivered positive growth during the quarter with the exception of the Williams-Sonoma Home and Hold Everything brands.

In our core brands, net revenues increased 5.9% in the second quarter of fiscal 2006 versus the second quarter of fiscal 2005, primarily driven by a positive consumer response to our core and seasonal merchandise in the Pottery Barn Kids and Williams-Sonoma brands. Within the Pottery Barn brand, despite an increase in net revenues during the second quarter, we have recently seen a softening in consumer demand.

In our emerging brands (West Elm, PBteen and Williams-Sonoma Home), net revenues increased 33.5% in the second quarter of fiscal 2006 versus the second quarter of fiscal 2005, primarily driven by the performance in the West Elm, PBteen and Williams-Sonoma Home brands.

In the West Elm brand, year-over-year revenue growth was driven by incremental revenue from new stores, improved catalog response, and increased traffic in e-commerce. In merchandising, we saw continued strength in furniture and textiles, in addition to decorative accessories and lighting. Also during the quarter, we re-launched our e-commerce website on a new IBM platform, and introduced enhanced functionality - bringing an improved on-line shopping experience to our customers.

In the PBteen brand, new product offerings and presentation, both of which were key initiatives for the brand as we entered the year, drove year-over-year revenue growth. From a merchandising perspective, we again saw strong performance in all furniture categories.

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In the Williams-Sonoma Home brand, growth in the second quarter of fiscal 2006 in the retail channel was driven by incremental revenues from new stores, with five new stores at an average of 15,000 square feet per store operating at the end of the quarter. In the direct-to-customer channel, we continued to see strong growth in the

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furniture category. In addition, we launched our new Williams-Sonoma Home e-commerce website in August, which allows our customers to preview the entire furniture assortment in all fabrics and frames through a comprehensive furniture viewing tool.

In January 2006, we decided to transition the merchandising strategies of our Hold Everything brand into our other existing brands by the end of fiscal 2006. In connection with this transition, we incurred a pre-tax charge of approximately \$13,500,000, or \$0.07 per diluted share, in the fourth quarter of fiscal 2005. In the second quarter of fiscal 2006, we incurred an additional charge of approximately \$961,000, or less than \$0.01 per diluted share. Of this pre-tax charge, approximately \$732,000 is included in cost of goods sold and approximately \$229,000 is included in selling, general and administrative expenses. All of our retail stores were closed during the first quarter of fiscal 2006. The final phase of our operational shutdown was completed in the second quarter of fiscal 2006, with our final Hold Everything catalog mailed on May 16, 2006 and our website ceasing operations on June 30, 2006. Our Outlet stores are being used for the final clearance of inventory and the merchandising categories the brand represented are being transitioned into our other brands.

Second Quarter of Fiscal 2006 Operational Results

Operationally, from a supply chain perspective, we continued to make progress on the execution of our daily store replenishment program and completed the in-sourcing of our east coast furniture hub. We also implemented several new warehouse management initiatives that we believe may reduce our costs associated with customer returns and replacements.

Fiscal 2006

As we look forward to the back half of the year, we have begun to see a softening in consumer demand, especially in our Pottery Barn brand. Because of this, we are staying focused on the things that we can control (customer service, visual merchandising, inventory management, and operational execution) and we are capitalizing on the marketing opportunities that we believe exist with our multi-channel strategy.

We will continue to focus on our long-term strategic initiatives of driving profitable top-line revenue growth, increasing our pre-tax operating margin and enhancing shareholder value.

To drive profitable top-line revenue growth, we are continuing to invest in the growth opportunities that we believe will provide the greatest returns: increasing retail leased square footage; expanding catalog circulation; substantially increasing electronic direct marketing and paid search; upgrading functionality on our e-commerce websites; and implementing, for the first time, the ability to issue and redeem gift cards in our direct-to-customer channel.

In order to increase our pre-tax operating margin, we will remain focused on: continuing to implement initiatives throughout the supply chain to reduce returns, replacements and damages; enhancing our daily store replenishment program in the New York metro-area where both customer delivery and store replenishment can be efficiently combined; and leveraging the in-sourced east coast furniture hub to enhance the furniture delivery experience for our customers and reduce our furniture delivery costs.

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Consistent with our strategic initiative to enhance shareholder value, we remain committed to returning capital to our shareholders through dividends and share repurchases, including the 5,000,000 share stock repurchase program authorized by our Board of Directors in August 2006.

NET REVENUES

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

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The following table summarizes our net revenues for the thirteen weeks ended July 30, 2006 (second quarter of fiscal 2006) and July 31, 2005 (second quarter of fiscal 2005), and the twenty-six weeks ended July 30, 2006 (year-to-date 2006) and July 31, 2005 (year-to-date 2005):

| | Thirteen Weeks Ended | | | | Twenty-Six Weeks Ended | | | |
|-----------------------------|----------------------|---------|------------------|---------|------------------------|---------|------------------|---------|
| | July 30, 2006 | % Total | July 31, 2005 | % Total | July 30, 2006 | % Total | July 31, 2005 | % Total |
| <i>Dollars in thousands</i> | | | | | | | | |
| Retail revenues | \$ 463,372 | 56.1% | \$ 434,147 | 55.9% | \$ 897,281 | 55.4% | \$ 831,335 | 55.5% |
| Direct-to-customer revenues | 362,164 | 43.9% | 342,092 | 44.1% | 722,541 | 44.6% | 665,592 | 44.5% |
| Net revenues | \$ 825,536 | 100.0% | \$ 776,239 | 100.0% | \$ 1,619,822 | 100.0% | \$ 1,496,927 | 100.0% |

Net revenues for the second quarter of fiscal 2006 increased by \$49,297,000, or 6.4%, over the second quarter of fiscal 2005. The increase was primarily driven by a year-over-year increase in store leased square footage of 7.5% (including 29 new store openings and the remodeling and expansion of an additional 18 stores, partially offset by the temporary closure of 18 stores and the permanent closure of 15 stores, for a net of 14 new store openings) and a comparable store sales increase of 1.2%. This increase was further driven by increased page circulation of 4.2% and continued strength in our Internet business primarily due to our efforts associated with electronic direct marketing and on-line advertising initiatives.

Net revenues for year-to-date 2006 increased by \$122,895,000, or 8.2%, over net revenues for year-to-date 2005. This was primarily due to a year-over-year increase in store leased square footage of 7.5% (including 29 new store openings and the remodeling and expansion of an additional 18 stores, partially offset by the temporary closure of 18 stores and the permanent closure of 15 stores, for a net of 14 new store openings) and a comparable store sales increase of 1.3%. This increase was further driven by increased page circulation of 5.8% and continued strength in our Internet business primarily due to our efforts associated with electronic direct marketing and on-line advertising initiatives.

RETAIL REVENUES AND OTHER DATA

| | Thirteen Weeks Ended | | Twenty-Six Weeks Ended | |
|--|----------------------|------------------|------------------------|------------------|
| | July 30, 2006 | July 31, 2005 | July 30, 2006 | July 31, 2005 |
| <i>Dollars in thousands</i> | | | | |
| Retail revenues | \$ 463,372 | \$ 434,147 | \$ 897,281 | \$ 831,335 |
| Percent growth in retail revenues | 6.7% | 13.4% | 7.9% | 13.3% |
| Percent increase in comparable store sales | 1.2% | 3.7% | 1.3% | 4.3% |
| Number of stores - beginning of period | 569 | 552 | 570 | 552 |
| Number of new stores | 2 | 8 | 9 | 10 |
| Number of new stores due to remodeling ^{1,2} | 10 | 4 | 15 | 5 |
| Number of closed stores due to remodeling ¹ | (8) | (4) | (13) | (7) |
| Number of permanently closed stores ³ | - | (1) | (8) | (1) |
| Number of stores - end of period | 573 | 559 | 573 | 559 |
| Store selling square footage at period-end | 3,204,000 | 2,998,000 | 3,204,000 | 2,998,000 |
| Store leased square footage (LSF) at period-end | 5,159,000 | 4,798,000 | 5,159,000 | 4,798,000 |

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

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² Fiscal year 2006 remodeled stores include one Williams-Sonoma, two Pottery Barn and one Pottery Barn Kids store reopenings after having been temporarily closed due to Hurricane Katrina.

³ Fiscal year 2006 permanently closed stores represent the closure of all eight of our remaining Hold Everything stores.

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| | Store Count | | | Store Count | | Avg. LSF | |
|----------------------|-------------------|----------|----------|------------------|------------------|------------------|------------------|
| | | | | | | Per Store | |
| | April 30, 2006 | Openings | Closings | July 30, 2006 | July 31, 2005 | July 30, 2006 | July 31, 2005 |
| Williams-Sonoma | 253 | 6 | (3) | 256 | 254 | 5,800 | 5,700 |
| Pottery Barn | 190 | 5 | (4) | 191 | 185 | 12,200 | 12,000 |
| Pottery Barn Kids | 91 | - | - | 91 | 88 | 7,800 | 7,800 |
| Hold Everything | - | - | - | - | 11 | - | 6,600 |
| West Elm | 14 | - | - | 14 | 6 | 16,100 | 14,700 |
| Williams-Sonoma Home | 5 | - | - | 5 | - | 14,700 | - |
| Outlets | 16 | 1 | (1) | 16 | 15 | 20,400 | 19,500 |
| Total | 569 | 12 | (8) | 573 | 559 | 9,000 | 8,600 |

Retail revenues in the second quarter of fiscal 2006 increased by \$29,225,000, or 6.7%, over the second quarter of fiscal 2005. The increase was primarily driven by a year-over-year increase in store leased square footage of 7.5% (including 29 new store openings and the remodeling and expansion of an additional 18 stores, partially offset by the temporary closure of 18 stores and the permanent closure of 15 stores, for a net of 14 new store openings) and a comparable store sales increase of 1.2%. Net revenues generated in the West Elm, Pottery Barn Kids, Williams-Sonoma, Williams-Sonoma Home and Pottery Barn brands were the primary contributors to the year-over-year revenue increase, partially offset by the late 2005 and first quarter 2006 closures of the Hold Everything stores. Pottery Barn and Pottery Barn Kids accounted for 40.6% of the growth in retail revenues during the second quarter of fiscal 2006 over the second quarter of fiscal 2005.

Retail revenues for year-to-date 2006 increased \$65,946,000, or 7.9%, over year-to-date 2005. The increase was primarily driven by a year-over-year increase in store leased square footage of 7.5% (including 29 new store openings and the remodeling and expansion of an additional 18 stores, partially offset by the temporary closure of 18 stores and the permanent closure of 15 stores, for a net of 14 new store openings) and a comparable store sales increase of 1.3%. Net revenues generated in the West Elm, Pottery Barn, Pottery Barn Kids, Williams-Sonoma and Williams-Sonoma Home brands were the primary contributors to the year-over-year revenue increase, partially offset by the late 2005 and first quarter 2006 closures of the Hold Everything stores. Pottery Barn and Pottery Barn Kids accounted for 42.3% of the growth in retail revenues during year-to-date 2006 over year-to-date 2005.

Comparable Store Sales

Comparable stores are defined as those stores in which gross square footage did not change by more than 20% in the previous 12 months and which have been open for at least 12 consecutive months without closure for seven or more consecutive days. Comparable stores exclude new retail concepts until such time as we believe that comparable store results in those concepts are meaningful to evaluating the performance of the retail strategy. For the second quarter of fiscal 2006 and 2005 and year-to-date 2006 and 2005, our total comparable store sales exclude the West Elm concept. In fiscal 2006, we expect to exclude West Elm and Williams-Sonoma Home. By measuring the year-over-year sales of merchandise in the stores that have a history of being open for a full comparable 12 months or more, we can better gauge how the core store base is performing since it excludes store remodelings, expansions and closings.

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

| | Thirteen Weeks Ended | | Twenty-Six Weeks Ended | |
|--|----------------------|---------------|------------------------|---------------|
| | July 30, 2006 | July 31, 2005 | July 30, 2006 | July 31, 2005 |
| <i>Percent increase (decrease) in comparable store sales</i> | | | | |
| Williams-Sonoma | 2.3% | (0.2%) | 2.1% | (0.4%) |
| Pottery Barn | (0.2%) | 5.6% | 0.4% | 5.8% |
| Pottery Barn Kids | 8.1% | 4.1% | 5.7% | 7.0% |
| Outlets | (8.6%) | 12.8% | (6.4%) | 16.0% |
| Hold Everything ¹ | - | (17.6%) | - | (17.2%) |
| Total | 1.2% | 3.7% | 1.3% | 4.3% |

¹ Hold Everything stores are excluded from the 2006 comparable store sales calculation as its remaining eight stores were closed during the first quarter of fiscal 2006.

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

DIRECT-TO-CUSTOMER REVENUES

| | Thirteen Weeks Ended | | Twenty-Six Weeks Ended | |
|--|----------------------|---------------|------------------------|---------------|
| | July 30, 2006 | July 31, 2005 | July 30, 2006 | July 31, 2005 |
| <i>Dollars in thousands</i> | | | | |
| Catalog revenues ¹ | \$ 148,409 | \$ 169,306 | \$ 307,761 | \$ 339,295 |
| Internet revenues ¹ | 213,755 | 172,786 | 414,780 | 326,297 |
| Total direct-to-customer revenues ¹ | \$ 362,164 | \$ 342,092 | \$ 722,541 | \$ 665,592 |
| Percent growth in direct-to-customer revenues | 5.9% | 11.5% | 8.6% | 11.6% |
| Percent (decrease) increase in number of catalogs circulated | (3.4%) | 8.9% | (0.6%) | 8.3% |
| Percent growth in number of pages circulated | 4.2% | 17.4% | 5.8% | 17.7% |

¹ Approximately 55% of our company-wide non-gift registry Internet revenues are driven by customers who recently received a catalog and approximately 45% are incremental to the direct-to-customer channel.

Direct-to-customer revenues in the second quarter of fiscal 2006 increased by \$20,072,000, or 5.9%, over the second quarter of fiscal 2005. This increase was primarily driven by net revenues generated in the Pottery Barn Kids, Pottery Barn, PBteen, West Elm and Williams-Sonoma

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brands, primarily due to an overall increase in page circulation of 4.2% and continued strength in our Internet business, resulting from our expanded efforts associated with electronic direct marketing and our on-line advertising initiatives. All brands in the direct-to-customer channel delivered positive growth during the quarter with the exception of the Williams-Sonoma Home and Hold Everything brands.

Direct-to-customer revenues for year-to-date 2006 increased \$56,949,000, or 8.6%, over year-to-date 2005. This increase was primarily driven by net revenues generated in the Pottery Barn Kids, Pottery Barn, PBteen, West Elm and Williams-Sonoma brands, primarily due to an overall increase in page circulation of 5.8% and continued strength in our Internet business, resulting from our expanded efforts associated with electronic direct marketing and our on-line advertising initiatives. All brands in the direct-to-customer channel delivered positive growth for year-to-date 2006 with the exception of the Williams-Sonoma Home and Hold Everything brands.

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| | Thirteen Weeks Ended | | | | Twenty-Six Weeks Ended | | | |
|-----------------------------|----------------------|-------------------|------------------|-------------------|------------------------|-------------------|------------------|-------------------|
| | July 30, 2006 | % Net Revenues | July 31, 2005 | % Net Revenues | July 30, 2006 | % Net Revenues | July 31, 2005 | % Net Revenues |
| <i>Dollars in thousands</i> | | | | | | | | |
| Cost of goods sold | \$ 510,976 | 61.9% | \$ 481,404 | 62.0% | \$ 999,841 | 61.7% | \$ 917,170 | 61.3% |

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

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

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

Second Quarter of Fiscal 2006 vs. Second Quarter of Fiscal 2005

Cost of goods sold increased by \$29,572,000, or 6.1%, in the second quarter of 2006 compared to the second quarter of 2005. Including expense of approximately \$1,600,000 associated with the implementation of FSP FAS 13-1 and the Hold Everything transition, cost of goods sold as a percentage of net revenues decreased 10 basis points in the second quarter of fiscal 2006 from the second quarter of fiscal 2005. This decrease was primarily driven by a year-over-year improvement in cost of merchandise across all core brands, partially offset by a rate increase in occupancy expenses primarily due to the implementation of FSP FAS 13-1 and the Hold Everything transition, as well as higher direct-to-customer shipping costs.

In the retail channel, cost of goods sold as a percentage of retail net revenues increased 40 basis points in the second quarter of fiscal 2006 compared to the second quarter of fiscal 2005 resulting from a rate increase in occupancy expenses primarily due to the implementation of FSP FAS 13-1 and the Hold Everything transition, partially offset by a year-over-year improvement in cost of merchandise across all core brands.

In the direct-to-customer channel, cost of goods sold as a percentage of direct-to-customer net revenues decreased 50 basis points in the second quarter of fiscal 2006 compared to the second quarter of fiscal 2005. This decrease was primarily driven by a year-over-year improvement in cost of merchandise across all core brands, partially offset by an increase in occupancy expenses and higher direct-to-customer shipping costs.

Year-to-Date 2006 vs. Year-to-Date 2005

Cost of goods sold for year-to-date 2006 increased by \$82,671,000, or 9.0%, over year-to-date 2005. Including expense of approximately \$3,800,000 associated with the Hold Everything transition and the implementation of FSP FAS 13-1, cost of goods sold as a percentage of net revenues increased 40 basis points for year-to-date 2006 compared to year-to-date 2005. This increase was primarily driven by fiscal 2005 infrastructure investments that

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were not fully implemented until the back half of 2005, including: retail occupancy costs in our emerging brand stores, the incremental costs associated with daily store replenishment and increased distribution capacity. This increase was further driven by the expense associated with the Hold Everything transition and the implementation of FSP FAS 13-1, as well as higher customer shipping costs. This increase was partially offset by a year-over-year improvement in cost of merchandise across all core brands.

In the retail channel, cost of goods sold as a percentage of retail net revenues increased 70 basis points for year-to-date 2006 compared to year-to-date 2005 resulting from fiscal 2005 infrastructure investments that were not fully implemented until the back half of 2005, including: retail occupancy costs in our emerging brand stores and the incremental costs associated with daily store replenishment. This increase was further driven by the charge associated with the Hold Everything transition and the implementation of FSP FAS 13-1, partially offset by a year-over-year improvement in cost of merchandise across all core brands.

In the direct-to-customer channel, cost of goods sold as a percentage of direct-to-customer net revenues increased 50 basis points for year-to-date 2006 compared to year-to-date 2005. This increase was primarily due to an increase in occupancy expenses associated with increased distribution capacity and higher direct-to-customer shipping costs, partially offset by a year-over-year improvement in cost of merchandise across all core brands.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

| | Thirteen Weeks Ended | | | | Twenty-Six Weeks Ended | | | |
|--|----------------------|-------------------|------------------|-------------------|------------------------|-------------------|------------------|-------------------|
| | July 30, 2006 | % Net Revenues | July 31, 2005 | % Net Revenues | July 30, 2006 | % Net Revenues | July 31, 2005 | % Net Revenues |
| <i>Dollars in thousands</i> | | | | | | | | |
| Selling, general and administrative expenses | \$ 260,312 | 31.5% | \$ 245,628 | 31.6% | \$ 531,043 | 32.8% | \$ 486,847 | 32.5% |

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

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

Second Quarter of Fiscal 2006 vs. Second Quarter of Fiscal 2005

Selling, general and administrative expenses increased by \$14,684,000, or 6.0%, in the second quarter of fiscal 2006 compared to the second quarter of fiscal 2005. Including an approximate \$3,200,000 net benefit associated with certain unusual business events (unredeemed gift certificate income due to a change in estimate, litigation settlement income, the expense associated with the departure of our Chief Executive

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Officer and the expense associated with the Hold Everything transition), partially offset by the implementation of FAS 123R, selling, general and administrative expenses as a percentage of net revenues decreased 10 basis points in the second quarter of fiscal 2006 from the second quarter of fiscal 2005. This decrease was primarily driven by the recording of income associated with unredeemed gift certificates resulting from a change in estimate, the recording of income from the settlement of certain litigation, and reductions in other general expenses. This decrease was partially offset by higher employment and advertising costs. Increased employment costs as a percentage of net revenues were primarily driven by an increase in stock-based compensation expense from the implementation of FAS 123R, expense incurred in connection with the departure of our Chief Executive Officer, and the ongoing investment in the growth of the West Elm and Williams-Sonoma Home brands. Higher advertising costs as a percentage of net revenues were primarily driven by reduced catalog productivity in the Pottery Barn brand.

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In the retail channel, selling, general and administrative expenses as a percentage of retail net revenues decreased 20 basis points in the second quarter of fiscal 2006 compared to the second quarter of fiscal 2005. This decrease resulted primarily from a change in estimate for recording income associated with unredeemed gift certificates and a reduction in other general expenses, partially offset by an increase in employment costs due to the ongoing investment in the growth of the West Elm and Williams-Sonoma Home brands.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of direct-to-customer net revenues increased 80 basis points in the second quarter of fiscal 2006 compared to the second quarter of fiscal 2005. This increase was primarily due to higher advertising costs as a percentage of net revenues driven by reduced catalog productivity in the Pottery Barn brand and increased employment costs.

Year-to-Date 2006 vs. Year-to-Date 2005

Selling, general and administrative expenses for year-to-date 2006 increased by \$44,196,000, or 9.1%, over year-to-date 2005. Including expense of approximately \$6,200,000 associated with the implementation of FAS 123R, partially offset by unusual business events (unredeemed gift certificate income due to a change in estimate, litigation settlement income, the expense associated with the departure of our Chief Executive Officer and the expense associated with the Hold Everything transition), selling, general and administrative expenses as a percentage of net revenues increased 30 basis points for year-to-date 2006 from year-to-date 2005. This increase was primarily driven by increased employment costs. Increased employment costs as a percentage of net revenues were primarily driven by an increase in stock-based compensation expense from the implementation of FAS 123R, expense incurred in connection with the departure of our Chief Executive Officer, and the ongoing investment in the growth of the West Elm and Williams-Sonoma Home brands. This increase was partially offset by the recording of income associated with unredeemed gift certificates resulting from a change in estimate and the settlement of certain litigation.

In the retail channel, selling, general and administrative expenses as a percentage of retail net revenues increased 20 basis points for year-to-date 2006 compared to year-to-date 2005. This increase resulted from increased employment costs primarily driven by the ongoing investment in the growth of the West Elm and Williams-Sonoma Home brands, partially offset by a change in estimate for recording income associated with unredeemed gift certificates.

In the direct-to-customer channel, selling, general and administrative expenses as a percentage of direct-to-customer net revenues decreased 20 basis points for year-to-date 2006 compared to year-to-date 2005. This decrease was primarily driven by a rate decrease in advertising costs resulting from a year-over-year reduction in catalog advertising costs in the Hold Everything brand (due to the final catalog being mailed on May 16, 2006) and a greater percentage of total company net revenues being generated in the e-commerce channel, which incurs advertising expense at a lower rate than the company average. This rate decrease was partially offset by a rate increase in advertising costs resulting from reduced catalog productivity in the Pottery Barn brand.

INTEREST INCOME

Interest income was \$4,056,000 in the second quarter of fiscal 2006, compared to \$881,000 in the second quarter of fiscal 2005, comprised primarily of income from short-term investments classified as cash and cash equivalents. For year-to-date 2006, interest income was \$7,378,000 compared to \$1,984,000 for year-to-date 2005. The increase in interest income during the second quarter of fiscal 2006 and year-to-date 2006 compared to the second quarter of fiscal 2005 and year-to-date 2005 resulted from higher cash balances during 2006 compared to 2005, as well as an increase in the interest rates associated with these short-term investments.

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INCOME TAXES

Our effective tax rate was 38.4% for the second quarter of fiscal 2006 and 37.9% for the second quarter of fiscal 2005. Our second quarter of fiscal 2006 income tax rate increased over the second quarter of fiscal 2005 due to the timing of favorable resolutions of certain tax matters in the second quarter of fiscal 2005, resulting in a lower second quarter of fiscal 2005 tax rate.

Our effective tax rate was 38.4% for year-to-date 2006 and 39.3% for year-to-date 2005. Our year-to-date 2006 tax rate decreased primarily due to an increase in reserves for potential state income tax exposure in 2005, resulting in a higher year-to-date 2005 tax rate. We expect our effective tax rate to be in the range of 38.1% to 38.3% in fiscal 2006. Throughout the year, we expect that there could be ongoing variability in our quarterly tax rates as taxable events occur and exposures are re-evaluated.

LIQUIDITY AND CAPITAL RESOURCES

As of July 30, 2006, we held \$187,377,000 in cash and cash equivalents. As is consistent with our industry, our cash balances are seasonal in nature, with the fourth quarter representing a significantly higher level of cash than in other periods. Throughout the fiscal year, we utilize our cash balances to build our inventory levels in preparation for our fourth quarter holiday sales. In the remainder of fiscal 2006, we plan to utilize our cash resources to fund our inventory and inventory-related purchases, catalog advertising and marketing initiatives, current store development and infrastructure strategies, share repurchases and issuance of dividends. In addition to the current cash balances on-hand, we have a \$300,000,000 credit facility that may be used for loans or letters of credit. No amounts were borrowed by us under the credit facility in year-to-date 2006 or year-to-date 2005. However, as of July 30, 2006, \$35,973,000 in issued but undrawn standby letters of credit was outstanding under the credit facility. We believe our cash on-hand, in addition to our available credit facilities, will provide adequate liquidity for our business operations and growth opportunities over the upcoming twelve-month period.

For year-to-date 2006, net cash used in operating activities was \$22,281,000 compared to net cash used in operating activities of \$14,685,000 for year-to-date 2005. Net cash used for year-to-date 2006 was primarily attributable to the payment of income taxes and the purchase of merchandise inventories to support the increase in sales in our core and emerging brands. This was partially offset by an increase in deferred lease incentives due to the construction of additional retail stores during the year.

For year-to-date 2006, net cash used in investing activities was \$84,481,000 compared to net cash used in investing activities of \$77,142,000 for year-to-date 2005. For year-to-date 2006, purchases of property and equipment were comprised of \$50,492,000 for stores, \$24,205,000 for systems development projects (including e-commerce websites) and \$9,784,000 for distribution and facility infrastructure projects.

In fiscal 2006, we anticipate investing \$185,000,000 to \$205,000,000 in the purchase of property and equipment, primarily for the construction of 28 new stores and 27 remodeled stores, systems development projects (including e-commerce websites), and distribution and facility infrastructure projects.

For year-to-date 2006, net cash used by financing activities was \$68,029,000 compared to net cash provided in financing activities of \$5,875,000 for year-to-date 2005. Net cash used by financing activities was primarily due to the repurchase of common stock and the payment of dividends.

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In March 2006, our Board of Directors authorized a stock repurchase program to acquire up to 2,000,000 shares of our outstanding common stock. During the second quarter of fiscal 2006, we repurchased and retired all 2,000,000 shares of our common stock under this program at a weighted average cost of \$32.33 per share and an aggregate cost of approximately \$64,653,000.

The following table summarizes our repurchases of shares of our common stock during the second quarter of fiscal 2006:

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of a Publicly Announced Repurchase Plan | Maximum Number of Shares that May Yet be Purchased Under Any Plan |
|-------------------------------|----------------------------------|------------------------------|--|---|
| May 1, 2006 - May 28, 2006 | - | - | - | 2,000,000 |
| May 29, 2006 - June 25, 2006 | - | - | - | 2,000,000 |
| June 26, 2006 - July 30, 2006 | 2,000,000 | \$ 32.33 | 2,000,000 | - |
| Total | 2,000,000 | \$32.33 | 2,000,000 | - |

In August 2006, our Board of Directors authorized a stock repurchase program to acquire up to 5,000,000 shares of our outstanding common stock. Stock repurchases under this program may be made through open market and privately negotiated transactions at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements and other market conditions. The stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

Dividend Policy

Prior to March 2006, no cash dividend had ever been declared or paid on our common stock. In March 2006, our Board of Directors authorized the initiation of a quarterly cash dividend. The quarterly dividend of approximately \$11,600,000, or \$0.10 per common share, was paid on May 24, 2006, to shareholders of record as of the close of business on April 26, 2006. On June 22, 2006, we declared a quarterly dividend of \$0.10 per common share, or approximately \$11,500,000, which was paid on August 24, 2006 to shareholders of record as of the close of business on July 27, 2006. The indicated annual cash dividend, subject to capital availability, is \$0.40 per common share, or approximately \$46,000,000 in fiscal 2006 based on the current number of common shares outstanding.

Critical Accounting Policies

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

During the second quarter of fiscal 2006, we completed an analysis of our historical gift certificate and gift card redemption patterns, which included an independent actuarial study based on our historical redemption data. As a result of this analysis, we concluded that the likelihood of our gift certificates and gift cards being redeemed beyond four years from the date of issuance is remote. As a result, we have changed our estimate of the elapsed time for recording income associated with unredeemed gift certificates and gift cards to four years from our prior estimate of seven years.

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Impact of Inflation

The impact of inflation on results of operations was not significant for year-to-date 2006 or for year-to-date 2005.

Seasonality

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest Rate Risk

The interest payable on our credit facility, industrial development bond and the bond-related debt associated with our Memphis-based distribution facilities is based on variable interest rates and is, therefore, affected by changes in market interest rates. If interest rates on existing variable rate debt rose 53 basis points (an approximate 10% increase in the associated variable rates as of July 30, 2006), our results from operations and cash flows would not be materially affected.

In addition, we have fixed and variable income investments consisting of short-term investments classified as cash and cash equivalents, which are also affected by changes in market interest rates. An increase in interest rates of 10% would have an immaterial effect on the value of these investments. Declines in interest rates would, however, decrease the income derived from these investments.

Foreign Currency Risks

We purchase a significant amount of inventory from vendors outside of the U.S. in transactions that are denominated in U.S. dollars. Approximately 5% of our international purchase transactions are in currencies other than the U.S. dollar. As of July 30, 2006, any currency risks related to these transactions are not significant to us. A material decline in the relative value of the U.S. dollar to other foreign currencies could, however, lead to increased purchasing costs.

As of July 30, 2006, we have 14 retail stores in Canada, which expose us to market risk associated with foreign currency exchange rate fluctuations. Any gain or loss from these currency exchange rate fluctuations is recorded in selling, general and administrative expenses each reporting period and has not been material to us.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of July 30, 2006, an evaluation was performed by management, with the participation of our Chief Executive Officer (CEO) and our Executive Vice President, Chief Operating and Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow timely discussions regarding required disclosures, and that such information is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

Changes in Internal Control Over Financial Reporting

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

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

A description of the risks and uncertainties associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risks and uncertainties associated with our business previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended January 29, 2006. You should carefully consider such risks and uncertainties, together with the other information contained in this report, our Annual Report on Form 10-K for the fiscal year ended January 29, 2006 and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.

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We must successfully anticipate changing consumer preferences and buying trends, and manage our inventory commensurate with customer demand.

Our success depends, in large part, upon our ability to anticipate and respond in a timely manner to changing merchandise trends and customer demands. Consumer preferences cannot be predicted with certainty and may change between selling seasons. Changes in customer preferences and buying trends may also affect our brands differently. If we misjudge either the market for our merchandise or our customers' purchasing habits, our sales may decline significantly, and we may be required to mark down certain products to sell the resulting excess inventory or to sell such inventory through our outlet stores or other liquidation channels at prices which are significantly lower than our retail prices, either of which would negatively impact our business and operating results.

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

Our business depends, in part, on factors affecting consumer spending that are out of our control.

Our business depends on consumer demand for our products and, consequently, is sensitive to a number of factors that influence consumer spending, including general economic conditions, disposable consumer income, fuel prices, recession and fears of recession, war and fears of war, inclement weather, consumer debt, conditions in the housing market, interest rates, sales tax rates and rate increases, inflation, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. These factors may also affect our various brands and channels differently. Adverse changes in factors affecting discretionary consumer spending could reduce consumer demand for our products, thus reducing our sales and harming our business and operating results. For example, the August 2005 natural disaster caused by Hurricane Katrina will likely continue to affect consumer spending in the vicinity of the disaster.

We face intense competition from companies with brands or products similar to ours.

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

The competitive challenges facing us include:

- anticipating and quickly responding to changing consumer demands better than our competitors;
- maintaining favorable brand recognition and achieving customer perception of value;
- effectively marketing and competitively pricing our products to consumers in several diverse market segments;
- developing innovative, high-quality products in colors and styles that appeal to consumers of varying age groups and tastes, and in ways that favorably distinguish us from our competitors; and
- effectively managing our supply chain and distribution strategies in order to provide our products to our consumers on a timely basis.

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

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We depend on key domestic and foreign vendors for timely and effective sourcing of our merchandise, and we are subject to various risks and uncertainties that might affect our vendors' ability to produce quality merchandise.

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

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

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

Our dependence on foreign vendors subjects us to a variety of risks and uncertainties.

In fiscal 2005, we sourced our products from manufacturers in 35 countries outside of the United States. Approximately 63% of our merchandise purchases were foreign-sourced, primarily from Asia and Europe. Our dependence on foreign vendors means that we may be affected by declines in the relative value of the U.S. dollar to other foreign currencies. For example, any upward valuation in the Chinese Yuan against the U.S. Dollar may result in higher costs to us for those goods that we source from mainland China. Although approximately 95% of our foreign purchases of merchandise are negotiated and paid for in U.S. dollars, declines in foreign currencies and currency exchange rates might negatively affect the profitability and business prospects of one or more of our foreign vendors. This, in turn, might cause such foreign vendors to demand higher prices for merchandise, delay merchandise shipments to us, or discontinue selling to us, any of which could ultimately reduce our sales or increase our costs.

We are also subject to other risks and uncertainties associated with changing economic and political conditions in foreign countries. These risks and uncertainties include import duties and quotas, concerns over anti-dumping, work stoppages, economic uncertainties (including inflation), foreign government regulations, wars and fears of war, political unrest, natural disasters and other trade restrictions. We cannot predict whether any of the countries in which our products are currently manufactured or may be manufactured in the future will be subject to trade restrictions imposed by the U.S. or foreign governments or the likelihood, type or effect of any such restrictions. Any event causing a disruption or delay of imports from foreign vendors, including the imposition of additional import restrictions, restrictions on the transfer of funds and/or increased tariffs or quotas, or both, could increase the cost or reduce the supply of merchandise available to us and adversely affect our business, financial condition and operating results. Furthermore, some or all of our foreign vendors' operations may be adversely affected by political and financial instability resulting in the disruption of trade from exporting countries, restrictions on the transfer of funds and/or other trade disruptions.

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

The growth of our sales and profits depends, in large part, on our ability to successfully open new stores.

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

- our identification and availability of suitable store locations;
- our success in negotiating leases on acceptable terms;
- our ability to secure required governmental permits and approvals;
- our hiring and training of skilled store operating personnel, especially management;
- our timely development of new stores, including the availability of construction materials and labor and the absence of significant construction and other delays in store openings based on weather or other events;
- the availability of financing on acceptable terms, if at all; and
- general economic conditions.

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

We must timely and effectively deliver merchandise to our stores and customers.

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

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

The operation of our direct-to-customer business depends on our ability to maintain the efficient and uninterrupted operation of our order-taking and fulfillment operations and our e-commerce websites. Disruptions or slowdowns in these areas could result from disruptions in telephone service or power outages, inadequate system capacity, system issues, computer viruses, security breaches, human error, changes in programming, union organizing activity, disruptions in our third party labor contracts, natural disasters or adverse weather conditions. These problems could result in a reduction in sales as well as increased selling, general and administrative expenses.

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

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

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

We experience fluctuations in our comparable store sales.

Our success depends, in part, upon our ability to increase sales at our existing stores. Various factors affect comparable store sales, including the number, size and location of stores we open, close, remodel or expand in any period, the general retail sales environment, consumer preferences and buying trends, changes in sales mix among distribution channels, our ability to efficiently source and distribute products, changes in our merchandise mix, competition, current local and global economic conditions, the timing of our releases of new merchandise and promotional events, the success of marketing programs, the cannibalization of existing store sales by our new stores, increased catalog circulation, and continued strength in our Internet business. Among other things, weather conditions can affect comparable store sales because inclement weather can alter consumer behavior or require us to close certain stores temporarily and thus reduce store traffic. Even if stores are not closed, many customers may decide to avoid going to stores in bad weather. These factors have caused and may continue to cause our comparable store sales results to differ materially from prior periods and from earnings guidance we have provided. For example, the August 2005 natural disaster caused by Hurricane Katrina resulted in five temporary store closures. As of July 30, 2006, all five stores have been reopened.

Our comparable store sales have fluctuated significantly in the past on an annual, quarterly and monthly basis, and we expect that comparable store sales will continue to fluctuate in the future. Our comparable store sales increases for fiscal years 2005, 2004 and 2003 were 4.9%, 3.5% and 4.0%, respectively. Past comparable store sales are no indication of future results, and comparable store sales may decrease in the future. Our ability to maintain and improve our comparable store sales results depends, in large part, on maintaining and improving our forecasting of customer demand and buying trends, selecting effective marketing techniques, providing an appropriate mix of merchandise for our broad and diverse customer base and using effective pricing strategies. Any failure to meet the comparable store sales expectations of investors and security analysts in one or more future periods could significantly reduce the market price of our common stock.

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

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

We have historically experienced fluctuations in customer response to our catalogs. Customer response to our catalogs is substantially dependent on merchandise assortment, merchandise availability and creative presentation, as well as the selection of customers to whom the catalogs are mailed, changes in mailing strategies, and the sizing and timing of delivery of the catalogs. In addition, environmental organizations may attempt to create an unfavorable impression of our paper use in catalogs. The failure to effectively produce or distribute our catalogs could affect the timing of catalog delivery. The timing of catalog delivery has been and can be affected by postal service delays. For example, the August 2005 natural disaster caused by Hurricane Katrina created domestic ground and rail transportation capacity constraints that resulted in late catalog delivery. Any delays in the timing of catalog delivery could cause customers to forego or defer purchases.

We must successfully manage our Internet business.

The success of our Internet business depends, in part, on factors over which we have limited control. In addition to changing consumer preferences and buying trends relating to Internet usage, we are vulnerable to certain additional risks and uncertainties associated with the Internet, including changes in required technology interfaces, website downtime and other technical failures, costs and technical issues as we upgrade our website software, computer viruses, changes in applicable federal and state regulation, security breaches, and consumer privacy concerns. Our failure to successfully respond to these risks and uncertainties might adversely affect the sales in our Internet business, as well as damage our reputation and brands.

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

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

We must successfully manage the complexities associated with a multi-channel and multi-brand business.

During the past few years, with the launch and expansion of our Internet business, new brands and brand extensions, our overall business has become substantially more complex. The changes in our business have forced us to develop new expertise and face new challenges, risks and uncertainties. For example, we face the risk that our Internet business might cannibalize a significant portion of our retail and catalog businesses, and we face the risk of increased catalog circulation cannibalizing our retail sales. While we recognize that our Internet sales cannot be entirely

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incremental to sales through our retail and catalog channels, we seek to attract as many new customers as possible to our e-commerce websites. We continually analyze the business results of our three

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channels and the relationships among the channels, in an effort to find opportunities to build incremental sales. However, as our Internet business grows and as we add e-commerce websites for more of our concepts, these increased Internet sales may cannibalize a portion of our retail and catalog businesses.

We may not be able to introduce new brands and brand extensions, or to reposition existing brands, to improve our business.

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

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

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

Our inability or failure to protect our intellectual property would have a negative impact on our business.

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

We have been sued and may be named in additional lawsuits in a growing number of industry-wide business method patent litigation cases relating to our business operations.

There appears to be a growing number of business method patent infringement lawsuits instituted against companies such as ours. The plaintiff in each case claims to hold a patent that covers certain technology or methodologies which are allegedly infringed by the operation of the defendants' business. We are currently a defendant in such patent infringement cases and may be named in others in the future, as part of an

industry-wide trend. Even in cases where a plaintiff's claim lacks merit, the defense costs in a patent infringement case can be high. Additional patent infringement claims may be brought against us, and the cost of defending such claims or the ultimate resolution of such claims may harm our business and operating results.

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We need to successfully manage our employment, occupancy and other operating costs.

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

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

We are undertaking certain systems changes that might disrupt our supply chain operations.

Our success depends on our ability to source and distribute merchandise efficiently through appropriate systems and procedures. We are in the process of substantially modifying our information technology systems supporting the product pipeline, including design, sourcing, merchandise planning, forecasting and purchase order, inventory, distribution, transportation and price management. Modifications will involve updating or replacing legacy systems with successor systems during the course of several years. There are inherent risks associated with replacing our core systems, including supply chain and merchandising systems disruptions that affect our ability to get the correct products into the appropriate stores and delivered to customers. We may not successfully launch these new systems, or the launch may result in supply chain and merchandising systems disruptions. Any such disruptions could negatively impact our business and operating results.

We are implementing changes to our data center information technology infrastructure that might disrupt our business and cost more than expected.

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

Our operating and financial performance in any given period might not meet the extensive guidance that we have provided to the public.

We provide extensive public guidance on our expected operating and financial results for future periods. Although we believe that this guidance provides investors and analysts with a better understanding of management's expectations for the future, and is useful to our shareholders and potential shareholders, such guidance is comprised of forward-looking statements subject to the risks and uncertainties described in this report

and in our other public filings and public statements. Our guidance may not always be accurate. If in the future

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our operating or financial results for a particular period do not meet our guidance or the expectations of investment analysts or if we reduce our guidance for future periods, the market price of our common stock could significantly decline.

Our quarterly results of operations might fluctuate due to a variety of factors, including seasonality.

Our quarterly results have fluctuated in the past and may fluctuate in the future, depending upon a variety of factors, including shifts in the timing of holiday selling seasons, including Valentine's Day, Easter, Halloween, Thanksgiving and Christmas, and the strategic importance of fourth quarter results. A significant portion of our revenues and net earnings have been realized during the period from October through December. In anticipation of increased holiday sales activity, we incur certain significant incremental expenses, including the hiring of a substantial number of temporary employees to supplement our existing workforce. If, for any reason, we were to realize significantly lower-than-expected revenues or net earnings during the October through December selling season, our business and results of operations would be materially adversely affected.

We may require external funding sources for operating funds.

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

We will require a significant amount of cash to pay quarterly dividends at intended levels and for our stock repurchase programs.

In March 2006, we initiated a quarterly cash dividend of \$0.10 per common share. In addition, in August 2006, our Board of Directors authorized the repurchase of up to 5,000,000 shares of our common stock. The dividend and the share repurchase program may require a significant portion of our cash earnings. As a result, we may not retain a sufficient amount of cash to finance growth opportunities, new product development initiatives, unanticipated capital expenditures or to fund our operations. Our Board of Directors may, at its discretion, decrease the intended level of dividends or entirely discontinue the payment of dividends at any time. The stock repurchase program does not have an expiration date and may be limited or terminated at any time. Our ability to pay dividends and repurchase shares will depend on our ability to generate cash flows from operations in the future. This ability may be subject to certain economic, financial, competitive and other factors that are beyond our control. Any failure to pay dividends or repurchase shares after we have announced our intention to do so may negatively impact our reputation and investor confidence in us and negatively impact our stock price. In addition, we may be subject to lawsuits regarding the use of our cash for dividends or share repurchases.

We are exposed to potential risks from legislation requiring companies to evaluate controls under Section 404 of the Sarbanes-Oxley Act of 2002.

We have evaluated and tested our internal controls in order to allow management to report on, and our registered independent public accounting firm to attest to, our internal controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002. We have incurred, and expect to continue

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to incur, significant expenses and a diversion of management's time to meet the requirements of Section 404. If we are not able to continue to meet the requirements of Section 404 in a timely manner or with adequate compliance, we would be required to disclose material weaknesses if they develop or are uncovered and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission or the New York Stock Exchange. Any

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such action could negatively impact the perception of us in the financial market and our business. In addition, our internal controls may not prevent or detect all errors and fraud. A control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable assurance that the objectives of the control system will be met.

Changes to accounting rules or regulations may adversely affect our results of operations.

Changes to existing accounting rules or regulations may impact our future results of operations. For example, on December 16, 2004, the FASB issued SFAS No. 123R, Share Based Payment, which requires us, starting in the first quarter of fiscal 2006, to measure compensation costs for all stock-based compensation at fair value and record compensation expense equal to that value over the requisite service period. This accounting rule is estimated to have a negative impact of approximately 10% on our fiscal 2006 diluted earnings per share. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective. Other new accounting rules or regulations and varying interpretations of existing accounting rules or regulations have occurred and may occur in the future. Future changes to accounting rules or regulations or the questioning of current accounting practices, may adversely affect our results of operations.

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

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

We must properly account for our unredeemed gift certificates and merchandise credits.

We maintain a liability for unredeemed gift certificates and merchandise credits until the earlier of redemption, escheatment or four years. After four years, the remaining unredeemed gift certificate or merchandise credit liability is relieved and recorded within selling, general and administrative expenses. In the event that a state or states were to require that these unredeemed certificates and credits be escheated to that state or states, then our business and operating results would be harmed.

We may experience fluctuations in our tax obligations and effective tax rate.

We are subject to income taxes in many U.S. and Canadian jurisdictions. We record tax expense based on our estimates of future payments which include reserves for estimates of probable settlements of foreign and domestic tax audits. At any one time, many tax years are subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. As a result, we expect that throughout the year there could be on-going variability in our quarterly tax rates as taxable events occur and exposures are re-evaluated. Further, our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings.

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We rely on the services of key personnel, whose knowledge of our business and expertise would be difficult to replace.

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

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

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

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

Our Annual Meeting of Shareholders was held on May 23, 2006. At this meeting, the shareholders took the following actions:

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

| Name | For | Withheld |
|----------------------|-------------|-----------|
| Sanjiv Ahuja | 104,594,678 | 187,100 |
| Adrian D.P. Bellamy | 104,208,755 | 573,023 |
| Patrick J. Connolly | 104,626,229 | 155,549 |
| Adrian T. Dillon | 104,631,511 | 150,267 |
| Jeanne P. Jackson | 104,184,028 | 597,750 |
| W. Howard Lester | 102,513,584 | 2,268,194 |
| Michael R. Lynch | 104,521,411 | 260,367 |
| Edward A. Mueller | 104,513,036 | 268,742 |
| Richard T. Robertson | 104,361,126 | 420,652 |
| David B. Zenoff | 104,598,918 | 182,860 |

(II) The shareholders approved, by the vote indicated, an amendment and restatement of the Williams-Sonoma, Inc. 2001 Long-Term Incentive Plan to (i) increase the shares issuable under the plan by 6,000,000 shares, plus 705,743 shares that remained available for issuance in our 1993 Stock Option Plan and our 2000 Nonqualified Stock Option Plan as of March 15, 2006, plus any shares subject to outstanding options under these plans that subsequently expire unexercised, up to a maximum of 754,160 shares and (ii) to make certain other amendments:

| For | Against | Abstain | Broker Non-Vote |
|------------|------------|---------|-----------------|
| 79,948,894 | 17,791,744 | 49,936 | 6,991,204 |

(III) The shareholders ratified, by the vote indicated, the selection of Deloitte & Touche LLP as our independent registered public accounting firm for the fiscal year ending January 28, 2007:

| For | Against | Abstain | Broker Non-Vote |
|-------------|-----------|---------|-----------------|
| 102,770,534 | 1,976,395 | 34,849 | 0 |

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(a) Exhibits

| Exhibit | |
|---------|--|
| Number | Exhibit Description |
| 3.1 | Amended and Restated Bylaws of Williams-Sonoma, Inc. |
| 10.1 | Separation Agreement entered into July 9, 2006 between Williams-Sonoma, Inc. and Edward Mueller (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the Commission on July 11, 2006, File No. 001-14077) |
| 31.1 | Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended |
| 31.2 | Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended |
| 32.1 | Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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SIGNATURE

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

WILLIAMS-SONOMA, INC.

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

Date: September 8, 2006