KIRKLAND'S, INC
Form 10-Q
December 16, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: **November 1, 2008** Commission file number**: 000-49885**

KIRKLAND S, INC.
(Exact name of registrant as specified in its charter)

Tennessee	**62-1287151**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

431 Smith Lane Jackson, Tennessee	**38301**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(731) 988-3600**

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

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

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

(Do not check if a smaller reporting company)

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

As of November 28, 2008, 19,636,934 shares of the Registrant s Common Stock, no par value, were outstanding.

KIRKLAND S, INC.
TABLE OF CONTENTS

	Page
PART I FINANCIAL INFORMATION:	
Item 1. Financial Statements	
Consolidated Balance Sheets at November 1, 2008, February 2, 2008, and November 3, 2007 (unaudited)	3
Consolidated Statements of Operations for the 13-week and 39-week periods ended November 1, 2008, and November 3, 2007 (unaudited)	4
Consolidated Statement of Shareholders Equity for the 39-week period ended November 1, 2008 (unaudited)	5
Consolidated Statements of Cash Flows for the 39-week periods ended November 1, 2008, and November 3, 2007 (unaudited)	6
Notes to Consolidated Financial Statements (unaudited)	7
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	9
Item 3. Quantitative and Qualitative Disclosures About Market Risk	17
Item 4. Controls and Procedures	18
PART II OTHER INFORMATION:	
Item 1A. Risk Factors	19
Item 6. Exhibits	19
SIGNATURES	20
EX-31.1	
EX-31.2	
EX-32.1	
EX-32.2	

Table of Contents

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

	November 1, 2008	February 2, 2008	November 3, 2007
ASSETS			
Current assets:			
Cash and cash equivalents	$ 2,020	$ 5,820	$ 316
Inventories, net	58,773	41,246	62,778
Income taxes receivable		2,900	6,324
Prepaid expenses and other current assets	5,645	7,968	7,899
Total current assets	66,438	57,934	77,317
Property and equipment, net	46,726	63,002	67,386
Other assets	827	1,196	2,223
Total assets	$ 113,991	$ 122,132	$ 146,926
LIABILITIES AND SHAREHOLDERS EQUITY			
Current liabilities:			
Revolving line of credit	$	$	$ 20,813
Accounts payable	21,826	15,786	24,157
Accrued expenses	14,400	16,576	15,381
Current portion of deferred rent	7,797	8,990	7,937
Total current liabilities	44,023	41,352	68,288
Deferred rent	30,075	34,460	34,482
Other liabilities	2,715	3,750	2,897
Total liabilities	76,813	79,562	105,667
Shareholders equity:			
Common stock, no par value; 100,000,000 shares authorized; 19,636,934, 19,585,093 and 19,680,781 shares issued and outstanding at November 1, 2008, February 2, 2008 and November 3, 2007, respectively	141,659	141,334	141,513
Accumulated deficit	(104,481)	(98,764)	(100,254)
Total shareholders equity	37,178	42,570	41,259
Total liabilities and shareholders equity	$ 113,991	$ 122,132	$ 146,926

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

Table of Contents

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

	13-Week Period Ended		39-Week Period Ended	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007
Net sales	$ 85,878	$ 88,743	$ 257,639	$ 258,416
Cost of sales (exclusive of depreciation and amortization as shown below)	57,253	63,980	174,237	187,611
Gross profit	28,625	24,763	83,402	70,805
Operating expenses:				
Compensation and benefits	16,651	17,171	49,489	53,355
Other operating expenses	8,810	10,396	25,803	32,057
Impairment charges			352	813
Severance charge		965		965
Depreciation and amortization	4,685	4,862	13,840	14,744
Total operating expenses	30,146	33,394	89,484	101,934
Operating loss	(1,521)	(8,631)	(6,082)	(31,129)
Interest expense	34	210	93	394
Interest income	(16)		(63)	(180)
Other (income) expense, net	45	(34)	(291)	(65)
Loss before income taxes	(1,584)	(8,807)	(5,821)	(31,278)
Income tax provision (benefit)	(113)	1,843	(104)	(3,882)
Net loss	$ (1,471)	$ (10,650)	$ (5,717)	$ (27,396)
Basic and diluted loss per share	$ (0.07)	$ (0.55)	$ (0.29)	$ (1.40)
Basic and diluted weighted average number of shares outstanding	19,634	19,525	19,621	19,503

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

4

Table of Contents

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

	Common Stock			Total
	Shares	Amount	Accumulated Deficit	Shareholders Equity
Balance at February 2, 2008	19,585,093	$ 141,334	$ (98,764)	$ 42,570
Exercise of employee stock options and employee stock purchases	51,841	69		69
Stock compensation expense		256		256
Net loss			(5,717)	(5,717)
Balance at November 1, 2008	19,636,934	$ 141,659	$ (104,481)	$ 37,178

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

5

Table of Contents

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

	39-Week Period Ended	
	November 1, 2008	November 3, 2007
Cash flows from operating activities:		
Net loss	$ (5,717)	$ (27,396)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation of property and equipment	13,840	14,744
Amortization of landlord construction allowance	(6,186)	(5,152)
Amortization of debt issue costs	20	15
Impairment charges	352	813
Loss on disposal of property and equipment	503	162
Stock compensation	256	602
Cumulative effect of change in accounting principle		(79)
Deferred income taxes	219	960
Changes in assets and liabilities:		
Inventories, net	(17,527)	(17,988)
Prepaid expenses and other current assets	2,323	(2,500)
Other noncurrent assets	139	(238)
Accounts payable	6,040	3,585
Income taxes receivable / payable	2,900	(7,306)
Accrued expenses and other liabilities	(2,604)	5,646
Net cash used in operating activities	(5,442)	(34,132)
Cash flows from investing activities:		
Proceeds from sale of property and equipment	3,700	45
Capital expenditures	(2,127)	(11,836)
Net cash provided by (used in) investing activities	1,573	(11,791)
Cash flows from financing activities:		
Borrowings on revolving line of credit		189,393
Repayments on revolving line of credit		(168,580)
Debt issue costs		(68)
Exercise of stock options and employee stock purchases	69	136
Net cash provided by financing activities	69	20,881

Cash and cash equivalents:		
Net decrease	(3,800)	(25,042)
Beginning of the period	5,820	25,358
End of the period	$ 2,020	$ 316

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

Table of Contents

KIRKLAND S, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 Basis of Presentation

Kirkland s, Inc. (the Company) is a specialty retailer of home décor with 321 stores in 34 states as of November 1, 2008. The consolidated financial statements of the Company include the accounts of Kirkland s, Inc. and its wholly-owned subsidiaries, Kirkland s Stores, Inc. and Kirklands.com, Inc. Significant intercompany accounts and transactions have been eliminated.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, including normal recurring adjustments, considered necessary for a fair presentation have been included. These financial statements should be read in conjunction with the audited financial statements included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on May 1, 2008.

It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than those at fiscal year end. In addition, because of seasonality factors, the results of the Company s operations for the 13-week and 39-week periods ended November 1, 2008, are not indicative of the results to be expected for any other interim period or for the entire fiscal year. The Company s fiscal year ends on the Saturday closest to January 31, resulting in years of either 52 or 53 weeks. All references to a fiscal year refer to the fiscal year ending on the Saturday closest to January 31 of the following year.

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

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

Note 2 Impairments and Severance Charges

The Company reviews long-lived assets with definite lives at least annually and whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. This review includes the evaluation of individual underperforming retail stores and assessing the recoverability of the carrying value of the fixed assets related to the store. Future cash flows are projected for the remaining lease life. If the estimated future cash flows are less than the carrying value of the assets, the Company records an impairment charge equal to the difference, if any, between the assets fair value and carrying value.

During the first quarter of fiscal 2008, the Company recorded an impairment charge totaling approximately $352,000 for the difference in estimated fair value and the carrying value of the fixed assets related to three stores with negative operating cash flows for the trailing 52 weeks. There was no impairment charge recorded in the third quarter of fiscal 2008, or fiscal 2007. During the first two quarters of fiscal 2007, the Company recorded impairment charges totaling $813,000.

During the third quarter of fiscal 2007, the Company incurred a charge related to separation costs associated with a restructuring of corporate personnel that occurred during the quarter. This charge totaled approximately $965,000, or $0.04 per share. The Company eliminated 74 positions, including field multi-unit management and corporate positions at its Jackson and Nashville offices.

Table of Contents

Note 3 Income Taxes

Effective Tax Rate The Company calculates its annual effective tax rate in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. The seasonality of the Company s business is such that the Company expects to offset losses in the early periods of the fiscal year with income in the later periods of the year. The Company did not record an income tax benefit for the 39-week period ended November 1, 2008 as a result of the Company s cumulative losses in recent years. The Company utilized its available carryback benefit of approximately $2.9 million as of the end of fiscal 2007 and subsequently received a federal tax refund in the amount of approximately $2.9 million during the first half of fiscal 2008. Included in income tax expense for the 39-week period ended November 3, 2007 is an adjustment to record a valuation allowance against the Company s net deferred tax assets of approximately $2.8 million, or $0.14 per diluted share.

Deferred tax assets and liabilities are recognized based on the differences between the financial statement and the tax law treatment of certain items. Realization of certain components of deferred tax assets is dependent upon the occurrence of future events. The Company records valuation allowances to reduce its deferred tax assets to the amount it believes is more likely than not to be realized. These valuation allowances can be impacted by changes in tax laws, changes to statutory tax rates, and future taxable income levels and are based on the Company s judgment, estimates, and assumptions regarding those future events. In the event the Company were to determine that it would not be able to realize all or a portion of the net deferred tax assets in the future, the Company would increase the valuation allowance through a charge to income tax expense in the period that such determination is made. Conversely, if the Company were to determine that it would be able to realize its deferred tax assets in the future, in excess of the net carrying amounts, the Company would decrease the recorded valuation allowance through a decrease to income tax expense in the period that such determination is made. As of November 1, 2008, the Company remains uncertain about its ability to use the net deferred tax assets; therefore, a full valuation allowance continues to be recorded.

The Company provides for uncertain tax positions and the related interest and penalties, if any, based upon management s assessment of whether a tax benefit is more likely than not to be sustained upon examination by tax authorities. At November 1, 2008, the Company believes it has appropriately accounted for any unrecognized tax benefits. To the extent the Company prevails in matters for which a liability for an unrecognized tax benefit is established or is required to pay amounts in excess of the liability, the Company s effective tax rate in a given financial statement period may be affected. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is approximately $300,000 at November 1, 2008. The Company does not currently anticipate that the total amount of unrecognized tax benefits will significantly increase or decrease by the end of fiscal 2008.

Note 4 Loss Per Share

Basic loss per share is based upon the weighted average number of outstanding common shares, which excludes non-vested restricted stock. Since the Company experienced a net loss for the 13 and 39-week periods ended November 1, 2008 and November 3, 2007, all outstanding stock options are excluded from the calculation of diluted loss per share due to their anti-dilutive impact.

Note 5 Commitments and Contingencies

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

Table of Contents

Office lease agreement

On March 1, 2007, the Company entered into an Office Lease Agreement, effective as of March 1, 2007 with a landlord, whereby the Company leased 27,547 square feet of office space in Nashville, Tennessee for a seven-year term. The Agreement provides for annual rent beginning at $13 per square foot for the first year and increasing each year to $15.45 per square foot in the last year. The Agreement also includes an option to renew the lease for an additional seven years, with the rent for such option period to be at the then-current market rental rate. The office primarily houses the merchandising and marketing, store operations and real estate teams, as well as certain other senior management personnel. The pre-tax opening costs of the Nashville office were approximately $446,000 and $1.2 million for the 13 and 39-week periods ended November 3, 2007.

Note 6 Property and Equipment

During the third quarter of fiscal 2008, the Company sold a building and land in Jackson, Tennessee formerly used as its corporate headquarters, which consists of approximately 40,000 square feet of office space. The net proceeds received from the sale of the land and building were approximately $2.8 million. Additionally, during the first quarter of fiscal 2008, the Company completed the sale of its corporate airplane resulting in net proceeds of approximately $816,000.

Note 7 Recent accounting pronouncements

In September 2006, the FASB issued Statement No. 157 *Fair Value Measurements*, or Statement 157. Statement 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Statement 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. FASB Staff Position No. FAS 157-2 *Effective Date of FASB Statement 157*, or FSP 157-2, delays the effective date of Statement 157 for nonfinancial assets and nonfinancial liabilities except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. For these items, the effective date will be for fiscal years beginning after November 15, 2008. Kirkland s adopted Statement 157 effective February 3, 2008. Management does not believe the adoption has had or will have a material impact on the Company s financial statements.

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

General

We are a specialty retailer of home décor in the United States, operating 321 stores in 34 states as of November 1, 2008. Our stores present a broad selection of distinctive merchandise, including framed art, mirrors, wall décor, candles, lamps, decorative accessories, accent furniture, textiles, garden accessories and artificial floral products. Our stores also offer an extensive assortment of holiday merchandise as well as items carried throughout the year suitable for giving as gifts. In addition, we use innovative design and packaging to market home décor items as gifts. We provide our predominantly female customers an engaging shopping experience characterized by a diverse, ever-changing merchandise selection at surprisingly attractive prices. Our stores offer a unique combination of style and value that has led to our emergence as a recognized name in home décor and has enabled us to develop a strong customer franchise.

During the 13 week period ended November 1, 2008, we did not open any new stores and closed three stores. The following table summarizes our stores and square footage under lease by venue type:

	Stores				Square Footage		Average Store Size	
	11/1/08		11/3/07		11/1/08	11/3/07	11/1/08	11/3/07
Mall	108	34%	147	42%	511,353	710,287	4,735	4,832
Off-Mall	213	66%	207	58%	1,342,012	1,285,787	6,301	6,212
Total	321	100%	354	100%	1,853,365	1,996,074	5,774	5,639

13-Week Period Ended November 1, 2008 Compared to the 13-Week Period Ended November 3, 2007

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

	13-Week Period Ended					
	November 1, 2008		November 3, 2007		Change	
	$	%	$	%	$	%
Net sales	$ 85,878	100.0%	$ 88,743	100.0%	($2,865)	(3.2%)
Cost of sales	57,253	66.7%	63,980	72.1%	(6,727)	(10.5%)
Gross profit	28,625	33.3%	24,763	27.9%	3,862	15.6%
Operating expenses:						
Compensation and benefits	16,651	19.4%	17,171	19.3%	(520)	(3.0%)
Other operating expenses	8,810	10.3%	10,396	11.7%	(1,586)	(15.3%)
Severance charge		0.0%	965	1.1%	(965)	(100.0%)
Depreciation and amortization	4,685	5.5%	4,862	5.5%	(177)	(3.6%)
Total operating expenses	30,146	35.1%	33,394	37.6%	(3,248)	(9.7%)
Operating loss	(1,521)	(1.8%)	(8,631)	(9.7%)	7,110	(82.4%)
Interest expense, net	18	0.0%	210	0.2%	(192)	(91.4%)
Other (income) expense, net	45	0.1%	(34)	0.0%	79	(232.4%)
Loss before income taxes	(1,584)	(1.8%)	(8,807)	(9.9%)	7,223	(82.0%)
Income tax provision (benefit)	(113)	(0.1%)	1,843	2.1%	(1,956)	(106.1%)
Net loss	($1,471)	(1.7%)	($10,650)	(12.0%)	$ 9,179	(86.2%)

Net sales. The overall decrease in net sales was primarily due to a decrease in average store count during the quarter, slightly offset by an increase in comparable store sales of 1.2% for the period. Comparable store sales in our mall store locations were up 2.2% for the third quarter, while comparable store sales for our off-mall store locations were up 0.8%. The comparable store sales increase was primarily due to an increase in the average ticket partially offset by a decline in the number of transactions. The average ticket was up during the quarter reflecting an increase in items per transactions. Transactions decreased during the quarter reflecting a slight decrease in traffic counts and customer conversion rates. The strongest performing categories were art, lamps, furniture, and floral.

We did not open any new stores during the third quarter of fiscal 2008 and opened 35 stores in fiscal 2007, and we closed three stores during the third quarter of fiscal 2008 and 49 stores in fiscal 2007. We ended the third quarter of fiscal 2008 with 321 stores in operation compared to 354 stores as of the end of the third quarter of fiscal 2007, representing a 9.3% decrease in the store base and a 7.1% decrease in total square footage under lease.

Table of Contents

Gross profit. The increase in gross profit as a percentage of net sales resulted from a combination of factors. The merchandise margin increased from 48.9% in the third quarter of fiscal 2007 to 52.9% in the third quarter of fiscal 2008. Merchandise margin is calculated as net sales minus product cost of sales, excluding outbound freight, store occupancy, and central distribution costs. Merchandise markdowns were lower in the current year due to better sell through and a more compelling product offering. Additionally, the level of promotional activity was reduced compared to the heavy use of coupons in the prior year quarter. The occupancy ratio decreased versus the prior year period primarily due to closing underperforming stores as well as favorable lease renewals and extensions. The continued shift of the store base to less costly, off-mall locations also helped improve the ratio. Freight costs as a percentage of sales were flat as compared to the prior year period. Central distribution costs as a percentage of sales were slightly higher than the prior year as a result of a decreased revenue base.

Compensation and benefits. At the store-level, the compensation and benefits expense ratio was slightly higher during the third quarter of fiscal 2008 as compared to the third quarter of 2007. We experienced an increase in average hourly wages at the store level which was somewhat offset by higher comparable store sales during the third quarter of fiscal 2008. At the corporate level, the compensation and benefits ratio remained flat for the third quarter of 2008 as compared to the third quarter of 2007.

Other operating expenses. The decrease in these operating expenses as a percentage of net sales was primarily due to the positive comparable store sales performance and the effect of large reductions in marketing activities as compared to the prior year period. Corporate level operating expenses decreased as a percentage of net sales due to the positive comparable store sales performance coupled with lower professional fees and travel expenses. During the third quarter of fiscal 2007, the Company incurred a charge related to separation costs associated with a restructuring of corporate personnel that occurred during the quarter. This charge totaled approximately $965,000, or $0.04 per share. The Company eliminated 74 positions, including field multi-unit management and corporate positions at its Jackson and Nashville offices.

Depreciation and amortization. Depreciation and amortization remained flat as a percentage of sales as a result of a reduction in capital expenditures in recent quarters offset by the acceleration of depreciation on planned store closings and a smaller average store base.

Income tax provision (benefit). No income tax benefit has been recorded in the current year quarter due to our provision of a full valuation allowance against deferred tax assets because of our cumulative losses in recent years. In the prior year quarter, we incurred tax expense of $1.8 million due to the limited ability to carryback losses for two tax years.

Net loss and loss per share. As a result of the foregoing, we reported a net loss of $1.5 million, or $0.07 per share, for the third quarter of fiscal 2008 as compared to a net loss of $10.7 million, or $0.55 per share, for the third quarter of fiscal 2007.

39-Week Period Ended November 1, 2008 Compared to the 39-Week Period Ended November 3, 2007

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

	39-Week Period Ended					
	November 1, 2008		November 3, 2007		Change	
	$	%	$	%	$	%
Net sales	$ 257,639	100.0%	$ 258,416	100.0%	($777)	(0.3%)
Cost of sales	174,237	67.7%	187,611	72.6%	(13,374)	(7.1%)
Gross profit	83,402	32.4%	70,805	27.4%	12,597	17.8%
Operating expenses:						
Compensation and benefits	49,489	19.2%	53,355	20.6%	(3,866)	(7.2%)
Other operating expenses	25,803	10.0%	32,057	12.4%	(6,254)	(19.5%)

Table of Contents

	39-Week Period Ended					
	November 1, 2008		November 3, 2007		Change	
	$	%	$	%	$	%
Impairment charges	352	0.1%	813	0.3%	(461)	(56.7%)
Severance charge		0.0%	965	0.4%	(965)	(100.0%)
Depreciation and amortization	13,840	5.4%	14,744	5.7%	(904)	(6.1%)
Total operating expenses	89,484	34.7%	101,934	39.4%	(12,450)	(12.2%)
Operating loss	(6,082)	(2.4%)	(31,129)	(12.0%)	25,047	(80.5%)
Interest expense, net	30	0.0%	214	0.1%	(184)	(86.0%)
Other income, net	(291)	(0.1%)	(65)	0.0%	(226)	347.7%
Loss before income taxes	(5,821)	(2.3%)	(31,278)	(12.1%)	25,457	(81.4%)
Income tax benefit	(104)	0.0%	(3,882)	(1.5%)	3,778	(97.3%)
Net loss	($5,717)	-2.2%	($27,396)	-10.6%	$ 21,679	-79.1%

Net sales. The overall decrease in net sales was primarily due to a decrease in the average store count offset by an increase in comparable store sales of 2.7% for the period. Comparable store sales in our mall store locations were up 6.2% for the first three quarters, while comparable store sales for our off-mall store locations were up 1.1%. The comparable store sales increase was primarily due to an increase in transaction volume driven by higher customer conversion rates coupled with a slight increase in the average ticket. The average ticket reflected an increase in items per transaction offset by a decrease in the average retail selling price.

We opened 3 new stores during the first three quarters of fiscal 2008 and 35 stores in fiscal 2007, and we closed 17 stores during the first three quarters of fiscal 2008 and 49 stores in fiscal 2007. We ended the third quarter of fiscal 2008 with 321 stores in operation compared to 354 stores as of the end of the third quarter of fiscal 2007, representing a 9.3% decrease in the store base and a 7.1% decrease in total square footage under lease.

Gross profit. The increase in gross profit as a percentage of net sales resulted from a combination of factors. The merchandise margin increased from 48.9% in the first three quarters of fiscal 2007 to 51.8% in the first three quarters of fiscal 2008. Merchandise margin is calculated as net sales minus product cost of sales, excluding outbound freight, store occupancy, and central distribution costs. Merchandise markdowns were lower in the current year due to better sell through and a more compelling product offering. Additionally, the level of promotional activity was reduced compared to the heavy use of coupons in the prior year period. The occupancy ratio decreased versus the prior year period primarily due to the leveraging effect of the positive comparable store sales. Additionally, rent reductions achieved in certain lease renewals and the closing of underperforming stores also benefited the comparison. Freight costs and central distribution costs were flat as a percentage of net sales as compared to the prior year period.

Compensation and benefits. At the store-level, the compensation and benefits expense ratio decreased for the first three quarters of fiscal 2008 as compared to the first three quarters of 2007 primarily due to the positive comparable store sales performance offset slightly by a higher average wage during the third quarter of fiscal 2008. At the corporate level, the compensation and benefits ratio decreased for the first three quarters of 2008 as compared to the first three quarters of 2007 primarily due to the reductions in corporate salaries and benefits as a result of personnel reductions in late fiscal 2007.

Other operating expenses. The decrease in these operating expenses as a percentage of net sales at the store level was primarily due to the positive comparable store sales performance and the effect of large reductions in marketing activities as compared to the prior year period. Corporate level operating expenses decreased as a percentage of net sales due to the positive comparable store sales performance coupled with lower professional fees and travel expenses. Also, in the prior year period, we incurred expenses of approximately $1.2 million, or $0.05 per diluted share, related to the opening of a satellite office in Nashville, Tennessee. These expenses were associated with personnel relocation costs and moving expenses.

Table of Contents

Impairment charges. During the first three quarters of fiscal 2008, we incurred a charge related to the impairment of fixed assets related to certain underperforming stores in the pre-tax amount of approximately $352,000, or $0.02 per diluted share compared to impairment charges of $813,000 in the prior year period.

Severance charge. During the third quarter of fiscal 2007, we incurred a charge related to separation costs associated with a restructuring of corporate personnel that occurred during the quarter. This charge totaled approximately $965,000, or $0.04 per share.

Depreciation and amortization. The decrease in depreciation and amortization as a percentage of sales was primarily the result of the positive comparable store sales performance combined with a reduction in capital spending in recent periods and a smaller store base.

Income tax provision (benefit). No income tax benefit has been recorded in the current year due to our provision of a full valuation allowance against deferred tax assets because of our cumulative losses in recent years. During the second quart of fiscal 2007, we established a valuation allowance on our net deferred tax assets in the amount of $2.8 million.

Net loss and loss per share. As a result of the foregoing, we reported a net loss of $5.7 million, or $0.29 per share, for the first three quarters of fiscal 2008 as compared to a net loss of $27.4 million, or $1.40 per share, for the first three quarters of fiscal 2007.

Liquidity and Capital Resources

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

Cash flows from operating activities. Net cash used in operating activities was $5.4 million and $34.1 million for the first three quarters of fiscal 2008 and fiscal 2007, respectively. Net cash used in operating activities depends heavily on operating performance, changes in working capital and the timing and amount of payments for income taxes. The change in the amount of cash used in operating activities as compared to the prior year period was significantly impacted by the improvement in our operating performance resulting from the 2.7% increase in our year-to-date comparable store sales, the increase in profit margin and the reduction in operating expenses. Inventories increased approximately $17.5 million during the first three quarters of fiscal 2008 as compared to an increase of $18.0 million during the prior year period. Inventories averaged approximately $183,000 per store at November 1, 2008, as compared to $177,000 per store at November 3, 2007. Accounts payable increased $6.0 million during the first three quarters of fiscal 2008 as compared to an increase of $3.6 million for the prior year period. The change in accounts payable is primarily due to the timing and amount of merchandise receipt flow. We also received an income tax refund of approximately $2.9 million during the first three quarters of fiscal 2008 whereas we made cash tax payments of approximately $2.5 million in the prior-year period.

Cash flows from investing activities. Net cash provided by investing activities for the first three quarters of fiscal 2008 consisted principally of the sale of our corporate aircraft and former corporate headquarters building and land in Jackson, Tennessee resulting in net proceeds of approximately $816,000 and $2.8 million, respectively. These cash inflows were offset by capital expenditures for the period of approximately $2.1 million as compared to $11.8 million for the prior year period. These expenditures primarily related to new store construction. During the first three quarters of fiscal 2008, we opened three stores compared to 18 stores in the prior year period. We expect that capital expenditures for all of fiscal 2008 will be approximately $3 million, primarily to fund the maintenance of our existing investments in stores, information technology, and the distribution center, as well as the openings of the three new stores. As of November 1, 2008, we had no new lease commitments for new stores. Capital

expenditures, including leasehold improvements and furniture and fixtures, and equipment for our new stores in fiscal 2008 average approximately $400,000 to $430,000 per store. We received landlord allowances in connection with the construction of our three new stores in fiscal 2008 which are reflected as a component of cash flows from operating activities within our consolidated statement of cash flows.

Cash flows from financing activities. Net cash provided by financing activities was $69,000 and $20.9 million for the first three quarters of fiscal 2008 and fiscal 2007, respectively. Cash flows from financing activities for the first three quarters of fiscal 2008 were related to employee stock purchases. During the first three quarters of fiscal 2007, cash flows from financing activities primarily related to bank revolver borrowings.

Revolving credit facility. Effective October 4, 2004, we entered into a five-year senior secured revolving credit facility with a revolving loan limit of up to $45 million. On August 6, 2007, we entered into the First Amendment to Loan and Security Agreement (the Amendment) which provided the Company with additional availability under our borrowing base through higher advance rates on eligible inventory. As a result of the amendment, the aggregate size of the overall credit facility remained unchanged at $45 million, but the term of the facility was extended two years making the new expiration date October 4, 2011. Amounts outstanding under the amended facility, other than First In Last Out (FILO) loans, bear interest at a floating rate equal to the 60-day LIBOR rate (2.97% at November 1, 2008) plus 1.25% to 1.50% (depending on the amount of excess availability under the borrowing base). FILO loans, which apply to the first approximate $2 million borrowed at any given time, bear interest at a floating rate equal to the 60-day LIBOR rate plus 2.25% to 2.50% (depending on the amount of excess availability under the borrowing base). Additionally, we pay a quarterly fee to the bank equal to a rate of 0.2% per annum on the unused portion of the revolving line of credit. Borrowings under the facility are collateralized by substantially all of our assets and guaranteed by our subsidiaries. The maximum availability under the credit facility is limited by a borrowing base formula, which consists of a percentage of eligible inventory and receivables less reserves. The facility also contains provisions that could result in changes to the presented terms or the acceleration of maturity. Circumstances that could lead to such changes or acceleration include a material adverse change in the business or an event of default under the credit agreement. The facility has one financial covenant that requires the Company to maintain excess availability under the borrowing base, as defined in the credit agreement, of at least $3.0 million to $4.5 million depending on the size of the borrowing base, at all times.

As of November 1, 2008, we were in compliance with the covenants in the facility and there were no outstanding borrowings under the credit facility, with approximately $41 million available for borrowing (net of the availability block as described above).

At November 1, 2008, our balance of cash and cash equivalents was approximately $2.0 million and the borrowing availability under our facility was $41 million (net of the availability block as described above). During fiscal 2007, we undertook a number of measures to reduce expenses and improve liquidity, including corporate headcount reductions, slowing store growth, closing underperforming stores, commencing the sale of non-essential assets, enhancing and maximizing our existing credit facility, and reducing our planned inventory needs. We also received approximately $2.9 million in federal tax refunds during the first half of fiscal 2008. We believe that cash flow from operations, including the impact of the aforementioned initiatives, coupled with funds received from the sale of assets will result in peak borrowings that are lower than the prior year and will be sufficient to fund our planned capital expenditures and working capital requirements for at least the next twelve months.

Off-Balance Sheet Arrangements

None.

Significant Contractual Obligations and Commercial Commitments

None.

Critical Accounting Policies and Estimates

There have been no significant changes to our critical accounting policies during fiscal 2008. Refer to our Annual Report on Form 10-K for the fiscal year ended February 2, 2008, for a summary of our critical accounting policies.

Table of Contents

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

The following information is provided pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Certain statements under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-Q are forward-looking statements made pursuant to these provisions. Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that does not directly relate to any historical or current fact. Words such as should, likely to, forecasts, strategy, goal, anticipates, believes, expects, estimates, intends, plans, projects, and sim identify such forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from the results projected in such statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

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

If We Are Unable to Successfully Execute Our Turnaround Strategy, Our Results of Operations Will Not Improve.

A Prolonged Economic Downturn Could Result in Reduced Net Sales and Profitability.

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

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

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

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

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

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

Table of Contents

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

Our Business Is Highly Seasonal and Our Fourth Quarter Contributes a Disproportionate Amount of Our Net Sales, Net Income and Cash Flow, and Any Factors Negatively Impacting Us During Our Fourth Quarter Could Reduce Our Net Sales, Net Income and Cash Flow, Leaving Us with Excess Inventory and Making It More Difficult for Us to Finance Our Capital Requirements.

We May Experience Significant Variations in Our Quarterly Results.

The Agreement Governing Our Debt Places Certain Reporting and Consent Requirements on Us Which May Affect Our Ability to Operate Our Business in Accordance with Our Business Strategy.

We Are Highly Dependent on Customer Traffic in Malls and Shopping Centers, and Any Reduction in the Overall Level of Traffic Could Reduce Our Net Sales and Increase Our Sales and Marketing Expenses.

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

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

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

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

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risks related to our operations result primarily from changes in short-term London Inter-Bank Offered Rates, or LIBOR, as our senior credit facility utilizes short-term LIBOR rates and/or contracts. The base interest rate used in our senior credit facility is the 60-day LIBOR, however, from time to time, we may enter into one or more LIBOR contracts. These LIBOR contracts vary in length and interest rate, such that adverse changes in short-term interest rates could affect our overall borrowing rate when contracts are renewed.

As of November 1, 2008, there were zero borrowings outstanding under our revolving credit facility, which is based upon a 60-day LIBOR rate.

We were not engaged in any foreign exchange contracts, hedges, interest rate swaps, derivatives or other financial instruments with significant market risk as of November 1, 2008.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures*. Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15(d)-(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act) as of November 1, 2008 have concluded, based on the evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15, that our disclosure controls and procedures were effective.

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

Table of Contents

PART II OTHER INFORMATION

ITEM 1A. RISK FACTORS

In addition to factors set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995, in Part I Item 2 of this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended February 2, 2008, and the new risk factor set forth below which could materially affect our business, financial condition or future results. The risks described in this report and in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Our performance may be affected by general economic conditions and the current global financial crisis.

Our performance is subject to worldwide economic conditions and their impact on levels of consumer spending, which have recently deteriorated significantly and may remain depressed, or be subject to further deterioration, for the foreseeable future. Some of the factors that are having an impact on discretionary consumer spending include general economic conditions, employment, consumer debt, reductions in net worth based on recent severe market declines, residential real estate and mortgage markets, taxation, fuel and energy prices, interest rates, consumer confidence and other macroeconomic factors.

The worldwide specialty retail industry is heavily influenced by general economic cycles: Specialty retail is a cyclical industry that is heavily dependent upon the overall level of consumer spending. Purchases of home décor tend to be highly correlated with the cycles of the levels of disposable income of our consumers. As a result, any substantial deterioration in general economic conditions could adversely affect our net sales and results of operations. Downturns, or the expectation of a downturn, in general economic conditions could adversely affect consumer spending patterns, our sales and our results of operations.

Consumer purchases of discretionary items generally decline during recessionary periods and other periods where disposable income is adversely affected. The downturn in the economy may continue to affect consumer purchases of our merchandise and have an adversely impact on our results of operations and continued growth. Because home décor is generally considered to be a discretionary purchase, declines in consumer spending may have a more negative affect on specialty retailers in our industry segment than on retailers in general. Therefore, we may not be profitable if there is a decline in consumer spending.

The recent distress in the financial markets has resulted in extreme volatility in security prices and diminished liquidity and credit availability, and there can be no assurance that our liquidity will not be affected by changes in the financial markets and the global economy. Tightening of the credit markets and recent or future turmoil in the financial markets could also make it more difficult for us to access funds, refinance our existing indebtedness (if necessary), to enter into agreements for new indebtedness or to obtain funding through the issuance of the our securities.

In addition, the current credit crisis is having a significant negative impact on businesses around the world, and the impact of this crisis on our major suppliers cannot be predicted. The inability of key suppliers to access liquidity, or the insolvency of key suppliers, could lead to their failure to deliver our merchandise. Worsening economic conditions could also result in difficulties for financial institutions (including bank failures) and other parties that we may do business with, which could potentially, impair our ability to access financing under existing arrangements or to otherwise recover amounts as they become due under our other contractual arrangements. Additionally, both as a result and independent of the current financial crisis in the United States, material fluctuations in currency exchange rates could have a negative impact on our business.

ITEM 6. EXHIBITS

(a) Exhibits.

Exhibit No.	Description of Document
31.1	

	Certification of the President and Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
31.2	Certification of the Senior Vice President and Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
32.1	Certification of the President and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of the Senior Vice President and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

Table of Contents

SIGNATURES

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

KIRKLAND S, INC.

Date: December 10, 2008

/s/ Robert E. Alderson
Robert E. Alderson
President and Chief Executive Officer

/s/ W. Michael Madden
W. Michael Madden
Senior Vice President and Chief Financial Officer

20