

KIRKLAND'S, INC  
Form 10-Q  
November 30, 2017  
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 October 28, 2017

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: 000-49885

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

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

5310 Maryland Way  
Brentwood, Tennessee 37027  
(Address of principal executive offices) (Zip Code)

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

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

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

Common Stock, no par value - 15,994,457 shares outstanding as of November 15, 2017.

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## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## KIRKLAND'S, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(in thousands, except share data)

	October 28, 2017	January 28, 2017	October 29, 2016
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$27,885	\$63,937	\$28,260
Inventories, net	107,322	75,447	99,989
Prepaid expenses and other current assets	23,063	13,656	19,503
Total current assets	158,270	153,040	147,752
Property and equipment:			
Equipment	20,618	19,525	19,321
Furniture and fixtures	79,481	78,492	77,390
Leasehold improvements	116,251	109,494	107,640
Computer software and hardware	57,683	52,740	51,158
Projects in progress	9,046	5,520	6,932
Property and equipment, gross	283,079	265,771	262,441
Accumulated depreciation	(167,952)	(154,901)	(148,508)
Property and equipment, net	115,127	110,870	113,933
Deferred income taxes	968	1,198	—
Other assets	6,552	5,038	3,135
Total assets	\$280,917	\$270,146	\$264,820
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
Current liabilities:			
Accounts payable	\$44,030	\$32,890	\$44,062
Accounts payable to related party vendor	7,671	5,008	8,614
Income taxes payable	—	6,273	—
Accrued expenses	34,699	30,270	29,711
Total current liabilities	86,400	74,441	82,387
Deferred rent	54,196	52,656	53,846
Deferred income taxes	2,561	479	1,689
Other liabilities	9,916	8,757	8,347
Total liabilities	153,073	136,333	146,269
Shareholders' equity:			
Preferred stock, no par value, 10,000,000 shares authorized; no shares issued or outstanding at October 28, 2017, January 28, 2017, or October 29, 2016, respectively	—	—	—
Common stock, no par value; 100,000,000 shares authorized; 16,002,387; 15,906,635; and 15,899,840 shares issued and outstanding at October 28, 2017, January 28, 2017, and October 29, 2016, respectively	167,063	165,245	164,526

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Accumulated deficit	(39,219 )	(31,432 )	(45,975 )
Total shareholders' equity	127,844	133,813	118,551
Total liabilities and shareholders' equity	\$280,917	\$270,146	\$264,820

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

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KIRKLAND'S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(in thousands, except per share data)

	13-Week Period Ended		39-Week Period Ended	
	October 28,	October 29,	October 28,	October 29,
	2017	2016	2017	2016
Net sales	\$ 144,979	\$ 138,240	\$ 409,503	\$ 391,168
Cost of sales	82,773	78,637	234,068	224,127
Cost of sales related to merchandise purchased from related party vendor	11,668	9,125	32,278	24,753
Cost of sales (exclusive of depreciation as shown below)	94,441	87,762	266,346	248,880
Gross profit	50,538	50,478	143,157	142,288
Operating expenses:				
Compensation and benefits	28,072	27,050	80,556	77,507
Other operating expenses	19,427	18,601	54,501	52,057
Depreciation	6,806	6,435	19,841	18,703
Total operating expenses	54,305	52,086	154,898	148,267
Operating loss	(3,767 )	(1,608 )	(11,741 )	(5,979 )
Interest expense	69	67	195	206
Other income	(229 )	(61 )	(448 )	(172 )
Loss before income taxes	(3,607 )	(1,614 )	(11,488 )	(6,013 )
Income tax benefit	(1,245 )	(768 )	(3,919 )	(2,516 )
Net loss	\$ (2,362 )	\$ (846 )	\$ (7,569 )	\$ (3,497 )
Loss per share:				
Basic	\$ (0.15 )	\$ (0.05 )	\$ (0.48 )	\$ (0.22 )
Diluted	\$ (0.15 )	\$ (0.05 )	\$ (0.48 )	\$ (0.22 )
Weighted average shares outstanding:				
Basic	16,013	15,897	15,932	15,844
Diluted	16,013	15,897	15,932	15,844

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

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KIRKLAND'S, INC.

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)

(in thousands, except share data)

	Common Stock		Accumulated Deficit	Total Shareholders' Equity
	Shares	Amount		
Balance at January 28, 2017	15,906,635	\$ 165,245	\$ (31,432 )	\$ 133,813
Issuance of common stock under employee stock purchase plan	28,179	253	—	253
Exercise of stock options	28,346	—	—	—
Restricted stock issued	101,979	—	—	—
Net share settlement of stock options and restricted stock units	(43,851 )	(201 )	—	(201 )
Repurchase and retirement of common stock	(18,901 )	—	(218 )	(218 )
Stock-based compensation expense	—	1,766	—	1,766
Net loss	—	—	(7,569 )	(7,569 )
Balance at October 28, 2017	16,002,387	\$ 167,063	\$ (39,219 )	\$ 127,844

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

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

	39-Week Period Ended	
	October 28, 2017	October 29, 2016
Cash flows from operating activities:		
Net loss	\$(7,569 )	\$(3,497 )
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation of property and equipment	19,841	18,703
Amortization of deferred rent	(5,784 )	(3,856 )
Amortization of debt issue costs	40	70
Loss on disposal of property and equipment	157	295
Stock-based compensation expense	1,766	2,521
Deferred income taxes	2,312	205
Changes in assets and liabilities:		
Inventories, net	(31,875 )	(31,767 )
Prepaid expenses and other current assets	(2,071 )	708
Other noncurrent assets	(1,554 )	(1,000 )
Accounts payable	10,502	18,307
Accounts payable to related party vendor	2,663	6,356
Income taxes refundable	(13,609 )	(9,915 )
Accrued expenses and other current and noncurrent liabilities	12,912	15,093
Net cash (used in) provided by operating activities	(12,269 )	12,223
Cash flows from investing activities:		
Proceeds from sale of property and equipment	—	4
Capital expenditures	(23,617 )	(28,069 )
Net cash used in investing activities	(23,617 )	(28,065 )
Cash flows from financing activities:		
Refinancing costs	—	(271 )
Cash used in net share settlement of stock options and restricted stock	(201 )	(263 )
Employee stock purchases	253	284
Repurchase and retirement of common stock	(218 )	—
Net cash used in financing activities	(166 )	(250 )
Cash and cash equivalents:		
Net decrease	(36,052 )	(16,092 )
Beginning of the period	63,937	44,352
End of the period	\$27,885	\$28,260
Supplemental schedule of non-cash activities:		
Non-cash accruals for purchases of property and equipment	\$1,997	\$1,896

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





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KIRKLAND'S, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 - Basis of Presentation

Kirkland's, Inc. (the "Company") is a specialty retailer of home décor and gifts in the United States operating 415 stores in 36 states as of October 28, 2017, as well as an e-Commerce enabled website, [www.kirklands.com](http://www.kirklands.com). The condensed consolidated financial statements of the Company include the accounts of Kirkland's, Inc. and its wholly-owned subsidiaries, Kirkland's Stores, Inc., Kirkland's DC, Inc., and Kirkland's Texas, LLC. All intercompany accounts and transactions have been eliminated.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and are presented in accordance with the requirements of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals, 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 March 31, 2017.

It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than those at fiscal year-end. In addition, because of seasonality factors, the results of the Company's operations for the 13-week and 39-week periods ended October 28, 2017 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.

The preparation of the condensed 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 condensed 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, but are not limited to impairment assessments on long-lived assets, asset retirement obligations, inventory reserves, self-insurance reserves, income tax liabilities, stock-based compensation, employee bonus accruals, gift card breakage, sales return reserves, customer loyalty program accruals and contingent liabilities.

In the fourth quarter of fiscal 2016, the Company concluded that it was appropriate to classify related party transactions separately in the consolidated financial statements. In fiscal 2016, this information was provided in the notes to the consolidated financial statements. See "Note 6 - Related Party Transactions" for further discussion.

In the first quarter of fiscal 2017, the Company adopted accounting guidance which affected the presentation in the statement of cash flows of excess tax benefits or deficiencies from the exercise of stock options. See "Note 8 - New Accounting Pronouncements" for further discussion. The Company has elected to apply the amendments using a retrospective transition method for all periods presented and therefore the presentation of previously reported excess tax benefits on the unaudited condensed consolidated statements of cash flows has been changed to conform to the presentation used in the current period. As a result, approximately \$78,000 of excess tax benefits related to share-based awards which were previously classified as cash flows from financing activities in the 39-week period ended October 29, 2016 have been reclassified as cash flows from operating activities.

Certain other amounts in the fiscal 2016 operating activities section of the condensed consolidated statement of cash flows have been reclassified to conform to the fiscal 2017 presentation. These reclassifications had no effect on reported net income.

For the 39-week period ended October 28, 2017, the Company recorded a \$1.2 million one-time out-of-period adjustment of ancillary rent payments to prepaid expenses and other current assets from cost of sales.

#### Note 2 - Income Taxes

An estimate of the annual effective tax rate is used at each interim period based on the facts and circumstances available at that time, while the actual effective tax rate is calculated at year-end. For the 13-week periods ended October 28, 2017 and October 29, 2016, the Company recorded an income tax benefit of 34.5% and 47.6% of the loss before income taxes, respectively. For the 39-week periods ended October 28, 2017 and October 29, 2016, the Company recorded an income tax benefit of 34.1% and 41.8% of the loss before income taxes, respectively. The decrease in the tax rates for both the 13-week and 39-week periods

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ended October 28, 2017 was primarily due to new accounting guidance related to share-based compensation, which requires the inclusion of excess tax benefits and deficiencies as a component of income taxes.

## Note 3 - Loss Per Share

Basic loss per share is computed by dividing net loss by the weighted average number of shares outstanding during each period presented, which excludes non-vested restricted stock units. Diluted loss per share is computed by dividing net loss by the weighted average number of shares outstanding plus the dilutive effect of stock equivalents outstanding during the applicable periods using the treasury stock method. Diluted loss per share reflects the potential dilution that could occur if options to purchase stock were exercised into common stock and if outstanding grants of restricted stock were vested. Stock options and restricted stock units that were not included in the computation of diluted loss per share, because to do so would have been antidilutive, were approximately 1.6 million and 1.5 million shares for the 13-week periods ended October 28, 2017 and October 29, 2016, respectively, and 1.5 million and 1.4 million shares for the 39-week periods ended October 28, 2017 and October 29, 2016, respectively.

## Note 4 - Commitments and Contingencies

The Company was named as a defendant in a putative class action filed in April 2017 in the United States District Court for the Western District of Pennsylvania, *Gennock v. Kirkland's, Inc.* The Complaint alleges that the Company, in violation of federal law, published more than the last five digits of a credit or debit card number on customers' receipts. The Company denies the material allegations of the complaint and has filed a motion to dismiss. On November 29, 2017, the Magistrate Judge recommended that the Company's motion to dismiss be denied. The Company will file objections to the recommendation and plans to appeal if the recommendation is adopted by the Court. The Company continues to believe that the case is without merit and intends to vigorously defend itself against the allegations. The matter is covered by insurance, and the Company does not believe that the case will have a material adverse effect on the Company's consolidated financial condition, operating results or cash flows.

The Company is also party to other pending legal proceedings and claims that arise in the normal course of business. Although the outcome of such proceedings and claims cannot be determined with certainty, the Company's management is of the opinion that it is unlikely that such proceedings and any claims in excess of insurance coverage will have a material effect on the Company's consolidated financial condition, operating results or cash flows.

## Note 5 - Stock-Based Compensation

The Company maintains equity incentive plans under which it may grant non-qualified stock options, incentive stock options, restricted stock, restricted stock units, or stock appreciation rights to employees, non-employee directors and consultants. Compensation expense is recognized on a straight-line basis over the vesting periods of each grant. There have been no material changes in the assumptions used to compute compensation expense during the current quarter. The table below sets forth selected stock-based compensation information (in thousands, except share amounts) for the periods indicated:

	13-Week Period Ended October 28, 29, 2017	39-Week Period Ended October 28, 29, 2017	39-Week Period Ended October 28, 29, 2016	39-Week Period Ended October 28, 29, 2016
Stock-based compensation expense	\$582	\$ 817	\$1,766	\$2,521

Stock options granted	—	—	245,000	189,000
Restricted stock units granted	2,000	—	148,500	126,500

Note 6 - Related Party Transactions

The Company has an agreement with a related party vendor to purchase merchandise inventory. The vendor is considered a related party for financial reporting purposes because its principal owner is the spouse of one of the Company's two Vice Presidents of Merchandising. The table below sets forth selected results to this vendor in dollars (in thousands) and percentages for the periods indicated:

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	13-Week Period Ended October 28, 2017		39-Week Period Ended October 29, 2016	
Related Party Vendor:				
Purchases	\$17,684	\$16,318	\$41,743	\$33,257
Purchases as a percent of total merchandise purchases	20.4	% 19.8	% 21.5	% 17.5

## Note 7 - Stock Repurchase Program

On August 22, 2017, the Company announced that its Board of Directors authorized a stock repurchase plan providing for the purchase in the aggregate of up to \$10 million of the Company's outstanding common stock. Repurchases of shares will be made in accordance with applicable securities laws and may be made from time to time in the open market or by negotiated transactions. The amount and timing of repurchases will be based on a variety of factors, including stock acquisition price, regulatory limitations and other market and economic factors. The stock repurchase program does not require the Company to repurchase any specific number of shares, and the Company may terminate the repurchase program at any time. For the 13-week and 39-week periods ended October 28, 2017, the Company repurchased and retired 18,901 shares of common stock at an aggregate cost of approximately \$218,000 under this repurchase plan. As of October 28, 2017, the Company had approximately \$9.8 million remaining under the plan.

## Note 8 - New Accounting Pronouncements

## New Accounting Pronouncements Recently Adopted

In July 2015, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2015-11, "Inventory (Topic 330): Simplifying the Measurement of Inventory." This update requires an entity that determines the cost of inventory by methods other than last-in, first-out and the retail inventory method to measure inventory at the lower of cost and net realizable value. The Company adopted this guidance in the first quarter of fiscal 2017 using a prospective application. The adoption of this guidance did not have a material impact on its condensed consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU 2016-04, "Liabilities - Extinguishments of Liabilities (Subtopic 405-20): Recognition of Breakage for Certain Prepaid Stored-Value Products." This update requires that liabilities related to the sale of prepaid stored-value products (gift cards) be adjusted periodically to reflect breakage. The Company adopted this guidance in the first quarter of fiscal 2017. The Company was recording gift card breakage prior to the adoption of this guidance; therefore, the adoption of this guidance did not have a material impact on its condensed consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU 2016-09, "Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting" ("ASU 2016-09"). ASU 2016-09 addresses several aspects of the accounting for share-based compensation transactions including: (a) income tax consequences when awards vest or are settled, (b) classification of awards as either equity or liabilities, (c) a policy election to account for forfeitures as they occur rather than on an estimated basis and (d) classification of excess tax impacts on the statement of cash flows. The Company adopted this guidance in the first quarter of fiscal 2017, which did not have a material impact on its condensed consolidated financial statements and related disclosures. The amendments requiring recognition of excess tax benefits and tax deficiencies in the income statement have been applied prospectively. The inclusion of excess tax benefits and deficiencies as a component of our income tax expense will increase volatility within our provision for income taxes as the amount of excess tax benefits or deficiencies from share-based compensation awards are dependent on our stock price at the date the awards are exercised or settled. The Company does not expect the impact to be material to the consolidated results of operations; however, such determination is subject to change based

on facts and circumstances at the time when awards vest or settle. The Company accounts for forfeitures of share-based awards when they occur. The Company has applied the amendments related to the presentation of excess tax benefits on the statement of cash flows using a retrospective transition method, and as a result, excess tax benefits related to share-based awards which had been previously classified as cash flows from financing activities have been reclassified as cash flows from operating activities.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." This update clarifies and provides specific guidance on eight cash flow classification issues that are not currently addressed by U.S. generally accepted accounting principles and thereby reduces the current and potential future diversity in practice. The Company adopted this guidance in the first quarter of fiscal 2017. The adoption of this guidance did not impact the classification of any of the Company's cash flow activity and therefore did not have a material impact on its condensed consolidated financial statements and related disclosures.

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New Accounting Pronouncements Not Yet Adopted

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers (Topic 606)” (“ASU 2014-09”). Under ASU 2014-09, an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. ASU 2014-09 also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In July 2015, the FASB approved a one-year deferral of ASU 2014-09. As a result of the deferral, the amendments in ASU 2014-09 will be effective for the Company at the beginning of its fiscal 2018 year. Companies that transition to this new standard may either retrospectively restate each prior reporting period or reflect the cumulative effect of initially applying the updates with an adjustment to retained earnings at the date of adoption. The Company plans to adopt this standard in the first quarter of fiscal 2018 using the modified retrospective method. The Company has identified its loyalty program and right of return as the areas that will most likely be affected by the new revenue recognition guidance. The Company is still in the process of evaluating the impact the adoption of ASU 2014-09 will have on its condensed consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)”, which supersedes the existing guidance for lease accounting, Leases (Topic 840) (“ASU 2016-02”). ASU 2016-02 requires lessees to recognize a lease liability and a right-of-use asset for all leases. Lessor accounting remains largely unchanged. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. Early adoption is permitted for all entities. ASU 2016-02 requires a modified retrospective approach for all leases existing at, or entered into after the date of initial adoption, with an option to elect to use certain transition relief. The Company is currently evaluating the impact of this new standard on its condensed consolidated financial statements and is anticipating a material impact on the Company’s consolidated financial statements because the Company is party to a significant number of lease contracts.

Note 9 - Senior Credit Facility

During the period of August 19, 2011 through February 26, 2016, the Company was party to an Amended and Restated Credit Agreement (the “2011 Credit Agreement”) with Bank of America, N.A. as administrative agent and collateral agent, and the lenders named therein (the “Lenders”). The 2011 Credit Agreement included a senior secured revolving credit facility of \$50 million, a swingline availability of \$5 million and a maturity date of August 2016. Borrowings under the 2011 Credit Agreement bore interest at an annual rate equal to LIBOR plus a margin ranging from 175 to 225 basis points with no LIBOR floor, and the fee paid to the Lenders on the unused portion of the credit facility was 37.5 basis points per annum.

On February 26, 2016, the Company entered into a Joinder and First Amendment to Amended and Restated Credit Agreement (the “2016 Credit Agreement”). The 2016 Credit Agreement increased the Company’s senior secured revolving credit facility from \$50 million to \$75 million, increased the swingline availability from \$5 million to \$10 million, extended the maturity date from August 2016 to February 2021 and added a \$25 million incremental accordion feature. Borrowings under the 2016 Credit Agreement bear interest at an annual rate equal to LIBOR plus a margin ranging from 125 to 175 basis points with no LIBOR floor, and the fee paid to the Lenders on the unused portion of the credit facility is 25 basis points per annum.

Borrowings under the 2011 and 2016 Credit Agreements are subject to certain conditions and contain customary events of default, including, without limitation, failure to make payments, a cross-default to certain other debt, breaches of covenants, breaches of representations and warranties, a change in control, certain monetary judgments and bankruptcy and ERISA events. Upon any such event of default, the principal amount of any unpaid loans and all other obligations under the Credit Agreements may be declared immediately due and payable. The maximum



availability under the facility is limited by a borrowing base formula which consists of a percentage of eligible inventory and eligible credit card receivables, less reserves.

The Company is subject to an Amended and Restated Security Agreement (“Security Agreement”) with its Lenders. Pursuant to the Security Agreement, the Company pledged and granted to the administrative agent, for the benefit of itself and the secured parties specified therein, a lien on and security interest in all of the rights, title and interest in substantially all of the Company’s assets to secure the payment and performance of the obligations under the Credit Agreements.

As of October 28, 2017, the Company was in compliance with the covenants in the 2016 Credit Agreement, and there were no outstanding borrowings under the credit facility, with approximately \$75.0 million available for borrowing.

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

Forward-Looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to provide an understanding of our financial condition, change in financial condition, cash flow, liquidity and results of operations. The following MD&A discussion should be read in conjunction with the condensed consolidated financial statements and notes to those statements that appear elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the fiscal year ended January 28, 2017, filed with the Securities and Exchange Commission on March 31, 2017 (the "Annual Report"). The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed or referred to in the forward-looking statements. Factors that could cause or contribute to any differences include, but are not limited to, those discussed under the caption "Cautionary Statement for Purposes of the "Safe Harbor" Provisions of the Private Securities Litigation Reform Act of 1995" and under Part II, Item 1A - "Risk Factors".

General

We are a specialty retailer of home décor and gifts in the United States, operating 415 stores in 36 states as of October 28, 2017, as well as an e-Commerce enabled website, [www.kirklands.com](http://www.kirklands.com). Our stores present a broad selection of distinctive merchandise, including framed art, mirrors, wall décor, candles and related items, lamps, decorative accessories, accent furniture, textiles, garden-related accessories and artificial floral products. Our stores also offer an extensive assortment of holiday merchandise during seasonal periods as well as items carried throughout the year suitable for gift-giving. In addition, we use innovative design and packaging to market home décor items as gifts. We provide our customers an engaging shopping experience characterized by a diverse, ever-changing merchandise selection reflecting current styles at prices which provide discernible value. This combination of ever-changing and stylish merchandise, value pricing and a stimulating store experience has led to our emergence as a leader in home décor and enabled us to develop a strong customer base.

Overview of Key Financial Measures

Total revenue and gross profit are the most significant drivers of our operating performance. Total revenue consists of all merchandise sales to customers, gift card breakage and shipping revenue associated with internet sales, net of returns and exclusive of sales taxes. We use comparable store sales to measure our ability to achieve sales increases from stores that have been open for at least 13 full fiscal months. Stores closed during the year are included in the comparable store sales calculation only for the full fiscal months of the year the stores were open. Relocated stores are removed from the comparable store base and treated as a new store for comparable store sales purposes. The e-Commerce store is included in comparable store sales. Increases in comparable store sales are an important factor in maintaining or increasing the profitability of existing stores. Gross profit is the difference between total revenue and cost of sales (exclusive of depreciation). Cost of sales (exclusive of depreciation) has various distinct components including: product cost of sales (including inbound freight, inventory shrinkage and loyalty reward program charges), store occupancy costs, outbound freight costs (including e-Commerce shipping) and central distribution costs. Merchandise margin is calculated as net sales minus product cost of sales. Product and outbound freight costs are variable, while occupancy and central distribution costs are largely fixed. Accordingly, gross profit expressed as a percentage of total revenue can be influenced by many factors including overall sales performance.

Store Growth

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During the 13-week period ended October 28, 2017, we opened 10 new stores and closed one store compared to 11 new store openings and one closure during the 13-week period ended October 29, 2016. During the 39-week period ended October 28, 2017, we opened 26 new stores and closed 15 stores compared to 38 new store openings and 13 closures during the 39-week period ended October 29, 2016. The following table summarizes our stores and square footage under lease:

	October 28, 2017	October 29, 2016
Number of stores	415	401
Square footage	3,275,638	3,130,780
Average square footage per store	7,893	7,807

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## 13-Week Period Ended October 28, 2017 Compared to the 13-Week Period Ended October 29, 2016

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

	13-Week Period Ended		October 29, 2016		Change		
	October 28, 2017		October 29, 2016				
	\$	%	\$	%	\$	%	
Net sales	\$144,979	100.0 %	\$138,240	100.0 %	\$6,739	4.9	%
Cost of sales (exclusive of depreciation as shown below)	94,441	65.1	87,762	63.5	6,679	7.6	
Gross profit	50,538	34.9	50,478	36.5	60	0.1	
Operating expenses:							
Compensation and benefits	28,072	19.4	27,050	19.6	1,022	3.8	
Other operating expenses	19,427	13.4	18,601	13.5	826	4.4	
Depreciation	6,806	4.7	6,435	4.6	371	5.8	
Total operating expenses	54,305	37.5	52,086	37.7	2,219	4.3	
Operating loss	(3,767)	(2.6)	(1,608)	(1.2)	(2,159)	134.3	
Interest expense	69	—	67	—	2	3.0	
Other income	(229)	(0.1)	(61)				