Zumiez Inc
Form 10-Q
December 02, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED OCTOBER 29, 2011**

OR

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

Commission file number 000-51300

ZUMIEZ INC.

(Exact name of registrant as specified in its charter)

Washington	**91-1040022**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

6300 Merrill Creek Parkway, Suite B, Everett, WA 98203

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: (425) 551-1500

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

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	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 x No

At November 25, 2011, there were 31,128,018 shares outstanding of common stock.

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ZUMIEZ INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	October 29, 2011 (Unaudited)	January 29, 2011
Assets		
Current assets		
Cash and cash equivalents	$ 13,881	$ 11,357
Marketable securities	123,177	117,444
Receivables	8,717	6,129
Inventories	93,839	56,303
Prepaid expenses and other	8,235	7,210
Deferred tax assets	2,599	2,418
Total current assets	250,448	200,861
Fixed assets, net	87,597	78,248
Goodwill and other intangibles	13,154	13,154
Long-term deferred tax assets	3,415	5,703
Long-term investments	2,698	2,766
Long-term other assets	493	899
Total long-term assets	107,357	100,770
Total assets	$ 357,805	$ 301,631
Liabilities and Shareholders Equity		
Current liabilities		
Trade accounts payable	$ 40,296	$ 16,371
Accrued payroll and payroll taxes	8,489	7,580
Income taxes payable	6,224	4,108
Deferred rent and tenant allowances	4,225	3,719
Other liabilities	12,410	13,683
Total current liabilities	71,644	45,461
Long-term deferred rent and tenant allowances	32,506	27,629
Long-term other liabilities	1,942	1,806
Total long-term liabilities	34,448	29,435
Total liabilities	106,092	74,896
Commitments and contingencies (Note 4)		
Shareholders equity		
Preferred stock, no par value, 20,000 shares authorized; none issued and outstanding		
Common stock, no par value, 50,000 shares authorized; 31,129 shares issued and outstanding at October 29, 2011 and 30,835 shares issued and outstanding at January 29, 2011	97,647	91,373
Accumulated other comprehensive income (loss)	73	(17)
Retained earnings	153,993	135,379
Total shareholders equity	251,713	226,735

Total liabilities and shareholders equity	$	357,805	$	301,631

See accompanying notes to condensed consolidated financial statements

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ZUMIEZ INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	October 29, 2011	**October 30, 2010**	**October 29, 2011**	**October 30, 2010**
Net sales	$ 153,951	$ 135,859	$ 372,015	$ 322,657
Cost of goods sold	93,807	83,267	241,152	214,068
Gross profit	60,144	52,592	130,863	108,589
Selling, general and administrative expenses	37,327	33,617	101,944	95,236
Operating profit	22,817	18,975	28,919	13,353
Interest income, net	440	370	1,387	1,087
Other (expense) income, net	(129)	32	(71)	103
Earnings before income taxes	23,128	19,377	30,235	14,543
Provision for income taxes	8,991	7,065	11,621	5,345
Net income	$ 14,137	$ 12,312	$ 18,614	$ 9,198
Basic earnings per share	$ 0.46	$ 0.41	$ 0.61	$ 0.31
Diluted earnings per share	$ 0.45	$ 0.40	$ 0.60	$ 0.30
Weighted average shares used in computation of earnings per share:				
Basic	30,599	30,029	30,487	29,908
Diluted	31,122	30,762	31,093	30,696

See accompanying notes to condensed consolidated financial statements

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ZUMIEZ INC.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(In thousands)

(Unaudited)

	Common Stock Shares	Common Stock Amount	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
Balance at January 29, 2011	30,835	$ 91,373	$ (17)	$ 135,379	$ 226,735
Net income				18,614	18,614
Change in unrealized gain or loss on available-for-sale investments, net of tax of $50			78		78
Foreign currency translation, net of tax of $			12		12
Comprehensive income					18,704
Issuance and exercise of stock-based compensation, including tax benefit of $1,677	294	2,267			2,267
Stock-based compensation expense		4,007			4,007
Balance at October 29, 2011	31,129	$ 97,647	$ 73	$ 153,993	$ 251,713

	Common Stock Shares	Common Stock Amount	Accumulated Other Comprehensive Income	Retained Earnings	Total
Balance at January 30, 2010	30,251	$ 81,399	$ 101	$ 111,176	$ 192,676
Net income				9,198	9,198
Change in unrealized gain or loss on available-for-sale investments, net of tax of $41			(63)		(63)
Comprehensive income					9,135
Issuance and exercise of stock-based compensation, including tax benefit of $1,827	418	3,140			3,140
Stock-based compensation expense		3,563			3,563
Balance at October 30, 2010	30,669	$ 88,102	$ 38	$ 120,374	$ 208,514

See accompanying notes to condensed consolidated financial statements

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ZUMIEZ INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	October 29, 2011	**October 30, 2010**
Cash flows from operating activities:		
Net income	$ 18,614	$ 9,198
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	14,587	13,402
Deferred taxes	2,052	(282)
Stock-based compensation expense	4,007	3,563
Loss on disposal of assets		262
Excess tax benefit from stock-based compensation	(1,677)	(1,827)
Other	70	(10)
Changes in operating assets and liabilities:		
Receivables	(3,046)	(1,803)
Inventories	(37,587)	(32,175)
Prepaid expenses and other	(939)	(1,847)
Trade accounts payable	23,032	20,590
Accrued payroll and payroll taxes	912	1,601
Income taxes payable	3,115	586
Deferred rent and tenant allowances	5,468	2,157
Other liabilities	(3,430)	1,450
Net cash provided by operating activities	25,178	14,865
Cash flows from investing activities:		
Additions to fixed assets	(18,376)	(23,901)
Purchases of marketable securities and other investments	(119,352)	(85,369)
Sales and maturities of marketable securities and other investments	112,106	98,011
Net cash used in investing activities	(25,622)	(11,259)
Cash flows from financing activities:		
Proceeds from exercise of stock-based compensation, net of withholding tax payments	1,269	1,313
Excess tax benefit from stock-based compensation	1,677	1,827
Net cash provided by financing activities	2,946	3,140
Effect of exchange rate changes on cash and cash equivalents	22	
Net increase in cash and cash equivalents	2,524	6,746
Cash and cash equivalents, beginning of period	11,357	1,568
Cash and cash equivalents, end of period	$ 13,881	$ 8,314
Supplemental disclosure on cash flow information:		
Cash paid during the period for income taxes	6,438	5,034
Accrual for purchases of fixed assets	3,527	809

See accompanying notes to condensed consolidated financial statements

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ZUMIEZ INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Nature of Business and Basis of Presentation

Nature of Business Zumiez Inc. (the Company, we, us, its and our) is a leading specialty retailer of action sports related apparel, footwear, equipment and accessories operating under the Zumiez brand name. At October 29, 2011, we operated 442 stores primarily located in shopping malls, giving us a presence in 38 states and Canada. Our stores cater to young men and women between the ages of 12 and 24 who seek popular brands representing a lifestyle centered on activities that include skateboarding, surfing, snowboarding, bicycle motocross (or BMX) and motocross. We support the action sports lifestyle and promote our brand through a multi-faceted marketing approach that is designed to integrate our brand image with our customers activities and interests. In addition, we operate a website that sells merchandise online and provides content and a community for our target customers. The Company was formed in August 1978 and its home office is located in Everett, Washington. The Company operates within one reportable segment based on the similar nature of products sold, production, merchandising and distribution processes involved, target customers and economic characteristics.

Fiscal Year We use a fiscal calendar widely used by the retail industry that results in a fiscal year consisting of a 52- or 53-week period ending on the Saturday closest to January 31. Each fiscal year consists of four 13-week quarters, with an extra week added to the fourth quarter every five or six years. Fiscal 2011 is the 52-week period ending January 28, 2012. Fiscal 2010 was the 52-week period ending January 29, 2011. The first nine months of fiscal 2011 was the 39-week period ended October 29, 2011. The first nine months of fiscal 2010 was the 39-week period ended October 30, 2010.

Basis of Presentation The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial reporting. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The unaudited condensed consolidated financial statements include the accounts of Zumiez Inc. and its wholly-owned subsidiaries. All significant intercompany transactions and balances are eliminated in consolidation.

In our opinion, the unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the condensed consolidated balance sheet at October 29, 2011, the condensed consolidated statements of operations for the three and nine months ended October 29, 2011 and October 30, 2010, the condensed consolidated statements of changes in shareholders equity for the nine months ended October 29, 2011 and October 30, 2010 and the condensed consolidated statements of cash flows for the nine months ended October 29, 2011 and October 30, 2010.

The financial data at January 29, 2011 is derived from audited financial statements, which are included in our Annual Report on Form 10-K for the year ended January 29, 2011, and should be read in conjunction with the audited financial statements and notes thereto. Interim results are not necessarily indicative of results for the full fiscal year due to seasonal and other factors.

Use of Estimates The preparation of financial statements in conformity with GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements as well as the reported amounts of revenues and expenses during the reporting period. These estimates can also affect supplemental information disclosed by us, including information about contingencies, risk and financial condition. Actual results could differ from these estimates and assumptions.

Reclassification of Previously Issued Financial Statements Certain prior period amounts have been reclassified to conform to the current period presentation. These reclassifications do not have a material impact on our condensed consolidated financial statements. We have reclassified $0.5 million and $0.9 million on the condensed consolidated statements of operations for the three and nine months ended October 30, 2010 from selling, general and administrative expenses to cost of goods sold related to occupancy, fulfillment and warehousing costs associated with our ecommerce business. We have reclassified these expenses to align the classification of our ecommerce business expenses with the classification of other occupancy, distribution and warehousing costs in cost of goods sold.

Correction of an Error in Previously Issued Consolidated Statements of Cash Flows We determined that we have incorrectly reported certain amounts related to accruals for purchases of fixed assets in our condensed consolidated statements of cash flows for all reporting periods prior to October 29, 2011. Upon subsequent review, we determined that the purchases of fixed assets should be reported as Cash flows from investing activities once paid, not upon purchase. In this Form 10-Q for the nine months ended October 30, 2010, for reasons described below, the Company is revising its condensed consolidated statements of

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cash flows so that accruals for purchases of fixed assets are reported once paid, and to provide the required supplemental disclosure on cash flow information for Accruals for purchases of fixed assets for the current and prior reporting period. All financial information contained in this Form 10-Q gives effect to these revisions. The revisions did not result in a change to the Company s previously-reported revenues, operating profit, net income, cash and cash equivalents, or shareholders equity.

We considered all of the relevant quantitative and qualitative factors related to the correction of the error under SEC Staff Accounting Bulletin Topic 1N, Financial Statements *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), and determined that the impact on previously-issued and current period condensed consolidated financial statements was not material. Therefore, we are revising the prior period condensed consolidated statements of cash flows for the immaterial error in this Form 10-Q and are not amending previously-filed reports.

The following tables reconcile our condensed consolidated statements of cash flows from the previously-reported results to the revised results for the nine months ended October 30, 2010 (in thousands):

		Nine Months Ended October 30, 2010
Condensed consolidated statements of cash flows:		
Net cash provided by operating activities (as reported)	$	15,443
Impact of accrual for fixed assets unpaid as of quarter end		(578)
Net cash provided by operating activities (as revised)	$	14,865
Net cash used in investing activities (as reported)	$	(11,837)
Impact of accrual for fixed assets unpaid as of quarter end		578
Net cash used in investing activities (as revised)	$	(11,259)

2. Recent Accounting Pronouncements

Recently Adopted Accounting Standards In January 2010, the Financial Accounting Standards Board (FASB) issued guidance that requires reporting entities to make new disclosures about fair value measurements including significant transfers into and out of Level 1 and Level 2 fair value measurements and information on purchases, sales, issuances and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. In addition, the guidance clarifies certain existing disclosure requirements. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for the additional Level 3 reconciliation disclosures, which are effective for interim and annual reporting periods beginning after December 15, 2010. We adopted the additional Level 3 reconciliation disclosure requirements in the three months ended April 30, 2011. The adoption of this guidance did not have a material impact on our financial position, results of operations or cash flows.

Recently Issued Accounting Standards In September 2011, the FASB issued guidance that provides entities testing goodwill for impairment to have the option of performing a qualitative assessment before calculating the fair value of the reporting unit. If entities determine, based on qualitative factors, the fair value of the reporting unit is more likely than not less than the carrying value, the two-step impairment test would be required. This guidance is effective for interim and annual reporting periods beginning after December 15, 2011, with early adoption permitted. We do not expect the adoption will have a material impact on our financial position, results of operations or cash flows.

In June 2011, the FASB issued guidance that requires an entity to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders equity. This guidance is effective for interim and annual reporting periods beginning after December 15, 2011, with early adoption permitted. As this guidance only amends the presentation of the components of comprehensive income, the adoption will not have an impact on our financial position, results of operations or cash flows.

In May 2011, the FASB issued guidance that amends certain accounting and disclosure requirements related to fair value measurements. This guidance is effective for interim and annual reporting periods beginning after December 15, 2011. We do not expect the adoption will have a material impact on our financial position, results of operations or cash flows.

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3. Cash, Cash Equivalents and Marketable Securities

The following tables summarize the estimated fair value of our cash, cash equivalents and marketable securities and the gross unrealized holding gains and losses at October 29, 2011 and January 29, 2011 (in thousands):

	October 29, 2011			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	$ 11,989	$	$	$ 11,989
Money market funds	390			390
State and local government securities	1,502			1,502
Total cash and cash equivalents	13,881			13,881
Marketable securities:				
Treasury and agency securities	3,000	4		3,004
Corporate debt securities	2,020	29		2,049
State and local government securities	107,000	216	(148)	107,068
Variable-rate demand notes	11,950			11,950
Total marketable securities	$ 123,970	$ 249	$ (148)	$ 124,071
Less: Long-term marketable securities (1)				(894)
Total current marketable securities				$ 123,177

	January 29, 2011			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	$ 7,160	$	$	$ 7,160
Money market funds	928			928
State and local government securities	3,269			3,269
Total cash and cash equivalents	11,357			11,357
Marketable securities:				
Treasury and agency securities	6,043	26		6,069
State and local government securities	103,110	125	(195)	103,040
Variable-rate demand notes	9,205			9,205
Total marketable securities	$ 118,358	$ 151	$ (195)	$ 118,314
Less: Long-term marketable securities (1)				(870)
Total current marketable securities				$ 117,444

(1) At October 29, 2011 and January 29, 2011, we held one $1.0 million par value auction rate security valued at $0.9 million, net of a $0.1 million temporary impairment charge, classified as available-for-sale marketable securities and included in long-term investments on the condensed consolidated balance sheets.

All of our available-for-sale securities, excluding our auction rate security, have an effective maturity of two years or less and may be liquidated, at our discretion, prior to maturity. For the three and nine months ended October 29, 2011 and October 30, 2010, realized gains and losses on sales of available-for-sale marketable securities were not material. We use the specific identification method to determine any realized gains or losses from the sale of our marketable securities classified as available-for-sale.

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The following tables summarize the gross unrealized holding losses and fair value for investments in an unrealized loss position at October 29, 2011 and January 29, 2011, and the length of time that individual securities have been in a continuous loss position (in thousands):

	October 29, 2011					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Marketable securities:						
State and local government securities	31,356	(42)	894	(106)	32,250	(148)
Total marketable securities	$ 31,356	$ (42)	$ 894	$ (106)	$ 32,250	$ (148)

	January 29, 2011					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Marketable securities:						
State and local government securities	42,761	(62)	1,907	(133)	44,668	(195)
Total marketable securities	$ 42,761	$ (62)	$ 1,907	$ (133)	$ 44,668	$ (195)

We did not record a realized loss for other-than-temporary impairments during the three and nine months ended October 29, 2011 and October 30, 2010. At October 29, 2011 and January 29, 2011, we had $0.9 million invested, net of temporary impairment charge of $0.1 million, in an auction rate security that is classified as available-for-sale marketable securities in long-term investments on the condensed consolidated balance sheets. Auction rate securities are generally long-term debt instruments that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined calendar intervals. This mechanism generally allows existing investors to rollover their holdings and continue to own their respective securities or liquidate their holdings by selling their securities at par value. Prior to February 3, 2008, we invested in these securities for short periods of time as part of our cash management program. However, the uncertainties in the credit markets that began in early 2008 have prevented us and other investors from liquidating holdings of auction rate securities in recent auctions for these securities because the amount of securities submitted for sale has exceeded the amount of purchase orders. Should the auction continue to fail, we do not intend to sell the security and it is not more likely than not that we will be required to sell the investment before the liquidity in the market improves. Additionally, the investment is fully collateralized by the U. S. government. Although we are uncertain as to when the liquidity issues relating to this investment will improve, we consider the issue temporary. As a result of the temporary decline in fair value for our auction rate security, we have recorded an unrealized loss of $0.1 million, which is included in accumulated other comprehensive income (loss) on the condensed consolidated balance sheets at October 29, 2011 and January 29, 2011. We continue to monitor the market for auction rate securities and consider its impact, if any, on the fair market value of the investment. It is possible that further declines in fair value may occur, and those declines, if any, would be recognized in accordance with GAAP, and if it is later determined that the fair value of this security is other-than-temporarily impaired, we will record a loss in the condensed consolidated statement of operations. Due to our belief that the market for this investment may take in excess of twelve months to fully recover, we have classified it as a noncurrent asset in long-term investments on the condensed consolidated balance sheets at October 29, 2011 and January 29, 2011.

4. Commitments and Contingencies

Leases We are committed under operating leases for all of our retail store locations and our current combined home office and ecommerce fulfillment center generally with terms of five to ten years. Total rent expense, base rent expense and contingent and other rent expense for the three and nine months ended October 29, 2011 and October 30, 2010 is as follows (in thousands). Included in other rent expense are payments of real estate taxes, insurance and common area maintenance costs.

	Three Months Ended		Nine Months Ended	
	October 29, 2011	October 30, 2010	October 29, 2011	October 30, 2010
Base rent expense	$ 10,720	$ 9,362	$ 30,985	$ 27,658
Contingent and other rent expense	6,955	6,233	19,358	17,848

Total rent expense	$ 17,675	$	15,595	$ 50,343	$	45,506

At October 29, 2011, we were committed to property owners for operating lease obligations for $402.7 million. A majority of our leases provide for ongoing co-tenancy requirements or early cancellation clauses that would further lower rental rates, or permit lease terminations, or both, in the event that co-tenants cease to operate for specific periods or if certain sales levels are not met in specific periods. Most of the store leases require payment of a specified minimum rent and contingent rent based on a percentage of the store s net sales in excess of a specified threshold. Amounts in the table below do not include contingent rent, real estate taxes, insurance or common area maintenance costs unless these costs are fixed and determinable. Future minimum commitments on all leases at October 29, 2011 are as follows (in thousands):

	Operating Lease Obligations
Fiscal 2011	$ 13,059
Fiscal 2012	53,675
Fiscal 2013	54,936
Fiscal 2014	53,367
Fiscal 2015	50,947
Thereafter	176,710
Total	$ 402,694

Purchase Commitments At October 29, 2011 and January 29, 2011, we had outstanding purchase orders to acquire merchandise from vendors of $91.6 million and $76.5 million, including $1.2 million and $0.5 million of letters of credit outstanding. We have an option to cancel these commitments with no notice prior to shipment, except for private label purchase orders in which we are obligated to repay certain contractual amounts upon cancellation.

Litigation We are involved from time to time in claims, proceedings and litigation arising in the ordinary course of business. We have made accruals with respect to these matters, where appropriate, which are reflected in our condensed consolidated financial statements. For some matters, the amount of liability is not probable or the amount cannot be reasonable estimated and therefore accruals have not been made. We may enter into discussions regarding settlement of these matters, and may enter into settlement agreements if we believe settlement is in the best interest of the Company s shareholders.

A putative class action, *Chandra Berg et al. v. Zumiez Inc.*, was filed against the Company in the Los Angeles Superior Court under case number BC408410 on February 25, 2009. The Complaint alleged causes of action for failure to pay overtime wages to present and former store managers in California, failure to provide meal periods and rest breaks to store managers, failure to reimburse retail employees for clothing required by the Company s dress code, failure to reimburse retail employees for business expenses, failure to provide store managers with accurate itemized wage statements, failure to pay terminated store managers all wages due at the time of termination, unfair business practices and declaratory relief. Plaintiff filed a First Amended Complaint on April 2, 2010 which added an additional plaintiff/class representative and a new cause of action for penalties for alleged Labor Code violations under the Private Attorneys General Act. We filed an answer to the First Amended Complaint and conducted discovery. On February 8, 2010, we attended a mediation wherein no settlement was reached. Plaintiffs filed their motion for class certification, and we filed our opposition to class certification. Plaintiffs reply papers were filed on August 2, 2010. On September 1, 2010, the Company announced that it had reached an agreement to settle. The settlement agreement is $2.1 million, which includes settlement awards to class members, incentive payments to the two plaintiffs, attorneys fees and costs and claims administration costs. The court granted preliminary approval of the settlement on November 3, 2010, and granted final approval of the settlement on February 23, 2011. The claims administrator has distributed the settlement funds pursuant to the Court s order and the settlement agreement. The accrued charge of $2.1 million was recorded in selling, general and administrative expenses on the condensed consolidated statements of operations for the three months ended July 31, 2010 and was paid out on March 10, 2011.

Insurance Reserves We are responsible for medical and dental insurance claims up to a specified aggregate amount. We maintain a reserve for estimated medical and dental insurance claims based on historical claims experience and other estimated assumptions. The insurance reserve at October 29, 2011 and January 29, 2011 was $0.6 million and $0.4 million.

5. Fair Value Measurements We apply the following fair value hierarchy, which prioritizes the inputs used to measure fair value into three levels and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement:

Level 1 Quoted prices in active markets for identical assets or liabilities;

Level 2 Quoted prices for similar assets or liabilities in active markets or inputs that are observable; and

Level 3 Inputs that are unobservable.

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We follow the guidelines for assessing fair value measurements consistent with GAAP that requires an assessment of whether certain factors exist to indicate that the market for an instrument is not active at the measurement date. If, after evaluating those factors, the evidence indicates the market is not active, a company must determine whether recent quoted transaction prices are associated with distressed transactions.

The following tables summarize assets measured at fair value on a recurring basis at October 29, 2011 and January 29, 2011 (in thousands):

	October 29, 2011		
	Level 1	Level 2	Level 3
Cash equivalents:			
Money market funds	$ 390	$	$
State and local government securities		1,502	
Marketable securities:			
Treasury and agency securities		3,004	
Corporate debt securities		2,049	
State and local government securities		106,174	
Variable-rate demand notes		11,950	
Long-term investments:			
State and local government securities			894
Equity investment			1,804

	January 29, 2011		
	Level 1	Level 2	Level 3
Cash equivalents:			
Money market funds	$ 928	$	$
State and local government securities		3,269	
Marketable securities:			
Treasury and agency securities		6,069	
State and local government securities		102,170	
Variable-rate demand notes		9,205	
Long-term investments:			
State and local government securities			870
Equity investment			1,896

Our policy is to recognize transfers into and transfers out of hierarchy levels as of the actual date of the event or change in circumstances that caused the transfer.

The Level 2 marketable securities primarily include state and local municipal securities, U.S. Treasury securities, U.S. Agency securities and variable-rate demand notes. Fair values are based on quoted market prices for similar assets or liabilities or determined using inputs that use readily observable market data that are actively quoted and can be validated through external sources, including third-party pricing services, brokers and market transactions.

The Level 3 state and local government securities represent a $1.0 million par value auction rate security, net of temporary impairment charge of $0.1 million. Our valuation method for the auction rate security is based on numerous assumptions including assessments of the underlying security, expected cash flows, credit ratings, liquidity and other relevant factors.

The Level 3 equity investment represents our 14.3% interest in a manufacturer of apparel and hard goods, which we acquired for $2.0 million on May 11, 2010. The equity investment is valued using comparative market multiples adjusted by an estimated discount factor. We have elected to apply fair value accounting for this investment, which would otherwise be accounted for under the equity method of accounting. We have elected fair value accounting, as we believe the terms of the contract are more properly reflected through the fair value method. The investment balance is reported in long-term investments on the condensed consolidated balance sheets, with the corresponding changes in the fair value recorded in other income (expense), net on the condensed consolidated statements of operations.

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The investment agreement allows for a put option, where we have an option to sell our interest back to the investee for the greater of the initial purchase price of $2.0 million or the fair value of the investment. This put option is allowed any time following the fifth anniversary of the initial investment, but prior to the seventh anniversary of the initial investment. Additionally, the investment agreement allows for a call option, where the investee has an option to repurchase the interest from us for the fair value of the investment. This call option is allowed any time on or after the seventh anniversary of the initial investment. We have elected to apply fair value accounting for the put and call options. The put option has a nominal value and the call option has no fair value, given that the investment would be repurchased at its fair value if the call option were exercised.

The assumptions, assessments and the interpretations of relevant market data are subject to uncertainties and are difficult to predict and require significant judgment. The use of different assumptions, applying different judgment to inherently subjective matters and changes in future market conditions could result in significantly different estimates of fair value.

The following tables present the changes in the Level 3 fair value category for the nine months ended October 29, 2011 and October 30, 2010 (in thousands):

	State and Local Government Securities	Equity Investment
Beginning balance at January 29, 2011	$ 870	$ 1,896
Unrealized gain included in accumulated other comprehensive income (loss)	24	
Unrealized loss included in other (expense) income, net		(92)
Ending balance at October 29, 2011	$ 894	$ 1,804

	State and Local Government Securities	Equity Investment
Beginning balance at January 30, 2010	$ 872	$
Purchases		2,000
Unrealized gain included in accumulated other comprehensive income (loss)	8	
Unrealized loss included in other (expense) income, net		(2)
Ending balance at October 30, 2010	$ 880	$ 1,998

There were no assets measured at fair value on a nonrecurring basis for the nine months ended October 29, 2011 and October 30, 2010.

6. Equity Awards We maintain the Zumiez Inc. 2005 Equity Incentive Plan (the 2005 Equity Incentive Plan) under which non-qualified stock options and restricted stock have been granted to employees and non-employee directors.

We account for stock-based compensation by which the estimated fair value of stock-based awards granted is recognized as compensation expense over the vesting period, net of estimated forfeitures. Stock-based compensation expense is recognized using an accelerated method for stock options and a straight-line basis for restricted stock. We estimate forfeitures of stock-based awards based on historical experience and expected future activity.

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The fair value of restricted stock grants is measured based on the closing fair market value of our common stock on the date of grant. The fair value of stock option grants are estimated on the date of grant using the Black-Scholes option pricing method with the following weighted-average assumptions used for stock option grants issued during the nine months ended October 29, 2011 and October 30, 2010:

	Nine Months Ended	
	October 29, 2011	October 30, 2010
Dividend yield	%	%
Volatility rate	65.00%	67.50%
Average expected life (in years)	6.25	6.50
Average risk-free interest rate	1.05%	2.37%
Weighted-average fair value per share of stock options granted	$ 13.35	$ 12.24

The following table summarizes our stock option activity for the nine months ended October 29, 2011 (in thousands except grant date weighted-average exercise price and weighted-average remaining contractual life):

	Stock Options	Grant Date Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (in Years)	Intrinsic Value (1)
Outstanding at January 29, 2011	1,118	$ 14.86		
Granted year to date	90	$ 22.33		
Exercised year to date	(140)	$ 7.06		
Forfeited year to date	(135)	$ 21.67		
Outstanding at October 29, 2011	933	$ 15.77	5.74	$ 9,344
Exercisable at October 29, 2011	524	$ 17.71	5.13	$ 4,894

(1) Intrinsic value for stock options is defined as the difference between the market price of the Company s common stock on the last business day of the quarter and the weighted average exercise price of in-the-money options outstanding at the end of each fiscal period. The market value per share was $23.45 at October 29, 2011.

The following table summarizes our restricted stock activity for the nine months ended October 29, 2011 (in thousands except grant date weighted-average fair value):

	Restricted Stock	Grant Date Weighted Average Fair Value	Intrinsic Value (1)
Outstanding at January 29, 2011	592	$ 12.55	
Granted year to date	186	$ 25.13	
Vested year to date	(220)	$ 12.46	
Forfeited year to date	(52)	$ 17.15	
Outstanding at October 29, 2011	506	$ 16.74	$ 11,873

(1) Intrinsic value for restricted stock is defined as the market value of the outstanding restricted stock on the last business day of the quarter. The market value per share was $23.45 at October 29, 2011.

We recorded $1.2 million and $1.1 million of total stock-based compensation expense for the three months ended October 29, 2011 and October 30, 2010. We recorded $4.0 million and $3.6 million of total stock-based compensation expense for the nine months ended October 29, 2011 and October 30, 2010.

At October 29, 2011, there was $7.5 million of total unrecognized compensation cost related to unvested stock options and restricted stock grants. This cost has a weighted-average recognition period of 1.1 years.

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7. Comprehensive Income or Loss Comprehensive income or loss represents all changes in equity during a period except those resulting from investments by and distributions to shareholders. Comprehensive income for the three and nine months ended October 29, 2011 and October 30, 2010 is as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	October 29, 2011	October 30, 2010	October 29, 2011	October 30, 2010
Net income	$ 14,137	$ 12,312	$ 18,614	$ 9,198
Net change in unrealized gains (losses) on available-for-sale investments, net of tax	(33)	26	78	(63)
Foreign currency translation	(57)		12	
Comprehensive income	$ 14,047	$ 12,338	$ 18,704	$ 9,135

8. Earnings Per Share, Basic and Diluted The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts).

	Three Months Ended		Nine Months Ended	
	October 29, 2011	October 30, 2010	October 29, 2011	October 30, 2010
Net income	$ 14,137	$ 12,312	$ 18,614	$ 9,198
Weighted average common shares for basic earnings per share	30,599	30,029	30,487	29,908
Dilutive effect of stock options and restricted stock	523	733	606	788
Weighted average common shares for diluted earnings per share	31,122	30,762	31,093	30,696
Basic earnings per share	$ 0.46	$ 0.41	$ 0.61	$ 0.31
Diluted earnings per share	$ 0.45	$ 0.40	$ 0.60	$ 0.30

Total anti-dilutive common stock options not included in the calculation of diluted earnings per share were approximately 0.3 million for the three and nine months ended October 29, 2011 and 0.3 million for the three and nine months ending October 30, 2010.

9. Exit or Disposal Activities On March 2, 2010, we acquired a 168,450 square foot building in Corona, California for $11.8 million and we have relocated our distribution facility to this facility to be more effective at distributing our products. In July 2010, we entered into an amendment of the lease for our current combined home office, ecommerce fulfillment center and the exited distribution facility in Everett, Washington, which terminated our lease commitments for a portion of the leased space in exchange for additional charges to be paid over the life of the remaining lease period (through June 2017). The lease termination costs recorded reflect the present value of these future charges.

Cumulatively, in conjunction with the closure of the Everett, Washington distribution facility, we recorded $0.9 million of employee benefit costs (severance and performance bonuses), $0.6 million of lease termination costs and $0.8 million of other costs to exit the facility. Additionally, we incurred a $0.3 million charge on disposal of long-lived assets and we recognized a $0.2 million benefit related to deferred rent liability. These amounts were included in cost of goods sold on the condensed consolidated statements of operations. We do not expect to incur material additional costs related to the relocation.

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The following table is a summary of the exit and disposal activity and liability balances as a result of this relocation (in thousands):

	Employee benefit costs	Lease termination costs	Other exit costs	Total
January 30, 2010	$	$	$	$
Additions	882		288	1,170
Payments	(716)		(198)	(914)
May 1, 2010	166		90	256
Additions		1,051	305	1,356
Payments	(111)	(186)	(253)	(550)
Adjustments	9	(457)		(448)
July 31, 2010	64	408	142	614
Additions			208	208
Payments	(19)	(60)	(341)	(420)
Adjustments		2		2
October 30, 2010	45	350	9	404
Additions			5	5
Payments	(30)	(59)	(14)	(103)
Adjustments		2		2
January 29, 2011	15	293		308
Payments	(15)	(23)		(38)
Adjustments		2		2
April 30, 2011		272		272
Payments		(12)		(12)
Adjustments		2		2
July 30, 2011		262		262
Payments		(12)		(12)
Adjustments		2		2
October 29, 2011 (1)	$	$ 252	$	$ 252

(1) The exit or disposal provisions at October 29, 2011 are included in other liabilities and long-term other liabilities on the condensed consolidated balance sheet.

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Item 2: MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this document. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those discussed in Item 1A Risk Factors in our Form 10-K filed with the SEC on March 15, 2011 and in this Form 10-Q.

Forward-looking statements relate to our expectations for future events and future financial performance. Generally, the words anticipates, expects, intends, may, should, plans, believes, predicts, potential, continue and similar expressions identify forward-looking statements. Forward-looking statements involve risks and uncertainties, and future events and circumstances could differ significantly from those anticipated in the forward-looking statements. These statements are only predictions. Actual events or results may differ materially. Factors which could affect our financial results are described below under the heading Risk Factors and in Item 1A Risk Factors of our Form 10-K referred to in the preceding paragraph. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assume responsibility for the accuracy and completeness of the forward-looking statements. We undertake no duty to update any of the forward-looking statements after the date of this report to conform such statements to actual results or to changes in our expectations.

References in the following discussion to we, us, our, the Company and similar references mean Zumiez Inc. and its wholly-owned subsidiaries, unless otherwise expressly stated or the context otherwise requires.

Overview

We are a specialty retailer of action sports related apparel, footwear, equipment and accessories operating under the Zumiez brand name. At October 29, 2011, we operated 442 stores primarily located in shopping malls, giving us a presence in 38 states and Canada. Our stores cater to young men and women between the ages of 12 and 24 who seek popular brands representing a lifestyle centered on activities that include skateboarding, surfing, snowboarding, BMX and motocross. We support the action sports lifestyle and promote our brand through a multi-faceted marketing approach that is designed to integrate our brand image with our customers activities and interests. This approach, combined with our differentiated merchandising strategy, store design, comprehensive training programs and passionate employees, allows us to provide an experience for our customers that we believe is consistent with their attitudes, fashion tastes and identities and is otherwise unavailable in most malls. Accordingly, our success is largely dependent upon our ability to anticipate, identify and respond to the fashion tastes of our customers and to provide merchandise that satisfies customer demands.

General

Net sales constitute gross sales net of actual and estimated returns and deductions for promotions. Net sales include our in-store sales and our ecommerce sales, which includes ecommerce shipping revenue. Ecommerce sales were 6.4% and 4.4% of total net sales for the three months ended October 29, 2011 and October 30, 2010 and 6.0% and 3.6% of total net sales for the nine months ended October 29, 2011 and October 30, 2010. Sales of gift cards are deferred and recognized when gift cards are redeemed. The amount of the gift card liability is determined taking into account our estimate of the portion of gift cards that will not be redeemed or recovered (gift card breakage). Gift card breakage is recognized as revenue after 24 months, at which time the likelihood of redemption is considered remote based on our historical redemption data.

We report comparable store sales based on net sales beginning on the first anniversary of the first day of operation of a new store. Our comparable store sales also include our ecommerce sales. Changes in our comparable store sales between two periods are based on net sales of stores which were in operation during both of the two periods being compared and, if a store is included in the calculation of comparable store sales for only a portion of one of the two periods being compared, then that store is included in the calculation for only the comparable portion of the other period. Any change in square footage of an existing comparable store, including remodels, does not eliminate that store from inclusion in the calculation of comparable store sales. There may be variations in the way in which some of our competitors and other retailers calculate comparable or same store sales. As a result, data herein regarding our comparable store sales may not be comparable to similar data made available by our competitors or other retailers.

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Cost of goods sold consists of branded merchandise costs and our private label merchandise costs including design, sourcing, importing and inbound freight costs. Our cost of goods sold also includes shrinkage and buying, occupancy, distribution and warehousing costs. This may not be comparable to the way in which our competitors or other retailers compute their cost of goods sold. We receive cash consideration from vendors, which have been recorded as a reduction of cost of goods sold if the inventory has sold, as a reduction of the carrying value of the inventory if the inventory is still on hand, or a reduction of selling, general and administrative expense if the amounts are reimbursements of specific, incremental and identifiable costs of selling the vendors products.

With respect to the freight component of our ecommerce sales, we arrange and pay the freight for our customers and bill them for this service, unless our customers have their product shipped to one of our stores or we have free shipping promotions to our customers, in which case we do not bill our customers. Such amounts billed are included in net sales and the related freight cost is charged to cost of goods sold.

Selling, general and administrative expenses consist primarily of store personnel wages and benefits, administrative staff and infrastructure expenses, outbound freight, store supplies, depreciation on fixed assets at our home office and stores, facility expenses and training, advertising and marketing costs. Credit card fees, insurance, public company expenses, legal expenses and other miscellaneous operating costs are also included in selling, general and administrative expenses. This may not be comparable to the way in which our competitors or other retailers compute their selling, general and administrative expenses.

Key Performance Indicators

Our management evaluates the following items, which we consider key performance indicators, in assessing our performance:

Comparable store sales. As previously described in detail under the caption General, comparable store sales provide a measure of sales growth for stores open at least one year over the comparable prior year period.

We consider comparable store sales to be an important indicator of our current performance. Comparable store sales results are important to achieve leveraging of our costs, including store payroll, store supplies and rent. Comparable store sales also have a direct impact on our total net sales, cash and working capital.

Gross profit. Gross profit measures whether we are optimizing the price and inventory levels of our merchandise. Gross profit is the difference between net sales and cost of goods sold. Any inability to obtain acceptable levels of initial markups or any significant increase in our use of markdowns could have an adverse effect on our gross profit and results of operations.

Operating profit. We view operating profit as a key indicator of our success. The key drivers of operating profit are comparable store sales, gross profit, our ability to control selling, general and administrative expenses and our level of capital expenditures affecting depreciation expense.

Store productivity. We review our stores operating profit as a measure of the stores profitability.

Critical Accounting Estimates

Our condensed consolidated financial statements have been prepared in conformance with GAAP. In connection with the preparation of the condensed consolidated financial statements, we are required to make assumptions and estimates about future events and apply judgments that affect the reported amount of assets, liabilities, revenue, expenses and the related disclosures. We base our assumptions, estimates and judgments on historical experience, current trends and other factors that we believe to be relevant at the time the condensed consolidated financial statements are prepared. On a regular basis, we review the accounting policies, assumptions, estimates and judgments to ensure that the condensed consolidated financial statements are presented fairly and in accordance with GAAP. However, because future events and their effects cannot be determined with certainty, actual results could differ from our assumptions and estimates, and such differences could be material.

There have been no significant changes to our critical accounting estimates as discussed in our Annual Report on Form 10-K for the fiscal year ended January 29, 2011.

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Results of Operations

The following table presents, for the periods indicated, selected items on the condensed consolidated statements of operations as a percent of net sales:

	Three Months Ended		Nine Months Ended	
	October 29, 2011	October 30, 2010	October 29, 2011	October 30, 2010
Net sales	100.0 %	100.0 %	100.0 %	100.0 %
Cost of goods sold	60.9	61.3	64.8	66.3
Gross profit	39.1	38.7	35.2	33.7
Selling, general and administrative expenses	24.3	24.7	27.4	29.6
Operating profit	14.8	14.0	7.8	4.1
Interest and other income, net	0.2	0.3	0.3	0.4
Earnings before income taxes	15.0	14.3	8.1	4.5
Provision for income taxes	5.8	5.2	3.1	1.6
Net income	9.2%	9.1%	5.0%	2.9%

Three Months (13 weeks) Ended October 29, 2011 Compared With Three Months (13 weeks) Ended October 30, 2010

Net Income

Net income for the three months ended October 29, 2011 was $14.1 million, or $0.45 per diluted share, compared with net income of $12.3 million, or $0.40 per diluted share, for the three months ended October 30, 2010. Our effective income tax rate for the three months ended October 29, 2011 was 38.9% compared to 36.5% for the three months ended October 30, 2010.

Net Sales

Net sales were $154.0 million for the three months ended October 29, 2011 compared to $135.9 million for the three months ended October 30, 2010, an increase of $18.1 million or 13.3%. The increase reflected a comparable store sales increase of 6.0% for the three months ended October 29, 2011 as well as the net addition of 42 stores (43 new stores offset by one store closure) subsequent to October 30, 2010.

The increase in comparable stores sales was primarily driven by an increase in dollars per transaction, partially offset by a decline in comparable store transactions. Dollars per transaction increased due to an increase in average unit retail, partially offset by a decrease in units per transaction. Comparable store sales increases in footwear, men s clothing, junior s clothing and boy s clothing were partially offset by a comparable store sales decrease in accessories and hardgoods. For information as to how we define comparable stores, see General above.

Gross Profit

Gross profit was $60.1 million for the three months ended October 29, 2011 compared to $52.6 million for the three months ended October 30, 2010, an increase of $7.5 million, or 14.4%. As a percentage of net sales, gross profit increased 40 basis points for the three months ended October 29, 2011 to 39.1% from 38.7% for the three months ended October 30, 2010. The increase was primarily due to distribution center efficiencies.

Selling, General and Administrative Expenses

Selling, general and administrative (SG&A) expenses were $37.3 million for the three months ended October 29, 2011 compared to $33.6 million for the three months ended October 30, 2010, an increase of $3.7 million, or 11.0%. SG&A expenses as a percent of sales decreased by 40 basis points for the three months ended October 29, 2011 to 24.3% compared to 24.7% for the three months ended October 30, 2010. The decrease was primarily due to 40 basis points in store operating efficiencies and a 50 basis points decrease in corporate costs, partially offset by an increase in web operating expenses as a percent of total sales of 50 basis points due to the growth of the web business.

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Nine Months (39 weeks) Ended October 29, 2011 Compared With Nine Months (39 weeks) Ended October 30, 2010

Net Income

Net income for the nine months ended October 29, 2011 was $18.6 million, or $0.60 per diluted share, compared with net income of $9.2 million, or $0.30 per diluted share, for the nine months ended October 30, 2010. Our effective income tax rate for the nine months ended October 29, 2011 was 38.4% compared to 36.8% for the nine months ended October 30, 2010.

Net Sales

Net sales were $372.0 million for the nine months ended October 29, 2011 compared to $322.7 million for the nine months ended October 30, 2010, an increase of $49.3 million or 15.3%. The increase reflected a comparable store sales increase of 8.3% for the nine months ended October 29, 2011 as well as the net addition of 42 stores (43 new stores offset by one store closure) subsequent to October 30, 2010.

The increase in comparable stores sales was primarily driven by an increase in dollars per transaction, slightly offset by a decline in comparable store transactions. Dollars per transaction increased due to an increase in average unit retail, partially offset by a decrease in units per transaction. Comparable store sales increases in footwear, men s clothing, accessories and junior s clothing were partially offset by comparable store sales decreases in hardgoods and boy s clothing. For information as to how we define comparable stores, see General above.

Gross Profit

Gross profit was $130.9 million for the nine months ended October 29, 2011 compared to $108.6 million for the nine months ended October 30, 2010, an increase of $22.3 million, or 20.5%. As a percentage of net sales, gross profit increased 150 basis points for the nine months ended October 29, 2011 to 35.2% from 33.7% for the nine months ended October 30, 2010. The increase was primarily due to a 70 basis points decrease related to costs incurred in the nine months ended October 30, 2010 associated with the relocation of our distribution center, 50 basis points decrease due to leveraging our store occupancy cost over a 8.3% comparable store sales gain and 40 basis points in distribution center efficiencies.

Selling, General and Administrative Expenses

Selling, general and administrative (SG&A) expenses were $101.9 million for the nine months ended October 29, 2011 compared to $95.2 million for the nine months ended October 30, 2010, an increase of $6.7 million, or 7.0%. SG&A expenses as a percent of sales decreased by 220 basis points for the nine months ended October 29, 2011 to 27.4% compared to 29.6% for the nine months ended October 30, 2010. The decrease was primarily due to 130 basis points in store operating efficiencies, a 70 basis points impact of a litigation settlement of $2.1 million incurred in the nine months ended October 30, 2010 and a 50 basis points decrease in corporate costs, partially offset by an increase in web operating expenses as a percent of total sales of 40 basis points due to the growth of the web business.

Liquidity and Capital Resources

Our primary uses of cash are for operational expenditures, capital investments, inventory purchases, store remodeling, store fixtures and ongoing infrastructure improvements such as technology enhancements and distribution capabilities. Historically, our main sources of liquidity have been cash flows from operations.

The significant components of our working capital are inventories and liquid assets such as cash, cash equivalents, marketable securities and receivables, reduced by accounts payable and accrued expenses. Our working capital position benefits from the fact that we generally collect cash from sales to customers the same day or within several days of the related sale, while we typically have longer payment terms with our vendors.

Our capital requirements include construction and fixture costs related to the opening of new stores and remodeling expenditures for existing stores. Future capital requirements will depend on many factors, including the pace of new store openings, the availability of suitable locations for new stores and the nature of arrangements negotiated with landlords. In that regard, our net investment to open a new store has varied significantly in the past due to a number of factors, including the geographic location and size of the new store, and is likely to vary significantly in the future. In addition, we will incur construction costs in fiscal 2011 and fiscal 2012 related to building our new home office in Lynnwood, Washington.

During fiscal 2011, we expect to incur approximately $28 million to $30 million on capital expenditures, which will primarily relate to leasehold improvements and fixtures for the 45 new stores we plan to open in fiscal 2011 and the construction of our new home office building in Lynnwood, Washington. There can be no assurance that actual fiscal 2011 capital expenditures will not differ from this expected amount.

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Operating Activities

Net cash provided by operating activities increased by $10.3 million to $25.2 million for the nine months ended October 29, 2011 from $14.9 million for the nine months ended October 30, 2010. Our operating cash flows result primarily from cash received from our customers, offset by cash payments we make for inventory, employee compensation, store occupancy expenses and other operational expenditures. Cash received from our customers generally corresponds to our net sales. Because our customers primarily use credit cards or cash to buy from us, our receivables from customers settle quickly. Changes to our operating cash flows have historically been driven primarily by changes in operating income, which is impacted by changes to non-cash items such as depreciation, amortization and accretion, deferred taxes, and excess tax benefit from stock-based compensation, and changes to the components of working capital.

Investing Activities

Net cash used in investing activities was $25.6 million for the nine months ended October 29, 2011, related to $18.4 million of capital expenditures primarily for new store openings and $7.2 million in net purchases of marketable securities. Net cash used in investing activities was $11.3 million for the nine months ended October 30, 2010, related to $23.9 million of capital expenditures primarily for the purchase of our distribution center in Corona, California and new store openings, partially offset by $12.6 million in net sales and maturities of marketable securities.

Financing Activities

Net cash provided by financing activities for the nine months ended October 29, 2011 was $2.9 million related to proceeds from stock-based compensation exercises and the related tax benefit. Net cash provided by financing activities for the nine months ended October 30, 2010 was $3.1 million related to the proceeds received from stock-based compensation exercises and the related tax benefit.

Sources of Liquidity

Our most significant sources of liquidity continue to be funds generated by operating activities and available cash, cash equivalents and current marketable securities. We expect these sources of liquidity and available borrowings under our revolving credit facility will be sufficient to meet our foreseeable cash requirements for operations and planned capital expenditures for at least the next twelve months. Beyond this time frame, if cash flows from operations and borrowings under our revolving credit facility are not sufficient to meet our capital requirements, then we will be required to obtain additional equity or debt financing in the future. However, there can be no assurance that equity or debt financing will be available to us when we need it, or if available, that the terms will be satisfactory to us and not dilutive to our then-current shareholders.

On August 29, 2011, we renewed and amended our secured credit agreement with Wells Fargo Bank, N.A., and the prior facility agreement was terminated. The credit agreement provides us with a secured revolving credit facility until September 1, 2013 of up to $25.0 million, which, pursuant to an accordion feature, may be increased to $35.0 million at our discretion. The secured revolving credit facility provides for the issuance of a standby letter of credit in an amount not to exceed $5.0 million outstanding at any time and with a term not to exceed 365 days. The commercial line of credit provides for the issuance of a commercial letter of credit in an amount not to exceed $10.0 million and with terms not to exceed 120 days. The amount of borrowings available at any time under our secured revolving credit facility is reduced by the amount of standby and commercial letters of credit outstanding at that time. There were no outstanding borrowings under the secured revolving credit facility at October 29, 2011 and January 29, 2011. We had open commercial letters of credit outstanding under our secured revolving credit facility of $1.2 million at October 29, 2011 and $0.5 million at January 29, 2011. The secured revolving credit facility bears interest at the Daily One Month LIBOR rate plus 1.00%. The credit agreement contains a number of restrictions and covenants that generally limit our ability to, among other things, (1) incur additional debt, (2) undergo a change in ownership and (3) enter into certain transactions. The credit agreement also contains financial covenants that require us to meet certain specified financial tests and ratios, including, a maximum net loss not to exceed $10.0 million after taxes on a trailing four-quarter basis provided, that, there shall be added to net income all charges for impairment of goodwill and store assets not to exceed $5.0 million in aggregate, and a minimum quick ratio of 1.25. The quick ratio is defined as our cash and near cash equivalents plus certain defined receivables divided by the outstanding borrowings. Our accounts receivable, general intangibles, inventory and equipment have been pledged to secure our obligations under the credit agreement. We must also provide financial information and statements to our lender. We were in compliance with all such covenants at October 29, 2011.

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Contractual Obligations and Commercial Commitments

There were no material changes outside the ordinary course of business in our contractual obligations during the nine months ended October 29, 2011. The following table summarizes the total amount of future payments due under our contractual obligations at October 29, 2011 (in thousands):

	Total	Fiscal 2011	Fiscal 2012 and Fiscal 2013	Fiscal 2014 and Fiscal 2015	Thereafter
Operating lease obligations	$ 402,694	$ 13,059	$ 108,611	$ 104,314	$ 176,710
Purchase obligations	91,572	91,572			
Total	$ 494,266	$ 104,631	$ 108,611	$ 104,314	$ 176,710

We occupy our retail stores and our current combined home office and ecommerce fulfillment center under operating leases generally with terms of five to ten years. At October 29, 2011, we were committed to property owners for operating lease obligations for $402.7 million. A majority of our leases provide for ongoing co-tenancy requirements or early cancellation clauses that would further lower rental rates, or permit lease terminations, or both, in the event that co-tenants cease to operate for specific periods or if certain sales levels are not met in specific periods. Most of the store leases require payment of a specified minimum rent and contingent rent based on a percentage of the store s net sales in excess of a specified threshold. Amounts in the above table do not include contingent rent, real estate taxes, insurance or common area maintenance costs unless these costs are fixed and determinable.

At October 29, 2011, we had outstanding purchase orders to acquire merchandise from vendors of $91.6 million, including $1.2 million of letters of credit outstanding. We have an option to cancel these commitments with no notice prior to shipment, except for private label purchase orders in which we are obligated to repay certain contractual amounts upon cancellation.

Off-Balance Sheet Obligations

We did not have any off-balance sheet obligations at October 29, 2011.

Impact of Inflation

We do not believe that inflation has had a material impact on our net sales or operating results in the recent past. There can be no assurance that our business will not be affected by inflation in the future.

Risk Factors

Investing in our securities involves a high degree of risk. The following risk factors, issues and uncertainties should be considered in evaluating our future prospects. In particular, keep these risk factors in mind when you read forward-looking statements elsewhere in this report. Forward-looking statements relate to our expectations for future events and time periods. Generally, the words anticipate, believe, expect, intend and similar expressions identify forward-looking statements. Forward-looking statements involve risks and uncertainties, and future events and circumstances could differ significantly from those anticipated in the forward-looking statements. Any of the following risks could harm our business, operating results or financial condition and could result in a complete loss of your investment. Additional risks and uncertainties that are not yet identified or that we currently think are immaterial may also harm our business and financial condition in the future.

Significant fluctuations and volatility in the price of cotton, foreign labor costs and other raw materials used in the production of our merchandise may have a material adverse effect on our business, results of operations and financial conditions.

Increases in the cost of cotton, foreign labor costs or other raw materials used in the production of our merchandise can result in higher costs in the price we pay for this merchandise. The costs for cotton are affected by weather, consumer demand, speculation on the commodities market and other factors that are generally unpredictable and beyond our control. Our gross profit and earnings per share could be adversely affected to the extent that the selling prices of our products do not increase proportionately with the increases in the costs of cotton or other materials. Increasing labor costs and oil-related product costs, such as manufacturing and transportation costs, could also adversely impact gross profit.

Additionally, significant changes in the relationship between carrier capacity and shipper demand could increase transportation costs, which could also adversely impact gross profit.

In the current fiscal year, we are aware of increased cotton, oil and other input costs that affect our cost of goods. We are working with our vendors and private label manufacturers to manage these cost increases. While we believe we have strategies in place to mitigate the increase in cost, there can be no assurance our efforts will be successful and our gross profit margins may decline.

Most of our merchandise is produced by foreign manufacturers; therefore, the availability and costs of these products may be negatively affected by risks associated with international trade and other international conditions.

Most of our merchandise is produced by manufacturers around the world. Some of these facilities are located in regions that may be affected by natural disasters, political instability or other conditions that could cause a disruption in trade. Trade restrictions such as increased tariffs or quotas, or both, could also affect the importation of merchandise generally and increase the cost and reduce the supply of merchandise available to us. Any reduction in merchandise available to us or any increase in its cost due to tariffs, quotas or local issues that disrupt trade could have a material adverse effect on our results of operations. Although the prices charged by vendors for the merchandise we purchase are primarily denominated in United States dollars, a continued decline in the relative value of the United States dollar to foreign currencies could lead to increased merchandise costs, which could negatively affect our competitive position and our results of operation.

Our ability to attract customers to our stores depends heavily on the success of the shopping malls in which our stores are located; any decrease in customer traffic in those malls could cause our sales to be less than expected.

In order to generate customer traffic we depend heavily on locating our stores in prominent locations within successful shopping malls. Sales at these stores are derived, in part, from the volume of traffic in those malls. Our stores benefit from the ability of a mall s other tenants to generate consumer traffic in the vicinity of our stores and the continuing popularity of malls as shopping destinations. Our sales volume and mall traffic generally may be adversely affected by, among other things, economic downturns in a particular area, competition from ecommerce retailers, non-mall retailers and other malls, increases in gasoline prices and the closing or decline in popularity of other stores in the malls in which we are located. An uncertain economic outlook could curtail new shopping mall development, decrease shopping mall traffic, reduce the number of hours that shopping mall operators keep their shopping malls open or force them to cease operations entirely. A reduction in mall traffic as a result of these or any other factors could have a material adverse effect on our business, results of operations and financial condition.

Our growth strategy depends on our ability to open and operate new stores each year, which could strain our resources and cause the performance of our existing stores to suffer.

Our growth largely depends on our ability to open and operate new stores successfully. However, our ability to open new stores is subject to a variety of risks and uncertainties, and we may be unable to open new stores as planned, and any failure to successfully open and operate new stores would have a material adverse effect on our results of operations. We intend to continue to open new stores in future years while remodeling a portion of our existing store base annually. In addition, our proposed expansion will place increased demands on our operational, managerial and administrative resources. These increased demands could cause us to operate our business less effectively, which in turn could cause deterioration in the financial performance of our individual stores and our overall business. To the extent our new store openings are in markets where we already have stores, we may experience reduced net sales in existing stores in those markets. In addition, successful execution of our growth strategy may require that we obtain additional financing, and we cannot assure you that we will be able to obtain that financing on acceptable terms or at all.

If we fail to effectively execute our expansion strategy, we may not be able to successfully open new store locations in a timely manner, if at all, which could have an adverse affect on our net sales and results of operations.

Our ability to open and operate new stores successfully depends on many factors, including, among others, our ability to:

- identify suitable store locations, the availability of which is outside of our control;
- negotiate acceptable lease terms, including desired tenant improvement allowances;
- source sufficient levels of inventory at acceptable costs to meet the needs of new stores;

hire, train and retain qualified store personnel;

successfully integrate new stores into our existing operations; and

identify and satisfy the merchandise preferences of new geographic areas.

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In addition, many of our planned new stores are to be opened in regions of the United States or international locations in which we currently have few, or no, stores. The expansion into these markets may present competitive, merchandising and distribution challenges that are different from those currently encountered in our existing markets. Any of these challenges could adversely affect our business and results of operations.

The expansion of our store base to Canada may present increased risks due to our limited familiarity with that market.

In fiscal 2011, we opened store locations in Canada. The Canadian market may have different competitive conditions, consumer tastes and discretionary spending patterns that our existing markets. As a result, new stores in that market may be less successful than our stores in the United States. Additionally, consumers in the Canadian market may not be familiar with our brand, and we may need to build brand awareness in that market. Furthermore, we have limited experience with the legal and regulatory environments and market practices outside of the United States and cannot guarantee that we will be able penetrate or successfully operate in the Canadian market. We may also incur additional costs in complying with applicable Canadian laws and regulations as they pertain to both our products and our operations.

Our business is dependent upon our being able to anticipate, identify and respond to changing fashion trends, customer preferences and other fashion-related factors; failure to do so could have a material adverse effect on us.

Customer tastes and fashion trends in the action sports lifestyle market are volatile and tend to change rapidly. Our success depends on our ability to effectively anticipate, identify and respond to changing fashion tastes and consumer preferences, and to translate market trends into appropriate, saleable product offerings in a timely manner. If we are unable to successfully anticipate, identify or respond to changing styles or trends and misjudge the market for our products or any new product lines, our sales may be lower than predicted and we may be faced with a substantial amount of unsold inventory or missed opportunities. In response to such a situation, we may be forced to rely on markdown