RADIANT LOGISTICS, INC
Form 10-Q
November 09, 2018

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 September 30, 2018

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from to

Commission File Number 001-35392

RADIANT LOGISTICS, INC.

(Exact name of Registrant as Specified in Its Charter)

Delaware	04-3625550
(State or Other Jurisdiction of	(IRS Employer
Incorporation or Organization)	Identification No.)

405 114th Ave S.E., Bellevue, WA 98004
(Address of principal executive offices)

(425) 943-4599
(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the 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	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.

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

There were 49,459,188 shares outstanding of the registrant's common stock, par value $.001 per share, as of November 1, 2018.

RADIANT LOGISTICS, INC.

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RADIANT LOGISTICS, INC.

Condensed Consolidated Balance Sheets

(In thousands, except share and per share data)	September 30, 2018 (unaudited)	June 30, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,956	$ 6,992
Accounts receivable, net of allowance of $2,035 and $1,703, respectively	100,444	137,578
Contract assets	27,254	—
Income tax receivable	1,073	2,105
Prepaid expenses and other current assets	8,499	6,599
Total current assets	145,226	153,274
Technology and equipment, net	19,125	18,566
Goodwill	65,389	65,389
Intangible assets, net	63,055	65,264
Deposits and other assets	1,248	2,945
Total other long-term assets	129,692	133,598
Total assets	$ 294,043	$ 305,438
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$ 80,462	$ 90,153
Operating partner commissions payable	13,869	14,322
Accrued expenses	6,608	5,404
Current portion of notes payable	3,946	3,726
Current portion of contingent consideration	1,100	960
Transition and lease termination liability	1,094	1,385
Other current liabilities	259	295
Total current liabilities	107,338	116,245
Notes payable, net of current portion	41,475	43,197
Contingent consideration, net of current portion	1,380	1,615
Deferred rent liability	987	1,020
Deferred income taxes	8,297	8,665
Other long-term liabilities	367	1,082
Total long-term liabilities	52,506	55,579
Total liabilities	159,844	171,824
Commitments and contingencies (Note 14)		

Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized; 839,200 shares issued and outstanding, liquidation preference of $20,980	1	1
Common stock, $0.001 par value, 100,000,000 shares authorized; 49,544,886 and 49,511,907 shares issued, and 49,453,088 and 49,420,109 shares outstanding, respectively	31	31
Additional paid-in capital	118,236	117,968
Treasury stock, at cost, 91,798 shares	(253)	(253)
Retained earnings	16,071	15,539
Accumulated other comprehensive income (loss)	(119)	186
Total Radiant Logistics, Inc. stockholders' equity	133,967	133,472
Non-controlling interest	232	142
Total equity	134,199	133,614
Total liabilities and equity	$ 294,043	$ 305,438

The accompanying notes form an integral part of these condensed consolidated financial statements.

RADIANT LOGISTICS, INC.

Condensed Consolidated Statements of Comprehensive Income

(unaudited)

(In thousands, except share and per share data)	Three Months Ended September 30, 2018	2017
Revenues	$218,883	$197,977
Operating expenses:		
Cost of transportation and other services	164,015	152,374
Operating partner commissions	24,828	19,692
Personnel costs	14,545	13,993
Selling, general and administrative expenses	7,124	6,303
Depreciation and amortization	3,633	3,575
Transition and lease termination costs	—	107
Change in fair value of contingent consideration	(95)	(300)
Total operating expenses	214,050	195,744
Income from operations	4,833	2,233
Other income (expense):		
Interest income	12	7
Interest expense	(789)	(771)
Foreign currency transaction gains (losses)	34	(85)
Other	150	130
Total other expense	(593)	(719)
Income before income taxes	4,240	1,514
Income tax expense	(977)	(626)
Net income	3,263	888
Less: net income attributable to non-controlling interest	(180)	(61)
Net income attributable to Radiant Logistics, Inc.	3,083	827
Less: preferred stock dividends	(511)	(511)
Net income allocable to common stockholders	$2,572	$316
Other comprehensive income (loss):		
Foreign currency translation loss	(305)	(805)
Comprehensive income	$2,958	$83
Income per share allocable to common stockholders:		

Basic and Diluted	$0.05	$0.01
Weighted average common shares outstanding:		
Basic	49,437,930	49,085,545
Diluted	50,705,434	50,642,953

The accompanying notes form an integral part of these condensed consolidated financial statements.

RADIANT LOGISTICS, INC.

Condensed Consolidated Statements of Changes in Equity

(unaudited)

(In thousands, except share and per share data)	RADIANT LOGISTICS, INC. STOCKHOLDERS' EQUITY										
	Preferred Stock		Common Stock		Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Radiant Logistics, Inc. Stockholders Equity	Non-Controlling Interest	Total Equity
	Shares	Amount	Shares	Amount							
Balance as of June 30, 2018	839,200	$1	49,420,109	$31	$117,968	$(253)	$15,539	$186	$133,472	$142	$133,614
Cumulative effect adjustment, upon adoption of ASC 606 on July 1, 2018 (Note 2)	—	—	—	—	—	—	(335)	—	(335)	—	(335)
Cumulative effect adjustment, upon adoption of ASU 2016-16 on July 1, 2018 (Note 2)	—	—	—	—	—	—	(1,705)	—	(1,705)	—	(1,705)
Share-based compensation	—	—	—	—	331	—	—	—	331	—	331
Issuance of common stock upon exercise of stock options	—	—	32,979	—	(63)	—	—	—	(63)	—	(63)
Preferred dividends paid	—	—	—	—	—	—	(511)	—	(511)	—	(511)

Distribution to non-controlling interest	—	—	—	—	—	—	—	—	—	(90)	(90)
Net income	—	—	—	—	—	—	3,083	—	3,083	180	3,263
Other comprehensive loss	—	—	—	—	—	—	—	(305)	(305)	—	(305)
Balance as of September 30, 2018	839,200	$1	49,453,088	$31	$118,236	$(253)	$16,071	$(119)	$133,967	$232	$134,199

The accompanying notes form an integral part of these condensed consolidated financial statements.

RADIANT LOGISTICS, INC.

Condensed Consolidated Statements of Cash Flows

(unaudited)

(In thousands, except share and per share data)	Three Months Ended September 30,	
	2018	2017
OPERATING ACTIVITIES:		
Net income	$3,263	$888
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES		
share-based compensation	331	350
amortization of intangible assets	2,472	2,494
depreciation and amortization of technology and equipment	1,161	1,081
deferred income tax benefit	(253)	(512)
amortization of debt issuance costs	59	62
change in fair value of contingent consideration	(95)	(300)
transition and lease termination costs	—	107
gain on disposal of technology and equipment	(16)	(4)
change in allowance for doubtful accounts	332	231
CHANGES IN OPERATING ASSETS AND LIABILITIES:		
accounts receivable	4,440	(6,592)
contract assets	6,759	—
income tax receivable	1,055	(233)
prepaid expenses, deposits and other assets	(1,876)	692
accounts payable	(5,488)	(939)
operating partner commissions payable	506	623
accrued expenses	(5,761)	503
other liabilities	(742)	473
deferred rent liability	(29)	112
transition and lease termination liability	(276)	(213)
Net cash provided by (used for) operating activities	5,842	(1,177)
INVESTING ACTIVITIES:		
Payments to acquire businesses	—	(1,025)
Purchases of technology and equipment	(1,134)	(1,383)
Proceeds from sale of technology and equipment	232	41
Net cash used for investing activities	(902)	(2,367)
FINANCING ACTIVITIES:		
Proceeds from (repayments to) credit facility, net	(2,003)	4,975
Payments of debt issuance costs	—	(87)
Repayments of notes payable	(843)	(835)
Payments of preferred stock dividends	(511)	(511)

Distribution to non-controlling interest	(90)	—
Payments of employee tax withholdings related to cashless exercise of stock options	(63)	(2)
Net cash provided by (used for) financing activities	(3,510)	3,540
Effect of exchange rate changes on cash and cash equivalents	(466)	(37)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	964	(41)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	6,992	5,808
CASH AND CASH EQUIVALENTS, END OF PERIOD	$7,956	$5,767
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Income taxes paid	$178	$1,404
Interest paid	$735	$701

The accompanying notes form an integral part of these condensed consolidated financial statements.

RADIANT LOGISTICS, INC.

Condensed Consolidated Statements of Cash Flows (continued)

(unaudited)

Supplemental disclosure of non-cash investing and financing activities:

In September 2017, the Company issued 10,019 shares of common stock at a fair value of $4.99 per share in satisfaction of $50 of the Sandifer-Valley Transportation & Logistics, Ltd. Purchase price, resulting in an increase to common stock and additional paid-in capital of $50.

During the three months ended September 30, 2018, the Company acquired $812 of refrigerated trailers financed through a capital lease.

In September 2018, $262 was recorded as an increase to accrued expenses and intangible assets for the purchase of a customer list.

The accompanying notes form an integral part of these condensed consolidated financial statements.

RADIANT LOGISTICS, INC.

Notes to the Condensed Consolidated Financial Statements

(unaudited)

(Dollars in thousands, except share and per share data)

NOTE 1 – THE COMPANY AND BASIS OF PRESENTATION

The Company

Radiant Logistics, Inc. and its consolidated subsidiaries (the "Company") operates as a third-party logistics company, providing multi-modal transportation and logistics services primarily to customers based in the United States and Canada. The Company services a large and diversified account base which it supports from an extensive multi-brand network of over 100 operating locations (including 20 Company-owned offices) across North America as well as an integrated international service partner network located in other key markets around the globe. As a third-party logistics company, the Company has a carrier network of approximately 10,000 asset-based transportation companies, including motor carriers, railroads, airlines and ocean lines. The Company believes shippers value its services because it is able to objectively arrange the most efficient and cost-effective means, type and provider of transportation service since it is not influenced by the ownership of transportation assets. In addition, the Company's minimal investment in physical assets affords it the opportunity for a higher return on invested capital and net cash flows than the Company's asset-based competitors.

Through its operating locations across North America, the Company offers domestic and international air and ocean freight forwarding services and freight brokerage services including truckload services, less than truckload services; and intermodal services, which is the movement of freight in trailers or containers by combination of truck and rail. The Company's primary transportation services involve arranging shipments, on behalf of its customers, of materials, products, equipment and other goods that are generally larger than shipments handled by integrated carriers of primarily small parcels, such as FedEx, DHL and UPS, including arranging and monitoring all aspects of material flow activity utilizing advanced information technology systems. The Company also provides other value added supply chain services, including order fulfillment, inventory management, and warehouse and distribution services (collectively, "MM&D" services), and customs brokerage services to complement its core transportation service offering.

The Company expects to grow its business organically and by completing acquisitions of other companies with complementary geographical and logistics service offerings. The Company's organic growth strategy will continue to focus on strengthening existing and expanding new customer relationships leveraging the benefit of the Company's truck brokerage and intermodal service offerings, while continuing its efforts on the organic build-out of the Company's network of strategic operating partner locations. In addition, as the Company continues to grow and scale its business, the Company believes that it is creating density in its trade lanes which creates opportunities for the Company to more efficiently source and manage its transportation capacity.

In addition to its focus on organic growth, the Company will continue to search for acquisition candidates that bring critical mass from a geographic and purchasing power standpoint, along with providing complementary service offerings to the current platform. As the Company continues to grow and scale its business, it also remains focused on leveraging its back-office infrastructure and technology systems to drive productivity improvement across the

organization.

Interim Disclosure

The condensed consolidated financial statements included herein have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. The Company's management believes that the disclosures are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended June 30, 2018.

The interim period information included in this Quarterly Report on Form 10-Q reflects all adjustments, consisting of normal recurring adjustments, that are, in the opinion of the Company's management, necessary for a fair statement of the results of the respective interim periods. Results of operations for interim periods are not necessarily indicative of results to be expected for an entire year.

NOTE 2 - RECENT ACCOUNTING GUIDANCE

Recent Accounting Guidance Not Yet Adopted

In August 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2018-15 (Subtopic 350-40), Intangibles - Goodwill and Other - Internal-Use Software - Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract. This ASU aligns the accounting for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the accounting for implementation costs incurred to develop or obtain internal-use software. ASU 2018-15 is effective for the Company in the first quarter of fiscal year 2021, and early adoption is permitted. The Company is assessing the impact of this guidance on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement (ASU 2018-13), which modifies the disclosure requirements on fair value measurements. ASU 2018-13 is effective for the Company in the first quarter of fiscal 2021, and earlier adoption is permitted. The Company is assessing the impact of this guidance on its consolidated financial statements.

In February 2016 and July 2018, the FASB issued Accounting Standard Update ("ASU") 2016-02 (ASC Topic 842), Leases ASU 2018-10, Codification Improvements to Topic 842, and Leases, ASU 2018-11, Leases (Topic 842), Target improvements, respectively. These ASUs amend a number of aspects of lease accounting, including requiring lessees to recognize operating leases with a term greater than one year on their balance sheet as a right-of-use asset and corresponding lease liability, measured at the present value of the lease payments. Topic 842 is effective for the Company in the first quarter of fiscal year 2020. Companies are required to use a modified retrospective approach on adoption, with the option of applying the requirements of the standard either (1) retrospectively to each prior comparative reporting period presented, or (2) retrospectively at the beginning of the period of adoption, through a cumulative-effect adjustment to retained earnings. The Company is currently evaluating the impact of the standard on its consolidated financial statements and disclosures.

In February 2018, the FASB issued ASU 2018-02 (Topic 220), Income Statement—Reporting Comprehensive Income: Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This ASU was issued following the enactment of the U.S. Tax Cuts and Jobs Act of 2017 (the "Tax Act") and permits entities to elect a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Act. Topic 220 is effective for the Company in the first quarter of fiscal year 2020, and early adoption is permitted. The Company is assessing the impact of this guidance on its consolidated financial statements.

Recently Adopted Accounting Guidance

ASC 606 - Revenue from Contracts with Customers

On July 1, 2018, the Company adopted ASU 2014-09, Revenue from Contracts with Customers and all subsequent amendments to the ASU (collectively, "ASC 606") which superseded existing revenue recognition guidance under U.S. GAAP. The core principle of Accounting Standards Codification ("ASC") 606 is for an entity to recognize revenue to depict the transfer of promised goods or services to its customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also requires more detailed

disclosures to enable users of the financial statements to understand the nature, amount, timing and uncertainty of an entity's revenues and cash flows arising from contracts with customers.

The Company adopted ASC 606 using the modified retrospective method applied to those contracts not completed as of July 1, 2018. Results for reporting periods beginning after July 1, 2018 are presented under ASC 606 while prior period amounts continue to be reported in accordance with ASC 605. The Company recorded a cumulative effect adjustment of $335, net of tax, to decrease the opening balance of retained earnings as of July 1, 2018, for the initial application of ASC 606. The transition adjustment includes primarily certain transportation services transactions with customers that required a change in the timing of when revenue is recognized. The corresponding direct costs of revenue, including primarily purchased transportation costs and commissions, have been expensed as incurred. The Company satisfied a significant majority of the performance obligations for contract liabilities recorded upon the adoption and recognized the corresponding revenues and related direct costs of revenue during the three months ended September 30, 2018.

As stated, the comparative prior period information for the three months ended September 30, 2017 has not been adjusted and continues to be reported under the Company's historical revenue recognition policies as described in Note 2 to the consolidated financial statements in the Annual Report on Form 10-K filed on September 13, 2018.

The details of the significant changes and quantitative impact on the financial statement line items in the consolidated balance sheet as of July 1, 2018 for the adoption of ASC 606 were as follows:

(In thousands)	Balance as of June 30, 2018	Transition Adjustments	Balance as of July 1, 2018
Condensed Consolidated Balance Sheet			
Assets			
Accounts receivable, net of allowance for doubtful accounts	$137,578	$ (32,689)	$104,889
Contract assets	—	34,014	34,014
Liabilities			
Accounts payable	90,153	(3,995)	86,158
Operating partner commissions payable	14,322	(959)	13,363
Contract liabilities	—	6,716	6,716
Deferred income taxes	8,665	(102)	8,563
Equity			
Retained earnings	15,539	(335)	15,204

The tables below summarize the impacts of the application of ASC 606 as compared with ASC 605, the guidance that was in effect before the change on the condensed consolidated statements of operations for the three months ended September 30, 2018 and condensed consolidated balance sheet as of September 30, 2018:

	Three Months Ended September 30, 2018		
(In thousands, except per share data)	As Reported	Adjustments for ASC 606	Balance, ASC 605
Condensed Consolidated Statement of Operations			
Revenues	$218,883	$ (3,152)	$215,731
Operating expenses:			
Cost of transportation and other services	164,015	(2,917)	161,098
Operating partner commissions	24,828	(156)	24,672
Personnel costs	14,545	—	14,545
Selling, general and administrative expenses	7,124	—	7,124
Depreciation and amortization	3,633	—	3,633
Change in fair value of contingent consideration	(95)	—	(95)
Total operating expenses	214,050	(3,073)	210,977
Income from operations	4,833	(79)	4,754
Total other expense	(593)	—	(593)
Income before income taxes	4,240	(79)	4,161
Income tax expense	(977)	19	(958)

Net income	3,263	(60)	3,203
Less: net income attributable to noncontrolling interest	(180)	—	(180)
Net income attributable to Radiant Logistics, Inc.	3,083	(60)	3,023
Less: preferred stock dividends	(511)	—	(511)
Net income allocable to common stockholders	$2,572	$ (60)	$2,512
Income per share allocable to common stockholders			
- Basic and Diluted	$0.05	$ —	$0.05

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	September 30, 2018		
(In thousands)	As Reported	Adjustments for ASC 606	Balance, ASC 605
Condensed Consolidated Balance Sheet			
Assets			
Accounts receivable, net of allowance	$ 100,444	$ 24,102	$ 124,546
Contract assets	27,254	(27,254)	—
Liabilities			
Accounts payable	80,462	(2,917)	77,545
Operating partner commissions payable	13,869	(156)	13,713
Accrued expenses	6,608	—	6,608
Deferred income taxes	8,297	(19)	8,278
Equity			
Retained earnings	16,071	(60)	16,011

The adoption of ASC 606 did not have a material impact on the condensed consolidated statement of cash flows for the three months ended September 30, 2018.

The disclosure requirements of ASC 606 are included within the Company's revised revenue recognition accounting policy in Note 3 below.

ASU 2016-16 – Income Taxes

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory, which provides for the recognition of the income tax consequences on intra-entity asset transfers other than inventory when the transfer occurs.

On July 1, 2018, the Company adopted ASU 2016-16 using the modified retrospective method. The Company recorded a cumulative-effect adjustment of $1,705 directly to the beginning balance of retained earnings and deposits and other assets as of July 1, 2018. The adjustment reflects the recognition of the income tax consequence on the intra-entity transfer of stock of a subsidiary that occurred in a prior year. Under the modified retrospective method, the prior periods in a financial report do not have to be adjusted to reflect the new accounting requirements.

NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a) Principles of Consolidation

The condensed consolidated financial statements include the accounts of Radiant Logistics, Inc. and its wholly-owned subsidiaries as well as a single variable interest entity, Radiant Logistics Partners, LLC ("RLP"), which is 40% owned by Radiant Global Logistics, Inc. ("RGL"), and 60% owned by Radiant Capital Partners, LLC ("RCP", see Note 10), an entity owned by the Company's Chief Executive Officer. All significant intercompany balances and transactions have been eliminated.

Non-controlling interest in the condensed consolidated balance sheets represents the minority stockholders' proportionate share of equity in such subsidiary. Consolidated net income (loss) is allocated to the Company and non-controlling interest (minority stockholder) in proportion to their percentage ownership.

b) Use of Estimates

The preparation of financial statements and related disclosures in accordance with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be based upon amounts that could differ from these estimates.

c) Cash and Cash Equivalents

The Company maintains its cash in bank deposit accounts that, at times, may exceed federally-insured limits. The Company has not experienced any losses in such accounts.

d) Accounts Receivable

The Company's receivables are recorded when billed and represent amounts owed by third-party customers, as well as amounts owed by strategic operating partners. The carrying value of the Company's receivables, net of the allowance for doubtful accounts, represents their estimated net realizable value. The Company evaluates the collectability of accounts receivable on a customer-by-customer basis. The Company records an allowance for doubtful accounts to reduce the net recognized receivable to an amount the Company believes will be reasonably collected. The allowance for doubtful accounts is determined from the analysis of the aging of the accounts receivables, historical experience and knowledge of specific customers.

The Company derives a substantial portion of its revenue through independently-owned strategic operating partner locations operating under various Company brands. Each strategic operating partner is responsible for some or all of the collection of the accounts related to the underlying customers being serviced by such strategic operating partner. To facilitate this arrangement, based on contractual agreements, certain strategic operating partners are required to maintain a bad debt reserve in the form of a security deposit with the Company. The Company charges each strategic operating partner's bad debt reserve account for any accounts receivable aged beyond 90 days along with any other amounts owed to the Company by strategic operating partners. However, the bad debt reserve account may carry a deficit balance when amounts charged to this reserve account exceed amounts otherwise available. In these circumstances, a deficit bad debt reserve account is recognized as a receivable in the Company's financial statements. Some strategic operating partners are not required to establish a bad debt reserve; however, they are still responsible to make up for any deficits and the Company may withhold all or a portion of future commissions payable to the strategic operating partner to satisfy any deficit balance. Currently, a number of the Company's strategic operating partners have a deficit balance in their bad debt reserve accounts. The Company expects to replenish these funds through the future business operations of these strategic operating partners or as their customers satisfy the amounts payable to the Company. However, to the extent any of these strategic operating partners were to cease operations or otherwise be unable to replenish these deficit accounts, the Company would be at risk of loss for any such amounts and therefore has reserved for them.

e) Technology and Equipment

Technology and equipment is stated at cost, less accumulated depreciation and amortization. Depreciation and amortization is computed using the straight-line method over the estimated useful lives of the related assets. Upon retirement or other disposition of these assets, the cost and related accumulated depreciation or amortization are removed from the accounts and the resulting gain or loss, if any, is reflected in other income or expense. Expenditures for maintenance, repairs and renewals of minor items are expensed as incurred. Major renewals and improvements are capitalized.

f) Goodwill

Goodwill represents the excess acquisition cost of an acquired entity over the estimated fair values assigned to the net tangible and identifiable intangible assets acquired. The Company typically performs its annual goodwill impairment test effective as of April 1 of each year or more frequently if facts or circumstances indicate that the carrying amount may not be recoverable.

An entity has the option to perform a qualitative assessment to determine whether it is more-likely-than-not that the fair value of the reporting unit is less than its carrying amount prior to performing a quantitative impairment test. The qualitative assessment evaluates various factors, such as macro-economic conditions, industry and market conditions, cost factors, relevant events and financial trends that may impact the fair value of the reporting unit. If it is determined that the estimated fair value of the reporting unit is more-likely-than-not less than its carrying amount, including goodwill, a quantitative assessment is required. Otherwise, no further analysis is required.

If a quantitative assessment is performed, a reporting unit’s fair value is compared to its carrying value. A reporting unit’s fair value is determined based upon consideration of various valuation methodologies, including the income approach, which utilizes projected future cash flows discounted at rates commensurate with the risks involved, and multiples of current and future earnings. If the fair value of a reporting unit is less than its carrying amount, an impairment charge is recognized for the amount by which the carrying amount exceeds the reporting unit’s fair value; however, the loss recognized cannot exceed the total amount of goodwill allocated to that reporting unit. As of September 30, 2018, management believes there are no indications of impairment.

g) Long-Lived Assets

Long-lived assets, such as technology and equipment, and definite-lived intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable. If circumstances require a long-lived asset or asset group to be tested for possible impairment, the Company compares the undiscounted expected future cash flows to be generated by that asset or asset group to its carrying amount. If the carrying amount of the long-lived asset or asset group is not recoverable on an undiscounted cash flow basis, an impairment charge is recognized to the extent the carrying amount of the asset or asset group exceeds the fair value. Fair values of long-lived assets are determined through various techniques, such as applying probability weighted, expected present value calculations to the estimated future cash flows using assumptions a market participant would utilize, or through the use of a third-party independent appraiser or valuation specialist.

Management has performed a review of all long-lived assets and has determined no impairment of the respective carrying value has occurred as of September 30, 2018. Intangibles consist of customer related intangibles, trade names and trademarks, and non-compete agreements arising from the Company's acquisitions. Customer related intangibles are amortized using the straight-line method over a period of up to 10 years, trademarks and trade names are amortized using the straight-line method over 15 years, and non-compete agreements are amortized using the straight-line method over the term of the underlying agreements.

h) Business Combinations

The Company accounts for business acquisitions using the acquisition method as required by FASB ASC Topic 805, Business Combinations. The assets acquired and liabilities assumed in business combinations, including identifiable intangible assets, are recorded based upon their estimated fair values as of the acquisition date. The excess of the purchase price over the estimated fair value of the net tangible and identifiable intangible assets acquired is recorded as goodwill. Acquisition expenses are expensed as incurred. While the Company uses its best estimates and assumptions to accurately value assets acquired and liabilities assumed as of the acquisition date, the estimates are inherently uncertain and subject to refinement.

The fair values of intangible assets are estimated using a discounted cash flow approach with Level 3 inputs. The estimate of fair value of an intangible asset is equal to the present value of the incremental after-tax cash flows (excess earnings) attributable solely to the intangible asset over its remaining useful life. To estimate fair value, the Company uses risk-adjusted cash flows discounted at rates considered appropriate given the inherent risks associated with each type of asset. The Company believes the level and timing of cash flows appropriately reflects market participant assumptions.

For acquisitions that involve contingent consideration, the Company records a liability equal to the fair value of the contingent consideration obligation as of the acquisition date. The Company determines the acquisition date fair value of the contingent consideration based on the likelihood of paying the additional consideration. The fair value is estimated using projected future operating results and the corresponding future earn-out payments that can be earned upon the achievement of specified operating objectives and financial results by acquired companies using Level 3 inputs and the amounts are then discounted to present value. These liabilities are measured quarterly at fair value, and any change in the fair value of the contingent consideration liability is recognized in the condensed consolidated statements of comprehensive income. Amounts are generally due annually on November 1st, and 90 days following the quarter of the final earn-out period of each respective acquisition.

During the measurement period, which may be up to one year from the acquisition date, the Company records adjustments to the assets acquired and liabilities assumed with the corresponding adjustment to goodwill. Upon the conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recognized in the consolidated financial statements of comprehensive income.

i) Revenue Recognition (Effective July 1, 2018)
The Company’s revenues are primarily from transportation services which includes providing for the arrangement of freight, both domestically and internationally, through modes of transportations such as air freight, ocean freight, truckload, less than truckload and intermodal. The Company generates its transportation services revenue by purchasing transportation from direct carriers and reselling those services to its customers.

In general, each shipment transaction or service order constitutes a separate contract with the customer. A performance obligation is created once a customer agreement with an agreed upon transaction price exists. The transaction price is typically fixed and not contingent upon the occurrence or non-occurrence of any other event. The transaction price is generally due 30 to 45 days from the date of invoice. The Company’s transportation transactions provide for the arrangement of the movement of freight to a customer’s destination. The transportation services, including certain ancillary services, such as loading/unloading, freight insurance and customs clearance, that is provided to the customer as a single performance obligation. These performance obligations are satisfied and recognized in revenue upon the transfer of control of the services over the requisite transit period as the customer’s goods move from origin to destination. The Company determines the period to recognize revenue in transit is based upon the departure date and the delivery date, which may be estimated if delivery has not occurred as of the reporting date. Determination of the transit period and the percentage of completion of the shipment as of the reporting date requires management to make judgments that affect the timing of

revenue recognition. The Company has determined that revenue recognition over the transit period provides a reasonable estimate of the transfer of services to its customers as it depicts the pattern of the Company's performance under the contracts with its customers.

The Company also provides warehouse and distribution logistics services for its customers under contracts generally ranging from a few months to five years and include renewal provisions. These warehouse and distribution logistics services contracts provide for inventory management, order fulfilment and warehousing of the Customer's product and arrangement of transportation of the customer's product. The Company's performance obligations are satisfied over time as the customers simultaneously receive and consume the services provided by the Company as it performs. The transaction price is based on the consideration specified in the contract with the customer and contains fixed and variable consideration. In general, the fixed consideration component of a contract represents reimbursement for facility and equipment costs incurred to satisfy the performance obligation and is recognized on a straight-line basis over the term of the contract. The variable consideration component is comprised of cost reimbursement per unit pricing for time and pricing for materials used and is determined based on cost plus a mark-up for hours of services provided and materials used and is recognized over time based on the level of activity volume.

Other services include primarily customs clearance services performed as a single performance obligation. The Company recognizes revenue from this performance obligation at a point in time which is the completion of the services. Duties and taxes collected from the customer and paid to the customs agent on behalf of the customers are excluded from revenue.

The Company uses independent contractors and third-party carriers in the performance of its transportation services. The Company evaluates who controls the transportation services to determine whether its performance obligation is to transfer services to the customer or to arrange for services to be provided by another party. The Company determined it acts as the principal for its transportation services performance obligation since it is in control of establishing the prices for the specified services, managing all aspects of the shipments process and assuming the risk of loss for delivery and collection. Such transportation services revenue is presented on a gross basis in the statement of comprehensive income.

A summary of the Company's gross revenues disaggregated by major service lines and geographic markets (reportable segments), and timing of revenue recognition for the three months ended September 30, 2018 was as follows:

(In thousands)	United States	Canada	Corporate/ Eliminations	Total
Major Service Lines:				
Transportation services	$188,249	$22,936	$ (48)	$211,137
Value added services (1)	2,969	4,777	—	7,746
Total	$191,218	$27,713	$ (48)	$218,883
Timing of Revenue Recognition:				
Services transferred over time	$190,536	$27,713	$ (48)	$218,201
Services transferred at a point in time	682	—	—	682
Total	$191,218	$27,713	$ (48)	$218,883

[(1)]Value added services includes warehouse and distribution services, and other services.

Practical Expedients

The Company has elected to not disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied as of the end of the period as the Company's contracts with its transportation customers have an expected duration of one year or less.

For the performance obligation to transfer warehouse and distribution services in contracts with customers, revenue is recognized in the amount for which the Company has the right to invoice the customer, as this amount corresponds directly with the value provided to the customer for the Company's performance completed to date.

The Company also applies the practical expedient that permits the recognition of employee sales commissions related to transportation services as an expense when incurred since the amortization period of such costs is less than one year. These costs are included in the condensed consolidated statements of comprehensive income.

Contract Assets

Contract assets represent amounts for which the Company has the right to consideration for the services provided while a shipment is still in-transit but for which it has not yet completed the performance obligation or has not yet invoiced the customer. Upon completion of the performance obligations, which can vary in duration based upon the method of transport and billing the customer, these amounts become classified within accounts receivable.

Operating Partner Commissions

The Company enters into contractual arrangements with independent agents that operate, on behalf of the Company, an office in a specific location that engages primarily in arranging, domestic and international, transportation services. In return, the independent agent is compensated through the payment of sales commissions which are based on individual shipments. The Company accrues the independent agent's commission obligation ratably as the goods are transferred to the customer.

j)Defined Contribution Savings Plans

The Company has an employee savings plan under which the Company provides safe harbor matching contributions. The Company's contributions under the plan were $223 and $195 for the three months ended September 30, 2018 and 2017, respectively.

k) Income Taxes

Income taxes are accounted for using the asset and liability method. Deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more-likely-than-not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

The Company records a liability for unrecognized tax benefits resulting from uncertain income tax positions taken or expected to be taken in an income tax return. Interest and penalties, if any, are recorded as a component of interest expense or other expense, respectively.

l) Share-Based Compensation

The Company grants restricted stock awards, restricted stock units and stock options to certain directors, officers and employees. The Company accounts for share-based compensation as equity awards such that compensation cost is measured at the grant date based on the fair value of the award and is expensed ratably over the vesting period. The fair value of restricted stock is the market price as of the grant date, and the fair value of each stock option grant is estimated as of the grant date using the Black-Scholes option pricing model. Determining the fair value of share-based awards at the grant date requires judgment about, among other things, stock volatility, the expected life of the award, and other inputs. The Company accounts for forfeitures as they occur. The Company issues new shares of common stock to satisfy exercises and vesting of awards granted under its stock plans.

m) Basic and Diluted Income per Share Allocable to Common Stockholders

Basic income per common share is computed by dividing net income allocable to common stockholders by the weighted average number of common shares outstanding. Diluted income per common share is computed by dividing net income allocable to common stockholders by the weighted average number of common shares outstanding, plus the number of additional common shares that would have been outstanding if the potential common shares, such as restricted stock awards and stock options, had been issued and were considered dilutive. Net income allocable to common stockholders is after consideration for preferred stock dividends, whether or not declared.

n) Foreign Currency Translation

For the Company's foreign subsidiaries that prepare financial statements in currencies other than U.S. dollars, the local currency is the functional currency. All assets and liabilities are translated at period-end exchange rates and all income

statement amounts are translated at the weighted average rates for the period. Translation adjustments are recorded in accumulated other comprehensive (loss) income. Gains and losses on transactions of monetary items denominated in a foreign currency are recognized in other income (expense) in the condensed consolidated statements of comprehensive income.

o) Reclassifications of Previously Issued Financial Statements

Certain amounts for prior periods have been reclassified in the condensed consolidated financial statements to conform to the current year presentation.

NOTE 4 – EARNINGS PER SHARE

The computations of the numerator and denominator of basic and diluted income per share are as follows:

(In thousands, except share data)	Three Months Ended September 30, 2018	2017
Numerator:		
Net income attributable to Radiant Logistics, Inc.	$3,083	$827
Less: preferred stock dividends	(511)	(511)
Net income allocable to common stockholders	$2,572	$316
Denominator:		
Weighted average common shares outstanding, basic	49,437,930	49,085,545
Dilutive effect of share-based awards	1,267,504	1,557,408
Weighted average common shares outstanding, diluted	50,705,434	50,642,953
Potentially dilutive common shares excluded	1,051,488	1,102,731

NOTE 5 – BUSINESS ACQUISITIONS

On September 1, 2017, the Company, through a wholly-owned subsidiary, RGL, acquired the operations and assets of Sandifer-Valley Transportation & Logistics, Ltd., a Texas based company providing a full range of domestic and international cross-border services with Mexico. The Company has structured the transaction similar to previous acquisitions, with a portion of the expected purchase price payable in subsequent periods based on future performance of the acquired operation. The consideration paid, purchase price allocation, and pro forma results of operations and other disclosures have not been presented because the effect of this acquisition was not material to the financial statements. The results of operations for the business acquired are included in the financial statements as of the date of purchase.

NOTE 6 – TECHNOLOGY AND EQUIPMENT

(In thousands)	Useful Life	September 30, 2018	June 30, 2018
Computer software	3 - 5 years	$16,445	$15,842
Trailers and related equipment	3 - 15 years	6,856	6,362
Office and warehouse equipment	3 - 15 years	3,342	3,205
Leasehold improvements	(1)	3,316	3,155
Computer equipment	3 - 15 years	2,336	2,210
Furniture and fixtures	3 - 15 years	973	919

	33,268	31,693
Less: accumulated depreciation and amortization	(14,143)	(13,127)
	$ 19,125	$ 18,566

[(1)] The cost is amortized over the shorter of the lease term or useful life.

Depreciation and amortization expense related to technology and equipment was $1,161 and $1,081 for the three months ended September 30, 2018 and 2017, respectively. Computer software includes approximately $159 and $1,168 of software currently in development as of September 30, 2018 and June 30, 2018, respectively.

NOTE 7 – INTANGIBLE ASSETS

Intangible assets consisted of the following as of September 30, 2018 and June 30, 2018, respectively:

(In thousands)	September 30, 2018			
	Weighted Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer related	5.8 years	$96,778	$ (45,336)	$51,442
Trade names and trademarks	11.3 years	14,977	(3,490)	11,487
Covenants not to compete	1.5 years	875	(749)	126
		$112,630	$ (49,575)	$63,055

(In thousands)	June 30, 2018			
	Weighted Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer related	6.1 years	$96,515	$ (43,140)	$53,375
Trade names and trademarks	11.6 years	14,977	(3,236)	11,741
Covenants not to compete	1.7 years	875	(727)	148
		$112,367	$ (47,103)	$65,264

Amortization expense amounted to $2,472 and $2,494 for the three months ended September 30, 2018 and 2017, respectively. Future amortization expense for each of the next five fiscal years ending June 30 are as follows:

(In thousands)	
2019 (remaining)	$7,537
2020	9,729
2021	9,395
2022	8,841
2023	8,363

NOTE 8 – NOTES PAYABLE

Notes payable consist of the following:

(In thousands)	September 30, 2018	June 30, 2018
Senior Credit Facility	$ 19,605	$ 21,537
Senior Secured Loans	23,531	23,965
Other debt	3,098	2,286
Unamortized debt issuance costs	(813)	(865)
Total notes payable	45,421	46,923
Less: current portion	(3,946)	(3,726)
Total notes payable, net of current portion	$ 41,475	$ 43,197

Future maturities of notes payable for each of the next five fiscal years ending June 30 and thereafter are as follows:

(In thousands)	
2019 (remaining)	$2,936
2020	4,141
2021	4,414
2022	24,312
2023	5,018
Thereafter	5,413
	$46,234

Bank of America Credit Facility

The Company has a $75,000 senior credit facility (the “Senior Credit Facility”) with Bank of America, N.A. (the “Lender”) on its own behalf and as agent to the other lenders named therein, currently consisting of the Bank of Montreal (as the initial member of the syndicate under such loan), pursuant to a Second Amendment to Amended and Restated Loan and Security Agreement. The Senior Credit Facility includes a $3,500 sublimit to support letters of credit and matures June 14, 2022.

Borrowings accrue interest based on the Company’s average daily availability at the Lender’s base rate plus 0.25% to 0.75% or LIBOR plus 1.25% to 1.75%. The Senior Credit Facility provides for advances of up to 85% of the eligible Canadian and domestic accounts receivable, 75% of eligible accrued but unbilled domestic receivables and eligible foreign accounts receivable, all of which are subject to certain sub-limits, reserves and reductions. The Senior Credit Facility is collateralized by a first-priority security interest in all of the assets of the U.S. co-borrowers, a first-priority security interest in all of the accounts receivable and associated assets of the Canadian co-borrowers (the “Canadian A/R Assets”) and a second-priority security interest on the other assets of the Canadian borrowers.

Borrowings are available to fund future acquisitions, capital expenditures, repurchase of Company stock or for other corporate purposes. The terms of the Senior Credit Facility are subject to customary financial and operational covenants, including covenants that may limit or restrict the ability to, among other things, borrow under the Senior Credit Facility, incur indebtedness from other lenders, and make acquisitions. As of September 30, 2018, the Company was in compliance with all of its covenants.

As of September 30, 2018, based on available collateral and outstanding letter of credit commitments, there was $53,400 available for borrowing under the Senior Credit Facility.

Senior Secured Loans

In connection with the Company’s acquisition of Wheels International Inc. (“Wheels”), Wheels obtained a CAD$29,000 senior secured Canadian term loan from Integrated Private Debt Fund IV LP (“IPD IV”) pursuant to a CAD$29,000,000 Credit Facilities Loan Agreement. The Company and its U.S. and Canadian subsidiaries are guarantors of the Wheels obligations thereunder. The loan matures on April 1, 2024 and accrues interest at a rate of 6.65% per annum. The Company is required to maintain five months interest in a debt service reserve account to be controlled by IPD IV. The amount of approximately $600 is recorded as deposits and other assets in the accompanying condensed consolidated financial statements. The Company made interest-only payments for the first 12 months followed by

monthly principal and interest payments of CAD$390 that will be paid through maturity.

In connection with the Company's acquisition of Lomas, Wheels obtained a CAD$10,000 senior secured Canadian term loan from Integrated Private Debt Fund V LP pursuant to a CAD$10,000,000 Credit Facilities Loan Agreement. The Company and its U.S. and Canadian subsidiaries are guarantors of the Wheels obligations thereunder. The loan matures on June 1, 2024 and accrues interest at a fixed rate of 6.65% per annum. The loan repayment consists of monthly principal and interest payments of CAD$149.

The loans may be prepaid in whole at any time providing the Company gives at least 30 days prior written notice and pays the difference between (i) the present value of the loan interest and the principal payments foregone discounted at the Government of Canada Bond Yield for the term from the date of prepayment to the maturity date, and (ii) the face value of the principal amount being prepaid.

The loans are collateralized by a (i) first-priority security interest in all of the assets of Wheels except the Canadian A/R Assets, (ii) a second-priority security interest in the Canadian A/R Assets, and (iii) a second-priority security interest on all of the Company's assets. As of September 30, 2018, the Company was in compliance with all of its covenants.

Capital Lease Facility

In April 2018, the Company, through its wholly-owned subsidiary, Clipper Exxpress Company, entered into a lease financing agreement with Bank of America Leasing & Capital, LLC, for the lease of 100 refrigerated trailers with the aggregate acquisition cost not to exceed $5,000 through December 31, 2018. As of September 30, 2018, the Company has financed approximately $3,098 of trailer equipment under the agreement. The term of the lease shall be 84 months from November 30, 2018 and as lessee, the Company will be obligated to purchase the trailers at the end of the lease for a nominal amount.

NOTE 9 – STOCKHOLDERS' EQUITY

The Company is authorized to issue 5,000,000 shares of preferred stock, par value at $0.001 per share and 100,000,000 shares of common stock, $0.001 per share.

Series A Preferred Stock

The Company has 839,200 shares issued and outstanding of 9.75% Series A Cumulative Redeemable Perpetual Preferred Stock ("Series A Preferred Shares issued and outstanding"), which have a liquidation preference of $25.00 per share. Dividends on the Series A Preferred Shares are cumulative from the date of original issue and are payable on January 31, April 30, July 31 and October 31, as and if declared by the Company's board of directors. If the Company does not pay dividends in full on any two payment dates (whether consecutive or not), the per annum dividend rate will increase an additional 2.0% per annum per $25.00 stated liquidation preference, up to a maximum of 19.0% per annum. If the Company fails to maintain the listing of the Series A Preferred Shares on the NYSE American or other exchange for 30 days or more, the per annum dividend rate will increase by an additional 2.0% per annum so long as the listing failure continues. The Series A Preferred Shares require the Company to maintain a Fixed Charge Coverage Ratio of at least 2.0. If the Company is not in compliance with this ratio, then it cannot pay any dividend on its common stock. As of September 30, 2018, the Company was in compliance with this ratio.

Commencing on December 20, 2018, the Company may redeem, at its option, the Series A Preferred Shares, in whole or in part, at a cash redemption price of $25.00 per share plus accrued and unpaid dividends (whether or not declared). Among other things, the Series A Preferred Shares have no stated maturity, are not subject to any sinking fund or other mandatory redemption, and are not convertible into or exchangeable for any of the Company's other securities. Holders of Series A Preferred Shares generally have no voting rights, except if the Company fails to pay dividends on the Series A Preferred Shares for six or more quarterly periods (whether consecutive or not). Under such circumstances, holders of Series A Preferred Shares will be entitled to vote to elect two additional directors to the Company's board of directors, until all unpaid dividends have been paid or declared and set aside for payment. In addition, certain changes to the terms of the Series A Preferred Shares cannot be made without the affirmative vote of the holders of two-thirds of the outstanding Series A Preferred Shares, voting as a separate class. The Series A Preferred Shares are senior to the Company's common stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series A Preferred Shares are listed on the NYSE American under the symbol "RLGT-PA."

For the three months ended September 30, 2018, the Company's board of directors declared and paid cash dividends to holders of Series A Preferred Shares in the amount of $0.609375 per share, totaling $511.

Common Stock

In March 2018, the Company's board of directors authorized the repurchase of up to 5,000,000 shares of the Company's common stock through December 31, 2019. There have been no purchases of common stock executed under the

repurchase program through the date of this filing. Under the stock repurchase program, the Company is authorized to repurchase, from time-to-time, shares of its outstanding common stock in the open market at prevailing market prices or through privately negotiated transactions as permitted by securities laws and other legal requirements. The program does not obligate the Company to repurchase any specific number of shares and could be suspended or terminated at any time without prior notice.

NOTE 10 – VARIABLE INTEREST ENTITY AND RELATED PARTY TRANSACTIONS

RLP is owned 40% by RGL and 60% by RCP, a company for which the Chief Executive Officer of the Company is the sole member. RLP is a certified minority business enterprise that was formed for the purpose of providing the Company with a national accounts strategy to pursue corporate and government accounts with diversity initiatives. RCP's ownership interest entitles it to a majority of the profits and distributable cash, if any, generated by RLP. The operations of RLP are intended to provide certain benefits to the Company, including expanding the scope of services offered by the Company and participating in supplier diversity programs not otherwise available to the Company. In the course of evaluating and approving the ownership structure, operations and economics emanating from RLP, a committee consisting of the independent Board member of the Company, considered, among other factors, the significant benefits provided to the Company through association with a minority business enterprise, particularly as many of the Company's largest current and potential customers have a need for diversity offerings. In addition, the committee concluded that the economic relationship with RLP was on terms no less favorable to the Company than terms generally available from unaffiliated third-parties.

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Certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have the sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties are considered variable interest entities. RLP qualifies as a variable interest entity and is consolidated in these consolidated financial statements.

RLP recorded $300 in profits, of which RCP's distributable share was $180, for the three months ended September 30, 2018. RLP recorded $102 in profits, of which RCP's distributable share was $61 for the three months ended September 30, 2017. The non-controlling interest recorded as a reduction of income in the condensed consolidated statements of comprehensive income represents RCP's distributive share.

NOTE 11 – FAIR VALUE MEASUREMENTS

The accounting guidance for fair value, among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the reporting date. The framework for measuring fair value consists of a three-level valuation hierarchy that prioritizes the inputs to valuation techniques used to measure fair value based upon whether such inputs are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect market assumptions made by the reporting entity. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs utilize observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The fair value measurement level within the hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Assets and liabilities measured at fair value are based on one or more of the following three valuation techniques:

- Market approach: Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities;
- Cost approach: Amount that would be required to replace the service capacity of an asset (replacement cost); and
- Income approach: Techniques to convert future amounts to a single present amount based upon market expectations, including present value techniques, option-pricing and excess earning models.

Items Measured at Fair Value on a Recurring Basis

The following table sets forth the Company's financial liabilities measured at fair value on a recurring basis:

(In thousands)	Fair Value Measurements as of September 30, 2018	
	Level 3	Total
Contingent consideration	$2,480	$2,480

	Fair Value Measurements as of June 30, 2018	
	Level 3	Total
Contingent consideration	$2,575	$2,575

The following table provides a reconciliation of the financial liabilities measured at fair value using significant unobservable inputs (Level 3):

(In thousands)	Contingent Consideration
Balance as of June 30, 2018	$ 2,575
Change in fair value	(95)
Balance as of September 30, 2018	$ 2,480

The Company has contingent obligations to transfer cash payments and equity shares to former shareholders of acquired operations in conjunction with certain acquisitions if specified operating results and financial objectives are met over the next four fiscal years. Contingent consideration is measured quarterly at fair value, and any change in the fair value of the contingent liability is included in the condensed consolidated statements of comprehensive income. The Company recorded decreases to contingent consideration of $95 and $300 for the three months ended September 30, 2018 and 2017, respectively. The change in the current period is principally attributable to a net decrease in management's estimates of future earn-out payments through the remainder of its earn-out periods.

The Company uses projected future financial results based on recent and historical data to value the anticipated future earn-out payments. To calculate fair value, the future earn-out payments were then discounted using Level 3 inputs. The Company has classified the contingent consideration as Level 3 due to the lack of relevant observable market data over fair value inputs. The Company believes the discount rate used to discount the earn-out payments reflects market participant assumptions. Changes in assumptions and operating results could have a significant impact on the earn-out amount, up to a maximum of $10,980 through earn-out periods measured through August 2021, although there are no maximums on certain earn-out payments. Contingent consideration is net of advances of earn-out payments of $530, and includes approximately $1,100 that was earned during fiscal year 2018 and is payable November 2018.

Fair Value of Financial Instruments

The carrying values of the Company's cash, receivables, accounts payable, commissions payable, accrued expenses, and the income tax receivable approximate the fair values due to the relatively short maturities of these instruments. The carrying value of the Company's credit facility, notes payable and other long-term liabilities would not differ significantly from fair value (based on Level 2 inputs) if recalculated based on current interest rates.

NOTE 12 – INCOME TAXES

For the three months ended September 30, 2018 and 2017, respectively, the Company's income tax expense is composed of the following:

(In thousands)	Three Months Ended September 30,	
	2018	2017
Current income tax expense	$1,230	$1,138
Deferred income tax benefit	(253)	(512)
Income tax expense	$977	$626

The Tax Cuts and Jobs Act (the "Act") was enacted on December 22, 2017. The Act contains significant changes to the U.S. federal income tax laws, including reduction of the corporate tax rate from a top marginal rate of 35% to a flat rate of 21%. Additionally, the Act requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creates a new tax on certain foreign-sourced earnings. The Company has made a reasonable estimate of the effects on existing deferred tax balances and the one-time transition tax, and has not recorded any adjustments to the provisional amounts. The estimated amount of the one-time transition tax is expected to be insignificant due to the Company's controlled foreign companies' negative earnings and profits. The final impact of the Act may differ due to and among other things, changes in interpretations, assumptions made,

the issuance of additional guidance, and actions the Company may take as a result of the Act.

The Company's effective tax rates for the three months ended September 30, 2018 and 2017 are higher than the U.S. federal statutory rates primarily due to earnings in foreign operations and state taxes. The Company does not have any uncertain tax positions and has a federal net operating loss carryover of approximately $2,121 due to expire primarily through 2027 fiscal year and a foreign net operating loss carryover of approximately $1,647 due to expire through the 2038 fiscal year.

The Company and its wholly-owned U.S. subsidiaries file a consolidated Federal income tax return. The Company also files unitary or separate returns in various state, local, and non-U.S. jurisdictions based on state, local and non-U.S. filing requirements. Tax years which remain subject to examination by U.S. authorities are the years ended June 30, 2015 through June 30, 2018. Tax years which remain subject to examination by state authorities are the years ended June 30,2014 through June 30, 2018. Tax years which remain subject to examination by non-U.S. authorities are the periods ended December 31, 2014 through June 30, 2018. Occasionally acquired entities have tax years that differ from the Company and are still open under the relevant statute of limitations and therefore are subject to potential adjustment.

The Company's Canadian Subsidiary, Wheels International, Inc., is currently under examination by the Canada Revenue Agency for the year 2015. The amount of potential exposure, if any, is unknown and there is no reason to believe the Company should record a reserve.

NOTE 13 – SHARE-BASED COMPENSATION

The Company has two stock-based plans: the 2005 Stock Incentive Plan and the 2012 Stock Option and Performance Award Plan. Each plan authorizes the granting of up to 5,000,000 shares of the Company's common stock. The plans provide for the grant of stock options, stock appreciation rights, shares of restricted stock, restricted stock units, performance shares and performance units. Restricted stock awards and units are equivalent to one share of common stock and generally vest after three years. The Company does not plan to make additional grants under the 2005 Stock Incentive Plan.

Restricted Stock Awards

The Company recognized share-based compensation expense related to stock awards of $105 and $81 for the three months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, there was $1,234 of total unrecognized share-based compensation cost. Such costs are expected to be recognized over a weighted average period of approximately 2.02 years.

The following table summarizes stock award activity under the plans:

	Number of Units	Weighted Average Fair Value
Unvested balance as of June 30, 2018	490,829	$ 3.88
Granted	64,573	4.40
Forfeited	(31,574)	3.97
Unvested balance as of September 30, 2018	523,828	$ 3.94

Stock Options

Options are granted at exercise prices equal to the fair value of the common stock at the date of the grant and have a term of 10 years. Generally, grants under each plan vest 20% annually over a five-year period from the date of grant. The Company recognized share-based compensation expense related to stock options of $226 and $269 and for the three months ended September 30, 2018 and 2017, respectively. The aggregate intrinsic value of options exercised was $210 and $4 for the three months ended September 30, 2018 and 2017. As of September 30, 2018, there was $1,241 of total unrecognized share-based compensation cost. Such costs are expected to be recognized over a weighted average period of approximately 1.83 years.

The following table summarizes stock option activity under the plans:

Number of Shares	Weighted Average	Weighted Average Remaining	Aggregate Intrinsic Value

		Exercise Price	Contractual Life (Years)	(in thousands)
Outstanding as of June 30, 2018	2,795,588	$ 3.22	5.60	$ 2,815
Exercised	(101,709)	2.53	—	210
Forfeited	(25,892)	6.08	—	—

			$ 578	$ 1,026	$ 17,844
Receivables	1,039	1,911	4,863		
Inventory	20,802	23,230	42,226		
Prepaid expenses and other	395	1,166	2,820		
Deferred tax assets	668	859	1,059		
Total current assets	23,482	28,192	68,812		
Leasehold improvements and equipment, net	18,076	26,619	30,854		
Total assets	$ 41,558	$ 54,811	$ 99,666		
Liabilities and Shareholders Equity					
Current liabilities					
Current portion of long-term debt	$ 544	$	$		
Revolving credit facility	300				
Book overdraft	4,464	429			
Trade accounts payable	9,273	11,240	25,168		
Accrued payroll and payroll taxes	1,609	2,561	2,481		
Income taxes payable	1,846	2,611			
Current portion of deferred rent and tenant allowances	319	1,045	960		
Other accrued liabilities	2,152	5,550	4,828		
Total current liabilities	20,507	23,436	33,437		
Long-term debt, less current portion					
Long-term deferred rent and tenant allowances, less current portion	1,277	4,065	5,794		
Deferred tax liabilities	1,336	1,511	1,182		
Total liabilities	$ 23,120	$ 29,012	$ 40,413		
Commitments and contingencies (Note 9)					
Shareholders equity					
Preferred stock, no par value, 20,000,000 shares authorized; none issued and outstanding at January 31, 2004, January 29, 2005 and July 30, 2005 (unaudited)					
Common stock, no par value, 50,000,000 shares authorized; 11,305,261, 11,305,261 and 13,457,330 shares issued and outstanding at January 31, 2004, January 29, 2005 and July 30, 2005 (unaudited), respectively	44	44	32,460		
Employee stock options		95	177		
Retained earnings	18,541	25,808	26,616		
Receivable from parent	(147)	(148)			
Total shareholders equity	18,438	25,799	59,253		
Total liabilities and shareholders equity	$ 41,558	$ 54,811	$ 99,666		

The accompanying notes are an integral part of these financial statements

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ZUMIEZ INC.
STATEMENTS OF OPERATIONS
(In thousands, except share and per share amounts)

	Fiscal Year Ended December 31, 2002	One Month Ended February 1, 2003	Fiscal Year Ended January 31, 2004	January 29, 2005	Six Months Ended July 31, 2004 (unaudited)	July 30, 2005
Net sales	$ 101,391	$ 6,392	$ 117,857	$ 153,583	$ 55,444	$ 72,776
Cost of goods sold	71,017	4,575	81,320	103,152	40,212	50,154
Gross margin	30,374	1,817	36,537	50,431	15,232	22,622
Selling, general and administrative expenses	23,404	2,013	29,076	38,422	15,639	21,332
Operating profit (loss)	6,970	(196)	7,461	12,009	(407)	1,290
Other income (expense)	148		8	8	2	1
Interest income (expense)	(317)	(12)	(293)	(250)	(156)	48
Earnings (loss) before income taxes	6,801	(208)	7,176	11,767	(561)	1,339
Provision (benefit) for income taxes	1,096	(39)	2,701	4,500	(122)	531
Net income (loss)	$ 5,705	$ (169)	$ 4,475	$ 7,267	$ (439)	$ 808
Basic net income (loss) per share	$ 0.49	$ (0.01)	$ 0.40	$ 0.64	$ (0.04)	$ 0.07
Diluted net income (loss) per share	$ 0.42	$ (0.01)	$ 0.35	$ 0.56	$ (0.04)	$ 0.06
Weighted average shares outstanding						
Basic	11,547,012	11,305,261	11,305,261	11,305,261	11,305,261	12,296,076
Diluted	13,581,579	11,305,261	12,811,855	12,938,858	11,305,261	13,115,740

The accompanying notes are an integral part of these financial statements

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ZUMIEZ INC.
STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY
(In thousands)

	Common Stock Shares	Amount	Additional Paid-In Capital	Employee Stock Options	Retained Earnings	Receivable from Parent	Total
Balance at December 31, 2001	11,014	$ 43	$ 407	$	$ 11,467		$ 11,917
Dividends declared					(922)		(922)
Stock issued upon exercise of options	580	2	98				100
Stock redemption	(1,645)	(6)	(6,549)		(2,015)		(8,570)
Stock purchased by parent	1,356	5	6,044			(143)	5,906
Net income					5,705		5,705
Balance at December 31, 2002	11,305	$ 44	$	$	$ 14,235	$ (143)	$ 14,136
Net loss					(169)		(169)
Balance at February 1, 2003	11,305	$ 44	$	$	$ 14,066	$ (143)	$ 13,967
Cost incurred on behalf of parent						(4)	(4)
Net income					4,475		4,475
Balance at January 31, 2004	11,305	$ 44	$	$	$ 18,541	$ (147)	$ 18,438
Stock based compensation				95			95
Cost incurred on behalf of parent						(1)	(1)
Net income					7,267		7,267
Balance at January 29, 2005	11,305	$ 44	$	$ 95	$ 25,808	$ (148)	$ 25,799
Common shares issued, including tax benefit of $2.5 million (unaudited)	2,152	32,416					32,416
Stock based compensation (unaudited)				82			82
Cost incurred on behalf of parent (unaudited)						(1)	(1)
Parent receivable forgiven (unaudited)						149	149
Net income (unaudited)					808		808
Balance at July 30, 2005 (unaudited)	13,457	$ 32,460	$	$ 177	$ 26,616	$	$ 59,253

The accompanying notes are an integral part of these financial statements

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ZUMIEZ INC.
STATEMENTS OF CASH FLOWS
(In thousands)

	Fiscal Year Ended December 31, 2002	One Month Ended February 1, 2003	Fiscal Year Ended January 31, 2004	January 29, 2005	Six Months Ended July 31, 2004 (unaudited)	July 30, 2005
Cash flows from operating activities						
Net income (loss)	$ 5,705	$ (169)	$ 4,475	$ 7,267	$ (439)	$ 808
Adjustments to reconcile net income (loss) to net cash provided by operating activities						
Depreciation	3,571	332	4,185	5,857	2,569	3,466
Deferred tax expense	(136)	83	804	(16)	(116)	(528)
Stock compensation expense				95		82
Loss on disposal of assets	13		33	126	3	19
Changes in operating assets and liabilities						
Receivables	(317)	133	(272)	(872)	(381)	(2,952)
Inventory	(4,194)	(94)	(1,957)	(1,456)	(10,056)	(13,581)
Prepaid expenses	(179)	(24)	(79)	(771)	(99)	(1,654)
Trade accounts payable	1,599	(2,937)	(2,423)	995	5,567	8,513
Accrued payroll and payroll taxes	270	(1,007)	449	952	464	(80)
Income taxes payable	1,056	(120)	826	765	(2,697)	(2,611)
Other accrued liabilities	118	(682)	564	3,397	376	(575)
Deferred rent	433	34	370	48	176	306
Net cash provided by (used in) operating activities	$ 7,939	$ (4,451)	$ 6,975	$ 16,387	$ (4,633)	$ (8,787)
Cash flows from investing activities						
Additions to leasehold improvements and equipment	$ (7,186)	$ (42)	$ (5,937)	$ (11,060)	$ (4,817)	$ (6,382)
Advances (to) from shareholders	(109)					
Net cash used in investing activities	$ (7,295)	$ (42)	$ (5,937)	$ (11,060)	$ (4,817)	$ (6,382)
Cash flows from financing activities						
Change in book overdraft	$ 2,293	$ 2,774	$ 1,690	$ (4,035)	$ (1,168)	$ (429)
Borrowings on revolving credit facility	20,440	1,845	25,620	37,852	24,373	16,450
Payments on revolving credit facility	(20,440)		(27,165)	(38,152)	(12,044)	(16,450)
Proceeds from sale of stock						32,416
Principal payments on long-term debt	(1,087)	(272)	(1,087)	(544)	(544)	
Proceeds from exercise of stock options	100					
Stock purchased by parent	6,049					
Redemption of common stock		(7,094)				
Dividends paid	(922)					
Net cash provided by (used in) financing activities	$ 6,433	$ (2,747)	$ (942)	$ (4,879)	$ 10,617	$ 31,987
Net (decrease) increase in cash and cash equivalents	$ 7,077	$ (7,240)	$ 96	$ 448	$ 1,167	$ 16,818
Cash and cash equivalents						
Beginning of period	645	7,722	482	578	578	1,026
End of period	$ 7,722	$ 482	$ 578	$ 1,026	$ 1,745	$ 17,844
Supplemental disclosure of cash flow information						
Cash paid during the period for interest	$ 302	$ 12	$ 265	$ 250	$ 103	$ 59
Cash paid during the period for income taxes	176		1,172	3,812	2,752	2,605

The accompanying notes are an integral part of these financial statements

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NOTES TO FINANCIAL STATEMENTS

1. Nature and Ownership of Business and Basis of Presentation

Nature of Business Zumiez Inc. (the Company) is a leading specialty retailer of action sports related apparel, footwear, equipment and accessories operating under the Zumiez brand name. As of July 30, 2005, the Company operated 150 stores primarily located in shopping malls, giving the Company a presence in 18 states. The Company s 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. The Company supports the action sports lifestyle and promotes its brand through a multi-faceted marketing approach that is designed to integrate its brand image with its customers activities and interests. In addition, the Company operates a website which sells merchandise online and provides content and a community for its target customers. The Company, based in Everett, WA, was formed in August 1978 and operates within one reportable segment.

Change in Ownership Effective November 4, 2002, 95% of the shares of the Company were transferred to Zumiez Holdings LLC (the Parent) in exchange for cash, the redemption of a note receivable and the creation of two notes payable to two of the shareholders (the Transaction). In connection with the Transaction, the Company entered into common stock redemption agreements with two shareholders. Pursuant to the terms of the redemption agreements with these shareholders, the Company redeemed 1,485,651 shares of its common stock held by one shareholder for an aggregate purchase price of approximately $7.7 million, which amount was paid by the Company through delivery of a note payable for approximately $6.2 million and the cancellation of a $1.5 million note receivable and the Company redeemed 159,095 shares of common stock held by the other shareholder for an aggregate purchase price of approximately $829,000, which amount was paid by the Company through delivery of a note payable for approximately $829,000. Each of these notes payable have been paid in full.

Also on November 4, 2002, approximately 43% of the Parent was sold to certain affiliates (the Brentwood Affiliates) of Brentwood Private Equity III, LLC, a private equity firm, for approximately $25.3 million, of which approximately $17.1 million was distributed to two of the original shareholders of the Company. The Transaction did not result in a change in the operating control of the Company. While the Brentwood Affiliates have certain protective rights regarding their investment in the Parent, and therefore the Company, two of the Company s shareholders continue to serve in the function of the primary operating roles of the Company Chairman and Chief Executive Officer. In fiscal 2002, 2003 and 2004 the Company paid Brentwood Private Equity III, LLC consulting fees of $31,000, $200,000 and $200,000, respectively, under a Corporate Development and Administrative Services Agreement.

As part of the Transaction, the Company also authorized 20,000,000 shares of preferred stock, with a no par value. Subsequent to January 1, 2003 and prior to March 1, 2004, the Company had the right to require the Brentwood Affiliates to purchase at least $5.0 million, but no more than $10.0 million in the aggregate, of preferred stock. The Company did not exercise this right and no preferred stock was issued.

Also effective November 4, 2002, the Company terminated its Subchapter S tax election and elected to be taxed as a Subchapter C corporation under the Internal Revenue Code. As a result, the Company has been subject to federal and state income taxes beginning as of November 4, 2002. Prior to this date, the shareholders were taxed on the earnings of the Company on their personal income tax returns, in accordance with Subchapter S of the Internal Revenue Code. Therefore, no provision for income taxes or deferred taxes is recorded in these financial statements for operating results through November 3, 2002. Upon the conversion to a Subchapter C corporation, the Company recorded a net deferred tax asset of $373,000.

Fiscal Year Subsequent to December 31, 2002, the Company changed its fiscal year end from December 31 to a 52- or 53- week period ending on the Saturday closest to January 31. This fiscal calendar is widely used by the retail industry. As a result of the change in its fiscal year end, there was a one month conversion period ended February 1, 2003. Each fiscal year now consists of four 13-week quarters, with an extra week added to the fourth quarter every five or six years. Fiscal 2004 was the 52-week period ended January 29, 2005. Fiscal 2003 was the 52-week period ended January 31, 2004. Fiscal 2002 was the calendar year ended December 31, 2002.

NOTES TO FINANCIAL STATEMENTS (Continued)

Reincorporation (unaudited) On April 29, 2005, the Company reincorporated in the State of Washington from the State of Delaware. In connection with the reincorporation, the Company filed new articles of incorporation and adopted new bylaws. The new articles of incorporation changed the Company s common stock from $0.01 par value per share to no par value per share and increased the Company s authorized capital stock.

Initial Public Offering (unaudited) In May 2005, the Company completed an initial public offering of its common stock in which the Company sold 1,875,000 shares and certain selling shareholders sold 1,718,750 shares. The Company received net proceeds from the offering of approximately $29.7 million, after payment of underwriting discounts and commissions and offering expenses. The Company did not receive any of the proceeds from the sale of shares of common stock by the selling shareholders. Prior to this initial public offering, the Company was a majority owned subsidiary of the Parent, a holding company with no operating activities. The financial position and operating results of the Parent are not included in the Company s financial statements included in this prospectus. The Parent was dissolved in connection with the Company s recently completed initial public offering.

Basis of Presentation The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America.

Unaudited Interim Results

The accompanying balance sheet as of July 30, 2005, the statements of operations and the statements of cash flows for the six months ended July 31, 2004 and July 30, 2005, and the statement of changes in stockholders equity for the six months ended July 30, 2005, are unaudited. The unaudited interim financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to state fairly the Company s financial position, results of operations and cash flows for the six months ended July 31, 2004 and July 30, 2005. The financial data and other information disclosed in these notes to the financial statements related to the six months ended July 31, 2004 and July 30, 2005 are unaudited. The results for the six months ended July 30, 2005 are not necessarily indicative of the results to be expected for the fiscal year ending January 28, 2006 or for any other interim period or for any future year.

2. Summary of Significant Accounting Policies

Comprehensive Income Comprehensive income represents all changes in equity during a period except those resulting from investments by and distributions to shareholders. There was no difference between net income and comprehensive income for fiscal 2002, 2003 and 2004 and the one month period ended February 1, 2003.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make 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 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 the Company, including information about contingencies, risk, and financial condition. In preparing the financial statements, the Company makes routine estimates and judgments in determining the net realizable value of accounts receivable, inventory, fixed assets, and prepaid allowances. Some of the more significant estimates include the allowance for sales returns, the reserve for inventory valuation estimates and the expected useful lives of fixed assets. Actual results could differ from those estimates.

Concentration of Risk The Company maintains its cash and cash equivalents in accounts with one major financial institution in the United States of America, in the form of demand deposits, certificates of deposits and money market accounts. Deposits in this bank may exceed the amounts of federal deposit insurance provided on such deposits. The Company has not experienced any losses on its deposits of cash and

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NOTES TO FINANCIAL STATEMENTS (Continued)

cash equivalents. The Company s accounts receivable are primarily derived from credit card purchases from customers and are typically settled within one to two days.

Cash and Cash Equivalents The Company considers all highly liquid investments with maturity of three months or less when purchased to be cash equivalents.

Restricted Cash At December 31, 2002, February 1, 2003, January 31, 2004 and January 29, 2005, restricted cash consisted of a certificate of deposit held for the lessor of the Company s former combined home office and distribution center of $32,000 and is included in prepaid expenses and other. At July 30, 2005, the Company had no restricted cash balances (unaudited).

Receivables Consist primarily of tenant allowances and credit card transactions that remain outstanding at the end of the period. The Company does not extend credit to its customers, except through third-party credit cards.

Merchandise Inventories Merchandise inventories are valued at the lower of cost or market. The cost of merchandise inventories are based upon an average cost methodology and inventory costs are removed on a first-in, first-out. Merchandise inventories may include items that have been written down to the Company s best estimate of their net realizable value. The Company s decisions to write-down its merchandise inventories are based on its current rate of sale, the age of the inventory and other factors. Actual final sales prices to customers may be higher or lower than the Company s estimated sales prices and could result in a fluctuation in gross profit. Historically, any additional write-downs have not been significant and the Company does not adjust the historical carrying value of merchandise inventories upwards based on actual sales experience.

Leasehold Improvements and Equipment Leasehold improvements and equipment are stated at cost less accumulated depreciation. Amortization of leasehold improvements is computed on the straight-line method over the lesser of an asset s estimated useful life or the lease term (generally 7-10 years), whichever is shorter. Depreciation on furniture, fixtures and equipment is computed on the straight-line method over five years. Maintenance and repairs are expensed as incurred. The cost and related accumulated depreciation or amortization of assets sold or otherwise disposed of is removed from the accounts and the related gain or loss is reported in the statement of operations.

Valuation of Long-Lived Assets The Company has adopted SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets, and reviews the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Measurement of the impairment loss is based on the fair value of the asset, or group of assets. Generally, fair value will be determined using accepted valuation techniques, such as the present value of expected future cash flows.

Fair Value of Financial Instruments Statement of Financial Accounting Standards No. 107 (SFAS 107), Disclosures about Fair Value of Financial Instruments, requires management to disclose the estimated fair value of certain assets and liabilities defined by SFAS 107 as financial instruments. Financial instruments are generally defined by SFAS 107 as cash, evidence of ownership interest in an entity, or a contractual obligation that both conveys to one entity a right to receive cash or other financial instruments from another entity and imposes on the other entity the obligation to deliver cash or other financial instruments to the first entity. At January 29, 2005 and all other previous periods presented herein, the carrying amounts of cash and cash equivalents, receivables, payables and other accrued liabilities approximated fair value because of the short maturity of these financial instruments. The carrying value of the long-term debt and the revolving credit facility approximate the fair value because these financial instruments have floating interest rates which reflect current market conditions.

Deferred Rent, Rent Expense and Tenant Allowances The Company occupies its retail stores and combined home office and distribution center under operating leases generally with terms of seven to ten years. Some of these leases have early cancellation clauses, which permit the lease to be terminated if certain sales levels are not met in specific periods. Some leases contain renewal options for periods ranging from one to five years under substantially the same terms and conditions as the original leases. Most of the store leases

NOTES TO FINANCIAL STATEMENTS (Continued)

require payment of a specified minimum rent, plus a contingent rent based on a percentage of the store s net sales in excess of a specified threshold. Most of the lease agreements have defined escalating rent provisions, which are straight-lined over the term of the related lease, including any lease renewals deemed to be probable. The Company straight-lines and recognizes its rent expense over the term of the lease, plus the construction period prior to occupancy of the retail location, using a mid-month convention. For certain locations, the Company receives cash tenant allowances and has reported these amounts as a deferred liability which is amortized to rent expense over the term of the lease. Also included in rent expense are payments of real estate taxes, insurance and certain common area and maintenance costs in addition to the future minimum operating lease payments.

Income Taxes The provision for income taxes includes both current and deferred tax expenses. Current tax expense is the amount associated with current operating results. The Company follows the liability method of accounting for income taxes, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary difference between the carrying amounts and the tax bases of the assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax asserts to the amount expected to be realized.

Revenue Recognition Sales are recognized upon purchase by customers at the Company s retail store locations or upon shipment for orders placed through the Company s website as both title and risk of loss have transferred. The Company records the sale of gift cards as a current liability and recognizes revenue when a customer redeems a gift card. The Company reports shipping revenues and costs within sales and cost of goods sold, respectively. The Company accrues for estimated sales returns by customers based on historical sales return results. Sales return reserves were insignificant for all periods presented. The Company offers a return policy of generally 30 days.

The Company does not extend credit to customers, except through third-party credit cards. The majority of sales are through credit cards, and accounts receivable are composed primarily of amounts due from financial institutions related to credit card sales.

The Company records a liability when gift cards are issued and recognizes revenue when gift cards are redeemed. The Company has the right to assess gift card dormancy fees, but has historically not done so.

The Company presents its merchandise assortment as a percentage of net sales for the following categories: Men s , which includes men s apparel; Women s , which includes women s apparel; and Accessories and Other , which includes all other merchandise (e.g., hardgoods, accessories, footwear, etc.). The percentage of net sales for each of the aforementioned categories for fiscal 2002, the one month period ended February 1, 2003, fiscal 2003 and fiscal 2004 was as follows:

	Fiscal Year Ended December 31, 2002	One Month Ended February 1, 2003	Fiscal Year Ended January 31, 2004	Fiscal Year Ended January 29, 2005
Men s	31.0 %	26.7 %	29.6 %	32.1 %
Women s	13.7	14.2	16.4	16.0
Accessories and Other	55.3	59.1	54.0	51.9
Total	100.0 %	100.0 %	100.0 %	100.0 %

Cost of Goods Sold Cost of goods sold consists of the cost of merchandise sold to customers, inbound shipping costs, distribution costs, depreciation on leasehold improvements at the distribution center, buying and merchandising costs and store occupancy costs. This may not be comparable to the way in which the Company s competitors or other retailers compute their cost of goods sold.

Selling, General and Administrative Expense Selling, general and administrative expenses consist primarily of store personnel wages and benefits, administrative staff and infrastructure expenses, store supplies, depreciation on leasehold improvements at the home office and stores, facility expenses, and

NOTES TO FINANCIAL STATEMENTS (Continued)

training, advertising and marketing costs. Credit card fees, insurance and other miscellaneous operating costs are also included in selling, general and administrative expenses. This may not be comparable to the way in which the Company s competitors or other retailers compute their selling, general and administrative expenses. The Company does receive insignificant amounts of cash consideration from vendors which have been reported as a reduction of expenses as the amounts are reimbursements of specific, incremental and identifiable costs of selling the vendors products.

Advertising The Company expenses advertising costs as incurred. Advertising expenses are net of sponsorships. Advertising expense was approximately $322,000, $295,000 and $235,000 in fiscal 2002, 2003 and 2004, respectively, and $24,000 for the one month period ended February 1, 2003. Advertising expense for the six month period ending July 31, 2004 was $25,351 and advertising for the six month period ending July 30, 2005 resulted in net income of $900.

Net Income per Share Basic net income per common share is computed using the weighted average number of shares outstanding. Diluted net income per common share is computed using the weighted average number of shares outstanding adjusted for the incremental shares attributed to outstanding options to purchase common stock. Incremental shares of 2,034,567, 1,506,595 and 1,633,597 in fiscal 2002, 2003 and 2004, respectively, and 1,452,829, 1,489,656 and 819,664 for the one month period ended February 1, 2003, the six months ended July 31, 2004 and the six months ended July 30, 2005, respectively, were used in the calculation of diluted net income per common share.

Stock Compensation The Company has stock-based employee compensation plans, which are described further in note 7 below. The Company accounts for stock-based employee compensation arrangements on the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees and related amendments and interpretations. The Company complies with the disclosure provisions of Statement of Financial Accounting Standards No. 123 (SFAS 123), Accounting for Stock-Based Compensation, which requires fair value recognition for employee stock-based compensation.

If the computed fair values of the awards had been amortized to expense over the vesting period of the awards, pro forma net income (loss) and net income (loss) per share would have been reduced to the pro forma amounts indicated in the following table (in thousands, except per share data):

	Fiscal Year Ended December 31, 2002	One Month Ended February 1, 2003	Fiscal Year Ended January 31, 2004	Fiscal Year Ended January 29, 2005	Six Months Ended July 31, 2004 (unaudited)	July 30, 2005 (unaudited)
Net income (loss), as reported	$ 5,705	$ (169)	$ 4,475	$ 7,267	$ (439)	$ 808
Add: Stock-based compensation expense, as reported, net of tax				59		49
Deduct: Stock-based employee compensation expense determined under fair-value-based method, net of tax	(207)	(17)	(118)	(313)	(51)	(178)
Pro forma net income (loss)	5,498	(186)	4,357	7,013	(490)	679
Net income (loss) per share:						
Basic as reported	$ 0.49	$ (0.01)	$ 0.40	$ 0.64	$ (0.04)	$ 0.07
Basic pro forma	$ 0.48	$ (0.02)	$ 0.39	$ 0.62	$ (0.04)	$ 0.06
Diluted as reported	$ 0.42	$ (0.01)	$ 0.35	$ 0.56	$ (0.04)	$ 0.06
Diluted pro forma	$ 0.40	$ (0.02)	$ 0.34	$ 0.54	$ (0.04)	$ 0.05

Merchandise Risk The Company s success is largely dependent upon its ability to gauge the fashion tastes of its customers and provide merchandise that satisfies customer demand. Any inability to provide appropriate merchandise in sufficient quantities in a timely manner could have a material adverse effect on the Company s business, operating results and financial condition.

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NOTES TO FINANCIAL STATEMENTS (Continued)

Reclassifications Certain amounts in the prior year financial statements have been reclassified to conform to the current year s financial statement presentation. The reclassifications had no effect on shareholders equity or net income.

Recent accounting pronouncements

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, Inventory Costs an Amendment of ARB No. 43, Chapter 4. This statement clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and spoilage, requiring these items be recognized as current-period charges. In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement are effective for inventory costs incurred during fiscal years beginning after June 15, 2005 and will become effective for the Company beginning in fiscal 2006. The effect of adopting this statement is not expected to be significant to the Company s financial position and results of operations.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R, Share-Based Payment (Revised 2004) (FAS 123R). This statement addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for the company s equity instruments or liabilities that are based on the fair value of the company s equity securities or may be settled by the issuance of these securities. SFAS 123R eliminates the ability to account for share-based payments using APB 25, Accounting for Stock Issued to Employees and generally requires that such transactions be accounted for using a fair value method. On April 14, 2005, the Securities and Exchange Commission announced the adoption of a new rule that delays SFAS 123R compliance.

Under the SEC rule, the provisions of this statement are effective for annual periods beginning after June 15, 2005 and will become effective for the Company beginning with the first quarter of fiscal 2006. The Company has not yet determined which transaction method it will use to adopt SFAS 123R. The full impact that the adoption of this statement will have on the Company s financial position and results of operations will be determined by share-based payments granted in future periods and will increase the compensation expense that would otherwise have been recognized in accordance with APB 25. In addition, outstanding unvested options will result in additional compensation expense that otherwise would only have been recognized on a pro-forma basis.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 153, Exchanges of Non-Monetary Assets. This statement refines the measurement of exchanges of non-monetary assets between entities. The provisions of this statement are effective for fiscal periods beginning after June 15, 2005 and became effective for the Company beginning with the third quarter of fiscal 2005. Historically, the Company has not transacted significant exchanges of non-monetary assets, but future such exchanges would be accounted for under the standard, when effective.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections. This Statement requires retrospective application to prior periods financial statements of changes in accounting principle. The provisions of this statement become effective for fiscal periods beginning after December 15, 2005. The standard dictates that changes in accounting principle that are a result of a new pronouncement shall be subject to the reporting provisions of that pronouncement if they exist.

NOTES TO FINANCIAL STATEMENTS (Continued)

3. Transition Period Comparative Data

As a result of the change in the Company s fiscal year end there was a one month transition period. The following table presents certain condensed financial information for the one month ended February 2, 2002 (unaudited) and the one month ended February 1, 2003, respectively.

	One Month Ended February 2, 2002 (unaudited) (In thousands)	February 1, 2003
Summarized Statements of Operations		
Net sales	$ 5,831	$ 6,392
Cost of goods sold	3,961	4,575
Gross margin	$ 1,870	$ 1,817
Operating profit (loss)	$ 170	$ (196)
Net income (loss)	$ 161	$ (169)
Summarized Balance Sheets		
Assets		
Total current assets	$ 17,083	$ 19,646
Total assets	$ 30,318	$ 36,003
Liabilities and shareholders equity		
Total current liabilities	$ 15,972	$ 20,101
Total liabilities	$ 18,241	$ 22,036
Total shareholders equity	12,077	13,967
Total liabilities and shareholders equity	$ 30,318	$ 36,003

4. Leasehold Improvements and Equipment

Leasehold improvements and equipment consist of the following:

	January 31, 2004 (In thousands)	January 29, 2005
Leasehold improvements and other equipment	$ 20,102	$ 29,706
Store computer equipment	3,225	4,179
Store displays	9,923	13,822
Vehicles	53	53
	33,303	47,760
Less accumulated depreciation	(15,227)	(21,141)
	$ 18,076	$ 26,619

NOTES TO FINANCIAL STATEMENTS (Continued)

5. Long-Term Debt

Long-term debt consists of the following:

	January 31, 2004 (In thousands)	**January 29, 2005**
Note payable to bank, payable in quarterly installments of $272,000 plus interest at LIBOR (1.155% per annum at January 31, 2004) plus 2%, maturing July 1, 2004	$ 544	$
Less current portion	(544)	
	$	$

The note payable to bank at January 31, 2004 was collateralized by substantially all the assets of the Company. Additionally, this note payable contained covenants that required the Company to maintain certain working capital ratios and placed certain restrictions on the declaration and payment of dividends. The note was paid in full per the terms of the agreement in fiscal 2004.

In May 2003 the Company entered into an agreement for a new revolving credit facility of $20,000,000. The revolving credit facility has a $7,500,000 sub-limit for the issuance of letters of credit with 180 day maximum maturity. The outstanding borrowings under the revolving credit facility were $300,000 at January 31, 2004. The Company also had open letters of credit of $447,000 at January 31, 2004.

In September 2004 the Company entered into a loan modification agreement to the existing revolving credit facility. The loan modification agreement reduced certain applicable interest rates and extended the maturity date of the revolving credit facility to July 1, 2006. The borrowing capacity can be increased to $25.0 million if the Company requests and if the Company is in compliance with certain provisions. There were no outstanding borrowings under the revolving credit facility at January 29, 2005. The Company had open letters of credit of $671,000 at January 29, 2005. The revolving credit facility bears interest at floating rates based on the lower of the prime rate (5.25% at January 29, 2005) minus a prime margin ranging from 0.75% to 0.10% or the LIBOR rate (2.53% at January 29, 2005) plus a LIBOR margin ranging from 1.40% to 2.15%, in each case depending on the ratio of the Company s adjusted funded debt (as defined in the loan agreement, as amended) to EBITDAR (as defined in the loan agreement, as amended). The Company s obligations under the revolving credit facility are secured by almost all of its personal property, including, among other things, inventory, equipment and fixtures. The Company must reduce the amount of any outstanding advances under the revolving credit facility to no more than $5.0 million for a period of at least 30 consecutive days each year. The revolving credit facility also contains financial covenants that require the Company to meet specified financial ratios, including a debt to earnings ratio, an earnings to interest expense ratio and an inventory to debt ratio. The Company was in compliance with all covenants at January 29, 2005 and for the year then ended.

NOTES TO FINANCIAL STATEMENTS (Continued)

6. Income Taxes

The components of the current deferred tax assets and net long-term deferred tax assets (liabilities) are:

	January 31, 2004 (In thousands)	January 29, 2005
Current deferred tax assets (liabilities)		
Inventory	$ 621	$ 784
Employee benefits	124	167
Prepaid expenses	(77)	(92)
Charitable Contributions		
Total current deferred tax assets	668	859
Long-term deferred tax assets (liabilities)		
Property and equipment	(1,927)	(3,437)
Employee benefits		35
Deferred rent	591	1,891
Total long-term deferred tax liabilities	(1,336)	(1,511)
Net deferred tax liability	$ (668)	$ (652)

The components of the provision (benefit) for income taxes are:

	Fiscal Year Ended December 31, 2002 (In thousands)	One Month Ended February 1, 2003	Fiscal Year Ended January 31, 2004	Fiscal Year Ended January 29, 2005
Current				
Federal	$ 837	$ (122)	$ 1,526	$ 3,831
State	395		371	685
Total current	1,232	(122)	1,897	4,516
Deferred				
Federal	(129)	77	740	(21)
State	(7)	6	64	5
Total deferred	(136)	83	804	(16)
Provision (benefit) for income taxes	$ 1,096	$ (39)	$ 2,701	$ 4,500

NOTES TO FINANCIAL STATEMENTS (Continued)

The reconciliation of the income tax provision at the U.S. federal statutory rate to the Company s effective income tax rate is as follows for the fiscal year ended:

	Fiscal Year Ended December 31, 2002	One Month Ended February 1, 2003	Fiscal Year Ended January 31, 2004	Fiscal Year Ended January 29, 2005
Expected U.S. federal income taxes at statutory rates	34.0 %	34.0 %	34.0 %	34.0 %
State and local income taxes, net of federal effect	4.3		3.4	3.9
Benefit of Subchapter S election and termination	(22.3)	(0.9)		
Permanent differences			0.2	0.5
Other	0.1	(14.3)		(0.1)
	16.1 %	18.8 %	37.6 %	38.3 %

7. Stock Options

During fiscal 1997, the Company adopted the 1993 Stock Option Plan (the Plan) to provide for the granting of nonqualified stock options to executive officers and key employees of the Company as determined by a committee of the Company s board of directors, the 1993 Plan Committee (the Committee).

The date of grant, option price, vesting period and other terms specific to options granted under the Plan are determined by the Committee. All stock options granted under the Plan vest over a fixed period and expire ten years from the date of grant and no additional awards may be made under the Plan. Prior to fiscal 2004, the option price for all options granted was equal to the fair market value of the Company s common stock at the date of grant and no stock-based compensation expense was recognized during fiscal 2002, 2003 or the one month ended February 1, 2003.

During fiscal 2004, the Company adopted the 2004 Stock Option Plan (the 2004 Plan) to provide for the granting of incentive stock options and nonqualified stock options to executive officers and key employees of the Company as determined by a committee of the Company s board of directors, the 2004 Plan Committee. The terms of the 2004 Plan are generally the same as the Plan. The Company has authorized 3,682,793 shares of common stock for issuance under the 2004 Plan. The Company does not plan on making any new stock option grants under the 2004 Plan (unaudited).

During fiscal 2004, the Company issued stock options to certain employees with exercise prices below the fair market value of the Company s common stock at the date of grant. In accordance with the requirements of APB 25, the Company has recorded stock-based compensation for the difference between the exercise price of the stock options and the fair market value of the Company s stock at the grant date. During the fiscal 2004, the Company recorded stock-based compensation of $95,000 related to these options. Stock-based compensation expense is currently recognized over the vesting period of the awards, generally five to eight years. Excluding the impact of the adoption of FAS 123R, future compensation expense to be recognized through fiscal 2012 associated with these grants will be $961,000.

NOTES TO FINANCIAL STATEMENTS (Continued)

All grants of stock options have been to employees of the Company. There were no stock option grants, exercises, forfeitures or cancellations during fiscal 2002 or the one month period ended February 1, 2003. The fair values of the options granted under the Plan and the 2004 Plan were estimated using the minimum-value method with the assumptions from the table below:

	Fiscal Year Ended January 31, 2004	Fiscal Year Ended January 29, 2005
Dividend yield	%	%
Average risk-free interest rate:		
Expected lives Ten years	%	%
Expected lives Eight years	%	3.97 %
Expected lives Five years	3.30 %	3.41 %

The following table summarizes stock option activity:

	Fiscal Year Ended December 31, 2002		Fiscal Year Ended January 31, 2004		Fiscal Year Ended January 29, 2005		For Six Months Ended July 30, 2005	
	Number of Options	Weighted-Average Exercise Price	Number of Options	Weighted-Average Exercise Price	Number of Options	Weighted-Average Exercise Price	Number of Options (Unaudited)	Weighted-Average Exercise Price
Options outstanding at beginning of period	2,032,977	$ 1.66	1,452,828	$ 2.25	1,533,700	$ 2.47	1,855,397	$ 3.54
Options granted during the period			134,670	5.21	400,119	7.73		
Options exercised during the period	(580,149)	(0.17)					(277,069)	1.65
Options forfeited during the period			(53,798)	(3.55)	(78,422)	(3.92)		
Options outstanding at end of period	1,452,828	$ 2.25	1,533,700	$ 2.47	1,855,397	$ 3.54	1,578,327	$ 3.87
Weighted-average fair value of options granted				$ 0.71		$ 2.27		
Options exercisable	504,536	$ 1.65	672,693	$ 1.77	860,057	$ 2.03	698,332	$ 2.78

The following table summarizes information concerning outstanding and exercisable options at January 29, 2005:

	Options Outstanding		Options Exercisable
Exercise Price	Number of Options	Weighted-Average Remaining Contractual Life	Number of Options
$ 0.46	323,052	2.9	282,670
2.17	591,788	4.3	369,867
3.55	430,391	6.6	161,397
5.21	134,670	8.3	46,123
7.73	375,496	9.4	
Total	1,855,397		860,057

NOTES TO FINANCIAL STATEMENTS (Continued)

8. Related Party Transactions

During fiscal 2004, the Company paid $1,000 in fees related to the Transaction that are receivable from the Parent. At January 29, 2005, due to additional such payments by the Company, the balance was $148,000. This amount is reported in shareholders equity.

During fiscal 2001, the Company advanced $1,500,000 to a shareholder under a note receivable. At December 31, 2001, the outstanding balance of the note and accrued interest receivable was $1,533,750, and while the interest was paid in cash in fiscal 2002, the note was redeemed as part of the Transaction.

In fiscal 2002, 2003 and 2004 the Company paid Brentwood Private Equity III, LLC a consulting fee of $31,000, $200,000 and $200,000, respectively, under a Corporate Development and Administrative Services Agreement.

Related party transactions for the six months ended July 30, 2005 (unaudited) The Company paid $1,000 in fees on behalf of its Parent, resulting in a balance of $149,000, which was forgiven and the Parent was subsequently dissolved in connection with the Company s initial public offering. This amount was reported in shareholders equity and expensed to selling, general and administrative expense.

During the six months ended July 30, 2005 and July 31, 2004 (unaudited) the Company paid Brentwood Private Equity III, LLC a consulting fee of $53,000 and $100,000, respectively, under a Corporate Development and Administrative Services Agreement. This agreement was subsequently terminated in connection with the initial public offering, resulting in a prorated consulting fee for the six months ended July 30, 2005 of $3,000 compared to the fees per the agreement of $50,000 paid for the six months ended July 31, 2004.

9. Commitments and Contingencies

Leases The Company is committed under operating leases for all of its retail store locations. In addition to minimum future lease payments, all store leases provide for additional rental payments based on sales, as well as common area maintenance charges. During fiscal 2004, the Company entered into a lease for a new combined home office and distribution center under a noncancelable operating lease agreement that expires in July 2012, with two renewal optons. For leases that have fixed escalation clauses, minimum rents are recognized on a straight-line basis over the term of the lease.

Rent expense, including common area maintenance and other occupancy costs, was $11,754,000, $13,871,000, $17,136,000 and $919,000 for fiscal 2002, 2003, 2004 and the one month period ended February 1, 2003, respectively.

Future minimum annual commitments (in thousands) on all leases at January 29, 2005 are as follows:

	Retail Stores	**Home Office**	**Total**
Fiscal 2005	$ 9,977	$ 404	$ 10,381
Fiscal 2006	9,871	432	10,303
Fiscal 2007	9,228	467	9,695
Fiscal 2008	8,508	479	8,987
Fiscal 2009	8,376	492	8,868
Thereafter	25,183	982	26,165
	$ 71,143	$ 3,256	$ 74,399

Purchase Commitments The Company had outstanding purchase orders to acquire merchandise from vendors for approximately $28.1 million at January 29, 2005. These purchases are expected to be financed by cash flows from operations and the Company s revolving credit facility. The Company has an option to cancel such commitments with no notice prior to shipment.

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NOTES TO FINANCIAL STATEMENTS (Continued)

Litigation The Company is involved from time to time in litigation incidental to its business and, from time to time, the Company may make provisions for potential litigation losses. The Company follows SFAS 5, Accounting for Contingencies when assessing pending or potential litigation. Management believes, after considering a number of factors and the nature of the contingencies to which the Company is subject, that the outcome of these contingencies will not have a material adverse effect upon the results of operations or financial condition of the Company.

Insurance Reserves The Company is responsible for medical insurance claims up to a specified aggregate amount. The Company maintains a reserve for estimated medical insurance claims based on historical claims experience and other estimated assumptions. The Company follows SFAS 5, Accounting for Contingencies when assessing pending or potential claims.

Employment Agreement The Company has an employment agreement in place with a key employee. The agreement provides that if the Company terminates the employee s employment without cause or if he terminates his employment for good reason, the employee could be entitled to continue to receive his base salary up to a maximum commitment of $315,000.

10. Retirement Savings Plan

The Zumiez Investment Plan is a qualified plan under Section 401(k) of the Internal Revenue Code. The Company s 401(k) matching and profit-sharing contributions are discretionary and are determined annually by the Company. The Company contributed $50,000, $55,000 and $125,000 to the plan during fiscal 2002, 2003 and 2004, respectively.

11. Income (Loss) Per Share

Basic net income (loss) per share is based on the weighted average number of common shares outstanding. Diluted net income (loss) per share is based on the weighted average number of common shares and common share equivalents outstanding. Common share equivalents included in the computation represent shares issuable upon assumed exercise of outstanding stock options.

The following table sets forth the computation of basic and diluted net income (loss) per share (in thousands, except share and per share data):

	Fiscal Year Ended December 31, 2002	One Month Ended February 1, 2003	Fiscal Year Ended January 31, 2004	Fiscal Year Ended January 29, 2005	Six Months Ended July 31, 2004 (Unaudited)	Six Months Ended July 31, 2005
Net income (loss)	$ 5,705	$ (169)	$ 4,475	$ 7,267	$ (439)	$ 808
Weighted average common shares for basic net income (loss) per share	11,547,011	11,305,261	11,305,261	11,305,261	11,305,261	12,296,076
Dilutive effect of stock options	2,034,567		1,506,594	1,633,597		819,664
Weighted average common shares for diluted net income (loss) per share	13,581,578	11,305,261	12,811,855	12,938,858	11,305,261	13,115,740
Basic net income (loss) per share	$ 0.49	$ (0.01)	$ 0.40	$ 0.64	$ (0.04)	$ 0.07
Diluted net income (loss) per share	$ 0.42	$ (0.01)	$ 0.35	$ 0.56	$ (0.04)	$ 0.06

For the one month ended February 1, 2003, the dilutive effect of 1,452,829 options were excluded and for the six months ended July 31, 2004 (unaudited) the dilutive effect of 1,489,656 options were excluded from weighted average diluted shares outstanding because the effect was antidilutive.

NOTES TO FINANCIAL STATEMENTS (Continued)

12. Subsequent Events

Stock Split On April 14, 2005, the Company s Board of Directors and shareholders approved an amendment to the Company s Certificate of Incorporation to effect a 1 for 258.6485 split of the Company s common stock (the Stock Split). The Stock Split became effective on April 20, 2005. All reference to shares in the financial statements and the accompanying notes, including but not limited to the number of shares and per share amounts, unless otherwise noted, have been adjusted to reflect the Stock Split on a retroactive basis. Previously awarded stock options in the Company s common stock have been retroactively adjusted to reflect the Stock Split.

2,375,000 Shares
Common Stock

PROSPECTUS

November 8, 2005

Wachovia Securities

Piper Jaffray

William Blair & Company