

KIRKLAND'S, INC
Form 10-Q
June 06, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended April 30, 2016,

or

.. **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from _____ to _____.

Commission file number: 000-49885

KIRKLAND S, INC.

(Exact name of registrant as specified in its charter)

| | |
|--|---|
| Tennessee (State or other jurisdiction of | 62-1287151 (IRS Employer |
| incorporation or organization) | Identification No.) |
| 5310 Maryland Way Brentwood, Tennessee (Address of principal executive offices) | 37027 (Zip Code) |
| Registrant's telephone number, including area code: (615) 872-4800 | |

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

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

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

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Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

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

Common Stock, no par value 15,787,160 shares outstanding as of May 26, 2016.

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KIRKLAND S, INC.

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Table of Contents**KIRKLAND S, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

| | April 30, 2016 (Unaudited) | January 30, 2016 | May 2, 2015 (Unaudited) |
|---|-------------------------------|------------------------|----------------------------|
| ASSETS | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ 38,203 | \$ 44,352 | \$ 93,437 |
| Inventories, net | 69,107 | 68,222 | 58,291 |
| Prepaid expenses and other current assets | 13,627 | 15,206 | 8,343 |
| Total current assets | 120,937 | 127,780 | 160,071 |
| Property and equipment, gross | 246,665 | 240,020 | 208,817 |
| Accumulated depreciation | (138,039) | (134,478) | (120,384) |
| Property and equipment, net | 108,626 | 105,542 | 88,433 |
| Other assets | 2,659 | 1,934 | 2,283 |
| Total assets | \$ 232,222 | \$ 235,256 | \$ 250,787 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | | |
| Current liabilities: | | | |
| Accounts payable | \$ 24,753 | \$ 28,689 | \$ 26,072 |
| Income taxes payable | | 4,863 | 191 |
| Accrued expenses | 27,647 | 25,943 | 24,655 |
| Total current liabilities | 52,400 | 59,495 | 50,918 |
| Deferred rent | 49,974 | 48,280 | 41,057 |
| Non-current deferred income taxes | 1,191 | 1,342 | 435 |
| Other liabilities | 7,054 | 6,444 | 5,960 |
| Total liabilities | 110,619 | 115,561 | 98,370 |
| Shareholders equity: | | | |
| Preferred stock, no par value, 10,000,000 shares authorized; no shares issued or outstanding at April 30, 2016, January 30, 2016, or May 2, 2015, respectively | | | |
| Common stock, no par value; 100,000,000 shares authorized; 15,782,652; 15,774,681; and 17,248,267 shares issued and outstanding at April 30, 2016, January 30, 2016, and May 2, 2015, | 163,165 | 162,173 | 159,584 |

respectively

| | | | |
|--|------------|------------|------------|
| Accumulated deficit | (41,562) | (42,478) | (7,167) |
| Total shareholders' equity | 121,603 | 119,695 | 152,417 |
| Total liabilities and shareholders' equity | \$ 232,222 | \$ 235,256 | \$ 250,787 |

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

Table of Contents**KIRKLAND S, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)****(in thousands, except per share data)**

| | 13-Week Period Ended | |
|---|---------------------------------|------------------------|
| | April 30, 2016 | May 2, 2015 |
| Net sales | \$ 129,911 | \$ 118,310 |
| Cost of sales (exclusive of depreciation as shown below) | 80,374 | 70,647 |
| Gross profit | 49,537 | 47,663 |
| Operating expenses: | | |
| Compensation and benefits | 25,527 | 23,213 |
| Other operating expenses | 16,513 | 15,124 |
| Depreciation | 5,973 | 5,229 |
| Total operating expenses | 48,013 | 43,566 |
| Operating income | 1,524 | 4,097 |
| Interest expense, net | 73 | 70 |
| Other income, net | (59) | (55) |
| Income before income taxes | 1,510 | 4,082 |
| Income tax expense | 594 | 1,553 |
| Net income | \$ 916 | \$ 2,529 |
| Earnings per share: | | |
| Basic | \$ 0.06 | \$ 0.15 |
| Diluted | \$ 0.06 | \$ 0.14 |
| Weighted average shares for basic earnings per share | 15,780 | 17,238 |
| Effect of dilutive stock equivalents | 321 | 567 |
| Adjusted weighted average shares for diluted earnings per share | 16,101 | 17,805 |

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

Table of Contents**KIRKLAND S, INC.****CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)****(in thousands, except share data)**

| | Common Stock | | Accumulated | Total |
|----------------------------------|---------------------|---------------|--------------------|---------------------|
| | Shares | Amount | Deficit | Shareholders |
| | | | | Equity |
| Balance at January 30, 2016 | 15,774,681 | \$ 162,173 | \$ (42,478) | \$ 119,695 |
| Employee stock purchases | 7,971 | 97 | | 97 |
| Stock-based compensation expense | | 895 | | 895 |
| Net income | | | 916 | 916 |
| Balance at April 30, 2016 | 15,782,652 | \$ 163,165 | \$ (41,562) | \$ 121,603 |

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

Table of Contents**KIRKLAND S, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(in thousands)

| | 13-Week Period Ended | |
|---|-----------------------------|---------------|
| | April 30, | May 2, |
| | 2016 | 2015 |
| Cash flows from operating activities: | | |
| Net income | \$ 916 | \$ 2,529 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation of property and equipment | 5,973 | 5,229 |
| Amortization of deferred rent | (1,268) | (1,546) |
| Amortization of debt issue costs | 45 | 19 |
| Loss on disposal of property and equipment | 108 | 5 |
| Cash received for landlord construction allowances | 3,548 | 2,460 |
| Stock-based compensation expense | 895 | 1,236 |
| Excess tax benefits from exercise of stock options and vesting of restricted stock | | (815) |
| Deferred income taxes | (151) | (165) |
| Changes in assets and liabilities: | | |
| Inventories, net | (885) | (2,516) |
| Prepaid expenses and other current assets | 1,501 | (1,461) |
| Other noncurrent assets | (546) | (136) |
| Accounts payable | (4,419) | 1,367 |
| Income taxes refundable | (5,057) | (4,653) |
| Accrued expenses and other current and noncurrent liabilities | 2,000 | (2,169) |
| Net cash provided by (used in) operating activities | 2,660 | (616) |
| Cash flows from investing activities: | | |
| Capital expenditures | (8,682) | (2,675) |
| Net cash used in investing activities | (8,682) | (2,675) |
| Cash flows from financing activities: | | |
| Refinancing costs | (224) | |
| Excess tax benefits from exercise of stock options and restricted stock | | 815 |
| Cash used in net share settlement of stock options and restricted stock | | (1,556) |
| Employee stock purchases | 97 | 74 |
| Repurchase and retirement of common stock | | (1,743) |
| Net cash used in financing activities | (127) | (2,410) |
| Cash and cash equivalents: | | |
| Net decrease | (6,149) | (5,701) |

| | | |
|-------------------------|-----------|-----------|
| Beginning of the period | 44,352 | 99,138 |
| End of the period | \$ 38,203 | \$ 93,437 |

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

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KIRKLAND'S, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 Basis of Presentation

Kirkland's, Inc. (the Company) is a specialty retailer of home décor and gifts with 382 stores in 36 states as of April 30, 2016. The condensed consolidated financial statements of the Company include the accounts of Kirkland's, Inc. and its wholly-owned subsidiaries, Kirkland's Stores, Inc., Kirkland's DC, Inc., Kirkland's Texas, LLC, and Kirklands.com, LLC. All intercompany accounts and transactions have been eliminated.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. These financial statements should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 8, 2016.

It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than those at fiscal year-end. In addition, because of seasonality factors, the results of the Company's operations for the 13-week period ended April 30, 2016 are not indicative of the results to be expected for any other interim period or for the entire fiscal year. The Company's fiscal year ends on the Saturday closest to January 31, resulting in years of either 52 or 53 weeks. All references to a fiscal year refer to the fiscal year ending on the Saturday closest to January 31 of the following year.

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

Changes in estimates are recognized in the period when new information becomes available to management. Areas where the nature of the estimate makes it reasonably possible that actual results could materially differ from amounts estimated include, but are not limited to impairment assessments on long-lived assets, asset retirement obligations, inventory reserves, self-insurance reserves, income tax liabilities, stock-based compensation, employee bonus accruals, gift card breakage, sales return reserves, customer loyalty program accruals and contingent liabilities.

For the 13-week period ended April 30, 2016, the Company adopted accounting guidance which affected the presentation of deferred tax liabilities and assets as discussed in Note 7. This guidance was applied retrospectively for all periods presented and therefore the presentation of previously reported deferred tax assets has been changed to conform to the presentation used in the current period. The adoption of this guidance resulted in the reclassification of deferred tax assets of \$3.3 million and \$3.6 million from current assets to a reduction in noncurrent liabilities in the condensed consolidated balance sheets as of January 30, 2016 and May 2, 2015, respectively.

For the 13-week period ended April 30, 2016, the Company incurred approximately \$3.1 million of non-cash investing activities due to purchases of property and equipment awaiting processing for payment. This amount was included in accounts payable at April 30, 2016 and was not material for the 13-week period ended May 2, 2015.

Note 2 Income Taxes

An estimate of the annual effective tax rate is used at each interim period based on the facts and circumstances available at that time, while the actual effective tax rate is calculated at year-end. For the 13-week periods ended April 30, 2016 and May 2, 2015, the Company recorded an income tax expense of 39.3% and 38.0% of pre-tax income, respectively.

Note 3 Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding during each period presented, which excludes non-vested restricted stock units. Diluted earnings per share is computed by dividing net income by the weighted average number of shares outstanding plus the dilutive effect of stock equivalents outstanding during the applicable periods using the treasury stock method. Diluted earnings per share reflects the potential

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dilution that could occur if options to purchase stock were exercised into common stock and if outstanding grants of restricted stock were vested. Stock options and restricted stock units that were not included in the computation of diluted earnings per share, because to do so would have been antidilutive, were approximately 476,000 and zero shares for the 13-week periods ended April 30, 2016 and May 2, 2015, respectively.

Note 4 Commitments and Contingencies

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

Note 5 Stock-Based Compensation

The Company maintains equity incentive plans under which it may grant non-qualified stock options, incentive stock options, restricted stock, restricted stock units, or stock appreciation rights to employees, non-employee directors and consultants.

The Company granted no stock options or restricted stock units during each of the 13-week periods ended April 30, 2016 and May 2, 2015. Total stock-based compensation expense (a component of compensation and benefits) was \$895,000 for the 13-week period ended April 30, 2016 and \$1.2 million for the 13-week period ended May 2, 2015. Included in the 13-week period ended May 2, 2015 is \$600,000 of stock-based compensation expense that resulted from the accelerated vesting of stock options and restricted stock units upon the retirement of the Company's former Chief Executive Officer. Compensation expense is recognized on a straight-line basis over the vesting periods of each grant. There have been no other material changes in the assumptions used to compute compensation expense during the current quarter.

Note 6 Related Party Transactions

In July 2009, the Company entered into an agreement with a related party vendor to purchase merchandise inventory. The vendor is considered a related party for financial reporting purposes because its principal owner is the spouse of the Company's Vice President of Merchandising. The table below sets forth selected results to this vendor in dollars (in millions) and percentages for the periods indicated:

| | 13-Week Period Ended | |
|---|-----------------------------|---------------|
| | April 30, | May 2, |
| | 2016 | 2015 |
| Related Party Vendor: | | |
| Purchases | \$ 8.5 | \$ 7.1 |
| Purchases as a percent of total merchandise purchases | 15.4% | 12.7% |
| Cost of sales | \$ 8.7 | \$ 6.4 |
| Payable amounts outstanding at period end | \$ 2.1 | \$ 2.9 |

Note 7 New Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. Under ASU 2014-09, an entity will recognize revenue when it transfers promised goods or services to

customers in an amount that reflects what it expects in exchange for the goods or services. ASU 2014-09 also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In July 2015, the FASB approved a one-year deferral of ASU 2014-09. As a result of the deferral, the amendments in ASU 2014-09 will be effective for the Company at the beginning of its fiscal 2018 year. The Company is still evaluating the impact the adoption of ASU 2014-09 will have on its consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*. This update requires that deferred tax liabilities and assets be classified as noncurrent in the consolidated balance sheet. ASU 2015-17 may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The updated guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with early adoption permitted. The Company adopted this guidance in the first quarter of fiscal 2016. The Company elected to apply this guidance retrospectively for all periods presented. The adoption of this guidance affected the presentation of the deferred tax liabilities and assets within the Company's consolidated balance sheet; however, the updated guidance did not affect the accounting for deferred tax liabilities and assets. Other than the change in presentation, the adoption of this guidance did not have any material impacts on the consolidated financial statements.

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

Note 8 Senior Credit Facility

On February 26, 2016, the Company entered into a Joinder and First Amendment to Amended and Restated Credit Agreement (the Credit Agreement) with Bank of America, N.A. as administrative agent and collateral agent, and the lenders (the Lenders), amending our prior credit agreement entered into in 2011. The Credit Agreement increased our senior secured revolving credit facility from \$50 million to \$75 million, increased the swingline availability from \$5 million to \$10 million, added a \$25 million incremental accordion feature and extended the maturity date from August 2016 to February 2021. Borrowings under the facility bear interest at an annual rate equal to LIBOR plus a margin ranging from 125 to 175 basis points with no LIBOR floor. Additionally, a fee of 0.25% per annum is assessed on the unused portion of the facility.

Pursuant to the Credit Agreement, borrowings are subject to certain customary conditions and contain customary events of default, including, without limitation, failure to make payments, a cross-default to certain other debt, breaches of covenants, breaches of representations and warranties, a change in control, certain monetary judgments and bankruptcy and ERISA events. Upon any such event of default, the principal amount of any unpaid loans and all other obligations under the Credit Agreement may be declared immediately due and payable. The maximum availability under the facility is limited by a borrowing base formula which consists of a percentage of eligible inventory and eligible credit card receivables, less reserves.

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

As of April 30, 2016, the Company was in compliance with the covenants in the facility, and there were no outstanding borrowings under the credit facility, with approximately \$41.9 million available for borrowing.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Forward Looking Statements**

This Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to provide an understanding of our financial condition, change in financial condition, cash flow, liquidity and results of operations. The following MD&A discussion should be read in conjunction with the condensed consolidated financial statements and notes to those statements that appear elsewhere in this Form 10-Q and in our Annual Report on Form 10-K, filed April 8, 2016. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed or referred to in the forward-looking statements. Factors that could cause or contribute to any differences include, but are not limited to, those discussed under the caption Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995 and under Part II, Item 1A Risk Factors.

General

We are a specialty retailer of home décor and gifts in the United States, operating 382 stores in 36 states as of April 30, 2016, as well as an e-Commerce enabled website, www.kirklands.com. Our stores present a broad selection of distinctive merchandise, including framed art, mirrors, wall décor, candles and related items, lamps, decorative accessories, accent furniture, textiles, garden-related accessories and artificial floral products. Our stores also offer an extensive assortment of holiday merchandise during seasonal periods as well as items carried throughout the year suitable for gift-giving. In addition, we use innovative design and packaging to market home décor items as gifts. We provide our predominantly female customers an engaging shopping experience characterized by a diverse, ever-changing merchandise selection reflecting current styles at prices which provide discernible value. This combination of ever-changing and stylish merchandise, value pricing and a stimulating store experience has led to our emergence as a leader in home décor and enabled us to develop a strong customer franchise.

During the 13-week period ended April 30, 2016, we opened 14 new stores and closed eight stores compared to one new store opening and three store closures during the 13-week period ended May 2, 2015. The following table summarizes our stores and square footage under lease:

| | As of April 30, 2016 | As of May 2, 2015 |
|----------------------------------|-------------------------------------|----------------------------------|
| Number of stores | 382 | 342 |
| Square footage | 2,938,578 | 2,586,644 |
| Average square footage per store | 7,693 | 7,563 |

13-Week Period Ended April 30, 2016 Compared to the 13-Week Period Ended May 2, 2015

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

13-Week Period Ended

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| | April 30, 2016 | | May 2, 2015 | | Change | |
|----------------------------|----------------|--------|-------------|--------|------------|---------|
| | \$ | % | \$ | % | \$ | % |
| Net sales | \$ 129,911 | 100.0% | \$ 118,310 | 100.0% | \$ 11,601 | 9.8% |
| Cost of sales | 80,374 | 61.9% | 70,647 | 59.7% | 9,727 | 13.8% |
| Gross profit | 49,537 | 38.1% | 47,663 | 40.3% | 1,874 | 3.9% |
| Operating expenses: | | | | | | |
| Compensation and benefits | 25,527 | 19.6% | 23,213 | 19.6% | 2,314 | 10.0% |
| Other operating expenses | 16,513 | 12.7% | 15,124 | 12.8% | 1,389 | 9.2% |
| Depreciation | 5,973 | 4.6% | 5,229 | 4.4% | 744 | 14.2% |
| Total operating expenses | 48,013 | 36.9% | 43,566 | 36.8% | 4,447 | 10.2% |
| Operating income | 1,524 | 1.2% | 4,097 | 3.5% | (2,573) | (62.8%) |
| Interest expense, net | 73 | 0.1% | 70 | 0.1% | 3 | 4.3% |
| Other income, net | (59) | (0.1%) | (55) | (0.0%) | (4) | 7.3% |
| Income before income taxes | 1,510 | 1.2% | 4,082 | 3.4% | (2,572) | (63.0%) |
| Income tax expense | 594 | 0.5% | 1,553 | 1.3% | (959) | (61.8%) |
| Net income | \$ 916 | 0.7% | \$ 2,529 | 2.1% | \$ (1,613) | (63.8%) |

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Net sales. Net sales increased 9.8% to \$129.9 million for the first fiscal quarter of 2016 compared to \$118.3 million for the prior year period. The impact of net new store growth contributed an increase to net sales of \$11.0 million. An increase in comparable store sales, including e-Commerce sales, of 0.5%, contributed an increase over the prior year quarter of \$0.6 million. Comparable store sales, including e-Commerce sales, increased 3.0% in the prior year period. For the first fiscal quarter of 2016, the e-Commerce business was up 28.0% versus the prior year period, while comparable store sales at brick-and-mortar stores decreased 1.4%. For brick-and-mortar stores, the comparable store sales decrease was primarily due a decrease in transactions combined with a small decrease in the average ticket. The decreased transactions resulted from a decline in traffic, partially offset by an increase in conversion. The slight decrease in average ticket was due to a decrease in items sold per transaction, partially offset by an increase in the average unit retail price. The e-Commerce business benefitted from an increase in website traffic coupled with an increase in conversion, slightly offset by a decrease in average order size. The merchandise categories contributing most to the comparable store sales increase were mirrors, clocks, furniture, fragrance and Easter seasonal.

Gross profit. Gross profit as a percentage of net sales decreased from 40.3% in the first quarter of fiscal 2015 to 38.1% in the first quarter of fiscal 2016. The overall decrease in gross profit margin was primarily due to lower merchandise margins and higher store occupancy and central distribution costs partially offset by slightly lower outbound freight costs. Merchandise margin is calculated as net sales minus product cost of sales (including inbound freight), inventory shrinkage, and loyalty reward program charges. Merchandise margin excludes outbound freight, store occupancy and central distribution costs. Merchandise margin decreased from 56.4% in the first quarter of fiscal 2015 to 55.8% in the first quarter of fiscal 2016. The decrease in merchandise margin was primarily due to promotional markdowns to manage inventory levels. Store occupancy costs as a percentage of net sales increased due to the increased level of store opening activity in the quarter as well as some deleverage due to negative brick and mortar comparable store sales. Our central distribution costs increased as a percentage of net sales due to the addition of a 300,000 square-foot fulfillment facility in Jackson, Tennessee. We transitioned to fulfilling ecommerce orders out of this facility in the first quarter of 2016 which resulted in additional startup and labor costs.

Compensation and benefits. Compensation and benefits expenses at the store level increased as a percentage of net sales for the first quarter of fiscal 2016 as compared to the first quarter of fiscal 2015 due to lower comparable store sales, an increase in new store opening activity and higher healthcare costs. At the corporate level, the compensation and benefits ratio was lower in the first quarter of 2016 as compared to the prior year period due to lower stock-based compensation expense. In the prior year quarter there was \$0.6 million of stock-based compensation expense that resulted from the accelerated vesting of stock options and restricted stock units upon the retirement of our former Chief Executive Officer.

Other operating expenses. Other operating expenses decreased slightly as a percentage of net sales versus the prior year period. At the corporate level, professional and legal fees decreased in dollars and as a percent of net sales. At the store level, advertising expense increased in dollars and as a percentage of net sales compared to the prior year period primarily due to the increased new store opening activity.

Depreciation. The increase in depreciation as a percentage of sales reflects an increase in capital expenditures in recent fiscal years and the implementation of major technology upgrades.

Income tax expense. We recorded income tax expense of approximately \$0.6 million, or 39.3% of pre-tax income during the first quarter of fiscal 2016 compared to income tax expense of approximately \$1.6 million, or 38.0% of pre-tax income during the prior year quarter.

Net income and earnings per share. As a result of the foregoing, we reported net income of \$0.9 million, or \$0.06 per diluted share, for the first quarter of fiscal 2016 as compared to net income of \$2.5 million, or \$0.14 per diluted share,

for the first quarter of fiscal 2015.

Liquidity and Capital Resources

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

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Cash flows from operating activities. Net cash provided operating activities was approximately \$2.7 million for the first quarter of fiscal 2016, compared to net cash used in operating activities of approximately \$0.6 million for the first quarter of fiscal 2015. Cash flows from operating activities depend heavily on operating performance and changes in working capital. The change in the amount of cash from operations as compared to the prior year period was primarily the result of changes in working capital partially offset by a decline in operating performance.

Cash flows from investing activities. Net cash used in investing activities for the first quarter of fiscal 2016 consisted of \$8.7 million in capital expenditures as compared to \$2.7 million in capital expenditures for the prior year period. The capital expenditures in the current year period related to the opening of 14 new stores during the period, investments in our existing stores, improvements to our supply chain, as well as investments in our omni-channel systems. Capital expenditures in the prior year period related primarily to technology investments in our stores and e-Commerce site, improvements to our supply chain, investments in existing stores, as well as the opening of one new store during the period. We expect that capital expenditures for all of fiscal 2016 will be approximately \$25 to \$30 million, primarily to fund the leasehold improvements of new stores, supply chain investments, improvements in our information technology infrastructure and multi-channel capabilities, and maintain our investments in existing stores.

Cash flows from financing activities. Net cash used in financing activities was approximately \$0.1 million for the first quarter of fiscal 2016, and was primarily related to debt issuance costs partially offset by employee stock purchases. Net cash used in financing activities was approximately \$2.4 million for the first quarter of fiscal 2015, and was primarily related to the repurchase and retirement of common stock and cash used in net share settlement of stock options and restricted stock, partially offset by tax benefits related to the exercise of employee stock options and vesting of restricted stock units.

Revolving credit facility. On February 26, 2016, we entered into a Joinder and First Amendment to Amended and Restated Credit Agreement (the "Credit Agreement") with Bank of America, N.A. as administrative agent and collateral agent, and the lenders (the "Lenders"), amending our prior credit agreement entered into in 2011. The Credit Agreement increased our senior secured revolving credit facility from \$50 million to \$75 million, increased the swingline availability from \$5 million to \$10 million, added a \$25 million incremental accordion feature and extended the maturity date from August 2016 to February 2021. Borrowings under the facility bear interest at an annual rate equal to LIBOR plus a margin ranging from 125 to 175 basis points with no LIBOR floor. Additionally, a fee of 0.25% per annum is assessed on the unused portion of the facility.

Pursuant to the Credit Agreement, borrowings are subject to certain customary conditions and contain customary events of default, including, without limitation, failure to make payments, a cross-default to certain other debt, breaches of covenants, breaches of representations and warranties, a change in control, certain monetary judgments and bankruptcy and ERISA events. Upon any such event of default, the principal amount of any unpaid loans and all other obligations under the Credit Agreement may be declared immediately due and payable. The maximum availability under the facility is limited by a borrowing base formula which consists of a percentage of eligible inventory and eligible credit card receivables, less reserves.

We are subject to an Amended and Restated Security Agreement (the "Security Agreement") with our Lenders. Pursuant to the Security Agreement, we pledged and granted to the administrative agent, for the benefit of itself and the secured parties specified therein, a lien on and security interest in all of the rights, title and interest in substantially all of our assets to secure the payment and performance of the obligations under the Credit Agreement.

As of April 30, 2016, we were in compliance with the covenants in the facility, and there were no outstanding borrowings under the credit facility, with approximately \$41.9 million available for borrowing.

At April 30, 2016, our balance of cash and cash equivalents was approximately \$38.2 million. We do not anticipate any borrowings under the credit facility during fiscal 2016. We believe that the combination of our cash balances and cash flow from operations will be sufficient to fund our planned capital expenditures and working capital requirements for at least the next twelve months.

Table of Contents**Related Party Transactions**

In July 2009, we entered into an agreement with a related party vendor to purchase merchandise inventory. The vendor is considered a related party for financial reporting purposes because its principal owner is the spouse of our Vice President of Merchandising. The table below sets forth selected results to this vendor in dollars (in millions) and percentages for the periods indicated:

| | 13-Week Period Ended | |
|---|-----------------------------|------------------------|
| | April 30, 2016 | May 2, 2015 |
| Related Party Vendor: | | |
| Purchases | \$ 8.5 | \$ 7.1 |
| Purchases as a percent of total merchandise purchases | 15.4% | 12.7% |
| Cost of sales | \$ 8.7 | \$ 6.4 |
| Payable amounts outstanding at period end | \$ 2.1 | \$ 2.9 |

Significant Contractual Obligations and Commercial Commitments*Construction Commitments*

The Company had commitments for new store construction projects totaling approximately \$1.2 million at April 30, 2016.

Critical Accounting Policies and Estimates

There have been no significant changes to our critical accounting policies during fiscal 2016. Refer to our Annual Report on Form 10-K for the fiscal year ended January 30, 2016, for a summary of our critical accounting policies.

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

The following information is provided pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Certain statements under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-Q are forward-looking statements made pursuant to these provisions. Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that does not directly relate to any historical or current fact. Words such as should, likely to, forecasts, strategy, goal, anticipates, believes, expects, estimates, intends, plans, projects, and similar identify such forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from the results projected in such statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

The factors listed below under the heading Risk Factors and in the other sections of this Form 10-Q provide examples of risks, uncertainties and events that could cause our actual results to differ materially from the expectations expressed in our forward-looking statements.

These forward-looking statements speak only as of the date of this report and, except as required by law, we undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this

report.

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

If We Do Not Generate Sufficient Cash Flow, We May Not Be Able to Implement Our Growth Strategy.

If We Are Unable to Profitably Open and Operate New Stores at a Rate that Exceeds Planned Store Closings, We May Not Be Able to Adequately Execute Our Growth Strategy, Resulting in a Decrease in Net Sales and Net Income.

Our Success Depends Upon our Marketing, Advertising and Promotional Efforts. If We are Unable to Implement them Successfully, or if Our Competitors Market, Advertise or Promote More Effectively than We Do, Our Revenue May Be Adversely Affected.

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

We May Not Be Able to Successfully Respond to Technological Change, Our Website Could Become Obsolete and Our Financial Results and Conditions Could be Adversely Affected.

Inventory Loss and Theft and the Inability to Anticipate Inventory Needs may Result in Reduced Net Sales.

Inability to Successfully Develop and Maintain a Relevant and Reliable Multichannel Experience for Our Customers Could Adversely Affect Our Sales, Results of Operations and Reputation.

Our Results Could be Negatively Impacted if our Merchandise Offering Suffers a Substantial Impediment to its Reputation Due to Real or Perceived Quality Issues.

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

Weather Conditions Could Adversely Affect Our Sales and/or Profitability by Affecting Consumer Shopping Patterns.

We are Exposed to the Risk of Natural Disasters, Pandemic Outbreaks, Global Political Events, War and Terrorism That Could Disrupt Our Business and Result in Lower Sales, Increased Operating Costs and Capital Expenditures.

Our Performance May be Affected by General Economic Conditions.

Our Profitability is Vulnerable to Inflation and Cost Increases.

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

Failure to Control Merchandise Returns Could Negatively Impact the Business.

We May Experience Significant Variations in Our Quarterly Results.

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

Our Freight Costs and thus Our Cost of Goods Sold are Impacted by Changes in Fuel Prices.

New Legal Requirements Could Adversely Affect Our Operating Results.

Litigation May Adversely Affect Our Business, Financial Condition, Results of Operations or Liquidity.

Product Liability Claims Could Adversely Affect Our Reputation.

If We Fail to Protect Our Brand Name, Competitors May Adopt Trade Names that Dilute the Value of Our Brand Name.

Failure to Protect the Integrity and Security of Individually Identifiable Data of Our Customers and Employees Could Expose Us to Litigation and Damage Our Reputation; The Expansion of Our e-Commerce Business Has Inherent Cybersecurity Risks That May Result in Business Disruptions.

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

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

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

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

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

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

If We Fail to Maintain an Effective System of Internal Control, We May Not be Able to Accurately Report Our Financial Results.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company does not utilize financial instruments for trading or other speculative purposes, nor does it utilize leveraged financial instruments. There have been no material changes in the market risk factors from those disclosed in the Company's Form 10-K for the year ended January 30, 2016.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures.* Both our President and Chief Executive Officer and Vice President and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15(d)-(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act)) have concluded that as of April 30, 2016 our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by the Company in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

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

Table of Contents**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

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

ITEM 1A. RISK FACTORS

In addition to factors set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations' Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995, in Part I Item 2 of this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016, which could materially affect our business, financial condition or future results. The risks described in this report and in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

ITEM 6. EXHIBITS

- (a) Exhibits.

| Exhibit No. | Description of Document |
|------------------------|--------------------------------|
|------------------------|--------------------------------|

| | |
|------|---|
| 31.1 | Certification of the President and Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) |
| 31.2 | Certification of the Vice President and Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) |
| 32.1 | Certification of the President and Chief Executive Officer pursuant to 18 U.S.C. Section 1350 |
| 32.2 | Certification of the Vice President and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 |
| 101 | Interactive Data File (Quarterly Report on Form 10-Q, for the quarter ended April 30, 2016, furnished in XBRL (eXtensible Business Reporting Language)) |

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SIGNATURES

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

KIRKLAND S, INC.

Date: June 6, 2016

/s/ W. Michael Madden
W. Michael Madden
President and Chief Executive Officer

Date: June 6, 2016

/s/ Adam C. Holland
Adam C. Holland
Vice President and Chief Financial Officer

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