

Lumber Liquidators Holdings, Inc.  
Form 10-Q  
November 09, 2010  
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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 September 30, 2010**

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: 001-33767**

**Lumber Liquidators Holdings, Inc.**

**(Exact name of registrant as specified in its charter)**

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**3000 John Deere Road**

**Toano, Virginia**  
(Address of Principal Executive Offices)

**27-1310817**  
(I.R.S. Employer  
Identification No.)

**23168**  
(Zip Code)

**(757) 259-4280**  
(Registrant's telephone number, including area code)

**Not Applicable**

(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 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. (Check one):

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

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

As of November 8, 2010, there were 27,424,089 shares of the registrant's common stock, par value of \$0.001 per share, outstanding.

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**LUMBER LIQUIDATORS HOLDINGS, INC.**

Quarterly Report on Form 10-Q

For the quarter ended September 30, 2010

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**Table of Contents****PART I****FINANCIAL INFORMATION****Item 1. Financial Statements.****Lumber Liquidators Holdings, Inc.****Condensed Consolidated Balance Sheets****(in thousands, except share data)**

|  | <b>September 30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|-------------------------------|------------------------------|
|  | <i>(unaudited)</i>            |                              |
| <b>Assets</b>  |                               |                              |
| <b>Current Assets:</b>   |                               |                              |
| Cash and Cash Equivalents  | \$ 26,787                     | \$ 35,675                    |
| Merchandise Inventories  | 156,963                       | 133,342                      |
| Prepaid Expenses   | 4,862                         | 5,988                        |
| Other Current Assets   | 7,254                         | 4,356                        |
| <b>Total Current Assets</b>  | <b>195,866</b>                | <b>179,361</b>               |
| Property and Equipment, net  | 32,454                        | 20,491                       |
| Deferred Income Taxes  | 1,654                         | 2,002                        |
| Other Assets   | 4,524                         | 4,026                        |
| <b>Total Assets</b>  | <b>\$ 234,498</b>             | <b>\$ 205,880</b>            |
| <b>Liabilities and Stockholders Equity</b>   |                               |                              |
| <b>Current Liabilities:</b>  |                               |                              |
| Accounts Payable   | \$ 23,248                     | \$ 32,608                    |
| Customer Deposits and Store Credits  | 21,308                        | 9,805                        |
| Accrued Compensation   | 2,996                         | 4,512                        |
| Sales and Income Tax Liabilities   | 3,066                         | 2,770                        |
| Other Current Liabilities  | 7,955                         | 5,566                        |
| <b>Total Current Liabilities</b>   | <b>58,573</b>                 | <b>55,261</b>                |
| Deferred Rent  | 2,508                         | 2,185                        |
| <b>Stockholders Equity:</b>  |                               |                              |
| Common Stock (\$0.001 par value; 35,000,000 authorized; 27,421,589 and 27,234,222 outstanding, respectively) | 27                            | 27                           |
| Additional Capital   | 99,364                        | 94,726                       |
| Retained Earnings  | 74,026                        | 53,681                       |
| <b>Total Stockholders Equity</b>   | <b>173,417</b>                | <b>148,434</b>               |
| <b>Total Liabilities and Stockholders Equity</b>   | <b>\$ 234,498</b>             | <b>\$ 205,880</b>            |

*See accompanying notes to condensed consolidated financial statements*

**Table of Contents****Lumber Liquidators Holdings, Inc.****Condensed Consolidated Statements of Income**

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

(unaudited)

|  | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                  |
|--|-------------------------------------|-----------------|------------------------------------|------------------|
|  | 2010                                | 2009            | 2010                               | 2009             |
| <b>Net Sales</b>                             | \$ 147,192                          | \$ 140,520      | \$ 467,061                         | \$ 407,488       |
| Cost of Sales                                | 95,431                              | 89,336          | 303,256                            | 261,164          |
| <b>Gross Profit</b>                          | <b>51,761</b>                       | <b>51,184</b>   | <b>163,805</b>                     | <b>146,324</b>   |
| Selling, General and Administrative Expenses | 44,909                              | 38,727          | 130,985                            | 114,269          |
| Operating Income                             | 6,852                               | 12,457          | 32,820                             | 32,055           |
| Interest and Other Income, net               | (143)                               | (116)           | (371)                              | (388)            |
| Income Before Income Taxes                   | 6,995                               | 12,573          | 33,191                             | 32,443           |
| Provision for Income Taxes                   | 2,711                               | 4,812           | 12,846                             | 12,649           |
| <b>Net Income</b>                            | <b>\$ 4,284</b>                     | <b>\$ 7,761</b> | <b>\$ 20,345</b>                   | <b>\$ 19,794</b> |
| <b>Net Income per Common Share Basic</b>     | <b>\$ 0.16</b>                      | <b>\$ 0.29</b>  | <b>\$ 0.74</b>                     | <b>\$ 0.74</b>   |
| <b>Net Income per Common Share Diluted</b>   | <b>\$ 0.15</b>                      | <b>\$ 0.28</b>  | <b>\$ 0.72</b>                     | <b>\$ 0.72</b>   |
| Weighted Average Common Shares Outstanding:  |                                     |                 |                                    |                  |
| Basic  | 27,420,415                          | 27,053,067      | 27,363,621                         | 26,905,554       |
| Diluted                                      | 28,234,339                          | 27,892,790      | 28,236,042                         | 27,535,516       |

*See accompanying notes to condensed consolidated financial statements*

**Table of Contents****Lumber Liquidators Holdings, Inc.****Condensed Consolidated Statements of Cash Flows**

(in thousands)

(unaudited)

|   | <b>Nine Months Ended<br/>September 30,</b> |                  |
|---|--|------------------|
|   | <b>2010</b>                                | <b>2009</b>      |
| <b>Cash Flows from Operating Activities:</b>                                      |  |                  |
| Net Income  | \$ 20,345                                  | \$ 19,794        |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |  |                  |
| Depreciation and Amortization   | 3,993                                      | 3,470            |
| Stock-Based Compensation Expense  | 2,355                                      | 2,298            |
| Changes in Operating Assets and Liabilities:                                      |  |                  |
| Merchandise Inventories   | (23,621)                                   | (15,326)         |
| Accounts Payable  | (11,135)                                   | 10,448           |
| Customer Deposits and Store Credits   | 11,503                                     | 1,739            |
| Prepaid Expenses and Other Current Assets   | (1,671)                                    | 1,468            |
| Other Assets and Liabilities  | 1,188                                      | 2,557            |
| <b>Net Cash Provided by Operating Activities</b>                                  | <b>2,957</b>                               | <b>26,448</b>    |
| <b>Cash Flows from Investing Activities:</b>                                      |  |                  |
| Purchases of Property and Equipment   | (14,127)                                   | (8,131)          |
| <b>Net Cash Used in Investing Activities</b>                                      | <b>(14,127)</b>                            | <b>(8,131)</b>   |
| <b>Cash Flows from Financing Activities:</b>                                      |  |                  |
| Proceeds from the Exercise of Stock Options                                       | 1,321                                      | 2,593            |
| Excess Tax Benefits on Stock Option Exercises                                     | 1,110                                      | 743              |
| Common Stock Purchased Pursuant to Equity Compensation Plans                      | (149)                                      | (39)             |
| Other   |  | (1)              |
| <b>Net Cash Provided by Financing Activities</b>                                  | <b>2,282</b>                               | <b>3,296</b>     |
| <b>Net (Decrease) Increase in Cash and Cash Equivalents</b>                       | <b>(8,888)</b>                             | <b>21,613</b>    |
| <b>Cash and Cash Equivalents, Beginning of Period</b>                             | <b>35,675</b>                              | <b>35,139</b>    |
| <b>Cash and Cash Equivalents, End of Period</b>                                   | <b>\$ 26,787</b>                           | <b>\$ 56,752</b> |

*See accompanying notes to condensed consolidated financial statements*

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**Lumber Liquidators Holdings, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(amounts in thousands, except share data and per share amounts)**

**(unaudited)**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Nature and Organization of Business***

Lumber Liquidators Holdings, Inc. and its subsidiaries (the Company) is a multi-channel specialty retailer of hardwood flooring, and hardwood flooring enhancements and accessories, operating as a single business segment. The Company offers an extensive assortment of exotic and domestic hardwood species, engineered hardwoods and laminates direct to the consumer. The Company also features the renewable flooring products, bamboo and cork, and provides a wide selection of flooring enhancements and accessories, including moldings, noise-reducing underlay and adhesives. These products are primarily sold under the Company's private label brands, including the premium Bellwood brand floors. The Company sells primarily to homeowners or to contractors on behalf of homeowners through a network of 213 store locations in primary or secondary metropolitan areas in 46 states. In addition to the store locations, the Company's products may be ordered, and customer questions/concerns addressed, through both the call center in Toano, Virginia, and the website, [www.lumberliquidators.com](http://www.lumberliquidators.com). The Company finishes the majority of the Bellwood products on its finishing line in Toano, Virginia, which along with the call center, corporate offices, and distribution center, represent the Corporate Headquarters.

***Basis of Financial Statement Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q for interim financial reporting pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). While these statements reflect all normal recurring adjustments which are, in the opinion of management, necessary for a fair presentation of the results of the interim period, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (U.S. GAAP) for complete financial statements. Therefore, the interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in the Lumber Liquidators Holdings, Inc. annual report filed on Form 10-K for the year ended December 31, 2009.

The consolidated financial statements of the Company include the accounts of its wholly owned subsidiaries. All significant intercompany transactions have been eliminated in consolidation.

Results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results to be expected for the full year.

***Fair Value of Financial Instruments***

The carrying amounts of financial instruments such as cash and cash equivalents, notes receivable, accounts payable and other liabilities approximate fair value because of the short-term nature of these items. Of these financial instruments, the cash equivalents are classified as Level 1 as defined in the Financial Accounting Standards Board ASC 820 fair value hierarchy. The Company had cash equivalents of \$11,045 at September 30, 2010 and \$27,022 at December 31, 2009.



**Table of Contents****NOTE 2. NET INCOME PER COMMON SHARE**

The following table sets forth the computation of basic and diluted net income per common share:

|                                     | Three Months Ended September 30, |            | Nine Months Ended September 30, |            |
|-------------------------------------|----------------------------------|------------|---------------------------------|------------|
|                                     | 2010                             | 2009       | 2010                            | 2009       |
| Net Income                          | \$ 4,284                         | \$ 7,761   | \$ 20,345                       | \$ 19,794  |
| Weighted Average Common Shares      |                                  |            |                                 |            |
| Outstanding Basic                   | 27,420,415                       | 27,053,067 | 27,363,621                      | 26,905,554 |
| Effect of Dilutive Securities:      |                                  |            |                                 |            |
| Common Stock Equivalents            | 813,924                          | 839,723    | 872,421                         | 629,962    |
| Weighted Average Common Shares      |                                  |            |                                 |            |
| Outstanding Diluted                 | 28,234,339                       | 27,892,790 | 28,236,042                      | 27,535,516 |
| Net Income per Common Share Basic   | \$ 0.16                          | \$ 0.29    | \$ 0.74                         | \$ 0.74    |
| Net Income per Common Share Diluted | \$ 0.15                          | \$ 0.28    | \$ 0.72                         | \$ 0.72    |

The following have been excluded from the computation of Weighted Average Common Shares Outstanding Diluted because the effect would be anti-dilutive:

|                         | Three Months Ended September 30, |        | Nine Months Ended September 30, |        |
|-------------------------|----------------------------------|--------|---------------------------------|--------|
|                         | 2010                             | 2009   | 2010                            | 2009   |
| Stock Options           | 287,017                          | 12,864 | 287,017                         | 12,864 |
| Restricted Stock Awards | 1,885                            | 6,110  | 1,885                           | 6,110  |

**NOTE 3. RELATED PARTY TRANSACTIONS**

As of September 30, 2010, the Company leased the Corporate Headquarters and 25 of its store locations from ANO LLC, a company that is wholly owned by the Company's founder and current chairman of the Board (the Founder). The Company also leased one store location from Wood on Wood Road, Inc. and one store location from BMT Holdings, LLC. Wood on Wood Road, Inc. is wholly owned by the Founder, and 50% of the membership interest of BMT Holdings, LLC is owned by the Founder. Rental expense related to these companies for the three and nine months ended September 30, 2010 was \$660 and \$1,978, respectively. Rental expense related to these companies for the three and nine months ended September 30, 2009 was \$630 and \$1,902, respectively.

**NOTE 4. COMMITMENTS AND CONTINGENCIES**

On September 3, 2009, a former store manager and a current assistant store manager at the time (together, the Plaintiffs) filed a putative class action suit against Lumber Liquidators, Inc. (LLI) in the Superior Court of California in and for the County of Alameda. The Plaintiffs allege that with regard to certain groups of current and former employees in LLI's California stores, LLI violated California law by failing to calculate and pay overtime wages properly, provide meal breaks, compensate for unused vacation time, reimburse for certain expenses and maintain required employment records. The Plaintiffs also claim that LLI did not calculate and pay overtime wages properly for certain of LLI's non-exempt employees, both in and out of California, in violation of federal law. In their suit, the Plaintiffs seek compensatory damages, certain statutory penalties, costs, attorney's fees and injunctive relief. LLI removed the case to the United States District Court for the Northern District of California. No class has been certified with regard to any of the alleged causes of action. LLI is vigorously defending the claims in this suit including class certification. While there is a reasonable possibility that a material loss may be incurred, the Company cannot estimate the loss or range of loss, if any, to the Company at this time.

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On or about September 7, 2010, a former store manager filed an action against LLI in the United States District Court for the Middle District of Florida. In the complaint, the former store manager alleges that LLI breached an alleged contract for the payment of a commission and violated the Fair Labor Standards Act ( FLSA ) by failing to pay him for overtime hours worked. In addition, he asserts a purported collective action on behalf of similarly situated LLI employees alleging that LLI denied them overtime wages in violation of the FLSA. No class has been certified with regard to the purported collective action. LLI intends to defend the claims in this suit vigorously including collective action certification. While there is a reasonable possibility that a material loss may be incurred, the Company cannot estimate the loss or range of loss, if any, to the Company at this time.

The Company also is, from time to time, subject to claims and disputes arising in the normal course of business. In the opinion of management, while the outcome of any such claims and disputes cannot be predicted with certainty, the ultimate liability of the Company in connection with these matters is not expected to have a material adverse effect on the Company's results of operations, financial position or cash flows.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

#### **Cautionary Note Regarding Forward-Looking Statements**

This report includes statements of our expectations, intentions, plans and beliefs that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and are intended to come within the safe harbor protection provided by those sections. These statements, which involve risks and uncertainties, relate to matters such as sales growth, comparable store net sales, impact of cannibalization, price changes, earnings performance, stock-based compensation expense, margins, return on invested capital, strategic direction, the demand for our products, and store openings. We have used words such as may, will, should, expects, intends, plans, anticipates, believes, thinks, estimates, seeks, predicts, could, projects, potential and other similar terms and references to assumptions, in this report to identify forward-looking statements. These forward-looking statements are made based on expectations and beliefs concerning future events affecting us and are subject to uncertainties, risks and factors relating to our operations and business environments, all of which are difficult to predict and many of which are beyond our control, that could cause our actual results to differ materially from those matters expressed or implied by these forward-looking statements. These risks and other factors include those listed in this report and in our other reports filed with the SEC, including the Item 1A, Risk Factors, section of the Form 10-K for the year ended December 31, 2009.

When considering these forward-looking statements, you should keep in mind the cautionary statements in this report and the documents incorporated by reference. New risks and uncertainties arise from time to time, and we cannot predict those events or how they may affect us. There may also be other factors that we cannot anticipate or that are not described in this report that could cause results to differ materially from our expectations. Forward-looking statements speak only as of the date they are made and we assume no obligation to update them after the date of this report as a result of new information, future events or subsequent developments, except as required by the federal securities laws.

This management discussion should be read in conjunction with the financial statements and notes included in Part I, Item 1. Financial Statements of this quarterly report and the audited financial statements and notes and management discussion included in our annual report filed on Form 10-K for the year ended December 31, 2009.

#### **Overview**

Lumber Liquidators is the largest specialty retailer of hardwood flooring in the United States, based on industry sources and our experience. We believe we have achieved a reputation for offering great value, superior service and a broad selection of high-quality hardwood flooring products. We offer an extensive selection of premium hardwood flooring products under multiple proprietary brands at everyday low prices designed to appeal to a diverse customer base. We believe that our vertically integrated business model enables us to offer a broad assortment of high-quality products to our customers at a lower cost than our competitors. As of September 30, 2010, we sold our products through 213 Lumber Liquidators stores in 46 states, a call center, websites and catalogs.

#### **2010 Highlights**

##### ***SAP Implementation.***

**Overview.** In June 2009, we signed a software license agreement with SAP Retail, Inc. ( "SAP" ) for a broad scope of SAP retail software products to implement an integrated business solution in multiple phases. On August 21, 2010, we implemented the first, and most significant, phase, which included:

An enhanced point-of-sale solution across our entire store base,

A warehouse management and inventory control system serving our entire distribution network,

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An integrated merchandising and product allocation system, and

Related management reporting functionality.

These new management information solutions were fully integrated with our website, call center and customer service systems.

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All critical information was converted from our previous information system and we have continued to operate our business without interruption since the conversion. However, the implementation of this system had a pervasive impact across our operations, primarily resulting in reduced productivity in our store and warehouse operations, adversely impacting our results in the quarter ended September 30, 2010. This reduction in productivity included:

The effectiveness of our store operations to satisfy existing customer orders, and generate new demand,

The efficiency of our product allocation and distribution, and

The allocation of resources required to operate our business.

The reduction in productivity was greatest in the initial weeks following implementation. Although the Company did not reach pre-implementation productivity by the end of the third quarter, operational efficiency and effectiveness improved during September and improvement has continued in the fourth quarter of 2010. Additional resources were allocated to address specific areas of concern in September, and we will continue to dedicate appropriate resources through the remainder of 2010 to improve operating productivity. In addition, general operating familiarity improved with continued execution. In an effort to focus appropriate resources on serving our domestic customers, we have postponed the opening of our first stores in Canada until the first quarter of 2011.

We remain confident in the long-term benefits of the integrated solution, and we believe our operations will ultimately benefit from enhancements not available through our previous information system. We expect the SAP system to enable us to further increase the discipline and efficiency with which we manage operations, and improve communication across our organization to support our growth plans. Our new system provides us with a platform that can grow and evolve as our supply chain network changes through additional warehouses and distribution centers. The new platform will also help facilitate our international expansion into Canada and other locations beyond North America, as well as the electronic exchange of information with our business partners. Additionally, we believe that we will benefit from better inventory information that will enable more precise allocations, automation of manual processes and improved management visibility which ultimately should positively impact net sales and margin dollars. We expect to enter 2011 with enhanced system capabilities that will offer us the opportunity to gain sales momentum and market share.

**Impact on Third Quarter Results.** Reduced productivity related to our SAP implementation impacted both our results of operations for the quarter ended September 30, 2010 and our financial position at that date, including:

Effective conversion of demand into net sales: Our total net sales for the third quarter of 2010 were \$147.2 million, 4.7% higher than net sales for the third quarter of 2009, and at our comparable stores,<sup>1</sup> net sales were down 5.7%. However, based on our results prior to implementation and customer demand through the quarter, we estimate that reduced productivity resulted in approximately \$12 million to \$14 million in unrealized net sales during the third quarter.

For the period of the third quarter prior to the implementation:

Net sales for the month of July 2010 were 15.5% higher and net sales at comparable stores were 4.6% higher than July 2009;

Net sales for the first 21 days of August 2010 were 23.6% higher and net sales at comparable stores were 11.5% higher than the comparable period in August 2009; and

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Customer deposits were \$13.4 million on August 21, 2010.

For the full month of August 2010, net sales increased only 1.8% in comparison to August 2009, and at our comparable stores, decreased 8.3%. In September 2010, net sales decreased 2.0% in comparison to September 2009 and comparable store net sales decreased 12.6%.

Customer demand, as evidenced by customer deposits on open orders, grew from \$13.4 million at implementation to \$16.1 million at the end of August 2010 and at September 30, 2010, our balance sheet reflects customer deposits and store credits of \$21.3 million. In comparison, the balance was \$12.2 million at September 30, 2009.

Customer deposits have historically represented one-half to two-thirds of our open orders at any given point in time. Our open orders are those where the customer has placed an order, but has not yet taken possession of the product. We generally require a 50% deposit on an open order, but depending on order-specific circumstances, we may receive a greater deposit. We recognize revenue when the customer takes possession of the merchandise, and until that time, a customer deposit is a liability on our balance sheet.

<sup>1</sup> We generally consider a store comparable on the first day of the thirteenth full calendar month after opening.

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We estimate this build in customer deposits over historic norms and over our expectations during the third quarter equated to approximately \$12.0 million to \$14.0 million in unrealized net sales during the third quarter.

**Efficient product movement:** Our gross margin for the third quarter of 2010 was 35.2%, which reflected less efficient transportation of products after implementation, increases in our inventory reserves and increases in certain finishing costs.

We estimate these costs reduced gross margin by approximately 30 basis points.

Prior to implementation, we significantly reduced product flow in preparation for a physical inventory at points within our distribution network, including our central warehouse operation. In the first few weeks following implementation, we were not able to re-establish the product flow as quickly as expected. Though we returned to anticipated levels of product distribution in mid-September, the unit count shipped during the third quarter of 2010 was significantly lower than our expectations. In addition, delays in shipping products necessary to fulfill orders resulted in more expedited modes of transportation, generally at higher costs.

We have historically utilized cycle counts of physical inventory on a sample basis to adjust our inventory reserves during the year, and performed a full physical count of all locations simultaneously in conjunction with our year-end closing procedures. Our annual shrinkage has generally been immaterial, and our related reserve is combined with an analysis of obsolescence. Together, those reserves were \$0.6 million and \$0.5 million at December 31, 2009 and December 31, 2008, respectively. As a result of physical inventory procedures performed prior to implementation, our evaluation of productivity within the new inventory control systems, and our general quarterly review procedures related to inventory, we increased our inventory reserve for loss and obsolescence. This reserve was \$1.7 million at September 30, 2010 and \$1.0 million at September 30, 2009.

The reduction in warehousing and merchandising productivity also impacted our finishing operations for the first few weeks following implementation. We finished fewer units per hour in comparison to historic norms due to the physical inventory procedures and slower ramp up of operations after implementation.

**Additional supporting resources:** We allocated a greater amount of internal and external resources than expected to stabilize our system after implementation, support operations and address the loss of productivity in certain key areas. As a result, capitalized costs associated with our implementation increased, and certain selling, general and administrative ( SG&A ) expenses were higher than expected. We believe these non-recurring costs were approximately \$0.5 million and included:

Warehousing costs, where loss of productivity increased our cost per throughput unit,

Store point-of-sale support,

Customer service support,

Supplemental training, and

Financial accounting and reporting.

Through September 30, 2010, we had capitalized approximately \$13.9 million related to our new integrated system, including work allowing for international operations. We now expect an additional \$1.5 million to \$2.5 million in capitalized costs by the end of 2010. We had previously expected capitalized costs to reach a total of \$13.0 million for the project by the end of 2010. Increases were primarily a result of scope expansion and the development of processes to enhance the visibility and the reporting required to stabilize the system after implementation and generally moderate the loss of productivity.

Increased inventory carrying levels and reduced liquidity: We believe our merchandise inventory levels at September 30, 2010 were approximately \$8.0 million higher than the levels would have been had the open demand discussed above been converted into invoiced sales. In addition, we aggressively increased inventory levels prior to implementation, and as result, our relationship of accounts payable to merchandise inventory at the end of the third quarter of 2010 was not comparable to prior periods.



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**Expectations and Risks for the Fourth Quarter.** We continue to experience the impacts of reduced productivity in the fourth quarter of 2010, though operational efficiency and effectiveness are improving. We currently expect to regain much of the pre-implementation productivity during the fourth quarter, but we anticipate that achievement will continue to require resources greater than expected. Amongst our key challenges in the fourth quarter:

Timely service of the significant build in open orders existing at September 30, 2010 to convert that demand into invoiced sales. While we have reduced open demand in October 2010, we may continue to carry open orders at a higher level than our historic norm through December 31, 2010. As such, we may not fully convert that demand into invoiced sales in the fourth quarter.

Increase in-store comfort with the new functionality to serve new demand. The productivity of our store operations must continue to improve to allow both conversion of demand existing at September 30, 2010 into fourth quarter sales, and provide appropriate service to new customers.

Enhance efficiency of product flow. While we believe we have restored appropriate product flow through our distribution network, we continue to allocate greater resources to those areas, resulting in greater costs per unit than our historic norm.

Our October 2010 net sales increased approximately 14.5% over the prior year period, and net sales at our comparable stores increased 2.9%. Customer deposits and store credits at October 31, 2010 were approximately \$17.0 million, down from \$21.3 million at September 30, 2010 and comparable to \$12.2 million at October 31, 2009.

***Outlook.***

In addition to the productivity challenges described above, we believe that, relative to historical metrics, the wood flooring market is likely to remain in a weakened state through the remainder the fourth quarter of 2010. The wood flooring market for homeowners is highly fragmented and dependent on home-related discretionary spending, which is impacted by a number of complex economic and demographic factors that may vary locally, regionally and nationally. Many of the economic indicators associated with the wood flooring market and generally associated with consumer discretionary spending remain weak. While our results have been impacted by the implementation of our integrated business solution, we continue to believe we deliver a unique value proposition to our customers, which translates to gains in our share of the wood flooring market.

Based on our results to date and current trends, we expect the following for the fourth quarter and full year 2010:

Total net sales for the fourth quarter of 2010 increasing 10% - 15% over the fourth quarter of 2009 for a range of \$151 million to \$157 million. Comparable store net sales are expected to increase in the low to mid-single digits.

Total net sales for the full year of 2010 in the range of \$618 million to \$624 million and comparable store net sales increases in the low single digits.

Opening nine to 11 new store locations domestically in the fourth quarter of 2010, for a total of 36 to 38 new store locations in 2010.

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Fourth quarter 2010 earnings per diluted share in the range of \$0.21 to \$0.27, and full year 2010 earnings per diluted share in the range of \$0.93 to \$0.99, based on a diluted share count of approximately 28.2 million shares and an effective tax rate in the range of 38.7% to 39.0%.

### Results of Operations

#### Net Sales

|  | For the three months ended |                       | For the nine months ended |                       |
|--|----------------------------|-----------------------|---------------------------|-----------------------|
|  | September 30,<br>2010      | September 30,<br>2009 | September 30,<br>2010     | September 30,<br>2009 |
|  | (dollars in thousands)     |                       |                           |                       |
| Net sales                                      | \$ 147,192                 | \$ 140,520            | \$ 467,061                | \$ 407,488            |
| Percentage increase                            | 4.7%                       | 14.2%                 | 14.6%                     | 11.4%                 |
| Comparable store net sales (decrease) increase | (5.7)%                     | 1.9%                  | 2.4%                      | (1.8)%                |

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Net sales for the third quarter of 2010 increased \$6.7 million, or 4.7%, over the third quarter of 2009 as a result of an increase of \$14.7 million in non-comparable store net sales which was partially offset by a decrease of \$8.0 million in comparable store net sales. Net sales for the nine months ended September 30, 2010 increased \$59.6 million, or 14.6%, over the same prior year period as a result of a \$9.9 million increase in comparable store net sales and an increase of \$49.7 million in non-comparable store net sales. In addition to effects from our system implementation, our net sales have been impacted by the following factors:

New store locations continue to drive our net sales growth. In the first nine months of 2010, we opened 27 new stores, 13 of which were in new markets. Of the 27 new stores opened in the first nine months of 2009, 18 were in new markets. For the full year 2009, we opened 36 new stores, including 24 in new markets. We have opened 70 of our 213 store locations in the 24 months after September 30, 2008, and our recent store opening activity is as follows:

|   | 2010       | 2009       |
|---|------------|------------|
| Number of stores at January 1               | 186        | 150        |
| New stores opened during the first quarter  | 11         | 10         |
| Number of stores at March 31                | 197        | 160        |
| New stores opened during the second quarter | 6          | 8          |
| Number of stores at June 30                 | 203        | 168        |
| New stores opened during the third quarter  | 10         | 9          |
| <b>Number of stores at September 30</b>     | <b>213</b> | <b>177</b> |

Net sales benefited from more consistent in-stock positions of certain key product lines, such as laminates, moldings and accessories. These product lines are included within our never out of stock program through which we have strengthened our in-stock commitment to our top selling products by region across all product lines. Our sales mix of moldings and accessories increased to 14.0% and 13.7% of total net sales in the three and nine months ended September 30, 2010, respectively, from 13.1% and 12.4% in the three and nine months ended September 30, 2009, respectively.

Consumer demand throughout 2009 and 2010 has generally shifted our mix of products sold, or sales mix, to certain key product lines which generally have a lower than average retail price per unit, resulting in decreases in our average sale<sup>2</sup>. However, these sales mix trends have begun to stabilize in the most recent six months. We believe we have grown our market share in these product lines. Changes to comparable prior year results were as follows:

|   | For the three months ended |                       | For the nine months ended |                       |
|---|----------------------------|-----------------------|---------------------------|-----------------------|
|   | September 30,<br>2010      | September 30,<br>2009 | September 30,<br>2010     | September 30,<br>2009 |
|   |                            |                       | increase (decrease)       |                       |
| <b>Comparable Stores:</b>                       |                            |                       |                           |                       |
| Net sales                                       | (5.7)%                     | 1.9%                  | 2.4%                      | (1.8)%                |
| Customers invoiced <sup>1</sup>                 | (5.2)%                     | 14.1%                 | 6.8%                      | 10.4%                 |
| Average sale <sup>2</sup>                       | (0.6)%                     | (10.7)%               | (4.1)%                    | (11.0)%               |
| Average retail price per unit sold <sup>3</sup> | 0.3%                       | (10.6)%               | (4.2)%                    | (10.2)%               |

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- <sup>1</sup> Approximated by applying our average sale to total net sales at comparable stores
- <sup>2</sup> Average sale is calculated on a total company basis
- <sup>3</sup> Average retail price per unit sold is calculated on a total company basis and excludes certain service revenue

- <sup>2</sup> Average sale is defined as the average invoiced sale per customer, measured on a monthly basis and excluding transactions of less than \$250 (which are generally sample orders, or add-ons or fill-ins to previous orders) and of more than \$30,000 (which are usually contractor orders).

**Table of Contents****Gross Profit and Gross Margin**

|               | For the three months ended |                       | For the nine months ended |                       |
|---------------|----------------------------|-----------------------|---------------------------|-----------------------|
|               | September 30,<br>2010      | September 30,<br>2009 | September 30,<br>2010     | September 30,<br>2009 |
|               | (dollars in thousands)     |                       |                           |                       |
| Net Sales     | \$ 147,192                 | \$ 140,520            | \$ 467,061                | \$ 407,488            |
| Cost of Sales | 95,431                     | 89,336                | 303,256                   | 261,164               |
| Gross Profit  | \$ 51,761                  | \$ 51,184             | \$ 163,805                | \$ 146,324            |
| Gross Margin  | 35.2%                      | 36.4%                 | 35.1%                     | 35.9%                 |

Gross profit increased \$0.6 million and \$17.5 million, or 1.1% and 11.9%, for the three and nine month periods ended September 30, 2010, respectively, from the comparable prior year periods. The gross margin decline in comparing the three and nine months ended September 30, 2010, to those ended September 30, 2009, was primarily due to the following factors:

Less efficient unit flow following the SAP system implementation, including expedited transportation, and certain adjustments to inventory reserves, reduced gross margin for the third quarter of 2010 by approximately 30 basis points.

In aggregate, sales mix shifts were neutral to gross margin in comparing both the three and nine month periods ended September 30, 2010 and 2009, as follows:

Our sales mix increased in certain product lines that generally carry a higher than average gross margin, including laminates, bamboo and engineered hardwoods. In addition, consumers continued to generally prefer the premium products within these product categories, such as strand bamboos and handscraped engineered hardwoods. Further, moldings and accessories continued to benefit from a strengthened in-stock position, and these product lines generally carry a gross margin higher than our average.

Liquidation deals, used as promotional opportunities to generate incremental traffic, have generally yielded lower gross margins in 2010 than in 2009, and in each year, those gross margins have been lower than average.

Continued weakness in the macroeconomic environment has generally resulted in a shift away from certain hardwood product lines that traditionally carry higher than average retail prices per unit sold, but slightly lower than average gross margins. However, in the third quarter of 2010, the sales mix of exotic hardwoods in total improved slightly relative to the third quarter of 2009.

Increased product costs, primarily transportation costs and certain finishing costs, reduced gross margin by approximately 120 basis points and 80 basis points in comparing the three and nine months ended September 30, 2010 and 2009, respectively. The increase in product costs resulted primarily from the following factors:

Inbound transportation costs capitalized into the unit cost of products sold were substantially higher in the first nine months of 2010 than in 2009. Overall, the gross margin impact of falling international container rates reached a low point against our

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historic norm in the third quarter of 2009, with an up to 60 basis point benefit against that historic norm. In the first six months of 2010, these international container rates approximated our historic norm.

Partially offsetting these rising inbound transportation costs were increased direct shipments received by our stores, either through our China consolidation center or direct from the mill to the store. In the third quarter of 2010, 23.7% of our purchases were received directly at the store, up from 14.4% in the same period of 2009. For the nine months ended September 30, 2010, 16.4% of our purchases were received directly at the store, compared to 17.3% in the same period of 2009.

Transportation costs of moving our products from our warehouse in Toano to the store locations, between store locations, and to the customer from our store locations are charged to cost of sales as incurred. These costs increased due to both a per mile increase, primarily due to increases in fuel surcharges, and an increase in the number of miles driven, primarily due to a greater number of units shipped. This increase in units shipped primarily resulted from a combination of our increase in sales volume, including the sales mix shift to a lower average retail price, and generally higher in-store average inventory levels.

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Our efforts to expand and regionalize our assortment of Bellawood products resulted in 2010 per unit finishing costs generally higher than those in 2009, primarily due to greater demand for products which are less efficient to finish.

**Operating Income and Operating Margin**

|                  | For the three months ended |                       | For the nine months ended |                       |
|------------------|----------------------------|-----------------------|---------------------------|-----------------------|
|                  | September 30,<br>2010      | September 30,<br>2009 | September 30,<br>2010     | September 30,<br>2009 |
|                  | (dollars in thousands)     |                       |                           |                       |
| Gross Profit     | \$ 51,761                  | \$ 51,184             | \$ 163,805                | \$ 146,324            |
| SG&A Expenses    | 44,909                     | 38,727                | 130,985                   | 114,269               |
| Operating Income | \$ 6,852                   | \$ 12,457             | \$ 32,820                 | \$ 32,055             |
| Operating Margin | 4.7%                       | 8.9%                  | 7.0%                      | 7.9%                  |

Operating income for the third quarter ended September 30, 2010 decreased \$5.6 million over the third quarter of 2009 as the \$0.6 million increase in gross profit discussed above was offset by a \$6.2 million increase in SG&A expenses. SG&A expenses for the third quarter of 2010 included approximately \$0.5 million in incremental expenses related to the SAP system implementation. Operating income for the nine months ended September 30, 2010 increased \$0.8 million over the same period in 2009 as the \$17.5 million increase in gross profit discussed above was primarily offset by a \$16.7 million increase in SG&A expenses. The increases in SG&A expenses were principally due to the following factors:

Salaries, commissions and benefits increased \$2.1 million and \$8.8 million for the three and nine months ended September 30, 2010, respectively, from the comparable prior year periods. As a percentage of net sales, salaries, commissions and benefits increased to 11.8% and 11.1% for the three and nine months ended September 30, 2010, respectively, from 10.9% and 10.6% for the three and nine months ended September 30, 2009, respectively.

Store salaries, commissions and benefits expense increased approximately \$1.4 million in comparing the three months ended September 30, 2010 and 2009, and increased \$5.9 million in comparing the nine months, primarily due to the 36 new stores opened subsequent to September 30, 2009, increased overtime related to the SAP system implementation and increases in certain store-level incentives.

Our corporate store-support infrastructure, including bonus accruals, decreased approximately \$0.2 million in comparing the third quarter of 2010 to 2009 and increased approximately \$0.2 million in comparing the nine months ended September 30, 2010 to 2009.

Labor costs for our distribution, warehousing and finishing functions increased approximately \$0.9 million and \$2.7 million in comparing the three and nine months ended September 30, 2010 and 2009, respectively, due primarily to increased sales volume, higher in-stock positions of merchandise inventories and additional overtime incurred related to the SAP system implementation.

Advertising expenses increased \$1.2 million to \$13.3 million, or 9.0% of net sales, for the three months ended September 30, 2010, from \$12.1 million, or 8.6% of net sales, for the comparable prior year period. For the nine months ended September 30, 2010, advertising expenses increased \$1.9 million to \$39.1 million, or 8.4% of net sales, down from 9.1% of net sales for the nine months ended September 30, 2009. While our advertising spend has historically featured national campaigns, we have more recently emphasized flexibility in message and media to optimize our spend within a changing marketplace, expanding localized and targeted programs. As a result of our continued investment in enhancing the effectiveness of our campaigns coupled with the growth in our

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store base, particularly in existing markets, we have reduced advertising expenses as a percentage of net sales in comparing the nine-month periods ended September 30, 2010 and 2009. We believe we would have leveraged advertising spend in the third quarter of 2010 had we converted open orders into sales at rates commensurate with our historic norms.

Occupancy costs increased \$0.8 million to \$5.6 million, or 3.8% of net sales, in the three months ended September 30, 2010, from \$4.8 million, or 3.4% of net sales in the third quarter of 2009. For the nine months ended September 30, 2010, occupancy costs increased \$2.8 million to \$16.3 million, or 3.5% of net sales, from \$13.5 million, or 3.3% of net sales, for the first nine months of 2009. These increases were primarily due to the 36 stores opened between September 30, 2009 and September 30, 2010.

Depreciation and amortization expenses were \$1.4 million and \$3.8 million in the three and nine months ended September 30, 2010, respectively. As a percentage of net sales, depreciation and amortization expenses were 1.0% and 0.8% in the three and nine months ended September 30, 2010, respectively, and 0.8% and 0.9% in the three and nine months ended September 30, 2009, respectively. We began depreciating our new SAP system in August 2010.



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Stock-based compensation expense was 0.6% and 0.5% of net sales for the three and nine months ended September 30, 2010, respectively, compared to 0.5% and 0.6% of net sales for the three and nine months ended September 30, 2009, respectively.

Other SG&A expenses increased \$1.6 million and \$2.8 million for the three and nine months ended September 30, 2010, respectively, from the comparable prior year periods. As a percentage of net sales, these expenses were 4.4% and 3.7% in the three and nine months ended September 30, 2010, respectively, and 3.4% and 3.6% in the three and nine months ended September 30, 2009, respectively. The increase was primarily due to higher information technology expenses related to the SAP implementation, store-base growth and certain bankcard discount rate fees, which increased due to greater consumer preference for certain extended-term promotional programs. As a result of the SAP system implementation, other expenses in the third quarter of 2010 included additional training and travel expenses.

**Provision for Income Taxes**

|                            | For the three months ended |                       | For the nine months ended |                       |
|----------------------------|----------------------------|-----------------------|---------------------------|-----------------------|
|                            | September 30,<br>2010      | September 30,<br>2009 | September 30,<br>2010     | September 30,<br>2009 |
|                            | (dollars in thousands)     |                       |                           |                       |
| Provision for income taxes | \$ 2,711                   | \$ 4,812              | \$ 12,846                 | \$ 12,649             |
| Effective tax rate         | 38.7%                      | 38.3%                 | 38.7%                     | 39.0%                 |

The effective tax rate increased to 38.7% for the third quarter of 2010 from 38.3% in the third quarter of 2009 primarily due to the absence of certain favorable one-time adjustments recorded in the prior year. The effective tax rate for the nine month period ended September 30, 2010 decreased from the comparable 2009 period primarily due to lower state income taxes.

**Net Income**

|                              | For the three months ended |                       | For the nine months ended |                       |
|------------------------------|----------------------------|-----------------------|---------------------------|-----------------------|
|                              | September 30,<br>2010      | September 30,<br>2009 | September 30,<br>2010     | September 30,<br>2009 |
|                              | (dollars in thousands)     |                       |                           |                       |
| Net Income                   | \$ 4,284                   | \$ 7,761              | \$ 20,345                 | \$ 19,794             |
| As a percentage of net sales | 2.9%                       | 5.5%                  | 4.4%                      | 4.9%                  |

Net income decreased 44.8% comparing the third quarter of 2010 to 2009, and increased 2.8% comparing the nine months ended September 30, 2010 to the nine months ended September 30, 2009.

**Seasonality**

Our net sales fluctuate slightly as a result of seasonal factors, and we adjust merchandise inventories in anticipation of those factors, causing variations in our build of merchandise inventories. We experience slightly higher net sales in spring and fall, when more home remodeling and home building activities are taking place, and slightly lower net sales in holiday periods and during the hottest summer months. These seasonal fluctuations, however, are minimized to some extent by our national presence, as markets experience different seasonal characteristics.

**Liquidity and Capital Resources**

Our principal liquidity requirements have been to meet our working capital and capital expenditure needs. Our principal sources of liquidity are \$26.8 million of cash and cash equivalents at September 30, 2010, our cash flow from operations and our \$25.0 million of availability under a revolving credit facility. We expect to use this liquidity for general corporate purposes, including providing additional long-term capital to support the growth of our business (primarily through opening new stores) and maintaining our existing stores. We believe that our cash flow from operations, together with our existing liquidity sources, will be sufficient to fund our operations and anticipated capital expenditures over at

least the next 24 months.

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In 2010, we expect capital expenditures to total between \$18 million and \$21 million. In addition to general capital requirements, we have or intend to:

open between 36 and 38 new store locations;

implement our SAP information technology system;

continue remodeling existing store showrooms to enhance consistency in presentation; and

make improvements to our Corporate Headquarters in Toano, Virginia.

**Cash and Cash Equivalents**

During the first nine months of 2010, cash and cash equivalents decreased \$8.9 million to \$26.8 million. The decrease of cash and cash equivalents was primarily due to \$3.0 million of net cash provided by operating activities and \$1.3 million in proceeds from the exercise of stock options, offset by the use of \$14.1 million to purchase property and equipment.

During the first nine months of 2009, cash and cash equivalents increased \$21.6 million to \$56.8 million. The increase of cash and cash equivalents was primarily due to \$26.4 million of net cash provided by operating activities and \$2.6 million in proceeds from the exercise of stock options, partially offset by the use of \$8.1 million to purchase property and equipment.

**Merchandise Inventories**

Merchandise inventories at September 30, 2010 increased \$23.6 million from December 31, 2009, as an increase in available for sale inventory of \$33.4 million was offset by a decrease in inbound in-transit inventory of \$9.8 million. We consider merchandise inventories either available for sale or inbound in-transit, based on whether we have physically received the products at our central distribution center in Toano, Virginia, at an individual store location, or in another facility where we control and monitor inspection, including the China consolidation center.

Merchandise inventories and available inventory per store in operation were as follows:

|                                      | As of September 30,<br>2010 | As of December 31,<br>2009 | As of September 30,<br>2009 |
|--------------------------------------|-----------------------------|----------------------------|-----------------------------|
|                                      |                             | <i>(in thousands)</i>      |                             |
| Inventory Available for Sale         | \$ 142,734                  | \$ 109,369                 | \$ 87,483                   |
| Inventory Inbound In-Transit         | 14,229                      | 23,973                     | 16,574                      |
| <b>Total Merchandise Inventories</b> | <b>\$ 156,963</b>           | <b>\$ 133,342</b>          | <b>\$ 104,057</b>           |
| <br>                                 |                             |                            |                             |
| <b>Available Inventory Per Store</b> | <b>\$ 670</b>               | <b>\$ 588</b>              | <b>\$ 494</b>               |

Available inventory per store at September 30, 2010 is higher than December 31, 2009 primarily due to reduced productivity as a result of the SAP implementation and strategic increases in available inventory for certain product lines. Available inventory per store at September 30, 2010 is higher than September 30, 2009 due to these same factors, as well as the implementation of our never out of stock program in the fourth quarter of 2009.

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The build in open demand resulting from reduced productivity subsequent to our SAP implementation is estimated to have increased inventory carrying levels by approximately \$8.0 million. In addition, available for sale inventory is substantially higher than our expectations due primarily to the following:

Expanded product assortments of certain engineered hardwoods across a range of retail price points introduced in the third quarter of 2010, particularly in our southern and western stores, increased inventory by approximately \$3.0 million.

We took advantage of opportunistic liquidation deals and available domestic hardwood buys, which we believe will serve demand in future periods. These strategic purchases increased inventory by approximately \$5.0 million.

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We increased our commitment to moldings during the SAP implementation and introduced certain new accessories, increasing inventory by approximately \$4.0 million.

We increased inventory carrying levels prior to our SAP implementation, and we continued to take advantage of opportunities to drive demand in the fourth quarter of 2010. However, we continue to expect our available inventory per store at December 31, 2010 to be lower than the level at December 31, 2009.

### ***Cash Flows***

**Operating Activities.** Net cash provided by operating activities was \$3.0 million for the nine months ended September 30, 2010, and \$26.4 million for the nine months ended September 30, 2009. Net cash provided by operating activities decreased due primarily to a build of merchandise inventories, as previously discussed, and the timing of inventory receipts which reduced accounts payable, partially offset by an increase in customer deposits and store credits.

**Investing Activities.** Net cash used in investing activities was \$14.1 million for the nine months ended September 30, 2010 and \$8.1 million for the nine months ended September 30, 2009. Net cash used in investing activities for the first nine months of 2010 included \$8.2 million related to our integrated business solution, of which \$3.6 million was spent in the third quarter of 2010. During both the three and nine months ended September 30, 2009, we had capitalized approximately \$2.8 million in total expenditures related to this initiative. In addition, net cash used in investing activities during the first nine months of both 2010 and 2009 included capital purchases of store fixtures, equipment and leasehold improvements for the new stores opened in the first nine months, routine capital purchases of computer hardware and software, and certain leasehold improvements in our Corporate Headquarters.

**Financing Activities.** Net cash provided by financing activities was \$2.3 million for the nine months ended September 30, 2010 and \$3.3 million for the nine months ended September 30, 2009, primarily attributable to proceeds from the exercise of stock options.

### **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements or other financing activities with special-purpose entities.

### **Critical Accounting Policies and Estimates**

Critical accounting policies are those that we believe are both significant and that require us to make difficult, subjective or complex judgments, often because we need to estimate the effect of inherently uncertain matters. We base our estimates and judgments on historical experiences and various other factors that we believe to be appropriate under the circumstances. Actual results may differ from these estimates, and we might obtain different estimates if we used different assumptions or conditions. We have had no significant changes in our critical accounting policies and estimates since our last annual report on Form 10-K for the year ended December 31, 2009.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

#### ***Interest Rates.***

We are exposed to interest rate risk through the investment of our cash and cash equivalents. We invest our cash in short-term investments with maturities of three months or less. Changes in interest rates affect the interest income we earn, and therefore impact our cash flows and results of operations. In addition, any future borrowings under our revolving credit agreement would be exposed to interest rate risk due to the variable rate of the facility.

We currently do not engage in any interest rate hedging activity and currently have no intention to do so in the foreseeable future. However, in the future, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

### **Item 4. Controls and Procedures.**

*Evaluation of disclosure controls and procedures.* Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report on

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Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

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*Changes in internal control over financial reporting.* We have made significant changes to our internal control over financial reporting to address the implementation of the SAP system that occurred during the third quarter of 2010. Our third quarter 2010 implementation included point-of-sale, warehouse management, merchandising, product allocation, general ledger and related management reporting systems. Our internal controls impacting these processes and systems, including information technology general controls, significantly changed or were modified in the third quarter of 2010.

## **PART II**

### **OTHER INFORMATION**

#### **Item 1. Legal Proceedings.**

On September 3, 2009, a former store manager and a current assistant store manager at the time (together, the Plaintiffs ) filed a putative class action suit against LLI in the Superior Court of California in and for the County of Alameda. The Plaintiffs allege that with regard to certain groups of current and former employees in LLI's California stores, LLI violated California law by failing to calculate and pay overtime wages properly, provide meal breaks, compensate for unused vacation time, reimburse for certain expenses and maintain required employment records. The Plaintiffs also claim that LLI did not calculate and pay overtime wages properly for certain of LLI's non-exempt employees, both in and out of California, in violation of federal law. In their suit, the Plaintiffs seek compensatory damages, certain statutory penalties, costs, attorney's fees and injunctive relief. LLI removed the case to the United States District Court for the Northern District of California. No class has been certified with regard to any of the alleged causes of action. LLI is vigorously defending the claims in this suit including class certification. While there is a reasonable possibility that a material loss may be incurred, we cannot estimate the loss or range of loss, if any, to us at this time.

On or about September 7, 2010, a former store manager filed an action against LLI in the United States District Court for the Middle District of Florida. In the complaint, the former store manager alleges that LLI breached an alleged contract for the payment of a commission and violated the FLSA by failing to pay him for overtime hours worked. In addition, he asserts a purported collective action on behalf of similarly situated LLI employees alleging that LLI denied them overtime wages in violation of the FLSA. No class has been certified with regard to the purported collective action. LLI intends to defend the claims in this suit vigorously including collective action certification. While there is a reasonable possibility that a material loss may be incurred, we cannot estimate the loss or range of loss, if any, to us at this time.

We also are, from time to time, subject to claims and disputes arising in the normal course of business. In the opinion of management, while the outcome of any such claims and disputes cannot be predicted with certainty, our ultimate liability in connection with these matters is not expected to have a material adverse effect on our results of operations, financial position or cash flows.

#### **Item 1A. Risk Factors.**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A, Risk Factors, in our annual report on Form 10-K for the year ended December 31, 2009, which could materially affect our business, financial condition or future results. Other than the risk factor described below, there have been no material changes to those risk factors since we filed our fiscal 2009 annual report on Form 10-K. The risks described in our annual report on Form 10-K are not the only risks we face. 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 results of operations.

***If we are unable to regain productivity levels as quickly as anticipated in the aftermath of the SAP® system implementation or if subsequent phases of the implementation are unsuccessful, our operations and anticipated results may be impacted.***

On August 22, 2010, we implemented the most significant phase of our integrated business solution from SAP. The implementation had a pervasive impact on our information systems and across all of our operations, including store operations, merchandising, technology and finance. Although we believe that we will regain much of our pre-implementation productivity during the fourth quarter of 2010, it is possible that our operational efficiency and effectiveness will not recover as quickly as we anticipate. Further, as we continue to utilize the system, other issues may arise that could impact our operations and results. In such circumstances, there may be additional adverse effects on our capital resources, financial condition, results of operations and liquidity.





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Although the most significant phase of the SAP system was implemented in August 2010, we anticipate that there will be subsequent phases. Although such subsequent phases are significantly smaller in scope, difficulties relating to the implementation of these subsequent phases may negatively impact our operations and results.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None.

**Item 3. Defaults Upon Senior Securities.**

None.

**Item 4. (Removed and Reserved).**

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

The exhibits listed in the exhibit index following the signature page are furnished as part of this report.

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**SIGNATURES**

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

LUMBER LIQUIDATORS HOLDINGS, INC.

(Registrant)

Date: November 9, 2010

By: /s/ Daniel E. Terrell  
Daniel E. Terrell

Chief Financial Officer

(Principal Financial and Principal Accounting Officer)

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EXHIBIT INDEX

**Exhibit**

| <b>Number</b> | <b>Exhibit Description</b>   |
|---------------|--|
| 10.01         | Separation and Release Agreement between Lumber Liquidators Services, LLC and Andrew P. Shulklapper, effective as of October 22, 2010 (filed as Exhibit 10.1 to the Company's current report on Form 8-K, filed on October 25, 2010 (File No. 001-33767), and incorporated by reference) |
| 31.01         | Certification of Principal Executive Officer of Lumber Liquidators Holdings, Inc. pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.02         | Certification of Principal Financial Officer of Lumber Liquidators Holdings, Inc. pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.01         | Certification of Principal Executive Officer and Principal Financial Officer of Lumber Liquidators Holdings, Inc. pursuant to Section 906 of the Sarbanes-Oxley act of 2002  |