



# Kirkland's®

2004 Annual Report

# About the COMPANY

Kirkland's is a leading specialty retailer of home decor in the United States, operating 320 stores in 37 states as of January 29, 2005. Our stores present a broad selection of distinctive merchandise, including framed art, mirrors, candles, lamps, accent furniture, accent rugs, garden accessories and artificial floral products. We also offer an extensive assortment of holiday merchandise as well as items carried throughout the year suitable for giving as gifts. In addition, we use innovative design and packaging to market home decor items as gifts. We provide our predominantly female customers an engaging shopping experience characterized by a diverse, ever-changing merchandise selection at surprisingly attractive prices. Our stores offer a unique combination of style and value that has led to our emergence as a leader in home decor and has enabled us to develop a strong customer franchise.



- Corporate Headquarters and Central Distribution Center

## Statement of Operations Data:

*(In thousands, except per share amounts)*

	2005	2004
Net sales	\$ 394,429	\$ 369,158
Operating income	\$ 11,481	\$ 30,169
Net income	\$ 6,589	\$ 18,041
Earnings per diluted share	\$ 0.34	\$ 0.92

## Store and Other Data:

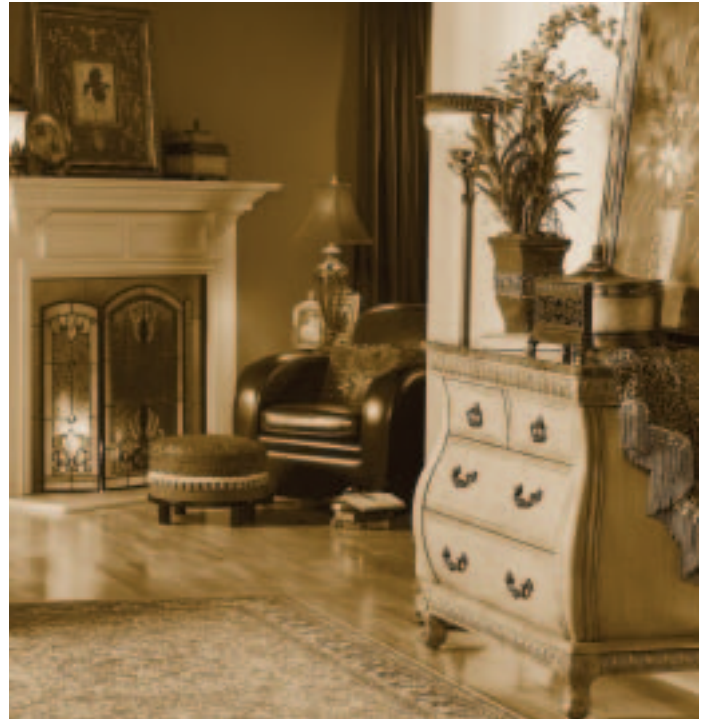
Comparable store sales increase (decrease)	(5.2)%	(0.2)%
Number of stores at year end	320	280
Average net sales per store (in thousands)	\$ 1,322	\$ 1,423
Average net sales per square foot	\$ 286	\$ 311
Inventory yield <sup>(1)</sup>	279.8%	287.7%
Return on assets <sup>(2)</sup>	5.1%	15.4%

## Balance Sheet Data at Year End:

Total assets	\$ 130,137	\$ 116,814
Total debt	\$ —	\$ —
Shareholders' equity	\$ 65,120	\$ 58,072

<sup>(1)</sup> Inventory yield is defined as gross profit divided by average inventory for each of the preceding four quarters.

<sup>(2)</sup> Return on assets equals net income allocable to common shareholders divided by total assets.



# Building for THE FUTURE

With sound strategies  
and an unwavering  
commitment to our  
customers, associates  
and shareholders, we  
are bullish on the  
future we are building  
for Kirkland's.

Kirkland's stores are destination locations for shoppers interested in stylish home décor at great prices. Founded in 1966, the company has evolved through the years to meet the changing needs and preferences of customers in many different markets and regions of the United States. During the past seven fiscal years, we have more than doubled our store base, principally through new store openings. We opened 54 new stores in fiscal 2004, with 44 of these stores located in non-mall shopping venues that have become the destinations of choice for many female shoppers. We ended the year with 320 stores operating in 37 states. We expect to continue our growth in fiscal 2005, as we seek to build 55-60 new stores. By opening new stores in these favored non-mall locations, and simultaneously closing mall stores where we do not perceive long-term potential, we intend to position ourselves for greater visibility with customers, higher store-level productivity, and better financial performance.

As we grow, we also are working to strengthen the vital areas that will support and drive an expanding and changing business. During 2004, we made solid executive hires in Store Operations, Merchandising and Marketing. These people were attracted to the exciting growth opportunity that lies before us, and we expect that opportunity to attract additional talent to the company in fiscal 2005. Another positive development this past year was the opening of our state-of-the-art distribution center in June 2004, which marked a major leap forward in our capability at managing and controlling merchandise flow to our stores. With sound strategies and an unwavering commitment to our customers, associates and shareholders, we are bullish on the future we are building for Kirkland's.

# Letter to Shareholders

I am pleased to report on the state of Kirkland's to our fellow shareholders, customers, and associates. Fiscal 2004 was a year of considerable challenge for Kirkland's. Our financial results were clearly less than planned for the year, due both to external factors as well as key areas of our business where we did not execute nearly as well as we must. Consumer appetite for discretionary home purchases softened during the year, as economic pressures impacted moderate-income households that form the core of our customer base. Another trend that emerged more clearly during the past year was our customer's preference for more convenient, non-mall shopping centers. We saw noticeably better performance in our stores located in non-mall venues than we did in our mall stores. With 241 of our 320 stores at year-end operating in malls, this trend contributed strongly to our struggle to produce comparable store sales increases. Beyond these external influences, we failed to give our customer enough of what she reasonably demands from us, both in terms of product and service. Clearly, doing a better job determining her needs and preferences and responding accordingly will be critical to our success at reversing these negative financial trends in fiscal 2005.

For the year, we reported a comparable store sales decline of 5.2%, largely due to our inability to excite customers with our merchandise offering in the second half of the year. Total sales for the year increased 6.8% to \$394.4 million, while earnings declined to \$0.34 per diluted share from \$0.92 per diluted share in fiscal 2003. Significant markdown activity aimed at driving business affected our merchandise margin during much of the year, and the large comparable store sales declines in third and fourth quarters also caused expense ratios to climb, leading to our lowest earnings in five years.

As a fellow shareholder, I am disappointed by these results but far from discouraged. The past year brought several pieces of good news for long-term investors in Kirkland's. In particular, a recap of fiscal 2004 would not be complete without acknowledging the contributions and accomplishments of our teams in logistics and real estate. Culminating a multi-year process of planning, facility construction, and systems design and implementation, we commenced operations in a new, 771,000-square-foot distribution center in June 2004. This state-of-the-art facility forms the cornerstone of our strategy to build a supply chain that can keep our expanding chain of stores supported with the right product, in the right quantity, at the right time. In real estate, we intensified our emphasis on opening stores in non-mall venues, including lifestyle centers, power strips, and freestanding locations. We opened 44 of our 54 new stores in non-mall locations, and we also closed 14 mall stores. Our confidence in this non-mall expansion strategy continues to grow as these stores are producing sales that are equivalent to mall locations with occupancy costs that are well below those of mall stores. The co-tenancy and location of these centers are also

typically a better match for our core customer. We will continue to pursue this "off-mall" strategy in 2005 and beyond.

I am also encouraged that our company's financial condition remains sound. For the third year in a row, we finished the year with no debt. We will use our cash balances, together with operating cash flow and availability under our credit line, to finance all of our working capital and growth-related investment activities during 2005.

Our management team has spent significant time since the third quarter of 2004 studying our business and determining appropriate strategies and actions to turn the business around. We believe the direction is clear, and our entire team is unified behind our vision of a "new" Kirkland's that is more attentive and responsive to customers, knows who our customer is and maintains constant communication with her, is more enjoyable and rewarding for our associates, and certainly is better positioned to produce superior financial results for shareholders. Every major area of the company owns a piece of this vision for a more productive and more profitable Kirkland's.

In merchandising, we have been working since last fall to build a broader, deeper, more capable team of buyers, planners, and allocators. This group is deploying better practices and taking advantage of our enhanced logistics capability. Great attention is being focused on content improvement to better match our brand and on the quality of products offered. As we do this, be assured Kirkland's will retain its commitment to provide customers with the best values in the marketplace.

From a strictly financial standpoint, a prominent area of focus in fiscal 2005 will be improving our gross margin, which declined





significantly for the second straight year. The success of a retail business always begins with sales, but to a large extent, gross margin is a more controllable financial metric. While we cannot control the macroeconomic environment that is still affecting the home furnishings sector, we can control our merchandising and the customer experience in our stores. Our ability to improve merchandise margin will be a function of better-planned and more consistently replenished product, but also our ability to control inventory levels and SKUs. In fiscal 2004, we were frequently too broad in our merchandise assortments and not sufficiently focused on our core strengths of stylish, quality home décor at great prices. Our opportunity in 2005 is to make our stores more appealing to customers by presenting more focused product assortments on the selling floor, doing a better job tracking and replenishing best-selling items, and reducing the margin-eroding effect of heavy markdowns due to inventory overstocks. We are underway with each of these initiatives, and we expect to make progress on these strategies and practices throughout 2005.

In store operations, we are already benefiting from the leadership of Dwayne Cochran, an industry veteran who joined us in October 2004 as Executive Vice President of Store Operations. Dwayne's passion for creating a store experience that excites customers and energizes associates is contagious, and our store managers and associates indeed own a critical element of ensuring that customers leave our stores satisfied and eager to visit again. Areas of focus in our store operations group include making improvements in hiring and training staff, better utilizing payroll hours, and emphasizing customer interaction and selling in order to more fully exploit the advantages of a highly-edited, stylish, well-priced and better-timed merchandise offering. We expect these initiatives as well as others underway to help us realize the goal of better service to our very loyal customer base and, ultimately, better sales.

Marketing also owns an important piece of our vision, and we have taken significant steps since the third quarter of fiscal 2004 toward building a coherent strategy and a deeper, more experienced team. In fiscal 2005, our efforts will center on better and more regular communication with our customers to reinforce the Kirkland's brand and to give each customer a reason to visit our stores again and again. Our marketing efforts will include e-mail, direct mail, and well-coordinated in-store promotional events.

Our logistics effort has been greatly improved with the mid-2004 opening of our new distribution center. Armed with a fully integrated warehouse management system and automated conveyance and sortation systems, the facility has already improved distribution center throughput, enabled unit cost reduction, reduced order fulfillment cycles, and lowered freight costs as a percentage of shipped inventory. In 2005, we will continue to advance our full supply chain vision with a goal to improve and better control product flow from manufacturer to distribution center to store level. Our target is to bring at least 90% of all goods through the distribution center in fiscal 2005 in order to achieve further efficiencies, improve the quality and timeliness of store merchandise allocations, and help control transportation costs.



Real estate may be the area where our path is the clearest and the success of our core strategies is the most evident. Our goal is still to develop a national footprint for Kirkland's. Our concept is a terrific fit for a variety of off-mall destination centers that are increasingly favored by our core female customer. We expect to open 55 to 60 new stores in fiscal 2005, with virtually 100% of these expected to be non-mall locations. We will close approximately 30 stores during the year, almost all of which will be older mall locations. With the financial productivity of our non-mall locations consistently exceeding the performance of our mall stores, the numbers clearly support our goal for non-mall stores to reach 50% of our total store base by the end of fiscal 2006.

I hope that you share my optimism for Kirkland's future in 2005 and beyond. We believe we have a great team in place, a very favorable opportunity to continue our store growth nationwide, and the right strategies to return us to the level of sales and earnings we know we are capable of achieving. Most importantly, we are committed to delivering the best merchandise and customer service possible to our loyal customer base.

We expect to report improvement in each of these areas to you during fiscal 2005. Thank you for your continued support and investment in Kirkland's. As always, we look forward to seeing you in our stores.

Sincerely,

A handwritten signature in black ink that reads "Robert E. Alderson". The signature is written in a cursive, flowing style.

Robert E. Alderson  
*Chairman, President and Chief Executive Officer*

# Directors and Officers

## Directors

Carl Kirkland

*Chairman Emeritus of the Board, Kirkland's, Inc.*

Robert E. Alderson

*Chairman of the Board, President and Chief Executive Officer, Kirkland's, Inc.*

Steven J. Collins

*Principal, Advent International Corporation*

Reynolds C. Faulkner

*Executive Vice President and Chief Financial Officer, Kirkland's, Inc.*

David M. Mussafer

*Managing Director, Advent International Corporation*

R. Wilson Orr, III

*Managing Director, SSM Partners*

John P. Oswald

*Managing Director, Capital Trust Group*

Ralph T. Parks

*Retired Chief Executive Officer, Footaction, USA*

Murray M. Spain

*President, World Wide Basics, LLC*

## Officers

Carl Kirkland

*Chairman Emeritus of the Board*

Robert E. Alderson

*Chairman of the Board, President and Chief Executive Officer*

Reynolds C. Faulkner

*Executive Vice President and Chief Financial Officer*

Dwayne F. Cochran

*Executive Vice President and Director of Stores*

Andrew P. Gallina

*Vice President of Marketing*

Michelle R. Gaul

*Vice President of Human Resources*

James W. Harris

*Territorial Vice President*

Roland L. Mackie

*Vice President of Real Estate*

W. Michael Madden

*Vice President of Finance*

Deborah A. McDonald

*Vice President of Visual Merchandising*

Al Oliver

*Vice President of Merchandising – Product Development*

Tracy Parker

*Territorial Vice President*

Lowell E. Pugh II

*Vice President, General Counsel and Secretary*

Grey W. Satterfield

*Vice President of Merchandising – Planning*

Connie L. Scoggins

*Vice President of Finance and Treasurer/Controller*

Toni F. Warren

*Vice President of Merchandising – Replenishment*

Todd A. Weier

*Vice President of Logistics*

# Corporate Data

## Corporate Headquarters

Kirkland's, Inc.  
805 North Parkway  
Jackson, Tennessee 38305  
731.668.2444  
www.kirklands.com

## Transfer Agent and Registrar

StockTrans, Inc.  
44 West Lancaster Avenue  
Ardmore, Pennsylvania 19003  
610.649.7300

*Shareholders seeking information concerning stock transfers, change of address and lost certificates should contact StockTrans directly.*

## Independent Auditors

PricewaterhouseCoopers LLP  
Memphis, Tennessee

## Corporate Counsel

Pepper Hamilton LLP  
Philadelphia, Pennsylvania

## Safe Harbor

Except for historical information contained herein, the statements in this annual report are forward-looking and made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve known and unknown risks and uncertainties, which may cause Kirkland's actual results to differ materially from forecasted results. Those risks and uncertainties include, among other things, the competitive environment in the home décor industry in general and in Kirkland's specific market areas, inflation, product availability and growth opportunities, seasonal fluctuations, and economic conditions in general. Those and other risks are more fully described in Kirkland's filings with the Securities and Exchange Commission, including the Company's Annual Report on Form 10-K filed on April 14, 2005. Kirkland's disclaims any obligation to update any such factors or to publicly announce results of any revisions to any of the forward-looking statements contained herein to reflect future events or developments.

## Annual Report (Form 10-K)

A copy of the Company's fiscal 2004 Annual Report on Form 10-K as filed with the Securities and Exchange Commission is available to shareholders by contacting the Investor Relations Department at the address above.

## Annual Meeting

The Annual Meeting of Shareholders will be held at 3:00 p.m. Central Daylight Time on June 6, 2005, at the Crescent Club, 6075 Poplar Avenue, 9th Floor, Memphis, Tennessee.

## Stock Market Information

The Company's common stock is traded on the NASDAQ National Market under the symbol KIRK. On April 8, 2005, there were approximately 84 holders of record and 3,050 beneficial owners of the Company's common stock. The following table sets forth, for the periods indicated, the high and low last sale prices of shares of the common stock as reported by NASDAQ:

	High	Low
Fiscal 2003:		
Quarter ended May 3, 2003	\$ 15.40	\$ 10.45
Quarter ended August 2, 2003	\$ 18.16	\$ 14.25
Quarter ended November 1, 2003	\$ 22.01	\$ 14.96
Quarter ended January 31, 2004	\$ 22.15	\$ 14.41
Fiscal 2004:		
Quarter ended May 1, 2004	\$ 18.05	\$ 13.88
Quarter ended July 31, 2004	\$ 18.57	\$ 10.20
Quarter ended October 30, 2004	\$ 10.50	\$ 7.55
Quarter ended January 29, 2005	\$ 12.56	\$ 8.69

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