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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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**FORM 10-K**

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☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

**For the fiscal year ended January 31, 2004**

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 1-09100

**Gottschalks Inc.**

(Exact name of Registrant as Specified in its Charter)

Delaware

77-0159791

(State or Other Jurisdiction of Incorporation or Organization)

(I.R.S. Employer Identification Number)

**7 River Park Place East**

**Fresno, California 93720**

(Address of Principal Executive Offices including Zip Code)

Registrant's Telephone Number, Including Area Code: **(559) 434-4800**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of each exchange on which registered

**Common Stock, \$.01 par value**

**New York Stock Exchange  
Pacific Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: None

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 ☒ ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ☐ No ☒

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of August 2, 2003: Common Stock, \$.01 par value: \$16,902,103.

On March 31, 2004 the Registrant had outstanding 12,883,802 shares of Common Stock.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive proxy statement with respect to its Annual Stockholders' Meeting scheduled to be held on June 24, 2004, which will be filed pursuant to Regulation 14A, are incorporated by reference into Part III of this Form 10-K.

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# Gottschalks Inc.

## 2003 ANNUAL REPORT ON FORM 10-K

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## **PART I**

### **Item 1. BUSINESS**

#### **GENERAL**

Gottschalks Inc. (the "Company") is a regional department and specialty store chain based in Fresno, California. As of January 31, 2004, the Company operated 63 full-line "Gottschalks" department stores located in 6 Western states, with 39 stores located in California, 12 in Washington, 6 in Alaska, and 2 in each of Oregon, Nevada and Idaho. The Company also operates 11 "Village East" and "Gottschalks" specialty stores which carry a limited selection of merchandise.

The Company's department stores typically offer a wide range of better to moderate brand-name and private-label merchandise, including mens, womens, juniors and childrens apparel; cosmetics, shoes, fine jewelry and accessories; and home furnishings including china, housewares, domestics, small electric appliances and, in selected locations, furniture and mattresses. The majority of the Company's department stores range from 40,000 to 150,000 in gross square feet, and are generally anchor tenants of regional shopping malls or strategically located strip centers.

The Company has operated continuously for 100 years since it was founded by Emil Gottschalk in 1904. At the time the Company initially offered its stock to the public in 1986, the Company operated 10 department stores. Since then, a net total of 53 department stores have been added. Twenty-six stores were added through acquisitions. The Company is incorporated in the state of Delaware.

Gottschalks Inc. dissolved its wholly-owned subsidiary, Gottschalks Credit Receivables Corporation ("GCRC"), on July 30, 2003. This subsidiary was formed in 1994 in connection with a receivables securitization program. As more fully described in Note 2 to the Consolidated Financial Statements, on January 31, 2003 the Company sold its credit card accounts and accounts receivable to Household Bank (SB), N.A. ("Household"). (See Note 2 to the Consolidated Financial Statements.)

#### **OPERATING STRATEGY**

##### **Merchandising Strategy**

The Company's merchandising strategy is directed at offering and promoting moderate to better priced brand-name merchandise recognized by its customers for style and value. Brand-name merchandise is complemented with offerings of private-label. Brand-name apparel, shoes, cosmetics and accessories lines carried by the Company include Estee Lauder, Lancome, Clinique, Chanel, Dooney & Bourke, Nine West, Liz Claiborne, Calvin Klein, Guess?, Nautica, Karen Kane, Tommy Hilfiger, Ralph Lauren, Haggar, Koret and Levi Strauss. Brand-name merchandise carried for the home includes Waterford, Lenox, Lladro, Krups, Kitchenaid, Calphalon and Samsonite.

The Company has also directed considerable effort towards improving the quality and increasing the penetration of private-label merchandise in its overall merchandise mix. The Company's most well recognized private-label is "Shaver Lake," currently carried in the womens, mens and childrens departments, as well as in certain departments in the home division. The "Shaver Lake" brand is exclusively offered in Gottschalks stores, and provides an opportunity to increase Gottschalks' brand acceptance and promote competitive differentiation. The Company plans to expand its private label offerings in mens and womens casual clothing in 2004.

The Company purchases merchandise from numerous suppliers. In no instance did purchases from any single vendor amount to more than 6% of the Company's net purchases in fiscal 2003. The Company's merchandising activities are conducted centrally from its corporate offices in Fresno, California.

The Company's merchandise mix as a percentage of total sales (including leased department sales) is reflected in the following table:

	<b>Fiscal Years</b>				
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>	<b>1999</b>
Women's Apparel.....	28.1 %	29.0 %	29.3 %	28.0 %	26.6 %
Cosmetics, Shoes & Accessories.....	24.3	23.6	22.5	22.5	22.2
Home.....	20.1	20.4	20.1	20.8	22.1
Men's Apparel.....	13.3	13.0	13.8	14.0	13.7
Junior's and Children's Apparel.....	10.6	10.5	10.5	10.7	10.3
Leased Departments.....	3.6	3.5	3.8	4.0	5.1
Total Sales.....	<u>100.0 %</u>	<u>100.0 %</u>	<u>100.0 %</u>	<u>100.0 %</u>	<u>100.0 %</u>

## Store Locations

The Company's stores are located primarily in diverse, growing, non-major metropolitan or suburban areas in the western United States where management believes there is strong demand and fewer competitors offering similar better to moderate brand-name merchandise and a high level of customer service. The Company has historically avoided expansion into the center of major metropolitan areas that are served by the Company's larger competitors and has instead sought to open new stores in nearby suburban or secondary market areas.

The Company's department stores are generally anchor tenants of regional shopping malls or strategically located strip centers. Other anchor tenants in the malls or strip centers generally complement the Company's goods with a mixture of competing and non-competing merchandise and serve to increase customer foot traffic. With new regional shopping mall construction on the decline, one of the Company's strategies is to open stores in smaller and more diverse locations that may not be served by its larger competitors that adopt a more standardized approach to expansion.

The Company currently has no new store openings planned for fiscal 2004. Any future new store openings will focus on sites that will serve to “fill in” geographical areas between existing stores. Management believes this strategy will improve the Company’s ability to leverage advertising, transportation and other operating costs more effectively. In addition to opening individual store locations, the Company may also pursue additional selective strategic acquisitions.

The Company has continued to invest in the renovation and refixturing of its existing store locations in an attempt to maintain and improve market share in those market areas. In fiscal 2002 and 2003, the Company reduced its expenditures for renovation and refixturing primarily because of liquidity concerns. However, the Company plans to increase such capital expenditures to historical levels beginning in fiscal 2004 and initiate remodel activity at a number of store locations.

Store renovation projects can range from updating décor and improving in-store lighting, fixturing, wall merchandising and signage, to more extensive remodeling and expansion projects. The Company sometimes receives reimbursement from mall owners and vendors for certain of its new store construction costs and costs associated with the renovation and refixturing of existing store locations. Such contributions have enhanced the Company’s ability to enter into attractive market areas that are consistent with the Company’s long-term expansion plans.

The following tables present selected data related to the Company's stores for the fiscal years indicated:

	Fiscal Years				
	2003	2002	2001	2000	1999
<b>Stores open at year-end:</b>					
Department stores.....	63	(1) 69	(1) 73	(1) 79	(2) 42
Specialty stores (3).....	11	12	13	17	20
Total	<u>74</u>	<u>81</u>	<u>86</u>	<u>96</u>	<u>62</u>
<b>Gross store square footage(4) (in thousands):</b>					
Department stores.....	5,406	5,665	5,876	6,139	4,377
Specialty stores.....	42	54	54	63	77
Total	<u>5,448</u>	<u>5,719</u>	<u>5,930</u>	<u>6,202</u>	<u>4,454</u>

(1) The Company closed 6 stores in fiscal 2003, 4 stores in fiscal 2002 and 6 stores in fiscal 2001, all of which were acquired in the Lamonts acquisition in July 2000.

(2) The Company opened 37 new department stores in fiscal 2000, including the 34 store locations acquired from Lamonts on July 24, 2000, and three additional new stores opened during the third and fourth quarter of the year.

(3) The Company has continued to close certain free-standing Village East stores as their leases expire and incorporate those stores as separate departments into nearby Gottschalks department stores.

(4) Reflects total store square footage, including office space, storage, service and other support space, and selling space.

Following is a summary of the Company's department store locations, by store size:

	<b># of stores open</b>
Larger than 200,000 gross square feet.....	3
150,000 - 199,999 gross square feet.....	6
100,000 - 149,999 gross square feet.....	9
40,000 - 99,999 gross square feet.....	38
20,000 - 39,999 gross square feet.....	7
Total.....	<u>63</u>

## **Marketing Strategy**

The Company's marketing strategy is based on a multi-media approach, using newspapers, television, radio, direct mail, internet, and catalogs to highlight seasonal promotions, selected brand-name merchandise and frequent storewide sales events. Advertising efforts are focused on communicating the branded merchandise offered by the Company, and the high levels of quality, value and customer service available in the Company's stores. In its efforts to improve the effectiveness of its advertising expenditures, the Company uses data captured through its private-label credit card to develop segmented advertising and promotional events targeted at specific customers who have established purchasing patterns for certain brands, departments or store locations.

The Company's sales promotion strategy also focuses on special events such as fashion shows, bridal shows and wardrobing seminars in its stores and in the communities in which they are located to convey fashion trends to its customers. The Company receives reimbursement for certain of its promotional activities from some of its vendors.

In 2004, the Company will celebrate its 100<sup>th</sup> year of operation under the Gottschalks name. This unique event will be the focal point of marketing and merchandising strategies throughout the year culminating in a gala and the ringing of the closing bell of the New York Stock Exchange on September 17, 2004, the actual date of the 100<sup>th</sup> Year Anniversary.

The Company offers selected merchandise, a Bridal & Gift Registry service, and other general corporate information on the World Wide Web at <http://www.gottschalks.com>, and sells merchandise through its mail order department. The information on the Company's website is not part of this annual report.

## **Customer Service**

Management believes one way the Company can differentiate itself from its competitors is to provide a consistently high level of customer service. The Company has a “Four Star” customer service program, designed to continually emphasize and reward high standards of customer service in the Company’s stores. Sales associates are encouraged to keep notebooks of customers' names, clothing sizes, birthdays, and major purchases, to telephone customers about promotional sales and to send thank-you notes and other greetings to their customers during their normal working hours. Product seminars and other training programs are frequently conducted in the Company’s stores and its corporate headquarters to ensure that sales associates will be able to provide useful product information to customers. The Company also offers opportunities for management training and leadership classes for those associates identified for promotion within the Company. Various financial incentives are offered to the Company’s sales associates for reaching sales performance goals.

In addition to providing a high level of personal sales assistance, management believes that well-stocked stores, a liberal return and exchange policy, frequent sales promotions and a conveniently located and attractive shopping environment enhance its customers’ shopping experience and increase customer loyalty. Management also believes that maintaining appropriate staffing levels in its stores, particularly at peak selling periods, is essential for providing a high level of customer service.

Management focus for 2004 will also include an increased effort to attract and service the 30 to 55 year old age group, as well as, the Hispanic customer that continues to be a growing segment of the customer base in many current markets.

## **Distribution of Merchandise**

The Company operates a 420,000 square foot distribution center located in Madera, California. The facility, constructed in 1989, is located in close proximity to the Company’s corporate headquarters in Fresno, California. The facility serves all of the Company’s store locations, with daily distributions of merchandise to all stores, including its stores located in states outside California. During the period of July 2000 through June 2001, the Company distributed merchandise to its locations in Washington, Alaska, Idaho and 2 of the stores located in Oregon through an outsourced facility located in Kent, Washington. The Company ceased using the outsourced facility in June 2001, consolidating all of its distribution functions to the facility in Madera.

The Company has continued to improve its logistical systems, focusing on the adoption of new technology and operational best practices, with the goals of receiving, processing and distributing merchandise to stores at a faster rate and at a lower cost per unit. The Company’s logistical systems enable the Company to “cross dock” the majority of its merchandise, thereby processing merchandise through the distribution center in several minutes as compared to the several day timeframe required in the past. The Company has formal guidelines for vendors with respect to shipping, receiving and invoicing for merchandise. Vendors that do not comply with the guidelines are charged specified fees depending upon the degree of non-compliance. Such



fees are intended to offset higher costs associated with the processing of and payment for such merchandise.

### **Private-Label Credit Card**

#### *Sale of Receivables*

On January 31, 2003, pursuant to the terms of a Purchase and Sale Agreement, the Company sold its proprietary credit card accounts and accounts receivable to Household. The \$102.8 million proceeds consisted of \$100.3 million for the sale of the accounts and receivables and \$2.5 million in prepaid program revenues. Proceeds from the sale were used to pay in full \$73.2 million principal and interest due to certificateholders under the Company's accounts receivable securitization program plus \$3.4 million in prepayment penalties. The remaining proceeds of \$26.2 million were applied as a reduction of outstanding borrowings under the Company's revolving credit facility.

In connection with the sale, the Company entered into two additional agreements, an Interim Servicing Agreement (the "ISA") and a Credit Card Program Agreement (the "CCA"). Under the terms of the ISA, the Company continued to service the credit card receivables until May 14, 2003. Household compensated the Company for providing the interim servicing. The compensation was equal to the costs of providing such services during the interim period.

The CCA sets forth the terms and conditions under which Household will issue Gottschalks private-label credit cards and pay the Company for sales made on the cards. The CCA has a term of five (5) years and is cancellable by either party under certain circumstances. The CCA further provides for the Company to be paid a percentage of Net Cardholder Charges and a percentage of other Revenue (such terms as defined in the CCA). The Company has determined during the course of 2003 that the amounts received under the CCA approximately equal the net revenues from its former in-house credit card operations, net of operating expenses and interest expense. Although no assurances can be given that the amounts under the CCA will continue at those levels or at all.

#### *Credit Card Program*

Management believes the private-label credit card enhances the Company's ability to generate and retain market share as well as increase sales. Private-label credit card sales as a percentage of total sales were 41.2%, 43.2% and 40.9% in fiscal 2003, 2002 and 2001, respectively. The decline in the 2003 private card penetration was due to the transition of service from the Company to Household. Efforts are underway between the Company and Household to increase the private card penetration in 2004.

The Company has a variety of credit-related programs which management believes have improved customer service and increased credit-sales. Such programs include:

- An "Instant Credit" program, through which successful credit applicants receive a discount ranging from 10% to 50% (depending on the results of the Instant Credit scratch-off card) on the first day's purchases made with the Company's credit card;
- A "55-Plus" charge account program, which offers additional merchandise and service discounts to customers 55 years of age and older;
- "Gold Card" and "55-Plus Gold Card" programs, which offer special services at a discount for customers who have a minimum net spending history on their charge accounts of \$1,000 per year; and
- Various credit-card related promotional events throughout the year.

A key element to the re-vitalization of the Company's private label credit card relates to the re-structured Rewards program, as described below:

The "Gottschalks Rewards" program, which offers an annual merchandise rebate certificate for up to 5% of annual credit purchases on the Company's credit card (up to a maximum of \$10,000 of annual purchases) has been converted to a "points" program that allows customers to earn bonus points with every private label card purchase which can be applied towards future purchases of merchandise. A number of promotions, such as double points are planned for 2004 to coincide with the Company's celebration of its 100<sup>th</sup> Year Anniversary.

## **Competition and Seasonality**

See Part I, Item I, "Risk Factors – We Face Significant Competition from Other Retailers" and "Risk Factors – Our Business is Susceptible to Economic Conditions and Other Factors that Affect our Markets, Some of Which are Beyond our Control".

## **Employees**

As of January 31, 2004, the Company had approximately 5,800 employees, including 3,490 employees working part-time (less than 32 hours per week on a regular basis). As of February 1, 2003, the Company had 6,400 employees (including 3,850 working part-time). The decrease in the number of employees from the prior year is partially attributable to the store closures in fiscal 2003. The Company hires additional temporary employees and increases the hours of part-time employees during seasonal peak selling periods. Approximately 57 employees in two former Lamonts locations in King County, Washington are covered by a collective bargaining agreement with the United Food and Commercial Worker's Union (UFCW). After the acquisition of Lamonts' assets, which included the leases of those two stores, the Company engaged in good faith bargaining and as a result, ratified an agreement with the union for a 2-½ year term commencing on April 7, 2001. The agreement was set to expire on September 30, 2003 but was extended to September 30, 2004. Management does not believe that the agreement will have a material effect on the Company's business, financial condition or results of operations. Management considers its employee relations to be good.

## **ACQUISITIONS**

The Company has completed two significant acquisitions in its operating history, including the acquisition of 8 stores from The Harris Company (“Harris”) in fiscal 1998, and an additional 34 store locations from Lamont’s Apparel, Inc. (“Lamonts”) in fiscal 2000.

### **The Harris Acquisition**

On August 20, 1998, the Company acquired substantially all of the assets and assumed certain liabilities of Harris, a wholly-owned subsidiary of El Corte Ingles (“ECI”) of Spain. Harris operated nine full-line department stores located in the Southern California area. As planned, the Company closed one of the acquired stores on January 31, 1999. The purchase price for the assets consisted of 2,095,900 shares of common stock of the Company and a \$22.2 million 8% Extendable Subordinated Note, due August 2003 (subsequently extended to May 2007) (the “Subordinated Note”). As a result of the acquisition, Harris became a significant stockholder of the Company, and both Harris and ECI became affiliates of the Company. The Company also leases three of its store locations from ECI. (See Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations – “Liquidity and Capital Resources – Transactions with Affiliate.”)

### **The Lamonts Acquisition**

The Company completed the largest acquisition in its operating history on July 24, 2000, significantly expanding its presence throughout the Pacific Northwest and Alaska. Under the transaction (hereinafter the “Lamonts acquisition”), the Company acquired 37 department store leases, related store fixtures and equipment and one store building from Lamonts, a bankrupt specialty apparel store chain, for a cash purchase price of \$20.1 million. Concurrent with the closing of the transaction, the Company sold one of the store leases for \$2.5 million, and subsequently terminated two other store leases, resulting in a net cash purchase price of \$17.6 million for 34 store leases, related store fixtures and equipment and one store building. The Company did not acquire any of Lamonts’ merchandise inventory, customer credit card receivables or other corporate assets in the transaction, nor did the Company assume any material liabilities, other than the 34 store leases. The 34 stores acquired were located in 5 Western states, with 19 stores in Washington, 7 in Alaska, 5 in Idaho, 2 in Oregon and 1 in Utah. The Company converted the acquired stores to the Gottschalks banner and re-opened the stores in late August and early September 2000. In fiscal 2001, the Company closed 6 of the acquired stores that were determined to be either underperforming or inconsistent with the long-term operating strategy of the Company. In fiscal 2002, the Company closed another 4 of the acquired stores and an additional 6 stores were closed in fiscal 2003. The Company continues to operate 18 of the original 34 stores acquired from Lamonts some of which have continued to perform below expectations. In the event the Company is unable to improve the performance of such underperforming stores, the Company may consider the sale, sublease or closure of these stores in the future.

## **Available Information**

Gottschalks' internet address is <http://www.gottschalks.com>. We have made available, free of charge through our website, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Forms 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after such documents are electronically filed with, or furnished to, the Securities and Exchange Commission.

## **Executive Officers of the Registrant**

Information relating to the Company's executive officers is included in Part III, Item 10 of this report and is incorporated herein by reference.

## **FORWARD-LOOKING STATEMENTS**

This Form 10-K contains certain “forward-looking statements” regarding activities, developments and conditions that the Company anticipates may occur or exist in the future relating to things such as:

- the Company’s ability to meet debt obligations and adhere to the restrictions and covenants imposed under its various debt agreements;
- the timely receipt of merchandise and the Company’s ability to obtain adequate trade credit from its key factors and vendors;
- the Company’s ability to either improve the operating results and cash flows of certain of the stores acquired in the Lamonts acquisition, or to sell, sublease or close those stores that continue to be underperforming;
- the impact of higher interest rates;
- the impact of higher operating costs, including workers’ compensation, health care and energy costs;
- future capital expenditures;
- the Company’s competitive strategy, competitive pricing and other competitive pressures;
- the effect of the adoption of new accounting standards by the Company;
- the realization of the Company’s deferred tax assets;
- the Company’s assumptions and expectations underlying its critical accounting policies (see “Management’s Discussion and Analysis of Financial Condition and Results of Operations”);
- the overall level of consumer spending and demand for the products offered;
- general economic conditions;
- the impact of sales promotions and customer service programs on consumer spending;
- lease extensions and suitable alternative store locations; and
- the future cost and utilization of consumer credit programs under the CCA.

Such forward-looking statements can be identified by words such as: “believes,” “anticipates,” “expects,” “intends,” “seeks,” “may,” “will,” “projects,” “forecasts,” “plans” and “estimates”. The Company bases its forward-looking statements on its current views and assumptions. As a result, those statements are subject to risks and uncertainties that could cause actual results to

differ materially from those predicted. Some of the factors that could cause the Company's results to differ from those predicted include the following risk factors, as well as other risks and uncertainties discussed in other documents filed by the Company with the Securities and Exchange Commission. In addition, the Company typically earns a disproportionate share of its operating income in the fourth quarter due to seasonal buying patterns, which are difficult to forecast with certainty. While the Company believes that its assumptions are reasonable, it cautions that it is impossible to predict the impact of such factors which could cause actual results to differ materially from predicted results.

THE FOLLOWING LIST OF IMPORTANT FACTORS IS NOT EXCLUSIVE AND THE COMPANY DOES NOT UNDERTAKE TO REVISE OR UPDATE ANY FORWARD-LOOKING STATEMENT TO REFLECT EVENTS OR CIRCUMSTANCES THAT OCCUR AFTER THE STATEMENT IS MADE.

### **RISK FACTORS**

The Company's business is subject to certain risks, and those risks should be considered while evaluating its business and financial results. Any of the risks discussed below could materially and adversely affect the Company's operating results and financial condition, as well as the projections and beliefs about its future performance. Accordingly, the Company's results could differ materially from those projected in its forward-looking statements. In addition, the preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts and timing of revenue and expenses, the reported amounts and classification of assets and liabilities and the disclosure of contingent assets and liabilities. Actual results could differ materially from the Company's estimates and assumptions. (See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies".)

#### **The Company's Sources of Liquidity Are Limited**

The Company's working capital requirements are currently met through a combination of cash generated by operations, borrowings under its senior revolving credit facility, short-term trade and factor credit, and by proceeds from external financings and sale transactions. In the event these sources of liquidity are not adequate, the Company may be required to pursue one or more alternative strategies to improve its liquidity position, which could include the sale of additional stores or the issuance of additional equity or equity-linked securities. If the estimates or assumptions relative to any one of these sources of liquidity are not realized, the Company's business, financial condition and results of operations may be materially adversely affected.

Because the Company is already highly leveraged, the ability to obtain additional or alternative sources of financing in the future for working capital, capital expenditures, new store openings, acquisitions and other general corporate purposes is limited. This limited financial flexibility may result in increased vulnerability to general adverse economic and industry conditions, a more limited ability to react to changes in the business environment and the industry in which the Company competes, and the Company being at a competitive disadvantage with competitors that

have less debt and greater access to capital resources. In addition, a significant portion of the Company's cash flow from operations must be dedicated to the payment of principal, interest and other fees relative to its debt, which reduces the funds available for operations. Risks and uncertainties associated with the previously described sources of liquidity are described more fully below.

The Company is highly dependent on its ability to borrow against its senior revolving credit facility for working capital purposes. As of March 1, 2004, the Company re-negotiated its senior revolving credit facility (the "GE facility") for which General Electric Capital Corporation ("GE Capital") acts as administrative agent. The facility provides for borrowings of up to \$165.0 million and has been extended through February 28, 2007. The GE facility is secured by substantially all the Company's assets. The GE facility provides for lower rates of interest than the previous credit facility and refinanced an existing real estate loan, which also has resulted in lower interest costs to the Company. In addition, the GE facility reduced the number of financial covenants to one fixed charge covenant. Borrowings under the GE facility are subject to a restrictive borrowing base equal to a specified percentage of eligible credit card receivables, which are considered cash equivalents, and a specified percentage of merchandise inventory, less other reserves that are established by GE Capital. Several factors can influence the maximum amount the Company is able to borrow under this facility, including, without limitation, the level of eligible inventory, the appraised value of eligible inventory and the level of reserves established against eligible inventory. Any significant reduction to the Company's borrowing capacity under the GE facility would have a material adverse affect on the Company's liquidity position.

The GE facility contains restrictive financial and operating covenants, including without limitation, the requirement to maintain a minimum fixed charge coverage ratio (as defined in the related agreement). Certain of the Company's other debt agreements also contain financial and other restrictive covenants, as well as cross default provisions. Accordingly, the failure to comply with these restrictions and covenants would cause a cross-default under the majority of the Company's other debt agreements. Any of these defaults, if not waived, could result in a majority of the Company's debt becoming immediately due and payable. If this were to occur, the Company may not be able to repay the debt or borrow sufficient funds to refinance it. Even if new financing were available, the Company may not be able to complete such refinancing quickly enough or at financially acceptable terms. (See Part II, Item 7, "Management's Discussion and Analysis of Results of Operations and Financial Condition".)

### **The Company Is Highly Dependent On Key Relationships With Factors And Vendors**

The success of the Company's business is highly dependent upon the adequacy of trade credit offered by key factors and vendors, the vendors' ability and willingness to sell its products at favorable prices and terms, and the willingness of vendors to ship merchandise on a timely basis. Restrictions to the amount of trade credit granted by key factors and vendors can adversely impact the volume of merchandise the Company is able to purchase. Any significant reduction in the volume of merchandise the Company is able to purchase, or a prolonged disruption in the timing of when merchandise is received, would have a material adverse affect on the Company's business, liquidity position, and results of operations.

The Company began to experience a significant reduction in the level of unsecured credit offered by many of its factors and vendors in late fiscal 2001. In February 2002, the level of unsecured credit offered by vendors increased, but unsecured credit granted by key factors, which can represent over 50% of total trade credit granted to the Company, remained restricted. Management negotiated the restoration of partially secured credit lines with certain key factors by issuing standby letters of credit. The issuance of those letters of credit reduced the Company's borrowing availability under its revolving line of credit. In order to offset the majority of this availability reduction, Harris, an affiliate of the Company, agreed to provide a short-term credit enhancement to the revolving credit facility under the terms of a Credit Facilitation Agreement (the "CFA") entered into with the Company on February 22, 2002. During 2002, the CFA was amended three times to provide for extensions of the expiration date of the Harris letter of credit. Under the terms of the third amendment to the CFA, the Harris letter of credit was cancelled and the CFA was terminated as a result of the closing of the sale of receivables to Household.

Despite the increase in the amount of unsecured credit granted by the Company's vendors and factors, such amounts remained below historical levels throughout fiscal 2002. The Company continued to experience improvement in unsecured credit levels a result of the Household transaction and improved operating results in 2003. The Company has been able to purchase adequate levels of merchandise to support its operations. The Company has also eliminated the outstanding factor letters of credit effective in March of 2004.

Nonetheless, there can be no assurance the Company will continue to receive an adequate level of key factor and vendor trade credit to support its operations. Any significant reductions of trade and factor support may impair the Company's ability to purchase an adequate level of merchandise to support its operations. The inability to purchase an adequate level of merchandise would have a material adverse affect on the Company's business, liquidity position and results of operations.

### **The Company Has Worked Through The Integration Challenges With The Lamonts Acquisition**

As described more fully in the Company's Annual Reports on Form 10-K for the years ended February 1, 2003, February 2, 2002 and February 3, 2001, many of the stores acquired from Lamonts performed below expectations in fiscal 2002, 2001 and 2000.

Based on reviews of the long-term prospects of each of the acquired stores, management decided to close 6 of the acquired stores in fiscal 2001, 4 in fiscal 2002 and 6 in fiscal 2003. After these store closings, the Company continued to operate 18 of the original 34 acquired stores. However, certain of those stores continue to perform below expectations. In the event the Company is unable to improve the operating performance of those locations, management may consider the sale, sublease or closure of those locations in the future. In the past, the Company has successfully improved the operating results and cash flows of underperforming locations through a variety of strategies, including revising the merchandise mix, changing store management, revising marketing strategies, renegotiating lease agreements and reducing

operating costs. There can be no assurance, however, that these strategies will improve the operating results and cash flows of those underperforming stores, or that the Company will be able to sell, sublease or close those stores in the event their performance does not improve. In addition, the Company may incur certain costs and expenses in connection with the sale or closure of those locations that may not be fully offset by sale proceeds, sublease income or favorable lease terminations. As a result, added store closure costs may be incurred in the future.

During fiscal 2002, the Company performed an analysis of all of its underperforming store locations, which consisted primarily of former Lamonts locations. This analysis was performed by comparing projected net operating cash flows, including estimated proceeds from the sale of certain assets, to the carrying value of the stores' long-lived assets. As a result of this analysis, the Company recorded non-cash asset impairment charges of \$9.5 million to write down property and equipment, leasehold interests and goodwill related to certain of the under-performing stores. No further impairment of long-lived assets was identified and recorded with respect to underperforming stores during 2003. If actual market conditions are less favorable than those projected, additional charges for the impairment of long-lived assets may be incurred in the future.

### **The Company Faces Significant Competition From Other Retailers**

The retail business is highly competitive, and if the Company fails to compete effectively, it could lose market share. The Company's primary competitors include national, regional and local chain department and specialty stores, general merchandise stores, discount and off-price retailers and outlet malls. Increased use and acceptance of the internet and other home shopping formats also creates increased competition. Some of these competitors offer similar or better-branded merchandise and have greater financial resources to purchase larger quantities of merchandise at lower prices. The Company's ability to counteract these competitive pressures depends on its ability to:

- offer merchandise which reflects the different regional and local needs of its customers;
- differentiate and market the Company as a home-town, locally-oriented store (as opposed to its more nationally focused competitors); and
- continue to offer adequate quantities of better to moderately priced branded and private label merchandise at comparable profit margins.

### **The Company's Business Is Susceptible To Economic Conditions And Other Factors That Affect Its Markets, Some Of Which Are Beyond Its Control**

***General Economic and Market Conditions.*** The Company's stores are located primarily in non-major metropolitan, suburban and agricultural areas in the western United States. A substantial portion of the stores are located in California and Washington. The Company's success depends upon consumer spending, which may be materially and adversely affected by any of the following events or conditions:

- a downturn in the national, California or Pacific Northwest economies;
- a downturn in the local economies where the stores are located;
- a decline in consumer confidence;



- an increase in interest rates;
- inflation or deflation;
- consumer credit availability;
- consumer debt levels;
- higher energy costs in California and the Pacific Northwest;
- higher healthcare and workers' compensation insurance costs;
- higher property and casualty insurance costs;
- tax rates and policy; and
- unemployment trends.

***Seasonality and Weather.*** Seasonal influences affect the Company's sales and profits. The Company experiences its highest levels of sales and profits during the Christmas selling months of November and December, and, to a lesser extent, during the Easter holiday and Back-to-School seasons. The Company has increased working capital needs prior to the Christmas season to carry significantly higher inventory levels and generally increases its selling staff levels to meet anticipated demands. Any substantial decrease in sales during its traditional peak selling periods could materially adversely impact the Company's business, financial condition and results of operations.

The Company also depends on normal weather patterns across its markets. Historically, unusual weather patterns have significantly impacted its business.

***Consumer Trends.*** The Company's success partially depends on its ability to anticipate and respond to changing consumer preferences and fashion trends in a timely manner. However, it is difficult to predict what merchandise consumers will demand, particularly merchandise that is trend driven. Failure to accurately predict constantly changing consumer tastes, preferences and spending patterns could adversely affect short and long-term results.

***War and Acts of Terrorism.*** The involvement of the United States in war or other conflicts have had an adverse impact on the Company by, among other things, adversely affecting retail sales as a result of reduced consumer spending, and by causing substantial increases in fuel prices thereby increasing the costs of doing business. Any future war, political conflict or significant act of terrorism on U.S. soil or elsewhere could have an adverse effect from the foregoing and by impeding the flow of imports or domestic products to the Company.

### **The Company May Face Higher Operating Costs**

Approximately 46.9% of the Company's debt at January 31, 2004 has underlying variable interest rates, which may result in higher interest expense in the event interest rates are raised. (See Item 7A "Qualitative and Quantitative Disclosures about Market Risk.")

A substantial portion of the Company's stores are located in California and Washington. As a result, the Company is particularly sensitive to negative occurrences in those states. In mid-fiscal 2001, problems associated with the deregulation of the electric industry in California resulted in intermittent service interruptions and higher utility rates. The Company may face similar situations in the future. The Company's inability to adequately address these problems could

have a material adverse affect on its financial position and results of operations. In addition, the Company is facing higher workers' compensation, health insurance and property and casualty insurance costs in the market areas in which it operates. There can be no assurance that the Company will be able to fully offset the negative impact of such higher costs.

### **The Company Depends On Key Personnel**

The Company's success depends to a large extent on its executive management team. The loss of the services of certain of its executives could have a material adverse effect on the Company. The Company cannot guarantee that it will be able to retain such key personnel or attract additional qualified members to its management team in the future.

The Company also depends on attracting and retaining a large number of qualified employees to maintain and increase sales and to execute its customer service programs. Many of its employees are in entry level or part-time positions with historically high levels of turnover. The Company's ability to meet its employment needs is dependent on a number of factors, including the following factors which affect its ability to hire or retain qualified employees:

- unemployment levels;
- minimum wage legislation;
- rising health care costs; and
- changing demographics in the local economies where stores are located.

## **Item 2. PROPERTIES**

### **Corporate Office and Distribution Center**

The Company's corporate headquarters is located in an office building in Fresno, California. The building was constructed in 1991 and is owned by a limited partnership in which the Company holds a 36% interest as the sole limited partner. The Company leases 89,000 square feet of the 176,000 square foot building under a twenty-year lease expiring in 2011. The lease contains two consecutive ten-year renewal options and the Company receives favorable rental terms under the lease. As described in Note 6 to the Consolidated Financial Statements, the Company has financed its interest in the partnership with a three-year promissory note maturing in May 2005. The Company believes that its current office space is adequate to meet its office space requirements for the foreseeable future.

The Company's distribution center, constructed in 1989, is a 420,000 square foot distribution facility located in Madera, California, which is in close proximity to the Company's corporate headquarters. The facility was originally designed to provide for the future growth of the Company and its processing capacity and physical size is readily expandable. The Company leases the distribution facility from an unrelated party under a 20-year lease expiring in the year 2009, with six consecutive five-year renewal options.

## Store Leases and Locations

The Company owns seven of its 63 department stores, all but one of which are subject to mortgage loans, and leases the remaining 56 department stores and all of its 11 specialty stores, and remains obligated under the lease for one of the department stores closed in fiscal 2001. Most of the Company's department store leases expire in various years through 2021, and have renewal options for one or more periods ranging from five to 20 years. Leases for specialty store locations generally do not contain renewal options. While there is no assurance that the Company will be able to negotiate further extensions of any particular lease, management believes that satisfactory extensions or suitable alternative store locations will be available.

Certain of the department and specialty store leases provide for the payment of additional contingent rentals based on a percentage of sales, require the payment of property taxes, insurance and maintenance costs, and, in certain cases, also provide for rent abatements and scheduled rent increases during the lease terms. The Company leases three of its department stores from ECI, an affiliate of the Company. Additional information pertaining to the Company's store leases is included in Note 8 to the Consolidated Financial Statements.

The following table contains additional information about the Company's stores open as of the end of fiscal 2003:

<u>State</u>	<u># of Stores</u>	<u>Gross Square Footage(1)</u>
<b><u>Department Stores:</u></b>		
California.....	39	4,048,636
Washington.....	12	627,102
Alaska.....	6	339,987
Oregon.....	2	110,400
Nevada.....	2	199,300
Idaho.....	2	80,054
Total	<u>63</u>	<u>5,405,479</u>
<b><u>Specialty Stores:</u></b>		
California.....	10	39,170
Nevada.....	1	3,211
Total	<u>11</u>	<u>42,381</u>

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(1) Reflects total store square footage, including office space, storage, service and other support space, and selling space.

### **Item 3. LEGAL PROCEEDINGS**

On March 5, 2004, AT&T filed a breach of contract complaint in the United States District Court in Fresno, California demanding the payment of approximately \$768,000 for telecommunication services allegedly supplied to the Company in 2002 and 2003. The Company has answered and denied the AT&T allegations and demand. At this time it is not possible to predict the outcome of this dispute, but the Company believes that it is not liable for the amounts demanded by AT&T, and will vigorously defend any action AT&T files to pursue its claim.

The Company is party to other legal proceedings and claims which have arisen during the ordinary course of business. In the opinion of management, the ultimate outcome of such litigation and claims is not expected to have a material adverse effect on the Company's financial position or results of its operations.

### **Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS**

No matters were submitted to a vote of security holders of the Company during the fourth quarter of the fiscal year covered in this report.

## **PART II**

### **Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

The Company's common stock is listed for trading on both the New York Stock Exchange ("NYSE") and the Pacific Stock Exchange. The following table sets forth the high and low sales prices per share of common stock as reported on the NYSE Composite Tape under the symbol "GOT" during the periods indicated:

<b>Fiscal Quarters</b>	<b>2003</b>		<b>2002</b>	
	<b>High</b>	<b>Low</b>	<b>High</b>	<b>Low</b>
1st Quarter.....	\$ 1.58	\$ 0.94	\$ 3.85	\$ 2.24
2nd Quarter.....	\$ 2.17	\$ 1.15	\$ 3.48	\$ 2.43
3rd Quarter.....	\$ 4.00	\$ 1.80	\$ 2.70	\$ 1.17
4th Quarter.....	\$ 4.68	\$ 3.14	\$ 2.13	\$ 1.47

On March 31, 2004, the Company had 767 stockholders of record, some of which were brokerage firms or other nominees holding shares for multiple stockholders. The closing price of the Company's common stock as reported by the NYSE on March 31, 2004 was \$5.58 per share.

The Company has not paid a cash dividend since its initial public offering in 1986. The Board of Directors has no present intention to pay cash dividends in the foreseeable future, and will determine whether to declare cash dividends in the future depending on the Company's earnings, financial condition and capital requirements. In addition, the Company's senior revolving credit agreement and certain of its other debt agreements prohibit the Company from paying dividends

without prior written consent from those lenders. (See Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations.")

The following table provides information as of January 31, 2004 about the Company's Common Stock that may be issued upon the exercise of options granted to employees or members of the Board of Directors under all of the Company's existing equity compensation plans.

<b>Plan Category</b>	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders.....	1,688,500	\$5.36	1,015,750
Equity compensation plans not approved by security holders.....	N/A	N/A	N/A
Total.....	1,688,500	\$5.36	1,015,750

## **Item 6. SELECTED FINANCIAL DATA**

The Company reports on a 52/53 week fiscal year ending on the Saturday nearest to January 31. The fiscal years ended January, 31, 2004, February 1, 2003, February 2, 2002, February 3, 2001 and January 29, 2000, are referred to herein as fiscal 2003, 2002, 2001, 2000 and 1999, respectively. All fiscal years noted include 52 weeks, except for fiscal 2000, which includes 53 weeks. Management believes the Company's results of operations for fiscal 2000 were not materially affected by results applicable to the 53<sup>rd</sup> week.

The selected financial data below should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the Consolidated Financial Statements of the Company and related notes included elsewhere herein.

	Fiscal Years				
	2003	2002	2001	2000	1999
	(In thousands of dollars, except share data)				
<b>RESULTS OF OPERATIONS(1):</b>					
Net sales.....	\$ 660,574	\$ 665,916	\$ 678,866	\$ 643,385	\$ 541,275
Net credit revenues.....	3,729	8,225	8,420	9,150	8,709
Net leased department revenues (1).....	3,525	3,557	3,965	3,853	4,209
Total revenues.....	<u>667,828</u>	<u>677,698</u>	<u>691,251</u>	<u>656,388</u>	<u>554,193</u>
Costs and expenses:					
Cost of sales.....	435,370	441,426	450,723	421,329	354,010
Selling, general and administrative expenses.....	203,966	207,885	210,658	194,246	167,561
Depreciation and amortization (2).....	13,177	13,374	13,256	11,154	9,465
Asset impairment charges (3).....		9,502			1,933
Store closure costs (4).....			729		
Receivables sale costs (5).....		1,749			
New store pre-opening costs (6).....				4,684	495
Total costs and expenses.....	<u>652,513</u>	<u>673,936</u>	<u>675,366</u>	<u>631,413</u>	<u>533,464</u>
Operating income .....	<u>15,315</u>	<u>3,762</u>	<u>15,885</u>	<u>24,975</u>	<u>20,729</u>
Other (income) expense:					
Interest expense.....	13,296	15,883	14,364	13,750	11,408
Losses on early extinguishment of debt (7).....		3,695	696		
Miscellaneous income.....	(2,262)	(1,802)	(1,587)	(1,408)	(1,555)
	<u>11,034</u>	<u>17,776</u>	<u>13,473</u>	<u>12,342</u>	<u>9,853</u>
Income (loss) from continuing operations before income taxes.....	4,281	(14,014)	2,412	12,633	10,876
Income tax expense (benefit).....	<u>1,529</u>	<u>(6,495)</u>	<u>851</u>	<u>4,775</u>	<u>4,240</u>
Income (loss) from continuing operations.....	2,752	(7,519)	1,561	7,858	6,636
Discontinued operations:					
Loss from operation of closed stores.....	(547)	(1,948)	(1,721)	(1,180)	
Loss on store closures (8).....	(789)	(4,801)			
Income tax benefit.....	<u>(454)</u>	<u>(2,295)</u>	<u>(585)</u>	<u>(401)</u>	
Loss on discontinued operations.....	<u>(882)</u>	<u>(4,454)</u>	<u>(1,136)</u>	<u>(779)</u>	
Net income (loss).....	<u>\$ 1,870</u>	<u>\$ (11,973)</u>	<u>\$ 425</u>	<u>\$ 7,079</u>	<u>\$ 6,636</u>

Net income (loss) per common share

Basic:

Income (loss) from continuing operations.....	0.22	(0.59)	0.12	0.62	0.53
Loss on discontinued operations.....	(0.07)	(0.35)	(0.09)	(0.06)	0.00
Net income (loss) per common share.....	0.15	(0.94)	0.03	0.56	0.53

Diluted:

Income (loss) from continuing operation.....	0.21	(0.59)	0.12	0.62	0.53
Loss on discontinued operations.....	(0.07)	(0.35)	(0.09)	(0.06)	0.00
Net income (loss) per common share..... \$	0.14	\$ (0.94)	\$ 0.03	\$ 0.56	\$ 0.53

Weighted-average number of common shares outstanding:

Basic.....	12,830	12,747	12,681	12,614	12,577
Diluted.....	12,919	12,747	12,691	12,632	12,616

	Fiscal Years				
	2003	2002	2001	2000	1999
	(In thousands of dollars)				
<b>SELECTED BALANCE SHEET DATA:</b>					
Retained interest in					
receivables sold.....	\$	\$	\$ 19,222	\$ 19,853	\$ 29,138
Receivables, net.....	9,145	10,641	11,331	9,248	7,597
Merchandise inventories (9).....	156,458	164,615	161,041	185,226	130,028
Property and equipment, net.....	129,832	139,888	153,200	147,711	120,393
Total assets.....	323,992	348,729	392,193	410,059	316,164
Working capital.....	108,949	79,949	104,378	111,011	104,719
Long-term obligations,					
less current portion.....	91,302	75,097	110,216	113,012	80,674
Subordinated note					
payable to affiliate.....	22,180	21,989	21,646	21,303	20,961
Stockholders' equity.....	108,323	106,324	118,172	117,573	110,238

	Fiscal Years					
	2003	2002	2001	2000	1999	
	(In thousands of dollars, except per square foot data)					
<b>OTHER SELECTED DATA:</b>						
Sales growth:						
Total store sales (10).....	(3.5)%	(2.7)%	8.5% (11)	22.6% (12)	9.9%	
Comparable store sales (13).....	(0.7)%	(0.8)%	0.4% (11)	5.6% (14)	7.7% (15)	
					(15)	
Comparable stores data (13)(16):						
Sales per selling square foot.....	\$ 149	\$ 148 (17)	\$ 173 (17)	\$ 176	\$ 168	
Selling square footage.....	4,451	4,654 (17)	3,478 (17)	3,384	2,758	
Capital expenditures.....	\$ 4,363	\$ 8,279	\$ 18,683	\$ 29,635	\$ 16,059	
Current ratio.....	2.50:1	1.70:1	1.97:1	1.93:1	2.38:1	

- (1) Certain prior year amounts on the statement of operations have been reclassified to present discontinued operations to conform to the current year presentation in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets.
- (2) Net leased department revenues consist of sales totaling \$24.5 million, \$24.9 million, \$28.9 million, \$27.7 million and \$29.0 million in fiscal 2003, 2002, 2001, 2000 and 1999, respectively, less cost of sales.
- (3) Depreciation and amortization includes the amortization of goodwill totaling \$570,000, \$553,000 and \$536,000 in fiscal 2001, 2000 and 1999, respectively, and the (amortization) accretion of leasehold interests totaling \$18,000, \$(95,000), \$41,000 and \$203,000 in fiscal 2003, 2002, 2001 and 2000, respectively. Effective the beginning of fiscal 2002, the Company implemented the provisions of SFAS No. 142. As a result, the Company no longer amortizes goodwill and instead tests it annually for impairment. The Company continues to amortize leasehold interests (see Note 1 to the Consolidated Financial Statements).



- (4) The fiscal 2002 charge consists of non-cash asset impairment charges to write down long-lived assets related to certain underperforming stores (see Note 10 to the Consolidated Financial Statements). The fiscal 1999 amount represents a non-recurring charge related to the write-off of an investment in a co-operative buying group.
- (5) The fiscal 2001 amount represents costs incurred in connection with (i) the closure of six stores in fiscal 2001, net of proceeds from the sale or favorable termination of the related store leases, and (ii) the discontinuation of the use of an outsourced distribution center facility located in Kent, Washington. See Note 9 to the Consolidated Financial Statements.
- (6) Represents receivable sale transaction costs, net of an interest only strip. The interest only strip represents the portion of the initial program fees to be received that is considered a residual interest in the assets sold. See Note 2 to the Consolidated Financial Statements.
- (7) Fiscal 2000 includes \$4.1 million pre-tax of non-recurring costs associated with the re-opening of the continuing stores acquired in the Lamonts acquisition.
- (8) The 2002 amount represents securitization program prepayment penalties and the write-off of unamortized loan fees (see Note 2 to the Consolidated Financial Statements). The 2001 amount consists of the prepayment penalty and the write-off of unamortized loan fees related to the early retirement of the Company's previous revolving credit facility (see Note 6 to the Consolidated Financial Statements).
- (9) The fiscal 2003 amount represents costs related to the closure of seven stores primarily consisting of lease termination costs, severance, and other incremental costs associated with the store closings. The fiscal 2002 amount represents costs associated with the closure of four stores in fiscal 2002 including lease termination costs, severance, and other incremental costs associated with the store closings, asset impairment charges related to stores closed in fiscal 2003 and fiscal 2002, and a gain on sale of two store leases and certain fixtures in fiscal 2002. See Note 9 to the Consolidated Financial Statements.
- (10) The significant increase in merchandise inventories in fiscal 2000 as compared to fiscal 1999 relates primarily to additional inventories purchased for stores acquired in connection with the Lamonts acquisition in that year (see Part I, Item 1, "Business – Acquisitions"). The decrease in inventory from fiscal 2000 to fiscal 2001 and from fiscal 2002 to 2003 is primarily due to the reduction of inventory levels to more closely reflect selling trends, and to store closures.
- (11) Total store sales include sales from stores closed which are reported net of expenses in discontinued operations.
- (12) Represents total sales and comparable store sales growth percentages for fiscal 2001 as compared to the comparable 52 week period in fiscal 2000. Total sales and comparable store sales for the 52 week period in fiscal 2001 increased by 7.1% and decreased by 0.9%, respectively, as compared to the 53 week period in fiscal 2000.
- (13) The increase in total store sales in fiscal 2000 is primarily due to the addition of 37 stores in the second half of fiscal 2000, including the 34 stores acquired in the Lamonts acquisition.
- (14) Comparable stores are defined as stores which have been open for at least 12 full months and which remain open as of the applicable reporting date.
- (15) Represents comparable store sales growth for the first 52 weeks of fiscal 2000 as compared to the same period of fiscal 1999. Comparable store sales for the 53 week period in fiscal 2000 increased by 6.9% as compared to the 52 week period in fiscal 1999.
- (16) The comparable store sales increases in fiscal 2000 and 1999 were favorably impacted by the conversion of leased shoe departments to owned departments in 28 department stores effective August 1, 1999.

- (17) Includes leased department sales in order to facilitate an understanding of the Company's sales relative to its selling square footage.
- (18) The decrease in sales per selling square foot and the increase in selling square footage from 2001 to 2002 is attributable to the inclusion in 2002 comparable stores of the less productive former Lamonts stores.

## **Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Following is management's discussion and analysis of significant factors that have affected the Company's financial position and its results of operations for the periods presented in the accompanying consolidated financial statements.

Fiscal 2003, 2002, and 2001 results all include 52 weeks.

### **Critical Accounting Policies**

The Company's significant accounting policies are described in Note 1 to the Consolidated Financial Statements included in Part IV, Item 15 of this Form 10-K. The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to its revenue recognition policy, the carrying value of its merchandise inventories, the adequacy of its store closure reserves, and the valuation of its long-lived assets and deferred tax assets. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. In the past, actual results have not been materially different from the Company's estimates.

Some of the Company's significant accounting policies involve a higher degree of judgment or complexity than its other accounting policies. The policies described below have been identified as critical to the Company's business operations and the understanding of its results of operations. The impact and associated risks related to these policies on the Company's business operations are discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations.

### **Revenue Recognition Policy**

Net retail sales are recognized at the point-of-sale, net of estimated sales returns and allowances and exclusive of sales tax. Net retail sales also include all amounts billed to a customer in a sale transaction for shipping and handling, including customer delivery charges. Revenues on special order sales are recognized when the merchandise is delivered to the customer and the merchandise has been paid for in its entirety.

The Company records an allowance for estimated sales returns in the period in which the related sale occurs. These estimates are based primarily on historical sales returns. If the historical data used to calculate these estimates does not properly reflect future returns, and adjustments to the allowance for estimated sales returns may be necessary.

### **Inventory Valuation**

Merchandise inventory, which consists of merchandise held for resale, is valued at the lower of LIFO (last-in, first-out) cost or market using the retail inventory method ("RIM") of accounting. Inherent in the RIM calculation are various judgments and estimates including, among others, merchandise markon, markups, markdowns and shrinkage, which significantly impact the ending inventory valuation at cost, as well as resulting gross margins. The Company applies various methodologies to ensure that the application of the RIM is consistent for all periods presented. Such methodologies include the development of consistent cost-to-retail ratios and the grouping of homogenous classes of merchandise. Estimated inventory shrinkage between physical inventory dates is based on historical experience. Should actual inventory shrinkage results differ from the Company's estimate, year-end revisions to inventory shrinkage expense recognized on an interim basis may be required.

Estimating the market value of the Company's merchandise inventory requires assumptions about future demand and market conditions. Such estimates are based on actual and forecasted sales trends, current inventory levels and aging information by merchandise categories. The Company records markdowns to value merchandise inventories at net realizable value. If forecasted sales are not achieved, or if other indicators of impairment are present, additional markdowns may be needed in future periods to clear excess or slow-moving merchandise, which may result in lower gross margins.

### **Reserve for Store Closure Costs**

In the event a store is closed before its lease has expired, the remaining lease obligation after the closing date (less anticipated sublease rental income or proceeds from lease settlements, if any) is expensed at the date the store ceases operations. Asset impairment charges related to furniture, fixtures and equipment, leasehold improvements, goodwill and leasehold interests are expensed in the period in which management adopts a plan to close the store if impairment is considered likely as a result of such planned closure, or at such other time as impairment becomes likely. Severance and other incremental costs associated with a store closure are expensed as incurred.

As of January 31, 2004, the Company had a reserve for store closure costs totaling \$337,000, which consisted primarily of estimated future lease obligations for one of the store locations closed in fiscal 2001 and one of the store locations closed in fiscal 2003. In the event the Company is not successful in selling or subleasing the locations closed in fiscal 2001 as soon as management expects, additional reserves for store closure costs may be recorded. In addition, in the event the Company decides to close additional store locations in fiscal 2004 or beyond, additional reserves for store closure costs, which may be material, may be incurred.

## **Impairment of Long-Lived Assets**

The Company's long-lived assets consist primarily of property and equipment, goodwill, leasehold interests and other long-term assets. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. With respect to store locations, the Company performs an evaluation of whether an impairment charge should be recorded whenever a store experiences unfavorable operating performance. A store's assets are evaluated for impairment by comparing its estimated undiscounted cash flows over its estimated remaining lease term to its carrying value. If the cash flows are not sufficient to recover the carrying value, a loss equal to the difference between the carrying value and the estimated fair value of the asset is recognized. Estimates of future cash flows are based on a variety of factors, including historical experience in similar locations, changes in merchandising, promotional or operating strategy that may affect the profitability of a particular location, knowledge of the market area and in some cases, expected sale proceeds or sublease income, and independent appraisals. In addition, the analysis assumes that new store locations typically take three years to achieve their full profit potential. Various uncertainties, including but not limited to changes in consumer preferences, increased competition or a general deterioration in economic conditions could adversely impact the expected cash flows to be generated by an asset or group of assets. In fiscal 2002, the Company recorded asset impairment charges in connection with store closures, and such charges are included in loss on store closures in the accompanying consolidated income statement. In addition, asset impairment charges were recorded for certain underperforming store locations which continue to be operated. If actual performance or fair value estimates for other locations are less favorable than management's projections, future asset impairment charges may be necessary. Similar procedures are used when analyzing other corporate assets for impairment.

Effective the beginning of fiscal 2002, the provisions of SFAS No. 142 were implemented. As a result, the Company no longer amortizes previously recorded goodwill. The Company performs an annual impairment review of goodwill as required by the statement, unless more frequent reviews are warranted by specific events or circumstances. There can be no assurance that at the time these reviews are completed that material impairment charges will not be recorded.

## **Income Taxes**

The carrying value of the Company's net deferred tax assets assumes that the Company will be able to generate sufficient future taxable income to realize the value of these assets. In determining the appropriate valuation allowance, management considers all available evidence for certain tax credit, net operating loss and capital loss carryforwards that would likely expire prior to their utilization. Management believes it is more likely than not that the Company will generate sufficient future taxable income in the appropriate carryforward periods to realize the benefit of its remaining net deferred tax assets. However, if the available evidence were to change in the future, an adjustment to the valuation allowance may be required, resulting in additional income tax expense.

## **Accounting for the Securitization and Sale of Receivables**

Prior to the sale of its customer credit card accounts and accounts receivable to Household on January 31, 2003, the Company conveyed all of the receivables generated under its private label customer credit cards to a wholly-owned subsidiary, GCRC, on a daily basis. Those receivables that met certain eligibility requirements of the program were simultaneously conveyed to the Gottschalks Credit Card Master Trust ("GCC Trust") to be used as collateral for securities issued to investors. GCC Trust was a qualified special purpose entity and was not consolidated in the Company's financial statements. The transfers of such receivables were accounted for as sales for financial reporting purposes pursuant to SFAS No. 140, "Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," and as such, the transferred receivables were removed from the Company's balance sheet at the time of the transfer. The Company retained a beneficial ownership interest in certain of the receivables transferred under the program and also retained an uncertificated ownership interest in the retained interest to future interest income (interest-only strip) and other receivables that did not meet certain eligibility requirements of the program. The retained interests and the interest-only strips were carried at their estimated fair values, which were estimated based upon the present value of the expected future cash flows, calculated using management's best estimates of key assumptions about anticipated credit losses, account prepayment speeds, discount rates and other factors necessary to derive an estimate of fair values. The gain or loss on the sale of the receivables was calculated by comparing the carrying amount of the financial assets involved in the transfer to their relative fair values at the date of transfer. The certificated portion of the retained interests were considered readily marketable and were classified as available for sale and carried at their estimated fair values in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities."

## **Results of Operations**

The following table sets forth for the periods indicated certain items from the Company's Consolidated Statements of Operations, expressed as a percent of net sales:

	<b>Fiscal Years</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net sales.....	100.0 %	100.0 %	100.0 %
Net credit revenues.....	0.6	1.2	1.2
Net leased department revenues.....	<u>0.5</u>	<u>0.5</u>	<u>0.6</u>
Total revenues.....	101.1	101.7	101.8
Costs and expenses:			
Cost of sales.....	65.9	66.3	66.4
Selling, general and administrative expenses.....	30.9	31.2	31.0
Depreciation and amortization.....	2.0	2.0	2.0
Asset impairment charges.....	0.0	1.4	0.0
Store closure costs.....	0.0	0.0	0.1
Receivables sale costs.....	<u>0.0</u>	<u>0.3</u>	<u>0.0</u>
Total costs and expenses.....	<u>98.8</u>	<u>101.2</u>	<u>99.5</u>
Operating income.....	2.3	0.5	2.3
Other (income) expense:			
Interest expense.....	2.0	2.3	2.1
Losses on early extinguishment of debt.....	0.0	0.5	0.1
Miscellaneous income.....	<u>(0.3)</u>	<u>(0.3)</u>	<u>(0.2)</u>
	<u>1.7</u>	<u>2.5</u>	<u>2.0</u>
Income (loss) before income taxes.....	0.6	(2.0)	0.3
Income tax expense (benefit).....	<u>0.2</u>	<u>(1.0)</u>	<u>0.1</u>
Income (loss) from continuing operations.....	<u>0.4</u>	<u>(1.0)</u>	<u>0.2</u>
Discontinued operations:			
Income (loss) from operation of closed stores.....	(0.1)	(0.3)	(0.3)
Loss on store closures.....	(0.1)	(0.7)	0.0
Income tax benefit.....	<u>(0.1)</u>	<u>(0.3)</u>	<u>(0.1)</u>
Loss on discontinued operations.....	<u>(0.1)</u>	<u>(0.7)</u>	<u>(0.2)</u>
Net income (loss).....	<u><u>0.3 %</u></u>	<u><u>(1.7)%</u></u>	<u><u>(0.0)%</u></u>

## ***Fiscal 2003 Compared to Fiscal 2002***

### **Net Sales**

Net sales from continuing operations decreased by approximately \$5.3 million, or 0.8%, to \$660.6 million in fiscal 2003 as compared to \$665.9 million in fiscal 2002. The fiscal 2003 sales decrease is primarily attributable to continued downturn in the general economic environment in much of the Company's market areas resulting in lower consumer spending during the first half of the fiscal period. Comparable store sales for fiscal 2003, which includes sales for stores open for the full period in both years, decreased by 0.7% as compared to the same 52-week period of the prior year.

The Company operated 63 department stores and 11 specialty stores as of the end of fiscal 2003 as compared to 69 department stores and 12 specialty stores as of the end of fiscal 2002. As described more fully in Note 9 to the accompanying financial statements, during fiscal 2003 the Company closed six department stores. Two such stores were closed in February 2003, and one store was closed in each of March 2003, April 2003, July 2003 and January 2004. During fiscal 2002 the Company closed two stores in each of June 2002 and January 2003.

### **Net Credit Revenues**

As described more fully in Note 2 to the accompanying financial statements, in January 2003, pursuant to the terms of a Purchase and Sale Agreement between the Company and Household Bank SB (N.A.) ("Household"), the Company sold its private label credit card accounts and accounts receivable to Household. In connection with the sale, the Company entered into two additional agreements with Household: an Interim Servicing Agreement (the "ISA") and a Credit Card Program Agreement (the "CCA"). Under the terms of the ISA, the Company continued to service the credit card receivables until Household assumed their servicing on May 14, 2003, as planned. Household compensated the Company for providing the services during the interim servicing period. The CCA provides that the Company will be paid a percentage of Net Cardholder Charges and a percentage of Other Revenue (each as defined in the CCA). All amounts received under the CCA, including amortization of prepaid program revenue, are reflected in the table below as service charge revenues. In connection with the sale, the Company also terminated its receivables securitization program.

As a result, net credit revenues related to the Company's credit card receivables portfolio decreased by approximately \$4.5 million or 54.7%, to \$3.7 million in fiscal 2003 as compared to \$8.2 million in fiscal 2002. As a percent of net sales, net credit revenues were 0.6% of net sales in fiscal 2003 as compared to 1.2% in fiscal 2002. Net credit revenues consist of the following:

<b>(In thousands)</b>	<b>2003</b>	<b>2002</b>
Service charge revenues.....	\$ 2,649	\$ 17,813
Interim servicing compensation - net.....	1,088	
Amortization of interest-only strip.....	(313)	
Interest expense on securitized receivables.....		(4,863)
Charge-offs on receivables sold and provision for credit losses on receivables ineligible for sale.....	305	(4,821)
Gain on sale of receivables.....		96
	<u>\$ 3,729</u>	<u>\$ 8,225</u>

The interim servicing compensation amount represents servicing fees under the ISA attributable to general corporate activities that were not offset by direct costs of servicing the portfolio during the interim period. These revenues ceased at the end of the interim servicing period on May 14, 2003.

In connection with the sale of the receivables, on January 31, 2003, the Company recorded a \$313,000 interest-only strip that was amortized over the estimated life of the underlying assets sold (approximately five months). The interest-only strip represented the portion of the initial revenues under the CCA that is considered a residual interest in the assets sold. The interest-only strip has been fully amortized.

As expected, the Company experienced a substantial decrease in net credit revenues in fiscal 2003 as a result of the receivables sale to Household, as well as a reduction in selling, general and administrative expenses as a result of outsourcing the credit card servicing to Household and a reduction in interest expense arising from reduced line of credit borrowings resulting from the application of the proceeds from the Household transaction. As a result, the net credit revenues the Company receives under the CCA approximately equals the net revenues from its former in-house credit card operations, net of operating expenses and interest expense.

### **Net Leased Department Revenues**

Net rental income generated by the Company's various leased departments decreased by approximately \$0.03 million, or 0.9%, to \$3.53 million in fiscal 2003 as compared to \$3.56 million in fiscal 2002. This decrease is primarily due a continued downturn in the general economic environment in much of the Company's market areas resulting in lower consumer spending during the first three quarters of the fiscal year.

Leased department sales are presented net of the related costs for financial reporting purposes. Sales generated in the Company's leased departments, consisting primarily of fine jewelry departments and beauty salons, totaled \$24.5 million in fiscal 2003 as compared to \$24.9 million in fiscal 2002.



## **Cost of Sales**

Cost of sales from continuing operations, which includes costs associated with the buying, handling and distribution of merchandise, decreased by approximately \$6.0 million to \$435.4 million in fiscal 2003 as compared to \$441.4 million in fiscal 2002, a decrease of 1.4%. The dollar decrease is primarily due to the decrease in sales volume. The Company's gross margin percentage increased to 34.1% in fiscal 2003 as compared to 33.7% in fiscal 2002. The increase in the gross margin percentage was primarily due to a change in accounting for certain allowances received from vendors as a result of the Company's adoption of Emerging Issues Task Force ("EITF") Issue No. 02-16 Accounting by a Customer (including a Reseller) for Cash Consideration Received from a Vendor that previously would have been reported as reductions in advertising expense, in addition to lower markdowns as a percentage of sales as compared to the prior year.

## **Selling, General and Administrative Expenses**

Selling, general and administrative expenses from continuing operations decreased by approximately \$3.9 million, or 1.9%, to \$204.0 million in fiscal 2003 as compared to \$207.9 million in fiscal 2002. As a percentage of net sales, selling, general and administrative expenses decreased 0.3% to 30.9% in fiscal 2003 as compared to 31.2% in fiscal 2002. The dollar decrease is primarily attributable to the elimination of the in-house credit card operations in connection with the sale of receivables to Household and cost reduction efforts initiated throughout all areas of the Company, particularly in the areas of payroll and related fringe benefits, reduced advertising expenditures resulting from an increased reliance on more effective targeted marketing efforts (partially offset by the change in accounting for certain allowances previously mentioned), and reduced communications costs. Such cost savings were partially offset by increased professional fees and insurance costs. The Company is continuing to implement programs aimed at reducing operating costs throughout all areas of the Company. Although the Company anticipates it will be successful in achieving its cost reduction initiatives, there can be no assurance that the Company will be able to fully offset the impact of increases in certain of these costs in the future.

## **Depreciation and Amortization**

Depreciation and amortization expense, which includes the (amortization) accretion of intangible assets other than goodwill decreased by approximately \$0.2 million or 1.5%, to \$13.2 million in fiscal 2003 as compared to \$13.4 million in fiscal 2002. As a percent of net sales, depreciation and amortization expense was 2.0% in fiscal 2003 and fiscal 2002. The dollar decrease is primarily the result of impairment charges taken during fiscal 2002 related to certain underperforming stores, partially offset by additional depreciation related to information systems placed in service during 2002 and capital expenditures for the renovation and expansion of certain existing stores.

## **Asset Impairment Charges**

No asset impairment charges related to continuing operations were recorded during fiscal 2003. During fiscal 2002, the Company recorded non-cash asset impairment charges of \$9.5 million to write down long-lived assets related to certain underperforming stores that the Company continues to operate, primarily former Lamonts locations. These charges consisted of \$3.6 million of property and equipment, \$5.8 million of leasehold interests and \$0.1 million of goodwill. The charges were determined by comparing projected net operating cash flows, including estimated proceeds from the sale of certain assets, to the carrying value of the stores' long-lived assets.

## **Receivables Sale Costs**

In connection with the sale of accounts receivable to Household in fiscal 2002, the Company recorded receivable sale transaction costs of \$2.0 million including consulting, legal, and other fees, and the net non-cash write-off of the remaining accounts of GCRC. These charges are partially offset by a \$0.3 million retained interest only strip that was amortized over the estimated life of the underlying assets sold (estimated to be approximately five months). The interest only strip represents the portion of the initial program fees to be paid that is considered a residual interest in the assets sold.

## **Interest Expense**

Interest expense, which includes the amortization of deferred financing costs, decreased by approximately \$2.6 million to \$13.3 million in fiscal 2003 as compared to \$15.9 million in fiscal 2002, a decrease of 16.3%. As a percent of net sales, interest expense decreased to 2.0% in fiscal 2003 as compared to 2.3% in fiscal 2002. These decreases are primarily due to lower outstanding borrowings on the Company's revolving credit facility as a result of the sale of the receivables to Household. The weighted-average interest rate applicable to the facility was 5.2% in fiscal 2003 as compared to 5.5% in fiscal 2002.

Interest expense related to securitized receivables is reflected as a reduction of net credit revenues and is not included in interest expense for financial reporting purposes.

## **Losses on Early Extinguishment of Debt**

In fiscal 2002, in connection with the termination of its receivables securitization program, the Company recorded a loss on extinguishment of debt of \$3.7 million representing prepayment penalties and the write-off of unamortized deferred loan fees related to the program.

## **Miscellaneous Income**

Miscellaneous income, which includes the amortization of deferred income and other miscellaneous income and expense amounts, increased by approximately \$0.5 million to \$2.3 million in fiscal 2003 as compared to \$1.8 million in fiscal 2002. As a percent of net sales, miscellaneous income was 0.3% in fiscal 2003 and fiscal 2002. This increase was primarily due

to an increase in the net income of the partnership which owns the Company's corporate headquarters building. The Company has a 36% interest in the partnership and accounts for its investment using the equity method of accounting. Fiscal 2002 includes recoveries of prior interest charges arising from the partial settlement of certain net operating loss carryback claims, partially offset by charges to the Company's partnership investment in its corporate offices related to the partnership's implementation of SFAS No. 133.

## Income Taxes

The Company's effective tax rate for continuing operations is an expense of 35.7% in fiscal 2003 as compared to a benefit of 46.3% in fiscal 2002. Including the tax benefit reported in discontinued operations, the Company's effective tax rate is an expense of 36.5% in fiscal 2003 as compared to a benefit of 42.3% in fiscal 2002. The fiscal 2002 tax benefit includes \$0.8 million arising from the realization of net operating loss carryback claims.

## Income From Continuing Operations

As a result of the foregoing, the Company reported income from continuing operations of \$2.8 million, or \$0.21 per diluted share, in fiscal 2003 as compared to a net loss of \$7.5 million, or \$0.59 per diluted share, in fiscal 2002.

## Discontinued Operations

As described more fully in Note 9 to the accompanying financial statements, during fiscal 2003 the Company closed six store locations. During fiscal 2002 the Company closed four store locations. These stores were determined to be either underperforming or inconsistent with the Company's long-term operating strategy. The net loss from operating these stores was \$0.5 million in fiscal 2003 and \$1.9 million in fiscal 2002. The loss from operation of discontinued stores consists of the following:

<u>(In thousands)</u>	<u>2003</u>	<u>2002</u>
Net sales from closed stores.....	\$ 6,973	\$ 25,512
Cost of sales.....	4,437	15,669
Selling, general and administrative expenses.....	3,013	10,906
Depreciation and amortization.....	<u>70</u>	<u>885</u>
Total costs and expenses.....	7,520	27,460
Loss from operations of closed stores.....	<u>\$ (547)</u>	<u>\$ (1,948)</u>

Net costs associated with the closure of stores totaled \$0.8 million in fiscal 2003 primarily consisting of lease termination costs, severance, and other incremental costs associated with the store closings. Net costs associated with the closure of stores totaled \$4.8 million in fiscal 2002

consisting of lease termination costs, severance and other incremental costs associated with the store closings of approximately \$0.6 million and non-cash asset impairment charges related to stores closed in fiscal 2003 and fiscal 2002 of \$4.5 million, partially offset by a gain of \$0.3 million from the sale of lease rights and fixtures and equipment related to two of the closed locations.

Certain of the Company's remaining stores have continued to perform below expectations. In the event the Company is unable to improve the operating performance of such underperforming stores, the Company may consider the sale, sublease or closure of those stores in the future. In the past, the Company has successfully improved the operating results and cash flows of underperforming stores through a variety of strategies, including revising the merchandise mix, changing store management, revising marketing strategies, renegotiating lease agreements and reducing operating costs. However, there can be no assurance that these strategies will improve the operating results and cash flows of the remaining underperforming stores, or that the Company will be able to sell, sublease or close those stores in the event their performance does not improve. In addition, the Company may incur certain costs and expenses in connection with the sale or closure of those locations that may not be fully offset by sale proceeds, sublease income or favorable lease terminations.

## **Net Income**

As a result of the foregoing, the Company reported net income of \$1.9 million in fiscal 2003 as compared to a net loss of \$12.0 million in fiscal 2002. On a per diluted share basis the 2003 net income was \$0.14 per share as compared to net loss of \$0.94 per share in fiscal 2002.

## ***Fiscal 2002 Compared to Fiscal 2001***

### **Net Sales**

Net sales from continuing operations decreased by approximately \$13.3 million, or 1.9%, to \$665.9 million in fiscal 2002 as compared to \$678.9 million in fiscal 2001. The fiscal 2002 sales decrease is primarily attributable to the closure of six stores in fiscal 2001 and to a continued downturn in the general economic environment in many of the Company's market areas resulting in lower consumer spending. Results of operations of the fiscal 2001 store closures are included in continuing operations in the accompanying statement of operations. Sales related to those stores were \$7.6 million in fiscal 2001. Comparable store sales for fiscal 2002, which includes sales for stores open for the full period in both years, decreased by 0.8% as compared to the same 52-week period of the prior year.

The Company operated 69 department stores and 12 specialty stores as of the end of fiscal 2002 as compared to 73 department stores and 13 specialty stores as of the end of fiscal 2001. As described more fully in Note 9 to the accompanying financial statements, during fiscal 2002 the Company announced the closure of eight stores. Two such stores were closed in each of June 2002, January 2003 and February 2003, and one store was closed in each of March 2003 and April 2003. Six stores were closed in June and July 2001, with one of those stores subsequently reopened in September 2001. The Company closed one additional store at the end of January

2002, resulting in a total of six stores closed in fiscal 2001.

### **Net Credit Revenues**

Net credit revenues related to the Company's credit card receivables portfolio decreased by approximately \$0.2 million or 2.3%, to \$8.2 million in fiscal 2002 as compared to \$8.4 million in fiscal 2001. As a percent of net sales, net credit revenues were 1.2% of net sales in both fiscal 2002 and fiscal 2001. Net credit revenues consist of the following:

<u>(In thousands)</u>	<u>2002</u>	<u>2001</u>
Service charge revenues.....	\$ 17,813	\$ 17,817
Interest expense on securitized receivables.....	(4,863)	(4,902)
Charge-offs on receivables sold and provision for credit losses on receivables ineligible for sale.....	(4,821)	(4,550)
Gain on sale of receivables.....	96	55
	<u>\$ 8,225</u>	<u>\$ 8,420</u>

Service charge revenues and interest expense on securitized receivables in fiscal 2002 were essentially equal to fiscal 2001. The Company's credit sales as a percent of total sales increased to 43.2% in fiscal 2002 as compared to 40.9% in fiscal 2001.

Charge-offs on receivables sold and the provision for credit losses on receivables ineligible for sale increased by \$0.3 million, or 6.0%, in fiscal 2002 as compared to fiscal 2001. As a percentage of net sales, such losses increased to 0.7% in fiscal 2002 as compared to 0.6% in fiscal 2001. These increases reflect higher bankruptcies and higher unemployment rates caused by the economic downturn in certain of the Company's market areas.

### **Net Leased Department Revenues**

Net rental income generated by the Company's various leased departments decreased by approximately \$0.4 million, or 10.0%, to \$3.6 million in fiscal 2002 as compared to \$4.0 million in fiscal 2001. This decrease is primarily due to the August 2001 termination of the shoe department leases in 36 of the Company's Pacific Northwest and Alaska locations, which were operated by an independent lessee. The Company subsequently re-opened Company-operated shoe departments in 15 of those stores. Pursuant to Staff Accounting Bulletin ("SAB") No. 101, sales generated in those departments after the termination of the leases are included in total sales as opposed to net leased department revenues for financial reporting purposes.

Leased department sales are presented net of the related costs for financial reporting purposes. Sales generated in the Company's leased departments, consisting primarily of fine jewelry departments, the shoe departments in 36 Pacific Northwest and Alaska locations (prior to the termination of the lease in August 2001) and beauty salons, totaled \$24.9 million in fiscal 2002 as compared to \$28.0 million in fiscal 2001.

## **Cost of Sales**

Cost of sales from continuing operations, which includes costs associated with the buying, handling and distribution of merchandise, decreased by approximately \$9.3 million to \$441.4 million in fiscal 2002 as compared to \$450.7 million in fiscal 2001, a decrease of 2.1%. The dollar decrease is primarily due to the decrease in sales volume. The Company's gross margin percentage increased to 33.7% in fiscal 2002 as compared to 33.6% in fiscal 2001. The increase in the gross margin percentage was primarily due to lower markdowns as a percentage of sales as compared to the prior year.

## **Selling, General and Administrative Expenses**

Selling, general and administrative expenses from continuing operations decreased by approximately \$2.8 million, or 1.3%, to \$207.9 million in fiscal 2002 as compared to \$210.7 million in fiscal 2001. As a percentage of net sales, selling, general and administrative expenses increased 0.2% to 31.2% in fiscal 2002 as compared to 31.0% in fiscal 2001. The dollar decrease is primarily attributable to realized benefits from cost reduction efforts and store closures, partially offset by increases in health care, workers' compensation and property and casualty insurance costs. Lower sales volume contributed to the increase in selling, general and administrative costs as a percentage of net sales.

## **Depreciation and Amortization**

Depreciation and amortization expense, which includes the (amortization) accretion of intangible assets (leasehold interests and, in fiscal 2001, goodwill), increased by approximately \$0.1 million or 1.0%, to \$13.4 million in fiscal 2002 as compared to \$13.3 million in fiscal 2001. As a percent of net sales, depreciation and amortization expense was 2.0% in fiscal 2002 and fiscal 2001. The dollar increase is primarily due to additional depreciation related to information systems placed in service during 2002 and capital expenditures for the renovation and expansion of certain existing stores. These increases were partially offset by the discontinuance of goodwill amortization as a result of the implementation of SFAS No. 142.

Effective the beginning of fiscal 2002, the Company adopted the provisions of SFAS No. 142. As a result, goodwill is no longer amortized and instead is evaluated for impairment annually, or at any time certain indicators of impairment arise. The amortization of goodwill totaled \$0.6 million in fiscal 2001. The Company will continue to amortize leasehold interests over their estimated lease terms.

## **Asset Impairment Charges**

During 2002, the Company recorded non-cash asset impairment charges of \$9.5 million to write down long-lived assets related to certain underperforming stores, primarily former Lamonts locations. These charges consisted of \$3.6 million of property and equipment, \$5.8 million of leasehold interests and \$0.1 million of goodwill. The charges were determined by comparing projected net operating cash flows, including estimated proceeds from the sale of certain assets, to the carrying value of the stores' long-lived assets. No such costs were recorded in 2001.

## **Store Closure Costs**

During the second quarter of 2001 the Company closed six of the acquired stores that also were determined to be either underperforming or inconsistent with the long-term operating strategy of the Company. One of those stores was subsequently re-opened in the third quarter of 2001. As planned, the Company also discontinued the use of an outsourced distribution center facility located in Kent, Washington, in June 2001 and consolidated all of the Company's distribution functions into its distribution facility in Madera, California. One additional acquired store was closed in January 2002. Net costs associated with closure of those stores and the outsourced distribution center facility totaled \$0.7 million. This amount consists of estimated lease termination costs, non-cash asset impairment charges, severance and other incremental costs associated with the closure of the stores totaling \$2.0 million, less \$1.3 million of cash proceeds received as a result of the sale of lease rights, fixtures and equipment.

## **Receivables Sale Costs**

In connection with the sale of accounts receivable to Household, the Company recorded receivable sale transaction costs of \$2.0 million in fiscal 2002 including consulting, legal, and other fees, and the net non-cash write-off of the remaining accounts of GCRC. These charges are partially offset by a \$0.3 million retained interest only strip that was amortized during 2003 over the estimated life of the underlying assets sold (estimated to be approximately five months). The interest only strip represents the portion of the initial program fees to be paid that is considered a residual interest in the assets sold.

## **Interest Expense**

Interest expense, which includes the amortization of deferred financing costs, increased by approximately \$1.5 million to \$15.9 million in fiscal 2002 as compared to \$14.4 million in fiscal 2001, an increase of 10.6%. As a percent of net sales, interest expense increased to 2.4% in fiscal 2002 as compared to 2.1% in fiscal 2001. These increases are primarily due to amortization of higher deferred financing costs relating to long-term financings entered into in the fourth quarter of fiscal 2001 and the first three quarters of fiscal 2002, and to an amendment fee relating to the Company's revolving credit facility. These increases were partially offset by lower average outstanding borrowings on the Company's working capital facility.

Interest expense related to securitized receivables is reflected as a reduction of net credit revenues and is not included in interest expense for financial reporting purposes.

## **Losses on Early Extinguishment of Debt**

In fiscal 2002, in connection with the termination of its receivables securitization program, the Company recorded a loss on extinguishment of debt of \$3.7 million representing prepayment penalties and the write-off of unamortized deferred loan fees related to the program. In fiscal 2001, the Company recorded a \$0.7 million charge consisting of the prepayment penalty and the write-off of unamortized loan fees related to the early retirement of the Company's previous revolving credit facility.

## Miscellaneous Income

Miscellaneous income, which includes the amortization of deferred income and other miscellaneous income and expense amounts, increased by approximately \$0.2 million to \$1.8 million in fiscal 2002 as compared to \$1.6 million in fiscal 2001. As a percent of net sales, miscellaneous income increased to 0.3% in fiscal 2002 as compared to 0.2% in fiscal 2001. The dollar increase primarily relates to recoveries of prior interest charges arising from the partial settlement of certain net operating loss carryback claims, partially offset by charges to the Company's partnership investment in its corporate offices related to the partnership's implementation of SFAS No. 133.

## Income Taxes

The Company's effective tax rate for continuing operations is a benefit of 46.3% in fiscal 2002 as compared to an expense of 35.3% in fiscal 2001. Including the tax benefit reported in discontinued operations, the Company's effective tax rate is a benefit of 42.3% in fiscal 2002 as compared to an expense of 38.5% in fiscal 2001. The fiscal 2002 tax benefit includes \$0.8 million arising from the realization of net operating loss carryback claims.

## Income From Continuing Operations

As a result of the foregoing, the Company reported a net loss from continuing operations of \$7.5 million, or \$0.59 per diluted share, in fiscal 2002 as compared to net income from continuing operations of \$1.6 million, or \$0.12 per diluted share, in fiscal 2001.

## Discontinued Operations

As described more fully in Note 9 to the accompanying financial statements, during fiscal 2003 the Company closed six store locations. During fiscal 2002 the Company closed four store locations. These stores were determined to be either underperforming or inconsistent with the Company's long-term operating strategy. The net loss from operating these stores was \$1.9 million in fiscal 2002 and \$1.7 million in fiscal 2001. The loss from operation of discontinued stores consists of the following:

<b>(In thousands of dollars)</b>	<b>2002</b>	<b>2001</b>
Net sales from closed stores.....	\$ 25,512	\$ 31,836
Net lease department revenues.....		128
Total Revenues.....	25,512	31,964
Cost of sales.....	15,669	19,558
Selling, general and administrative expenses.....	10,906	13,260
Depreciation and amortization.....	885	867
Total costs and expenses.....	27,460	33,685
Loss from operations of closed stores.....	<u>\$ (1,948)</u>	<u>\$ (1,721)</u>



Net costs associated with the closure of stores totaled \$4.8 million in fiscal 2002 consisting of lease termination costs, severance and other incremental costs associated with the store closings of approximately \$0.6 million and non-cash asset impairment charges related to stores closed in fiscal 2003 and fiscal 2002 of \$4.5 million, partially offset by a gain of \$0.3 million from the sale of lease rights and fixtures and equipment related to two of the closed locations.

As previously noted, results of operations of the fiscal 2001 store closures are included in continuing operations in the accompanying statement of operations. Store closure costs related to fiscal 2001 store closures are reported separately in continuing operations in the accompanying statement of operations.

Certain of the Company's remaining stores have continued to perform below expectations. In the event the Company is unable to improve the operating performance of such underperforming stores, the Company may consider the sale, sublease or closure of those stores in the future. In the past, the Company has successfully improved the operating results and cash flows of underperforming stores through a variety of strategies, including revising the merchandise mix, changing store management, revising marketing strategies, renegotiating lease agreements and reducing operating costs. However, there can be no assurance that these strategies will improve the operating results and cash flows of the remaining underperforming stores, or that the Company will be able to sell, sublease or close those stores in the event their performance does not improve. In addition, the Company may incur certain costs and expenses in connection with the sale or closure of those locations that may not be fully offset by sale proceeds, sublease income or favorable lease terminations.

## **Net Income**

As a result of the foregoing, the Company reported a loss of \$12.0 million in fiscal 2002 as compared to net income of \$0.4 million in fiscal 2001. On a per share basis (basic and diluted), the 2002 net loss was \$0.94 per share as compared to net income of \$0.03 per share in fiscal 2001.

## **Liquidity and Capital Resources**

The Company's working capital requirements are currently met through a combination of cash provided by operations, borrowings under its senior revolving credit facility, short-term trade and factor credit and by proceeds from external financings and sale transactions. As described more fully below and in Note 2 to the Consolidated Financial Statements, on January 31, 2003 the Company sold its credit card accounts and accounts receivable to Household. Proceeds from the sale were used to reduce the Company's debt, including off-balance sheet securitization obligations, by over \$100 million. At the closing date, the Company's availability under its revolving credit facility increased by approximately \$30 million and the Company experienced increases in availability from \$7 million to \$33 million during fiscal 2003 as compared to fiscal 2002. Availability was \$37.0 million as of January 31, 2004. As of March 1, 2004, the company re-negotiated its senior revolving credit facility. The GE facility provides for borrowings of up to \$165.0 million and has been extended through February 1, 2007, from the previous expiration of January 31, 2005. The GE facility provides for lower rates of interest than the previous credit

facility and refinanced an existing real estate loan, which also has resulted in lower interest costs to the Company. In addition, the GE facility reduced the number of financial covenants to one fixed charge covenant. As a result, the Company expects improvements in availability to continue and believes its liquidity position after the sale of the receivables and the re-negotiation of the revolving credit facility is substantially improved in comparison to prior years.

In fiscal 2003, the Company generated a total of \$23.1 million from operations as compared to \$20.9 million positive cash flow from operations in fiscal 2002. The increase is primarily due to a further reduction in inventory levels in fiscal 2003 related to store closures and adjustments in stock to more optimal levels. The positive effects of these inventory reductions on cash flows from operations were partially offset by reductions in certain accrued expenses, primarily related to amounts due Household during the Company's interim servicing of the accounts receivable, and payments for certain worker's compensation reserves.

As described more fully below, recent efforts to improve the Company's liquidity position have included the following: (i) the sale of receivables to Household; (ii) refinancing the Company's revolving credit facility, which was successfully completed on February 1, 2002 and subsequently amended to more favorable terms on March 1, 2004; (iii) restoring trade and factor credit; (iv) selling, subleasing or closing underperforming stores; (v) completing other financing and sale transactions; and (vi) reducing operating costs.

## **Sources of Liquidity**

### ***Sale of Receivables***

On January 31, 2003, pursuant to the terms of a Purchase and Sale Agreement between the Company and Household, the Company sold substantially all of its private label credit card accounts and the related accounts receivable to Household. The \$102.8 million purchase price was paid in cash at closing, \$100.3 million of which was allocated to the purchase of such credit card accounts and receivables and \$2.5 million of which comprised prepaid program revenue. Proceeds from the sale were used to pay in full \$73.2 million principal and accrued interest due to the Series 1999-1 and Series 2000-1 certificateholders under the Company's accounts receivable securitization program plus \$3.4 million in prepayment penalties. The remaining proceeds of \$26.2 million and \$3.8 million of cash remaining on deposit in certain bank accounts relating to the securitization was released to the Company at closing. All of the \$30 million released to the Company was applied as a reduction of outstanding borrowings under the Company's revolving credit facility. As a result, the Company's availability under the credit line increased by \$30 million at the closing date and the Company experienced increases in availability from \$7 million to \$33 million during fiscal 2003 as compared to fiscal 2002. Availability was \$37.0 million as of January 31, 2004.

In connection with the sale, on January 31, 2003 the Company entered into two additional agreements with Household: an Interim Servicing Agreement (the "ISA") and a Credit Card Program Agreement (the "CCA"). Under the terms of the ISA, the Company continued to service the credit card receivables until Household assumed the servicing on May 14, 2003.

Household compensated the Company for providing the services during the interim servicing period.

The CCA sets forth the terms and conditions under which Household will issue credit cards to the Company's customers and pay the Company for sales made on the cards. Under the terms of the CCA, the Company is required to perform certain duties, including the duties to receive in-store customer payments on behalf of Household and remit such payments to Household. The CCA has a term of five (5) years and is cancelable earlier by either party under certain circumstances, as described in the CCA. The CCA further provides that the Company will be paid a percentage of Net Cardholder Charges and a percentage of Other Revenue (each as defined in the CCA). As expected, the Company experienced a substantial decrease in net credit revenues in fiscal 2003 as a result of the receivables sale to Household, as well as a reduction in selling, general and administrative expenses as a result of outsourcing the credit card servicing to Household and a reduction in interest expense arising from reduced line of credit borrowings resulting from the application of the proceeds from the Household transaction. As a result, the net credit revenues the Company receives under the CCA approximately equals the net credit revenues from its former in-house credit card operations, net of operating expenses and interest expense, although no assurances can be given that the amounts received under the CCA will continue at these levels or at all.

### ***Senior Secured Credit Facility***

On February 1, 2002, the Company entered into a three-year senior revolving credit facility with General Electric Capital Corporation ("GE Capital") as agent, and The CIT Group/Business Credit as syndication agent (the "Original GE facility"). On March 1, 2004, subsequent to the Company's fiscal year end, the Company finalized an amendment and restatement of the Original GE facility (the "GE facility"). As of January 31, 2004, outstanding borrowings under the Original GE facility totaled \$51.0 million, and excess borrowing availability under the facility, after the deduction of the minimum availability requirement and other reserves, totaled \$37.0 million. The Company classified a total of \$50.0 million and \$30.0 million as of January 31, 2004 and February 1, 2003, respectively, as long-term in the accompanying financial statements, representing that portion of outstanding borrowings under the facility which are not expected to be repaid within one year of the respective balance sheet dates. Substantially all of the Company's assets, including its merchandise inventories, were pledged to GE Capital under this facility.

As of January 31, 2004, interest charged on amounts borrowed under the Tranche A portion of the Original GE facility were at the prime rate plus 0.5% per annum (4.50% at January 31, 2004), or at the Company's option, at the applicable LIBOR rate plus 2.75% per annum (3.85% at January 31, 2004). In addition, the Company paid an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the Tranche A facility. Amounts borrowed under the Tranche B portion of the Original GE facility bore interest at prime plus 10%, or at the Company's option, at LIBOR plus 12.0%. Beginning in fiscal 2003, the interest rate applicable to the Tranche A portion was adjusted upwards or downwards on a quarterly basis based on a pricing matrix which was tied to the Company's Leverage Ratio (as defined in the agreement).

Under the pricing matrix, the applicable interest rate could range from a rate as low as prime, or LIBOR plus 2.75%, to as high as prime plus 0.75%, or LIBOR plus 3.50%.

The Original GE facility contained restrictive financial and operating covenants, including the requirement to maintain a minimum twelve-month trailing EBITDA and a minimum accounts payable to inventory ratio. In addition, the Original GE facility also did not permit the repayment of the Subordinated Note on its scheduled maturity date of August 20, 2003, which resulted in the maturity of that note automatically being extended to August 20, 2006. As of January 31, 2004, management believes the Company was in compliance with all restrictive financial covenants applicable to the Original GE facility.

As previously noted, subsequent to the Company's fiscal year end on March 1, 2004, the Company finalized an amendment and restatement of the Original GE facility. The GE facility provides up to \$165.0 million of working capital financing and is extended through February 1, 2007, with an option to extend the facility through February 2, 2009, for a limited time and under certain conditions. The GE facility consists of a revolving credit facility of up to \$156.0 million (including a \$20.0 million letter of credit sub-facility) and a fully funded fixed term loan of \$9.0 million. Borrowings under the revolving credit facility are limited to the sum of (a) specified percentages of eligible credit card receivables, which are considered cash equivalents, and (b) the lesser of specified percentages of (i) the cost of eligible inventory and (ii) the net recovery value of the inventory, as determined by periodic valuation performed by an independent appraiser. Such borrowings are further limited by a requirement to maintain a minimum of \$5.0 million of excess availability at all times, and other reserves that are in effect. Substantially all of the Company's assets, including its merchandise inventories, continue to be pledged to GE Capital under the GE facility.

As of March 1, 2004, interest charged on amounts borrowed under the GE facility for revolving loans were at the prime rate plus 0.25% per annum (4.25% at March 1, 2004), or at the Company's option, at the applicable LIBOR rate plus 2.25% per annum (3.35% at March 1, 2004). In addition, the Company pays an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the Tranche A facility. Amounts borrowed under the Term Loan portion of the GE facility bear interest at 6.6% per annum. The interest rate applicable to the revolving loans under the GE facility may be adjusted upwards or downwards on a quarterly basis based on a pricing matrix which is tied to the Company's borrowing availability. Under the pricing matrix, the applicable interest rate could range from a rate as low as prime, or LIBOR plus 1.50%, to as high as prime plus 0.75%, or LIBOR plus 2.75%.

On March 22, 2002, the Company had entered into a \$15.0 million financing with Kimco Capital Corp. (the "Kimco facility") at a fixed interest rate of 12.0% per annum. The Kimco facility was secured by first priority liens on three of the Company's owned stores and with subordinate liens on substantially all other assets of the Company securing the Original GE facility. Proceeds from the Kimco facility were used to repay previously existing mortgage loans on two of those properties and one term loan and to pay certain fees and costs associated with the transaction. The remaining \$4.1 million of proceeds was used to reduce outstanding borrowings under the Original GE facility. The Kimco facility was co-terminus with the Original GE facility, with monthly principal payments of \$80,000 plus interest at a fixed rate of 12% per annum, and a

balloon payment upon maturity on January 31, 2005 of \$12.4 million. In March 2004, the Company prepaid the remaining \$13.2 million balance of the Kimco facility (including a prepayment penalty, and other transaction fees and costs) with borrowings under the GE facility. The term loan under the GE facility is collateralized by two of the three owned stores previously securing the Kimco facility.

The GE facility contains restrictive financial and operating covenants, including the requirement to maintain a fixed charge coverage ratio of 1:1 (as defined in the agreement). The GE facility also does not permit the repayment of the Subordinated Note, and accordingly the scheduled maturity date of the Subordinated Note has been extended to May 30, 2007.

### ***Trade Credit and Transactions with Affiliate***

The success of the Company's business is highly dependent upon the adequacy of trade credit offered by key factors and vendors, the vendors' ability and willingness to sell its products at favorable prices and terms, and the willingness of vendors to ship merchandise on a timely basis. Restrictions to the amount of trade credit granted by key factors and vendors can adversely impact the volume of merchandise the Company is able to purchase. Any significant reduction in the volume of merchandise the Company is able to purchase, or a prolonged disruption in the timing of when merchandise is received, would have a material adverse effect on the Company's business, liquidity position, and results of operations.

The Company began to experience a significant reduction in the level of unsecured credit offered by many of its factors and vendors in late fiscal 2001. On February 1, 2002, the level of unsecured credit offered by vendors increased, but unsecured credit granted by key factors, which can represent over 50% of total trade credit granted to the Company, remained restricted. Management negotiated the restoration of partially secured credit lines with certain key factors by issuing standby letters of credit. Certain of those letters of credit were collateralized by the Harris letter of credit, which is described below. The issuance of those letters of credit reduced the Company's borrowing availability under its revolving line of credit. In order to offset the majority of this availability reduction, Harris, an affiliate of the Company, agreed to provide a short-term credit enhancement to the revolving line of credit under the terms of the CFA entered into with the Company on February 22, 2002. During 2002, the CFA was amended three times to provide for extensions of the expiration date of the Harris letter of credit. Under the terms of the third amendment to the CFA, the Harris letter of credit was cancelled and the CFA was terminated as a result of the closing of the sale of receivables to Household.

Nevertheless, the Company has been able to purchase an adequate level of merchandise to support its operations to date. Upon the completion of the receivables sale to Household, the Company's largest factor significantly increased its unsecured credit line and substantially all of the Company's major unfactored suppliers increased their credit lines to historical levels. As a result of continued improvements in the Company's operations and liquidity position, including the March 1, 2004 renegotiation of the GE facility, all of the letters of credit issued for the benefit of certain key factors have been allowed to expire and credit lines continue to increase with all of the Company's key factors and many of the Company's unfactored suppliers. Nonetheless, there can be no assurance the Company will continue to receive an adequate level

of key factor and vendor trade credit to support its operations. Any significant reductions of trade and factor support may impair the Company's ability to purchase an adequate level of merchandise to support its operations. The inability to purchase an adequate level of merchandise would have a material adverse affect on the Company's business, liquidity position and results of operations.

### ***Other Financings***

On February 19, 2002, the Company completed a \$1.0 million, seven-year term loan financing of its corporate aircraft.

On May 24, 2002, the Company completed the financing of its ownership interest in the partnership that owns the Company's corporate headquarters building. Proceeds from this transaction, totaling \$3.7 million, were used to reduce outstanding borrowings under the Original GE facility. The related note payable bears interest at a variable rate of prime plus 1.5% per annum, which is payable monthly. The \$3.7 million principal portion of the note payable is due in full upon maturity on May 24, 2005.

The Company may consider various other sources of liquidity in the future, including but not limited to the issuance of additional securities that might have a dilutive effect on existing shareholders or incurring additional indebtedness which would increase the Company's leverage.

### ***Uses of Liquidity***

The Company's primary uses of liquidity are for working capital, debt service requirements and capital expenditures. Capital expenditures in fiscal 2003, totaling \$4.4 million, were primarily related to information system enhancements and the renovation, refixturing, and expansion of certain existing locations. The Company presently has no commitments to open or remodel any stores in fiscal 2004.

As of January 31, 2004, the Company had issued a total of \$8.4 million of standby letters of credit and documentary letters of credit totaling \$1.9 million. The standby letters of credit were issued to secure credit lines with key factors and to provide collateral for a workers compensation insurance policy. As previously mentioned subsequent to January 31, 2004 the factor letters of credit have all been allowed to expire on their respective expiration dates. Management believes that the likelihood of any draws under the remaining workers compensation standby letters of credit is remote. Documentary letters of credit are issued in the ordinary course of business to facilitate the purchase of merchandise from overseas suppliers. The supplier draws against the documentary letter of credit upon delivery of the merchandise.

### ***Contractual Obligations***

The following tables set forth certain information concerning the Company's debt obligations and commitments to make future payments under contracts, such as debt and lease agreements, and under contingent commitments.

Contractual Obligations:

Payments due by period (1)						
(In thousands)						
	Fiscal 2004	Fiscal 2005	Fiscal 2006	Fiscal 2007	Fiscal 2008	There- after
Long-term debt (2).....	\$ 14,149	\$ 4,565	\$ 907	\$ 958	\$ 984	\$ 15,822
Capitalized lease obligations.....	2,572	2,205	1,466	947	476	2,680
Subordinated note payable to affiliate (3).....				22,179		
Non-cancelable operating leases.....	23,766	22,556	21,729	18,600	16,679	73,640
Purchase Obligations (4).....	786	716	439	183	141	472
Total contractual cash obligations.....	<u>\$ 41,273</u>	<u>\$ 30,042</u>	<u>\$ 24,541</u>	<u>\$ 42,867</u>	<u>\$ 18,280</u>	<u>\$ 92,614</u>

Amount of commitment expiration by period						
(In thousands)						
	Fiscal 2004	Fiscal 2005	Fiscal 2006	Fiscal 2007	Fiscal 2008	There- after
Senior revolving credit facility (5).....	\$	\$	\$	\$ 51,009	\$	\$
Standby letters of credit.....	8,430					
Documentary letters of credit.....	1,946					
	<u>\$ 10,376</u>	<u>\$</u>	<u>\$</u>	<u>\$ 51,009</u>	<u>\$</u>	<u>\$</u>

(1) See Notes 6, 7 and 8 to the Consolidated Financial Statements.

(2) \$12.4 million of contractual obligations originally due in fiscal 2005 were early terminated on March 1, 2004.

(3) In connection with the amendment of the Company's revolving credit facility, the term of the Subordinated Note was extended to May 2007.

(4) Purchase obligations include agreements to purchase goods or services that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Agreements that are cancelable without penalty have been excluded. Purchase obligations relate primarily to service and maintenance agreements and information technology contracts.

(5) Represents outstanding borrowings under the Company's senior revolving credit facility as of January 31, 2004 (such commitment was extended from its original date of January 31, 2005, on March 1, 2004). The table presents that amount as due at February 28, 2007, the end of the commitment period for the facility.

Cash generated by operations, together with liquidity provided by the GE facility, the CCA and other financial resources, including without limitation the factors described below, are expected to adequately finance the Company's planned cash requirements for fiscal 2004. However, the Company's actual results may differ from the expectations set forth in the preceding sentence.

The Company's liquidity and capital resources may be affected by a number of factors and risks (many of which are beyond the control of the Company), including but not limited to the availability of adequate borrowing capacity and the ability to maintain compliance with restrictive debt covenants contained in the Company's senior revolving credit facility and its other debt obligations; adequate cash flows generated by operations; and the adequacy of factor and trade credit. Because the Company is already highly leveraged, the ability to obtain additional or alternative sources of financing in the future for working capital, capital expenditures, new store openings, acquisitions and other general corporate purposes is limited. If the estimates or assumptions relative to any one of these sources of liquidity are not realized, or if those sources of liquidity become significantly reduced, the Company's liquidity position, financial condition and results of operations may be materially adversely affected.

### **Recently Issued Accounting Standards**

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The Company adopted SFAS No. 143 effective the beginning of fiscal 2003 and its adoption did not have a significant effect on the Company's financial position or its results of operations.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145, among other things, eliminates the prior requirement that all gains and losses from the early extinguishment of debt were to be classified as an extraordinary item. Upon adoption of SFAS No. 145, gains and losses from the early extinguishment of debt are now classified as an extraordinary item only if they meet the "unusual and infrequent" criteria contained in Accounting Principles Board Opinion ("APBO") No. 30. In addition, upon adoption of SFAS No. 145, all gains and losses from the early extinguishment of debt that had previously been classified as an extraordinary item are to be reassessed to determine if they would have met the "unusual and infrequent" criteria of APBO No. 30. Any such gain or loss that would not have met the APBO No. 30 criteria is retroactively reclassified and reported as a component of income before extraordinary item. The Company has determined that its previously-recognized loss from the early extinguishment of debt that occurred in fiscal 2001 would not have met the APBO No. 30 criteria for classification as an extraordinary item, and accordingly such previously-reported loss from the early extinguishment of debt has been retroactively reclassified and is now reported as a component of income before income taxes. The Company has also determined that the fiscal 2002 loss from the early extinguishment of debt does not meet the APBO No. 30 criteria for extraordinary item classification, and accordingly such 2002 loss is reported as a component of income before income taxes.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses accounting for restructuring and similar costs. SFAS No.



146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of the Company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS No. 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized. Adoption of the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002 did not have a material impact on the Company's financial position or its results of operations.

During 2002, the Emerging Issues Task Force reached a consensus on Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor." Under the new guidance, if the consideration received represents a payment for assets delivered to the vendor, it should be classified as revenue. If the consideration is a reimbursement of a specific, incremental, identifiable cost incurred in selling the vendor's product, the cost should be characterized as a reduction of that incurred cost. Generally, all other cash consideration received from a vendor should be classified as a reduction of cost of sales. As required, the Company adopted this guidance during fiscal 2003 and its adoption had no material impact on the Company's sales, results of operations, cash flows or financial position.

### **Inflation**

Although inflation has not been a material factor in the Company's operations during the past several years, the Company has experienced increases in the costs of certain merchandise, salaries, employee benefits and other general and administrative costs, including utilities, health care and workers' compensation and property and casualty insurance costs. The Company is generally able to offset these increases by adjusting its selling prices or by modifying its operations. The Company's ability to adjust selling prices is limited by competitive pressures in its market areas.

The Company values its merchandise inventories at the lower of LIFO cost or market using the retail inventory method of accounting. Under the LIFO method, which is determined by using the department store price indices published by the Bureau of Labor Statistics, the cost of products sold reported in the financial statements approximates current costs and thus reduces the impact of inflation due to increasing costs on reported income. The valuation of the Company's merchandise inventories under the LIFO method is currently equal to that as determined by the first-in, first-out (FIFO) method of accounting.

### **Seasonality**

The Company's business, like that of most retailers, is subject to seasonal influences, with the major portion of net sales, gross profit and operating income realized during the Christmas selling months of November and December of each year, and, to a lesser extent, during the Easter and Back-to-School selling seasons. The Company's results may also vary from quarter to quarter as a result of, among other things, the timing and level of the Company's sales promotions, weather, fashion trends and the overall health of the economy, both nationally and in

the Company's market areas. Working capital requirements also fluctuate during the year, increasing substantially prior to the Christmas selling season when the Company must carry significantly higher inventory levels.

The following table sets forth unaudited quarterly results of operations for fiscal 2003 and 2002 (in thousands, except per share data). Certain prior quarter amounts have been reclassified to discontinued operations to conform to the current year presentation in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets."

<b>2003</b>					
<b>Quarter Ended</b>	<b>May 3</b>	<b>August 2</b>	<b>November 1</b>	<b>January 31</b>	
Net sales from continuing operations.....	\$ 137,915	\$ 149,757	\$ 145,288	\$ 227,615	
Gross profit.....	46,575	53,455	50,916	74,259	
Income (loss) from continuing operations.....	(3,563)	334	(2,590)	8,571	
Discontinued operations, net of tax.....	(424)	(309)	(22)	(127)	
Net income (loss).....	(3,987)	25	(2,612)	8,444	
Net income (loss) per common share Basic					
Income (loss) from continuing operations.....	\$ (0.28)	\$ (0.03)	\$ (0.20)	\$ 0.67	
Discontinued operations.....	\$ (0.03)	\$ 0.03	\$ --	\$ (0.01)	
Net income (loss) per common share.....	\$ (0.31)	\$ --	\$ (0.20)	\$ 0.66	
Diluted					
Income (loss) from continuing operations.....	\$ (0.28)	\$ (0.03)	\$ (0.20)	\$ 0.66	
Discontinued operations.....	\$ (0.03)	\$ 0.03	\$ --	\$ (0.01)	
Net income (loss) per common share.....	\$ (0.31)	\$ --	\$ (0.20)	\$ 0.65	
Weighted-average number of common shares outstanding:					
Basic.....	12,801	12,818	12,844	12,857	
Diluted.....	12,801	12,818	12,844	13,102	

<b>2002</b>					
<b>Quarter Ended</b>	<b>May 4</b>	<b>August 3</b>	<b>November 2</b>	<b>February 1</b>	
Net sales from continuing operations.....	\$ 143,737	\$ 149,382	\$ 148,284	\$ 224,513	
Gross profit.....	48,909	52,240	51,543	71,800	
Loss from continuing operations (1).....	(2,010)	(2,009)	(2,209)	(1,291)	
Discontinued operations, net of tax (2)....	(662)	(121)	(394)	(3,277)	
Net loss.....	(2,672)	(2,130)	(2,603)	(4,568)	
Net income (loss) per common share Basic and diluted					
Loss from continuing operations.....	\$ (0.16)	\$ (0.16)	\$ (0.17)	\$ 0.10	
Discontinued operations.....	\$ (0.05)	\$ (0.01)	\$ (0.03)	\$ (0.26)	
Net loss per common share.....	\$ (0.21)	\$ (0.17)	\$ (0.20)	\$ (0.36)	
Weighted-average number of common shares outstanding:					
Basic and diluted.....	12,726	12,737	12,754	12,771	

- (1) Net loss before income taxes in the period ended February 1, 2003 includes pre-tax charges of \$9.5 million non-cash charges related to impairment of long-lived assets in certain of the Company's underperforming locations, \$1.7 million of charges related to the sale of receivables, and \$3.7 million of charges related to the early extinguishment of accounts receivable securitization debt.
- (2) Discontinued operations for the period ended February 1, 2003 includes primarily non-cash pre-tax charges of \$5.1 million related to the write down of assets and to post closure lease obligations in connection with the closure of six stores.

## **Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company is exposed to market risks in the normal course of business due to changes in interest rates on short-term borrowings under its senior revolving credit facility. As of January 31, 2004, the Company also had one term loan bearing variable interest rates. The Company does not engage in financial transactions for speculative or trading purposes, nor does the Company purchase or hold any derivative financial instruments.

As of January 31, 2004, borrowings subject to a variable interest rate, represented 46.9% of the Company's total outstanding borrowings. The interest payable on the Company's senior revolving credit facility is based on variable interest rates and is therefore affected by changes in market interest rates. An increase of 55 basis points on existing floating rate borrowings (a 10% change from the Company's weighted-average interest rate as of January 31, 2004) would reduce the Company's pre-tax net income and cash flow by approximately \$0.6 million. This 55 basis point increase in interest rates would not materially affect the fair value of the Company's fixed rate financial instruments. (See Note 1 to the Consolidated Financial Statements.)

## **Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The response to this item is set forth under Part IV, Item 15, included elsewhere herein.

## **Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **Item 9A. CONTROLS AND PROCEDURES**

The Company maintains "disclosure controls and procedures," as such term is defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that are designed to ensure that information required to be disclosed in the Company's reports, pursuant to the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding the required disclosures. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only

reasonable assurances of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

The Company's Chief Executive Officer and Chief Financial Officer (its principal executive officer and principal financial officer, respectively), have evaluated the effectiveness of the Company's "disclosure controls and procedures," as of January 31, 2004. Based on their evaluation, except as noted in the next paragraph, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective. There were no changes in the Company's internal controls over financial reporting identified in connection with such evaluation that occurred during the Company's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

During the fiscal 2002 financial reporting process, management, in consultation with the Company's independent accountants, identified a deficiency in the Company's financial reporting systems and procedures relating to the reconciliation of the accounts payable subsidiary ledgers to the general ledger. This deficiency constituted a "Reportable Condition" under standards established by the American Institute of Certified Public Accountants. Management has completed, with the assistance of outside consultants, the design, development and implementation of processes and controls to address this deficiency, the completion of which extended into fiscal 2003. The final resolution of this matter did not have a significant effect on the Company's financial position or its results of operations.

### **PART III**

#### **Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY**

The information required by Item 10 of Form 10-K, other than the following information required by Paragraph (b) of Item 401 of Regulation S-K, is incorporated by reference from those portions of the Company's definitive proxy statement with respect to the Annual Stockholders' Meeting scheduled to be held on June 24, 2004, to be filed pursuant to Regulation 14A (the "2003 Proxy") under the headings "Nominees for Election as Director" and "Section 16(a) Beneficial Ownership Reporting Compliance."

As of March 31, 2004, the name, age and title of the senior executive officers of the Company are as follows:

<b>Name</b>	<b>Age</b>	<b>Position</b>
James R. Famalette	51	President and Chief Executive Officer

Gary L. Gladding	63	Executive Vice President/General Merchandise Manager
J. Gregory Ambro	51	Senior Vice President/Chief Administrative and Financial Officer
Michael J. Schmidt	62	Senior Vice President/Director of Stores

James R. Famalette became President and Chief Executive Officer of the Company on June 25, 1999 after serving as President and Chief Operating Officer of the Company since April 14, 1997. Prior to joining the Company, Mr. Famalette was President and Chief Executive Officer of Liberty House, a department and specialty store chain based in Honolulu, Hawaii, from 1993 through 1997, and served in a variety of other positions with Liberty House from 1987 through 1993, including Vice President, Stores and Vice President, General Merchandise Manager. From 1975 to 1987 he served in a variety of senior level management positions with Village Fashions/Cameo Stores and Colonies, a specialty store chain.

Gary L. Gladding has been Executive Vice President of the Company since 1987, and joined the Company as Vice President/General Merchandise Manager in 1983 (1). Prior to 1983, he served in a variety of management positions with Lazarus Department Stores, a division of Federated Department Stores, Inc., and the May Department Stores Co.

J. Gregory Ambro became Senior Vice President/Chief Administrative and Financial Officer of the Company on November 20, 2003. Prior to joining Gottschalks, Mr. Ambro served for three years as Senior Vice President and Chief Financial Officer of Bradlees, a regional discount department store in the Northeast. From 1995 to 2000 he served as Chief Financial Officer of Marshalls, an off-price retailer, Streamline, a grocery and consumer products retailer and Harris Teeter, an upscale supermarket chain in the Southeast. From 1978 to 1994 Mr. Ambro served in a variety of financial positions for Marshalls and the May Department Stores Co.

Michael J. Schmidt became Senior Vice President/Director of Stores of the Company in 1985(1). From 1983 through 1985, he was Manager of the Company's Fresno, California Fashion Fair store. Prior to joining the Company, he held management positions with Liberty House, Allied Corporation and R.H. Macy & Co., Inc.

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(1) References to the Company prior to 1986 are more specifically to the Company's predecessor and former subsidiary, E. Gottschalk and Co., Inc.

**Item 11. EXECUTIVE COMPENSATION**

The information required by this item is incorporated by reference from those portions of the Company's 2004 Proxy under the headings "Executive Compensation" and "Director Compensation for Fiscal Year 2003."

**Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The information required by this item is incorporated by reference from the portion of the Company's 2004 Proxy under the heading "Security Ownership of Certain Beneficial Owners and Management."

**Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information required by this item is incorporated by reference from the portion of the Company's 2004 Proxy under the heading "Certain Relationships and Related Transactions."

**Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

Information responsive to Part III, Item 14 is included in the Proxy Statement, to be filed by Registrant with the Commission pursuant to Regulation 14A, under the captions therein entitled "Information on Independent Public Accountants" and is incorporated herein by reference pursuant to General Instruction G(3).

**PART IV**

**Item 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULE, AND REPORTS ON FORM 8-K**

(a)(1) The following consolidated financial statements of Gottschalks Inc. and Subsidiary as required by Item 8 are included in this Part IV, Item 15:

Consolidated balance sheets - As of January 31, 2004 and February 1, 2003.

Consolidated statements of operations -- Fiscal years ended January 31, 2004, February 1, 2003 and February 2, 2002

Consolidated statements of stockholders' equity -- Fiscal years ended January 31, 2004, February 1, 2003 and February 2, 2002

Consolidated statements of cash flows -- Fiscal years ended January 31, 2004, February 1, 2003 and February 2, 2002

Notes to consolidated financial statements -- Three fiscal years ended January 31, 2004 Independent auditors' report

(a)(2) The following financial statement schedule of Gottschalks Inc. and Subsidiary is included in Item 15(d):

Schedule II -- Valuation and qualifying accounts

All other schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are included in the Consolidated Financial Statements, are not required under the related instructions or are inapplicable, and therefore have been omitted.

(a)(3) The following exhibits are required by Item 601 of Regulation S-K and Item 15(c):

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## EXHIBIT INDEX

<b>Exhibit Number</b>	<b>Description</b>	<b>Incorporated by Reference From the Following Document</b>
3.1	Certificate of Incorporation of the Registrant, as amended	Registration Statement on Form S-1 (File No. 33-3949)
3.2	By-Laws of the Registrant	Filed electronically herewith
10.1	Gottschalks Inc. Retirement Savings Plan(*)	Registration Statement on Form S-1 (File No. 33-3949)
10.2	Participation Agreement dated as of December 1, 1988 among Gottschalks Inc., General Foods Credit Investors No. 2 Corporation and Manufacturers Hanover Trust Company of California relating to the sale-leaseback of the Stockton and Bakersfield department stores and the Madera distribution facility	Annual Report on Form 10-K for the year ended January 29, 1994 (File No. 1-09100)
10.3	Lease Agreement dated December 1, 1988 by and between Manufacturers Hanover Trust Company of California and Gottschalks Inc. relating to the sale-leaseback of department stores in Stockton and Bakersfield, California and the Madera distribution facility	Annual Report on Form 10-K for the year ended January 29, 1994 (File No. 1-09100)
10.4	Ground Lease dated December 1, 1988 by and between Gottschalks Inc. and Manufacturers Hanover Trust Company of California relating to the sale-leaseback of the Bakersfield department store	Annual Report on Form 10-K for the year ended January 29, 1994 (File No. 1-09100)
10.5	Memorandum of Lease and Lease Supplement dated July 1, 1989 by and between Manufacturers Hanover Trust Company of California and Gottschalks Inc. relating to the sale-leaseback of the Stockton department store	Annual Report on Form 10-K for the year ended January 29, 1994 (File No. 1-09100)
10.6	Tax Indemnification Agreement dated as of August 1, 1989 by and between Gottschalks Inc. and General Foods Credit Investors No. 2 Corporation relating to the sale-leaseback of the Stockton and Bakersfield department stores and the Madera distribution facility	Annual Report on Form 10-K for the year ended January 29, 1994 (File No. 1-09100)
10.7	Ground Lease dated August 17, 1989 by and between Gottschalks Inc. and Manufacturers Hanover Trust Company of California relating to the sale-leaseback of the Madera distribution facility	Annual Report on Form 10-K for the year ended January 29, 1994 (File No. 1-09100)
10.8	Lease Supplement dated as of August 17, 1989 by and between Manufacturers Hanover Trust Company of California and Gottschalks Inc. relating to the sale-leaseback of the Madera distribution facility	Annual Report on Form 10-K for the year ended January 29, 1994 (File No. 1-09100)
10.9	Agreement of Limited Partnership dated March 16, 1990, by and between River Park Properties I and Gottschalks Inc. relating to the Company's corporate headquarters	Annual Report on Form 10-K for the year ended February 2, 1991 (File No. 1-09100)
10.10	Lease Agreement dated as of March 16, 1990 by and between Gottschalks Inc. and River Park Properties I relating to the Company's corporate headquarters	Annual Report on Form 10-K for the year ended January 29, 1994 (File No. 1-09100)
10.11	Form of Severance Agreement dated March 31, 1995 by and between Gottschalks Inc. and the following senior executives of the Company: Joseph W. Levy, Gary L. Gladding and Michael J. Schmidt(*)	Annual Report on Form 10-K for the year ended January 28, 1995 (File No. 1-09100)

10.12	1994 Key Employee Incentive Stock Option Plan(*)	Registration Statement on Form S-8 (File #33-54789)
10.13	1994 Director Nonqualified Stock Option Plan(*)	Registration Statement on Form S-8 (File #33-54783)
10.14	Agreement of Sale dated June 27, 1995, by and between Gottschalks Inc. and Jack Baskin relating to the sale and leaseback of the Capitola, California property	Quarterly Report on Form 10-Q for the quarter ended July 29, 1995 (File No. 1-09100)
10.15	Lease and Agreement dated June 27, 1995, by and between Jack Baskin and Gottschalks Inc. relating to the sale and leaseback of the Capitola, California property	Quarterly Report on Form 10-Q for the quarter ended July 29, 1995 (File No. 1-09100)
10.16	Promissory Notes and Security Agreements dated October 4, 1995 and October 10, 1995 by and between Gottschalks Inc. and Midland Commercial Funding	Quarterly Report on Form 10-Q for the quarter ended October 28, 1995 (File No. 1-09100)
10.17	Promissory Note and Security Agreement dated October 2, 1996, by and between Gottschalks Inc. and Heller Financial, Inc. (**)	Quarterly Report on Form 10-Q for the year ended November 2, 1996 (File No. 1-09100)
10.18	Gottschalks Inc. 1998 Stock Option Plan(*)	Registration Statement on Form S-8 (File #33-61471)
10.19	Gottschalks Inc. 1998 Employee Stock Purchase Plan(*)	Registration Statement on Form S-8 (File #33-61473)
10.20	Asset Purchase Agreement dated as of July 21, 1998 among Gottschalks Inc., The Harris Company and El Corte Ingles, S. A. together with all Exhibits thereto	Current Report on Form 8-K dated July 21, 1998 (File No. 1-09100)
10.21	Non-Negotiable, Extendable, Subordinated Note due August 20, 2003 issued to The Harris Company	Current Report on Form 8-K dated August 20, 1998 (File No. 1-09100)
10.22	Registration Rights Agreement between The Harris Company and Gottschalks Inc. dated August 20, 1998	Current Report on Form 8-K dated August 20, 1998 (File No. 1-09100)
10.23	Tradename License Agreement between The Harris Company and Gottschalks Inc. dated August 20, 1998	Current Report on Form 8-K dated August 20, 1998 (File No. 1-09100)
10.24	Stockholders' Agreement among El Corte Ingles, S. A., Gottschalks Inc., Joseph Levy and Bret Levy dated August 20, 1998	Current Report on Form 8-K dated August 20, 1998 (File No. 1-09100)
10.25	Standstill Agreement between El Corte Ingles, S. A., and Gottschalks Inc. dated August 20, 1998	Current Report on Form 8-K dated August 20, 1998 (File No. 1-09100)
10.26	Store Lease Agreement between El Corte Ingles, S. A., and Gottschalks Inc. dated August 20, 1998 re: East Hills Mall, Bakersfield, California	Current Report on Form 8-K dated August 20, 1998 (File No. 1-09100)

10.27	Store Lease Agreement between El Corte Ingles, S. A., and Gottschalks Inc. dated August 20, 1998 re: Moreno Valley Mall at Towngate, Moreno Valley, California	Current Report on Form 8-K dated August 20, 1998 (File No. 1-09100)
10.28	Store Lease Agreement between El Corte Ingles, S. A., and Gottschalks Inc. dated August 20, 1998 re: Antelope Valley Mall at Palmdale, California	Current Report on Form 8-K dated August 20, 1998 (File No. 1-09100)
10.29	Form of Severance Agreement dated January 21, 1999 by and between Gottschalks Inc. and Michael S. Geele (*)	Annual Report on Form 10-K for the year ended January 30, 1999 (File No. 1-09100)
10.30	Receivables Purchase Agreement dated March 1, 1999 by and between Gottschalks Credit Receivables Corporation and Gottschalks Inc.	Annual Report on Form 10-K for the year ended January 30, 1999 (File No. 1-09100)
10.31	Pooling and Servicing Agreement dated as of March 1, 1999 by and among Gottschalks Credit Receivables Corporation, Gottschalks Inc. and Bankers Trust Company	Annual Report on Form 10-K for the year ended January 30, 1999 (File No. 1-09100)
10.32	Series 1999-1 Supplement to Pooling and Servicing Agreement dated March 1, 1999 by and among Gottschalks Credit Receivables Corporation, Gottschalks Inc. and Bankers Trust Company	Annual Report on Form 10-K for the year ended January 30, 1999 (File No. 1-09100)
10.33	Employment Agreement dated June 25, 1999 by and between Gottschalks Inc. and James R. Famalette(*)	Quarterly Report on Form 10-Q for the quarter ended July 31, 1999 (File No. 1-09100)
10.34	Asset Purchase Agreement dated April 24, 2000 by and between Gottschalks Inc. and Lamonts Apparel, Inc.	Annual Report on Form 10-K for the year ended January 29, 2000 (File No. 1-09100)
10.35	Amendment No. 1 to the Asset Purchase Agreement dated May 16, 2000 by and between Gottschalks Inc. and Lamonts Apparel, Inc.	Quarterly Report on Form 10-Q for the quarter ended July 29, 2000 (File No. 1-09100)
10.36	Promissory Note dated July 24, 2000 by and between Gottschalks Inc. and Heller Financial Leasing, Inc. (**)	Quarterly Report on Form 10-Q for the Quarter ended July 29, 2000 (File No. 1-09100)
10.37	Series 2000-1 Supplement to the Pooling and Servicing Agreement dated as of November 16, 2000 by and among Gottschalks Credit Receivables Corporation, Gottschalks Inc. and Bankers Trust Company	Annual Report on Form 10-K for the year ended February 3, 2001 (File No. 1-09100)
10.38	Amendment No. 1 to Pooling and Servicing Agreement and the Series 1999-1 Supplement dated November 16, 2000 by and among Gottschalks Credit Receivables Corporation, Gottschalks Inc. and Bankers Trust Company	Annual Report on Form 10-K for the year ended February 3, 2001 (File No. 1-09100)
10.39	Promissory Note and Security Agreement dated May 16, 2001, by and between Gottschalks Inc. and Heller Financial, Inc. (**)	Quarterly Report on Form 10-Q for the quarter ended May 5, 2001 (File No. 1-09100)
10.40	Amended and Restated Series 2000-1 Supplement to the Pooling and Servicing Agreement dated as of November 15, 2001 by and among Gottschalks Credit Receivables Corporation, Gottschalks Inc. and Bankers Trust Company	Annual Report on Form 10-K for the year ended February 2, 2002 (File No. 1-09100)

10.41	Certificate Purchase Agreement dated November 15, 2001 by and among Warehouse Line LLC, Bank Hapoalim B.M., and Gottschalks Credit Receivables Corporation	Annual Report on Form 10-K for the year ended February 2, 2002 (File No. 1-09100)
10.42	Amendment to Employment Agreement dated December 3, 2001 by and between Gottschalks Inc. and James R. Famalette (*)	Annual Report on Form 10-K for the year ended February 2, 2002 (File No. 1-09100)
10.43	Credit Agreement dated January 31, 2002 by and among Gottschalks Inc., General Electric Capital Corporation and The CIT Group/Business Credit	Current Report on Form 8-K dated January 31, 2002
10.44	Credit Facilitation Agreement dated February 22, 2002 by and between Gottschalks Inc. and The Harris Company	Current Report on Form 8-K/A (Amendment No. 2) dated February 22, 2002 (File No. 1-09100)
10.45	First Amendment to Credit Agreement dated February 22, 2002 by and among Gottschalks Inc., General Electric Capital Corporation and The CIT Group/Business Credit	Current Report on Form 8-K/A (Amendment No. 2) dated February 22, 2002 (File No. 1-09100)
10.46	Credit Agreement dated March 22, 2002 by and between Gottschalks Inc. and KIMCO Capital Corp.	Annual Report on Form 10-K for the year ended February 2, 2002 (File No. 1-09100)
10.47	Second Amendment to Credit Agreement dated March 22, 2002 by and among Gottschalks Inc., General Electric Capital Corporation, The CIT Group/Business Credit, LaSalle Retail Finance and Foothill Capital Corporation	Annual Report on Form 10-K for the year ended February 2, 2002 (File No. 1-09100)
10.48	Third Amendment to Credit Agreement dated April 30, 2002, by and among Gottschalks Inc., General Electric Capital Corporation, The CIT Group/Business Credit, LaSalle Retail Finance and Foothill Capital Corporation	Current Report on Form 8-K dated May 6, 2002
10.49	First Amendment to Credit Facilitation Agreement dated May 29, 2002, by and between Gottschalks Inc. and Harris	Current Report on Form 8-K dated May 29, 2002
10.50	Second Amendment to Credit Facilitation Agreement dated August 29, 2002, by and between Gottschalks Inc. and Harris	Current Report on Form 8-K dated August 29, 2002
10.51	Third Amendment to Credit Facilitation Agreement dated January 10, 2003, by and between Gottschalks Inc. and Harris	Current Report on Form 8-K dated January 10, 2003
10.52	Purchase and Sale Agreement dated January 30, 2003 by and among Gottschalks Credit Receivables Corporation, Gottschalks Inc. and Household Bank (SB), N.A.	Current Report on Form 8-K dated January 31, 2003
10.53	Interim Servicing Agreement dated January 30, 2003 by and between Gottschalks Inc. and Household Bank (SB), N.A.	Current Report on Form 8-K dated January 31, 2003
10.54	Credit Card Program Agreement dated January 30, 2003 by and between Gottschalks Inc. and Household Bank (SB), N.A.	Current Report on Form 8-K dated January 31, 2003
10.55	Amendment to Amended and Restated Receivables Purchase Agreement dated January 31, 2003 by and between Gottschalks Inc. and Gottschalks	Current Report on Form 8-K dated January 31, 2003

Credit Receivables Corporation

10.56	Consent and Fourth Amendment to Credit Agreement dated January 30, 2003 by and among Gottschalks Inc., General Electric Capital Corporation, The CIT Group/Business Credit, Inc., LaSalle Retail Finance, and Foothill Capital Corporation	Current Report on Form 8-K dated January 31, 2003
10.57	Fifth Amendment to Credit Agreement dated January 30, 2003 by and among Gottschalks Inc., General Electric Capital Corporation, The CIT Group/Business Credit, Inc., LaSalle Retail Finance, and Foothill Capital Corporation.	Current Report on Form 8-K dated January 31, 2003
10.58	Acknowledgement, Release and Amendment to Credit Agreement dated January 30, 2003 by and between Gottschalks Inc. and Kimco Capital Corp.	Current Report on Form 8-K dated January 31, 2003
10.59	Sixth Amendment to Credit Agreement dated February 28, 2003 by and among Gottschalks Inc., General Electric Capital Corporation, The CIT Group/Business Credit, Inc., LaSalle Retail Finance, and Foothill Capital Corporation.	Current Report on Form 8-K dated March 4, 2003.
10.60	Seventh Amendment to Credit Agreement dated May 2, 2003 by and among Gottschalks Inc., General Electric Capital Corporation, The CIT Group/Business Credit, Inc., LaSalle Retail Finance, and Foothill Capital Corporation.	Current Report on Form 8-K dated May 5, 2003.
21.	Subsidiary of the Registrant	Annual Report on Form 10-K for the year ended January 28, 1995 (File No. 1-09100)
23.	Independent Auditors' Consent	Filed electronically herewith
(*)	Management contract, compensatory plan or arrangement.	
(**)	These loans were retired with proceeds from a mortgage loan completed on March 22, 2002 (See Exhibit 10.46)	

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(b) Reports on Form 8-K -- The Company filed the following Reports on Form 8-K during the fourth quarter of fiscal 2003:

The Company filed a Form 8-K dated March 4, 2003, pursuant to Item 5, Other Events, describing the Sixth Amendment to the Credit Agreement by and among Gottschalks Inc., General Electric Capital Corporation, The CIT Group/Business Credit, Inc., LaSalle Retail Finance, and Foothill Capital Corporation.

The Company filed a Form 8-K dated May 5, 2003, pursuant to Item 5, Other Events, describing the Seventh Amendment to the Credit Agreement by and among Gottschalks Inc., General Electric Capital Corporation, The CIT Group/Business Credit, Inc., LaSalle Retail Finance, and Foothill Capital Corporation.

- (c) Exhibits -- The response to this portion of Item 15 is submitted as a separate section of this report.
- (d) Financial Statement Schedule--The response to this portion of Item 15 is submitted as a separate section of this report.

**ANNUAL REPORT ON FORM 10-K**

**ITEM 8, 15(a)(1) and (2), (c) and (d)**

**CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**CERTAIN EXHIBITS**

**FINANCIAL STATEMENT SCHEDULE**

**YEAR ENDED JANUARY 31, 2004**

**GOTTSCHALKS INC. AND SUBSIDIARY**

**FRESNO, CALIFORNIA**

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of  
Gottschalks, Inc.  
Fresno, California

We have audited the accompanying consolidated balance sheets of Gottschalks, Inc. and Subsidiary (the "Company") as of January 31, 2004 and February 1, 2003, and the related consolidated statements of operation, stockholders' equity and cash flows for each of the three fiscal years in the period ended January 31, 2004. Our audits also included the financial statement schedule listed in the Index at Item 15(a)(2). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amount and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Gottschalks, Inc. and Subsidiary at January 31, 2004 and February 1, 2003, and the results of their operations and their cash flows for each of the three fiscal years in the period ended January 31, 2004 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, in fiscal 2002 the Company changed its method of accounting for goodwill and other intangible assets.

As discussed in Note 1 to the consolidated financial statements, in fiscal 2003 the Company changed its method of accounting for discontinued operations to conform to Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

/s/ Deloitte & Touche LLP

Fresno, California  
April 20, 2004



**GOTTSCHALKS INC. AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share data)

	<u>January 31,</u> <u>2004</u>	<u>February 1,</u> <u>2003</u>
<u>ASSETS</u>		
CURRENT ASSETS:		
Cash.....	\$ 5,172	\$ 6,215
Receivables - net.....	9,145	10,641
Merchandise inventories.....	156,458	164,615
Other.....	10,849	12,614
Total current assets.....	<u>181,624</u>	<u>194,085</u>
PROPERTY AND EQUIPMENT - net.....	129,832	139,888
OTHER ASSETS:		
Goodwill - net.....	7,501	7,501
Other intangibles - net.....	854	658
Other.....	4,180	6,597
	<u>12,535</u>	<u>14,756</u>
	<u>\$ 323,991</u>	<u>\$ 348,729</u>
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
CURRENT LIABILITIES:		
Trade accounts payable and accrued expenses.....	\$ 67,373	\$ 79,973
Revolving line of credit.....	1,009	28,845
Current portion of long-term debt.....	1,789	1,719
Current portion of capitalized lease obligations.....	1,936	2,970
Deferred income taxes.....	569	337
Total current liabilities.....	<u>72,676</u>	<u>113,844</u>
LONG-TERM OBLIGATIONS, less current portion.....	91,302	75,097
OTHER LIABILITIES.....	16,874	18,917
DEFERRED INCOME TAXES.....	12,637	12,558
SUBORDINATED NOTE PAYABLE TO AFFILIATE - net.....	22,180	21,989
COMMITMENTS AND CONTINGENCIES (Notes 8 and 16)		
STOCKHOLDERS' EQUITY:		
Common stock, par value of \$.01 per share; 30,000,000 shares authorized; 12,878,802 and 12,801,669 issued.....	129	128
Additional paid-in capital.....	71,440	71,313
Retained earnings.....	36,753	34,883
	<u>108,322</u>	<u>106,324</u>
	<u>\$ 323,991</u>	<u>\$ 348,729</u>

See notes to consolidated financial statements.

**GOTTSCHALKS INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(In thousands, except per share data)**

	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net sales.....	\$ 660,574	\$ 665,916	\$ 678,866
Net credit revenues.....	3,729	8,225	8,420
Net leased department revenues.....	3,525	3,557	3,965
Total revenues.....	<u>667,828</u>	<u>677,698</u>	<u>691,251</u>
Costs and expenses:			
Cost of sales.....	435,370	441,426	450,723
Selling, general and administrative expenses.....	203,966	207,885	210,658
Depreciation and amortization.....	13,177	13,374	13,256
Asset impairment charges.....		9,502	
Store closure costs.....			729
Receivables sale costs.....		1,749	
Total costs and expenses.....	<u>652,513</u>	<u>673,936</u>	<u>675,366</u>
Operating income .....	<u>15,315</u>	<u>3,762</u>	<u>15,885</u>
Other (income) expense:			
Interest expense.....	13,296	15,883	14,364
Losses on early extinguishment of debt.....		3,695	696
Miscellaneous income.....	(2,262)	(1,802)	(1,587)
	<u>11,034</u>	<u>17,776</u>	<u>13,473</u>
Income (loss) from continuing operations before income tax (benefit).....	4,281	(14,014)	2,412
Income tax expense (benefit).....	1,529	(6,495)	851
Income (loss) from continuing operations.....	<u>2,752</u>	<u>(7,519)</u>	<u>1,561</u>
Discontinued operations:			
Loss from operations of closed stores.....	(547)	(1,948)	(1,721)
Loss on store closures.....	(789)	(4,801)	
Income tax benefit.....	(454)	(2,295)	(585)
Loss on discontinued operations.....	<u>(882)</u>	<u>(4,454)</u>	<u>(1,136)</u>
Net income (loss).....	<u>\$ 1,870</u>	<u>\$ (11,973)</u>	<u>\$ 425</u>
Net income (loss) per common share:			
Basic			
Income (loss) from continuing operations.....	\$ 0.22	\$ (0.59)	\$ 0.12
Loss on discontinued operations .....	\$ (0.07)	\$ (0.35)	\$ (0.09)
Net income (loss) per common share.....	\$ 0.15	\$ (0.94)	\$ 0.03
Diluted			
Income (loss) from continuing operations.....	\$ 0.21	\$ (0.59)	\$ 0.12
Loss on discontinued operations .....	\$ (0.07)	\$ (0.35)	\$ (0.09)
Net income (loss) per common share.....	\$ 0.14	\$ (0.94)	\$ 0.03
Weighted average number of common shares outstanding			
Basic.....	12,830	12,747	12,681
Diluted.....	12,919	12,747	12,691

See notes to consolidated financial statements.

**GOTTSCHALKS INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
(In thousands, except share data)

	<u>Common Stock</u>		<u>Additional</u>	<u>Retained</u>	
	<u>Shares</u>	<u>Amount</u>	<u>Paid-in</u>	<u>Earnings</u>	<u>Total</u>
			<u>Capital</u>		
BALANCE, FEBRUARY 3, 2001.....	12,656,769	\$ 127	\$ 71,015	\$ 46,431	\$ 117,573
Net income.....				425	425
Shares issued under stock purchase plan.....	<u>69,595</u>	<u></u>	<u>174</u>	<u></u>	<u>174</u>
BALANCE, FEBRUARY 2, 2002.....	12,726,364	127	71,189	46,856	118,172
Net loss.....				(11,973)	(11,973)
Shares issued under stock purchase plan.....	<u>75,305</u>	<u>1</u>	<u>124</u>	<u></u>	<u>125</u>
BALANCE, FEBRUARY 1, 2003.....	12,801,669	128	71,313	34,883	106,324
Net income.....				1,870	1,870
Issuance of common stock pursuant to nonqualified stock purchase plan.....	9,000		27		27
Shares issued under stock purchase plan.....	<u>68,133</u>	<u>1</u>	<u>100</u>	<u></u>	<u>101</u>
BALANCE, JANUARY 31, 2004.....	<u>12,878,802</u>	<u>\$ 129</u>	<u>\$ 71,440</u>	<u>\$ 36,753</u>	<u>\$ 108,322</u>

See notes to consolidated financial statements.

**GOTTSCHALKS INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands of dollars)

	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b>OPERATING ACTIVITIES:</b>			
Net income (loss).....	\$ 1,870	\$ (11,973)	\$ 425
Adjustments:			
Depreciation and amortization.....	13,249	14,259	14,123
Deferred income taxes.....	311	(2,613)	(300)
Amortization of deferred income and other deferred items.....	(2,243)	718	(1,017)
Provision for credit losses.....	200	825	1,247
Asset impairment charges.....		9,502	
Store closure costs.....	789	4,801	729
Net loss from sale of assets.....	59	131	122
Other non-cash items, net.....	(968)	(139)	1,777
Decrease(increase) in assets:			
Receivables.....	1,295	(2,972)	(3,275)
Merchandise inventories.....	9,426	(2,370)	24,951
Other current and long-term assets.....	3,785	9,420	4,997
Increase (decrease) in liabilities:			
Trade accounts payable and accrued expenses.....	(5,891)	5,951	(2,372)
Other current and long-term liabilities.....	1,180	(4,669)	2,123
Net cash provided by operating activities.....	<u>23,062</u>	<u>20,871</u>	<u>43,530</u>
<b>INVESTING ACTIVITIES:</b>			
Available-for-sale securities:			
Maturities.....		(383,147)	(345,638)
Purchases.....		377,982	344,269
Purchases of property and equipment.....	(4,363)	(8,279)	(18,683)
Proceeds from sale of lease rights, fixtures and equipment.....	27	1,010	1,306
Proceeds from investment in limited partnership.....	352	216	194
Net cash used in investing activities.....	<u>(3,984)</u>	<u>(12,218)</u>	<u>(18,552)</u>
<b>FINANCING ACTIVITIES:</b>			
Net proceeds (repayments) under retired revolving credit facility.....			(112,828)
Net proceeds (repayments) from new revolving credit facility.....	(7,836)	(37,062)	95,908
Proceeds from sale of credit card accounts receivable.....		100,319	
Net proceeds from 2000-1 Series Certificates.....			2,000
Principal payments on retired 1999-1 Series Certificate.....		(53,000)	
Principal payments on retired 2000-1 Series Certificate.....		(20,000)	
Proceeds from sale and leaseback transactions.....		1,334	8,116
Proceeds from long-term obligations.....		20,010	4,000
Principal payments on long-term obligations.....	(4,568)	(14,737)	(8,419)
Changes in cash management liability.....	(7,845)	(1,195)	(7,610)
Debt issuance costs.....		(973)	(6,405)
Proceeds from sale of stock under employee stock purchase plans.....	128	125	174
Net cash (used in) financing activities.....	<u>(20,121)</u>	<u>(5,179)</u>	<u>(25,064)</u>
<b>INCREASE (DECREASE) IN CASH.....</b>	<u>(1,043)</u>	<u>3,474</u>	<u>(86)</u>
<b>CASH AT BEGINNING OF YEAR.....</b>	<u>6,215</u>	<u>2,741</u>	<u>2,827</u>
<b>CASH AT END OF YEAR.....</b>	<u>\$ 5,172</u>	<u>\$ 6,215</u>	<u>\$ 2,741</u>
<b>SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING ACTIVITIES:</b>			
Acquisition of equipment under capital leases.....	\$ <u>          </u>	\$ <u>          </u>	\$ <u>233</u>

See notes to consolidated financial statements.

# **GOTTSCHALKS INC. AND SUBSIDIARY**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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### **1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES**

Gottschalks Inc. (the "Company") is a regional department and specialty store chain based in Fresno, California. As of January 31, 2004, the Company operated 63 full-line department stores located in six Western states, with 39 stores located in California, 12 in Washington, 6 in Alaska, 2 in Oregon and 2 in both Nevada and Idaho. The Company also operated 11 specialty stores which carry a limited selection of merchandise. The Company's department stores typically offer a wide range of better to moderate brand-name and private-label merchandise, including men's, women's, junior's and children's apparel, cosmetics, shoes and accessories, and also a wide array of home furnishings, including domestics, china, housewares, small electrics and, in certain locations, furniture and mattresses.

Use of Estimates - The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Such estimates and assumptions are subject to inherent uncertainties which may cause actual results to differ from reported amounts.

Principles of Consolidation - The accompanying financial statements include the accounts of Gottschalks Inc., and its wholly-owned subsidiary, Gottschalks Credit Receivables Corporation ("GCRC") (collectively, the "Company"). All significant intercompany transactions and balances have been eliminated in consolidation.

Fiscal Year - The Company's fiscal year ends on the Saturday nearest January 31. Fiscal years 2003, 2002 and 2001 ended on January 31, 2004, February 1, 2003 and February 2, 2002, respectively. Fiscal 2003, 2002 and 2001 each included 52 weeks.

Revenue Recognition - Net retail sales are recorded at the point-of-sale and include sales of merchandise, net of estimated returns and exclusive of sales tax. Net retail sales also include all amounts billed to customers for shipping and handling, including customer delivery charges. Revenues on special order sales are recognized when the merchandise is delivered to the customer and has been paid for in its entirety. The Company does not sell merchandise on layaway.

Net leased department revenues consist of rental income from lessees and sub-lessees. Sales generated in such leased departments totaled \$24,460,000, \$24,878,000 and \$27,950,000 in 2003, 2002 and 2001, respectively.

Transfers and Servicing of Financial Assets - On January 31, 2003, the Company terminated its receivables securitization program and sold substantially all of its customer credit card receivables to Household Bank (SB), N.A. ("Household") (Note 2).

At that time the Company also entered into an interim servicing agreement to service the receivables on behalf of Household until such time as they were able to convert the accounts to their systems and a program agreement whereby the Company will participate in revenues generated from the portfolio. The transaction was accounted for as a sale of financial assets in accordance with Statement of Financial Accounting Standards ("SFAS") No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities". Servicing fees received under the interim servicing agreement were considered to approximate the fair value of the cost to service the receivables during the interim servicing period, resulting in no servicing asset or liability. A portion of the program fees paid represented residual interest in the assets transferred at the time of the transaction. Accordingly, the Company recorded an interest only strip in the amount of \$312,000 that was amortized as a charge to results of operations over the estimated life of the underlying assets sold on the transaction date.

Prior to January 31, 2003, the Company accounted for the transfer and sale of receivables pursuant to its receivables securitization program in accordance with SFAS No. 140. SFAS No. 140 required the Company to recognize gains and losses on transfers of financial assets (securitizations) that qualified as sales and to recognize as assets certain financial components that were retained as a result of such sales, which consisted primarily of the retained interest in receivables sold and the retained rights to future interest income from the serviced assets in excess of the contractually specified servicing fee (interest-only strips). The estimated cost to service the assets was equal to the contractually specified servicing fee, resulting in no servicing asset or liability at February 2, 2002.

The retained interest in receivables sold was initially recorded at the date of the sale by allocating the previous carrying amount between the assets sold and the retained interests based on their relative fair values. Any gain or loss on the sale was dependent upon the allocation of the previous carrying amount of the receivables sold to the retained interests. Retained interests were subsequently carried at their respective fair values, which were estimated based upon the present value of the expected future cash flows, calculated using management's best estimates of key assumptions about anticipated credit losses, account repayment speeds, discount rates and other factors necessary to derive estimates of fair value.

The certificated portion of the retained interest was considered readily marketable and was classified as available-for-sale in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Due to the short-term revolving nature of the credit card portfolio, the carrying value of the Company's retained interest approximated its fair value, resulting in no unrealized gains or losses.

Receivables - As of January 31, 2004 and February 1, 2003, receivables consist of vendor claims of \$9,426,000, less allowances of \$281,000, and vendor claims of \$10,722,000, less allowances of \$81,000, respectively.

Merchandise Inventories - Inventories, which consist of merchandise held for resale, are valued by the retail method and are stated at last-in, first-out (LIFO) cost, which is not in excess of market. Current cost, which approximates replacement cost, under the first-in, first-out (FIFO) method is equal to the LIFO value of inventories at January 31, 2004 and February 1, 2003. The

Company includes in inventory the capitalization of certain indirect buying handling and distribution costs to better match these costs with the related sales.

Store Closure Costs - In the event a store is closed before its lease has expired, the remaining lease obligation after the closing date (less anticipated sublease rental income or proceeds from lease settlements, if any) is expensed at the date the store ceases operations. Asset impairment charges, if any, related to furniture, fixtures and equipment, leasehold improvements, goodwill and leasehold interests are expensed in the period in which management adopts a plan to close the store if impairment is considered likely as a result of such planned store closure or at such other time as impairment becomes likely. Severance and other incremental costs associated with a store closure are expensed as incurred.

New Store Pre-Opening Costs – New store pre-opening costs are expensed as incurred and may vary significantly from year to year depending on the number of new stores opened.

Property and Equipment - Property and equipment is stated on the basis of cost or appraised value as to certain contributed land. Depreciation and amortization is computed by the straight-line method for financial reporting purposes over the shorter of the estimated useful lives of the assets or the lease term, which range from 20 to 40 years for buildings and leasehold improvements and 3 to 15 years for furniture, fixtures and equipment. The amortization of buildings and equipment under capital leases is computed by the straight-line method over the term of the lease or the estimated economic life of the asset, depending on the criteria used to classify the lease, and such amortization is combined with depreciation in the accompanying income statements. Maintenance and repairs are charged to expense as incurred and major improvements are capitalized.

Software Development Costs – Costs associated with the acquisition or development of software for internal use that meet the criteria of AICPA Statement of Position No. 98-1, "Accounting for Costs of Computer Software Developed or Obtained for Internal Use" are capitalized and amortized over the expected useful life of the software, which generally ranges from 3 to 10 years. Software development costs capitalized under SOP No. 98-1 in fiscal 2003, 2002 and 2001 totaled \$29,000, \$673,000, and \$1,057,000 respectively. In 2003 and 2002, the Company completed and placed in service all information systems projects to which such costs were capitalized and commenced the amortization of such costs over their estimated useful lives at that time. Amortization of such costs totaled \$408,000 and \$260,000 in fiscal 2003 and 2002. There was no amortization of such costs in fiscal 2001.

Goodwill – The Company adopted the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets" effective the beginning of fiscal 2002 and discontinued the amortization of previously recorded goodwill as of that date (Note 4). During the first six months of fiscal 2002, as required by the statement, the Company performed an initial impairment review of goodwill. The Company also performed the required annual impairment review of goodwill for fiscal 2003 and fiscal 2002. As a result of these reviews, the Company concluded that there was no impairment charge as of the respective measurement dates.

Leasehold Interests – Leasehold interests associated with acquired leases are amortized on a straight-line basis over the respective lease terms, including option renewal periods if renewal of the lease is probable, which range from 1 to 40 years.

Cash Management Liability - Under the Company's cash management program, checks issued by the Company and not yet presented for payment frequently result in overdraft balances for accounting purposes. Such amounts represent interest-free, short-term borrowings by the Company.

Deferred Income - Deferred income consists primarily of donated land and cash incentives received to construct a store and enter into a lease arrangement, and the prepaid program fee arising from the receivables sale to Household. Land contributed to the Company is included in land and recorded at appraised fair market values. Deferred income relating to contributed land is amortized over the average depreciable life of the related fixed assets built on the land for locations that are owned by the Company, and over the minimum lease periods of the related building leases with respect to locations that are leased by the Company, ranging from 10 to 32 years. Beginning in fiscal 2003, the prepaid program fee is being amortized over the five-year term of the program agreement. Deferred income, net of accumulated amortization, totaling \$13,335,000 and \$14,837,000 as of January 31, 2004 and February 1, 2003 respectively, is included in other long-term liabilities.

Deferred Lease Payments - Certain of the Company's department store operating leases provide for rent abatements and scheduled rent increases during the lease terms. The Company recognizes rental expense for such leases on a straight-line basis over the respective lease terms and records the difference between rental expense and amounts paid under the leases as deferred lease payments. Deferred lease payments, totaling \$3,597,000 at January 31, 2004 and \$3,778,000 at February 1, 2003, are included in other liabilities.

Advertising Costs – Advertising costs, totaling \$30,597,000, \$31,245,000 and \$33,053,000 in 2003, 2002 and 2001, respectively, are included in selling, general and administrative expenses for financial reporting purposes and are expensed when the related advertisement first takes place. Cash payments and credits received from vendors to reimburse advertising costs are recorded as reductions of advertising costs. During fiscal 2003 \$1,990,000 of such reimbursements were reclassified as reductions to cost of goods sold because they did not meet certain criteria of newly adopted EITF 02-16.

Income Taxes - Deferred tax assets and liabilities are generally recognized for the expected future tax consequences of events that have been included in the financial statements or tax returns, determined based on the differences between the financial statement and tax basis of assets and liabilities and net operating loss and tax credit carryforwards, and by using enacted tax rates in effect when the differences are expected to reverse. A valuation allowance is recorded when it is more likely than not that the carrying amounts of deferred tax assets will not be fully realized.

Stock-Based Compensation - At January 31, 2004, the Company has two stock-based employee compensation plans, which are more fully described in Note 13. The Company accounts for



those plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation. The Company's calculations were made using the Black-Scholes option pricing model, which is more fully described in Note 13.

<u>(In thousands, except per share data)</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income (loss) as reported.....	\$ 1,870	\$ (11,973)	\$ 425
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects.....	<u>(99)</u>	<u>(347)</u>	<u>(527)</u>
Pro forma net income (loss).....	<u>\$ 1,771</u>	<u>\$ (12,320)</u>	<u>\$ (102)</u>
Earnings (loss) per share:			
As reported:			
Basic.....	\$ 0.15	\$ (0.94)	\$ 0.03
Diluted.....	\$ 0.13	\$ (0.94)	\$ 0.03
Pro-forma:			
Basic.....	\$ 0.14	\$ (0.97)	\$ (0.01)
Diluted.....	\$ 0.14	\$ (0.97)	\$ (0.01)

Long-Lived Assets - The Company periodically evaluates the carrying value of long-lived assets to be held and used, including intangible assets other than goodwill, when events and circumstances warrant such a review. When the anticipated undiscounted cash flow from a long-lived asset is less than its carrying value, a loss is recognized based on the amount by which its carrying value exceeds its fair market value. Fair market value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risks involved, and in some cases, the expected proceeds from the sale or sublease of a particular asset, or independent appraisals. There were no asset impairment charges from continuing operations recognized in 2003. In 2002, the Company recognized asset impairment charges of \$9,502,000 relating to underperforming stores (Note 10) and \$4,523,000 in connection with stores closed during fiscal 2003 and 2002 (Note 9). In 2001, the Company recognized asset impairment charges of \$775,000 in connection with the closure of six stores.

Discontinued Operations – The Company has determined that due to the regional concentration of certain of the stores closed during fiscal 2003 and certain other factors, a significant portion of

the operations and cash flows of the closed stores have been eliminated from the ongoing operations of the Company, and the combined effect of such operations, including the effect of stores closed during fiscal 2002, have become material to the Company's results of operations taken as a whole. Accordingly, as prescribed by Statement of Financial Accounting Standard No. 144, results of operations of stores closed during 2003 and 2002 are excluded from continuing operations and reported separately in discontinued operations for all periods presented.

Fair Value of Financial Instruments - The carrying value of the Company's cash and cash management liability, receivables, notes receivable, the interest only strip arising from the sale of receivables to Household, trade payables and other accrued expenses, revolving line of credit and letters of credit approximate their estimated fair values because of the short maturities or variable interest rates underlying those instruments. The Subordinated Note is carried at its estimated fair value.

The fair values of the Company's mortgage loans and notes payable are estimated using discounted cash flow analysis, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements. Borrowings with aggregate carrying values of \$37,464,000 and \$38,943,000 at January 31, 2004 and February 1, 2003, had estimated fair values of \$39,712,000 and \$41,639,000 at January 31, 2004 and February 1, 2003, respectively.

Derivatives – Effective the beginning of 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities". SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. SFAS No. 133 requires the recognition of all derivative instruments as either assets or liabilities in the balance sheet measured at fair value. SFAS No. 133 also establishes criteria for a derivative to qualify as a hedge for accounting purposes. The adoption of SFAS No. 133 did not have a significant impact on the Company's financial position, results of its operations or its cash flows.

Segment Reporting – The Company operates in one reportable segment.

Comprehensive Income – There were no items of other comprehensive income in 2003, 2002 or 2001, and therefore net income is equal to comprehensive income for each of those years.

Recently Issued Accounting Standards - In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The Company adopted SFAS No. 143 effective the beginning of fiscal 2003 and its adoption did not have a significant effect on the Company's financial position or its results of operations.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145, among other things, eliminates the prior requirement that all gains and losses from the early extinguishment of debt were to be classified as an extraordinary item. Upon adoption of SFAS No. 145, gains and losses from the early extinguishment of debt are now classified as an extraordinary item only if they meet the "unusual and infrequent" criteria contained in Accounting Principles Board Opinion ("APBO") No. 30. In addition, upon adoption of SFAS No. 145, all gains and losses from the early extinguishment of debt that had previously been classified as an extraordinary item are to be reassessed to determine if they would have met the "unusual and infrequent" criteria of APBO No. 30. Any such gain or loss that would not have met the APBO No. 30 criteria is retroactively reclassified and reported as a component of income before extraordinary item. The Company has determined that its previously-recognized loss from the early extinguishment of debt that occurred in fiscal 2001 would not have met the APBO No. 30 criteria for classification as an extraordinary item, and accordingly such previously-reported loss from the early extinguishment of debt has been retroactively reclassified and is now reported as a component of income before income taxes. The Company has also determined that the fiscal 2002 loss from the early extinguishment of debt does not meet the APBO No. 30 criteria for extraordinary item classification, and accordingly such 2002 loss is reported as a component of income before income taxes.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of the Company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS No. 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized. Adoption of the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002 did not have a material impact on the Company's financial position or its results of operations.

During 2002, the Emerging Issues Task Force reached a consensus on Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor." Under the new guidance, if the consideration received represents a payment for assets delivered to the vendor, it should be classified as revenue. If the consideration is a reimbursement of a specific, incremental, identifiable cost incurred in selling the vendor's product, the cost should be characterized as a reduction of that incurred cost. Generally, all other cash consideration received from a vendor should be classified as a reduction of cost of sales. As required, the Company adopted this guidance in the first quarter of 2003 and its adoption has had no material impact on the Company's sales, results of operations or financial position.

Reclassifications – Certain amounts in the accompanying 2002 and 2001 consolidated financial statements have been reclassified to conform with the 2003 presentation.

## **2. SALE OF RECEIVABLES AND RECEIVABLES**

### *Sale of Receivables*

On January 31, 2003, pursuant to the terms of a Purchase and Sale Agreement between the Company and Household, the Company sold substantially all of its private label credit card accounts and the related accounts receivable to Household. The \$102,819,000 purchase price was paid in cash at closing, \$100,319,000 of which was allocated to the purchase of such credit card accounts and receivables and \$2,500,000 of which comprised prepaid program revenue. Proceeds from the sale were used to pay in full \$73,225,000 principal and accrued interest due to the Series 1999-1 and Series 2000-1 certificateholders under the Company's accounts receivable securitization program plus \$3,362,000 in prepayment penalties. The remaining proceeds of \$26,233,000 and \$3,845,000 of cash remaining on deposit in certain bank accounts relating to the securitization was released to the Company at closing. All of the \$30,078,000 released to the Company was applied as a reduction of outstanding borrowings under the Company's revolving credit facility. Concurrently, the Company's obligation to sell its accounts receivable to the securitization trust was terminated pursuant to Amendment No. 1 to the Amended and Restated Receivables Purchase Agreement between the Company and GCRC. Fiscal 2002 results of operations include a charge for receivables sale costs of \$1,749,000.

In connection with the sale, on January 31, 2003 the Company entered into two additional agreements with Household: an Interim Servicing Agreement (the "ISA") and a Credit Card Program Agreement (the "CCA"). Under the terms of the ISA, the Company continued to service the credit card receivables until Household assumed the servicing on May 14, 2003, as planned. Net credit revenues for fiscal 2003 include \$1,088,000 representing the excess of interim servicing compensation over the direct servicing costs.

The CCA sets forth the terms and conditions under which Household will issue credit cards to the Company's customers and pay the Company for sales made on the cards. Under the terms of the CCA, the Company is required to perform certain duties, including the duties to receive in-store customer payments on behalf of Household and remit such payments to Household. The CCA has a term of five (5) years and is cancelable earlier by either party under certain circumstances. The CCA further provides the Company will be paid a percentage of Net Cardholder Charges and a percentage of Other Revenue (each as defined in the CCA).

In connection with the sale the Company recorded receivable sale transaction costs of \$2,062,000 including consulting, legal, and other fees, and the net non-cash write-off of the remaining accounts of GCRC. These charges are partially offset by a \$313,000 interest only strip that was amortized over the estimated life of the underlying assets sold (estimated to be approximately five months). The interest only strip represents the portion of the initial program fees to be received that is considered a residual interest in the assets sold.

In addition to the receivable sale transaction costs, the Company recorded a loss on the extinguishment of debt of \$3,695,000 arising from securitization program prepayment penalties and the write-off of unamortized deferred loan fees related to the program.

### Receivables Securitization Program

Prior to the termination of the receivables securitization program on January 31, 2003, the Company conveyed all of its accounts receivable arising under its private label customer credit cards on a daily basis to its wholly-owned subsidiary, GCRC. Those receivables that met certain eligibility requirements of the program were simultaneously conveyed to Gottschalks Credit Card Master Trust ("GCC Trust"), to be used as collateral for securities issued to investors. GCC Trust was a qualified special purpose entity under SFAS No. 140, and was not consolidated in the Company's financial statements. The transfer of receivables under the program were accounted for as sales for financial reporting purposes under SFAS No. 140, and as such, the transferred receivables were removed from the Company's balance sheet at the time of the transfer. Securities issued under the program were issued by GCC Trust, which was not consolidated in the Company's financial statements. Certain of the securities issued by GCC Trust represented the Company's retained interest in the receivables sold. The Company also retained receivables that were ineligible for transfer to GCC Trust. The Company serviced and administered the portfolio for a 3% per annum monthly servicing fee, which totaled \$2,301,000 in 2002 and \$2,254,000 in 2001. Under the program, monthly cash flows generated by the Company's credit card portfolio, consisting of principal and interest collections, were first used to pay certain costs of the program, which included the payment of principal (when required) and interest to the investors, and monthly servicing fees to the Company. Any excess cash flows were then available to fund additional purchases of newly generated receivables, ultimately serving as a source of working capital financing for the Company.

On March 1, 1999, GCC Trust issued a \$53.0 million principal amount 7.66% Fixed Base Class A-1 Credit Card Certificate (the "1999-1 Series Certificate") to a single investor through a private placement. Interest on the 1999-1 Series Certificate was earned by the certificate holder on a monthly basis at a fixed interest rate of 7.66%.

On November 16, 2000, GCC Trust issued a \$24.0 million Variable Base Class A-1 Credit Card Certificate (the "2000-1 Series Certificates"). Upon the expiration of the original 2000-1 Series Certificate, GCC Trust issued two new 2000-1 Series Certificates on November 15, 2001 in an aggregate principal amount of up to \$20.0 million. The Company borrowed against the 2000-1 Series Certificates on a revolving basis, similar to a revolving line of credit arrangement, and such borrowings bore interest at variable rates equal to the one-month LIBOR rate plus 2.75%, with a minimum rate of 5.0%. Borrowings against the Series 2000-1 Certificates were limited to a specified percentage of the outstanding balance of receivables underlying the certificates, and therefore varied depending on seasonal fluctuations in the underlying receivables.

The Company retained a beneficial ownership interest in certain of the receivables transferred under the program, represented by Exchangeable and Subordinated Certificates, and also retained an uncertificated ownership interest in the retained right to receive future interest income (interest-only strip) and other receivables that did not meet certain eligibility requirements of the program. These retained interests were pledged as collateral under the Company's senior revolving credit facility (see Note 6).

### *Net Credit Revenues*

Net credit revenues associated with the Company's credit card receivable portfolio, including securitized receivables, consists of the following:

<b>(In thousands)</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
Service charge revenues.....	\$ 2,649	\$ 17,813	\$ 17,817
Interim servicing compensation - net.....	1,088		
Amortization of interest-only strip.....	(313)		
Interest expense on securitized receivables...		(4,863)	(4,902)
Charge-offs on receivables sold and provision for credit losses on receivables ineligible for sale.....	305	(4,821)	(4,550)
Gain on sale of receivables.....		96	55
	<u>\$ 3,729</u>	<u>\$ 8,225</u>	<u>\$ 8,420</u>

### **3. PROPERTY AND EQUIPMENT**

Property and equipment consists of the following:

<b>(In thousands)</b>	<b>January 31, 2004</b>	<b>February 1, 2003</b>
Furniture, fixtures and equipment.....	\$ 95,522	\$ 113,188
Buildings and leasehold improvements.....	86,794	84,545
Land.....	15,185	15,185
Buildings and equipment under capital leases.....	18,720	18,720
Construction in progress.....	<u>1,141</u>	<u>1,223</u>
	217,362	232,861
Less accumulated depreciation and amortization.....	<u>(87,530)</u>	<u>(92,973)</u>
	<u>\$ 129,832</u>	<u>\$ 139,888</u>

### **4. GOODWILL AND INTANGIBLE ASSETS**

The Company adopted the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets" effective February 3, 2002 and discontinued the amortization of previously recorded goodwill as of that date. Previously recorded goodwill arising from the Lamonts acquisition in 2000 of \$0.6 million as of February 2, 2002, has been reallocated to property and equipment. The remainder of the Company's previously recorded goodwill, net of accumulated amortization, totaled \$7.6 million as of February 2, 2002. The majority of goodwill arose from the acquisition of nine stores (one of which was subsequently closed as planned) in a business combination which

occurred in 1998 and the remainder was attributable to a store acquired in a business combination which occurred in 1987. These acquired stores had a history of profitability prior to their acquisition and have continued to generate operating profit in excess of the Company average store operating profit.

The Company has completed step one of the two-step process prescribed by SFAS No. 142 to annually test its previously recorded goodwill for impairment and has determined that each store location represents a reporting unit for such purpose. As part of this process the Company allocated associated goodwill to relevant reporting units. The Company engaged an independent third party to provide estimates of the fair value of the reporting units and compared such estimated fair values to the net carrying values of the reporting units. As a result of this process the Company concluded that there was no impairment as of the measurement dates of February 2, 2002, November 2, 2002 and November 1, 2003. In addition there have been no events or changes in circumstances since November 1, 2003 that would indicate that a potential impairment has arisen. Accordingly, step two of the SFAS No. 142 process is unnecessary.

The following table shows the pro-forma effect for 2001 of no longer amortizing goodwill:

<u>(In thousands, except per share data)</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income (loss):			
Net income (loss) as reported.....	\$ 1,870	\$ (11,973)	\$ 425
Goodwill amortization, net of related income tax benefit.....			350
Adjusted net income (loss).....	<u>\$ 1,870</u>	<u>\$ (11,973)</u>	<u>\$ 775</u>
Net income (loss) per share (diluted):			
Net income (loss) as reported.....	\$ 0.14	\$ (0.94)	\$ 0.03
Goodwill amortization, net of related income tax benefit.....			0.03
Adjusted net income (loss).....	<u>\$ 0.14</u>	<u>\$ (0.94)</u>	<u>\$ 0.06</u>

SFAS No. 142 also requires disclosure of intangible assets which are subject to amortization. As of January 31, 2004 and February 1, 2003, the following lease-related interests are classified as intangible assets:

<u>(In thousands)</u>	<u>January 31, 2004</u>	<u>February 1, 2003</u>
Intangible assets - leasehold interests.....	\$ 819	\$ 509
Accumulated net accretion.....	35	149
Net.....	<u>\$ 854</u>	<u>\$ 658</u>

These leasehold interests relate to leases purchased in the Lamonts acquisition which were adjusted to reflect fair value. The underlying leases had lives of three to forty years. The increase in leasehold interests in fiscal 2003 is primarily attributable to the net charge off of leasehold interests related to the relocation or restructuring of two of the Company's store locations during 2003.

During 2003, 2002 and 2001, net accretion (amortization) included in continuing operations related to certain of these leasehold interests was \$18,000, \$(95,000) and \$41,000, respectively. The Company anticipates amortization on certain of these intangible assets of \$82,000 in each of fiscal years 2003 through 2007. Additionally, the Company anticipates accretion on certain of these intangible assets of \$34,000 in each of fiscal years 2004 through 2007.

## 5. TRADE ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Trade accounts payable and accrued expenses consist of the following:

<b>(In thousands)</b>	<b>January 31, 2004</b>	<b>February 1, 2003</b>
Trade accounts payable.....	\$ 20,035	\$ 22,648
Cash management liability.....	7,326	15,005
Accrued expenses.....	19,579	23,010
Accrued payroll and related liabilities.....	7,718	7,179
Taxes, other than income taxes.....	12,059	12,115
Federal and state income taxes payable.....	656	16
	<u>\$ 67,373</u>	<u>\$ 79,973</u>

## 6. DEBT

### *Senior Revolving Credit Facility*

On February 1, 2002, the Company entered into a three-year senior revolving credit facility with General Electric Capital Corporation ("GE Capital") as agent, and The CIT Group/Business Credit as syndication agent (the "Original GE facility"). On March 1, 2004, subsequent to the Company's fiscal year end, the Company finalized an amendment and restatement of the Original GE facility (the "GE facility"). The Original GE facility provided up to \$165.0 million of working capital financing through January 31, 2005, with \$159.0 million provided under a Tranche A revolving credit facility (including a \$20.0 million letter of credit sub-facility) and the remaining \$6.0 million provided through a fully funded Tranche B facility. As of January 31, 2004, outstanding borrowings under the Original facility totaled \$51.0 million, and excess borrowing availability under the facility, after the deduction of the minimum availability requirement and other reserves, totaled \$37.0 million. The Company classified a total of \$50.0 million and \$30.0 million as of January 31, 2004 and February 1, 2003, respectively, as long-term in the accompanying financial statements, representing that portion of outstanding borrowings under the facility which are not expected to be repaid within one year of the



respective balance sheet dates. Substantially all of the Company's assets, including its merchandise inventories, were pledged to GE Capital under this facility.

As of January 31, 2004, interest charged on amounts borrowed under the Tranche A portion of the Original GE facility were at the prime rate plus 0.5% per annum (4.50% at January 31, 2004), or at the Company's option, at the applicable LIBOR rate plus 2.75% per annum (3.85% at January 31, 2004). In addition, the Company paid an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the Tranche A portion of the Original GE facility. Amounts borrowed under the Tranche B portion of the Original GE facility bore interest at prime plus 10%, or at the Company's option, at LIBOR plus 12.0%. Beginning in fiscal 2003, the interest rate applicable to the Tranche A portion was adjusted upwards or downwards on a quarterly basis based on a pricing matrix which was tied to the Company's Leverage Ratio (as defined in the agreement). Under the pricing matrix, the applicable interest rate could range from a rate as low as prime or LIBOR plus 2.75%, to as high as prime plus 0.75%, or LIBOR plus 3.50%.

The Original GE facility contained restrictive financial and operating covenants, including the requirement to maintain a minimum twelve-month trailing EBITDA and a minimum accounts payable to inventory ratio. In addition, the Original GE facility also did not permit the repayment of the Subordinated Note on its scheduled maturity date of August 20, 2003, which resulted in the maturity of that note automatically being extended to August 20, 2006. As of January 31, 2004, management believes the Company was in compliance with all restrictive financial covenants applicable to the Original GE facility.

As previously noted, subsequent to the Company's fiscal year end on March 1, 2004, the Company finalized an amendment and restatement of the Original GE facility. The GE facility provides up to \$165.0 million of working capital financing and is extended through February 1, 2007, with an option to extend the facility through February 2, 2009 for a limited time and under certain conditions. The GE facility consists of a revolving credit facility of up to \$156.0 million (including a \$20.0 million letter of credit sub-facility) and a fully funded fixed term loan of \$9.0 million. Borrowings under the revolving credit facility are limited to the sum of (a) specified percentages of eligible credit card receivables, which are considered cash equivalents, and (b) the lesser of specified percentages of (i) the cost of eligible inventory and (ii) the net recovery value of the inventory, as determined by periodic valuation performed by an independent appraiser. Such borrowings are further limited by a requirement to maintain a minimum of \$5.0 million of excess availability at all times, and other reserves that are in effect. Substantially all of the Company's assets, including its merchandise inventories, continue to be pledged to GE Capital under the GE facility.

As of March 1, 2004, interest charged on amounts borrowed under the GE facility for revolving loans were at the prime rate plus 0.25% per annum (4.25% at March 1, 2004), or at the Company's option, at the applicable LIBOR rate plus 2.25% per annum (3.35% at March 1, 2004). In addition, the Company pays an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the Tranche A facility. Amounts borrowed under the Term Loan portion of the GE facility bear interest at 6.6% annum. The interest rate applicable to the revolving loans under the GE facility may be adjusted upwards or downwards on a quarterly

basis based on a pricing matrix which is tied to the Company's borrowing availability. Under the pricing matrix, the applicable interest rate could range from a rate as low as prime, or LIBOR plus 1.50%, to as high as prime plus 0.75%, or LIBOR plus 2.75%

On March 22, 2002, the Company had entered into a \$15.0 million financing with Kimco Capital Corp. (the "Kimco facility") at a fixed interest rate of 12.0% per annum. The Kimco facility was secured by first priority liens on three of the Company's owned stores and with subordinate liens on substantially all other assets of the Company securing the Original GE facility. Proceeds from the Kimco facility were used to repay previously existing mortgage loans on two of those properties and one term loan and to pay certain fees and costs associated with the transaction. The remaining \$4.1 million of proceeds was used to reduce outstanding borrowings under the Original GE facility. The Kimco facility was co-terminus with the Original GE facility, with monthly principal payments of \$80,000 plus interest at a fixed rate of 12% per annum, and a balloon payment upon maturity on January 31, 2005 of \$12.4 million. In March 2004, the Company prepaid the remaining \$13.2 million balance of the Kimco facility (including a prepayment penalty, and other transaction fees and costs) with borrowings under the GE facility. The term loan under the GE facility is collateralized by two of the three owned stores previously securing the Kimco facility.

The GE facility contains restrictive financial and operating covenants, including the requirement to maintain a fixed charge coverage ratio of 1:1 (as defined in the agreement). The GE facility also does not permit the repayment of the Subordinated Note, and accordingly the scheduled maturity date of the Subordinated Note has been extended to May 30, 2007.

### *Long-Term Obligations*

Long-term obligations consist of the following:

<b>(In thousands)</b>	<b>January 31, 2004</b>	<b>February 1, 2003</b>
Revolving line of credit.....	\$ 50,000	\$ 30,000
9.39% mortgage loans payable, due 2010.....	17,513	17,926
12.0% note payable, due 2005.....	13,240	14,200
Capital lease obligations.....	7,643	10,613
Variable rate note payable, due 2005.....	3,700	3,700
Other mortgage loans and notes payable.....	2,931	3,347
	<u>95,027</u>	<u>79,786</u>
Less current portion.....	<u>3,725</u>	<u>4,689</u>
	<u>\$ 91,302</u>	<u>\$ 75,097</u>

On February 19, 2002, the Company completed a \$1.0 million seven-year term loan financing of its corporate aircraft.

In addition, on May 24, 2002, the Company completed the financing of its ownership interest in the partnership that owns the Company's corporate headquarters. Proceeds from this transaction, totaling \$3.7 million, were used to reduce outstanding borrowings under the Original GE facility. The related note payable bears interest at a variable rate of prime plus 1.5% per annum (5.5% at January 31, 2004), which is payable monthly. The \$3.7 million principal portion of the note payable is due in full upon maturity on May 24, 2005.

The scheduled annual principal maturities of the Company's mortgage loans and notes payable are \$14,149,000, \$4,565,000, \$907,000, \$958,000 and \$984,000 for 2004 through 2008, with \$15,822,000 payable thereafter. Included in the 2004 scheduled maturities is \$12.4 million of principal maturities which were paid on March 1, 2004 in connection with the early termination of the Kimco facility.

Deferred debt issuance costs related to the Company's various financing arrangements are included in other current and long-term assets and are charged to income as additional interest expense over the life of the related indebtedness. Such costs, net of accumulated amortization, totaled \$2,475,000 at January 31, 2004 and \$4,481,000 at February 1, 2003.

Interest paid, net of amounts capitalized, was \$11,140,000 in 2003, \$18,041,000 in 2002 and \$17,395,000 in 2001. No interest expense was capitalized in 2003. Capitalized interest expense was \$159,000 in 2002 and \$209,000 in 2001. The weighted-average interest rate charged on the Company's revolving line of credit was 5.16% in 2003, 5.47% in 2002 and 5.48% in 2001.

Substantially all of the Company's assets, including its merchandise inventories, are pledged as collateral under the Company's various debt agreements. Certain of the Company's long-term debt agreements contain financial and other restrictive covenants, as well as cross default provisions. Accordingly, the failure to comply with these restrictions and covenants, if not waived, would cause a cross-default under the majority of all of the Company's debt agreements, including the GE facility. Management believes the Company was in compliance with all applicable financial covenants as of January 31, 2004.

## **7. SUBORDINATED NOTE PAYABLE TO AFFILIATE**

The Company issued a Subordinated Note to Harris in the principal amount of \$22,179,000 on August 20, 1998 as partial consideration for the Harris acquisition. (See Note 15.) The Subordinated Note, discounted to an effective interest rate of 10% at issuance, bears interest at a fixed rate of 8%, which is payable semi-annually. The principal portion of the Subordinated Note was originally due and payable on August 20, 2003, unless such payment would result in a default on any of the Company's other credit facilities, in which case its maturity would automatically be extended by three years to August 2006. Because the Original GE facility did not permit the repayment of the Subordinated Note on its scheduled maturity date of August 20, 2003, its maturity date was extended to August 20, 2006. Subsequent to fiscal year ended January 31, 2004, in connection with the GE facility the Subordinated Note was further extended to a maturity date of May 30, 2007. The Subordinated Note is unsecured, contains no restrictive financial covenants and is subordinate to the payment of all debt, including trade credit, of the Company. The discount on the Subordinated Note was amortized as additional interest expense

over the original term of the note and became fully amortized at August 20, 2003. The unamortized discount totaled \$191,000 as of February 1, 2003. Interest paid to Harris totaled \$2,117,000 in 2003, 2002 and 2001.

## 8. LEASES

The Company leases certain retail department stores, specialty stores, land, furniture and fixtures and equipment under capital and noncancellable operating leases that expire in various years through 2021. Certain of the leases provide for the payment of additional contingent rentals based on a percentage of sales, require the payment of property taxes, insurance and maintenance costs and have renewal options for one or more periods ranging from five to twenty years. The Company leases three of its department stores from El Corte Ingles ("ECI") of Spain. ECI is the parent company of Harris, and both Harris and ECI are affiliates of the Company. (See Note 15.) Rent paid or accrued to ECI totaled \$859,000 in 2003, \$864,000 in 2002 and \$872,000 in 2001.

Future minimum lease payments as of February 1, 2003, by year and in the aggregate, under capital leases and noncancellable operating leases with initial or remaining terms in excess of one year are as follows:

<u>(In thousands)</u>	<u>Capital Leases</u>	<u>Operating Leases</u>
2004.....	\$ 2,572	\$ 23,766
2005.....	2,205	22,556
2006.....	1,466	21,729
2007.....	946	18,600
2008.....	476	16,679
Thereafter.....	2,680	73,640
Total minimum lease payments.....	10,345	\$ 176,970
Amount representing interest.....	(2,702)	
Present value of minimum lease payments....	7,643	
Less current portion.....	(1,936)	
	<u>\$ 5,707</u>	

Rental expense consists of the following:

<u>(In thousands)</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Operating leases:			
Buildings:			
Minimum rentals.....	\$ 23,125	\$ 23,409	\$ 24,500
Contingent rentals.....	2,895	3,016	3,074
Fixtures and equipment.....	1,994	1,618	1,972
	<u>\$ 28,014</u>	<u>\$ 28,043</u>	<u>\$ 29,546</u>

One of the Company's lease agreements contains a restrictive financial covenant pertaining to the debt to tangible net worth ratio with which management believes the Company was in compliance at February 1, 2003.

## 9. DISCONTINUED OPERATIONS

From time to time the Company may consider closure of certain store locations that are determined to be either underperforming or inconsistent with the long-term operating strategy of the Company. All of the store locations closed in each of the fiscal years 2003, 2002, and 2001 were acquired from Lamonts Apparel Inc. in July 2000, with the exception of one specialty store closed in 2003.

During fiscal 2003 the Company closed six store locations. During fiscal 2002 the Company closed four store locations. These stores were determined to be either underperforming or inconsistent with the Company's long-term operating strategy. The net loss from operating these stores was \$0.5 million in fiscal 2003, \$1.9 million in fiscal 2002, and \$1.7 million in fiscal 2001. The loss from operation of discontinued stores includes only revenues generated from, and expenses directly associated with, the operation of such stores and consists of the following:

<b>(In thousands)</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net sales from closed stores.....	\$ 6,973	\$ 25,512	\$ 31,836
Net lease department revenues.....			128
Total Revenues.....	6,973	25,512	31,964
Cost of sales.....	4,437	15,669	19,558
Selling, general and administrative expenses.....	3,013	10,906	13,260
Depreciation and amortization.....	70	885	867
Total costs and expenses.....	7,520	27,460	33,685
Loss from operations of closed stores.....	<u>\$ (547)</u>	<u>\$ (1,948)</u>	<u>\$ (1,721)</u>

Net costs associated with the closure of stores totaled \$0.8 million in fiscal 2003 primarily consisting of lease termination costs, severance, and other incremental costs associated with the store closings. Net costs associated with the closure of stores totaled \$4.8 million in fiscal 2002 consisting of lease termination costs, severance and other incremental costs associated with the store closings of approximately \$0.6 million and non-cash asset impairment charges related to stores closed in fiscal 2003 and fiscal 2002 of \$4.5 million, partially offset by a gain of \$0.3 million from the sale of lease rights and fixtures and equipment related to two of the closed locations.

During fiscal 2001 the Company closed six stores. As planned, the Company also discontinued the use of an outsourced distribution center facility located in Kent, Washington. Net costs associated with closure of those stores and the outsourced distribution center facility totaled \$729,000. This amount consists of estimated lease termination costs, non-cash asset impairment charges (including the write-off of allocated goodwill and leasehold interests), severance and other incremental costs associated with the closure of the stores totaling \$2,035,000, less \$1,306,000 of cash proceeds received as a result of the sale of lease rights, fixtures and equipment. Results of operations of the fiscal 2001 store closures are included in continuing operations in the accompanying statement of operations. Store closure costs related to fiscal 2001 store closures are reported separately in continuing operations in the accompanying statement of operations.

In the event the Company is unable to improve the operating performance of any underperforming stores, the Company may consider the sale, sublease or closure of those stores in the future. In the past, the Company has successfully improved the operating results and cash flows of other underperforming stores through a variety of strategies, including revising the merchandise mix, changing store management, revising marketing strategies, renegotiating lease agreements and reducing operating costs. However, there can be no assurance that these strategies will improve the operating results and cash flows of those remaining underperforming stores, or that the Company will be able to sell, sublease or close those stores in the event their performance does not improve. In addition, the Company may incur certain costs and expenses in connection with the sale or closure of those locations that may not be fully offset by sale proceeds, sublease income or favorable lease terminations.

As of January 31, 2004, the Company had a reserve for store closure costs totaling \$337,000, which consisted primarily of estimated future lease obligations for one of the store locations closed in fiscal 2001 and one of the store locations closed in fiscal 2003. In the event the Company is not successful in selling or subleasing the location closed in fiscal 2001 as soon as management expects, additional reserves for store closure costs may be recorded. In addition, in the event the Company decides to close additional store locations in fiscal 2004 or beyond, additional reserves for store closure costs, which may be material, may be incurred.

## **10. ASSET IMPAIRMENT CHARGES**

During 2002, the Company recorded non-cash asset impairment charges of \$9.5 million to write down long-lived assets related to certain underperforming stores, primarily former Lamonts locations. These charges consisted of \$3.6 million of property and equipment, \$5.8 million of leasehold interests and \$0.1 million of goodwill. The charges were determined by comparing projected net operating cash flows, including estimated proceeds from the sale of certain assets, to the carrying value of the stores' long-lived assets. No such costs were recorded in 2003 or 2001.

## **11. INCOME TAXES**

The components of income tax expense (benefit) from continuing operations are as follows:

<b>(In thousands)</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
Current:			
Federal.....	\$ 1,848	\$ (4,179)	\$ 712
State.....	<u>221</u>	<u>(783)</u>	<u>439</u>
	2,069	(4,962)	1,151
Deferred:			
Federal.....	(677)	(2,035)	81
State.....	<u>137</u>	<u>502</u>	<u>(381)</u>
	<u>(540)</u>	<u>(1,533)</u>	<u>(300)</u>
	<u>\$ 1,529</u>	<u>\$ (6,495)</u>	<u>\$ 851</u>

The principal components of deferred tax assets and liabilities are as follows (in thousands):

	<b>January 31, 2004</b>		<b>February 1, 2003</b>	
	<b>Deferred Tax Assets</b>	<b>Deferred Tax Liabilities</b>	<b>Deferred Tax Assets</b>	<b>Deferred Tax Liabilities</b>
Current:				
Accrued employee benefits.....	\$ 1,036	\$	\$ 1,037	\$
State income taxes.....	74		1	
LIFO inventory reserve.....		(3,093)		(2,115)
Supplies inventory.....		(558)		(554)
Workers' compensation.....	1,825		678	
Other items, net.....	<u>1,628</u>	<u>(1,481)</u>	<u>1,604</u>	<u>(988)</u>
	4,563	(5,132)	3,320	(3,657)
Long-Term:				
Net operating loss and tax credit carryforwards.....	5,545		6,378	
State income taxes.....	659		612	
Property and equipment.....		(15,399)		(18,238)
Accounting for leases.....	659	(3,504)	678	(2,985)
Leasehold interests.....	1,841		2,645	
Impaired assets.....	1,450		1,841	
Deferred income.....	1,327	(3,558)	1,732	(3,303)
Valuation allowance.....	(1,818)		(1,438)	
Other items, net.....	<u>940</u>	<u>(779)</u>	<u>336</u>	<u>(816)</u>
	10,603	(23,240)	12,784	(25,342)
	<u>\$ 15,166</u>	<u>\$ (28,372)</u>	<u>\$ 16,104</u>	<u>\$ (28,999)</u>

Income tax expense (benefit) varies from the amount computed by applying the statutory federal income tax rate to income (loss) from continuing operations before income taxes. The reasons for this difference are as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Statutory rate.....	35.0 %	(35.0)%	35.0 %
State income taxes, net of federal income tax benefit.....	8.0	(0.9)	5.5
General business credits.....	(6.7)	(1.3)	(15.2)
Amortization of goodwill.....			5.8
Tax refund claims.....		(4.0)	
Other items, net.....	<u>(0.6)</u>	<u>(5.1)</u>	<u>4.2</u>
Effective rate.....	<u>35.7 %</u>	<u>(46.3)%</u>	<u>35.3 %</u>

Realization of the total deferred tax assets of \$15,166,000 is dependent upon generating sufficient taxable income in future periods.

At January 31, 2004, the Company has, for federal tax purposes, general business credits of \$2,282,000 that expire in the years 2018 through 2022, and alternative minimum tax credits of \$452,000 which may be used for an indefinite period. At January 31, 2004, the Company also has, for state tax purposes, \$5,212,000 of net operating loss carryforwards that expire in 2003 and \$2,245,000 of enterprise zone credits which may be used for an indefinite period. These carryforwards are available to offset future taxable income. The Company established valuation allowances of \$1,818,000 and \$1,438,000 at January 31, 2004 and February 1, 2003, respectively, which relate primarily to certain tax credit carryforwards whose realizability is uncertain.

The Company received income tax refunds, net of payments, of \$2,164,000 in 2003 and \$1,235,000 in 2002 and paid income taxes, net of refunds, of \$1,526,000 in 2001. The income tax refunds received in 2003 and 2002 were, in part, attributable to a final settlement of certain federal net operating loss carryback refund claims filed with the Internal Revenue Service. The Company recognized a federal income tax benefit of \$826,000 and interest income of \$569,000 (included in miscellaneous income) in 2002 related to the federal income tax refund claims.

## 12. EARNINGS PER SHARE

Net earnings per common share is computed by dividing net income by the weighted-average number of common shares outstanding during the year. Stock options represent potential common shares and are included in computing diluted earnings per share when the effect is dilutive. A reconciliation of the weighted-average shares used in the basic and diluted earnings per share calculation is as follows:



<u>(Shares in thousands)</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Weighted average number of			
shares - basic.....	12,830	12,747	12,681
Effect of assumed option exercises.....	<u>89</u>	<u>          </u>	<u>10</u>
Weighted average number of			
shares - diluted.....	<u>12,919</u>	<u>12,747</u>	<u>12,691</u>

Options with an exercise price greater than the average market price of the Company's common stock during the period are excluded from the computation of the weighted-average number of shares on a diluted basis as such options are anti-dilutive. Anti-dilutive options were outstanding for 1,522,568, 1,685,624 and 1,335,720 shares as of the end of 2003, 2002 and 2001, respectively.

### **13. STOCK OPTION AND STOCK PURCHASE PLANS**

The Company has certain stock option plans and an Employee Stock Purchase Plan, as described below. All of these plans have been approved by the Company's stockholders.

#### *Stock Option Plans.*

The Company has stock option plans for directors, officers and key employees which provide for the grant of non-qualified and incentive stock options. Under the plans, the option exercise price may not be lower than 100% of the fair market value of such shares at the date of the grant. Options granted generally vest on a ratable basis over five years and expire ten years from the date of the grant. At January 31, 2004, options for 1,015,750 shares were available for future grants under the plans.

Option activity under the plans is as follows:

	2003		2002		2001	
	Number of Shares	Weighted- Average Exercise Price	Number of Shares	Weighted- Average Exercise Price	Number of Shares	Weighted- Average Exercise Price
Options outstanding at beginning of year.....	1,713,000	\$ 5.99	1,535,500	\$ 6.68	1,364,500	\$ 7.34
Granted.....	279,500	1.64	295,500	2.61	262,500	3.26
Exercised.....	(9,000)	3.03				
Cancelled.....	(295,000)	5.57	(118,000)	6.42	(91,500)	6.59
Options outstanding at end of year.....	<u>1,688,500</u>	<u>\$ 5.36</u>	<u>1,713,000</u>	<u>\$ 5.99</u>	<u>1,535,500</u>	<u>\$ 6.68</u>
Options exercisable at end of year.....	<u>1,067,625</u>	<u>\$ 6.95</u>	<u>1,009,250</u>	<u>\$ 7.47</u>	<u>798,500</u>	<u>\$ 8.06</u>

Additional information regarding options outstanding as of January 31, 2004 is as follows:

Range of Exercise Prices	Number Outstanding	Weighted- Average Remaining Contractual Life (yrs.)	Weighted- Average Exercise Price
\$1.13 to \$3.28	627,500	8.41	\$ 2.28
\$3.52 to \$7.50	591,000	6.01	\$ 5.6
\$7.63 to \$10.87	470,000	2.76	\$ 9.16
<u>\$1.13 to \$10.87</u>	<u>1,688,500</u>	<u>6.00</u>	<u>\$ 5.36</u>

#### *Employee Stock Purchase Plan.*

The Company also has a statutory Employee Stock Purchase Plan, which allows its employees to purchase Company common stock at a 15% discount. Employees can purchase stock under the Plan through payroll deductions ranging from 1% to 10% of their annual compensation, up to a maximum of \$21,250 per employee per year. A total of 500,000 shares were originally registered under the Plan, with 294,243 shares issued through January 31, 2004.

### *Accounting for Stock Based Compensation.*

SFAS 123 requires the disclosure of pro forma net income and net income per share had the Company adopted the fair value method of accounting for stock-based compensation as of the beginning of 1995 (see Note 1). Under SFAS 123, the fair value of stock-based awards is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values.

The Company's calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Risk-free interest rate.....	1.3 %	2.3 %	4.2 %
Expected dividend yield.....	--	--	--
Expected volatility.....	57.0 %	57.00 %	51.50 %
Expected option life (years).....	5	5	5
Fair value of options granted.....	\$0.68	\$1.09	\$1.35

As allowed by SFAS No. 123, the impact of outstanding non-vested stock options granted prior to 1995 has been excluded from the pro-forma calculations. Accordingly the 2003, 2002 and 2001 pro-forma adjustments may not be indicative of future period pro-forma adjustments.

### **14. RETIREMENT SAVINGS PLAN**

The Company has a Retirement Savings Plan ("Plan") which qualifies as an employee retirement plan under Section 401(k) of the Internal Revenue Code. Full-time employees meeting certain requirements are eligible to participate in the Plan and may elect to have up to 20% of their annual eligible compensation, subject to certain limitations, deferred and deposited with a qualified trustee. Participants in the Plan may receive an employer matching contribution of up to 4% of the participants' eligible compensation, depending on the Company's quarterly and annual financial performance. Beginning 2001, the Company amended the Plan to provide for a guaranteed annual match of 3%, including the ability for participants to earn an additional 1% depending on the Company's annual financial performance. The Company recognized \$1,251,000, \$1,415,000 and \$1,454,000 in expense related to the Plan in 2003, 2002 and 2001, respectively.

### **15. TRANSACTIONS WITH AFFILIATES**

Harris and ECI became affiliates of the Company in fiscal 1998 when the Company acquired substantially all of the assets and business of Harris. The purchase price for the assets consisted of 2,095,900 shares of the Company's common stock and a Subordinated Note Payable in the

amount of \$22,179,000, due August 2006. (See Note 7).

On February 22, 2002, the Company entered into a Credit Facilitation Agreement with Harris. Under the Credit Facilitation Agreement, Harris agreed to guarantee an irrevocable standby letter of credit (the "Harris letter of credit") issued by a bank to Original GE Capital in the amount of \$7.0 million for the purpose of providing additional credit enhancement to the GE facility. The Harris letter of credit was used to collateralize standby letters of credit that were subsequently issued under the Original GE facility to key factors. During 2002, the Credit Facilitation Agreement was amended three times to provide for extensions of the expiration date of the Harris letter of credit. Under the terms of the third amendment, the Harris letter of credit was cancelled and the Credit Facilitation Agreement was terminated as a result of the closing of the sale of receivables to Household.

## **16. COMMITMENTS AND CONTINGENCIES**

On March 5, 2004, AT&T filed a breach of contract complaint in The United States District Court in Fresno, California demanding the payment of approximately \$768,000 for telecommunication services allegedly supplied to the Company in 2002 and 2003. The Company has answered and denied the AT&T allegations and demand. At this time it is not possible to predict the outcome of this dispute, but the Company believes that it is not liable for the amounts demanded by AT&T, and will vigorously defend any action AT&T files to pursue its claim.

The Company is party to other legal proceedings and claims which have arisen during the ordinary course of business. In the opinion of management, the ultimate outcome of such litigation and claims is not expected to have a material adverse effect on the Company's financial position or results of its operations.

The Company presently has no commitments to open any stores in fiscal 2004. As of January 31, 2004, the Company had issued a total of \$8.4 million of standby letters of credit and documentary letters of credit totaling \$1.9 million. As of February 1, 2003, the Company had issued a total of \$11.3 million of standby letters of credit and documentary letters of credit totaling \$2.0 million. The standby letters of credit were issued to secure credit lines with key factors and to provide collateral for a workers compensation insurance policy. Subsequent to January 31, 2004 the factor letters of credit were allowed to expire at their respective expiration dates. Management believes the likelihood of any draws under the workers compensation standby letters of credit are remote. Documentary letters of credit are issued in the ordinary course of business to facilitate the purchase of merchandise from overseas suppliers. The supplier draws against the documentary letter of credit upon delivery of the merchandise.

## SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS

### GOTTSCHALKS INC. AND SUBSIDIARY

COL. A	COL. B	COL. C	COL. D	COL. E	COL. F
Description	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts Describe	Deductions Describe	Balance at End of Period
<b>Year ended January 31, 2004:</b>					
Store closure reserve.....	\$ 618,000	\$ 542,000 (3)	\$	\$ (823,000) (4)	\$ 337,000
Deferred tax asset valuation allowance.....	\$ 1,438,000	\$ 380,000 (5)	\$	\$	\$ 1,818,000
Allowance for vendor claims receivable.....	\$ 81,000	\$ 200,000 (6)	\$	\$	\$ 281,000
<b>Year ended February 1, 2003:</b>					
Allowance for doubtful accounts.....	\$ 354,544	\$ 825,061 (1)	\$	\$ (1,179,605) (2)	\$
Store closure reserve.....	\$ 529,000	\$ 581,000 (3)	\$	\$ (492,000) (4)	\$ 618,000
Deferred tax asset valuation allowance.....	\$ 645,000	\$ 793,000 (5)	\$	\$	\$ 1,438,000
Allowance for vendor claims receivable.....	\$ 91,000	\$	\$	\$ (10,000) (6)	\$ 81,000
<b>Year ended February 2, 2002:</b>					
Allowance for doubtful accounts.....	\$ 368,634	\$ 1,247,269 (1)	\$	\$ (1,261,359) (2)	\$ 354,544
Store closure reserve.....	\$	\$ 2,035,000 (3)	\$	\$ (1,506,000) (4)	\$ 529,000
Deferred tax asset valuation allowance.....	\$	\$ 645,000 (5)	\$	\$	\$ 645,000
Allowance for vendor claims receivable.....	\$ 86,000	\$ 5,000 (6)	\$	\$	\$ 91,000

(1) Represents the provision for credit losses on receivables ineligible for sale.

(2) Represents uncollectible accounts written off, net of recoveries, pertaining to receivables ineligible for sale. The 2002 amount includes \$389,000 representing the write-off of the remaining allowance at the date of the receivables sale to Household.

- (3) Represents costs incurred for store closures in 2003, 2002 and 2001 and for the discontinuation of an outsourced distribution facility in 2001, including the remaining lease obligations, asset impairment charges related to the improvements, fixtures and lease rights, severance and other incremental costs.
- (4) Represents cash proceeds received as a result of the sale of lease rights, fixtures and equipment, net of amounts paid in connection with store closures in 2002 and 2001 and the discontinuation of the outsourced distribution facility in fiscal 2001.
- (5) Represents increases to the deferred tax asset valuation allowance.
- (6) Represents changes in estimate for the allowance for vendor claims receivable.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, (the "Exchange Act") the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: April 26, 2004

GOTTSCHALKS, Inc.

By: /s/ James R. Famalette

James R. Famalette

*President and Chief Executive Officer*

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Joseph W. Levy</u> Joseph W. Levy	Chairman	April 26, 2004
<u>/s/ James R. Famalette</u> James R. Famalette	President, Chief Executive Officer and Director (principal executive officer)	April 26, 2004
<u>/s/ J. Gregory Ambro</u> J. Gregory Ambro	Chief Administrative and Financial Officer (principal financial and accounting officer)	April 26, 2004
<u>/s/ O. James Woodward III</u> O. James Woodward III	Director	April 26, 2004
<u>/s/ Sharon Levy</u> Sharon Levy	Director	April 26, 2004
<u>/s/ James Czech</u> James Czech	Director	April 26, 2004
<u>/s/ Joseph J. Penbera</u> Joseph J. Penbera	Director	April 26, 2004
<u>/s/ Fred Ruiz</u> Fred Ruiz	Director	April 26, 2004
<u>/s/ Max Gutmann</u> Max Gutmann	Director	April 26, 2004
<u>/s/ Thomas H. McPeters</u> Tom McPeters	Director	April 26, 2004
<u>/s/ Dale H. Achabal</u> Dale H. Achabal	Director	April 26, 2004
<u>/s/ Jorge Pont Sanchez</u> Jorge Pont Sanchez	Director	April 26, 2004

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