

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

FORM 10-K

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

**For the fiscal year ended January 29, 2005**

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:

<u><b>Title of Each Class</b></u>	<u><b>Name of each exchange on which registered</b></u>
<b>Common Stock, \$.01 par value</b>	<b>New York Stock Exchange Pacific Stock Exchange</b>

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 ☒ No ☐

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 July 31, 2004: Common Stock, \$.01 par value: \$61,239,760.

On March 31, 2005 the Registrant had outstanding 13,093,269 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 23, 2005, which will be filed pursuant to Regulation 14A, are incorporated by reference into Part III of this Form 10-K.

# Gottschalks Inc.

## 2004 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 29, 2005, 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 6 “Village East” and “Gottschalks” specialty stores which carry a limited selection of merchandise. The Company is incorporated in the state of Delaware.

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.

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., which has subsequently been acquired by HSBC Group (“HSBC”).

#### **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, Haggard, 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 2005 through additional brand names such as Methode.

The Company purchases merchandise from numerous suppliers. In no instance did purchases from any single vendor amount to more than 5.0% of the Company's net purchases in fiscal 2004. 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>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
Women's Apparel.....	28.6 %	28.1 %	29.0 %	29.3 %	28.0 %
Cosmetics, Shoes & Accessories.....	25.3	24.3	23.6	22.5	22.5
Home.....	18.9	20.1	20.4	20.1	20.8
Men's Apparel.....	12.8	13.3	13.0	13.8	14.0
Junior's and Children's Apparel.....	10.8	10.6	10.5	10.5	10.7
Leased Departments.....	3.6	3.6	3.5	3.8	4.0
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 enclosed, regional shopping mall construction on the decline, the Company's strategy 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 and "Lifestyle Centers" that feature a variety of retailers, upscale restaurants and typically a major, multi-screen movie theatre.

The Company currently has 2 new stores opening in 2005. On April 15, 2005 the Company opened a 43,260 square foot store in the Heritage Mall in Albany, Oregon. This will represent the third store the Company operates in the State of Oregon. In early August 2005 the Company plans to open a 100,000 square foot 2 level store in a Lifestyle Center located in a high growth area in the northern part of Fresno, CA. This store is being developed as a new prototype for the Company that will feature a balanced merchandise presentation that will focus on the 35 to 45

year old customer, as well as, appealing to the traditional 55 year old customer base. 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 as stores may become available as a result of competitor consolidations.

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 increased such capital expenditures in fiscal 2004 and will initiate further remodel activity at a number of store locations in fiscal 2005.

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.

Additionally, in April 2005 the Company closed a 36,000 square foot store in Fig Garden Village in Fresno, CA, the impact of which will be more than offset by the August 2005 opening of the 100,000 square foot store in northern Fresno, CA.

During 2004, the Company closed 5 specialty stores and integrated their merchandise into the nearby Gottschalks stores in the malls where they reside.

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

	<b>Fiscal Years</b>				
	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
<b>Stores open at year-end:</b>					
Department stores.....	63	63 (1)	69 (1)	73 (1)	79 (2)
Specialty stores (3).....	6	11	12	13	17
Total	<u>69</u>	<u>74</u>	<u>81</u>	<u>86</u>	<u>96</u>
<b>Gross store square footage(4) (in thousands):</b>					
Department stores.....	5,406	5,406	5,665	5,876	6,139
Specialty stores.....	30	42	54	54	63
Total	<u>5,436</u>	<u>5,448</u>	<u>5,719</u>	<u>5,930</u>	<u>6,202</u>

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(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 celebrated its 100<sup>th</sup> year of operation under the Gottschalks name. This unique event was 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 2005 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.

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 HSBC. 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. HSBC 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 HSBC 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. 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 40.1%, 41.2%, and 43.2% in fiscal 2004, 2003, and 2002, respectively. The decline in the private card penetration is due to the transition of service from the Company to HSBC. Efforts are underway between the Company and HSBC to increase the private card penetration in 2005.

The Company has a variety of credit-related programs which management believes have improved customer service and will increase 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 their first purchase and 10% on additional purchases made the remainder of the day the account is opened;
- A "55-Plus" charge account program, which offers additional merchandise and service discounts to customers 55 years of age and older; 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, which was redesigned in 2004, as described below:

The "Gottschalks Rewards" program offers one point for every one dollar in net annual spending using the Company's private label credit card. At the end of each calendar year qualifying customers are sent a merchandise certificate for up to 5% of the total points accumulated, up to a maximum of 10,000 points. Using a "points-based" system allows the Company to offer "double point" opportunities for opening new accounts and other promotions periodically throughout each year.

### **Competition and Seasonality**

See Part I, Item I, "Risk Factors – We Face Significant Competition from Other Retailers" and "Risk Factors – The Company's Business is Susceptible to Economic Conditions and Other Factors That Affect Its Markets, Some of Which are Beyond Its Control".

### **Employees**

As of January 29, 2005, the Company had approximately 5,700 employees, including 3,420 employees working part-time (less than 32 hours per week on a regular basis). As of January 31, 2004, the Company had 5,800 employees (including 3,490 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). Management does not believe that the agreement will have a material affect 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 2009) (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, unemployment 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 sources, 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.

Although the Company has significantly improved its leverage position, 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 may be 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.

The Company's existing debt agreements impose operating and financial restrictions that limit the Company's ability to make dividend payments and grant liens, among other matters.

### **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 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 52.3% of the Company's debt at January 29, 2005 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, unemployment 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. Because of the favorable interest rate environment, on March 15, 2005 the Company extended the financing of its interest in the partnership through an amortizing five-year note at a fixed interest rate of 7.5%. 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 6 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 7 to the Consolidated Financial Statements.

The following table contains additional information about the Company's stores open as of the end of fiscal 2004:

<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.....	5	26,856
Nevada.....	1	3,211
Total	<u>6</u>	<u>30,067</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. The Company believes that it is not liable for the amounts demanded by AT&T, however, it has accrued liabilities for estimated settlement costs that management believes are reasonable. Although the final resolution of these matters may be greater than the Company's recorded liability, management does not believe the ultimate resolution will have a material adverse effect on the Company's business, financial condition or results of operations.

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, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

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:

<u>Fiscal Quarters</u>	<u>2004</u>		<u>2003</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
1st Quarter.....	\$ 6.48	\$ 4.73	\$ 1.58	\$ 0.94
2nd Quarter.....	\$ 6.10	\$ 4.66	\$ 2.17	\$ 1.15
3rd Quarter.....	\$ 6.89	\$ 3.85	\$ 4.00	\$ 1.80
4th Quarter.....	\$ 9.15	\$ 6.03	\$ 4.68	\$ 3.14

On March 31, 2005, the Company had 705 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, 2005 was \$10.35 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 29, 2005 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.

<u>Plan Category</u>	<u>Number of securities to be issued upon exercise of outstanding options</u>	<u>Weighted-average exercise price of outstanding options</u>	<u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u>
Equity compensation plans approved by security holders.....	1,547,750	\$4.96	594,500
Equity compensation plans not approved by security holders.....	N/A	N/A	N/A
Total.....	<u>1,547,750</u>	<u>\$4.96</u>	<u>594,500</u>

## **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 29, 2005, January, 31, 2004, February 1, 2003, February 2, 2002 and February 3, 2001 are referred to herein as fiscal 2004, 2003, 2002, 2001 and 2000, 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.

Subsequent to the issuance of its financial statements for the year ended January 31, 2004, as a result of a letter issued on February 7, 2005 by the Office of the Chief Accountant of the Securities and Exchange Commission ("SEC") to the American Institute of Certified Public Accountants regarding certain operating lease-related accounting issues and their applications under generally accepted accounting principles in the United States of America ("GAAP"), the Company determined that its then current manner in which it accounted for certain lease related matters was not in accordance with GAAP. Corrections to the Company's lease accounting policies include an adjustment to depreciation expense to correct the depreciable lives being used for certain leasehold costs and improvements, and to correct the recording of certain tenant allowances and construction reimbursements, as reductions in rent expense, which are included in selling general and administration expenses, that had previously been recorded as reductions in the cost of the underlying constructed assets. In addition, the restatement includes adjusting lease terms of certain leases to include bargain renewal option periods where exercise of the options would be reasonably assured, and recognizing the straight-line effect over the lease term of such changes in rents during the options periods. Accordingly, fiscal years 2000 through 2003 have been restated from amounts previously reported. See Note 16 of the accompanying consolidated financial statements.

In addition, the Company had previously classified newly generated receivables and payments on receivables under the securitization program as investing activities, and classified the gross proceeds from the sale of its proprietary credit card portfolio and the repayment of the 1999-1 and 2000-1 Series Certificates as financing activities in its consolidated statements of cash flows. To correct this error, the Company has restated its fiscal 2002 consolidated statement of cash flows to reflect the change in receivables and the net proceeds received by the Company from the sale of its proprietary credit card portfolio as operating activities, since the credit card receivables originated from the sale of the Company's merchandise. See Note 16 of the accompanying consolidated financial statements.

(In thousands of dollars, except share data)	Fiscal Years				
	2004	2003(1) (as restated)	2002(1) (as restated)	2001(1) (as restated)	2000(1) (as restated)
<b>RESULTS OF OPERATIONS:</b>					
Net sales.....	\$ 661,992	\$ 660,574	\$ 665,916	\$ 678,866	\$ 643,385
Net credit revenues.....	3,106	3,729	8,225	8,420	9,150
Net leased department revenues (2).....	3,515	3,525	3,557	3,965	3,853
Total revenues.....	<u>668,613</u>	<u>667,828</u>	<u>677,698</u>	<u>691,251</u>	<u>656,388</u>
Costs and expenses:					
Cost of sales.....	432,128	435,370	441,426	450,723	421,329
Selling, general and administrative expenses.....	206,897	203,448	207,367	210,147	193,883
Depreciation and amortization (3).....	13,325	14,497	14,633	14,330	11,918
Asset impairment charges (4).....			9,502		
Store closure costs (5).....				729	
Receivables sale costs (6).....			1,749		
New store pre-opening costs (7).....					4,684
Total costs and expenses.....	<u>652,350</u>	<u>653,315</u>	<u>674,677</u>	<u>675,929</u>	<u>631,814</u>
Operating income .....	<u>16,263</u>	<u>14,513</u>	<u>3,021</u>	<u>15,322</u>	<u>24,574</u>
Other (income) expense:					
Interest expense.....	9,509	13,296	15,883	14,364	13,750
Losses on early extinguishment of debt (8).....			3,695	696	
Miscellaneous income.....	(1,565)	(2,262)	(1,802)	(1,587)	(1,408)
	<u>7,944</u>	<u>11,034</u>	<u>17,776</u>	<u>13,473</u>	<u>12,342</u>
Income (loss) from continuing operations before income taxes.....	8,319	3,479	(14,755)	1,849	12,232
Income tax expense (benefit).....	<u>3,018</u>	<u>1,243</u>	<u>(6,838)</u>	<u>634</u>	<u>4,622</u>
Income (loss) from continuing operations.....	5,301	2,236	(7,917)	1,215	7,610
Discontinued operations:					
Loss from operation of closed stores.....		(547)	(1,948)	(1,721)	(1,180)
Loss on store closures (9).....	(31)	(789)	(4,801)		
Income tax benefit.....	(11)	(454)	(2,295)	(585)	(401)
Loss on discontinued operations.....	<u>(20)</u>	<u>(882)</u>	<u>(4,454)</u>	<u>(1,136)</u>	<u>(779)</u>
Net income (loss).....	<u>\$ 5,281</u>	<u>\$ 1,354</u>	<u>\$ (12,371)</u>	<u>\$ 79</u>	<u>\$ 6,831</u>

Net income (loss) per common share

Basic:

Income (loss) from continuing operations.....	\$	0.41	\$	0.17	\$	(0.62)	\$	0.10	\$	0.60
Loss on discontinued operations.....		0.00		(0.07)		(0.35)		(0.09)		(0.06)
Net income (loss) per common share.....		0.41		0.10		(0.97)		0.01		0.54

Diluted:

Income (loss) from continuing operation.....		0.40		0.17		(0.62)		0.10		0.60
Loss on discontinued operations.....		0.00		(0.07)		(0.35)		(0.09)		(0.06)
Net income (loss) per common share.....	\$	0.40	\$	0.10	\$	(0.97)	\$	0.01	\$	0.54

Weighted-average number of  
common shares outstanding:

Basic.....	12,905	12,830	12,747	12,681	12,614
Diluted.....	13,352	12,919	12,747	12,691	12,632

(In thousands of dollars)	Fiscal Years				
	2004	2003(1)	2002(1)	2001(1)	2000(1)
		(as restated)	(as restated)	(as restated)	(as restated)
<b>SELECTED BALANCE SHEET DATA:</b>					
Retained interest in					
receivables sold.....	\$	\$	\$	\$ 19,222	\$ 19,853
Receivables, net.....	6,920	9,145	10,641	11,331	9,248
Merchandise inventories (10).....	152,753	156,552	164,615	161,041	185,226
Property and equipment, net.....	126,509	127,561	138,910	152,804	148,440
Total assets.....	315,575	322,199	347,849	392,336	410,775
Working capital.....	94,439	58,444	50,241	29,188	31,011
Long-term obligations,					
less current portion.....	71,403	41,302	45,097	35,216	33,012
Subordinated note					
payable to affiliate.....	21,180	22,180	21,989	21,646	21,303
Stockholders' equity.....	112,356	106,368	104,886	117,132	116,878

	Fiscal Years					
	2004	2003	2002	2001	2000	
	(In thousands of dollars, except percentages, ratios and per square foot data)					
<b>OTHER SELECTED DATA:</b>						
Sales growth:						
Total store sales (11).....	(0.7)%	(3.5)%	(2.7)%	8.5%	(12)	22.6% (13)
Comparable store sales (14).....	0.2%	(0.7)%	(0.8)%	0.4%	(12)	5.6% (15)
						(16)
Comparable stores data (14)(17):						
Sales per selling square foot.....	\$ 149	\$ 149	\$ 148	(18)\$ 173	(18)	\$ 176
Selling square footage.....	4,451	4,451	4,654	(18) 3,478	(18)	3,384
Capital expenditures.....	\$ 13,745	\$ 4,363	\$ 8,279	\$ 18,683	\$ 29,635	
Current ratio.....	2.18:1	1.47:1	1.35:1	1.16:1	1.15:1	

- (1) Fiscal years 2000 through 2003 have been restated from amounts previously reported as discussed in Note 16 of the accompanying consolidated financial statements.
- (2) Net leased department revenues consist of sales totaling \$24.3 million, \$24.5 million, \$24.9 million, \$28.9 million, and \$27.7 million in fiscal 2004, 2003, 2002, 2001, and 2000, respectively, less cost of sales.
- (3) Depreciation and amortization includes the amortization of goodwill totaling \$570,000 and \$553,000 in fiscal 2001 and 2000, respectively, and the (amortization) accretion of leasehold interests totaling \$37,200 in each of fiscal 2004, 2003, 2002, and 2001 and \$18,600 in fiscal 2000. 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 9 to the Consolidated Financial Statements).
- (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.
- (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 5 to the Consolidated Financial Statements).
- (9) The fiscal 2004 amount consists of incremental costs associated with the closure of one store at January 31, 2004. 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 8 to the Consolidated Financial Statements.
- (10) The decrease in inventory from fiscal 2003 to 2004 is primarily due to the reduction of inventory levels to more closely reflect selling trends, and to store closures. The decrease in inventory from fiscal 2000 to fiscal 2001 and from fiscal 2002 to 2003 is primarily due 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 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 are 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 2004, 2003 and 2002 results all include 52 weeks.

### **Overview**

The Company is a regional department and specialty store chain completing its 100th year of operation. As of January 29, 2005, the Company operated 63 full-line "Gottschalks" department stores located in six Western states, with the majority of those stores located in California. The Company also operates 6 "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 Company's operations are significantly impacted by competitive pressures from department stores, specialty stores, mass merchandisers and other retail channels, as well as general consumer-spending levels, including the impact of employment levels and other economic conditions. Such pressures during fiscal 2004 were partially offset by promotional activities surrounding the celebration of the Company's 100<sup>th</sup> anniversary resulting in a marginal increase in comparable store sales for fiscal 2004 of 0.2% as compared to fiscal 2003.

The Company's fiscal 2000 acquisition of 34 stores from the former Lamont's chain put significant pressure on the Company's operating performance and liquidity position. The Company subsequently closed 16 of the acquired stores and charged off the related assets and leasehold intangibles. In January 2003 the Company terminated its private label credit card receivables securitization program and sold the accounts and receivables to a third party, resulting in the payoff of \$73.2 million in off balance sheet debt and reduction in outstanding borrowings on the Company's revolving line of credit of approximately \$30.0 million. In March 2004 the Company amended and extended its revolving line of credit reducing the interest margin paid on outstanding borrowings and replacing certain higher variable interest debt with lower fixed interest debt. The Company was able to reduce its debt by an additional \$22.4 million during fiscal 2004.

As a result of this strategic repositioning the Company has been able to refocus on its marketing and merchandising strategies. In addition, the Company has resumed its "raise the bar" programs in its existing stores and is beginning to enhance top line growth through new store openings. On April 15, 2005 the Company opened a new 43,000 square foot store in Albany, Oregon and plans to open a 100,000 square foot lifestyle store in August 2005 in Fresno, California.

Subsequent to the issuance of its financial statements for the year ended January 31, 2004, as a

result of views expressed in a letter on February 7, 2005 by the Office of the Chief Accountant of the Securities and Exchange Commission ("SEC") to the American Institute of Certified Public Accountants regarding certain operating lease-related accounting issues and their applications under generally accepted accounting principles in the United States of America ("GAAP"), the Company determined that its then current manner in which it accounted for certain lease related issues was not in accordance with GAAP. Corrections to the Company's lease accounting policies include an adjustment to depreciation expense to correct the depreciable lives for certain leasehold improvements, and to correct the recording of certain tenant allowances and construction reimbursements, as reductions in rent expense, which are included in selling general and administration expenses, that had previously been recorded as reductions in the cost of the underlying constructed assets. In addition, the restatement includes adjusting lease terms of certain leases to include bargain renewal option periods where exercise of the options would be reasonably assured, and recognizing the straight-line effect over the lease term of such changes in rents during the option periods. As a result, the Company restated its consolidated financial statements for the fiscal years ended January 31, 2004 and February 1, 2003. Accordingly, the accompanying management's discussion and analysis of financial condition and results of operations gives effect to the restatement discussed in Note 16 of the accompanying consolidated financial statements.

In addition, the Company had previously classified newly generated receivables and payments on receivables under the securitization program as investing activities, and classified the gross proceeds from the sale of its proprietary credit card portfolio and the repayment of the 1999-1 and 2000-1 Series Certificates as financing activities in its consolidated statement of cash flows for the fiscal year ended February 1, 2003. To correct this error, the Company has restated its fiscal 2002 consolidated statement of cash flows to reflect the change in receivables and the net proceeds received by the Company from the sale of its proprietary credit card portfolio as operating activities, since the credit card receivables originated from the sale of the Company's merchandise. See Note 16 of the accompanying consolidated financial statements.

### **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, 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 29, 2005, the Company had no reserves for store closure costs. In the event the Company decides to close additional store locations in fiscal 2005 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 statement of operations. 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.

### **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.

The accompanying management's discussion and analysis of financial condition and results of operations gives effect to the restatement discussed in Note 16 of the accompanying consolidated financial statements.

### **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>2004</b>	<b>2003</b>	<b>2002</b>
Net sales.....	100.0 %	100.0 %	100.0 %
Net credit revenues.....	0.5	0.6	1.2
Net leased department revenues.....	0.5	0.5	0.5
Total revenues.....	101.0	101.1	101.7
Costs and expenses:			
Cost of sales.....	65.3	65.9	66.3
Selling, general and administrative expenses.....	31.2	30.8	31.1
Depreciation and amortization.....	2.0	2.2	2.2
Asset impairment charges.....	--	--	1.4
Store closure costs.....	--	--	--
Receivables sale costs.....	--	--	0.3
Total costs and expenses.....	98.5	98.9	101.3
Operating income.....	2.5	2.2	0.4
Other (income) expense:			
Interest expense.....	1.4	2.0	2.3
Losses on early extinguishment of debt.....	--	--	0.5
Miscellaneous income.....	(0.2)	(0.3)	(0.3)
	1.2	1.7	2.5
Income (loss) before income taxes.....	1.3	0.5	(2.1)
Income tax expense (benefit).....	0.5	0.2	(1.0)
Income (loss) from continuing operations.....	0.8	0.3	(1.1)
Discontinued operations:			
Income (loss) from operation of closed stores.....	--	(0.1)	(0.3)
Loss on store closures.....	--	(0.1)	(0.7)
Income tax benefit.....	--	(0.1)	(0.3)
Loss on discontinued operations.....	--	(0.1)	(0.7)
Net income (loss).....	0.8 %	0.2 %	(1.8)%

## ***Fiscal 2004 Compared to Fiscal 2003***

### **Net Sales**

Net sales from continuing operations increased by approximately \$1.4 million, or 0.2%, to \$662.0 million in fiscal 2004 as compared to \$660.6 million in fiscal 2003. The fiscal 2004 sales increase is primarily attributable to promotional activity related to the celebration of the Company's 100<sup>th</sup> anniversary, but was tempered by a continuing soft general economic environment in much of the Company's market areas and additional competitive pressures in the Central California markets. Comparable store sales for fiscal 2004, which includes sales for stores open for the full period in both years, increased by 0.2% as compared to the same 52-week period of the prior year.

The Company operated 63 department stores and 6 specialty stores as of the end of fiscal 2004 as compared to 63 department stores and 11 specialty stores as of the end of fiscal 2003. During 2004 the Company closed 5 specialty apparel stores and integrated their merchandise into the nearby Gottschalks store in the malls where they reside. As described more fully in Note 8 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.

### **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.), which has subsequently been acquired by HSBC Group ("HSBC"), the Company sold its private label credit card accounts and accounts receivable to HSBC. In connection with the sale, the Company entered into two additional agreements with HSBC: 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 HSBC assumed their servicing on May 14, 2003, as planned. HSBC 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.

Net credit revenues related to the Company's credit card receivables portfolio decreased by approximately \$0.6 million or 16.7%, to \$3.1 million in fiscal 2004 as compared to \$3.7 million in fiscal 2003. As a percent of net sales, net credit revenues were 0.5% of net sales in fiscal 2004 as compared to 0.6% in fiscal 2003. Net credit revenues consist of the following:

<u>(In thousands)</u>	<u>2004</u>	<u>2003</u>
Service charge revenues.....	\$ 2,955	\$ 2,649
Interim servicing compensation - net.....	--	1,088
Amortization of interest-only strip.....	--	(313)
Recoveries of previously charged off receivables....	151	305
	<u>\$ 3,106</u>	<u>\$ 3,729</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 was fully amortized at the end of 2003.

### **Net Leased Department Revenues**

Net rental income generated by the Company's various leased departments was \$3.5 million in fiscal 2004, essentially equal to fiscal 2003. 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 \$24.3 million in fiscal 2004 as compared to \$24.5 million in fiscal 2003.

### **Cost of Sales**

Cost of sales from continuing operations, which includes costs associated with the buying, handling and distribution of merchandise, decreased by approximately \$3.3 million to \$432.1 million in fiscal 2004 as compared to \$435.4 million in fiscal 2003, a decrease of 0.7%. The decrease is primarily due to the decrease in sales volume. The Company's gross margin percentage increased to 34.7% in fiscal 2004 as compared to 34.1% in fiscal 2003. The increase in the gross margin percentage was primarily due to reductions in comparable store average inventory which enabled the Company to increase turnover and better manage its markdown strategies .

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

Selling, general and administrative expenses from continuing operations increased approximately \$3.5 million, or 1.7%, to \$207.0 million in fiscal 2004 as compared to \$203.5 million in fiscal 2003. As a percentage of net sales, selling, general and administrative expenses increased 0.4% to 31.2% in fiscal 2004 as compared to 30.8% in fiscal 2003. The increase is primarily attributable to recent increases in unemployment insurance contribution rates and worker's compensation loss development rates in California. The Company is continuing to experience benefits from its cost control initiatives, but expects to see offsetting pressures from such rate increases in the foreseeable future.

## **Depreciation and Amortization**

Depreciation and amortization expense, which includes the (amortization) accretion of intangible assets other than goodwill, decreased by approximately \$1.2 million or 8.1%, to \$13.3 million in fiscal 2004 as compared to \$14.5 million in fiscal 2003. As a percent of net sales, depreciation and amortization expense was 2.0% in fiscal 2004 and 2.2% in fiscal 2003. 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.

## **Interest Expense**

Interest expense, which includes the amortization of deferred financing costs, decreased by approximately \$3.8 million to \$9.5 million in fiscal 2004 as compared to \$13.3 million in fiscal 2003, a decrease of 28.5%. As a percent of net sales, interest expense decreased to 1.4% in fiscal 2004 as compared to 2.0% in fiscal 2003. These decreases are primarily due to lower outstanding borrowings on the Company's revolving credit facility and the elimination of certain higher interest debt facilities resulting from the amendment and extension of the Company's revolving credit facility. Total debt was \$22.4 million lower at the end of fiscal 2004 as compared to the end of fiscal 2003. The weighted-average interest rate applicable to the facility was 4.6% in fiscal 2004 as compared to 5.2% in fiscal 2003.

## **Miscellaneous Income**

Miscellaneous income, which includes the amortization of deferred income and other miscellaneous income and expense amounts, decreased by approximately \$0.7 million to \$1.6 million in fiscal 2004 as compared to \$2.3 million in fiscal 2003. As a percent of net sales, miscellaneous income was 0.2% in fiscal 2004 and 0.3% in fiscal 2003. Fiscal 2003 included recovery of reserves related to the final settlement of certain net operating loss carry-back claims.

## **Income Taxes**

The Company's effective tax rate for continuing operations is 36.3% in fiscal 2004 as compared to 35.7% in fiscal 2003. Including the tax benefit reported in discontinued operations, the Company's effective tax rate is 36.3% in fiscal 2004 as compared to 36.8% in fiscal 2003.

## **Income From Continuing Operations**

As a result of the foregoing, the Company reported income from continuing operations of \$5.3 million, or \$0.40 per diluted share, in fiscal 2004 as compared \$2.2 million, or \$0.17 per diluted share, in fiscal 2003.

## **Discontinued Operations**

As described more fully in Note 8 to the accompanying financial statements, during fiscal 2003 the Company closed six 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. The loss from operation of discontinued stores consists of the following:

<b>(In thousands)</b>	<b>2004</b>	<b>2003</b>
Net sales from closed stores.....	\$ --	\$ 6,973
Cost of sales.....	--	4,437
Selling, general and administrative expenses.....	--	3,013
Depreciation and amortization.....	--	70
Total costs and expenses.....	--	7,520
Loss from operations of closed stores.....	\$ <u>--</u>	\$ <u>(547)</u>

Net costs associated with the closure of stores were minor in fiscal 2004 primarily consisting of incremental costs associated with the closure of one store at January 31, 2004. Net costs associated with the closure of stores totaled \$0.8 million in fiscal 2003 consisting of lease termination costs, severance and other incremental costs associated with the store closings.

Certain of the Company's stores may perform below expectations from time to time. 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.

## **Net Income**

As a result of the foregoing, the Company reported net income of \$5.3 million in fiscal 2004 as compared \$1.4 million in fiscal 2003. On a per diluted share basis the 2004 net income was \$0.40 per share as compared to net loss of \$0.10 per share in fiscal 2003.

## ***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 8 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 above and in Note 2 to the accompanying financial statements, in January 2003 the Company sold its private label credit card accounts and accounts receivable to HSBC. 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 HSBC, as well as a reduction in selling, general and administrative expenses as a result of outsourcing the credit card servicing to HSBC and a reduction in interest expense arising from reduced line of credit borrowings resulting from the application of the proceeds from the HSBC transaction. The net credit revenues the Company received under the CCA approximately equaled 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 to 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 \$203.5 million in fiscal 2003 as compared to \$207.4 million in fiscal 2002. As a percentage of net sales, selling, general and administrative expenses decreased 0.3% to 30.8% in fiscal 2003 as compared to 31.1% 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 HSBC 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 \$0.1 million or 1.0%, to \$14.5 million in fiscal 2003 as compared to \$14.6 million in fiscal 2002. As a percent of net sales, depreciation and amortization expense was 2.2% 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 HSBC 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 repayment of some borrowings with part of the net proceeds from the sale of the receivables to HSBC. 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 36.8% in fiscal 2003 as compared to a benefit of 42.5% 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 \$2.2 million, or \$0.17 per diluted share, in fiscal 2003 as compared to a net loss of \$7.9 million, or \$0.62 per diluted share, in fiscal 2002.

### **Discontinued Operations**

As described more fully in Note 8 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:

<b>(In thousands)</b>	<b>2003</b>	<b>2002</b>
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.....	70	885
Total costs and expenses.....	<u>7,520</u>	<u>27,460</u>
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.

### **Net Income**

As a result of the foregoing, the Company reported net income of \$1.4 million in fiscal 2003 as compared to a net loss of \$12.4 million in fiscal 2002. On a per diluted share basis the 2003 net income was \$0.10 per share as compared to net loss of \$0.97 per share in fiscal 2002.

### **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 accompanying financial statements, on January 31, 2003 the Company sold its credit card accounts and accounts receivable to HSBC. 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. As of March 1, 2004, the Company re-negotiated its senior revolving credit facility (the "GE facility"). The GE facility provides for borrowings of up to \$165.0 million and has been extended through February 28, 2009. 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 experienced an additional improvement of approximately \$21.0 million in average daily availability during fiscal 2004 as compared to fiscal 2003 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. Availability was \$56.7 million as of January 29, 2005.

In fiscal 2004, the Company generated a total of \$38.5 million from operations as compared to \$23.1 million positive cash flow from operations in fiscal 2003 and \$20.9 million in fiscal 2002. The \$15.4 million increase in cash provided by operating activities in fiscal 2004 relative to fiscal 2003 was primarily due to increased net income, the return of certain deposits and the timing of certain payables, partially offset by lower levels of inventory reductions.

Net cash used in investing activities amounted to \$13.7 million, \$4.0 million, and \$12.2 million in fiscal 2004, 2003, and 2002, respectively. The net cash outflow in fiscal 2004 increased from fiscal 2003 in the amount of \$9.7 million, primarily related to increased capital expenditures for store remodeling and new store construction (see "Uses of Liquidity").

Net cash used in financing activities was \$24.6 million, \$20.1 million, and \$5.2 million in fiscal 2004, 2003 and 2002, respectively. The net cash outflow in fiscal 2004 was principally attributable to the payoff of certain high interest debt and continued reductions of outstanding borrowing on the Company's revolving credit facility, partially offset by additional funds provided by a lower fixed interest term loan connected to the amended revolving credit agreement.

## **Sources of Liquidity**

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

On January 31, 2003, pursuant to the terms of a Purchase and Sale Agreement between the Company and HSBC, the Company sold substantially all of its private label credit card accounts and the related accounts receivable to HSBC. 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.

In connection with the sale, on January 31, 2003 the Company entered into two additional agreements with HSBC: 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 HSBC assumed the servicing on May 14, 2003. HSBC compensated the Company for providing the services during the interim servicing period.

The CCA sets forth the terms and conditions under which HSBC 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 HSBC and remit such payments to HSBC. 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 HSBC, as well as a reduction in selling, general and administrative expenses as a result of outsourcing the credit card servicing to HSBC and a reduction in interest expense arising from reduced line of credit borrowings resulting from the application of the proceeds from the HSBC transaction. The net credit revenues the Company received under the CCA has, to date, approximately equaled 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 the Company finalized an amendment and restatement of the Original GE facility (the "GE facility"). The GE facility provides up to \$165.0 million of working capital financing through February 28, 2009. 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 term loan of \$9.0 million. Borrowings under the revolving credit facility are limited to the sum of (a) a specified percentage of eligible credit card receivables, 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. As of January 29, 2005, outstanding borrowings under the GE facility totaled \$45.8 million, and excess borrowing availability under the facility, after the deduction of the minimum availability requirement and other reserves, totaled \$56.7 million.

In connection with the extension of the GE facility, the subordinated note in the principal amount of \$21.2 million at January 29, 2005 with an affiliate was extended through May 30, 2009 and provides for payment of up to \$8.0 million of principle balance through that date, subject to certain minimum excess availability requirements under the GE facility.

In January 2005 the Company amended the GE facility to provide for a springing lock-box

arrangement. Pursuant to guidance in the Financial Accounting Standards Board's Emerging Issues Task Force Issue No. 95-22, "Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include Both a Subjective Acceleration Clause and a Lock-Box Arrangement," the Company has classified all of its revolving credit facility as long-term as of fiscal year ended January 29, 2005. Although the Company has held the intent and ability to maintain this debt outstanding for more than one year, prior to such amendment the Company has classified its borrowings under the facility as a current liability pursuant to such guidance. Accordingly, borrowings under the revolving credit facility as of January 31, 2004 are classified as current liabilities.

As of January 29, 2005, interest charged on amounts borrowed under the revolving portion of the GE facility are at the prime rate (5.25% at January 29, 2005), or at the Company's option, at the applicable LIBOR rate plus 1.50% per annum (4.19% at January 29, 2005), and interest charged on the term loan is a fixed rate of 6.6% per annum. In addition, the Company pays an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the revolving portion of the GE facility. The interest rate applicable to the revolving portion of the GE facility is adjusted upwards or downwards on a quarterly basis based on a pricing matrix which is tied to the Company's daily average excess availability for the preceding fiscal quarter (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 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. 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). As of January 29, 2005, management believes the Company was in compliance with all restrictive financial covenants applicable to the GE facility.

### ***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. The Company has been able to purchase adequate levels of merchandise to support its operations and expects the level of trade credit to be sufficient to support its operations in the foreseeable future. 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.

Due to low liquidity levels during fiscal 2002 and 2003 unsecured credit granted by key factors, which can represent over 50% of total trade credit granted to the Company, was 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, the Harris Company, a subsidiary of El Corte Ingles and an affiliate of the Company, agreed to provide a short-term credit enhancement to the revolving line of credit under the terms of a Credit Facilitation Agreement (the "CFA") entered into with the Company on February 22, 2002. The CFA was terminated as a result of the closing of the sale of receivables to HSBC. As a result of continued improvements in the Company's operations and liquidity position, including sale of receivables to HSBC and 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 unsecured credit lines with all of the Company's key factors and many of the Company's unsecured suppliers are sufficient to provide an adequate level of merchandise to support the Company's operations.

### ***Other Financings***

On February 14, 2005, the Company amended and extended the financing of its ownership interest in the partnership that owns the Company's corporate headquarters building. The related note payable of \$3.7 million, which originally provided for interest only payments at a variable rate of interest of prime plus 1.5% per annum, and was due in full upon maturity on May 24, 2005, has been modified to a fully amortizing note bearing interest at a fixed rate of 7.50% per annum and maturing on February 24, 2010. There is no prepayment penalty associated with the note.

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 2004, totaling \$13.7 million, were primarily related to the renovation, refixturing, and expansion of certain existing locations, and to certain information system enhancements. In July of fiscal 2004 the Company entered into an agreement to open one new concept store in the River Park area of Fresno, California. The anticipated completion date of the project is August 2005 with an estimated net cost to the Company of approximately \$4.5 million. On April 15, 2005 the Company also opened a new store in Albany, Oregon at a total cost to the Company of approximately \$1.2 million.

As of January 29, 2005, the Company had issued a total of \$3.3 million of standby letters of credit and documentary letters of credit totaling \$2.1 million. The standby letters of credit were issued to provide collateral for workers compensation insurance policies. 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:**

<b>Payments due by period (1)</b>						
<b>(In thousands)</b>						
	<b>Fiscal 2005</b>	<b>Fiscal 2006</b>	<b>Fiscal 2007</b>	<b>Fiscal 2008</b>	<b>Fiscal 2009</b>	<b>There- after</b>
Long-term debt .....	\$ 1,525	\$ 1,597	\$ 1,702	\$ 1,786	\$ 1,710	\$ 14,865
Capitalized lease obligations.....	2,205	1,466	947	476	476	2,204
Subordinated note payable to affiliate (2).....	1,000	1,000	1,000	2,000	16,180	
Non-cancelable operating leases.....	23,169	22,772	19,475	17,570	15,013	75,700
Purchase obligations (3).....	6,416	439	183	141	115	358
Total contractual cash obligations.....	<u>\$ 34,315</u>	<u>\$ 27,274</u>	<u>\$ 23,307</u>	<u>\$ 21,973</u>	<u>\$ 33,494</u>	<u>\$ 93,127</u>

<b>Amount of commitment expiration by period</b>						
<b>(In thousands)</b>						
	<b>Fiscal 2005</b>	<b>Fiscal 2006</b>	<b>Fiscal 2007</b>	<b>Fiscal 2008</b>	<b>Fiscal 2009</b>	<b>There- after</b>
Senior revolving credit facility (4).....	\$	\$	\$	\$	\$ 45,753	\$
Standby letters of credit.....	3,250					
Documentary letters of credit.....	2,107					
	<u>\$ 5,357</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$ 45,753</u>	<u>\$</u>

(1) See Notes 5, 6 and 7 to the accompanying financial statements.

(2) In connection with the amendment of the Company's revolving credit facility, the term of the Subordinated Note was extended to May 2009 and provides for principal payments of up to \$8 million through that date.

(3) 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, and construction obligations.

(4) Represents outstanding borrowings under the Company's senior revolving credit facility as of January 29, 2005. The table presents that amount as due at February 28, 2009, the end of the commitment period for the facility.

In the ordinary course of business, the Company enters into arrangements with vendors to purchase merchandise up to twelve months in advance of expected delivery. These purchase orders do not contain any significant termination payments or other penalties if cancelled.

Cash generated by operations, together with liquidity provided by the GE facility, the CCA and other financial resources are expected to adequately finance the Company's planned cash requirements for fiscal 2005.

### **Recently Issued Accounting Standards**

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs – An Amendment of ARB No. 43, Chapter 4." This statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) and is effective for fiscal years beginning after June 15, 2005. The Company does not anticipate that the adopting of this statement will have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). This statement is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Under the provisions of this statement, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition alternatives include retrospective and prospective adoption methods. Under the retrospective method, prior periods may be restated based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either for all periods presented or as of the beginning of the year of adoption. The prospective method requires that compensation expense be recognized beginning with the effective date, based on the requirements of this statement, for all share-based payments granted after the effective date, and based on the requirements of SFAS 123, for all awards granted to employees prior to the effective date of this statement that remain unvested on the effective date. The provisions of this statement are effective as of the beginning of the first annual reporting period that begins after June 15, 2005. The Company is currently evaluating the requirements of this revision and has not determined its method of adoption.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions." This statement eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, and replaces it with an exception for exchanges that do not have commercial substance. The provisions of the statement are effective for fiscal periods beginning after June 15, 2005. The Company does not anticipate that the adopting of this statement will have a material impact on the Company's consolidated financial position, results of operations or cash flows.

### **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 2004 and 2003 (in thousands, except per share data). Summarized quarterly financial information in fiscal 2003 and the first three quarters of fiscal 2004 have been restated to reflect the correction of an error related to lease accounting as discussed in Note 16 to the accompanying financial statements.

**2004**

<b>Quarter Ended</b>					<b>May 1</b>	<b>July 31</b>	<b>October 30</b>	<b>January 29</b>
Net sales from continuing operations.....	\$	144,533	\$	147,776	\$	147,893	\$	221,790
Gross profit.....		49,714		52,292		52,472		75,387
Income (loss) from continuing operations as previously reported.....		(2,088)		350		(1,391)		8,822
Income (loss) from continuing operations (as restated).....		(2,216)		224		(1,529)		8,822
Discontinued operations, net of tax.....		(20)		--		--		--
Net income (loss) as previously reported.....		(2,108)		350		(1,391)		8,822
Net income (loss) (as restated).....		(2,236)		224		(1,529)		8,822
Net income (loss) per common share Basic								
Income (loss) from continuing operations as previously reported.....	\$	(0.16)	\$	0.03	\$	(0.11)	\$	0.68
Income (loss) from continuing operations (as restated).....	\$	(0.17)	\$	0.02	\$	(0.12)	\$	0.68
Discontinued operations.....	\$	--	\$	--	\$	--	\$	--
Net income (loss) as previously reported.....	\$	(0.16)	\$	0.03	\$	(0.11)	\$	0.68
Net income (loss)(as restated).....	\$	(0.17)	\$	0.02	\$	(0.12)	\$	0.68
Diluted								
Income (loss) from continuing operations as previously reported.....	\$	(0.16)	\$	0.03	\$	(0.11)	\$	0.65
Income (loss) from continuing operations (as restated).....	\$	(0.17)	\$	0.02	\$	(0.12)	\$	0.65
Discontinued operations.....	\$	--	\$	--	\$	--	\$	--
Net income (loss) as previously reported.....	\$	(0.16)	\$	0.03	\$	(0.11)	\$	0.65
Net income (loss)(as restated).....	\$	(0.17)	\$	0.02	\$	(0.12)	\$	0.65
Weighted-average number of common shares outstanding:								
Basic.....		12,883		12,904		12,927		12,976
Diluted.....		12,883		13,266		12,927		13,552

**2003**

<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	\$ 227,614
Gross profit.....	46,575	53,455	50,916	74,258
Income (loss) from continuing operations as previously reported.....	(3,563)	334	(2,590)	8,571
Income (loss) from continuing operations (as restated).....	(3,683)	206	(2,720)	8,433
Discontinued operations, net of tax.....	(424)	(307)	(23)	(128)
Net income (loss) as previously reported.....	(3,987)	27	(2,613)	8,443
Net income (loss) (as restated).....	(4,107)	(101)	(2,743)	8,305
Net income (loss) per common share Basic				
Income (loss) from continuing operations as previously reported.....	\$ (0.28)	\$ 0.03	\$ (0.20)	\$ 0.67
Income (loss) from continuing operations (as restated).....	\$ (0.29)	\$ 0.02	\$ (0.21)	\$ 0.66
Discontinued operations.....	\$ (0.03)	\$ (0.03)	\$ --	\$ (0.01)
Net income (loss) as previously reported.....	\$ (0.31)	\$ --	\$ (0.20)	\$ 0.66
Net income (loss)(as restated).....	\$ (0.32)	\$ (0.01)	\$ (0.21)	\$ 0.65
Diluted				
Income (loss) from continuing operations as previously reported.....	\$ (0.28)	\$ 0.03	\$ (0.20)	\$ 0.66
Income (loss) from continuing operations (as restated).....	\$ (0.29)	\$ 0.02	\$ (0.21)	\$ 0.65
Discontinued operations.....	\$ (0.03)	\$ (0.03)	\$ --	\$ (0.01)
Net income (loss) as previously reported.....	\$ (0.32)	\$ --	\$ (0.20)	\$ 0.65
Net income (loss)(as restated).....	\$ (0.32)	\$ (0.01)	\$ (0.21)	\$ 0.64
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

## **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 29, 2005, 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 29, 2005, borrowings subject to a variable interest rate, represented 52.3% 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 52 basis points on existing floating rate borrowings (a 10% change from the Company's weighted-average interest rate as of January 29, 2005) would reduce the Company's pre-tax net income and cash flow by approximately \$0.4 million. This 52 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 accompanying 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), with the participation of the Company's management, have carried out an evaluation of the effectiveness of the Company's "disclosure controls and procedures," as of January 29, 2005.

As discussed in Note 16 to the accompanying consolidated Financial Statements, as a result of the February 7, 2005 letter issued by the Chief Accountant of the Securities and Exchange

Commission, we reviewed our policy related to the accounting for operating leases and the depreciable lives of related leasehold improvements. We determined that our policy should be corrected to adjust depreciation expense to correct the depreciable lives being used for certain leasehold costs and improvements, and to correct the recording of certain tenant allowances and construction reimbursements, as reductions in rent expense that had previously been recorded as reductions in the cost of the underlying constructed assets. In addition, the corrections include adjusting lease terms of certain leases to include bargain renewal option periods where exercise of the options would be reasonably assured, and recognizing the straight-line effect over the lease term of such changes in rents during the option periods. As a result, the Company restated its consolidated financial statements for each of the fiscal years ended January 31, 2004 and February 1, 2003, and its summary financial information in each of fiscal 2000 through 2003, included in this Annual Report on Form 10K.

After considering the underlying conditions that gave rise to the restatement discussed above, the Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K, were not effective in ensuring that material information relating to the Company, required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

#### **Changes in Internal Control Over Financial Reporting**

During the fourth quarter of fiscal 2004, there were no significant changes in the Company's internal controls over financial reporting or in other factors that could significantly affect internal controls over financial reporting.

During the first quarter of 2005, the Company remediated the material weakness in internal control over financial reporting and the ineffectiveness of its disclosure controls and procedures by conducting a review of its accounting related to leases, and correcting its method of accounting for tenant improvement allowances, lease terms and depreciable lives used for leasehold costs and improvements.

The evaluation referred to above did not identify any other significant change in our internal control over financial reporting that occurred during the period covered by this Annual Report on Form 10-K that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **PART III**

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

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 23, 2005, to be filed pursuant to Regulation 14A (the "2004 Proxy") under the headings "Nominees for Election as Director" and "Section 16(a) Beneficial Ownership Reporting Compliance."

As of March 31, 2005, 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	52	President and Chief Executive Officer
Gary L. Gladding	64	Executive Vice President/General Merchandise Manager
J. Gregory Ambro	52	Senior Vice President/Chief Administrative and Financial Officer
Michael J. Schmidt	63	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 2005 Proxy under the headings "Executive Compensation" and "Director Compensation for Fiscal Year 2004."

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

The information required by this item is incorporated by reference from the portion of the Company's 2005 Proxy under the heading "Security Ownership of Certain Beneficial Owners and Management" and Item 5. Market for Registrant's Common Equity, Related Stockholder matters and Issuer Purchases of Equity Securities in this report on Form 10-K.

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

The information required by this item is incorporated by reference from the portion of the Company's 2005 Proxy under the heading "Certain Relationships and Related Transactions."

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

The information required by this item is incorporated by reference from the portion of the Company's 2005 Proxy under the heading "Information on Independent Public Accountants".

**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:

Report of Independent Registered Public Accounting Firm

Consolidated balance sheets - As of January 29, 2005 and January 31, 2004 (as restated)

Consolidated statements of operations -- Fiscal years ended January 29, 2005, January 31, 2004 (as restated) and February 1, 2003 (as restated)

Consolidated statements of stockholders' equity -- Fiscal years ended January 29, 2005, January 31, 2004 (as restated) and February 1, 2003 (as restated)

Consolidated statements of cash flows -- Fiscal years ended January 29, 2005, January 31, 2004 (as restated) and February 1, 2003 (as restated)

Notes to consolidated financial statements

(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) and (b) 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	Registration Statement on Form S-1 (File No. 33-3949)
3.2	By-Laws of the Registrant	Annual Report on Form 10-K for the year ended February 3, 2001 (File No. 1-09100)
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)

	dated August 20, 1998 re: Antelope Valley Mall at Palmdale, California	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 Credit Receivables Corporation	Current Report on Form 8-K dated January 31, 2003
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

	January 30, 2003 by and between Gottschalks Inc. and Kimco Capital Corp.	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.	Consent of Independent Registered Public Accounting Firm	Filed electronically herewith
31.1	Rule 13a - 14(a) Certification of Chief Executive Officer	Furnished concurrently herewith
31.2	Rule 13a - 14(a) Certification of Chief Financial Officer	Furnished concurrently herewith
32.1	Certification of President and Chief Executive Officer and Chief Administrative Officer Pursuant to 18 U.S.C. § 1350, As Adopted Pursuant to § 906 of the Sarbanes-Oxley Act of 2002.	Furnished concurrently 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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**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 29, 2005**

**GOTTSCHALKS INC. AND SUBSIDIARY**

**FRESNO, CALIFORNIA**



## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

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 29, 2005 and January 31, 2004, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three fiscal years in the period ended January 29, 2005. 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 standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 29, 2005 and January 31, 2004, and the results of their operations and their cash flows for each of the three fiscal years in the period ended January 29, 2005 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 16, the Company's fiscal 2003 and 2002 consolidated financial statements have been restated.

/s/ Deloitte & Touche LLP

Fresno, California  
April 29, 2005

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

	<u>January 29, 2005</u>	<u>January 31, 2004</u> (As Restated) (See Note 16)
<u>ASSETS</u>		
CURRENT ASSETS:		
Cash.....	\$ 5,470	\$ 5,172
Receivables - net.....	6,920	9,145
Merchandise inventories.....	152,753	156,552
Other.....	9,669	10,849
Total current assets.....	174,812	181,718
PROPERTY AND EQUIPMENT - net.....	126,509	127,561
OTHER ASSETS:		
Goodwill - net.....	7,501	7,501
Other intangibles - net.....	652	689
Other.....	6,101	4,730
	14,254	12,920
	<u>\$ 315,575</u>	<u>\$ 322,199</u>
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
CURRENT LIABILITIES:		
Trade accounts payable and accrued expenses.....	\$ 75,414	\$ 67,467
Revolving line of credit.....		51,009
Current portion of long-term debt.....	1,525	1,789
Current portion of capitalized lease obligations.....	1,717	1,936
Deferred income taxes.....	1,717	1,073
Total current liabilities.....	80,373	123,274
LONG-TERM OBLIGATIONS, less current portion.....	71,403	41,302
OTHER LIABILITIES.....	18,298	18,228
DEFERRED INCOME TAXES.....	11,965	10,847
SUBORDINATED NOTE PAYABLE TO AFFILIATE - net.....	21,180	22,180
COMMITMENTS AND CONTINGENCIES (Notes 7 and 15)		
STOCKHOLDERS' EQUITY:		
Common stock, par value of \$.01 per share; 30,000,000 shares authorized; 12,955,935 and 12,878,802 issued.....	130	129
Additional paid-in capital.....	72,146	71,440
Retained earnings.....	40,080	34,799
	112,356	106,368
	<u>\$ 315,575</u>	<u>\$ 322,199</u>

See notes to consolidated financial statements.

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

	Fiscal Years Ended		
	January 29, 2005	January 31, 2004 (As Restated) (See Note 16)	February 1, 2003 (As Restated) (See Note 16)
Net sales.....	\$ 661,992	\$ 660,574	\$ 665,916
Net credit revenues.....	3,106	3,729	8,225
Net leased department revenues.....	3,515	3,525	3,557
Total revenues.....	<u>668,613</u>	<u>667,828</u>	<u>677,698</u>
Costs and expenses:			
Cost of sales.....	432,128	435,370	441,426
Selling, general and administrative expenses.....	206,897	203,448	207,367
Depreciation and amortization.....	13,325	14,497	14,633
Asset impairment charges.....			9,502
Receivables sale costs.....			1,749
Total costs and expenses.....	<u>652,350</u>	<u>653,315</u>	<u>674,677</u>
Operating income.....	16,263	14,513	3,021
Other (income) expense:			
Interest expense.....	9,509	13,296	15,883
Losses on early extinguishment of debt.....			3,695
Miscellaneous income.....	(1,565)	(2,262)	(1,802)
	<u>7,944</u>	<u>11,034</u>	<u>17,776</u>
Income (loss) from continuing operations before income tax (benefit).....	8,319	3,479	(14,755)
Income tax expense (benefit).....	3,018	1,243	(6,838)
Income (loss) from continuing operations.....	<u>5,301</u>	<u>2,236</u>	<u>(7,917)</u>
Discontinued operations:			
Loss from operations of closed stores.....	--	(547)	(1,948)
Loss on store closures.....	(31)	(789)	(4,801)
Income tax benefit.....	(11)	(454)	(2,295)
Loss on discontinued operations.....	<u>(20)</u>	<u>(882)</u>	<u>(4,454)</u>
Net income (loss).....	<u>\$ 5,281</u>	<u>\$ 1,354</u>	<u>\$ (12,371)</u>
Net income (loss) per common share:			
Basic			
Income (loss) from continuing operations.....	\$ 0.41	\$ 0.17	\$ (0.62)
Loss on discontinued operations.....	\$ (0.00)	\$ (0.07)	\$ (0.35)
Net income (loss) per common share.....	\$ 0.41	\$ 0.10	\$ (0.97)
Diluted			
Income (loss) from continuing operations.....	\$ 0.40	\$ 0.17	\$ (0.62)
Loss on discontinued operations.....	\$ (0.00)	\$ (0.07)	\$ (0.35)
Net income (loss) per common share.....	\$ 0.40	\$ 0.10	\$ (0.97)
Weighted average number of common shares outstanding			
Basic.....	12,922	12,830	12,747
Diluted.....	13,352	12,919	12,747

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>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-in</u>	<u>Earnings</u>	
			<u>Capital</u>		
BALANCE, FEBRUARY 2, 2002					
(As previously reported, see Note 16).....	12,726,364	\$ 127	\$ 71,189	\$ 46,856	\$ 118,172
Prior period adjustment.....				(1,040)	(1,040)
BALANCE, FEBRUARY 2, 2002					
(As restated, see Note 16).....	12,726,364	127	71,189	45,816	117,132
Net loss (as restated, See Note 16).....				(12,371)	(12,371)
Shares issued under stock purchase plan and related tax benefit.....	75,305	1	124		125
BALANCE, FEBRUARY 1, 2003					
(As restated, see Note 16).....	12,801,669	128	71,313	33,445	104,886
Net income (as restated, see Note 16).....				1,354	1,354
Issuance of common stock pursuant to nonqualified stock purchase plan and related tax benefit.....	9,000		27		27
Shares issued under stock purchase plan and related tax benefit.....	68,133	1	100		101
BALANCE, JANUARY 31, 2004					
(As restated, see Note 16).....	12,878,802	129	71,440	34,799	106,368
Net income.....				5,281	5,281
Issuance of common stock pursuant to nonqualified stock purchase plan and related tax benefit.....	132,250	1	634		635
Shares issued under stock purchase plan and related tax benefit.....	19,217		72		72
BALANCE, JANUARY 29, 2005.....	<u>13,030,269</u>	<u>\$ 130</u>	<u>\$ 72,146</u>	<u>\$ 40,080</u>	<u>\$ 112,356</u>

See notes to consolidated financial statements.

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

	<b>Fiscal Years Ended</b>		
	<b>January 29, 2005</b>	<b>January 31, 2004</b>	<b>February 1, 2003</b>
		(As restated) (See Note 16)	(As restated) (See Note 16)
<b>OPERATING ACTIVITIES:</b>			
Net income (loss).....	\$ 5,281	\$ 1,354	\$ (12,371)
Adjustments:			
Depreciation and amortization.....	13,326	14,569	15,518
Deferred income taxes.....	1,761	24	(2,955)
Amortization of deferred income and other deferred items.....	69	(2,446)	436
Net proceeds from sale of credit card accounts receivable.....	--	--	26,233
Provision for credit losses.....	--	200	825
Asset impairment charges.....	--	--	10,867
Store closure costs.....	31	789	3,762
Net loss on sales of stores.....	--	--	(326)
Net loss from sale of assets.....	16	59	131
Other non-cash items, net.....	(31)	(968)	(139)
Changes in assets and liabilities:			
Receivables.....	2,225	1,295	(7,051)
Merchandise inventories.....	5,287	9,332	(2,370)
Other current and long-term assets.....	779	3,515	9,184
Trade accounts payable and accrued expenses.....	8,005	(5,842)	5,950
Other current and long-term liabilities.....	1,787	1,181	(4,669)
Net cash provided by operating activities.....	<u>38,536</u>	<u>23,062</u>	<u>43,025</u>
<b>INVESTING ACTIVITIES:</b>			
Purchases of property and equipment.....	(13,745)	(4,363)	(8,279)
Proceeds from sale of lease rights, fixtures and equipment.....	3	27	1,010
Proceeds from investment in limited partnership.....	91	352	216
Net cash used in investing activities.....	<u>(13,651)</u>	<u>(3,984)</u>	<u>(7,053)</u>
<b>FINANCING ACTIVITIES:</b>			
Net proceeds (repayments) from new revolving credit facility.....	(14,256)	(7,836)	(37,062)
Proceeds from sale and leaseback transactions.....	--	--	1,334
Proceeds from long-term obligations.....	9,000	--	20,010
Principal payments on long-term obligations.....	(17,135)	(4,568)	(14,737)
Changes in cash management liability.....	(1,843)	(7,845)	(1,195)
Debt issuance costs.....	(1,060)	--	(973)
Proceeds from exercise of options.....	635	27	--
Proceeds from sale of stock under employee stock purchase plans.....	72	101	125
Net cash (used in) financing activities.....	<u>(24,587)</u>	<u>(20,121)</u>	<u>(32,498)</u>
<b>INCREASE (DECREASE) IN CASH.....</b>	<u>298</u>	<u>(1,043)</u>	<u>3,474</u>
<b>CASH AT BEGINNING OF YEAR.....</b>	<u>5,172</u>	<u>6,215</u>	<u>2,741</u>
<b>CASH AT END OF YEAR.....</b>	<u><u>\$ 5,470</u></u>	<u><u>\$ 5,172</u></u>	<u><u>\$ 6,215</u></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 29, 2005, 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 6 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 accounting principles generally accepted in the United States 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") for the year ended February 1, 2003. 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 2004, 2003 and 2002 ended on January 29, 2005, January 31, 2004 and February 1, 2003, respectively. Fiscal 2004, 2003 and 2002 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. The Company's policy with respect to gift certificates is to record revenue as the certificates are redeemed for merchandise. Prior to their redemption, the certificates are recorded as a liability. A reserve for estimated returns is established when sales are recorded.

Net leased department revenues consist of rental income from lessees and sub-lessees. Sales generated in such leased departments totaled \$24,295,000, \$24,460,000 and \$24,878,000 in 2004, 2003 and 2002, 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. (now "HSBC") (Note 2).

At that time the Company also entered into an interim servicing agreement to service the receivables on behalf of HSBC 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 \$313,000 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.

Receivables - As of January 29, 2005 and January 31, 2004 , receivables consist of vendor claims of \$7,010,000, less allowances of \$90,000, and vendor claims of \$9,426,000, less allowances of \$281,000, 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 29, 2005 and January 31, 2004 . The Company includes in inventory the capitalization of certain indirect buying handling and distribution costs to better match these costs with the related sales.

Under the retail inventory method, inventory is segregated into departments of merchandise having similar characteristics, and is stated at its current retail selling value. Inventory retail values are converted to a cost basis by applying specific average cost factors for each merchandise department. Cost factors represent the average cost-to-retail ratio for each merchandise department based on beginning inventory and the fiscal year purchase activity. The retail inventory method inherently requires management judgments and estimates, such as the amount and timing of permanent markdowns to clear unproductive or slow-moving inventory,

which may impact the ending inventory valuation as well as gross margins.

Permanent markdowns designated for clearance activity are recorded when the utility of the inventory has diminished. Factors considered in the determination of permanent markdowns include current and anticipated demand, customer preferences, age of the merchandise and fashion trends. When a decision is made to permanently mark down merchandise, the resulting gross margin reduction is recognized in the period the markdown is recorded.

Shrinkage is estimated as a percentage of sales for the period from the last inventory date to the end of the fiscal period. Such estimates are based on experience and the most recent physical inventory results. Physical inventories are taken within each merchandise department annually and inventory records are adjusted accordingly.

The Company receives cash or allowances from merchandise vendors as purchase price adjustments and in connection with cooperative advertising programs. Purchase price adjustments are generally credited to cost of sales and cooperative advertising allowances are generally credited against advertising expense in accordance with Emerging Issues Task Force (“EITF”) Issue No. 02-16, “Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor.”

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 - Depreciation of owned properties is provided primarily on a straight-line basis over the estimated asset lives, which range from 15 to 40 years for buildings and leasehold improvements and 3 to 15 years for furniture, fixtures and equipment. Buildings on leased land and leasehold improvements are amortized over the shorter of their economic lives or the lease term, beginning on the date the asset is put into use. The lease term, which includes all renewal periods that are considered to be reasonably assured, begins on the date the Company has access to the leased property. 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 statement of operations.

Operating Leases - The Company recognizes operating lease minimum rentals on a straight-line basis over the lease term. The Company receives contributions from landlords to fund buildings and leasehold improvements. Such contributions are recorded as deferred rent and amortized as reductions to lease expense over the lease term. Executory costs such as real estate taxes and maintenance, and contingent rentals such as those based on a percentage of sales are recognized as incurred. The lease term, which includes all renewal periods that are considered to be reasonably assured, begins on the date the Company has access to the leased property. Deferred



lease payments totaling \$3,431,000 at January 29, 2005 and \$4,401,000 at January 31, 2004, are included in other liabilities.

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 2004, 2003 and 2002 totaled \$74,000, \$29,000 and \$673,000 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 \$428,000, \$408,000 and \$260,000 in fiscal 2004, 2003 and 2002 respectively.

Goodwill – Goodwill and intangible assets having indefinite lives are not being amortized to earnings, but instead are subject to periodic testing for impairment. Goodwill and other intangible assets of a reporting unit are tested for impairment on an annual basis and more frequently if certain indicators are encountered. The Company has performed the required annual impairment review of goodwill for each of the fiscal years reported and concluded that there was no indication of impairment 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 20 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 lease incentives received to construct a store and enter into a lease arrangement, and the prepaid program fee arising from the receivables sale to HSBC. 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. Lease incentives are amortized as reductions in rent expense over the lease term which includes all renewal periods that are considered to be reasonably assured. 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 \$11,832,000 and \$13,335,000 as of January 29, 2005 and January 31, 2004 respectively, is included in other long-term liabilities.

Advertising Costs – Advertising costs, net of cooperative advertising allowances, totaling \$29,964,000, \$30,597,000 and \$31,245,000 in 2004, 2003 and 2002, respectively, are included in selling, general and administrative expenses for financial reporting purposes and are expensed when the related advertisement first takes place.

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 29, 2005, the Company has two stock-based employee compensation plans, which are more fully described in Note 12. 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 12.

<b>(In thousands, except per share data)</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
Net income (loss) as reported.....	\$ 5,281	\$ 1,354	\$ (12,371)
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects.....	(308)	(99)	(347)
Pro forma net income (loss).....	<u>\$ 4,973</u>	<u>\$ 1,255</u>	<u>\$ (12,718)</u>
Earnings (loss) per share:			
As reported:			
Basic.....	\$ 0.41	\$ 0.10	\$ (0.97)
Diluted.....	\$ 0.40	\$ 0.10	\$ (0.97)
Pro-forma:			
Basic.....	\$ 0.38	\$ 0.10	\$ (1.00)
Diluted.....	\$ 0.37	\$ 0.10	\$ (1.00)

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

2004 or 2003. In 2002, the Company recognized asset impairment charges of \$9,502,000 relating to underperforming stores (Note 9) and \$4,523,000 in connection with stores closed during fiscal 2003 and 2002 (Note 8).

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, were material to the Company's results of operations taken as a whole. Accordingly, as prescribed by Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets," results of operations of stores closed during 2003 and 2002 are excluded from continuing operations and reported separately in discontinued operations for all periods affected.

Fair Value of Financial Instruments - The carrying value of the Company's cash and cash management liability, receivables, 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 \$23,186,000 and \$37,464,000 at January 29, 2005 and January 31, 2004, had estimated fair values of \$25,033,000 and \$39,712,000 at January 29, 2005 and January 31, 2004, respectively.

Segment Reporting – The Company operates in one reportable segment.

Comprehensive Income – There were no items of other comprehensive income in 2004, 2003 or 2002, and therefore net income is equal to comprehensive income for each of those years.

Recently Issued Accounting Standards - In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 151, "Inventory Costs – An Amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4." This statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) and is effective for fiscal years beginning after June 15, 2005. The Company does not anticipate that the adoption of this statement will have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). This statement is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Under the provisions of this statement, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition alternatives include retrospective and prospective adoption methods. Under the retrospective method, prior periods may be restated based on the amounts previously recognized under SFAS 123 for

purposes of pro forma disclosures either for all periods presented or as of the beginning of the year of adoption. The prospective method requires that compensation expense be recognized beginning with the effective date, based on the requirements of this statement, for all share-based payments granted after the effective date, and based on the requirements of SFAS 123, for all awards granted to employees prior to the effective date of this statement that remain unvested on the effective date. The provisions of this statement are effective as of the beginning of the first annual reporting period that begins after June 15, 2005. The Company is currently evaluating the requirements of this revision and has not determined the impact of adopting this standard.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions." This statement eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, and replaces it with an exception for exchanges that do not have commercial substance. The provisions of the statement are effective for fiscal periods beginning after June 15, 2005. The Company does not anticipate that the adoption of this statement will have a material impact on the Company's consolidated financial position, results of operations or cash flows.

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 2003 and 2002 consolidated financial statements have been reclassified to conform with the 2004 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 HSBC, the Company sold substantially all of its private label credit card accounts and the related accounts receivable to HSBC. 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 HSBC: 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 HSBC 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 HSBC 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 HSBC and remit such payments to HSBC. 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 in 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 \$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 in 2002 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. 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.

### *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>2004</b>	<b>2003</b>	<b>2002</b>
Service charge revenues.....	\$ 2,955	\$ 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.....	151	305	(4,821)
Gain on sale of receivables.....			96
	<u>\$ 3,106</u>	<u>\$ 3,729</u>	<u>\$ 8,225</u>

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

Property and equipment consists of the following:

<b>(In thousands)</b>	<b>January 29, 2005</b>	<b>January 31, 2004</b>
Furniture, fixtures and equipment.....	\$ 100,871	\$ 95,839
Buildings and leasehold improvements.....	92,974	90,306
Land.....	15,185	15,185
Buildings and equipment under capital leases.....	18,720	18,720
Construction in progress.....	<u>7,095</u>	<u>1,141</u>
	234,845	221,191
Less accumulated depreciation and amortization.....	<u>(108,336)</u>	<u>(93,630)</u>
	<u>\$ 126,509</u>	<u>\$ 127,561</u>

#### 4. TRADE ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Trade accounts payable and accrued expenses consist of the following:

<b>(In thousands)</b>	<b>January 29, 2005</b>	<b>January 31, 2004</b>
Trade accounts payable.....	\$ 24,548	\$ 20,035
Cash management liability.....	5,483	7,326
Accrued expenses.....	23,385	19,673
Accrued payroll and related liabilities.....	8,139	7,718
Taxes, other than income taxes.....	12,059	12,059
Federal and state income taxes payable.....	1,801	656
	<u>\$ 75,415</u>	<u>\$ 67,467</u>

#### 5. 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 the Company finalized an amendment and restatement of the Original GE facility (the "GE facility"). The GE facility provides up to \$165.0 million of working capital financing through February 28, 2009. 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 term loan of \$9.0 million. Borrowings under the revolving credit facility are limited to the sum of (a) a specified percentage of eligible credit card receivables, 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. As of January 29, 2005, outstanding borrowings under the GE facility totaled \$45.8 million, and excess borrowing availability under the facility, after the deduction of the minimum availability requirement and other reserves, totaled \$56.7 million.

In January 2005 the Company amended the GE facility to provide for a springing a lock-box arrangement. Pursuant to guidance in the Financial Accounting Standards Board's Emerging Issues Task Force Issue No. 95-22, "Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include Both a Subjective Acceleration Clause and a Lock-Box Arrangement," the Company has classified all of its revolving credit facility as long-term as of fiscal year ended January 29, 2005. Although the Company has held the intent and ability to maintain this debt outstanding for more than one year, prior to such amendment the Company has classified its borrowings under the facility as a current liability pursuant to such guidance. Accordingly, borrowings under the revolving credit facility as of January 31, 2004, and February 1, 2003 are classified as current liabilities.

As of January 29, 2005, interest charged on amounts borrowed under the revolving portion of the GE facility are at the prime rate (5.25% at January 29, 2005), or at the Company's option, at the applicable LIBOR rate plus 1.5% per annum (4.19% at January 29, 2005), and interest charged

on the term loan is a fixed rate of 6.6% per annum. In addition, the Company pays an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the revolving portion GE facility. The interest rate applicable to the revolving portion of the GE facility is adjusted upwards or downwards on a quarterly basis based on a pricing matrix which was tied to the Company's daily average excess availability for the preceding fiscal quarter (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 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. 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). As of January 29, 2005, management believes the Company was in compliance with all restrictive financial covenants applicable to the GE facility.

### *Long-Term Obligations*

Long-term obligations consist of the following:

<b>(In thousands)</b>	<b>January 29, 2005</b>	<b>January 31, 2004</b>
Revolving line of credit.....	\$ 45,753	\$ --
9.39% mortgage loans payable, due 2010.....	17,059	17,513
12.0% note payable.....	--	13,240
Capital lease obligations.....	5,707	7,643
Variable rate note payable, due 2005.....	3,700	3,700
Other mortgage loans and notes payable.....	2,426	2,931
	<u>74,645</u>	<u>45,027</u>
Less current portion.....	3,242	3,725
	<u>\$ 71,403</u>	<u>\$ 41,302</u>

On February 14, 2005, the Company amended and extended the financing of its ownership interest in the partnership that owns the Company's corporate headquarters building. The related note payable of \$3.7 million, which originally provided for interest only payments at a variable rate of interest of prime plus 1.5% per annum, and was due in full upon maturity on May 24, 2005, has been modified to a fully amortizing note bearing interest at a fixed rate of 7.50% per annum and maturing on February 24, 2010. There is no prepayment penalty associated with the note.



The scheduled annual principal maturities of the Company's mortgage loans and notes payable are \$1,525,000, \$1,597,000, \$1,702,000, \$1,786,000 and \$1,710,000 for 2005 through 2009, with \$14,865,000 payable thereafter.

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 \$2,251,000 at January 29, 2005 and \$2,475,000 at January 31, 2004.

Interest paid, net of amounts capitalized, was \$8,075,000 in 2004, \$11,140,000 in 2003, and \$18,041,000 in 2002. No interest was capitalized in 2004 or 2003. Interest of \$159,000 was capitalized in 2002. The weighted-average interest rate charged on the Company's revolving line of credit was 4.56 in 2004, 5.16% in 2003, and 5.47% in 2002.

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. The Company was in compliance with all applicable financial covenants as of January 29, 2005.

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

The Company issued a Subordinated Note to Harris, a wholly owned subsidiary of El Corte Ingles ("ECI") of Spain, in the principal amount of \$22,179,000 on August 20, 1998 as partial consideration for the Harris acquisition (the "Original Note"). (See Note 14.) The Original Note, discounted to an effective interest rate of 10% at issuance, bore interest at a fixed rate of 8%. On December 7, 2004 a new Subordinated Note due May 30, 2009 superseded the Original Note. The new Subordinated Note bears interest at a fixed rate of 8% payable semi-annually and provides for principal payments of up to \$8.0 million prior to its maturity. Such payments are subject to certain liquidity restrictions under the GE facility. The Company made principal payments of \$1.0 million each upon execution of the note and subsequent to fiscal year end on February 20, 2005 as scheduled. Additional principal payments of \$1.0 million are scheduled for each of February 2006 and 2007 and principal payments of \$2.0 million are scheduled for each of February 2008 and 2009, with the balance due at maturity subject to the payment in full of the GE facility. 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. Interest paid to Harris totaled \$1,774,400 in 2004, 2003 and 2002.

## **7. 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 2020. 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 14.) Rent paid or accrued to ECI totaled \$856,000 in 2004, \$859,000 in 2003, and \$864,000 in 2002.

Future minimum lease payments as of January 29, 2005, 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:

<b>(In thousands)</b>	<b>Capital Leases</b>	<b>Operating Leases</b>
2005.....	\$ 2,205	\$ 23,169
2006.....	1,466	22,772
2007.....	947	19,475
2008.....	476	17,570
2009.....	476	15,013
Thereafter.....	2,204	75,700
Total minimum lease payments.....	7,774	\$ <u>173,699</u>
Amount representing interest.....	(2,067)	
Present value of minimum lease payments....	5,707	
Less current portion.....	(1,717)	
	<u>\$ 3,990</u>	

Rental expense consists of the following:

<b>(In thousands)</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
Operating leases:			
Buildings:			
Minimum rentals.....	\$ 23,360	\$ 23,125	\$ 23,409
Contingent rentals.....	2,839	2,895	3,016
Fixtures and equipment.....	1,910	1,994	1,618
	<u>\$ 28,109</u>	<u>\$ 28,014</u>	<u>\$ 28,043</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 January 29, 2005.

## 8. 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 and 2002 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 and \$1.9 million in fiscal 2002. 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>2004</b>	<b>2003</b>	<b>2002</b>
Net sales from closed stores.....	\$ --	\$ 6,973	\$ 25,512
Net lease department revenues.....	--	--	--
Total Revenues.....	--	6,973	25,512
Cost of sales.....	--	4,437	15,669
Selling, general and administrative expenses.....	--	3,013	10,906
Depreciation and amortization.....	--	70	885
Total costs and expenses.....	--	7,520	27,460
Loss from operations of closed stores.....	\$ --	\$ (547)	\$ (1,948)

Net costs associated with the closure of stores were minor in fiscal 2004, primarily consisting of incremental costs associated with the closure of one store at January 31, 2004. 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.

As of January 29, 2005, the Company had no reserves for store closure costs. In the event the Company decides to close additional stores in fiscal 2005 or beyond, additional store closure costs, which may be material, may be incurred.

## **9. 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 2004 or 2003.

## 10. INCOME TAXES

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

<b>(In thousands)</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
Current:			
Federal.....	\$ 1,066	\$ 1,848	\$ (4,179)
State.....	<u>180</u>	<u>221</u>	<u>(783)</u>
	1,246	2,069	(4,962)
Deferred:			
Federal.....	1,412	(896)	(2,316)
State.....	<u>360</u>	<u>70</u>	<u>440</u>
	<u>1,772</u>	<u>(826)</u>	<u>(1,876)</u>
	<u>\$ 3,018</u>	<u>\$ 1,243</u>	<u>\$ (6,838)</u>

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

	<b>January 29, 2005</b>		<b>January 31, 2004</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.....	\$ 1,094	\$	\$ 1,036	\$
State income taxes.....	110		74	
LIFO inventory reserve.....		(3,897)		(3,093)
Supplies inventory.....		(647)		(558)
Workers' compensation.....	2,718		1,825	
Valuation Allowance.....	(750)		(494)	
Other items, net.....	<u>1,210</u>	<u>(1,555)</u>	<u>1,448</u>	<u>(1,311)</u>
	4,382	(6,099)	3,889	(4,962)
Long-Term:				
Net operating loss and tax credit carryforwards.....	4,514		5,561	
State income taxes.....	690		567	
Property and equipment.....		(13,326)		(14,437)
Accounting for leases.....		(3,180)		(3,737)
Leasehold interests.....	878		1,911	
Impaired assets.....	1,239		1,450	
Deferred income.....	1,063	(3,812)	1,326	(3,558)
Deferred rent.....	1,206		1,232	
Valuation allowance.....	(1,504)		(1,323)	
Other items, net.....	<u>1,228</u>	<u>(960)</u>	<u>940</u>	<u>(779)</u>
	9,314	(21,278)	11,664	(22,511)
	<u>\$ 13,696</u>	<u>\$ (27,377)</u>	<u>\$ 15,553</u>	<u>\$ (27,473)</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>2004</u>	<u>2003</u>	<u>2002</u>
Statutory rate.....	35.0 %	35.0 %	(35.0)%
State income taxes, net of federal income tax benefit.....	4.3	8.0	(0.9)
General business credits.....	(2.3)	(6.7)	(1.3)
Amortization of goodwill.....			--
Tax refund claims.....		--	(4.0)
Other items, net.....	<u>(0.7)</u>	<u>(0.6)</u>	<u>(5.1)</u>
Effective rate.....	<u>36.3 %</u>	<u>35.7 %</u>	<u>(46.3)%</u>

Realization of the total deferred tax assets of \$13,696,000 is considered more likely than not and is dependent upon generating sufficient taxable income in future periods.

At January 29, 2005, the Company has, for federal tax purposes, general business credits of \$1,191,000 that expire in the years 2018 through 2022, and alternative minimum tax credits of \$699,000 which may be used for an indefinite period. At January 29, 2005, the Company also has, for state tax purposes, \$2,624,000 of enterprise zone credits which may be used for an indefinite period. These carryforwards are available to offset future taxable income. The Company has established valuation allowances of \$2,254,000 and \$1,818,000 at January 29, 2005 and January 31, 2004, respectively, which relate primarily to certain tax credit carryforwards whose realizability is uncertain.

The Company received income tax refunds, net of payments, of \$44,000 in 2004, \$2,164,000 in 2003 and \$1,235,000 in 2002. 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.

## **11. 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>2004</u>	<u>2003</u>	<u>2002</u>
Weighted average number of shares - basic.....	12,922	12,830	12,747
Effect of assumed option exercises.....	<u>430</u>	<u>89</u>	
Weighted average number of shares - diluted.....	<u>13,352</u>	<u>12,919</u>	<u>12,747</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 excluded from the calculation were 496,775, 1,522,568 and 1,685,624 shares as of the end of 2004, 2003 and 2002, respectively.

## **12. 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 29, 2005, options for 594,500 shares were available for future grants under the plans.

Option activity under the plans is as follows:

	<b>2004</b>		<b>2003</b>		<b>2002</b>	
	<b>Number of Shares</b>	<b>Weighted- Average Exercise Price</b>	<b>Number of Shares</b>	<b>Weighted- Average Exercise Price</b>	<b>Number of Shares</b>	<b>Weighted- Average Exercise Price</b>
Options outstanding at beginning of year.....	1,688,500	\$ 5.36	1,713,000	\$ 5.99	1,535,500	\$ 6.68
Granted.....	261,500	6.10	279,500	1.64	295,500	2.61
Exercised.....	(132,250)	3.71	(9,000)	3.03		
Cancelled.....	(270,000)	9.34	(295,000)	5.57	(118,000)	6.42
Options outstanding at end of year.....	<u>1,547,750</u>	<u>\$ 4.96</u>	<u>1,688,500</u>	<u>\$ 5.36</u>	<u>1,713,000</u>	<u>\$ 5.99</u>
Options exercisable at end of year.....	<u>941,375</u>	<u>\$ 5.69</u>	<u>1,067,625</u>	<u>\$ 6.95</u>	<u>1,009,250</u>	<u>\$ 7.47</u>

Options for 942,375, 1,070,625 and 1,010,000 shares were exercisable as of January 29, 2005, January 31, 2004 and February 1, 2004, respectively, and had a weighted average exercise price of \$5.69, \$6.95 and \$7.47 per share, respectively.

Additional information regarding options outstanding as of January 29, 2005 is as follows:

<b>Range of Exercise Prices</b>	<b>Number Outstanding</b>	<b>Weighted- Average Remaining Contractual Life (yrs.)</b>	<b>Weighted- Average Exercise Price</b>
\$1.13 to \$3.28	534,250	7.46	\$ 2.61
\$3.52 to \$6.03	622,000	6.94	\$ 5.04
<u>\$6.19 to \$9.21</u>	<u>391,500</u>	<u>4.10</u>	<u>\$ 8.03</u>
<u>\$1.13 to \$9.21</u>	<u>1,547,750</u>	<u>6.40</u>	<u>\$ 5.69</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 313,460 shares issued through January 29, 2005.



### *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 weighted average fair values of options on their grant date during Fiscal 2004, 2003 and 2002, where the exercise price equaled the market price on the date of grant, were \$6.10, \$1.53 and \$2.61, respectively. The estimated fair value of each option grant is calculated using the Black-Scholes option pricing model with the following weighted average assumptions:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Risk-free interest rate.....	3.4 %	1.3 %	2.3 %
Expected dividend yield.....	--	--	--
Expected volatility.....	55.0 %	57.0 %	57.0 %
Expected option life (years).....	5	5	5
Fair value of options granted.....	\$3.41	\$0.68	\$1.09

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.

### **13. 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 statutory 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 \$1,166,000, \$1,251,000 and \$1,415,000 in expense related to the Plan in 2004, 2003 and 2002, respectively.

### **14. 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 (See Note 6).

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 GE Capital in the amount of \$7.0 million for the purpose of providing additional credit enhancement to the Original 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. 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 HSBC.

## **15. 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. The Company believes that it is not liable for the amounts demanded by AT&T, however, it has accrued liabilities for estimated settlement costs that management believes are reasonable. Although the final resolution of these matters may be greater than the Company's recorded liability, management does not believe the ultimate resolution will have a material adverse effect on the Company's business, financial condition or results of operations.

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.

In July of fiscal 2004 the Company entered into an agreement to open one new concept store in the River Park area of Fresno, California. The anticipated completion date of the project is Summer 2005 with an estimated net cost to the Company of approximately \$4.5 million. On April 15, 2005 the Company also opened a new store in Albany, Oregon at a total cost to the Company of approximately \$1.2 million.

As of January 29, 2005, the Company had issued a total of \$3.3 million of standby letters of credit and documentary letters of credit totaling \$2.1 million. 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 workers compensation insurance policies. 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.

## **16. RESTATEMENT OF FINANCIAL STATEMENTS**

Subsequent to the issuance of its financial statements for the year ended January 31, 2004, as a result of a letter issued on February 7, 2005 by the Office of the Chief Accountant of the Securities and Exchange Commission ("SEC") to the American Institute of Certified Public Accountants regarding certain operating lease-related accounting issues and their applications

under generally accepted accounting principles in the United States of America ("GAAP"), the Company determined that its then current manner in which it accounted for certain lease related matters was not in accordance with GAAP. Corrections to the Company's lease accounting policies include an adjustment to depreciation expense to correct the depreciable lives being used for certain leasehold costs and improvements, and to correct the recording of certain tenant allowances and construction reimbursements, as reductions in rent expense, which are included in selling general and administration expenses, that had previously been recorded as reductions in the cost of the underlying constructed assets. In addition, the restatement includes adjusting lease terms of certain leases to include bargain renewal option periods where exercise of the options would be reasonably assured, and recognizing the straight-line effect over the lease term of such changes in rents during the option periods. As a result, the Company has restated the accompanying fiscal 2003 and 2002 consolidated financial statements from amounts previously reported.

In addition, the Company had previously classified newly generated receivables and payments on receivables under the securitization program as investing activities, and classified the gross proceeds from the sale of its proprietary credit card portfolio and the repayment of the 1999-1 and 2000-1 Series Certificates as financing activities in its consolidated statement of cash flows for the fiscal year ended February 1, 2003. To correct this error, the Company has restated its fiscal 2002 consolidated statement of cash flows to reflect the change in receivables and the net proceeds received by the Company from the sale of its proprietary credit card portfolio as operating activities, since the credit card receivables originated from the sale of the Company's merchandise.

A summary of the significant effects of the restatement is as follows:

#### Statement of Operations

<b>For the year ended:</b>	<b>January 31, 2004</b>	<b>January 31, 2004</b>	<b>February 1, 2003</b>	<b>February 1, 2003</b>
	(As previously reported)	(As restated)	(As previously reported)	(As restated)
Selling, general and administrative expenses.....	\$ 203,966	\$ 203,448	\$ 207,885	\$ 207,367
Depreciation and amortization.....	13,177	14,497	13,374	14,633
Operating income.....	15,315	14,513	3,762	3,021
Income (loss) from continuing operations before income tax (benefit).....	4,281	3,479	(14,014)	(14,755)
Income tax expense (benefit).....	1,529	1,243	(6,495)	(6,838)
Income (loss) from continuing operations.....	2,752	2,236	(7,519)	(7,917)
Net income (loss).....	\$ 1,870	\$ 1,354	\$ (11,973)	\$ (12,371)
Net income (loss) per common share:				
Basic				
Income (loss) from continuing operations.....	\$ 0.22	\$ 0.17	\$ (0.59)	\$ (0.62)
Loss from discontinued operations.....	\$ 0.07	\$ (0.07)	\$ (0.35)	\$ (0.35)
Net income (loss) per common share.....	\$ 0.15	\$ 0.10	\$ (0.94)	\$ (0.97)
Diluted				
Income (loss) from continuing operations.....	\$ 0.21	\$ 0.17	\$ (0.59)	\$ (0.62)
Loss from discontinued operations.....	\$ (0.07)	\$ (0.07)	\$ (0.35)	\$ (0.35)
Net income (loss) per common share.....	\$ 0.14	\$ 0.10	\$ (0.94)	\$ (0.97)

**Balance Sheet**

<b>As of:</b>	<b>January 31, 2004</b>	<b>January 31, 2004</b>
	(As previously reported)	(As restated)
Property and equipment, net.....	\$ 129,832	\$ 127,561
Other intangibles - net.....	854	689
Total other assets.....	12,535	12,920
Total assets.....	323,991	322,199
Deferred income taxes, current.....	569	1,073
Other liabilities.....	16,874	18,228
Deferred income taxes (less current portion).....	12,637	10,847
Retained earnings.....	36,753	34,799
Total stockholders' equity.....	108,322	106,368
Total liabilities and stockholders' equity.....	\$ 323,991	\$ 322,199

**Statement of Cash Flows**

<b>For the year ended:</b>	<b>February 1, 2003</b>	<b>February 1, 2003</b>
	(As previously reported)	(As restated)
Net cash provided by operating activities.....	\$ 20,871	\$ 43,025
Net cash used in investing activities.....	\$ (12,218)	\$ (7,053)
Net cash used in financing activities.....	\$ (5,179)	\$ (32,498)

## SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS

### GOTTSCHALKS INC. AND SUBSIDIARY

COL. A	COL. B	COL. C	COL. D	COL. E	COL. F
		ADDITIONS			
Description	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts Describe	Deductions Describe	Balance at End of Period
<u>Year ended January 29, 2005:</u>					
Store closure reserve.....	\$ 337,000	\$ -- --	\$ --	\$ (337,000)(4)	\$ --
Deferred tax asset					
valuation allowance.....	\$ 1,818,000	\$ 436,000 (5)	\$ --	\$ -- --	\$ 2,254,000
Allowance for vendor					
claims receivable.....	\$ 281,000	\$ -- --	\$ --	\$ (191,000)(6)	\$ 90,000
 <u>Year ended January 31, 2004:</u>					
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
 <u>Year ended February 1, 2003:</u>					
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

- (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 HSBC.
- (3) Represents costs incurred for store closures in 2003 and 2002, including the remaining lease obligations, asset impairment charges related to the improvements, fixtures and lease rights, severance and other incremental costs.

- (4) Represents amounts paid in connection with store closures and continuing lease payments related to one store closed in 2001. In 2002 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.
- (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 29, 2005

GOTTSCHALKS, Inc.

By: /s/ James R. Famalette

James R. Famalette

*President and Chief Executive Officer*

Pursuant to the requirements of the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Joseph W. Levy</u> Joseph W. Levy	Chairman	April 29, 2005
<u>/s/ James R. Famalette</u> James R. Famalette	President, Chief Executive Officer and Director (principal executive officer)	April 29, 2005
<u>/s/ J. Gregory Ambro</u> J. Gregory Ambro	Chief Administrative and Financial Officer (principal financial and accounting officer)	April 29, 2005
<u>/s/ O. James Woodward III</u> O. James Woodward III	Director	April 29, 2005
<u>/s/ Sharon Levy</u> Sharon Levy	Director	April 29, 2005
<u>/s/ James Czech</u> James Czech	Director	April 29, 2005
<u>/s/ Joseph J. Penbera</u> Joseph J. Penbera	Director	April 29, 2005
<u>/s/ Fred Ruiz</u> Fred Ruiz	Director	April 29, 2005
<u>/s/ Max Gutmann</u> Max Gutmann	Director	April 29, 2005
<u>/s/ Thomas H. McPeters</u> Tom McPeters	Director	April 29, 2005
<u>/s/ Dale H. Achabal</u> Dale H. Achabal	Director	April 29, 2005
<u>/s/ Jorge Pont Sanchez</u> Jorge Pont Sanchez	Director	April 29, 2005

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**SECTION 302 CERTIFICATION OF PRESIDENT AND  
CHIEF EXECUTIVE OFFICER**

I, James R. Famalette, certify that:

1. I have reviewed this annual report on Form 10-K of Gottschalks Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and



- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

April 29, 2005

By: /s/ James R. Famalette

James R. Famalette

*President and Chief Executive Officer*

**SECTION 302 CERTIFICATION OF CHIEF ADMINISTRATIVE AND  
FINANCIAL OFFICER**

I, J. Gregory Ambro, certify that:

1. I have reviewed this annual report on Form 10-K of Gottschalks Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

April 29, 2005

By: /s/ J. Gregory Ambro

J. Gregory Ambro

*Chief Administrative and Financial Officer*

**CERTIFICATION PURSUANT OF PRESIDENT AND CHIEF EXECUTIVE OFFER  
AND  
CHIEF ADMINISTRATIVE AND FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. § 1350, AS ADOPTED PURSUANT TO  
§ 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Gottschalks Inc. (the “Company”) on Form 10-K for the period ended January 29, 2005 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, James R. Famalette, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. 1350, as enacted by § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ James R. Famalette

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James R. Famalette

*President and Chief Executive Officer*

Date: April 29, 2005

A signed original of this written statement required by Section 906 has been provided to Gottschalks Inc. and will be retained by Gottschalks Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

**Exhibit 32.1**

**CERTIFICATION PURSUANT OF PRESIDENT AND CHIEF EXECUTIVE OFFER  
AND  
CHIEF ADMINISTRATIVE AND FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. § 1350, AS ADOPTED PURSUANT TO  
§ 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Gottschalks Inc. (the “Company”) on Form 10-K for the period ended January 29, 2005 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, J. Gregory Ambro, Chief Administrative and Financial Officer of the Company, certify, pursuant to 18 U.S.C. 1350, as enacted by § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ J. Gregory Ambro

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J. Gregory Ambro

*Chief Administrative and Financial Officer*

Date: April 29, 2005

A signed original of this written statement required by Section 906 has been provided to Gottschalks Inc. and will be retained by Gottschalks Inc. and furnished to the Securities and Exchange Commission or its staff upon request.