

Madison Clock Co.  
Est. 1847

# Kirkland's®

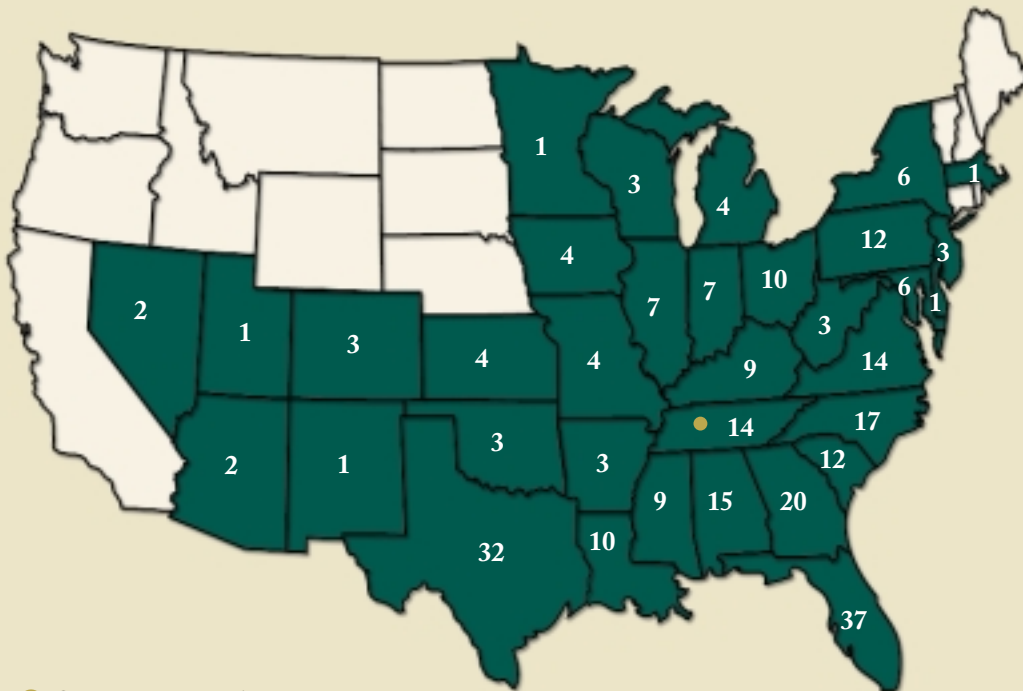
*2003 Annual Report*



*Positioned  
for Growth*

## About the Company

Kirkland's is a leading specialty retailer of home décor in the United States, operating 280 stores in 34 states as of January 31, 2004. Our stores present a broad selection of distinctive merchandise, including framed art, mirrors, candles, lamps, picture frames, accent rugs, garden accessories and artificial floral products. We also offer an extensive assortment of holiday merchandise, as well as items carried throughout the year suitable for giving as gifts. In addition, we use innovative design and packaging to market home décor items as gifts. We provide our predominantly female customers an engaging shopping experience characterized by a diverse, ever-changing merchandise selection at surprisingly attractive prices. Our stores offer a unique combination of style and value that has led to our emergence as a leader in home décor and has enabled us to develop a strong customer franchise.



● Corporate Headquarters  
and Central Distribution Center

*Numbers indicate number of stores in that state.*

## Financial Highlights

<b>Statement of Operations Data:</b>	52 Weeks Ended	52 Weeks Ended February 1, 2003	
	January 31, 2004	As Reported	Pro Forma <sup>(1)</sup>
<i>(In thousands, except per share amounts)</i>			
Net sales	\$ 369,158	\$ 341,504	\$ 341,504
Operating income	\$ 30,336	\$ 32,697	\$ 34,996
Net income	\$ 18,143	\$ 10,256	\$ 20,002
Earnings per diluted share	\$ 0.93	\$ 0.70	\$ 1.02
<b>Store and Other Data:</b>			
Comparable store sales increase (decrease)	(0.2)%	8.4%	
Number of stores at year end	280	249	
Average net sales per store <i>(in thousands)</i>	\$ 1,423	\$ 1,417	
Average net sales per square foot	\$ 311	\$ 313	
Inventory yield <sup>(2)</sup>	283.8%	283.1%	
Return on assets <sup>(3)</sup>	17.6%	13.0%	
<b>Balance Sheet Data at Year End:</b>			
Total assets	\$ 103,129	\$ 79,058	
Total debt	\$ —	\$ —	
Shareholders' equity	\$ 59,230	\$ 39,157	

<sup>(1)</sup> *Pro forma results are prepared on a basis to exclude certain effects of Kirkland's July 10, 2002, initial public offering. The pro forma results give effect to the initial public offering as though it took place at the beginning of the periods presented. In accordance with applicable securities regulations, Kirkland's has prepared the required disclosures for each of the pro forma financial measures presented in this annual report to shareholders. The disclosures are provided on page 8.*

<sup>(2)</sup> *Inventory yield is defined as gross profit divided by average inventory for each of the preceding four quarters.*

<sup>(3)</sup> *Return on assets equals net income allocable to common shareholders divided by total assets.*

## Dear Fellow Shareholders, Customers and Associates:

Our first full year as a public company was one of significant accomplishment. We grew our store base by 12%, produced returns on invested capital that distinguished Kirkland's as an industry leader and made meaningful progress toward building a stronger, more capable company. We ended the fiscal year with 280 stores in 34 states.

Despite these achievements, we fell short of our sales and earnings targets for fiscal 2003. Our sales results during the year were uneven, as the comparable store sales increase we had earned through the first three quarters was negated in what proved to be a challenging and disappointing fourth quarter. Comparable store sales decreased 0.2% for the year. Total net sales for the year increased 8.1% to a record \$369.2 million, driven by sales contributions from the 58 new stores added during fiscal 2002 and fiscal 2003. Income for fiscal 2003, excluding a \$0.03 per share charge relating to our anticipated move to a new distribution center, was \$0.96 per diluted share, compared with pro forma income of \$1.02 per diluted share for fiscal 2002.\* Reported net income for fiscal 2003 was \$0.93 per diluted share.

I would like to highlight two particular areas in which we achieved noteworthy progress during the past year. First, we took major strides in expanding and improving our real estate base. As promised, we opened 42 new stores during the year and closed 11 stores, enabling us to achieve a 12% net increase in the store base. Of this amount, 17 stores opened in off-mall venues, including our first freestanding store. Our diversification into these off-mall venues signals our customer's growing preference for these centers, as well as a shift in the economic attractiveness of these properties for Kirkland's and other specialty retail tenants. We still have a strong and profitable portfolio of mall stores, but positive results from these off-mall locations have encouraged us to consider our real estate alternatives carefully in each chosen market as we continue to open stores across the country. Our strategic direction is to open approximately 75% of our Class of 2004 stores in off-mall venues.

A second area where we made significant improvement during the year was in logistics and distribution. As our central distribution operation has grown in recent years, we have recognized the need for a more comprehensive approach to the management of our merchandise supply chain. During fiscal 2003, we accelerated our evaluation of all parts of the supply chain, from merchandise vendor to the store selling floor. We initiated several projects intended to improve the efficiency of our transportation network and the visibility of merchandise movements from the time of purchase to the time of receipt. We also reached an agreement to lease a new 771,000-square-foot distribution center in our hometown of Jackson, Tennessee. This facility, which is being built to our specifications, will consolidate the operations of the three separate buildings we operate today. We are on schedule to commence operations in this new facility in the second quarter of fiscal 2004.

We ended fiscal 2003 in excellent financial condition and well positioned to continue with our stated growth plans. Cash balances grew to \$17.4 million at year-end, and we anticipate financing all of our growth in 2004 with cash flow from operations and seasonal borrowings from our revolving credit facility. Our specific plan is to increase our store base by approximately 14% in fiscal 2004, based on 50-55 new store openings and 10-15 store closings.

As we look toward 2004, we know that several critical areas of our business must show improvement if we are to reach our full potential. These areas include merchandising and marketing, logistics and store operations. While the cornerstone of our success has long been our merchandising strategy, we must get even better at buying and selling merchandise. We are devoting significant effort toward augmenting our merchandising staff with greater breadth and depth in buying and planning. We also are taking a hard look at our marketing capability, which historically has not been a core competency within our organization. Great merchandise at great prices is no longer a sufficient formula for success. We must reinforce the

\* See reconciliation of pro forma financial information on page 8.



Kirkland's brand more consistently with our customer and remind her why Kirkland's deserves her time and her business. A rejuvenated focus on more effective marketing and brand development includes the possible addition of senior-level leadership, to create and implement better identification of and more productive communication with our customers. As part of our plan to understand and build closer relationships with our customers, we will introduce a proprietary Kirkland's credit card later this year.

Consistent with this theme of strengthening our bond with customers, we are creating a modern logistics operation that will do a better job of giving our customer what she wants, when she wants it. We anticipate a learning curve as we move to our new distribution facility. However, we expect this new facility, together with a new warehouse management system and the first-stage introduction of inventory sortation and handling equipment, to begin delivering significant benefits in fiscal 2005. These benefits include better labor efficiency, much faster throughput at the distribution center, more precise and timely shipments to each store, leaner store-level inventories and reduced store-level storage costs. In anticipation of this new, more capable facility, and in recognition of Kirkland's expanding geography, we are measurably improving transportation practices as we lay the groundwork for a transportation strategy that will deliver better service levels to our stores at lower costs. The ultimate objective of all these logistics initiatives is to help drive better sales and gross margin performance across all of our stores.

We also are rededicating ourselves to a higher standard of customer focus in our stores. We are implementing timesaving systems and practices in store operations so that we can shift more labor dollars to the selling floor, helping us to give more personal attention to customers and improving the shopping experience in our stores. We also are committed to hire and train better at all levels and to begin a long-term effort to improve our employee base in as dramatic a fashion as we have sought to improve systems and logistics – all for the benefit of our customers.

The most obvious measures of the financial strength of any retail concept are sales and earnings, and every ounce of energy within our company is being applied to producing more consistent results on both of these measures. At the same time, we need to remind ourselves as managers and shareholders that our core strengths and the fundamental reasons for investing in Kirkland's future have not changed: a truly differentiated specialty retail concept, a proven and productive store model and a virtually open-ended growth opportunity.

We hope that each of our constituencies – shareholders, customers and associates – appreciates the seriousness of our commitment to making 2004 a productive and profitable year. Kirkland's is a fabulous and proven concept with great appeal to customers. The growth opportunity is large and visible. Finally, we have both a sound strategy and a talented, motivated team in place to execute that strategy.

We offer our sincere thanks to each of you for your support and investment in Kirkland's. I look forward to seeing you in our stores.

Sincerely,



Robert E. Alderson  
*President and Chief Executive Officer*

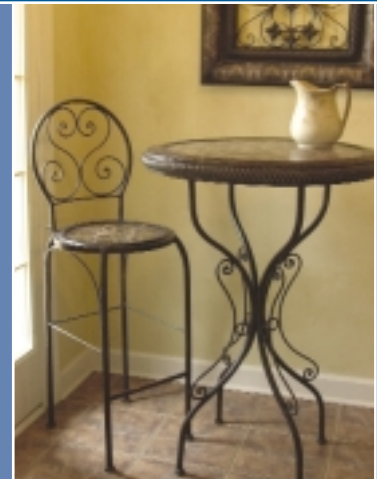
**Our customers** expect great merchandise at great prices. They also expect that merchandise to be displayed in an appealing manner that makes shopping at Kirkland's fun and even exciting. Our stores have a distinctive, "interior design" look that helps customers visualize the merchandise in their own homes. Using multiple merchandise arrangements to simulate home settings, associates group complementary merchandise creatively throughout the store, rather than displaying products strictly by category or product type. This cross-category merchandising strategy inspires decorating and gift-giving ideas and encourages customers to browse throughout the store.

Kirkland's merchandising approach begins with what our merchants call an **item focus**. While the merchandise mix in our stores encompasses a broad range of complementary categories, our strategic emphasis is to identify or develop key items, with each item having the potential to excite our customers and produce high sales volumes.

A second key element of our strategy is an emphasis on **product newness**. New merchandise flows regularly into our stores in response to market trends, sales results and changes in seasons. This ever-changing merchandise mix creates an exciting "treasure hunt" environment, encouraging strong customer loyalty and frequent return visits to our stores.

The third critical ingredient to the Kirkland's formula is our commitment to giving customers **exceptional value**. Our customers regularly experience the satisfaction of paying noticeably less for items similar or identical to those sold by other retail stores or through catalogs. This strategy of providing a unique combination of style and value is an important element in making Kirkland's a destination store.

## 4 High Quality & Value

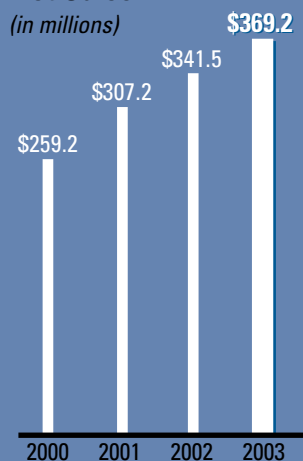




*By offering a unique combination of style and value, our stores become a destination for today's savvy consumer.*

*We believe our ever-changing merchandise mix creates an exciting "treasure hunt" environment, encouraging strong customer loyalty and frequent return visits.*

**Net Sales**  
(in millions)

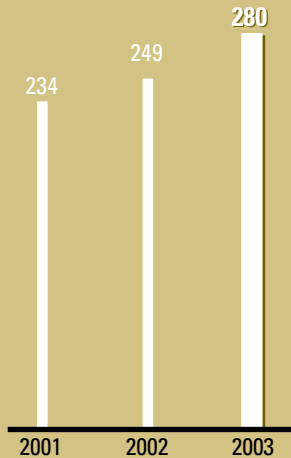






*Our ultimate goal is for Kirkland's to be a 1,000-store chain.*

Store Base



*A defining characteristic of our concept is its broad appeal to customers in metropolitan, middle and smaller markets throughout the country.*



*Our stated company goal* is to expand the store base from 280 at fiscal year-end 2003 to 320 stores by the end of fiscal 2004. This represents a 14% increase in the store base, up slightly from a 12% increase in 2003 and closer to our long-term goal of expanding at a 15% to 18% annual rate.

The most significant development in the Class of 2003 new stores was the increased percentage of leases executed for locations outside of regional enclosed malls. Of the 42 new stores opened in 2003, 17 were in off-mall venues such as lifestyle centers and outlet centers as well as our first freestanding store. We also entered five new states in 2003 – Delaware, Massachusetts, Minnesota, Nevada and Utah. At year-end, we operated in 34 states.

We have sharpened our priorities for the stores opening in 2004 as we continue to pursue the best expansion opportunities. Accelerating a trend from last year, we expect approximately 75% of our new stores in

2004 to be in off-mall locations, where we are finding many attractive opportunities. This strategy improves our negotiating position on desired mall stores; reduces our occupancy costs; and often shortens lease terms, thereby reducing risk. Most importantly, this strategy locates our stores in lifestyle centers or other off-mall venues closer to where our customers live and positions us with the best of the mall and non-mall specialty retail tenants.

## 280 Stores and Growing 7



## Reconciliation of Pro Forma Financial Information

In addition to reporting in accordance with generally accepted accounting principles (GAAP), we have reported our operating results on a pro forma basis to exclude certain effects of our initial public offering. We use this pro forma reporting internally to evaluate our performance without regard to the non-recurring financial effects of the initial public offering. We believe that this information provides investors with additional insight into our operating results.

### Pro Forma Operating Income

Pro forma operating income equals GAAP operating income adjusted for the effect of certain non-recurring, non-cash stock compensation charges related to certain stock options. The following sets forth the reconciliation of pro forma operating income to GAAP operating income:

<i>(In thousands)</i>	52 Weeks Ended February 1, 2003
Pro forma operating income	\$ 34,996
Non-cash stock compensation charges	(2,299)
GAAP operating income	<u>\$ 32,697</u>

### Pro Forma Income and Earnings Per Share

Pro forma income is prepared on a basis to exclude certain effects of our July 10, 2002, initial public offering. The pro forma figures give effect to the initial public offering as though it took place at the beginning of the periods presented. The following sets forth the reconciliation of pro forma income and pro forma earnings per diluted share to GAAP net income and GAAP earnings per diluted share:

<i>(In thousands, except per share amounts)</i>	52 Weeks Ended February 1, 2003
Pro forma income	\$ 20,002
Interest expense on debt retired in IPO	(3,203)
Non-recurring, non-cash stock compensation charges	(2,299)
Difference in debt issue cost amortization due to May 2002 refinancing	(641)
Accretion of redeemable preferred stock and dividends accrued on classes of preferred stock retired in IPO	(5,626)
Estimated tax effect using effective tax rate	2,348
Loss on early extinguishment of long-term debt	(325)
GAAP net income	<u>\$ 10,256</u>
Diluted weighted average shares outstanding - pro forma	19,522
New shares issued in IPO	(2,138)
Exercise of common stock warrants at IPO	(910)
Exchange of Class C Preferred Stock for common stock at IPO	(246)
Conversion of Class A, Class B and Class D Preferred Stock at IPO	(1,827)
Repurchase of common stock at IPO	256
Dilution from stock options	-
Diluted weighted average shares outstanding - GAAP	<u>14,657</u>
Pro forma earnings per diluted share	<u>\$ 1.02</u>
GAAP earnings per diluted share	<u>\$ 0.70</u>

# Corporate Data

## Directors

Carl Kirkland

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

Robert E. Alderson

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

Reynolds C. Faulkner

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

David M. Mussafer

*Managing Director, Advent International Corporation*

R. Wilson Orr, III

*Managing Director, SSM Ventures*

John P. Oswald

*Managing Director, Capital Trust Group*

Murray M. Spain

*President, World Wide Basics, LLC*

## Officers

Carl Kirkland

*Chairman of the Board*

Robert E. Alderson

*President and Chief Executive Officer*

Reynolds C. Faulkner

*Executive Vice President and Chief Financial Officer*

Chris T. LaFont

*Senior Vice President of Merchandising and General Merchandise Manager*

C. Edmond Wise, Jr.

*Senior Vice President of Store Operations*

James W. Harris

*Vice President of Store Operations and Human Resources*

Roland L. Mackie

*Vice President of Real Estate*

Deborah A. McDonald

*Vice President of Visual Merchandising*

Tracy Parker

*Vice President of Store Operations*

Lowell E. Pugh II

*Vice President, General Counsel and Secretary*

Grey W. Satterfield

*Vice President of Merchandising – Planning*

Connie L. Scoggins

*Vice President of Finance and Treasurer/Controller*

Toni F. Warren

*Vice President of Merchandising – Replenishment*

Todd A. Weier

*Vice President of Logistics*

## Corporate Headquarters

Kirkland's, Inc.

805 North Parkway

Jackson, Tennessee 38305

731.668.2444

www.kirklands.com

## Transfer Agent and Registrar

StockTrans, Inc.

44 West Lancaster Avenue

Ardmore, Pennsylvania 19003

610.649.7300

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

## Independent Auditors

PricewaterhouseCoopers LLP

Memphis, Tennessee

## Corporate Counsel

Pepper Hamilton LLP

Philadelphia, Pennsylvania

## Annual Report (Form 10-K)

A copy of the Company's fiscal 2003 Annual Report on Form 10-K as filed with the Securities and Exchange Commission is available to shareholders by contacting the Investor Relations Department at the address above.

## Annual Meeting

The Annual Meeting of Shareholders will be held at 5:30 p.m. Central Daylight Time on June 2, 2004, at the Jackson Country Club, 31 Jackson Country Club Lane, Jackson, Tennessee.

## Stock Market Information

The Company's common stock is traded on the NASDAQ National Market under the symbol KIRK. On April 7, 2004, there were approximately 72 holders of record and 1,880 beneficial owners of the Company's common stock. The following table sets forth, for the periods indicated, the high and low last sale prices of shares of the common stock as reported by NASDAQ since the Company commenced trading on July 11, 2002:

	High	Low
Fiscal 2002:		
Quarter ended August 3, 2002	\$ 14.87	\$ 10.00
Quarter ended November 2, 2002	\$ 17.50	\$ 9.55
Quarter ended February 1, 2003	\$ 18.80	\$ 10.47
Fiscal 2003:		
Quarter ended May 3, 2003	\$ 15.40	\$ 10.45
Quarter ended August 2, 2003	\$ 18.16	\$ 14.25
Quarter ended November 1, 2003	\$ 22.01	\$ 14.96
Quarter ended January 31, 2004	\$ 22.15	\$ 14.41



KIRKLAND'S, INC.  
805 NORTH PARKWAY  
JACKSON, TENNESSEE 38305  
731.668.2444  
[www.kirklands.com](http://www.kirklands.com)