ETHAN ALLEN INTERIORS INC
Form 10-Q
November 07, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2008

OR

o	**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: 1-11692

Ethan Allen Interiors Inc.

(Exact name of registrant as specified in its charter)

Delaware	**06-1275288**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
Ethan Allen Drive, Danbury, Connecticut	**06811**

(Address of principal executive offices)	(Zip Code)

(203) 743-8000

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x YesoNo

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act

Large accelerated filer	x	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

At September 30, 2008, there were 28,709,049 shares of Class A Common Stock,

par value $.01, outstanding.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(In thousands, except share data)

	September 30, 2008 (unaudited)	June 30, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 79,917	$ 74,376
Accounts receivable, less allowance for doubtful accounts of $1,842 at September 30, 2008 and $2,535 at June 30, 2008	11,549	12,672
Inventories (note 4)	187,495	186,265
Prepaid expenses and other current assets	22,016	32,860
Deferred income taxes	4,188	4,005
Total current assets	305,165	310,178
Property, plant and equipment, net	355,036	350,432
Goodwill and other intangible assets (notes 6 and 7)	94,633	96,823
Other assets	4,423	4,540
Total assets	$ 759,257	$ 761,973
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current maturities of long-term debt (note 8)	$ 41	$ 41
Customer deposits	42,640	47,297
Accounts payable	25,894	26,444
Accrued compensation and benefits	33,725	32,568
Accrued expenses and other current liabilities (note 5)	34,331	29,152
Total current liabilities	136,631	135,502
Long-term debt (note 8)	203,018	202,988
Other long-term liabilities	20,661	20,383
Deferred income taxes	22,948	27,327
Total liabilities	383,258	386,200
Shareholders equity:		
Class A common stock, par value $.01, 150,000,000 shares authorized; 48,274,870 shares issued at September 30, 2008 and 48,251,780 shares issued at June 30, 2008	482	482
Class B common stock, par value $.01, 600,000 shares authorized; no shares issued and outstanding at September 30, 2008 and June 30, 2008		
Preferred stock, par value $.01, 1,055,000 shares authorized; no shares issued and outstanding at September 30, 2008 and June 30, 2008		

Additional paid-in capital		355,121		354,725
		355,603		355,207
Less: Treasury stock (at cost), 19,565,821 shares at September 30, 2008 and 19,565,901 shares at June 30, 2008		(588,783)		(588,783)
Retained earnings		606,857		606,648
Accumulated other comprehensive income (note 12)		2,322		2,701
Total shareholders equity		375,999		375,773
Total liabilities and shareholders equity	$	759,257	$	761,973

See accompanying notes to consolidated financial statements.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Consolidated Statements of Operations (Unaudited)

(In thousands, except per share data)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007
Net sales	$ 205,841	$ 248,727
Cost of sales	93,900	115,270
Gross profit	111,941	133,457
Operating expenses:		
Selling	55,302	57,578
General and administrative	46,058	48,082
Restructuring and impairment charge (credit), net (note 5)	(1,630)	
Total operating expenses	99,730	105,660
Operating income	12,211	27,797
Interest and other miscellaneous income, net	1,100	2,922
Interest and other related financing costs (note 8)	2,901	2,935
Income before income taxes	10,410	27,784
Income tax expense (note 3)	2,988	10,280
Net income	$ 7,422	$ 17,504
Per share data (note 11):		
Basic earnings per common share:		
Net income per basic share	$ 0.26	$ 0.58
Basic weighted average common shares	28,703	30,084
Diluted earnings per common share:		
Net income per diluted share	$ 0.26	$ 0.57
Diluted weighted average common shares	28,847	30,464

See accompanying notes to consolidated financial statements.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(In thousands)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007
Operating activities:		
Net income	$ 7,422	$ 17,504
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,318	5,937
Compensation expense related to share-based awards	394	132
Provision (benefit) for deferred income taxes	(1,850)	49
Excess tax benefits from share-based payment arrangements		(2,081)
Restructuring and impairment charge (benefit), net	(3,854)	
(Gain) loss on disposal of property, plant and equipment	(5)	(552)
Other	66	69
Change in assets and liabilities, net of the effects of acquired businesses:		
Accounts receivable	931	347
Inventories	(561)	587
Prepaid and other current assets	9,192	1,509
Other assets	84	142
Customer deposits	(5,312)	4,144
Accounts payable	(550)	1,970
Accrued expenses and other current liabilities	5,253	2,552
Other long-term liabilities	547	9,141
Net cash provided by operating activities	18,075	41,450
Investing activities:		
Proceeds from the disposal of property, plant & equipment	5,729	5,063
Capital expenditures	(11,093)	(12,545)
Acquisitions	(375)	(705)
Other	(249)	6
Net cash used in investing activities	(5,988)	(8,181)
Financing activities:		
Payments on long-term debt	(10)	(9)
Proceeds from issuance of common stock	2	307
Excess tax benefits from share-based payment arrangements		2,081
Payment of cash dividends	(6,331)	(6,185)
Purchases and other retirements of company stock		(44,101)
Net cash used in financing activities	(6,339)	(47,907)
Effect of exchange rate changes on cash	(207)	243
Net increase (decrease) in cash & cash equivalents	5,541	(14,395)
Cash & cash equivalents - beginning of period	74,376	147,879
Cash & cash equivalents - end of period	$ 79,917	$ 133,484

See accompanying notes to consolidated financial statements.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Consolidated Statements of Shareholders Equity

Three Months Ended September 30, 2008

(Unaudited)

(In thousands, except share data)

	Common Stock	Additional Paid-In Capital	Treasury Stock	Accumulated Other Comprehensive Income	Retained Earnings	Total
Balance at June 30, 2008	$ 482	$ 354,725	$ (588,783)	$ 2,701	$ 606,648	$ 375,773
Share-based compensation expense (note 10)		394				394
Issuance of common stock upon issuance of share-based awards		2				2
Dividends declared on common stock					(7,213)	(7,213)
Other comprehensive income (note 12):						
Currency translation adjustments				(391)		(391)
Loss on derivatives, net of tax and other				12		12
Net income					7,422	7,422
Total comprehensive income						7,043
Balance at September 30, 2008	$ 482	$ 355,121	$ (588,783)	$ 2,322	$ 606,857	$ 375,999

See accompanying notes to consolidated financial statements.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Basis of Presentation and Recent Accounting Pronouncements

Basis of Presentation

Ethan Allen Interiors Inc. (Interiors) is a Delaware corporation incorporated on May 25, 1989. The consolidated financial statements include the accounts of Interiors, its wholly owned subsidiary Ethan Allen Global, Inc. (Global), and Global s subsidiaries (collectively We , Us , Our , Eth Allen , or the Company). All intercompany accounts and transactions have been eliminated in the consolidated financial statements. All of Global s capital stock is owned by Interiors, which has no assets or operating results other than those associated with its investment in Global.

Recently Adopted Accounting Pronouncements

On July 1, 2008, the Financial Accounting Standards Board (FASB) issued Statement No. 157, *Fair Value Measurements* (SFAS No. 157) which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements, yet does not require any new fair value measurements. In February 2008, the FASB issued FASB Staff Position No. 157-2 (FSP No. 157-2), which delayed the effective date of SFAS No. 157 as it relates to nonfinancial assets and nonfinancial liabilities until July 1, 2009 for the Company, except for items that are recognized or disclosed at fair value by the Company on a recurring basis. Effective July 1, 2008, the Company adopted the provisions of SFAS No. 157, except as it relates to those nonfinancial assets and nonfinancial liabilities excluded under FSP No. 157-2. Those excluded items for which the Company has not applied the fair value provisions of SFAS No. 157 include goodwill and other intangible assets (note 7), assets held for sale (note 5), liabilities for exit or disposal activities (note 5), and business acquisitions (note 6). The Company is currently evaluating the impact of this statement on the Company s financial position, results of operations and cash flows as it relates to nonfinancial assets and nonfinancial liabilities. For the impact of adoption of this statement on financial assets, financial liabilities, and nonfinancial assets recognized at fair value on a recurring basis, see note 13.

Statement of Financial Accounting Standard No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS No. 159), became effective for us on July 1, 2008. SFAS No. 159 gives us the option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities, with the difference between the carrying value before election and the fair value recorded upon election as an adjustment to beginning retained earnings. The fair value option may be elected on an instrument by instrument basis and is irrevocable, unless a new election date occurs. The Company did not apply the fair value option to any of its outstanding instruments, and therefore, SFAS No. 159 did not have an impact on the Company s consolidated financial statements.

(2) Interim Financial Presentation

All intercompany accounts and transactions have been eliminated in the consolidated financial statements. In our opinion, all adjustments, consisting only of normal recurring adjustments necessary for fair presentation, have been included in the consolidated financial statements. The results of operations for the three months ended September 30, 2008 are not necessarily indicative of results that may be expected for the entire fiscal year. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended June 30, 2008.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(3) Income Taxes

The Company reviews its expected annual effective income tax rates and makes changes on a quarterly basis as necessary based on certain factors such as changes in forecasted annual operating income; changes to actual or forecasted permanent book to tax differences; impacts from future tax audits with state, federal or foreign tax authorities; or impacts from tax law changes. The Company identifies items which are not normal and are nonrecurring in nature and treats these as discrete events. The tax effect of discrete items is recorded in the quarter in which the discrete events occur. Due to the volatility of these factors, the Company s consolidated effective income tax rate can change significantly on a quarterly basis.

In accordance with FASB Interpretation No. 48, A*ccounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109,* (FIN 48) we recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. We adopted the provisions set forth by FIN 48 effective July 1, 2007.

Essentially all of the unrecognized tax benefits, if recognized, would be recorded as a benefit to income tax expense. Our continuing practice is to recognize interest and penalties related to income tax matters as a component of income tax expense.

The Company s consolidated effective income tax rate was 28.7% and 37.0% for the three months ended September 30, 2008 and 2007, respectively. The current period lower effective tax rate is due primarily to a one time adjustment of $0.7 million made in the current quarter.

The Company conducts business globally and, as a result, the Company or one or more of its subsidiaries files income tax returns in the U.S., various state, and foreign jurisdictions. In the normal course of business, the Company is subject to examination by the taxing authorities in such major jurisdictions as Canada, Mexico and the U.S. As of September 30, 2008, certain subsidiaries of the Company are currently under audit from 2001 through 2007 in the U.S. It is reasonably possible that some of these audits may be completed during the next twelve months. While the amount of uncertain tax benefits with respect to the entities and years under audit may change within the next twelve months, it is not anticipated that any of the changes will be significant.

(4) Inventories

Inventories at September 30, 2008 and June 30, 2008 are summarized as follows (in thousands):

	September 30, 2008	June 30, 2008
Finished goods	$ 154,214	$ 153,981
Work in process	7,480	5,985
Raw materials	25,801	26,299
	$ 187,495	$ 186,265

Inventories are presented net of a related valuation allowance of $2.2 million at September 30, 2008 and $2.3 million at June 30, 2008.

(5) Restructuring and Impairment Charges

In recent years, we have developed, announced and executed plans to consolidate our operations as part of an overall strategy to maximize production efficiencies and maintain our competitive advantage.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

On January 10, 2008, we announced a plan to consolidate the operations of certain company owned retail design centers and retail service centers. In connection with this initiative, we have permanently ceased operations at eleven design centers and six retail service centers which, for the most part, were consolidated into other existing operations. We also implemented our design team concept across the Retail division at the end of fiscal 2008. These decisions resulted in a reduction in headcount of approximately 400 employees, with the reduction in headcount occurring mostly during the third and fourth quarters of fiscal 2008. Additionally, other actions taken during fiscal 2008 were not included in the restructuring plan. Altogether, there were more than 500 fewer associates in our Retail business by the end of fiscal 2008. In the first quarter of fiscal 2009, a $1.6 million restructuring and impairment net gain was recorded. Of this amount, $4.2 million was a realized gain on the sale of property classified as held for sale and was partially offset by $2.2 million in lease termination costs and adjustments for expected charges on leased properties no longer being used. Since the plan was announced, we have recorded pre-tax restructuring and impairment charges totaling $4.8 million, including $0.9 million in employee severance and other payroll and benefit costs, $5.3 million in lease termination and other exit costs, and a benefit of $1.4 million on long-lived assets. We do not anticipate any additional new charges related to this retail restructuring, however, the estimated present value of future lease payments with terms ranging from less than one to seven years, and one ground lease with 25 years remaining are included in the balance at September 30, 2008 and contain estimates that will likely require adjustment in the future. In addition to the retail charges, $0.4 million was recorded in the quarter to update the fair value of a wholesale plant site held for sale. These charges are reported together in the following table.

Activity in the Company s restructuring reserves is summarized as follows (in thousands):

	Balance at June 30, 2008	New charges (credits)	Utilized	Adjustments	Balance at September 30, 2008
Employee severance and other payroll and benefit costs	$	$ 64	$ (64)	$	$
Other plant exit costs	3,358	1,677	(1,581)	318	3,772
Write down of long-lived assets		(4,080)	3,688	392	
	$ 3,358	$ (2,339)	$ (2,043)	$ 709	$ 3,772

(6) Business Acquisitions

In August 2008, we acquired in two transactions, two Ethan Allen retail design centers from independent retailers for consideration of approximately $0.6 million of cash and forgiveness of receivables, assumed customer deposits of $0.7 million and other liabilities of $0.2 million. As a result of this acquisition, we recorded additional inventory of $0.7 million and goodwill of $0.7 million. There were no acquisitions completed during the three months ended September 30, 2007.

All acquisitions are subject to a contractual holdback or reconciliation period, during which the parties to the transaction may agree to certain normal and customary purchase accounting adjustments.

Goodwill associated with our acquisitions represents the premium paid to the seller related to the acquired business (i.e. market presence) and other fair value adjustments to the assets acquired and liabilities assumed. Further discussion of our goodwill and other intangible assets can be found in Note 7.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

A summary of our allocation of purchase price associated with acquisitions occurring during the three months ended September 30, 2008 is provided below (in thousands):

Nature of acquisition		2 design centers
Total consideration	$	567
Fair value of assets acquired and liabilities assumed:		
Inventory		669
PP&E and other assets		49
Customer deposits		(655)
A/P and other liabilities		(200)
Goodwill	$	704

(7) Goodwill and Other Intangible Assets

As of September 30, 2008, we had goodwill of $74.9 million and other indefinite-lived intangible assets of $19.7 million. Comparable balances as of June 30, 2008 were $77.1 million and $19.7 million, respectively.

Goodwill in the retail and wholesale segments was $49.4 million and $25.4 million, respectively, at September 30, 2008 and $48.9 million and $28.2 million, respectively, at June 30, 2008. Goodwill in the wholesale segment decreased $2.7 million in the quarter due to the effective settlement of tax positions taken in previous years. The wholesale segment, at both dates, includes indefinite-lived intangible assets of $19.7 million which represent Ethan Allen trade names.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, we do not amortize goodwill or other indefinite-lived intangible assets but, rather, evaluate such assets for impairment on an annual basis and between annual tests whenever events or circumstances indicate that the carrying value of the goodwill or other intangible asset may exceed its fair value. We conduct our required annual impairment test during the fourth quarter of each fiscal year. No impairment losses have been recorded on our goodwill or other indefinite-lived intangible assets as a result of applying the provisions of SFAS No. 142.

(8) Borrowings

Total debt obligations at September 30, 2008 and June 30, 2008 consist of the following (in thousands):

		September 30, 2008		June 30, 2008
5.375% Senior Notes due 2015	$	198,877	$	198,837
Industrial revenue bonds		3,855		3,855
Other debt		327		337
Total debt		203,059		203,029
Less current maturities		41		41
Total long-term debt	$	203,018	$	202,988

On September 27, 2005, we completed a private offering of $200.0 million of ten-year senior unsecured notes due 2015 (the Senior Notes). The Senior Notes were offered by Global and have an annual coupon rate of 5.375% with interest payable semi-annually in arrears on April 1 and October 1 of each year. Proceeds received in connection with the issuance of the Senior Notes, net of a related discount of $1.6 million, totaled $198.4 million. We used the net proceeds from the offering to expand our retail network, invest in our manufacturing and logistics operations, and for other general corporate purposes. As of September 30, 2008, outstanding borrowings related to this

ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

transaction have been included in the Consolidated Balance Sheets within long-term debt. The discount on the Senior Notes is being amortized to interest expense over the life of the related debt as is debt issuance costs of $2.0 million primarily for banking, legal, accounting, rating agency, and printing services and $0.8 million of losses on settled forward contracts entered in conjunction with this debt issuance.

(9) Litigation and Environmental Matters

We and our subsidiaries are subject to various environmental laws and regulations. Under these laws, we and/or our subsidiaries are, or may be, required to remove or mitigate the effects on the environment of the disposal or release of certain hazardous materials.

During the quarter ended September 30, 2008, we resolved our liability as a potentially responsible party (PRP) with respect to the remediation of two active sites listed, or proposed for inclusion, on the National Priorities List (NPL) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended (CERCLA). The sites two sites are located in Southington, Connecticut and Atlanta, Georgia. In each case, we were able to resolve our liability as part of de minimis settlements.

As a result, as of September 30, 2008 we remained a PRP only with respect to the NPL site located in High Point, North Carolina. We do not anticipate incurring significant costs with respect to the High Point, North Carolina site as we believe that we are not a major contributor based on the very small volume of waste generated by us in relation to total volume at that site. Our volumetric share at the High Point site is less than 1% of over 18 million gallons disposed of at the site and there are more than 2,000 PRPs, including more than 1,000 de minimis parties (of which we are one). The other PRPs at the site consist of local, regional, national and multi-national companies.

Liability under CERCLA may be joint and several. As such, to the extent certain named PRPs are unable, or unwilling, to accept responsibility and pay their apportioned costs, we could be required to pay in excess of our pro rata share of incurred remediation costs. Our understanding of the financial strength of other PRPs has been considered, where appropriate, in the determination of our estimated liability.

In addition, in July 2000, we were notified by the State of New York (the State) that we may be named a PRP in a separate, unrelated matter with respect to a site located in Carroll, New York. To date, no further notice has been received from the State and the State has not yet conducted an initial environmental study at this site.

As of September 30, 2008, we believe that established reserves related to these environmental contingencies are adequate to cover probable and reasonably estimable costs associated with the remediation and restoration of these sites. We believe our currently anticipated capital expenditures for environmental control facility matters are not material.

We are subject to other federal, state and local environmental protection laws and regulations and are involved, from time to time, in investigations and proceedings regarding environmental matters. Such investigations and proceedings typically concern air emissions, water discharges, and/or management of solid and hazardous wastes. We believe that our facilities are in material compliance with all such applicable laws and regulations.

Regulations issued under the Clean Air Act Amendments of 1990 required the industry to reformulate certain furniture finishes or institute process changes to reduce emissions of volatile organic compounds. Compliance with many of these requirements has been facilitated through the introduction of high solids coating technology and alternative formulations. In addition, we have instituted a variety of technical and procedural controls, including reformulation of finishing materials to reduce toxicity, implementation of high velocity low pressure spray systems, development of storm water protection plans and controls, and further development of related inspection/audit teams, all of which have served to reduce emissions per unit of production. We remain committed to implementing

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

new waste minimization programs and/or enhancing existing programs with the objective of (i) reducing the total volume of waste, (ii) limiting the liability associated with waste disposal, and (iii) continuously improving environmental and job safety programs on the factory floor which serve to minimize emissions and safety risks for employees. We will continue to evaluate the most appropriate, cost effective control technologies for finishing operations and design production methods to reduce the use of hazardous materials in the manufacturing process.

(10) Share-Based Compensation

On October 10, 2007, the Company s Board of Directors and M. Farooq Kathwari, our President and Chief Executive Officer, agreed to the terms of a new employment agreement expiring on June 30, 2012 (the Agreement). Pursuant to the terms of the Agreement, Mr. Kathwari was awarded options to purchase 150,000 shares of our common stock on October 10, 2007, and options to purchase an additional 90,000 shares on July 1, 2008, in each case at the closing stock price on the grant date. The 2007 grant was issued at an exercise price of $34.03, and vests in three installments of 33 1/3% on each June 30 of 2008, 2009 and 2010. The 2008 grant was issued at an exercise price of $24.62, and vests in two installments of 50% on each of June 30, 2009 and 2010. The Agreement provides for an additional grant of 60,000 options on July 1, 2009, with an exercise price equal to the closing price of a share of our common stock on the New York Stock Exchange on that date. The 2009 grant will vest on June 30, 2010. All options awarded under the Agreement have a contractual term of 10 years.

In connection with the Agreement, Mr. Kathwari received an award of 20,000 restricted shares with vesting based on continuing service and the performance of the Company s stock price during the 32 month period subsequent to the award date as compared to the Standard and Poor s 500 index. On July 1, 2008, an additional award of 20,000 restricted shares with the same vesting conditions (over a 36 month period) was granted. Mr. Kathwari will also receive, as per the Agreement, an additional grant of 20,000 restricted shares on July 1, 2009 with the same 36 month vesting, continuing service and performance conditions.

Also in connection with the Agreement, Mr. Kathwari received on November 13, 2007 an award of 15,000 restricted shares. These shares are service-based with 3,000 shares vesting on June 30 for each of the years 2008 through 2012.

(11) Earnings Per Share

Basic and diluted earnings per share are calculated using the following weighted average share data (in thousands):

	Three Months Ended September 30,	
	2008	**2007**
Weighted average common shares outstanding for basic calculation	28,703	30,084

Effect of dilutive stock options and other share-based awards	144	380
Weighted average common shares outstanding adjusted for dilution calculation	28,847	30,464

As of September 30, 2008 and 2007, stock options to purchase 1,814 and 785 common shares, respectively, were excluded from the respective diluted earnings per share calculation because their impact was anti-dilutive.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(12) Comprehensive Income

Total comprehensive income represents the sum of net income and items of other comprehensive income or loss that are reported directly in equity. Such items, which are generally presented on a net of tax basis, may include foreign currency translation adjustments, minimum pension liability adjustments (i.e. gains and losses) on certain derivative instruments, and unrealized gains and losses on certain investments in debt and equity securities. We have reported our total comprehensive income in the Consolidated Statements of Shareholders Equity.

Our accumulated other comprehensive income, which is comprised of losses on certain derivative instruments and accumulated foreign currency translation adjustments, totaled $2.3 million at September 30, 2008 and $2.7 million at June 30, 2008. Losses on derivative instruments are the result of cash flow hedging contracts entered into in connection with the issuance of the Senior Notes (see Note 8). Foreign currency translation adjustments are the result of changes in foreign currency exchange rates related to our operation of five Ethan Allen owned retail design centers located in Canada and our cut and sew plant located in Mexico. Foreign currency translation adjustments exclude income tax expense (benefit) given that the earnings of non-U.S. subsidiaries are deemed to be reinvested for an indefinite period of time.

(13) Financial Instruments

We adopted SFAS No. 157 on July 1, 2008 for all financial assets and liabilities and nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

SFAS No. 157 defines fair value as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability. The fair value should be calculated based on assumptions that market participants would use in pricing the asset or liability, not on assumptions specific to the entity. In addition, the fair value of liabilities should include consideration of non-performance risk including our own credit risk.

In addition to defining fair value, SFAS No. 157 expands the disclosure requirements around fair value and establishes a fair value hierarchy for valuation inputs. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

- Level 1 inputs are based upon unadjusted quoted prices for identical instruments traded in active markets.

- Level 2 inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

- Level 3 inputs are generally unobservable and typically reflect management s estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques that include option pricing models, discounted cash flow models, and similar techniques.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

The following section describes the valuation methodologies we use to measure different financial assets and liabilities at fair value.

Cash Equivalents

Cash equivalents consist of money market accounts and mutual funds in U.S. government and agency securities.

We use quoted prices in active markets for identical assets or liabilities to determine fair value. This pricing methodology applies to our Level 1 cash equivalents. We do not hold any Level 2 or Level 3 investments in our cash equivalents.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

At September 30, 2008, the Company s assets and liabilities measured at fair value on a recurring basis consist of $70.3 million in cash equivalents, which were valued using Level 1 inputs.

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

We measure certain assets, including our cost and equity method investments, at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. During the three months ended September 30, 2008, we did not record any other-than-temporary impairments on those assets required to be measured at fair value on a nonrecurring basis.

(14) Segment Information

Our operations are classified into two operating segments: wholesale and retail. These operating segments represent strategic business areas which, although they operate separately and provide their own distinctive services, enable us to more effectively offer our complete line of home furnishings and accessories.

The wholesale segment is principally involved in the development of the Ethan Allen brand, which encompasses the design, manufacture, domestic and offshore sourcing, sale and distribution of a full range of home furnishings and accessories to a network of independently owned and Ethan Allen owned design centers as well as related marketing and brand awareness efforts. Wholesale revenue is generated upon the wholesale sale and shipment of our product to all retail design centers, including those owned by Ethan Allen. Wholesale profitability includes (i) the wholesale gross margin, which represents the difference between the wholesale sales price and the cost associated with manufacturing and/or sourcing the related product, and (ii) other operating costs associated with wholesale segment activities.

The retail segment sells home furnishings and accessories to consumers through a network of Company owned design centers. Retail revenue is generated upon the retail sale and delivery of our product to our customers. Retail profitability includes (i) the retail gross margin, which represents the difference between the retail sales price and the cost of goods purchased from the wholesale segment, and (ii) other operating costs associated with retail segment activities.

Inter-segment eliminations result, primarily, from the wholesale sale of inventory to the retail segment, including the related profit margin.

We evaluate performance of the respective segments based upon revenues and operating income. While the manner in which our home furnishings and accessories are marketed and sold is consistent, the nature of the underlying recorded sales (i.e. wholesale versus retail) and the specific services that each operating segment provides (i.e. wholesale manufacturing, sourcing, and distribution versus retail selling) are different. Within the wholesale

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

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segment, we maintain revenue information according to each respective product line (i.e. case goods, upholstery, or home accessories and other).

A breakdown of wholesale sales by these product lines for the three months ended September 30, 2008 and 2007 is provided as follows:

	Three Months Ended September 30, 2008	2007
Case Goods	41%	47%
Upholstered Products	42	37
Home Accessories and Other	17	16
	100%	100%

Revenue information by product line is not as easily determined within the retail segment. However, because wholesale production and sales are matched, for the most part, to incoming orders, we believe that the allocation of retail sales by product line would be similar to that of the wholesale segment.

Segment information for the three months ended September 30, 2008 and 2007 is set forth as follows:

	Three Months Ended September 30, 2008		2007	
Net Sales:				
Wholesale segment	$	121,295	$	156,323
Retail segment		155,870		182,754
Elimination of inter-company sales		(71,324)		(90,350)
Consolidated Total	$	205,841	$	248,727
Operating Income:				
Wholesale segment (1)	$	11,885	$	26,780
Retail segment (2)		(3,052)		899
Adjustment of inter-company profit (3)		3,378		118
Consolidated Total	$	12,211	$	27,797
Capital Expenditures:				
Wholesale segment	$	1,632	$	2,044
Retail segment		9,461		10,501
Acquisitions (4) (5)		375		96
Consolidated Total	$	11,468	$	12,641

		September 30, 2008		June 30, 2008
Total Assets				
Wholesale segment	$	344,444	$	342,960
Retail segment		452,130		459,842
Inventory profit elimination(6)		(37,317)		(40,829)
Consolidated Total	$	759,257	$	761,973

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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(1) Operating income for the wholesale segment for 2008 includes a pre-tax restructuring and impairment charge of $0.4 million for the September quarter.
(2) Operating income for the retail segment for 2008 includes pre-tax restructuring and impairment net recovery of $2.0 million for the September quarter.
(3) Represents the change in the inventory profit elimination necessary to adjust for the embedded wholesale profit contained in Ethan Allen-owned design center inventory existing at the end of the period.
(4) Amount reflected as acquisitions for the three months ended September 30, 2008 includes the purchase of two retail design centers.
(5) Amount reflected as acquisitions for 2007 excludes the purchase (for consideration totaling $0.6 million) of a retail design center with an effective (closing) date of June 30, 2007 and for which funding did not occur until July 2, 2007.
(6) Represents the embedded wholesale profit contained in Ethan Allen-owned design center inventory that has not yet been realized. These profits are realized when the related inventory is sold.

There were 40 independent retail design centers located outside the United States at September 30, 2008. Approximately 3% to 4% of our net sales were derived from sales to these retail design centers.

(15) Subsequent Events

None

(16) Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)), which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity s fiscal year that begins after December 15, 2008 (July 1, 2009 for the Company). The impact of this statement on the Company s financial position, results of operations and cash flows will be dependent upon the terms, conditions and details of such acquisitions.

In February 2008, the FASB issued FASB Staff Position 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS No. 157 to July 1, 2009 for us, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We believe the adoption of the delayed items of SFAS No. 157 will not have a material impact on our financial statements.

(17) Financial Information About the Parent, the Issuer and the Guarantors

On September 27, 2005, Global (the Issuer) issued $200 million aggregate principal amount of Senior Notes which have been guaranteed on a senior basis by Interiors (the Parent), and other wholly owned subsidiaries of the Issuer and the Parent, including Ethan Allen Retail, Inc., Ethan Allen Operations, Inc., Ethan Allen Realty, LLC, Lake Avenue Associates, Inc. and Manor House, Inc. The subsidiary guarantors (other than the Parent) are collectively called the Guarantors . The guarantees of the Guarantors are unsecured. All of the guarantees are full, unconditional and joint and several and the Issuer and each of the Guarantors are 100% owned by the Parent. Ethan Allen (UK) Ltd., KEA International Inc. (which was legally dissolved in January 2007), Northeast Consolidated, Inc. (which was legally dissolved in June 2007), Riverside Water Works, Inc. (which was legally dissolved in June 2007), and our other subsidiaries which are not guarantors are called the Non-Guarantors .

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

The following tables set forth the condensed consolidating balance sheets as of September 30, 2008 and June 30, 2008, the condensed consolidating statements of operations for the three months ended September 30, 2008 and 2007, and the condensed consolidating statements of cash flows for the three months ended September 30, 2008 and 2007 of the Parent, the Issuer, the Guarantors and the Non-Guarantors.

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

CONDENSED CONSOLIDATING BALANCE SHEET

(In thousands)

September 30, 2008

	Parent	Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated
Assets						
Current assets:						
Cash and cash equivalents	$	$ 76,960	$ 2,957	$	$	$ 79,917
Accounts receivable, net		10,947	602			11,549
Inventories			224,812		(37,317)	187,495
Prepaid expenses and other current assets		11,823	14,381			26,204
Intercompany		732,361	212,547		(944,908)	
Total current assets		832,091	455,299		(982,225)	305,165
Property, plant and equipment, net		12,979	342,057			355,036
Goodwill and other intangible assets		37,905	56,728			94,633
Other assets		3,509	914			4,423
Investment in affiliated companies	670,584	106,157			(776,741)	
Total assets	$ 670,584	$ 992,641	$ 854,998	$	$ (1,758,966)	$ 759,257
Liabilities and Shareholders Equity						
Current liabilities:						
Current maturities of long-term debt	$	$	$ 41	$	$	$ 41
Customer deposits			42,640			42,640
Accounts payable		10,546	15,348			25,894
Accrued expenses and other current liabilities	7,316	44,329	16,411			68,056
Intercompany	289,590	597	654,721		(944,908)	
Total current liabilities	296,906	55,472	729,161		(944,908)	136,631
Long-term debt		198,877	4,141			203,018
Other long-term liabilities		7,781	12,880			20,661
Deferred income taxes		22,948				22,948
Total liabilities	296,906	285,078	746,182		(944,908)	383,258
Shareholders equity	373,678	707,563	108,816		(814,058)	375,999
Total liabilities and shareholders equity	$ 670,584	$ 992,641	$ 854,998	$	$ (1,758,966)	$ 759,257

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

CONDENSED CONSOLIDATING BALANCE SHEET

(In thousands)

June 30, 2008

	Parent	Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated
Assets						
Current assets:						
Cash and cash equivalents	$	$ 71,117	$ 3,259	$	$	$ 74,376
Accounts receivable, net		11,937	735			12,672
Inventories			227,094		(40,829)	186,265
Prepaid expenses and other current assets		15,355	21,510			36,865
Intercompany receivables		713,984	209,471		(923,455)	0
Total current assets		812,393	462,069		(964,284)	310,178
Property, plant and equipment, net		13,186	337,246			350,432
Goodwill and other intangible assets		37,905	58,918			96,823
Other assets		3,604	936			4,540
Investment in affiliated companies	662,726	117,368			(780,094)	
Total assets	$ 662,726	$ 984,456	$ 859,169	$	$ (1,744,378)	$ 761,973
Liabilities and Shareholders Equity						
Current liabilities:						
Current maturities of long-term debt			41			41
Customer deposits			47,297			47,297
Accounts payable		9,785	16,659			26,444
Accrued expenses and other current liabilities	6,438	36,885	18,397			61,720
Intercompany payables	283,216	597	639,601	41	(923,455)	
Total current liabilities	289,654	47,267	721,995	41	(923,455)	135,502
Long-term debt		198,837	4,151			202,988
Other long-term liabilities		7,819	12,564			20,383
Deferred income taxes		27,327				27,327
Total liabilities	289,654	281,250	738,710	41	(923,455)	386,200
Shareholders equity	373,072	703,206	120,459	(41)	(820,923)	375,773
Total liabilities and shareholders equity	$ 662,726	$ 984,456	$ 859,169	$	$ (1,744,378)	$ 761,973

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ETHAN ALLEN INTERIORS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

(In thousands)

Three Months Ended September 30, 2008

	Parent	Issuer	Guarantors	Non-Guarantors	Eliminations	Consolidated
Net sales	$	$ 121,596	$ 214,880	$	$ (130,635)	$ 205,841
Cost of sales		88,405	139,666		(134,171)	93,900
Gross profit		33,191	75,214		3,536	111,941
Selling, general and administrative expenses	41	13,291	88,028			101,360
Restructuring and impairment charge, (credit) net			(1,630)			(1,630)
Total operating expenses	41	3,291	86,398			99,730
Operating income (loss)	(41)	19,900	(11,184)		3,536	12,211
Interest and other miscellaneous income, net	7,463	(10,136)	8		3,765	1,100
Interest and other related financing costs		2,825	76			2,901
Income before income tax expense	7,422	6,939	(11,252)		7,301	10,410
Income tax expense		2,988				