

CHEROKEE INC
Form 10-Q
December 09, 2009
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended October 31, 2009.

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 0-18640

CHEROKEE INC.

(Exact name of registrant as specified in its charter)

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Delaware

(State or other jurisdiction of Incorporation or organization)

95-4182437

(IRS employer identification number)

6835 Valjean Avenue, Van Nuys, CA

(Address of principal executive offices)

91406

Zip Code

Registrant's telephone number, including area code **(818) 908-9868**

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller reporting company ☐

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

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

Class
Common Stock, \$.02 par value per share

Outstanding at December 9, 2009
8,814,187

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	October 31, 2009	January 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 9,262,000	\$ 13,652,000
Receivables, net	7,455,000	5,475,000
Prepaid expenses and other current assets	121,000	75,000
Income taxes receivable	1,657,000	1,609,000
Deferred tax asset	769,000	795,000
Total current assets	19,264,000	21,606,000
Deferred tax asset	651,000	894,000
Property and equipment, net of accumulated depreciation of \$781,000 and \$725,000, respectively	185,000	210,000
Trademarks, net of accumulated amortization of \$10,162,000 and \$9,081,000, respectively	8,115,000	9,013,000
Other assets	14,000	14,000
Total assets	\$ 28,229,000	\$ 31,737,000
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 897,000	\$ 954,000
Accrued compensation payable	2,260,000	2,902,000
Income taxes payable	1,226,000	734,000
Dividends payable	4,407,000	4,407,000
Total current liabilities	8,790,000	8,997,000
Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock, \$.02 par value, 1,000,000 shares authorized, none issued and outstanding		
Common stock, \$.02 par value, 20,000,000 shares authorized, 8,814,187 and 8,814,187 shares issued and outstanding at October 31, 2009 and at January 31, 2009, respectively	176,000	176,000
Additional paid-in capital	15,334,000	14,875,000
Retained earnings	3,929,000	7,689,000

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Stockholders' equity	19,439,000	22,740,000
Total liabilities and stockholders' equity	\$ 28,229,000	\$ 31,737,000

See the accompanying notes which are an integral part of these consolidated financial statements.

Table of Contents**CHEROKEE INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****Unaudited**

	Three months ended		Nine months ended	
	October 31, 2009	November 1, 2008	October 31, 2009	November 1, 2008
Royalty revenues	\$ 8,041,000	\$ 8,036,000	\$ 25,014,000	\$ 30,100,000
Selling, general and administrative expenses	3,330,000	3,370,000	9,791,000	10,999,000
Operating income	4,711,000	4,666,000	15,223,000	19,101,000
Other income:				
Interest and other income	6,000	46,000	19,000	144,000
Total other income	6,000	46,000	19,000	144,000
Income before income taxes	4,717,000	4,712,000	15,242,000	19,245,000
Income tax provision	1,946,000	1,461,000	5,781,000	7,282,000
Net income	\$ 2,771,000	\$ 3,251,000	\$ 9,461,000	\$ 11,963,000
Basic earnings per share	\$ 0.31	\$ 0.37	\$ 1.07	\$ 1.34
Diluted earnings per share	\$ 0.31	\$ 0.37	\$ 1.07	\$ 1.34
Weighted average shares outstanding				
Basic	8,814,187	8,880,561	8,814,187	8,905,743
Diluted	8,814,393	8,880,643	8,814,187	8,916,440

See the accompanying notes which are an integral part of these consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

Unaudited

	Shares	Common Stock Par Value	Additional Paid-in Capital	Retained Earnings	Total
Balance at January 31, 2009	8,814,187	\$ 176,000	\$ 14,875,000	\$ 7,689,000	\$ 22,740,000
Stock-based compensation			459,000		459,000
Tax benefit related to stock options exercised					
Proceeds from exercise of stock options					
Accrued dividends				(13,221,000)	(13,221,000)
Net income				9,461,000	9,461,000
Balance at October 31, 2009	8,814,187	\$ 176,000	\$ 15,334,000	\$ 3,929,000	\$ 19,439,000

See the accompanying notes which are an integral part of these consolidated financial statements.

Table of Contents**CHEROKEE INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****Unaudited**

	Nine months ended	
	October 31 2009	November 1, 2008
<u>Operating activities</u>		
Net income	\$ 9,461,000	\$ 11,963,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	57,000	40,000
Amortization of trademarks	1,081,000	1,056,000
Deferred income taxes	269,000	473,000
Stock-based compensation	459,000	410,000
Excess tax benefit from share-based payment arrangements		(148,000)
Changes in current assets and liabilities:		
Increase in accounts receivable	(1,980,000)	(32,000)
Increase in prepaid expenses and other assets	(46,000)	(51,000)
Increase in income taxes receivable	(48,000)	(27,000)
Increase (decrease) in accounts payable	(57,000)	255,000
Decrease in accrued compensation	(642,000)	(1,004,000)
Increase (decrease) in income taxes payable and other accrued liabilities	492,000	(1,091,000)
Net cash provided by operating activities	9,046,000	11,844,000
<u>Investing activities</u>		
Purchase of property and equipment	(32,000)	(72,000)
Purchase of trademarks, registration and renewal costs	(183,000)	(279,000)
Net cash used in investing activities	(215,000)	(351,000)
<u>Financing activities</u>		
Proceeds from exercise of stock options		231,000
Purchase and retirement of common stock		(1,977,000)
Dividends	(13,221,000)	(17,835,000)
Excess tax benefit from share-based payment arrangements		148,000
Net cash used in financing activities	(13,221,000)	(19,433,000)
Decrease in cash and cash equivalents	(4,390,000)	(7,940,000)
Cash and cash equivalents at beginning of period	13,652,000	21,955,000
Cash and cash equivalents at end of period	\$ 9,262,000	\$ 14,015,000
Cash paid during period for:		
Income taxes	\$ 4,604,000	\$ 7,826,000
Interest		
Declaration of dividends	\$ 4,407,000	\$ 4,407,000

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See the accompanying notes which are an integral part of these consolidated financial statements.

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CHEROKEE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements as of October 31, 2009 and for the three and nine month periods ended October 31, 2009 and November 1, 2008 have been prepared in accordance with U.S. generally accepted accounting principles (GAAP). These consolidated financial statements have not been audited by independent registered public accountants but include all adjustments, consisting of normal recurring accruals, which in the opinion of management of Cherokee Inc. (Cherokee or the Company) are necessary for a fair statement of the financial position and the results of operations for the periods presented. Certain previously reported amounts have been reclassified to conform to current year presentation. The accompanying consolidated balance sheet as of January 31, 2009 has been derived from audited consolidated financial statements, but does not include all disclosures required by GAAP. The results of operations for the three and nine month periods ended October 31, 2009 are not necessarily indicative of the results to be expected for the fiscal year ending January 30, 2010. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended January 31, 2009.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of sales and expenses during the reporting period. Actual results could differ from those estimates.

As used herein, the term First Quarter refers to the three months ended May 2, 2009; the term Second Quarter refers to the three months ended August 1, 2009; the term Third Quarter refers to the three months ended October 31, 2009; the term Nine Months refers to the nine months ended October 31, 2009; the term Fiscal 2010 refers to our fiscal year ending January 30, 2010; the term Fiscal 2009 refers to our most recent past fiscal year ended January 31, 2009; the term Fiscal 2008 refers to our fiscal year ended February 2, 2008; and the term Fiscal 2007 refers to our fiscal year ended February 3, 2007.

The Company has performed an evaluation of subsequent events through December 9, 2009, which is the date the financial statements were issued.

(2) Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, SPELL C. LLC, a Delaware limited liability corporation. All significant intercompany accounts and transactions have been eliminated in consolidation.

Revenue Recognition

Revenues from royalty and finders agreements are recognized when earned by applying contractual royalty rates to quarterly point of sale data received from our licensees. Our royalty recognition policy provides for recognition of royalties in the quarter earned, although a large portion of such royalty payments are actually received during the month following the end of a quarter. Revenues are not recognized unless collectability is reasonably assured. Certain royalty agreements that account for the majority of our historical revenues are structured to provide royalty rate reductions once certain cumulative levels of sales are achieved by our licensees. Revenue is recognized by applying the reduced contractual royalty rates prospectively to point of sale data as required sales thresholds are exceeded. The royalty rate reductions do not apply retroactively to sales since the beginning of the fiscal year, and as a consequence such royalty rate reductions do not impact previously recognized royalty revenue.

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As a result, our royalty revenues from certain licensees' retail sales of branded products are highest at the beginning of each fiscal year and decrease in each fiscal quarter as licensees reach certain retail sales thresholds contained in their respective license agreements. Therefore, the amount of royalty revenue we recognize in any quarter is dependent on the retail sales of branded products in such quarter and the royalty rate in effect after considering the cumulative level of retail sales. Historically, this has caused our first quarter to be our highest revenue and profitability quarter; our second quarter to be our next highest quarter, and our third and fourth quarters to be our lowest quarters. The amount of the royalty rate reductions and the level of retail sales at which they are achieved vary in each licensing agreement.

Earnings Per Share Computation

The following table provides a reconciliation of the numerator and denominator of the basic and diluted per-share computations for the three and nine month periods ended October 31, 2009 and November 1, 2008:

	October 31, 2009		November 1, 2008	
	3 Months	9 Months	3 Months	9 Months
Numerator:				
Net income-numerator for net income per common share and net income per common share assuming dilution	\$ 2,771,000	\$ 9,461,000	\$ 3,251,000	\$ 11,963,000
Denominator:				
Denominator for net income per common share-weighted average shares	8,814,187	8,814,187	8,880,561	8,905,743
Effect of dilutive securities:				
Stock options	206		82	10,697
Denominator for net income per common share, assuming dilution:				
Adjusted weighted average shares and assumed exercises	8,814,393	8,814,187	8,880,643	8,916,440

The diluted weighted average number of shares for the three month periods ended October 31, 2009 and November 1, 2008, respectively, excludes 348,969 and 375,981 shares, respectively, of common stock issuable on the exercise of stock options that have an exercise price above the average market price for the period because such stock options outstanding were anti-dilutive. The diluted weighted average number of shares for the nine month periods ended October 31, 2009 and November 1, 2008, respectively, excludes 354,723 and 224,311 shares, respectively, of common stock issuable on the exercise of stock options because such options were anti-dilutive.

Significant Contracts

Our two most significant contracts are our retail direct licensing agreements with Target Stores, a subsidiary of Target Corp. (Target) for the Cherokee brand in the United States, and with Great Britain's Tesco Stores Limited (Tesco) for the Cherokee brand in the United Kingdom, certain countries in Central Europe, and certain countries in Asia, as further described below.

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In 1997, we entered into a license agreement with Target that grants Target the exclusive right in the United States to use the Cherokee trademarks in various categories of merchandise. Effective February 1, 2008, we entered into a restated license agreement with Target (the Restated Target Agreement). The Restated Target Agreement grants Target the exclusive right in the United States to use the Cherokee trademarks in various specified categories of merchandise. The term of the Restated Target Agreement continues through January 31, 2012. However, the Restated Target Agreement provides that if Target remains current in its payments of the minimum guaranteed royalty of \$9.0 million for the preceding fiscal year, then the term of the Restated Target Agreement will continue to automatically renew for successive fiscal year terms provided that Target does not give notice of its intention to terminate the agreement during February of the calendar year prior to the date of termination. Under the Restated Target Agreement, Target has agreed to pay royalties based on a percentage of Target's net sales of Cherokee

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branded merchandise during each fiscal year ended January 31st, which percentage varies according to the volume of sales of merchandise.

On August 1, 2001, we entered into an exclusive international retail direct licensing agreement for the Cherokee brand with Tesco (the Tesco Agreement). Tesco was granted the exclusive right to manufacture, promote, sell and distribute a wide range of products bearing our Cherokee brand in the United Kingdom and Ireland and is obligated to pay us a royalty based upon a percentage of its net sales of Cherokee branded products in those countries. In January 2004, we expanded the Tesco Agreement to include South Korea, Malaysia, Thailand, Slovakia, and Hungary, and in 2005, we expanded the Tesco Agreement to include Poland and the Czech Republic. In March 2006, Tesco began to sell Cherokee branded products in the Czech Republic, Poland, and Slovakia, and, in July 2006, Tesco began to sell Cherokee branded products in Hungary. To date Tesco has not sold any Cherokee branded products in its Asian territories. The term of the Tesco Agreement expires on January 31, 2011, and Tesco has several options to extend this term.

We also have other licensing agreements regarding our brands, including with: (i) Zellers for our Cherokee brand in Canada; (ii) TJX Companies for our Carole Little and St. Tropez-West brands in the U.S. and other select countries; and (iii) a number of other international license agreements for our Cherokee brand. For a more complete description of our license agreements and other commercial agreements, please see our Annual Report on Form 10-K for Fiscal 2009.

Stock-Based Compensation

We currently maintain three equity-based compensation plans: (i) the Cherokee 1995 Incentive Stock Option Plan (the 1995 Plan); (ii) the 2003 Incentive Award Plan (the 2003 Plan); and (iii) the 2006 Incentive Award Plan (the 2006 Plan and, together with the 2003 Plan, the Plans). Each of these equity based compensation plans provide for the issuance of equity-based awards to officers and other employees and directors, and they have previously been approved by our stockholders. Stock options issued to employees are granted at the market price on the date of grant, generally vest over a three-year period, and generally expire seven to ten years from the date of grant. We issue new shares of common stock upon exercise of stock options.

The 1995 Plan was approved at the October 30, 1995 Annual Meeting of Stockholders. The options granted under the 1995 Plan vest in equal installments over a three-year period starting at the grant date and have a term of ten years. The 1995 Plan expired on July 24, 2005. However, options previously granted under the 1995 Plan will remain outstanding until the earlier of expiration or exercise. In the event that any outstanding option under the 1995 Plan expires or is terminated, the shares of common stock allocable to the unexercised portion of the option shall no longer be available for grant.

The 2003 Plan was approved at the June 9, 2003 Annual Meeting of Stockholders, and amended at the June 13, 2006 Annual Meeting of Stockholders. The principal purposes of the 2003 Plan are to provide an additional incentive for our directors, employees and consultants to further our growth, development and financial success and to enable us to obtain and retain their services. The Compensation Committee of the Board of Directors or another committee thereof (the Committee) administers the 2003 Plan with respect to grants to our employees or consultants and the full Board of Directors (the Board) administers the 2003 Plan with respect to grants to independent directors. Awards under the 2003 Plan may be granted to individuals who are then officers or other employees of Cherokee or any of our present or future subsidiaries. Such awards also may be granted to our consultants selected by the Committee for participation in the 2003 Plan. The 2003 Plan provides that the Committee may grant or issue stock options and restricted stock awards, or any combination thereof. Two types of stock options may be granted under the plan: incentive and non-qualified stock options. In addition, restricted stock may be sold to participants at various prices (but

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not below par value) and made subject to such restrictions as may be determined by the Board or Committee. The maximum number of shares authorized for the grant of awards under the 2003 Plan is 250,000. Furthermore, the maximum number of shares which may be subject to awards granted under the 2003 Plan to any individual in any calendar year cannot exceed 100,000. The vesting period and term for options granted under the 2003 Plan shall be set by the Committee, with the term being no greater than 10 years, and the options generally will vest over a specific time period as designated by the Committee upon the awarding of such options. During the Nine Months, we did not make any grants under the 2003 Plan, nor were there any forfeits of previously outstanding options. In the event that any outstanding option under the 2003 Plan expires or is terminated, the shares of common stock allocable to the unexercised portion of the option shall then become

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available for grant in the future, until the 2003 Plan expires on April 28, 2016. As of October 31, 2009, there were 40,096 shares available for option grants under the 2003 Plan.

The 2006 Plan was approved at the June 13, 2006 Annual Meeting of Stockholders. The principal purposes of the 2006 Plan are to provide an additional incentive for our directors, employees and consultants to further our growth, development and financial success and to enable us to obtain and retain their services. The 2006 Plan provides for the grant of options and restricted stock awards. The 2006 Plan is administered by the Committee with respect to grants to our employees or consultants and the full Board administers the 2006 Plan with respect to grants to independent directors. Awards under the 2006 Plan may be granted to individuals who are then officers or other employees of Cherokee or any of our present or future subsidiaries. Such awards also may be granted to our consultants selected by the Committee for participation in the 2006 Plan. The 2006 Plan provides that the Committee may grant or issue stock options and restricted stock awards, or any combination thereof. Two types of stock options may be granted under the 2006 Plan: incentive and non-qualified stock options. In addition, restricted stock may be sold to participants at various prices (but not below par value) and made subject to such restrictions as may be determined by the Board or Committee. The maximum number of shares authorized for the grant of awards under the 2006 Plan is 250,000. Furthermore, the maximum number of shares which may be subject to awards granted under the 2006 Plan to any individual in any calendar year cannot exceed 100,000. The vesting period and term for options granted under the 2006 Plan shall be set by the Committee, with the term being no greater than 10 years, and the options generally vesting over a specific time period as designated by the Committee upon the awarding of such options. During the Nine Months, we did not make any grants under the 2006 Plan, nor were there any forfeits of previously outstanding options. In the event that any outstanding option granted under the 2006 Plan expires or is terminated, the shares of common stock allocable to the unexercised portion of the option shall then become available for grant in the future, until the 2006 Plan expires on April 28, 2016. As of October 31, 2009, we had 35,250 shares available for grants of Awards under the 2006 Plan.

Stock-based compensation expense recognized for the Nine Months was \$459,000, as compared to \$410,000 for the comparable period in the prior year. There were no stock option grants in the Nine Months.

When grants of options are made, the expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar options, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. The expected stock price volatility is based on the historical volatility of our stock price. The risk-free interest rate is based on the U.S. Treasury yield in effect at the time of grant with an equivalent remaining term. The dividend yield is based on the past dividends paid and the current dividend yield at the time of grant.

A summary of activity for the Company's stock options for the Nine Months is as follows:

	Shares	Weighted Average Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding, at January 31, 2009	354,723	\$ 31.83		
Granted				
Exercised				
Canceled/forfeited				
Outstanding, at October 31, 2009	354,723	\$ 31.83	4.17	\$

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Vested and Exercisable at October 31, 2009	253,964	\$	33.29	3.65	\$
Non-vested and not exercisable at October 31, 2009	100,759	\$	28.30	5.84	\$

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As of October 31, 2009, total unrecognized stock-based compensation expense related to non-vested stock options was approximately \$397,000, which is expected to be recognized over a weighted average period of approximately 1.25 years. The total fair value of all options which vested during the Nine Months was \$355,000.

Trademarks

During the Third Quarter and Nine Months, the Company did not acquire any trademarks, nor were there any trademark acquisitions during the comparable periods last year. Trademark registration and renewal fees which were capitalized during the Third Quarter and Nine Months totaled \$66,000 and \$183,000, respectively. In comparison, for the third quarter and nine months of Fiscal 2009, the total trademark registration and renewal fees capitalized totaled \$86,000 and \$279,000, respectively.

Income Taxes

Income tax expense of \$1.9 million was recognized for the Third Quarter, resulting in an effective tax rate of 41.3%, as compared to 31.0% in the third quarter of Fiscal 2009 and compared to 37.8% for the full year of Fiscal 2009. The lower effective tax rate in the third quarter of Fiscal 2009 was due to the settlement of previously uncertain tax positions.

The Company files U.S. federal and state income tax returns. For federal income tax purposes, the Company is generally no longer subject to tax examinations for fiscal years prior to 2007. The Company's Fiscal 2008 federal tax return is currently under examination. With limited exception, our significant state tax jurisdictions are no longer subject to examinations by the various tax authorities for fiscal years prior to 2003. Although the outcome of tax audits is always uncertain, we believe that adequate amounts of tax, interest and penalties, if any, have been provided for in our income tax reserve for any adjustments that may result from future tax audits. We recognize interest and penalties, if any, related to unrecognized tax benefits within the provision for income taxes in our consolidated statement of income. As of January 31, 2009 and October 31, 2009, respectively, accrued interest on a gross basis was \$96,000 and \$62,000.

We adopted the provision of the Codification which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with ASC Topic 740, *Income Taxes* (ASC 740) effective February 4, 2007. The cumulative effect of applying ASC 740 resulted in a decrease to retained earnings of \$0.4 million as of February 4, 2007. As of January 31, 2009 and October 31, 2009, respectively, the total amount of gross unrecognized tax benefits was approximately \$0.5 and \$0.7 million, of which approximately \$0.5 and \$0.7 million represents the amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. It is reasonably possible that \$0.6 million of unrecognized tax benefits may decrease within the next 12 months as a result of settling certain positions. The expected net impact of the changes would not have a significant impact on the results of operations or the financial position of the Company.

Recent Accounting Pronouncements

In the third quarter of 2009, the Company adopted the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC and collectively, the Codification), which establishes the Codification as the source of authoritative accounting principles recognized by the

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FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. The historical GAAP hierarchy was eliminated and the Codification became the only level of authoritative GAAP, other than guidance issued by the SEC. The FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standard Updates (ASUs). ASUs will serve to update the Codification, provide background information about the guidance and provide the bases for conclusions on change(s) in the Codification. The Codification is effective for all financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of the Codification did not have an impact on our consolidated financial statements. However, references to specific accounting standards in the notes to our condensed consolidated financial statements have been changed to refer to the appropriate section of the Codification.

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In September 2006, the FASB issued FASB ASC Topic 820, *Fair Value Measurements and Disclosures* (ASC 820) which Cherokee adopted on its first day of Fiscal 2009. ASC 820 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. The adoption of ASC 820 did not have a material impact on our consolidated financial statements.

Cherokee adopted ASC Topic 825, *Financial Instruments* (ASC 825) on the first day of Fiscal 2009, which permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be included in net earnings at each subsequent reporting date. The adoption of ASC 825 did not have a material impact on our consolidated financial statements.

In May 2009, the FASB issued ASC Topic 855, *Subsequent Events* (ASC 855), which is intended to establish general standards of accounting for and disclosure of events that occurred after the balance sheet date but before financial statements are issued or are available to be issued. The statement requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. The statement was effective for the Company beginning in the Second Quarter.

(3) Dividends

On January 29, 2009, our Board of Directors approved a dividend of \$4.4 million, or \$0.50 per share, which was paid on March 18, 2009. On April 28, 2009, we declared a dividend of \$4.4 million, or \$0.50 per share, which was paid on June 18, 2009. On July 27, 2009, we declared a dividend of \$4.4 million, or \$0.50 per share, which was paid on September 16, 2009. On October 27, 2009, we declared a dividend of \$4.4 million, or \$0.50 per share, which is to be paid on December 16, 2009 to stockholders of record as of December 1, 2009.

(4) Related Party Transactions

The services of Mr. Robert Margolis, as our Chief Executive Officer are provided to us pursuant to a management agreement (the Management Agreement). The Management Agreement, as amended, provides for certain base compensation and bonuses, as defined, payable to Mr. Margolis. The initial term of the Management Agreement was until February 2, 2002, however, it will automatically be extended for each consecutive one year period in the event that pre-tax earnings, as defined, exceed specified levels as agreed upon by the Company's Compensation Committee. The Management Agreement provides that, for each fiscal year after fiscal 2000, if our EBITDA for such fiscal year is no less than \$5.0 million, then Mr. Margolis will receive a performance bonus equal to 10% of our EBITDA for such fiscal year in excess of \$2.5 million up to \$10.0 million, plus 15% of our EBITDA for such fiscal year in excess of \$10.0 million. For Fiscal 2010, pursuant to the Management Agreement, Mr. Margolis' base compensation is \$790,000. For the Nine Months the Company accrued bonus compensation payable totaling \$2.3 million, the majority of which pertains to Mr. Margolis' performance bonus for this period. As of October 31, 2009 and January 31, 2009, the Company accrued bonus compensation payable pertaining to Mr. Margolis' performance bonus of approximately \$2.0 million and \$2.9 million, respectively. If our EBITDA continues to increase, the bonus payable to Mr. Margolis under the Management Agreement will also increase.

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If the Company fails to meet the criteria for extending the term of the Management Agreement in any particular fiscal year, the Management Agreement will not be extended in that year and will thereafter be scheduled to expire two-years from the date of such failure, but the Management Agreement will remain eligible to be extended by an additional year in any subsequent fiscal year during the term of the Management Agreement in which the criteria to extend the term of the Management Agreement are satisfied. Pre-tax earnings for Fiscal 2008, Fiscal 2007 and Fiscal 2006 exceeded specified levels as set forth in the Management Agreement and as reviewed and agreed upon by the Company's Compensation Committee, thereby automatically extending the Management Agreement to February 1, 2011. However, pre-tax earnings for Fiscal 2009 did not exceed the specified criteria for extending the Management Agreement, and hence as of October 31, 2009, the expiration date of the Management Agreement is currently February 1, 2011. The Management Agreement also provides that Mr. Margolis may nominate one director to the Board of Directors and certain other investors may nominate one director to the Board of Directors.

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The Management Agreement may be terminated at any time without cause or in the event of certain circumstances, as defined in the Management Agreement. If we terminate the Management Agreement without cause or Mr. Margolis terminates the Management Agreement if we materially breach the terms and conditions of the Management Agreement or fail to perform any material obligation there under, Mr. Margolis is entitled to receive within 60 days of termination, a lump sum cash payment equal to three times the sum of his annual base compensation and the previous year's performance bonus, plus the pro rata earned performance bonus during such fiscal year up to the date of termination. (the Termination Payment). On August 28, 2007, we entered into an amendment (the Amendment) to the Management Agreement which amends, among other things, the provisions regarding the Termination Payment to reduce the payment by disregarding all revenues received from Mossimo, Inc. during Fiscal 2007 and also the related expenses associated with the termination of the Finder's Agreement. The Amendment was approved by the Company's stockholders at the Annual Meeting of the Stockholders on August 28, 2007. Mr. Margolis' annual base compensation for Fiscal 2010 is \$790,000 and his performance bonus for Fiscal 2009 was approximately \$2.9 million. In the event the Management Agreement, as amended, was terminated as described above, the Termination Payment for Mr. Margolis as of October 31, 2009 would be approximately \$11.1 million plus his pro rata earned performance bonus during Fiscal 2010 up to the date of termination.

On October 8, 2007, the Company entered into a contingent Finders Fee Agreement (the Contingent Finders Fee Agreement) with a director pertaining to his services as a director of the Company in introducing the Company to its licensee for the Cherokee brand in India. The Contingent Finders Fee Agreement called for the director to receive 5% of all royalty revenues received by the Company in years 6 through 10 (and possibly years 11 through 15) only if the licensee decides to renew the licensing agreement beyond the original five year term to a second five year term (years 6 through 10), and again if another five year term is renewed (years 11 through 15). The Contingent Finders Fee Agreement expires at the earlier of (i) termination of the licensing agreement with the subject licensee for India, or (ii) ten years of payments (through year 15). On November 17, 2009, the Company and its licensee entered into an amended agreement (Amendment) extending the first renewal term to ten (10) years. As the licensing agreement with the licensee has been renewed to a ten year term, there will be future payments made to the director under the Contingent Finders Fee Agreement if royalties are actually received by the Company in years 6 through 10. The director has not earned or received any payments or other compensation and will not receive any payments under the Contingent Finders Fee Agreement during the first five years of the agreement.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary note regarding forward looking statements

This quarterly report on Form 10-Q and other filings which we make with the Securities and Exchange Commission, as well as press releases and other written or oral statements we may make may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. When used, the words anticipates, believes, estimates, objectives, goals, aims, hopes, may, likely, similar expressions are intended to identify such forward-looking statements. In particular, the forward-looking statements in this Form 10-Q include, among others, statements regarding our goals or expectations regarding our future revenues and earnings, the anticipated retail sales by our current and future licensees, such as Target and Tesco, the likelihood that our licensees will achieve royalty rate reductions, our prospects for obtaining new licensees and our prospects for obtaining new brands to acquire or represent. Forward-looking statements involve known and unknown risks and uncertainties that may cause our actual results, performance, achievements or share price to be materially different from any future results, performance, achievements or share price expressed or implied by any forward-looking statements. Such risks and uncertainties include, but are not limited to, the financial condition of the apparel industry and the retail industry, the overall level of consumer spending, the effect of intense competition from other apparel lines both within and outside of Target and Tesco, adverse changes in licensee or consumer acceptance of products bearing the Cherokee or our other brands as a result of fashion trends or otherwise, the ability and/or commitment of our licensees to design, manufacture and market Cherokee or our other branded products, our dependence on two licensees for a substantial portion of our revenues, our dependence on our key management personnel, any adverse determination of claims, liabilities or litigation, and the effect of a breach or termination by us of the Management Agreement with our Chief Executive Officer. Several of these risks and uncertainties are discussed in more detail under Item 1A. Risk Factors in this Report on Form 10-Q or in the discussion and analysis below. You should, however, understand that it is not possible to predict or identify all risks and uncertainties and you should not consider the risks and uncertainties identified by us to be a complete set of all potential risks or uncertainties that could materially affect us. You should not place undue reliance on the forward-looking statements we make herein because some or all of them may turn out to be wrong. We undertake no obligation to update any of the forward-looking statements contained herein to reflect future events and developments.

Introduction

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The following discussion should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this Report on Form 10-Q. See Item 1. Consolidated Financial Statements and our Form 10-K for our fiscal year ended January 31, 2009 (Fiscal 2009).

Cherokee Inc. (which may be referred to as we, us, our or the Company) is in the business of marketing and licensing the Cherokee, Sideout and Carole Little brands and related trademarks and other brands we own or represent. We are one of the leading licensors of brand names and trademarks for apparel, footwear and accessories in the world.

We own several trademarks, including Cherokee®, Sideout®, Sideout Sport®, Carole Little®, CLII®, Saint Tropez-West®, Chorus Line®, All That Jazz®, Molly Malloy® and others. As of October 31, 2009, we had seventeen continuing license agreements covering both domestic and international markets. As part of our business strategy, we frequently evaluate other brands and trademarks for acquisition into our portfolio.

In addition to licensing our own brands, we also assist other brand-owners, companies, wholesalers and retailers in identifying licensees or licensors for their brands or stores. For example, during Fiscal 2008 we assisted Norma Kamali in her arrangement with Wal-Mart as a global licensee of the Norma Kamali brand.

We operate on a 52 or 53 week fiscal year ending on the Saturday nearest to January 31 in order to better align us with our licensees who generally also operate and plan using such a fiscal year. This results in a 53 week fiscal year approximately every four or five years. We do not believe that the extra week in the occasionally reported 53 week fiscal year results in any material impact on our financial results.

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On July 22, 1999, our Board of Directors authorized the repurchase of up to one million shares of our then outstanding common stock. Pursuant to this directive, and including certain repurchases of our common stock that were effected during Fiscal 2009 and are described below, we have used cash of \$7.5 million to repurchase and retire a total of 717,516 shares of our common stock since the stock repurchases were authorized. Our Board of Directors has authorized and approved the extension of the expiration date of our stock repurchase program to January 31, 2010 and increased the number of remaining shares which could currently be repurchased from time to time in the open market at prevailing market prices or in privately negotiated transactions to a total of 800,000 shares of our common stock. During Fiscal 2008 and Fiscal 2007, we did not repurchase any shares of our common stock. During Fiscal 2009, we purchased and retired a total of 109,716 shares of our common stock at an average price of \$17.99. We did not repurchase any shares of our common stock during the nine months ended October 31, 2009 (the "Nine Months"). Future repurchases of our stock, if any, will be made from time to time in the open market at prevailing market prices or in privately negotiated transactions.

Critical Accounting Policies and Estimates

Management's discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, management evaluates its estimates, including those related to revenue recognition, deferred taxes, impairment of long-lived assets, contingencies and litigation. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

We consider accounting policies relating to the following areas to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment:

- Revenue recognition;
- Provision for income taxes and deferred taxes;
- Impairment of long-lived assets;
- Contingencies and litigation; and
- Accounting for stock-based compensation.

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You should refer to our Annual Report on Form 10-K for Fiscal 2009, for a discussion of our policies on revenue recognition, deferred taxes, impairment of long-lived assets, contingencies and litigation and accounting for stock-based compensation.

Effective February 4, 2007, we adopted the provision of the Codification which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with ASC Topic 740, *Income Taxes* (ASC 740). ASC 740 prescribes a comprehensive model for how companies should recognize, measure, present, and disclose in their financial statements uncertain tax positions taken or expected to be taken on a tax return. Under ASC 740, tax positions shall initially be recognized in the financial statements when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with the tax authority assuming full knowledge of the position and all relevant facts. The cumulative effect of applying ASC 740 has resulted in a decrease to our retained earnings of approximately \$0.4 million as of February 4, 2007.

We recognize interest and penalties, if any, related to unrecognized tax benefits within the provision for income taxes in our consolidated statement of income. As of January 31, 2009 and October 31, 2009, respectively,

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accrued interest on a gross basis was \$96,000 and \$62,000. The total amount of gross unrecognized tax benefits as of January 31, 2009 and October 31, 2009, respectively, was approximately \$0.5 and \$0.7 million, of which approximately \$0.5 million and \$0.7 million represents the amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. It is reasonably possible that \$0.6 million of unrecognized tax benefits may decrease within the next 12 months as a result of settling certain positions. The expected net impact of the changes would not have a significant impact on our results of operations or financial position.

The Company files U.S. federal and state tax returns. For the federal tax returns, the Company is generally no longer subject to tax examinations for fiscal years prior to 2007. The Company's Fiscal 2008 federal tax return is currently under examination. With limited exception, our significant state tax jurisdictions are no longer subject to examinations by the various tax authorities for fiscal years prior to 2003.

On January 29, 2006, the Company adopted ASC Topic 718, *Compensation - Stock Compensation* (ASC 718), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors for employee stock options based on estimated fair values. ASC 718 supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) for periods beginning on or after January 1, 2006.

The Company accounts for stock based compensation in as required ASC 718 which requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The fair value of stock options are estimated using a Black-Scholes option valuation model. This model requires the input of subjective assumptions, including expected stock price volatility, estimated life and estimated forfeitures of each award. The fair value of equity-based awards is amortized over the vesting period of the award, and we have elected to use the straight-line method. We make quarterly assessments of the adequacy of the tax credit pool to determine if there are any deficiencies which require recognition in the consolidated statement of operations. Stock-based compensation expense recognized for the Nine Months was \$459,000, and for the nine months ended November 1, 2008 was \$410,000.

Recent Accounting Pronouncements

We describe recent accounting pronouncements in Item 1 Consolidated Financial Statements Notes to Consolidated Financial Statements.

Results of Operations

Retail Sales

During the Third Quarter, total U.S. dollar based retail sales of merchandise bearing the Cherokee brand in all licensed territories were 13.1% below the third quarter of last year, totaling \$433.5 million in the Third Quarter versus \$498.8 million in the third quarter of last year. Much of this decline was due to the following two factors: (i) a difficult retailing environment worldwide as a result of the global recession; and (ii) with respect to a couple of our licensees, the Cherokee brand had fewer adult product categories and Cherokee branded merchandise available for sale during the Third Quarter, as compared to the comparable period last year.

During the Nine Months, the total U.S. dollar based retail sales of merchandise bearing the Cherokee brand in all licensed territories were 23.4% below the comparable nine months of last year, totaling \$1.18 billion in the Nine Months as compared to \$1.54 billion in the comparable period of last year. A significant amount of this decline was due to the following two factors: (i) a difficult retailing environment worldwide as a result of the global recession; and (ii) the stronger U.S. dollar during the Nine Months as compared to the comparable period of last year, which resulted in lower comparative U.S. dollar-based retail sales from several of our larger international licensees, and ultimately lower U.S. dollar based royalties. Also, with respect to a couple of our licensees, the Cherokee brand had fewer adult product categories and Cherokee branded merchandise available for sale during the Nine Months, as compared to the comparable period last year.

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Pursuant to our typical arrangements with our licensees, we receive quarterly royalty statements and periodic retail sales information for Cherokee branded products and other product brands that we own or represent. However, our licensees are generally not required to provide, and typically do not provide, information that would enable us to determine the specific reasons for period-to-period fluctuations in retail sales of our branded products by our licensees in the specific territories in which they operate. Fluctuations in retail sales of Cherokee branded products or other product brands that we own or represent may be the result of a variety of factors, including, without limitation: (i) changes in the number of product categories for which a licensee chooses to use our brands from period-to-period, which generally results in changes in the amount of inventory (utilizing our brands) available for sale from period-to-period; (ii) the number of geographical markets/territories or number of stores in which our licensees are currently selling Cherokee or our other branded products from period-to-period; and (iii) our licensees experiencing changes in retail sales levels as a result of a variety of factors, including fashion-related and general retail sales trends (See Item IA Risk Factors).

During the Third Quarter, retail sales of Cherokee branded products by Target Stores totaled approximately \$225.6 million compared to approximately \$286.0 million for the third quarter of last year, or a decline of 21.1%. This decline was due to both a difficult retailing environment and a reduction in the number of men's and women's apparel categories currently being utilized for the Cherokee brand by Target in the Third Quarter, as compared to the prior year. Target's sales of Cherokee branded products for the Nine Months totaled \$584.9 million, as compared to \$788.5 million for the comparable period last year.

Tesco's U.S. dollar based retail sales of merchandise bearing the Cherokee brand, which included the U.K., Ireland, the Czech Republic, Slovakia, Poland, Hungary and Turkey for the Third Quarter and the third quarter of last year, were \$160.7 million compared to \$174.3 million, respectively, representing a total decline of 7.8%. Much of this decline was due to a difficult retail environment in the U.K. Retail sales in the United Kingdom, as measured in British Pounds Sterling, were down 3.6% in the Third Quarter as compared to the comparable period in the prior year. This was coupled with an unfavorable -10.0% change in exchange rates in the U.K., as compared to last year. Hence, retail sales in U.S. dollars for the United Kingdom totaled \$98.4 million in the Third Quarter, as compared to \$113.4 million in the third quarter of last year. Retail sales in the Tesco Central European countries of the Czech Republic, Slovakia, Poland and Hungary, as measured in their respective local currencies, ranged from a decline of 0.5% to 16.8%. The collective U.S. dollar based retail sales from Tesco Central Europe for the Third Quarter were \$52.4 million, as compared to \$54.8 million in the third quarter of last year.

Zeller's retail sales in Canada of merchandise bearing the Cherokee brand, in U.S. dollars, were approximately \$22.9 million during the Third Quarter compared to \$18.8 million for the third quarter of last year, representing a 21.5% increase. Retail sales as measured in Canadian dollars were up 3.3% in the Third Quarter as compared to the third quarter of last year. Also, the change in the exchange rates from last year's third quarter as compared to the Third Quarter increased 17.6% for Zellers, due to the weaker U.S. dollar in the Third Quarter. Zeller's sales of Cherokee merchandise for the Nine Months totaled \$49.6 million as compared to \$55.6 million in the comparable period last year.

Despite the difficult global retail environment and in general an overall stronger U.S. dollar in the First, Second and Third Quarters (as compared to the comparable periods last year), on a U.S. dollar basis we experienced retail sales increases with several of our smaller foreign licensees, including the countries of Brazil, Chile and Peru. We expect that several of our newer foreign territories, such as India, Brazil, Chile, Peru and Spain may continue to show growth in the remainder of Fiscal 2010. Our licensee in Spain, Eroski Sociedad Cooperativa, began selling Cherokee branded products in late August of 2009 and reported retail sales of \$5.2 million in U.S. dollars in the Third Quarter.

During the Third Quarter, retail sales of Carole Little and St. Tropez-West branded products by TJX were \$11.5 million, as compared to \$10.8 million for the third quarter of last year. For the Nine Months, retail sales of Carole Little and St. Tropez-West branded products by TJX totaled \$61.4 million, as compared to \$47.3 million for the comparable period last year, representing an increase of 30.0% over last year.

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Royalty Revenues and Expenses

Royalty revenues were \$8.0 million and \$25.0 million during the Third Quarter and the Nine Months, respectively, compared to \$8.0 million and \$30.1 million during the comparable periods last year, a decrease of zero and 17%, respectively. Royalty revenues from the Cherokee brand were \$7.4 million and \$22.7 million during the Third Quarter and Nine Months, respectively, compared to \$7.6 million and \$28.5 million for the comparable periods last year. During the Third Quarter and Nine Months, revenues of \$3.4 million and \$10.3 million, respectively, were recognized from Target Stores compared to \$3.7 million and \$13.0 million for the comparable periods last year, which accounted for 42% and 41% of our total revenues, in the Third Quarter and the Nine Months, respectively, versus 46% and 43% in the comparable periods last year. The decrease in royalty revenues from Target Stores for the Third Quarter and Nine Months compared to the comparable prior year periods was attributable to a difficult retail environment and also a significant reduction by Target of the Cherokee brand in the men's and women's apparel product categories, as compared to the prior year.

Revenues from all of the Tesco countries were \$2.9 million and \$9.6 million during the Third Quarter and Nine Months, respectively, compared to \$2.95 million and \$12.7 million for the comparable periods last year. Revenues from Tesco U.K. totaled \$1.8 million and \$5.9 million during the Third Quarter and Nine Months, respectively, compared to \$1.9 million and \$8.9 million for the comparable periods last year. The decline in the U.K. of the retail sales of Cherokee products in local currency over the Nine Months was -13.3%, which we attribute primarily to a difficult retail environment in the U.K. Royalties from Cherokee branded products in all other Tesco countries (Ireland, Central Europe and Turkey) was \$1.1 million and \$3.6 million for the Third Quarter and Nine Months, respectively, compared to \$1.1 million and \$3.8 million in the comparable periods last year. Royalties from Ireland, Central Europe and Turkey remained relatively flat from quarter to quarter because of the increase in Ireland and Turkey retail sales being offset by a decrease in retail sales in the Central European territories.

Revenues from Zellers were \$458,000 and \$992,000 during the Third Quarter and Nine Months, respectively, compared to \$376,000 and \$1.1 million for the comparable periods last year, due primarily to lower sales volumes over the Nine Months. Royalty revenues from our retail direct licensee in Mexico, Comercial Mexicana, totaled \$175,000 and \$477,000 during the Third Quarter and Nine Months, respectively, as compared to \$269,000 and \$786,000 in royalty revenues for the comparable periods last year. The decrease in royalties from Comercial Mexicana for the Third Quarter and Nine Months was due to both an unfavorable retail environment, and also the stronger U.S. dollar, as compared to the comparable periods last year.

Royalty revenues from the retail sales of products bearing our Sideout brand were \$51,000 and \$145,000, respectively, during the Third Quarter and Nine Months compared to \$65,000 and \$497,000 for the comparable periods last year. Revenues from Mervyn's for sales of Sideout branded products during the Third Quarter and Nine Months were zero, compared to \$26,000 and \$355,000 for the comparable periods last year, as Mervyn's has now liquidated its retail operations. We are actively seeking new U.S. licensees for our Sideout brand.

Revenues from international licensees of both Cherokee and Sideout brands, such as Tesco, Zellers, Comercial Mexicana and others were collectively \$4.0 million and \$12.6 million during the Third Quarter and Nine Months, respectively, compared to \$4.0 million and \$15.6 million for the comparable periods last year. This decline reflects a decrease in royalties from Tesco UK, Zellers (Canada), Comercial Mexicana, and a few smaller licensees due to lower retail sales, which was partially offset by growth from certain smaller international licensees from the countries of India, Brazil, Chile and Peru. In addition, it includes royalties from our licensee in Spain, which did not begin selling Cherokee branded apparel until August 2009.

Our Third Quarter and Nine Months revenues also included \$153,000 and \$802,000, respectively, from the Carole Little brands, as compared to the \$187,000 and \$630,000 for the comparable periods last year from these brands.

Royalty revenues for Target during the Third Quarter (\$3.4 million) were higher than that of the Second Quarter (\$2.7 million), primarily due to higher retail sales (\$225.6 million in the Third Quarter as compared to \$149.4 million in the Second Quarter). In addition, a lower average quarterly royalty rate was utilized for the Target royalties in the Third Quarter as compared to the Second Quarter, due to the attainment of certain contractual retail

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sales thresholds. Conversely, royalty revenues for Tesco during the Third Quarter (\$2.9 million) were lower than that of the Second Quarter (\$3.7 million), primarily due to lower retail sales (\$160.7 million in the Third Quarter as compared to \$182.3 million in the Second Quarter), and a lower average quarterly royalty rate being utilized in the Third Quarter.

We believe that our future revenues from Target, for the remaining three months of Fiscal 2010, will likely be down when compared to the revenues from Fiscal 2009, primarily due to the reduced presence of the Cherokee brand in men's and women's apparel categories, but we expect our presence in kids apparel categories at Target may grow. We believe that our future revenues from Zellers will continue to be down due to reduced economic activity and consumer spending as compared to Fiscal 2009. Based on Tesco's sales of Cherokee branded products in Fiscal 2009 and through the Nine Months, and the retail decline occurring in the United Kingdom, we believe that our future revenues from Tesco will likely be down when compared to the revenues from Fiscal 2009. Based upon the royalties received for the Nine Months from TJX, we estimate that our future royalty revenues from TJX may be up or flat when compared to the revenues from Fiscal 2009, but will depend upon the future condition of the U.S. retail market, which is currently difficult and uncertain. Furthermore, although the U.S. dollar has weakened somewhat when comparing the Third Quarter to the First and Second Quarters, it remains stronger when compared to the comparable periods last year. Should the U.S. dollar strengthen in the future against such foreign currencies, our future royalties from our international licensees will be negatively affected throughout the rest of Fiscal 2010.

We recognize royalty revenues in the quarter earned. A large portion of such royalty revenues recognized as earned are collected from licensees during the month following the end of a quarter. Our trade receivables balance of \$7.5 million as of the end of the Third Quarter included accrual for revenues earned from Target Stores, Zellers, Tesco, TJX and other licensees that are expected to be received in the month or 45 days following the end of the subject fiscal quarter.

Selling, general and administrative expenses for the Third Quarter and Nine Months were \$3.3 million and \$9.8 million, respectively, or 41.4% and 39.1%, of revenues, in comparison to selling, general and administrative expenses of \$3.4 million and \$11.0 million, respectively, or 41.9% and 36.5% of revenues during the comparable periods last year. Our selling, general and administrative expenses of \$3.33 million in our Third Quarter were lower than the \$3.37 million in the comparable quarter in the prior year. The overall decrease in our selling, general and administrative expenses of approximately \$40,000 during the Third Quarter was primarily attributable to the following positive: (i) lower marketing expenses as compared to the third quarter of last year; (ii) lower bank fees; (iii) lower professional service fees; and (iv) lower travel and entertainment expenses, as compared to last year. The decrease in our selling, general and administrative expenses of \$1.2 million during the Nine Months was primarily attributable to the following positive and negative variances: (i) lower marketing expenses as compared to the comparable period last year; (ii) lower bonus accrual expense of \$2.3 million as compared to \$2.9 million last year; (iii) lower salary and payroll related expenses as compared to the first nine months of last year; and (iv) higher stock option expense versus the comparable period last year.

We reported zero interest expense during the Third Quarter and Nine Months and during the comparable periods last year. During the Third Quarter and Nine Months our interest and other income was \$6,000 and \$19,000, respectively, compared to \$46,000 and \$144,000 for the comparable periods last year. The decrease in interest income is primarily due to lower cash balances and lower interest rates during the Third Quarter and Nine Months, as compared to the comparable periods in the prior year.

During the Third Quarter and Nine Months we recorded a tax provision of \$1.9 million and \$5.8 million, respectively, which equates to an effective tax rate of 41.3% and 37.9% for such periods, compared to \$1.46 million and \$7.3 million and an effective tax rate of 31.0% and 37.8% recorded for the same periods last year. The lower effective tax rate in the third quarter of Fiscal 2009 was due to the settlement of previously uncertain tax positions. We are making quarterly estimated tax payments for our federal and state income tax liabilities. During the Third Quarter and Nine Months our net income was \$2.8 million and \$9.5 million, or \$0.31 and \$1.07 per diluted share, respectively, compared to \$3.25 million and \$11.96 million or \$0.37 and \$1.34 per diluted share for the comparable periods last year.

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Liquidity and Capital Resources

Cash Flows. On October 31, 2009, we had cash and cash equivalents of \$9.3 million. On January 31, 2009, we had cash and cash equivalents of \$13.7 million. The \$4.4 million decrease in cash and cash equivalents during the Nine Months is primarily attributable to the payment of \$13.2 million in dividends, and the payment of our previously accrued management and employee bonuses of \$2.9 million during the First Quarter. These were partially offset by various other items detailed below.

During the Nine Months, cash provided by our operations was \$9.0 million, compared to \$11.8 million for the comparable period last year. The cash provided by operations of \$9.0 during the Nine Months was primarily due to net income of \$9.5 million offset by the changes in: (i) accounts receivable, which increased by \$2.0 million in the Nine Months, as compared to an increase of \$32,000 in the comparable period last year; (ii) accrued compensation, which decreased by \$0.6 million in the Nine Months, as compared to a greater decrease of \$1.0 million in the comparable period last year; and (iii) an increase in income taxes payable of \$0.5 million, as compared to a decrease of \$1.1 million in the comparable period last year. In addition, our cash from operations in the Nine Months includes non-cash stock-based compensation expense of \$459,000 as compared to \$410,000 in the comparable period last year, and our deferred tax assets decreased by \$269,000, as compared to a decrease of \$473,000 in the comparable period last year.

Cash used by investing activities during the Nine Months was \$215,000, which was comprised of \$32,000 of capital expenditures of office equipment, and \$183,000 in trademark registration and renewal fees for the Cherokee, Sideout and Carole Little brands. In comparison, during the comparable period last year, cash used by investing activities was \$351,000, which was comprised of \$72,000 of capital expenditures of office equipment, and \$279,000 in trademark registration and renewal fees for the Cherokee, Sideout and Carole Little brands.

Cash used in financing activities was \$13.2 million during the Nine Months, which included the payment of three dividends during this period. In comparison, during the comparable period last year, cash used in financing activities was \$19.4 million during the Nine Months, which included the payment of three dividends totaling \$17.8 million during this period, and also Cherokee using \$2.0 million to repurchase and retire 109,716 shares of its common stock. These uses were offset by the receipt of \$231,000 in proceeds from the exercise of stock options, and also \$148,000 of excess tax benefit related to stock options exercised.

Uses of Liquidity. We anticipate that our cash requirements through the end of Fiscal 2010 are primarily to fund operations, trademark registration expenses, capital expenditures, selectively expand our brand portfolio and, if adequate, to pay dividends and/or potentially repurchase shares of our common stock. Our historical dividend payments in the Nine Months exceeded our cash flow from operations, and our dividends may not continue at current levels unless cash flow from operations increases. The declaration and payment of any future dividends or repurchase of shares of our common stock will be at the discretion of our Board and will be dependent upon our financial condition, results of operations, cash flow, capital expenditures and other factors deemed relevant by our Board.

We are frequently approached by parties seeking to sell their brands and related trademarks. Should an established marketable brand or equity become available on favorable terms, we would be interested in pursuing such an acquisition and may elect to fund such acquisition, in whole or in part, using our then-available cash.

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Sources of Liquidity. Our primary source of liquidity is expected to be cash flow generated from operations, and cash and cash equivalents currently on hand. We believe our cash flow from operations together with our cash and cash equivalents currently on hand will be sufficient to meet our working capital, capital expenditure and other commitments through October 2010; provided that, if our Management Agreement with our CEO is terminated, we may not have sufficient cash to make the lump sum payment due to Mr. Margolis. We cannot predict our revenues and cash flow generated from operations. Some of the factors that could cause our revenues and cash flows to be materially lower are described under the caption titled *Risk Factors* in Item 1A of this Report on Form 10-Q.

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As of October 31, 2009, we did not have any credit facilities or lines of credit, and we are not the guarantor of any debt or any other material third-party obligations. As of October 31, 2009, we did not have any standby letters of credit nor any standby repurchase obligations.

If our revenues and cash flows during Fiscal 2010 are lower than Fiscal 2009, which we expect will likely occur, we would have less cash available to pay dividends, repurchase shares of our common stock or to explore or consummate the acquisition of other brands. In addition, if our revenues and cash flows decline materially, we may need to take steps to reduce expenditures by scaling back operations and reducing staff. However, any reduction of revenues would be partially offset by reductions in the amounts we would be required to pay under the Management Agreement, employee bonuses and any other agreements. We believe that we will have sufficient cash generated from our business activities to support our operations for at least the next twelve months.

Inflation and Changing Prices

Inflation, traditionally, has not had a significant effect on our operations. Since most of our future revenues are based upon a percentage of sales of the licensed products by our licensees, we do not anticipate that inflation will have a material negative impact on future operations.

Seasonality

Given our contractual royalty rate reductions with our licensees, as certain sales volume thresholds are achieved by our licensees in any given fiscal year, historically our first quarter has been our largest quarter; our second quarter has been our next largest quarter, and our third and fourth quarters have been our smallest quarters.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risk generally represents the risk that losses may occur in the values of financial instruments as a result of movements in interest rates, foreign currency exchange rates and commodity prices. We do not enter into derivatives or other financial instruments for trading or speculative purposes.

Interest: From time to time we invest our excess cash in interest-bearing temporary investments of high-quality issuers. Due to the short time the investments are outstanding and their general liquidity, these instruments are classified as cash equivalents in our consolidated balance sheet and do not represent a material interest rate risk to us. As of October 31, 2009, we had no long term debt obligations.

Foreign Currency: We conduct business in various parts of the world. We are exposed to fluctuations in exchange rates to the extent that the foreign currency exchange rate fluctuates in countries where our licensees do business, and significant fluctuations in exchange rates could result in a material affect on our results of operations or cash flow. For Fiscal 2009, revenues from international licensing comprised 53% of our

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consolidated revenues. For the Nine Months, international licensing royalties comprised 50.1% of our total revenues. A hypothetical 10% strengthening of the U.S. dollar relative to the foreign currencies of countries where we operate would have negatively affected our Nine Months revenues by approximately \$1.3 million, which represents 5.0% of the total revenues reported for the Nine Months.

Most of our international licensees are required to pay the royalty revenues owed to us in U.S. dollars. As a consequence, in past years the weakening of the U.S. dollar has benefited us in that the total royalty revenues reported from our international licensees such as Tesco and Zellers increases when the dollar weakens against such foreign currencies (the British Pound, the Canadian Dollar, and the Euro). However, during the First Quarter, Second Quarter and Third Quarter, the U.S. dollar was significantly stronger than it was in the comparable periods in the prior year, and hence had an unfavorable effect on the dollar based royalties we received from our international licensees. For example, the royalty revenues from Tesco U.K. in our First Quarter reflect a -27.6% unfavorable change in the exchange rate as compared to the exchange rate used in the first quarter of last year, and

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for the Second Quarter reflect a -19.0% unfavorable change in the exchange rate as compared to the exchange rate used in the second quarter of last year. Similarly, the royalty revenues from Tesco U.K. in the Third Quarter reflect a -10.0% unfavorable change in the exchange rate as compared to the third quarter of last year. In the future, should the dollar strengthen further against such foreign currencies, the total royalty revenues reported by us from such licensees would reflect such changes in the currency exchange rates. Accordingly, a strengthening dollar, compared to current exchange rates, would likely result in lower reported royalty revenues than otherwise would be reported as a result of such unfavorable exchange rate movements.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures.* Cherokee maintains disclosure controls and procedures, as such term is defined under Exchange Act Rule 13a-15 (e) that are designed to ensure that information required to be disclosed in Cherokee's Exchange Act reports 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 Cherokee's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Cherokee has carried out an evaluation under the supervision and with the participation of Cherokee's management, including Cherokee's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Cherokee's disclosure controls and procedures. Based upon their evaluation and subject to the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that Cherokee's disclosure controls and procedures were effective as of October 31, 2009.

(b) *Changes in internal controls.* Management determined that as of October 31, 2009, there have been no changes in Cherokee's internal controls over financial reporting that occurred during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In the ordinary course of business, from time to time we become involved in legal claims and litigation. In the opinion of management, based on consultations with legal counsel, the disposition of litigation currently pending against us is unlikely to have, individually or in the aggregate, a materially adverse effect on our business, financial position or results of operations.

ITEM 1A. RISK FACTORS

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In addition to the other information contained herein or incorporated herein by reference, the risks and uncertainties and other factors described below could have a material adverse effect on our business, financial condition, results of operations and share price and could also cause our future business, financial condition and results of operations to differ materially from the results contemplated by any forward-looking statement we may make herein, in any other document we file with the Securities and Exchange Commission, or in any press release or other written or oral statement we may make. Please also see Item 2. Management's Discussion and Analysis of Financial Condition And Results of Operations Cautionary Note Regarding Forward-Looking Statements for additional risks and uncertainties applicable to us.

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Our business is subject to intense competition.

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Royalties paid to us under our licensing agreements are generally based on a percentage of our licensee's net sales of licensed products. Cherokee, Carole Little and Sideout brand footwear, apparel, and accessories, which are manufactured and sold by both domestic and international wholesalers and retail licensees, are subject to extensive competition by numerous domestic and foreign companies. Such competitors with respect to the Cherokee brand include independent brands such as Levi Strauss & Co., The Gap, Old Navy, Martha Stewart Living Omnimedia Inc., Liz Claiborne, Iconix Brand Group, and VF Corp., and private label brands developed by retailers such as Faded Glory, Arizona, and Route 66. Competitors with respect to the Sideout brand include Quiksilver, Nike and other active wear companies. Factors which shape the competitive environment include quality of garment construction and design, brand name, style and color selection, price and the manufacturer's ability to respond quickly to the retailer on a national basis. In recognition of the increasing trend towards consolidation of retailers and greater emphasis by retailers on the manufacture of private label merchandise, in the United States our business plan focuses on creating strategic alliances with major retailers for their sale of products bearing our brands through the licensing of our trademarks directly to retailers. Therefore, our degree of success is dependent on the strength of our brands, consumer acceptance of and desire for our brands, our licensees' ability to design, manufacture and sell products bearing our brands and to respond to ever-changing consumer demands, and any significant failure by our licensees to do so could have a material adverse effect on our business prospects, financial condition, results of operations and liquidity. We cannot control the level of resources that our licensees commit to supporting our brands, and our licensees may choose to support other brands to the detriment of ours. Further, there are numerous risk factors that apply to the businesses of retailers that can affect their level of sales of products that carry our brands. Any decline in sales by our licensees can adversely affect our revenues. Factors that may adversely affect retailers include the following: weather; changes in the availability or cost of capital; shifts in the seasonality of shopping patterns; labor strikes or other work interruptions including work interruptions that impact supply chains and transport vendors; the impact of excess retail capacity; changes in the cost of accepting various payment methods and changes in the rate of utilization of these payment methods; material acquisitions or dispositions; investments in new business strategies; the success or failure of significant new business ventures or technologies; actions taken or omitted to be taken by legislative, regulatory, judicial and other governmental authorities and officials; and natural disasters, the outbreak of war, acts of terrorism or other significant national or international events. The risks associated with our business are more acute during periods of economic slowdown or recession. In addition to other consequences, these periods may be accompanied by decreased consumer spending generally, as well as decreased demand for, or additional downward pricing pressure on, the products carrying our brands. Accordingly, any prolonged economic slowdown or a lengthy or severe recession with respect to either the U.S. or the global economy is likely to have a material adverse effect on our results of operations, financial condition and business prospects. As a result, given the continued weakness of the U.S. and global economy, as well as the reduced purchasing power of consumers, we expect that our business will continue to suffer for so long as, and to the extent that, such adverse economic conditions exist.

In addition, other companies owning established trademarks could also enter into similar arrangements with retailers.

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Our business is largely dependent on royalties from two licensees, Target Stores and Tesco, which each accounted for 42% of our consolidated licensing revenues in Fiscal 2009, and accounted for 41% and 38%, respectively, of our Nine Months licensing revenues.

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Target and Tesco each generated 42% of our licensing revenues during Fiscal 2009, and 41% and 38%, respectively, of our licensing revenues for the Nine Months. We could suffer substantially decreased royalty revenues and cash flow under the Restated Target Agreement if Target were to reduce its sales of Cherokee branded products while continuing to pay the minimum royalties of \$9.0 million per fiscal year required under such agreement. The termination of either the Restated Target Agreement or the Tesco Agreement would have a material adverse effect upon our revenues and cash flow if we were unable to replace these royalty streams in a timely manner. We are unsure whether we would be able to replace the royalty payments received from Target and Tesco. Together, these two licensees accounted for 84% of our consolidated licensing revenues in Fiscal 2009 and accounted for 79% of our consolidated licensing revenues in our Nine Months.

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We are dependent on our intellectual property and we cannot assure you that we will be able to successfully protect our rights.

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We hold various trademarks including Cherokee, Sideout, Carole Little and others in connection with apparel, footwear and accessories. These trademarks are vital to the success and future growth of our business. These trademarks are registered with the United States Patent and Trademark Office and in numerous other countries. We also hold several trademark applications for Cherokee and Sideout in several countries. There can be no assurance that the actions taken by us to establish and protect our trademarks and other proprietary rights will prevent imitation of our products or infringement of our intellectual property rights by others, or prevent the loss of licensing revenue or other damages caused thereby. In addition, the laws of several countries in which we have licensed our intellectual property may not protect our intellectual property rights to the same extent as the laws of the United States. Despite our efforts to protect our intellectual property rights, unauthorized parties may attempt to copy aspects of our intellectual property, which could have a material adverse effect on our business prospects, financial condition, results of operations and liquidity. In the future we may be required to assert infringement claims against third parties, and there can be no assurance that one or more parties will not assert infringement claims against us. Any resulting litigation could result in significant expense and divert the efforts of our management personnel whether or not such litigation is determined in our favor.

We are dependent on our key management personnel.

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Our success is highly dependent upon the continued services of our key executives, including Robert Margolis, our Chairman and Chief Executive Officer; Howard Siegel, our President; and Russell J. Riopelle, our Chief Financial Officer. We have a limited number of employees and Mr. Margolis and our other executives' leadership and experience in the apparel licensing industry is important to the successful implementation of our business and marketing strategy. We do not carry key person life insurance covering any of our executives. The loss of the services of Mr. Margolis or our other key executives could have a material adverse effect on our business prospects, financial condition, results of operations and liquidity.

The Management Agreement with our Chief Executive Officer contains provisions that provide for a substantial cash payment to our Chief Executive Officer upon our breach or termination of the Management Agreement.

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Mr. Margolis' services as Chairman and Chief Executive Officer are provided to us pursuant to a management agreement (the "Management Agreement"). The current term of the Management Agreement ends February 1, 2011; however, the term may be extended indefinitely for additional one year terms so long as we meet certain pre-tax earnings thresholds. If we terminate the Management Agreement without cause or Mr. Margolis terminates the Management Agreement after we materially breach any of the terms and conditions thereof, we would be obligated to pay Mr. Margolis, within sixty days after the date of termination, a lump sum in cash equal to three times the sum of the annual base compensation under the Management Agreement at the rate in effect at the time of the termination plus the amount of the previous year's performance bonus under the Management Agreement. Mr. Margolis' annual base compensation for Fiscal 2010 is \$790,000 and his performance bonus for Fiscal 2009 was approximately \$2.9 million. Based on Mr. Margolis' salary for Fiscal 2009 and his bonus paid for Fiscal 2009, the lump sum payment owed upon such a termination would be approximately \$11.1 million, plus his pro rata earned performance bonus during Fiscal 2010 up to the date of termination.

At the time such payment is due, we may not have sufficient cash to make the lump sum payment to Mr. Margolis, and becoming obligated to make such payment would have a material adverse effect on our business prospects, financial condition, results of operations and liquidity. Under certain circumstances, the obligation to make such lump sum payment to Mr. Margolis could be triggered if a third party were to acquire us, which would increase such third party's acquisition costs, but would also each year thereafter reduce our annual operating expenses due to the elimination of annual bonus payments to Mr. Margolis pursuant to the Management Agreement.

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We may not pay dividends regularly in the future.

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Although we have paid dividends during each quarter since December 2003, there can be no assurances that we will continue to generate excess cash to pay dividends, or that we will continue to pay dividends with such excess cash if other, more compelling business opportunities are available, as determined by our Board of Directors. Our ability to generate excess cash from our operations in the future is dependent upon a variety of factors, including Cherokee's financial condition, results of operations, cash flow, capital requirements and other factors. Our recent historical dividend payments, including our dividend payments in the Nine Months, exceeded our cash flow from operations, and our dividends may not continue at current levels unless cash flow from operations increases. The declaration and payment of any future dividends or repurchase of shares of our common stock will be at the discretion of our Board and will be dependent upon our financial condition, results of operations, cash flow, capital expenditures and other factors deemed relevant by our Board. Should our future dividend payments end up exceeding our cash from operations, we will reduce the excess cash on our balance sheet and our Board of Directors may elect to further reduce or eliminate future dividend payments in order to align our dividend payments with the cash flow generated from our operations. Furthermore, should the dividend tax laws change such that taxes on dividends become higher than they currently are, or should we decide to use our excess cash to make acquisitions of complimentary business or brands, we may further reduce or eliminate the dividends we pay to our stockholders in favor of other ways to increase value for our stockholders.

The implementation of new accounting rules related to the accounting for uncertainty in income taxes affected our reported results of operations and will continue to impact our operating results in subsequent periods. Any subsequent changes in accounting rules may also have an adverse effect on our results of operations.

In Fiscal 2008 and subsequent periods, the income tax assets and liabilities we recognize for uncertain tax positions, if any, will be adjusted when the related income tax liabilities are paid, the income tax positions are settled with the taxing authorities, the related statutes of limitations expire or under other circumstances as provided in ASC 740. Our assessment of uncertain tax positions requires that we make estimates and judgments about the application of tax law, the expected resolution of uncertain tax positions and other matters. In the event that uncertain tax positions are resolved for amounts different than our estimates, or the related statutes of limitations expire without our being assessed additional income taxes, we will be required to adjust the amounts of the related assets and liabilities in the period in which such events occur. Such adjustments may have a material impact on our income tax provision and our results of operations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 6. EXHIBITS

(a) Exhibits

Exhibit Number	Description of Exhibit
31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: December 9, 2009

CHEROKEE INC.

By: /s/ Robert Margolis

Robert Margolis
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Russell J. Riopelle

Russell J. Riopelle
Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)