GOTTSCHALKS INC
Form 10-Q
September 06, 2006

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 29, 2006

OR

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

For the transition period from ________to _________

Commission file number 1-09100

Gottschalks Inc.
(Exact name of Registrant as specified in its Charter)

Delaware	**77-0159791**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

7 River Park Place East
Fresno, California 93720

(Address of Principal Executive Offices including Zip Code)

(559) 434-4800

(Registrant's Telephone Number, Including Area Code)

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 reports), and (2) has been subject to such filing requirements for the past 90 days. YES

x NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES

o NO x

The number of shares of the Registrant's common stock outstanding as of July 29, 2006 was 13,411,078.

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PART I -- FINANCIAL INFORMATION

Item 1. Financial Statements

GOTTSCHALKS INC.
CONDENSED BALANCE SHEETS (UNAUDITED - Note 1)
(In thousands of dollars)

	July 29, 2006	January 28, 2006	July 30, 2005
ASSETS			
CURRENT ASSETS:			
Cash	$ 6,494	$ 5,368	$ 6,010
Receivables, net	3,483	7,284	3,114
Merchandise inventories	163,402	159,986	168,484
Other	18,280	15,534	16,171
Total current assets	191,659	188,172	193,779
PROPERTY AND EQUIPMENT - NET	134,791	133,545	130,754
OTHER LONG-TERM ASSETS	13,238	13,305	13,244
	$ 339,688	$ 335,022	$ 337,777
LIABILITIES AND STOCKHOLDERS' EQUITY			
CURRENT LIABILITIES:			
Trade accounts payable and other current liabilities	$ 85,219	$ 88,472	$ 85,920
Current portion of long-term obligations	1,985	2,770	3,173
Total current liabilities	87,204	91,242	89,093
REVOLVING LINE OF CREDIT	75,764	47,935	61,953
LONG-TERM OBLIGATIONS (less current portion)	14,492	28,971	24,178
DEFERRED INCOME TAXES AND OTHER LIABILITIES	25,868	26,790	30,383
SUBORDINATED NOTE PAYABLE TO AFFILIATE	19,180	20,180	20,180
COMMITMENTS AND CONTINGENCIES			
STOCKHOLDERS' EQUITY	117,180	119,904	111,990
	$ 339,688	$ 335,022	$ 337,777

See notes to condensed financial statements.

GOTTSCHALKS INC.
CONDENSED STATEMENTS OF OPERATIONS (UNAUDITED - Note 1)
(In thousands of dollars, except per share data)

	Thirteen Weeks Ended		Twenty-Six We
	July 29, 2006	July 30, 2005	July 29, 2006
Net sales	$ 153,396	$ 149,646	$ 296,124
Net credit revenues	723	670	1,360
Net leased department revenues	694	667	1,435
Total revenues	154,813	150,983	298,919
Costs and expenses:			
Cost of sales	98,904	96,422	194,027
Selling, general and administrative expenses	50,182	48,816	100,123
Gain on sale of aircraft	(946)		(946)
Depreciation and amortization	3,772	3,225	7,334
New store opening costs	52	179	52
Total costs and expenses	151,964	148,642	300,590
Operating income (loss)	2,849	2,341	(1,671)
Other (income) expense:			
Interest expense	2,414	2,084	4,650
Miscellaneous income	(360)	(438)	(794)
	2,054	1,646	3,856
Income (loss) before income taxes	795	695	(5,527)
Income tax expense (benefit)	309	282	(2,154)
Income (loss) from continuing operations	486	413	(3,373)
Discontinued operations:			
Loss from operation of closed stores	--	(233)	(226)
Gain on store closures	--	--	72
Income tax benefit	--	79	52
Loss on discontinued operations	--	(154)	(102)
Net income (loss)	$ 486	$ 259	$ (3,475)
Net income (loss) per common share -			
Basic			
Income (loss) from continuing operations	$ 0.04	$ 0.03	$ (0.25)
Loss from discontinued operations	$ 0.00	$ (0.01)	$ (0.01)
Net income (loss) per common share	$ 0.04	$ 0.02	$ (0.26)
Diluted			
Income (loss) from continuing operations	$ 0.04	$ 0.03	$ (0.25)

Loss from discontinued operations....................	$	0.00	$	(0.01)	$	(0.01)	$
Net income (loss) per common share..................	$	0.04	$	0.02	$	(0.26)	$
Weighted average number of common shares outstanding -							
Basic		13,399		13,255		13,385	
Diluted..		13,685		13,872		13,385	

See notes to condensed financial statements.

GOTTSCHALKS INC.
CONDENSED STATEMENTS OF CASH FLOWS (UNAUDITED - Note 1)
(In thousands of dollars)

	Twenty-Six Weeks Ended	
	July 29, 2006	July 30, 2005
OPERATING ACTIVITIES:		
Net loss	$ (3,475)	$ (1,727)
Adjustments:		
Stock-based compensation	497	--
Excess tax benefits from exercise of stock options	(50)	--
Depreciation and amortization	7,365	6,530
Other adjustments, net	(969)	(1,140)
Store closure costs	81	47
Net gain on disposal of assets	(1,093)	--
Changes in operating assets and liabilities:		
Receivables	3,800	3,806
Merchandise inventories	(2,694)	(15,011)
Other current and long-term assets	(2,868)	829
Trade accounts payable and accrued expenses	(5,965)	2,888
Other current and long-term liabilities	(1,525)	(1,619)
Net cash used in operating activities	(6,896)	(5,397)
INVESTING ACTIVITIES:		
Capital expenditures	(12,236)	(11,524)
Proceeds from sale of property and equipment	3,979	--
Other	247	183
Net cash used in investing activities	(8,010)	(11,341)
FINANCING ACTIVITIES:		
Net proceeds under revolving line of credit	27,828	16,201
Debt issuance costs	(41)	--
Principal payments on long-term obligations	(16,264)	(2,542)
Proceeds from sale of stock under Employee Stock Purchase Plan	34	32
Proceeds from exercise of stock options	179	1,327
Excess tax benefits from exercise of stock options	50	--
Changes in cash management liability and other	4,246	2,260
Net cash provided by financing activities	16,032	17,278
INCREASE IN CASH	1,126	540
CASH AT BEGINNING OF PERIOD	5,368	5,470
CASH AT END OF PERIOD	$ 6,494	$ 6,010
SUPPLEMENTAL INFORMATION:		
Interest paid, net of capitalized interest	$ 4,291	$ 5,923
Income taxes paid	$ 2,123	$ 1,310

See notes to condensed financial statements.

GOTTSCHALKS INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)
Thirteen and Twenty-Six Weeks Ended July 29, 2006 and July 30, 2005

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Gottschalks Inc. (the "Company") is a regional department store chain based in Fresno, California. As of the end of the second quarter of the fiscal year ending February 3, 2007 ("fiscal 2006"), the Company operated 62 full-line Gottschalks department stores located in 6 Western states, with 39 stores in California, 9 in Washington, 6 in Alaska, 3 in each of Oregon and Idaho, and 2 in Nevada. The Company also operates 6 specialty stores, which carry a limited selection of merchandise. The Company's department stores typically offer a wide range of better to moderate brand-name and private-label merchandise for the entire family, including men's, women's, junior's and children's apparel; cosmetics, shoes, fine jewelry and accessories; and home furnishings, including china, housewares, domestics, small electric appliances and furniture (in select locations). The majority of the Company's department stores range from 40,000 to 150,000 gross square feet, and are generally anchor tenants of regional shopping malls or strategically located strip centers. The Company operates in one reportable operating segment.

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting primarily of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the twenty-six week period ended July 29, 2006 are not necessarily indicative of the results that may be expected for fiscal 2006 due to, among other reasons, the seasonal nature of the Company's business. These financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended January 28, 2006 (the "2005 Annual Report on Form 10-K"). The condensed balance sheet at January 28, 2006 has been derived from the audited financial statements as of that date.

Certain reclassifications were made to prior year's amounts to conform with the classifications of such amounts for the most recent year, including an insurance deposit of $6,253,000. This amount has been reclassified to other current assets and was previously reported as an offset to the Company's workers' compensation liability within trade accounts payable and accrued expenses as of July 30, 2005 to conform with January 28, 2006 and July 29, 2006 presentations.

2. STOCK-BASED COMPENSATION

The Company has stock option plans for directors, officers and key employees, which provide for the grant of non-qualified and incentive stock options. All such plans have been approved by the Company's stockholders. Under the plans, the option exercise price may not be lower than 100% of the fair market value of such shares at the date of the grant. Options granted generally vest on a ratable basis over four years and expire ten years from the date of the grant. At July 29, 2006, options for 1,440,000 shares were available for future grants under the plans.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"). The Company adopted SFAS No. 123R in the first quarter of 2006 using the modified prospective approach. Under the modified prospective method, compensation expense is recorded for the unvested portion of previously issued awards that remain outstanding at January 29, 2006 using the same estimate of the grant date fair value and the same attribution method used to determine the pro forma disclosure under SFAS No. 123. SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options after January 28, 2006, be recognized in the financial statements as compensation cost based on the fair value on the date of grant.

The Company determines fair value of such awards using the Black-Scholes option-pricing model. The Company uses historical data to estimate expected term of the awards and forfeiture rates, stratified into separate groups based on similar exercise and termination patterns. Expected stock volatility is based upon historical volatility of the Company's stock and other factors. The risk-free interest rate is based on the yield curve in effect at the time the options are granted, using U.S. constant maturities over the expected life of the option. The Company has historically not paid dividends and does not anticipate paying dividends during the expected term. Accordingly, the expected dividend yield is zero. There were no grants of options during the twenty-six weeks ended July 29, 2006. Options to purchase 280,000 shares were granted during the twenty-six weeks ended July 30, 2005. The estimated fair value of these option awards was calculated using the following weighted average assumptions:

Risk-free interest rate	3.8%
Expected dividend yield	--
Expected volatility	56.6%
Expected option life (years)	7.5

Option activity for the twenty-six weeks ended July 29, 2006 is as follows:

	Number of Shares	Weighted-average exercise price per share	Weighted-average remaining contractual life (in years)	Average intrinsic value
Outstanding at January 29, 2006........	1,400,475	$ 6.19		
Granted...............................	--	--		
Exercised.............................	(43,875)	4.04		
Cancelled or expired..................	(20,750)	6.64		
Outstanding at July 29, 2006..........	1,335,850	6.25	5.86	$8,349,063
Exercisable at July 29, 2006..........	946,350	$ 5.62	4.86	$5,318,487

The intrinsic value of options exercised during the first half of fiscal 2006 and the first half of fiscal 2005 was $177,255 and $1,326,832, respectively.

The Company recognized share-based compensation expense related to the unvested portion of previously issued awards of approximately $200,000 ($0.01 per diluted share, after related tax benefit of $79,000) and $492,000 ($0.02 per diluted share, after related tax benefit of $194,000) in the second quarter and first half of 2006, respectively, as a component of selling, general, and administrative expense. As of July 29, 2006, there was $985,000 of unrecognized compensation cost related to non- vested awards granted under the plans. That cost is expected to be recognized over a remaining term of up to 4 years.

Prior to the adoption of SFAS No. 123R, the Company accounted for its plans under the recognition and measurement principles of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. No stock-based employee compensation cost is reflected in net loss during the first half of 2005, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant.

The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123R.

(In thousands of dollars, except per share data)	Thirteen Weeks Ended July 30, 2005	Twenty-Six Weeks Ended July 30, 2005
Net income (loss) as reported....................	$ 259	$ (1,727)
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects..........	(137)	(208)
Pro-forma net income (loss)......................	$ 122	$ (1,935)
Net income (loss) per share (basic and diluted):		
As reported	$ 0.02	$ (0.13)
Pro-forma	$ 0.01	$ (0.15)

3. MERCHANDISE INVENTORIES

Inventories, which consist of merchandise held for resale, are valued by the retail method and are stated at last-in, first-out (LIFO) cost, which is not in excess of market value. The Company includes in inventory the capitalization of certain indirect costs related to the purchasing, handling and storage of merchandise. Current cost, which approximates replacement cost, under the first-in, first-out (FIFO) method was equal to the LIFO value of inventories at January 28, 2006. A valuation of inventory under the LIFO method is presently made only at the end of each year based on actual inventory levels and costs at that time. Since these factors are subject to variability beyond the control of management, interim results of operations are subject to the final year-end LIFO inventory valuation adjustment. Management does not currently anticipate that its year-end LIFO adjustment will materially affect the Company's fiscal 2006 operating results.

4. TRADE ACCOUNTS PAYABLE AND OTHER CURRENT LIABILITIES

Trade accounts payable and other current liabilities consist of the following:

(In thousands of dollars)	July 29, 2006	January 28, 2006	July 30, 2005
Trade accounts payable................	$ 29,760	$ 29,156	$ 34,710
Accrued expenses......................	31,367	33,715	26,206
Cash management liability.............	6,445	2,199	7,744
Accrued payroll and related liabilities.........................	6,899	6,074	6,317
Taxes, other than income taxes.........	8,442	12,663	8,713
Federal and state income taxes payable............................	647	2,814	513
Deferred income taxes payable.........	1,659	1,851	1,717
	$ 85,219	$ 88,472	$ 85,920

5. DEBT

Senior Revolving Credit Facility

On March 1, 2004 the Company amended and restated its senior revolving credit facility (the "credit facility") to provide up to $165.0 million of working capital financing through February 2, 2009. On January 26, 2006, the Company finalized an amendment to the credit facility increasing the commitment to $181 million, reducing the interest rate charged on outstanding borrowing by 25 basis points, and allowing for the payoff on February 1, 2006 of approximately $16.6 million of outstanding balances on higher interest rate mortgages related to four of the Company's owned properties (the "designated properties"). In addition, the amendment provides for an optional additional increase in the commitment of $19.0 million, and an optional extension of the credit facility through February 2, 2011. The credit facility, as amended, currently consists of a revolving credit facility of up to $172.0 million (including a $20.0 million letter of credit sub-facility) and a fully funded term loan of $9.0 million. Borrowings under the revolving credit facility, as amended, are limited to the sum of (a) a specified percentage of eligible credit card receivables, (b) the lesser of specified percentages of (i) the cost of eligible inventory and (ii) the net recovery value of the inventory, as determined by periodic valuation performed by an independent appraiser, and (c) the lesser of (i) up to 60% of the fair market value of the designated properties and (ii) $21.6 million. Such borrowings are further limited by a requirement to maintain a minimum of $5.0 million of excess availability at all times, and other reserves that are in effect. As of July 29, 2006, outstanding borrowings under the credit facility totaled $75.8 million, and excess borrowing availability under the credit facility, after the deduction of the minimum availability requirement and other reserves, totaled $53.9 million. Substantially all of the Company's assets, including its merchandise inventories, are pledged under the credit facility.

As of July 29, 2006, interest charged on amounts borrowed under the revolving portion of the credit facility are at the prime rate, or at the Company's option, at the applicable LIBOR rate plus 1.25% per annum, and interest charged on the term loan is a fixed rate of 6.6% per annum. In addition, the Company pays an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the revolving portion of the credit facility. The interest rate applicable to the revolving portion of the credit facility is adjusted upwards or downwards on a quarterly basis based on a pricing matrix which is tied to the Company's daily average excess availability for the preceding fiscal quarter (as defined in the agreement). Under the pricing matrix, the applicable interest rate could range from a rate as low as prime or LIBOR plus 1.25%, to as high as prime plus 0.50%, or LIBOR plus 2.50%.

The credit facility, as amended, contains restrictive financial and operating covenants, including the requirement to maintain a fixed charge coverage ratio of 1:1 (as defined in the agreement) if the Company's excess borrowing availability is below $15.0 million. As of July 29, 2006, management believes the Company was in compliance with all restrictive financial covenants applicable to the credit facility.

Long-Term Financings

The Company's long-term debt and capital lease obligations consist of the following:

(In thousands)	July 29, 2006	January 28, 2006	July 30, 2005
9.39% mortgage loans payable, due 2010.	$ --	$ 16,561	$ 16,816
Capital lease obligations.............	9,253	9,993	4,861
7.5% note payable, due 2010............	2,787	3,127	3,445
Other mortgage loans and notes payable.	4,437	2,060	2,229
	16,477	31,741	27,351
Less current portion..................	1,985	2,770	3,173
	$ 14,492	$ 28,971	$ 24,178

Substantially all of the Company's assets, including its merchandise inventories, are pledged as collateral under the Company's various debt agreements. Certain of the Company's long-term debt agreements contain financial and other restrictive covenants. The Company was in compliance with all such covenants as of July 29, 2006.

Subordinated Note

The Company's Subordinated Note to Harris, a wholly owned subsidiary of El Corte Ingles ("ECI") of Spain, is due May 30, 2009, bears interest at a fixed rate of 8% payable semi-annually and provides for principal payments of up to $8.0 million prior to its maturity. Such payments are subject to certain liquidity restrictions under the revolving credit facility. The Company made principal payments of $1.0 million each upon execution of the note, on February 20, 2005, and on February 21, 2006 as scheduled. An additional principal payment of $1.0 million is scheduled for February 2007 and principal payments of $2.0 million are scheduled for each of February 2008 and 2009, with the balance due at maturity subject to the payment in full of the revolving credit facility. The Subordinated Note is unsecured, contains no restrictive financial covenants and is subordinate to the payment of all debt, including trade credit, of the Company.

6. INTEREST RATE DERIVATIVE

The Company currently has an interest rate swap contract outstanding to effectively convert a portion of its variable-rate debt to fixed-rate debt. This contract entails the exchange of fixed-rate and floating-rate interest payments periodically over the agreement life. The following table indicates the notional amount as of July 29, 2006 and the range of interest rates paid and received by the Company during the twenty-six weeks ended July 29, 2006:

Fixed swap (notional amount)	$25,000,000
Range of receive rate	4.49%-5.32%
Pay rate	4.99%

In accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), and SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," the Company recognizes all derivatives on the balance sheet at fair value. Although the swap essentially provides for matched terms to its underlying obligation, and effectively mitigates its variability, it currently does not qualify for hedge accounting under SFAS No. 133.

The interest rate swap will expire February 2, 2009. The net income or expense from the exchange of interest rate payments is included in interest expense. The estimated fair value of the interest rate swap agreement, based on dealer quotes, at July 29, 2006 was a gain of $173,226 and represents the amount the Company would receive if the agreement was terminated as of that date. As of July 29, 2006, the Company reflected a derivative asset in other assets for such amount to recognize the fair value of the interest rate swap. Changes in the fair value of derivatives not designated as qualifying cash flow hedges are reported in interest expense. Accordingly, interest expense for the twenty-six weeks ended July 29, 2006 includes a favorable fair value adjustment of $317,035 related to the interest rate swap. All charges recorded pursuant to SFAS No. 133 are considered non-cash items in the statements of cash flows.

7. WEIGHTED AVERAGE NUMBER OF SHARES

Options with an exercise price greater than the average market price of the Company's common stock during the period, or outstanding in a period in which the Company reports a net loss, are excluded from the computation of the weighted average number of shares on a diluted basis, as such options are anti-dilutive. Approximately 469,800 and 12,500 options with an exercise price greater than the average market price of the Company's common stock have been excluded from the computation of the weighted average number of shares for the thirteen weeks ended July 29, 2006 and July 30, 2005, respectively. Weighted average options outstanding of approximately 1,005,100 and 1,333,800 were excluded from the computation of dilutive shares due to the Company's net loss position in the twenty-six weeks ended July 29, 2006 and July 30, 2005, respectively. Had the Company reported profit for these periods, approximately 356,800 and 93,800 options with exercise prices greater than the average market price of the Company's common stock during the twenty-six weeks ended July 29, 2006 and July 30, 2005, respectively, would have been excluded from the computation of the weighted average number of shares, and the approximate effect of dilutive options would have been 323,600 shares and 625,200 shares for the twenty-six weeks ended July 29, 2006 and July 30, 2005, respectively.

8. COMMITMENTS AND CONTINGENCIES

On September 19, 2005, the Company became subject to a complaint filed in the Superior Court of California for the County of Santa Cruz alleging violation of California law regarding payment of accrued vacation upon termination of employment. The complaint seeks wage payments for employees who allegedly forfeited accrued vacation, waiting time penalties, interest, injunctive relief and costs. The Company believes settlement of this matter is in its best interests and has entered into a memorandum of understanding for class settlement, which is pending court approval. The Company accrued $1.8 million during the fourth quarter of fiscal 2005 for estimated legal fees and settlement costs and management does not believe the ultimate resolution will have a material adverse effect on the Company's business, financial condition or results of operations.

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

In May 2006, the Company finalized an agreement to purchase the lease and certain fixtures of a 124,000 square foot store in Eugene, Oregon from Federated Department Stores. The Company expects to spend approximately $1.0 million to acquire and convert this facility to the Gottschalks format. The new store opened on August 31, 2006.

As of July 29, 2006, the Company had issued a total of $2.0 million of standby letters of credit and documentary letters of credit totaling $2.7 million. Management believes that the likelihood of any draws under the standby letters of credit is remote. Documentary letters of credit are issued in the ordinary course of business to facilitate the purchase of merchandise from overseas suppliers. The suppliers draw against the documentary letters of credit upon delivery of the merchandise to the Company's customs broker at a United States port.

9. DISCONTINUED OPERATIONS

During the first quarter of fiscal 2006 the Company closed one underperforming store in the Seattle/Tacoma market and during fiscal 2005 the Company closed 2 underperforming stores in the Seattle/Tacoma market. These stores are considered discontinued operations due to the Company's exit from the respective market areas. The closure of the Company's Fig Garden store during the first quarter of fiscal 2005 is not considered a discontinued operation due to the shift in revenues to other stores in the Fresno market, including the Fresno River Park store, which opened during the third quarter of fiscal 2005. The loss from operation of discontinued stores includes only revenues generated from, and expenses directly associated with, the operation of such stores and consists of the following:

	Thirteen Weeks Ended		Twenty-Six Weeks En	
(In thousands of dollars)	July 29, 2006	July 30, 2005	July 29, 2006	July 200
Net sales from closed stores..................	$ --	$ 1,991	$ 785	$ 3,

Cost of sales................................	--	1,119	737	2,
Selling, general and administrative expenses...	--	997	243	1,
Depreciation and amortization.................	--	108	31	
Total costs and expenses.....................	--	2,224	1,011	4,
Loss from operations of closed stores..........	$ --	$ (233)	$ (226)	$ (

The Company recorded a net gain on the sale of the building associated with the store closed during the first quarter of fiscal 2006 of approximately $147,000, which was partially offset by store closure costs of approximately $75,000 related to that store and one store closed at the end of fiscal 2005, primarily consisting of severance and other incremental costs associated with the store closing.

10. RECENT ACCOUNTING PRONOUNCEMENTS

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

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

In June 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. (FIN) 48, "Accounting for Uncertainty in Income Taxes," which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company is required to adopt FIN 48 beginning in fiscal year 2007 and is currently evaluating the impact, if any, of FIN 48 on its financial position, results of operations and cash flows.

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

Following is management's discussion and analysis of significant factors which have affected the Company's financial position and its results of operations for the periods presented in the accompanying condensed financial statements. The Company's operating results, like those of most retailers, are subject to seasonal influences, with the major portion of sales, gross margin and operating results realized during the fourth quarter of each fiscal year. Accordingly, performance for the thirteen and twenty-six week periods ended July 29, 2006 (hereinafter referred to as the "second quarter of fiscal 2006" and the "first half of fiscal 2006," respectively), is not necessarily indicative of performance for the remainder of the year.

Critical Accounting Policies

The Company's financial statements are based on the application of critical accounting policies, many of which require management to make significant estimates and assumptions. Some of these critical accounting policies involve a higher degree of judgment or complexity than its other accounting policies. The Company evaluates its estimates on an ongoing basis, including those related to its revenue recognition policy, the carrying value of its merchandise inventories, and the valuation of its long- lived assets, including goodwill, and its deferred tax assets. The impact and associated risks related to these policies on the Company's business operations are described more fully in the Company's 2005 Annual Report on Form 10-K.

Results of Operations

The following table sets forth the Company's Statements of Operations as a percent of net sales:

	Thirteen Weeks Ended		**Twenty-Six We**
	July 29, 2006	**July 30, 2005**	**July 29, 2006**
Net sales	100.0 %	100.0 %	100.0 %
Net credit revenues	0.5	0.4	0.4
Net leased department revenues	0.4	0.4	0.5
Total revenues	100.9	100.8	100.9
Costs and expenses:			
Cost of sales	64.5	64.4	65.5
Selling, general and administrative expenses	32.7	32.6	33.8
Gain on sale of aircraft	(0.6)		(0.3)
Depreciation and amortization	2.5	2.2	2.5
New store opening costs		0.1	
Total costs and expenses	99.1	99.3	101.5
Operating income (loss)	1.8	1.5	(0.6)
Other (income) expense:			
Interest expense	1.6	1.4	1.6
Miscellaneous income	(0.2)	(0.3)	(0.3)
	1.4	1.1	1.3
Income (loss) before income taxes	0.4	0.4	(1.9)
Income tax expense (benefit)	--	0.1	(0.7)
Income (loss) from continuing operations	0.4	0.3	(1.2)
Discontinued operations:			
Loss from operation of closed stores	--	(0.2)	--
Gain on store closures	--	--	--
Income tax benefit	--	0.1	--
Loss on discontinued operations	--	(0.1)	--
Net income (loss)	0.4 %	0.2 %	(1.2)%

Second Quarter of Fiscal 2006 Compared to Second Quarter of Fiscal 2005

Net Sales

Net sales from continuing operations increased by approximately $3.8 million to $153.4 million in the second quarter of fiscal 2006 as compared to $149.6 million in the second quarter of fiscal 2005, an increase of 2.5%. A return to more typical warm spring weather in May resulted in a solid sales trend that continued through June. However, the record heat wave in California at the end of July impacted sales while stores in the Pacific Northwest experienced solid sales gains. Performance in California stores improved during the final weekend of the quarter as weather normalized. Comparable store sales for the second quarter of fiscal 2006, which includes sales for stores open for the full period in both years, increased by 1.1% as compared to the second quarter of fiscal 2005.

The Company operated 62 department stores and 6 specialty stores as of the end of the second quarter of fiscal 2006, as compared to 63 department stores and 6 specialty stores as of the end of the second quarter of fiscal 2005.

Net Credit Revenues

Net credit revenues related to the Company's proprietary credit cards increased approximately $0.1 million in the second quarter of fiscal 2006 as compared to the second quarter of fiscal 2005. As a percent of net sales, net credit revenues was 0.5% of net sales in the second quarter of fiscal 2006 and 0.4% in the second quarter of fiscal 2005.

Net Leased Department Revenues

Net rental income generated by the Company's various leased departments in the second quarter of fiscal 2006 was virtually equal to the second quarter of fiscal 2005.

Leased department sales are presented net of the related costs for financial reporting purposes. Sales generated in the Company's leased departments in the second quarter of fiscal 2006 consisted primarily of sales in the fine jewelry departments and the beauty salons. These leased department sales were $4.9 million in the second quarter of fiscal 2006 and $4.8 million in the second quarter of fiscal 2005.

Cost of Sales

Cost of sales from continuing operations, which includes costs associated with the buying, handling and distribution of merchandise, increased by approximately $2.5 million to $98.9 million in the second quarter of fiscal 2006 as compared to $96.4 million in the second quarter of fiscal 2005, an increase of 2.6%. The Company's gross margin percentage was 35.5% in the second quarter of fiscal 2006 and 35.7% in the second quarter of fiscal 2005.

Selling, General and Administrative Expenses

Selling, general and administrative expenses from continuing operations increased by approximately $1.4 million to $50.2 million in the second quarter of fiscal 2006 as compared to $48.8 million in the second quarter of fiscal 2005, an increase of 2.8%. The increase is primarily attributable to increases in payroll costs and fringe benefits, including a moderate increase in worker compensation reserves and the expensing of $0.2 million in stock based compensation expense. In addition, higher energy costs are driving increases in utilities, certain supply costs, and outgoing freight charges. These increases are partially off-set by $0.4 million received in the second quarter of fiscal 2006 as a member of a class of a settled lawsuit against Visa U.S.A. Inc. and MasterCard International Incorporated. The Visa Check/MasterMoney Antitrust litigation settlement became final on June 1, 2005. The Company did not recognize its share of the settlement in its financial statements until cash was received. As a percent of net sales, selling, general and administrative expenses from continuing operations increased in the second quarter of fiscal 2006 by 0.1% to 32.7% as compared to the second quarter of fiscal 2005.

Gain on Sale of Aircraft

The Company sold a corporate aircraft on June 30, 2006 for $1,037,000 (net of selling costs) that resulted in a gain of $946,000 ($579,000 after tax). The gain is reflected in operating income as the aircraft was reported as an operating asset.

Depreciation and Amortization

Depreciation and amortization expense, which includes the amortization (accretion) of intangible assets other than goodwill, was $3.8 million in the second quarter of fiscal 2006 as compared to $3.2 million in the second quarter of fiscal 2005. As a percent of net sales, depreciation and amortization expense increased to 2.5% in the second quarter of fiscal 2006 as compared to 2.2% in the second quarter of fiscal 2005. This includes $0.1 million related to accelerated depreciation of assets due to the closing of the Danville, California store in August 2006. The dollar increase is also a result of the depreciation of capital additions related to the Company's new stores and major remodel projects at certain existing stores during fiscal 2005.

New Store Opening Costs

New store opening costs, which are expensed as incurred, typically include costs such as payroll and fringe benefits for store associates, store rents, temporary storage, utilities, travel, grand opening advertising, credit solicitation and other costs incurred prior to the opening of a store. The Company recognized new store opening costs totaling $0.1 million in connection with the opening of a new store in Eugene, Oregon in the second quarter of fiscal 2006. The store opened August 31, 2006. The Company recognized new store opening costs totaling $0.2 million in connection with the opening of new stores in each of Fresno, California and Albany, Oregon in the second quarter of fiscal 2005.

Interest Expense

Interest expense, which includes the amortization of deferred financing costs, increased by approximately $0.3 million to $2.4 million in the second quarter of fiscal 2006 as compared to $2.1 million in the second quarter of fiscal 2005, an increase of 15.8%. As a percent of net sales, interest expense increased to 1.6% in the second quarter of fiscal 2006 as compared to 1.4% in the second quarter of fiscal 2005. These increases are primarily due to continued increases in interest rates charged on the Company's variable rate debt. The weighted average interest rate applicable to the revolving credit facility was 7.0% in the second quarter of fiscal 2006 (7.2% at July 29, 2006) as compared to 5.6% in the second quarter of fiscal 2005.

Miscellaneous Income - Net

Miscellaneous income, which includes the amortization of deferred income and other non-operating income and expense amounts, was $0.4 million in the second quarter of fiscal 2006 and in the second quarter of fiscal 2005.

Income Taxes

The Company's interim effective tax rates from continuing operations of 38.8% in the second quarter of fiscal 2006 and 40.6% in the second quarter of fiscal 2005 relate to the net income reported in those periods and represent the Company's best estimates of the annual effective tax rates for those fiscal years. The final effective tax rate from continuing operations for fiscal 2005 was 33.5%, and the increase in the estimated interim rate for fiscal 2006 is primarily due to the expiration of certain federal tax credit programs.

Income From Continuing Operations

As a result of the foregoing, the Company reported income from continuing operations of $0.5 million, or $0.04 per share (basic and diluted), in the second quarter of fiscal 2006 as compared to income from continuing operations of $0.4 million, or $0.03 per share (basic and diluted) in the second quarter of fiscal 2005.

Net Income

As a result of the foregoing, the Company reported net income of approximately $0.5 million in the second quarter of fiscal 2006 as compared to net income of $0.3 million in the second quarter of 2005. On a per share basis, the net income was $0.04 per share (basic and diluted) in the second quarter of 2006 as compared to $0.02 per share (basic and diluted) in the second quarter of 2005.

First Half of Fiscal 2006 Compared to First Half of Fiscal 2005

Net Sales

Net sales increased by approximately $4.3 million to $296.1 million in the first half of fiscal 2006 as compared to $291.8 million in the first half of fiscal 2005, an increase of 1.5%. Sales during the first quarter of 2006 were sluggish, impacted in part by severe west coast weather. Comparable store sales for the first half of fiscal 2006, which includes sales for stores open for the full period in both years, were even as compared to the first half of fiscal 2005.

The Company operated 62 department stores and 6 specialty stores as of the end of the first half of fiscal 2006, as compared to 63 department stores and 6 specialty stores as of the end of the first half of fiscal 2005.

Net Credit Revenues

Net credit revenues related to the Company's proprietary credit cards were essentially equal for the first half of fiscal 2006 as compared to the first half of fiscal 2005. As a percent of net sales, net credit revenues were 0.4% in the first half of fiscal 2006 and 0.5% in the first half of fiscal 2005.

Net Leased Department Revenues

Net rental income generated by the Company's various leased departments were essentially equal in the first half of fiscal 2006 as compared to the first half of fiscal 2005.

Leased department sales are presented net of the related costs for financial reporting purposes. Sales generated in the Company's leased departments in the first half of fiscal 2006 consisted primarily of sales in the fine jewelry departments and the beauty salons. These leased department sales were $10.2 million in the first half of fiscal 2006 and $10.0 million in the first half of fiscal 2005.

Cost of Sales

Cost of sales, which includes costs associated with the buying, handling and distribution of merchandise, increased by approximately $3.6 million to $194.0 million in the first half of fiscal 2006 as compared to $190.4 million in the first half of fiscal 2005, an increase of 1.9%. The Company's gross margin percentage decreased to 34.4% in the first half of fiscal 2006 as compared to 34.8% in the first half of fiscal 2005.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased by approximately $3.6 million to $100.1 million in the first half of fiscal 2006 as compared to $96.6 million in the first half of fiscal 2005, an increase of 3.7%. The increase is primarily attributable to increases in payroll costs and fringe benefits, including a moderate increase in worker compensation reserves and $0.5 million in stock based compensation. Higher energy costs are driving increases in utilities, supply costs and freight charges. These increases are partially offset by $0.4 million received as a member of a class of a settled lawsuit against Visa U.S.A. Inc. and MasterCard International Incorporated. As a percent of net sales, selling, general and administrative expenses in the first half of fiscal 2006 increased by 0.7% as compared to the first half of fiscal 2005.

Gain on Sale of Aircraft

The Company sold a corporate aircraft on June 30, 2006 for $1,037,000 (net of selling costs) that resulted in a gain of $946,000 ($579,000 after tax). The gain is reflected in operating income as the aircraft was reported as an operating asset.

Depreciation and Amortization

Depreciation and amortization expense, which includes the amortization (accretion) of intangible assets other than goodwill, was $7.3 million in the first half of fiscal 2006 as compared to $6.3 million in the first half of fiscal 2005. As a percent of net sales, depreciation and amortization expense increased to 2.5% in the first half of fiscal 2006 as compared to 2.2% in the first half of fiscal 2005. This increase includes $0.1 million related to accelerated depreciation of assets due to the closing of the Danville, California store in August 2006. The dollar increase is also a result of the depreciation of capital additions related to the Company's new stores and major remodel projects at certain existing stores during fiscal 2005.

New Store Opening Costs

New store opening costs, which are expensed as incurred, typically include costs such as payroll and fringe benefits for store associates, store rents, temporary storage, utilities, travel, grand opening advertising, credit solicitation and other costs incurred prior to the opening of a store. The Company recognized new store opening costs totaling $0.1 million in connection with the opening of a new store in Eugene, Oregon in the first half of fiscal 2006. The store opened August 31, 2006. The Company recognized new store opening costs of $0.3 million in connection with the opening of new stores in each of Fresno, California and Albany, Oregon in the first half of 2005.

Interest Expense

Interest expense, which includes the amortization of deferred financing costs, increased by approximately $0.6 million to $4.6 million in the first half of fiscal 2006 as compared to $4.0 million in the first half of fiscal 2005, an increase of 15.9%. As a percent of net sales, interest expense increased to 1.6% in the first half of fiscal 2006 as compared to 1.4% in the first half of fiscal 2005. These increases are primarily due to continued increases in interest rates charged on the Company's variable rate debt and include a charge of $0.2 million related to the early termination of the Company's 9.39% mortgages. These increases were partially offset by a $0.3 million favorable fair value adjustment on the Company's $25 million notional amount interest swap. The Company anticipates that its interest rate swap will continue to provide protection against these rising interest rates for the near term. The weighted average interest rate applicable to the revolving credit facility was 7.0% in the first half of fiscal 2006 (7.2% at July 29, 2006) as compared to 5.6% in the first half of fiscal 2005.

Miscellaneous Income - Net

Miscellaneous income, which includes the amortization of deferred income and other non-operating income and expense amounts, was $0.8 million in the first half of fiscal 2006 and 2005.

Income Taxes

The Company's interim effective tax rates from continuing operations of 38.8% in the first half of fiscal 2006 and 37.8% in the first half of fiscal 2005 relate to the net losses incurred in those periods and represent the Company's best estimates of the annual effective tax rates for those fiscal periods.

Loss From Continuing Operations

The Company reported a loss from continuing operations of $3.4 million, or $0.25 per share (basic and diluted), and $1.3 million, or $0.10 per share (basic and diluted), in the first half of fiscal 2006 and fiscal 2005, respectively.

Discontinued Operations

The closure of one underperforming store in the Seattle/Tacoma area market during the first quarter of fiscal 2006 resulted in a net gain on sale of $0.1 million. This gain was partially offset by minor incremental costs associated with the closure of this and one other Seattle/Tacoma area store closed at the end of January 2006. Results of operations of the discontinued stores consist of the following:

(In thousands of dollars)	Thirteen Weeks Ended July 29, 2006	Thirteen Weeks Ended July 30, 2005	Twenty-Six Weeks En July 29, 2006	July 200
Net sales from closed stores	$ --	$ 1,991	$ 785	$ 3,
Cost of sales	--	1,119	737	2,
Selling, general and administrative expenses	--	997	243	1,
Depreciation and amortization	--	108	31	
Total costs and expenses	--	2,224	1,011	4,
Loss from operations of closed stores	$ --	$ (233)	$ (226)	$ (

Net Loss

As a result of the foregoing, the Company reported a net loss of approximately $3.5 million in the first half of fiscal 2006 as compared to net loss of $1.7 million in the first half of 2005. On a per share basis (basic and diluted), the net loss was $0.26 per share in the first half of 2006 as compared to $0.13 per share in the first half of 2005.

Liquidity and Capital Resources

As described more fully in the Company's 2005 Annual Report on Form 10-K and Note 5 to the accompanying financial statements, the Company's working capital requirements are currently met through a combination of cash provided by operations, borrowings under its senior revolving credit facility, and by short-term trade and factor credit. The Company's liquidity position, like that of most retailers, is affected by seasonal influences, with the greatest portion of cash from operations generated in the fourth quarter of each fiscal year.

The Company's use of cash during the first half of fiscal 2006 is primarily the result of the build-up of spring and summer inventory, after the winter holiday selling season and for the opening of the Eugene, Oregon store. The increase in net cash used in operations for the first half of fiscal 2006 as compared to the first half of 2005 reflects repayments of trade accounts payable, reductions in accrued expenses and a larger net loss.

Decreases in net cash used in investing activities are the result of proceeds received related to the sale and closure of one of the Company's owned stores in the Seattle market area. Capital spending during the first half of fiscal 2006 relates to renovations of primarily accessory and shoe areas of certain key stores and to upgrades to the Company's planning and allocation and point of sale systems. Capital spending during the first half of fiscal 2005 primarily relates to the opening of the Company's Albany, Oregon store and construction of the Fresno, California, River Park store.

Net cash provided by financing activities during the first half primarily relates to increased borrowing on the Company's revolving credit facility to fund the acquisition of inventory and capital expenditures, partially offset by ongoing payment of principal on long-term obligations. Increases to the Company's revolving line of credit during the first half of fiscal 2006 also include the pay off of the 9.39% mortgages on four of the Company's owned properties of approximately $16.6 million.

Sources of Liquidity

Senior Secured Credit Facility

On March 1, 2004 the Company amended and restated its senior revolving credit facility (the "credit facility") to provide up to $165.0 million of working capital financing through February 2, 2009. On January 26, 2006 the Company finalized an amendment to the credit facility increasing the commitment to $181 million, reducing the interest rate charged on outstanding borrowing by 25 basis points, and allowing for the payoff of approximately $16.6 million of outstanding balances on higher interest rate mortgages related to four of the Company's owned properties (the "designated properties"). In addition, the amendment provides for an optional additional increase in the commitment of $19.0 million, and an optional extension of the credit facility through February 2, 2011. The credit facility, as amended, currently consists of a revolving credit facility of up to $172.0 million (including a $20.0 million letter of credit sub-facility) and a fully funded term loan of $9.0 million. Borrowings under the revolving credit facility, as amended, are limited to the sum of (a) a specified percentage of eligible credit card receivables, (b) the lesser of specified percentages of (i) the cost of eligible inventory and (ii) the net recovery value of the inventory, as determined by periodic valuation performed by an independent appraiser, and (c) the lesser of (i) up to 60% of the fair market value of the designated properties and (ii) $21.6 million. Such borrowings are further limited by a requirement to maintain a minimum of $5.0 million of excess availability at all times, and other reserves that are in effect. As of July 29, 2006, outstanding borrowings under the credit facility totaled $75.8 million, and excess borrowing availability under the credit facility, after the deduction of the minimum availability requirement and other reserves, totaled $53.9 million. Substantially all of the Company's assets, including its merchandise inventories, are pledged under the credit facility.

As of July 29, 2006, interest charged on amounts borrowed under the revolving portion of the credit facility are at the prime rate, or at the Company's option, at the applicable LIBOR rate plus 1.25% per annum, and interest charged on the term loan is a fixed rate of 6.6% per annum. In addition, the Company pays an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the revolving portion of the credit facility. The interest rate applicable to the revolving portion of the credit facility is adjusted upwards or downwards on a quarterly basis based on a pricing matrix which is tied to the Company's daily average excess availability for the preceding fiscal quarter (as defined in the agreement). Under the pricing matrix, the applicable interest rate could range from a rate as low as prime plus 0.00% or LIBOR plus 1.25%, to as high as prime plus 0.50%, or LIBOR plus 2.50%.

The credit facility, as amended, contains restrictive financial and operating covenants, including the requirement to maintain a fixed charge coverage ratio of 1:1 (as defined in the agreement) if the Company's excess borrowing availability is below $15.0 million. As of July 29, 2006, management believes the Company was in compliance with all restrictive financial covenants applicable to the credit facility.

Trade Credit

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

Other Financings

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

Uses of Liquidity

The Company's primary uses of liquidity are for working capital, debt service requirements and capital expenditures. Capital expenditures during the second quarter of fiscal 2006 totaling $7.2 million relate to renovations of primarily accessory and shoe areas of certain key stores and to upgrades to the Company's planning and allocation and point of sale systems.

In May 2006, the Company finalized an agreement to purchase the lease and certain fixtures of a 124,000 square foot store in Eugene, Oregon from Federated Department Stores. The Company expects to spend approximately $1.0 million to acquire and convert this facility to the Gottschalks format. The store opened August 31, 2006.

As of July 29, 2006, the Company had issued a total of $2.0 million of standby letters of credit and documentary letters of credit totaling $2.7 million. The standby letters of credit were issued to provide collateral for workers compensation insurance policies. Management believes that the likelihood of any draws under the standby letters of credit is remote. Documentary letters of credit are issued in the ordinary course of business to facilitate the purchase of merchandise from overseas suppliers. The supplier draws against the documentary letter of credit upon delivery of the merchandise.

Subject to the previously described risks and uncertainties relative to the Company's sources of liquidity, management currently believes that the described sources of liquidity, including cash generated by operations, liquidity provided by the revolving credit facility and other financial resources, will be adequate to meet the Company's planned cash requirements for at least the next 12 months. However, the Company's actual results may differ from the expectations set forth in the preceding sentence. The Company's liquidity and capital resources may be affected by a number of factors and risks (many of which are beyond the control of the Company), including but not limited to the availability of adequate borrowing capacity, adequate cash flows generated by operations and the adequacy of factor and trade credit. If the estimates or assumptions relative to any one of these sources of liquidity are not realized, or if these sources of liquidity are significantly reduced or eliminated, the Company's liquidity position, financial condition and results of operations will be materially adversely affected.

Safe Harbor Statement.

Certain statements contained in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and the Company intends that such forward-looking statements be subject to the safe harbors created thereby. These forward-looking statements include the plans and objectives of management for future operations and the future economic performance of the Company that involve risks and uncertainties. In some instances, such statements may be identified by the use of forward-looking terminology such as "may," "will," "expects," "believes," "intends," "projects," "forecasts," "plans," "estimates," "anticipates," "continues," "targets," or similar terms, variations of such terms or the negative of such terms. Such statements are based on management's current expectations and are subject to a number of factors and uncertainties which could cause actual results to differ materially from those described in the forward-looking statements, including, without limitation, the Company's ability to meet debt obligations and adhere to the restrictions and covenants imposed under its various debt agreements; the timely receipt of merchandise and the Company's ability to obtain adequate trade credit from its key factors and vendors; risks arising from general economic and market conditions (including uncertainties arising from future acts of terrorism or war); the ability to modify operations in order to minimize the adverse impact of rising costs, including but not limited to health care, workers' compensation, property and casualty insurance, unemployment insurance, and utilities costs; the effects of seasonality and weather conditions, changing consumer trends and preferences, competition, consumer credit; the Company's dependence on its key personnel; and general labor conditions, all of which are described in more detail under the caption "Risk Factors" in Item 1A. "Business" in the Company's 2005 Annual Report on Form 10-K and other reports filed by the Company with the Securities and Exchange Commission. THE COMPANY DOES NOT PRESENTLY INTEND TO UPDATE THESE STATEMENTS AND UNDERTAKES NO DUTY TO ANY PERSON TO EFFECT ANY SUCH UPDATE UNDER ANY CIRCUMSTANCES.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As described more fully in Part II, Item 7A of the Company's 2005 Annual Report on Form 10-K, the Company is exposed to market risks in the normal course of business due to changes in interest rates on short-term borrowings under its revolving line of credit and on certain of its long-term borrowing arrangements. Based on current market conditions, management does not believe there has been a material change in the Company's exposure to interest rate risks as described in that report.

Item 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company maintains "disclosure controls and procedures," as such term is defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that are designed to ensure that information required to be disclosed in the Company's reports, pursuant to the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding the required disclosures. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which by their nature can provide only reasonable assurance regarding management's control objectives. The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer along with the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b). Based upon the foregoing, as of July 29, 2006, the Company's President and Chief Executive Officer along with the Company's Chief Financial Officer, concluded that the Company's disclosure controls and procedures are effective in reaching the level of reasonable assurance regarding management's control objectives.

There has been no change during the Company's fiscal quarter ended July 29, 2006 in the Company's internal control over financial reporting that was identified in connection with the evaluation required by Exchange Act Rule 13a-15(d) which has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. RISK FACTORS

Multiple risk factors exist which could have a material effect on the Company's operations, results of operations, profitability, financial position, liquidity and capital resources. These risk factors are more fully presented in the Company's 2005 Annual Report on Form 10-K as filed with the SEC.

There have been no material changes with respect to the risk factors disclosed in our 2005 Annual Report on Form 10-K.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On June 28, 2006, the Company held its 2006 Annual Meeting of Stockholders at which the following matter was submitted to a vote of the Company's shareholders:

1. The stockholders voted for eleven nominees for director, each for a one-year term. Each of the eleven nominees was elected. The results of the vote are as follows:

NOMINEE FOR DIRECTOR	VOTES FOR	VOTES WITHHELD
Joe Levy	12,381,725	372,939
James R. Famalette	12,584,880	169,784
Joseph J. Penbera	12,333,832	420,832
Sharon Levy	12,379,085	375,579
O. James Woodward III	12,415,037	339,627
Frederick R. Ruiz	12,618,044	136,620
James L. Czech	12,617,082	137,582
Thomas H. McPeters	12,582,217	172,447
Jorge Pont Sa nchez	12,598,400	156,264
Philip S. Schlein	12,614,382	140,282
Dale D. Achabal	12,583,579	171,085

Item 6. EXHIBITS

Exhibit Number	Exhibit Description
3.1	Certificate of Incorporation of the Company, as amended. (1)
3.2	Bylaws of the Company, as amended. (2)
31.1	Section 302 Certification of Chief Executive Officer. (3) PDF
31.2	Section 302 Certification of Chief Administrative and Financial Officer. (3) PDF
32.1	Certification of President and Chief Executive Officer and Chief Administrative and Financial Officer Pursuant to 18 U.S.C. §1350, As Adopted Pursuant to §906 of the Sarbanes-Oxley Act of 2002. (3) PDF

(1) Previously filed as an exhibit to Registration Statement on Form S-1 (File No. 33-3949).

(2) Previously filed as an exhibit to the Annual Report on Form 10-K for the year ended February 3, 2001 (File No. 1-09100).

(3) Furnished concurrently herewith.

SIGNATURES

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

Gottschalks Inc.
(Registrant)

September 6, 2006 By: /s/ James R. Famalette
James R. Famalette
(President and Chief Executive Officer)

September 6, 2006 By: /s/ J. Gregory Ambro
J. Gregory Ambro
(Senior Vice President/Chief Administrative and Financial Officer)