

bebe stores, inc.  
Form 10-K  
September 14, 2007

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 10-K

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

For the Fiscal Year Ended July 7, 2007

OR

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

Commission File Number 0-24395

## bebe stores, inc.

(Exact name of registrant as specified in its charter)

**California**  
(State or Jurisdiction of  
Incorporation or Organization)

**94-2450490**  
(IRS Employer  
Identification Number)

400 Valley Drive

Brisbane, California 94005

(Address of principal executive offices, including zip code)

Telephone: (415) 715-3900

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$0.001 per share

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act).  Large accelerated filer  Accelerated filer  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  No

The aggregate market value of voting stock held by non-affiliates of the registrant was approximately \$520,000,000 as of December 31, 2006, the last business day of the registrant's most recently completed second fiscal quarter, based upon the closing sale price per share of \$19.79 of the registrant's Common Stock as reported on the Nasdaq National Market on such date. Shares of Common Stock held by each executive officer and director and by each person who owns 10% or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily conclusive for other purposes.

As of August 31, 2007, 93,551,551 shares of Common Stock, \$0.001 per share par value, of the registrant were outstanding.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Part III incorporates information by reference from the definitive Proxy Statement for the 2007 Annual Meeting of Shareholders, to be filed with the Commission no later than 120 days after the end of the registrant's fiscal year covered by this Form 10-K.

The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from the results discussed in the forward-looking statements. Statements that are predictive in nature, that depend upon or refer to future events or conditions or that include words such as expects, anticipates, intends, plans, believes, estimates, thinks and similar expressions are forward-looking statements. Forward looking statements include statements about our expected results of operations, capital expenditures and store openings and closings. Although we believe that these statements are based on reasonable assumptions, we cannot assure you that our goals will be achieved. These forward-looking statements are made as of the date of this Form 10-K, and we assume no obligation to update or revise them or provide reasons why actual results may differ. Factors that might cause such a difference include, but are not limited to, our ability to respond to changing fashion trends, miscalculation of the demand for our products, disruption in supply, difficulties in manufacturing, effective management of our growth, the success of future store openings, decline in comparable store sales performance, competitive pressures in the apparel industry, changes in the level of consumer spending or preferences in apparel, our ability to attract and retain key management personnel, adverse economic conditions, and/or other factors discussed in Risk Factors and elsewhere in this Form 10-K.

## **PART I**

### **ITEM 1. BUSINESS**

#### **General**

We design, develop and produce a distinctive line of contemporary women's apparel and accessories. While we attract a broad audience, our target customer is a 21 to 35-year-old woman who seeks current fashion trends to suit her lifestyle. The bebe look appeals to a hip, sexy, sophisticated, body-conscious woman who takes pride in her appearance. The bebe customer expects value in the form of current fashion and high quality at a competitive price.

Our distinctive product offering includes a full range of separates, tops, dresses, active wear and accessories in the following lifestyle categories: career, evening, casual and active. We design and develop the majority of our merchandise in-house, which is manufactured to our specifications or is sourced directly from third party manufacturers.

As of July 7, 2007, we marketed our products under the bebe, COLLECTION bebe, BEBE SPORT, bbsp and bebe O brand names through our 273 retail stores, our on-line store at [www.bebe.com](http://www.bebe.com), and our 14 international licensee operated stores.

*bebe.* We were founded by Manny Mashouf, Chairman of the Board. We opened our first store in San Francisco, California in 1976, which was also the year we incorporated in California. As of July 7, 2007, we operated 198 bebe stores in 34 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Canada.

*BEBE SPORT.* We launched BEBE SPORT during fiscal 2003 to address the performance and active lifestyle needs of the bebe customer and offers a selection of sportswear and footwear under the BEBE SPORT and bbsp brand names. As of July 7, 2007, we operated 54 BEBE SPORT stores in 16 states, Puerto Rico and Canada.

*bebe outlets.* The Company utilizes the outlets as a clearance vehicle for merchandise from retail stores. In addition, the inventory includes a strong presentation of bebe logo merchandise and special cuts produced under the bebe O label exclusively for the outlet stores. As of July 7, 2007, the Company operated 20 bebe outlet stores in 11 states and Canada.

*On-line.* [bebe.com](http://bebe.com) is an extension of the bebe store experience and provides a complete assortment of bebe and BEBE SPORT merchandise. We also use it as a vehicle to communicate with our clients.

*bebe accessories.* In September 2006, we opened a new accessory concept featuring shoes and a unique selection of fine leather goods, bebe logo merchandise, outerwear and gift items. This boutique concept features shoes imported from Italy, Brazil and China.

### **Operating Strategy**

Our objective is to satisfy the fashion needs of the modern, sexy and sophisticated woman. The principal elements of our operating strategy to achieve this objective are as follows:

- 1. Provide distinctive fashion throughout a broad product line.** Our designers and merchandisers are inspired by global fashion trends. They interpret contemporary designs, colors and fabrications into our products to address the lifestyle needs of our customer. Our in-house design team allows us to quickly react to fashion trends, bringing newness into the merchandise mix to complement our core assortment.
- 2. Vertically integrate design, production, merchandising and retail functions.** Our vertical integration enables us to respond quickly to changing fashion trends, reduce risk of excess inventory and produce distinctive quality merchandise.
- 3. Manage merchandise mix.** Our approach to merchandising and proactive inventory management is critical to our success. By actively monitoring sell-through rates and the mix of categories and products in our stores, we are able to respond to emerging trends in a timely manner, better maximizing sales opportunities and minimizing liabilities.
- 4. Control distribution of merchandise.** We distribute our merchandise, other than licensed eyewear and international licensing, through Company owned retail stores and an on-line store. This distribution strategy enables us to control pricing, flow of goods, visual presentation and customer experience. We seek to ensure brand equity through this exclusive distribution.
- 5. Enhance brand image.** We attract customers through edgy, high-impact, visual advertising campaigns using print, outdoor, in-store, electronic and direct mail and e-mail communication vehicles. We also offer a line of merchandise branded with the distinctive bebe logo to increase brand awareness.

### **Stores and Expansion Opportunities**

We believe that there is opportunity to expand the number of bebe, BEBE SPORT and bebe outlet stores in new and existing markets. In selecting a specific site, we look for high traffic locations primarily in regional shopping centers and in freestanding street locations. We evaluate proposed sites based on the traffic pattern, co-tenancies, average sales per square foot achieved by neighboring stores, lease economics, demographic characteristics and other factors considered important regarding the specific location. For fiscal 2008, we plan to grow our operations primarily through the opening of new stores and expansion of existing stores with high sales per square foot.

Our stores typically have achieved profitability within the first full year of operation; however, we cannot guarantee that our stores will do so in the future. Actual store growth and future store profitability and rates of return will depend on a number of factors that include, but are not limited to, individual store economics and suitability of available sites.

In fiscal 2008, we plan to open 40 new stores, relocate or expand 6 existing stores and renovate 2 existing stores. We also plan to close up to 4 stores, resulting in net square footage growth of approximately 14%.

*bebe stores.* During fiscal 2007, we opened 20 bebe stores, closed 5 stores and expanded or relocated 9 existing bebe stores to larger spaces. Our bebe stores average 3,900 square feet and are primarily located in regional shopping malls and freestanding street locations. In fiscal 2008, we plan to open 25 to 27 bebe stores with an average square footage of approximately 3,900.



From time to time, we will open larger stores, such as our 7,600 square foot bebe flagship store on Rodeo Drive in Beverly Hills, California to further position bebe as an attainable luxury brand. In fiscal 2008, we plan to open two new stores similar to our location on Rodeo Drive, one on Oak Street in Chicago and the other in the Royal Hawaiian shopping mall in Honolulu. In addition, we intend to expand our bebe store in Newport Beach, California by approximately 2,000 square feet to a total square footage of approximately 7,200.

*BEBE SPORT stores.* During fiscal 2007, we opened 15 new BEBE SPORT stores. Our BEBE SPORT stores average approximately 2,400 square feet and are primarily located in regional shopping malls. *BEBE SPORT offers a selection of sportswear and footwear under the BEBE SPORT and bbsp brand names.* We have been conservative in our growth plans while we continue to update the BEBE SPORT concept. In fiscal 2008, we plan to open 8 to 10 BEBE SPORT stores with an average square footage of approximately 2,600.

*bebe outlet stores.* During fiscal 2007, we did not open any new bebe outlet stores but expanded one store. Our bebe outlet stores average 4,200 square feet and are primarily located in outlet malls. In the last quarter of 2008, we plan to open 3 to 5 new or expanded outlet stores under the new name 2b bebe and will continue to offer a selection of bebe logo product, bebe sale consolidations and an expanded assortment of product made exclusively for our Outlet stores under the new name 2b bebe.

*bebe accessories.* We opened our first bebe accessories store in the first quarter of fiscal 2007. This location is approximately 2,300 square feet. We currently do not plan to open any accessories stores in fiscal 2008.

*Store Closures.* We monitor the financial performance of our stores and have closed and will continue to close stores that we do not consider to be viable. Many of the store leases contain early termination options that allow us to close the stores in specified years if minimum sales levels are not achieved. During fiscal year 2007, we closed 5 stores. In fiscal 2008, we plan to close up to 4 stores.

*On-line store.* In February 2006, we migrated to a third-party platform which has and continues to provide improved functionality. We recently implemented several enhancements that have improved the marketing and promotional engines to drive client acquisition and conversion. The bebe.com website is a source of testing new concepts, building a community with our clients as well as providing a comprehensive product offer. We also plan to expand our ship to capabilities to include Canadian customers in fiscal 2008.

*International.* As of July 7, 2007, we had 14 international stores operated by licensees in South East Asia, United Arab Emirates, and Israel. Our international licensees purchase product from us to include in their licensed bebe stores, the stores are excluded from comparable store sales. As of July 7, 2007, wholesale revenue represented approximately one percent of total sales. In fiscal 2008, we plan to expand from 14 to 22 licensee operated stores. We expect this to include expansions in Israel, Mexico, the United Arab Emirates, Indonesia and Malaysia and strengthening our position in the Singapore and Thailand locations.

## **Merchandising**

Our merchandising strategy is to provide current, timely fashions in a broad selection of categories to suit the lifestyle needs of our customers. We market all of our merchandise under the bebe, COLLECTION bebe, BEBE SPORT, bbsp and bebe O brand names. In some cases, we select merchandise directly from third-party manufacturers. We do not have long-term contracts with any third party-manufacturers, and we purchase all of the merchandise from manufacturers by purchase order.

*Product Categories.* Our distinctive product offering includes a full range of fashion separates, tops, dresses, active wear and accessories in the following lifestyle categories: career, evening, casual and active. While each category's contribution as a percentage of total net sales varies seasonally, certain of the



product classifications are represented throughout the year. We regularly evaluate existing categories for potential expansion opportunities. We will also introduce watches, sunglasses and an expanded shoe and handbag assortment. We signed an agreement in August 2007 with Sketchers Footwear to produce our entire BEBE SPORT and bbsp footwear products and distribute to our BEBE SPORT stores as well as other stores worldwide. We anticipate that we will begin seeing product in our stores beginning the fourth quarter of fiscal 2008. Also, in the last quarter of fiscal 2008, we plan to launch a new assortment of product for our outlet division under the new name 2b bebe.

In August 2007, we signed an amendment to our licensed rights for optical eyewear which represented less than 1% of our business in fiscal 2007. The amendment extends the eyewear license to June 30, 2010. Under the terms of this agreement, the licensee manufactures and distributes products branded with the bebe logo to be sold at bebe stores and selected retailers. In fiscal 2007, we signed a new agreement with Safilo eyewear to develop, market and sell sunglasses in our bebe stores and Solstice owned stores. The first assortment will be featured in our bebe stores in November 2007.

*Product Development.* Our product development process enables our merchants to make informed and timely decisions prior to making fabric or merchandise purchase commitments. Our speed to market strategy allows us to quickly react to emerging fashion trends and customer demand. An established timeline ensures an adequate flow of inventory into the stores. We make monthly commitments based on current sales and fashion trends. A detailed merchandising classification plan supports the product development process and includes sales, inventory and profitability targets. We regularly adjust the plan to meet inventory and sales targets.

## **Marketing**

We have developed our advertising and direct marketing initiatives to elevate brand awareness, increase customer acquisition and retention and support key growth strategies.

During fiscal 2007, our marketing expenditures, as a percentage of net sales, were consistent with fiscal 2006. This supported the growth of our direct to consumer business, including national and regional print advertising and outdoor advertising, catalog circulation and the clubbebe loyalty program. In fiscal 2008, we currently anticipate that advertising expenditures as a percent of net sales will be similar to fiscal 2007.

### *Direct to Consumer*

In fiscal 2007, we increased the number of bebe catalogs mailed from fiscal 2006 and produced an additional bebe holiday catalog. In fiscal 2008, we are increasing our catalog circulation and maintaining the number of catalogs produced.

Clubbebe, our customer loyalty program, was launched in fiscal 2006 and as of July 7, 2007, had over 1.8 million members. Our improved client database, which has increased approximately 75% over the same time last year, has significantly contributed to increased direct mail performance.

### *Advertising*

We continue to build brand awareness through targeted advertising campaigns that maintain a focus on core customers while adding new image building media strategies to further elevate the brand to attainable luxury status.

An outside advertising agency works to create edgy, high-impact, provocative ads which are produced quarterly and are featured in leading fashion and lifestyle magazines. The images are also used for outdoor advertising, catalog, in-store visual presentation and on our website, bebe.com. To further our brand exposure, we signed actresses Rebecca Romijn as the face of bebe from Spring 2007 through Spring 2008



and Eva Longoria as the face of BEBE SPORT from Spring 2007 through Spring 2009. In the future, we plan to continue to pursue partnerships with models and celebrities who best represent the bebe brand image.

#### *Events*

Our semi annual collection preview events, where clients are invited to preview the latest collections, have become strategically important events in our stores. Additionally, we schedule major events throughout the year in partnership with national and regional magazines to benefit non-profit organizations.

#### **Store Operations**

As of September 2007, store operations was organized into six regions and 42 districts. Each region is managed by a zone or regional director, and each district is managed by a district manager. Each zone director is responsible for typically two regions, each regional director is typically responsible for five to eight districts, and each district manager is typically responsible for four to twelve stores. Each store is typically staffed with three to five managers in addition to sales associates.

We seek to instill enthusiasm and dedication in our store management personnel and our sales associates through incentive programs and regular communication with the stores. Sales associates, excluding associates in outlet stores, receive commissions on sales with a guaranteed minimum hourly compensation. Store managers receive base compensation plus incentive compensation based on sales and inventory control. Our district managers receive base compensation plus incentive compensation based on meeting sales and profitability benchmarks. Our regional managers and zone director participate in our management incentive program.

#### **Sourcing, Quality Control and Distribution**

All of our merchandise is marketed under the bebe, COLLECTION bebe, BEBE SPORT, bbsp and bebe O brand names. We design and develop the majority of our merchandise in-house, which is manufactured to our specifications or is sourced directly from third-party manufacturers. When we contract for merchandise production, the contractors produce garments based on designs, patterns and detailed specifications provided by us.

We use computer aided design systems to develop patterns and production markers as part of our product development process. We fit test sample garments before production to make sure patterns are accurate. We adhere to a strict formalized quality control program. Garments that do not pass inspection are returned to the manufacturer for rework or accepted at reduced prices for sale in our outlet stores.

The majority of our merchandise is received, inspected, processed, warehoused and distributed through our distribution center. Details about each receipt are supplied to merchandise planners who determine how the product should be distributed among the stores based on current inventory levels, sales trends and specific product characteristics. Advance shipping notices are electronically communicated to the stores and any goods not shipped are stored for replenishment purposes. Merchandise typically is shipped to the stores three times per week using common carriers.

#### **Competition**

The retail and apparel industries are highly competitive and are characterized by low barriers to entry. We expect competition in our markets to increase. The primary competitive factors in our markets are: brand name recognition, product styling, product quality, product presentation, product pricing, store ambiance, customer service and convenience.

### **Intellectual Property and Proprietary Rights**

The Company has registrations, or applications have been filed and are pending, with the United States Patent and Trademark Office ( USPTO ) and/or with certain foreign registries in many of our core classifications (including clothing, jewelry, eyewear and bags) for the following marks: bebe, COLLECTION bebe, BEBE SPORT, bbsp, 2b bebe and bebe O.

### **Information Services and Technology**

We are committed to utilizing technology to enhance our competitive position. Our information systems provide data for stores, production, merchandising, distribution and financial systems. The core business systems, which consist of both purchased and internally developed software, are accessed over a company-wide network providing corporate employees with access to key business applications.

Our investments in information systems have focused on our production, merchandise, store and financial accounting systems.

To support our growth we initiated a three year IS&T strategic plan, and we are currently entering year three of this plan. In year one, we completed the upgrade of our infrastructure, began the implementation of our new production management system, implemented Arthur planning, completed the conversion of our web site to a third-party platform and completed the roll out of clubbebe. In fiscal 2007, we went live with the first and second phases of our production management system which have led to increased efficiency and the reduction of paper. In year three, we plan to add Product Life Cycle Management (PLM) to our supply chain management and fully integrate with the production system as a phase three of our overall production management system. In other areas of the Company for fiscal 2007, we began the process of identifying partners to replace our current point of sale system and implement a new human resources system. We completed the selection of our point of sale software and new human resources systems partners. In addition, we completed the first phase of installing the new human resources system. After both of these systems have been successfully implemented or are well underway in the implementation process, we will begin to evaluate our merchandising system needs.

### **Employees**

As of July 7, 2007, we had 4,297 employees, of whom 416 were employed at the corporate offices, Los Angeles studio and distribution center. The remaining 3,881 employees were employed in store operations. There were 1,516 full-time employees and 2,781 employed on a part-time basis. This is an increase of approximately 8% as compared to prior fiscal year. In addition, our employees are not represented by any labor union, and the Company believes our relationship with our employees is good.

### **Available Information**

We make available on our website, [www.bebe.com](http://www.bebe.com), under Investor Relations, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after we electronically file or furnish such materials to the U.S. Securities and Exchange Commission ( SEC ).

Our Code of Business Conduct and Ethics, Policy for Reporting Violations and Complaints, Corporate Governance Principles and Practices for the Board of Directors, and Board of Directors Committee Charters are also available on our website, under Corporate Governance.

**EXECUTIVE OFFICERS AND DIRECTORS OF THE REGISTRANT****Executive Officers and Directors**

The following table sets forth certain information with respect to the executive officers and directors as of September 1, 2007:

| <b>Name</b>             | <b>Age</b> | <b>Position</b>                                     |
|-------------------------|------------|---|
| Manny Mashouf(1)        | 69         | Chairman of the Board                               |
| Barbara Bass(2)(3)*(4)  | 56         | Director  |
| Cynthia Cohen(2)(3)(4)* | 54         | Director  |
| Corrado Federico(4)(3)  | 66         | Director  |
| Caden Wang(2)*(4)       | 55         | Director  |
| Gregory Scott(1)        | 44         | Director and Chief Executive Officer                |
| Walter Parks(1)         | 48         | Chief Operating Officer and Chief Financial Officer |
| Barbara Wambach(1)      | 47         | Chief Administrative Officer                        |
| Susan Powers(1)         | 49         | Senior Vice President of Stores                     |
| Lawrence Smith(1)       | 41         | Vice President, General Counsel                     |
| Erin Stern(1)           | 37         | President BEBE SPORT                                |

(1) Executive Officer.

(2) Member, Audit Committee.

(3) Member, Compensation and Management Development Committee.

(4) Member, Nominating and Corporate Governance Committee.

(\*) Chairman of the Committee

*Manny Mashouf* founded bebe stores, inc. and has served as Chairman of the Board since our incorporation in 1976. Mr. Mashouf served as our Chief Executive Officer from 1976 to February 2004. Mr. Mashouf is the father of Paul Mashouf, Vice President of Manufacturing and Sourcing BEBE SPORT, and uncle of Hamid Mashouf, Vice President of Information Systems and Technology.

*Barbara Bass* has served as a director since February 1997. Since 1993, Ms. Bass has served as the President of the Gerson Bakar Foundation. From 1989 to 1992, Ms. Bass served as President and Chief Executive Officer of the Emporium Weinstock Division of Carter Hawley Hale Stores, Inc., a department store chain. Ms. Bass also serves on the Board of Directors of Starbucks Corporation and DFS Group Limited.

*Cynthia R. Cohen* has served as a director since December 2003. Ms. Cohen is founder and President of Strategic Mindshare, a strategic management consulting firm. She also serves on the Board of Directors of Hot Topic, Steiner Leisure Ltd and Equity One, Inc., as well as several privately held companies. Prior to founding Strategic Mindshare in 1990, she was a Partner in Management Consulting with Deloitte & Touche. Ms. Cohen serves on the Executive Advisory Board for the Center for Retailing Education and Research at the University of Florida and is Chairman of the Strategic Mindshare Foundation, a philanthropic organization.

*Corrado Federico* has served as a director since November 1996. Mr. Federico is President of Solaris Properties and has served as the President of Corado, Inc., a land development firm, since 1991. He is also an active retail consultant. From 1986 to 1991, Mr. Federico held the position of President and Chief Executive Officer of Esprit de Corp, Inc., a wholesaler and retailer of junior and children's apparel, footwear and accessories ( Esprit ). Mr. Federico also serves on the Board of Directors of Hot Topic, Inc.

*Caden Wang* has served as a director since October 2003. From 1999 to 2001, Mr. Wang served as Executive Vice President and Chief Financial Officer of LVMH Selective Retailing Group, which included international retail holdings such as DFS, Sephora and Miami Cruiseline Services. Mr. Wang has also served as the Chief Financial Officer for DFS, Gumps and Cost Plus. Mr. Wang is a Certified Public Accountant. Mr. Wang also serves on the Board of Directors of Leapfrog Enterprises, Inc.

*Gregory Scott* has served as the Chief Executive Officer since February 2004 and as director since August 2004. From 2000 to 2004, Mr. Scott was the President of the Arden B. division of The Wet Seal, Inc. From February 2000 to April 2000, Mr. Scott was President of Laundry, a division of Liz Claiborne. From 1996 to 2000, Mr. Scott was Vice President of Merchandising with bebe stores, inc.

*Walter Parks* has served as Chief Operating Officer since September 2006 and Chief Financial Officer since December 2003. From 2001 to 2003, Mr. Parks served as Executive Vice President and Chief Administrative Officer of Wet Seal, Inc. From 1999 to 2001, Mr. Parks served as the Executive Vice President and Chief Administrative Officer of Restoration Hardware, Inc. From 1997 to 1999, Mr. Parks served as Chief Financial Officer and Treasurer for Ann Taylor Stores Corporation, and in various other positions since joining that company in 1988.

*Barbara Wambach* has served as Chief Administrative Officer since August 2004. From February to August 2004, Ms. Wambach served as President and Chief Operating Officer of BEBE SPORT. From 2002 to 2004, Ms. Wambach served as Executive Vice President of Gap Body, a division of Gap, Inc. From 1999 to 2002, Ms. Wambach served as the Chief Executive Officer and President of eLUXURY.

*Susan Powers* has served as Senior Vice President of Stores since April 2007. From 2005 to 2007, Ms. Powers served as Vice President of Store Operations for Chico's FAS, Inc. From 2002 to 2005, Ms. Powers served as Vice President of Stores for The Wet Seal, Inc. From 1999 to 2002, Ms. Powers served as Vice President of Stores for BCBG Max Azria.

*Lawrence Smith* has served as Vice President, General Counsel since October 2004. Prior to joining bebe stores, inc., Mr. Smith served as Vice President, General Counsel for The Wet Seal, Inc. from January 2002 to October 2004. From January 1996 to January 2002, Mr. Smith served as Vice President, General Counsel for BCBG Max Azria.

*Erin Stern* joined bebe in August 2007 and currently serves as President BEBE SPORT. Prior to joining bebe stores, inc., Ms. Stern was Vice President and General Merchandising Manager for GAP Inc. as the head of the Old Navy Outlet Division. Prior to that she was Old Navy's Vice President and General Merchandising Manager of Baby. Ms. Stern launched her career in the Macy's executive training program.

#### **ITEM 1A. RISK FACTORS**

Our past performance may not be a reliable indicator of future performance because actual future results and trends may differ materially depending on a variety of factors, including, but not limited to, the risks and uncertainties discussed below. In addition, historical trends should not be used to anticipate results or trends in future periods.



Factors that might cause our actual results to differ materially from the forward-looking statements discussed elsewhere in this report, as well as affect our ability to achieve our financial and other goals, include, but are not limited to, the following:

**RISKS RELATING TO OUR BUSINESS:**

**1. The success of our business depends in large part on our ability to identify fashion trends as well as to react to changing customer demand in a timely manner.** Consequently, we depend in part upon the customer response to the creative efforts of our merchandising, design and marketing teams and their ability to anticipate trends and fashions that will appeal to our consumer base. If we miscalculate our customers' product preferences or the demand for our products, we may be faced with excess inventory. Historically, this type of occurrence has resulted in excess fabric for some products and markdowns and/or write-offs, which has impaired our profitability, and may do so in the future. Similarly, any failure on our part to anticipate, identify and respond effectively to changing customer demands and fashion trends will adversely affect our sales.

**2. If we are unable to obtain raw materials or unable to find manufacturing facilities or our manufacturers perform unacceptably, our sales may be negatively affected and our financial condition may be harmed.** We do not own any manufacturing facilities and therefore depend on contractors and third parties to manufacture our products. We place all of our orders for production of merchandise and raw materials by purchase order and do not have any long-term contracts with any manufacturer or supplier. If we fail to maintain favorable relationships with our manufacturers and suppliers or are unable to obtain sufficient quantities of quality raw materials on commercially reasonable terms, it could harm our business and results of operations. We cannot assure you that contractors and third-party manufacturers (1) will not supply similar products to our competitors, (2) will not stop supplying products to us completely or (3) will supply products in a timely manner. Untimely receipt of products may result in lower than anticipated sales and markdowns which would have a negative impact on earnings. Furthermore, we have received in the past, and may receive in the future, shipments of products from manufacturers that fail to conform to our quality control standards. In such event, unless we are able to obtain replacement products in a timely manner, we may lose sales. Certain of our third-party manufacturers store our raw materials. In the event our inventory was damaged or destroyed and we were unable to obtain replacement raw materials, our earnings could be negatively impacted.

**3. Our success depends on our ability to attract and retain key employees in order to support our existing businesses and future expansion.** From time to time we actively recruit qualified candidates to fill key executive positions from within our company. There is substantial competition for experienced personnel, which we expect will continue. We compete for experienced personnel with companies who have greater financial resources than we do. In the past, we have experienced significant turnover of our executive management team and retail store personnel. We are also exposed to employment practice litigation due to the large number of employees and high turnover of our sales associates. If we fail to attract, motivate and retain qualified personnel, it could harm our business and limit our ability to expand.

In addition, we depend upon the expertise and execution of our key employees, particularly Manny Mashouf, the founder, Chairman of the Board and majority shareholder, and Gregory Scott, our Chief Executive Officer and member of the Board of Directors. If we lose the services of Mr. Mashouf, Mr. Scott, or any key officers or employees, it could harm our business and results of operations. On November 8, 2006, Neda Mashouf resigned from the Company and from our Board of Directors. We previously identified Neda Mashouf as a key employee. The loss of Ms. Mashouf could have an adverse effect on our operations and as a result, our business could suffer.

**4. If we are not able to successfully develop new concepts, including BEBE SPORT, our revenue base and earnings may be impaired.** From time to time, we may pursue new concepts. For example, we

opened our first boutique accessory concept store in the first quarter of fiscal 2007. If the BEBE SPORT or other new concepts are not successful, our financial condition may be harmed.

**5. We cannot assure that future store openings will be successful and new store openings may impact existing stores.** We expect to open approximately 40 stores in fiscal 2008, of which approximately 25 to 27 will be bebe stores, approximately 8 to 10 will be BEBE SPORT stores and 3 to 5 will be 2b bebe outlet stores. In the past, we have closed stores as a result of poor performance, and we cannot assure that the stores that we plan to open in fiscal 2008, or any other stores that we might open in the future, will be successful or that our overall operating profit will increase as a result of opening these stores. During fiscal 2007 we closed 5 stores and during fiscal 2008, we anticipate closing up to 4 stores. Most of our new store openings in fiscal 2008 will be in existing markets. These openings may affect the existing stores' net sales and profitability. Our failure to predict accurately the demographic or retail environment at any future store location could have a material adverse effect on our business, financial condition and results of operations.

Our ability to effectively obtain real estate to open new stores depends upon the availability of real estate that meets our criteria, including traffic, square footage, co-tenancies, average sales per square foot, lease economics, demographics, and other factors, and our ability to negotiate terms that meet our financial targets. In addition, we must be able to effectively renew our existing store leases. Failure to secure real estate locations adequate to meet annual targets as well as effectively managing the profitability of our existing fleet of stores could have a material adverse effect on our business, financial condition and results of operations.

**6. We are subject to risks associated with our online sales.** We operate an on-line store at [www.bebe.com](http://www.bebe.com) to sell our merchandise, which we migrated to a third-party platform in February 2006. Although our online sales encompass a relatively small percentage of our total sales, our on-line operations are subject to numerous risks, including unanticipated operating problems, reliance on third-party computer hardware and software providers, system failures and the need to invest in additional computer systems. The on-line operations also involve other risks that could have an impact on our results of operations including but not limited to diversion of sales from our other stores, rapid technological change, liability for online content, credit card fraud and risks related to the failure of the computer systems that operate the website and its related support systems. In addition, with the migration to a third-party, we no longer have direct control of certain aspects of our on-line business. We cannot assure that our on-line store will continue to achieve sales and profitability growth or even remain at its current level.

**7. Any serious disruption at our major facilities could have a harmful effect on our business.** We currently operate a corporate office in Brisbane, California, a distribution facility in Benicia, California, and a design studio and production facility in Los Angeles, California. Any serious disruption at these facilities whether due to construction, relocation, fire, earthquake, terrorist acts or otherwise would harm our operations and could have a harmful effect on our business and results of operations. Furthermore, we have little experience operating essential functions away from our main corporate offices and are uncertain what effect operating such satellite facilities might have on business, personnel and results of operations.

**8. We rely on information technology, the disruption of which could adversely impact our business.** We rely on various information systems to manage our operations and regularly make investments to upgrade, enhance or replace such systems. To support our growth we initiated a three year IS&T strategic plan and we are currently entering year three of this plan. If we fail to successfully implement the plan, our business could be adversely affected.

**9. We face significant competition in the retail and apparel industry, which could harm our sales and profitability.** The retail and apparel industries are highly competitive and are characterized by low barriers to entry. We expect competition in our markets to increase. The primary competitive factors in our





markets are: brand name recognition, sourcing, product styling, quality, presentation and pricing, timeliness of product development and delivery, store ambiance, customer service and convenience.

We compete with traditional department stores, specialty store retailers, business to consumer websites, off-price retailers and direct marketers for, among other things, raw materials, market share, retail space, finished goods, sourcing and personnel. Because many of these competitors are larger and have substantially greater financial, distribution and marketing resources than we do, we may lack the resources to adequately compete with them. If we fail to remain competitive in any way, it could harm our business, financial condition and results of operations.

**10. Purchases of the merchandise we sell are generally discretionary and are therefore particularly susceptible to economic conditions.** The outlook for the United States economy is uncertain and is directly affected by global factors that are beyond our control. Such factors include disposable consumer income, oil prices, recession and fears of recession, war and fears of war, terrorist attacks, inclement weather, consumer debt, interest rates, sales tax rates, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. Consumers are generally more willing to make discretionary purchases, including purchases of fashion products, during periods in which favorable economic conditions prevail. If economic conditions change, our business, financial condition and results of operations could be adversely affected. We cannot predict the indirect effects such as rising oil and freight prices, consumer spending or other economic factors that natural disasters will have on our results of operations.

**11. Our business could be adversely impacted by unfavorable international political conditions.** Due to our international operations, our sales and operating results are, and will continue to be, affected by international social, political, legal and economic conditions. In particular, our business could be adversely impacted by instability or changes resulting in the disruption of trade with the countries in which our contractors, suppliers or customers are located, significant fluctuations in the value of the dollar against foreign currencies or restrictions on the transfer of funds, or additional trade restrictions imposed by the United States and other foreign governments. Trade restrictions, including increased tariffs or quotas, embargoes and customs restrictions could increase the cost or reduce the supply of merchandise available to us and adversely affect our financial condition and results of operations.

**12. If we are not able to successfully protect our intellectual property our ability to capitalize on the value of our brand name may be impaired.** Even though we take actions to establish, register and protect our trademarks and other proprietary rights, we cannot assure you that we will be successful or that others will not imitate our products or infringe upon our intellectual property rights. In addition, we cannot assure that others will not resist or seek to block the sale of our products as infringements of their trademark and proprietary rights.

Obstacles may exist that may prevent us from obtaining a trademark for the bebe name or related names. We may not be able to register certain trademarks, purchase the right or obtain a license to use the bebe name or related names on commercially reasonable terms. If we fail to obtain trademark, ownership or license the requisite rights, it would limit our ability to expand. In some jurisdictions, despite successful registration of our trademarks, third parties may allege infringement and bring actions against us. In addition, if our licensees fail to use our intellectual property correctly, the reputation and value associated with our trademarks may be diluted.

Furthermore, if we do not demonstrate use of our trademarks, our trademark rights may lapse over time.

**13. If an independent manufacturer violates labor or other laws, or is accused of violating any such laws, or if their labor practices diverge from those generally accepted as ethical, it could harm our business and brand image.** While we maintain a policy to monitor the operations of our independent

manufacturers by having an independent firm inspect these manufacturing sites, and all manufacturers are contractually required to comply with such labor practices, we cannot control the actions or the public's perceptions of such manufacturers, nor can we assure that these manufacturers will conduct their businesses using ethical or legal labor practices. Apparel companies can be held jointly liable for the wrongdoings of the manufacturers of their products. While we do not control their employees' employment conditions or the manufacturers' business practices, and the manufacturers act in their own interest, they may act in a manner that results in negative public perceptions of us and/or employee allegations or court determinations that we are jointly liable.

#### **RISKS RELATING TO OUR COMMON STOCK:**

**1. Our stock price may fluctuate because of the small number of shares that can be publicly traded and the low average daily trading volumes.** The vast majority of our outstanding shares of our common stock are subject to trading restrictions. As of July 7, 2007, of the approximately 93,000,000 shares of our common stock then outstanding, approximately 27,000,000 shares of our common stock were available to be publicly traded, and as a result, our average daily trading volumes are relatively low, and our stock price is vulnerable to market swings due to large purchases, sales and short sales of our common stock.

**2. Because Manny Mashouf beneficially owns a substantial portion of the outstanding shares, other shareholders may not be able to influence the direction the company takes.** As of September 4, 2007, Manny Mashouf, the Chairman of the Board, beneficially owned approximately 53% of the outstanding shares of our common stock. As a result, he can control the election of directors and the outcome of all issues submitted to the shareholders. This may make it more difficult for a third party to acquire shares, may discourage acquisition bids, and could limit the price that certain investors might be willing to pay for shares of common stock. This concentration of stock ownership may have the effect of delaying, deferring or preventing a change in control of our company.

**3. Our significant shareholders hold a substantial portion of our stock which may result in trading volatility or may adversely affect our common stock.** Ms. Neda Mashouf currently owns 18% of the outstanding shares of our common stock. As a result, any change in the ownership of a significant portion of these shares, including sales by Ms. Mashouf, may result in trading volatility in our common stock or may adversely affect our stock price.

**4. Our sales, margins and operating results are subject to seasonal and quarterly fluctuations.** Our business varies with general seasonal trends that are characteristic of the retail and apparel industries, such as the timing of seasonal wholesale shipments and other events affecting retail sales. As a result, our stores typically generate a higher percentage of our annual net sales and profitability in the second quarter of our fiscal year (which includes the holiday selling season) compared to other quarters.

In addition, our comparable store sales have fluctuated significantly in the past, and we expect that they will continue to fluctuate in the future. A variety of factors affect comparable store sales, including fashion trends, competition, current economic conditions, the timing of release of new merchandise and promotional events, changes in our merchandise mix, the success of marketing programs and weather conditions. Our ability to deliver strong comparable store sales results and margins depends in large part on accurately forecasting demand and fashion trends, selecting effective marketing techniques, providing an appropriate mix of merchandise for our customer base, managing inventory effectively, and optimizing store performance by closing under performing stores.

Such fluctuations may adversely affect the market price of our common stock.

**5. Failure to comply with Section 404 of the Sarbanes-Oxley Act of 2002 could negatively impact investor confidence.** In order to meet the requirements of the Sarbanes-Oxley Act of 2002 in future periods, we must continuously document, test, monitor and enhance our internal control over financial

reporting. We cannot assure that the periodic evaluation of our internal controls required by Section 404 of the Sarbanes-Oxley Act will not result in the identification of significant control deficiencies and/or material weaknesses or that our auditors will be able to attest to the effectiveness of our internal control over financial reporting. Failure to maintain the effectiveness of our internal control over financial reporting or to comply with the requirements of this Act could have a material adverse effect on our reputation, financial condition and market price of our common stock.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

**None.**

**ITEM 2. PROPERTIES**

As of July 7, 2007, our 273 stores, all of which are leased, encompassed approximately 992,000 total square feet. The typical store lease is for a 10-year term and requires us to pay a base rent and a percentage rent if certain minimum sales levels are achieved. Many of the leases provide a lease termination option in certain specified years of the lease if certain minimum sales levels are not achieved. In addition, leases for locations typically require us to pay property taxes, utilities, repairs and common area maintenance fees.

Our main corporate headquarters are currently located in a facility in Brisbane, California. The Brisbane facility is approximately 35,000 square feet and houses administrative offices, planning operations and store support services. The lease expires in April 2014. We also lease a 144,000 square foot distribution center in Benicia, California. The lease expires in April 2013. In fiscal 2004, we acquired a 50,000 square foot design studio and production facility in Los Angeles, California that houses our design, merchandising and production activities.

**ITEM 3. LEGAL PROCEEDINGS**

As of the date of this filing, we are involved in ongoing legal proceedings as described below.

A former employee sued bebe in a complaint filed on April 28, 2005 in the United States District Court for the Northern District of California (case No. C050177) alleging violations under the Fair Labor Standards Act, specifically that we obligated her to buy and wear its brand clothing as a uniform, without reimbursement or credit, and the net effect of deducting the value of such required purchases from her wages would often result in her not being paid minimum wages. The plaintiff purports to bring the action also on behalf of a class of hourly, non-managerial employees who are similarly situated. The lawsuit seeks compensatory, statutory and injunctive relief. We have negotiated a confidential settlement in this case which remains subject to court approval. One objection to the settlement has been filed by the plaintiff in the lawsuit described in the next paragraph of this section. We have accrued an amount that we believe reasonably estimates the potential liability, which did not have a material impact on our financial position or results of operations.

A former employee sued us in a complaint filed July 27, 2006 in the Superior Court of California, San Mateo County (case No. CIV 456550) alleging a failure to pay all wages, failure to pay overtime wages, failure to pay minimum wages, failure to provide meal periods, violation of Labor Code §450, violation of Labor Code §2802 and California Code of Regulations §11040(9)(A), statutory wage violations (late payment of wages), unlawful business practices under Business and Professions Code §16720 and §17200, conversion of wages and violation of Civil Code §52.1. The plaintiff purports to bring the action also on behalf of current and former California bebe employees who are similarly situated. The lawsuit seeks compensatory, statutory, punitive, restitution and injunctive relief. Due to certain similarities in claims between this action and the one previously mentioned (Case No. C050177), the parties and the Court have postponed active litigation and discovery until such time as the previously mentioned case resolves

the claims in common. Notwithstanding, the Court in this case has set a hearing in June, 2008 regarding whether class certification would be appropriate if, and to the extent, any claim(s) in this case remain(s) active at that time.

A customer sued us in a complaint filed December 14, 2006 in the Superior Court of Contra Costa County (case no. C06-02630) alleging that we utilized a certain type of preprinted credit card form in a return transaction in violation of California Civil Code §1747.08. The plaintiff purports to bring the action also on behalf of other customers who are similarly situated. The lawsuit seeks compensatory, statutory, and injunctive relief. The parties have begun discovery and a case management conference is set for later this month.

Three customers filed separate complaints alleging that we violated The Fair Credit Reporting Act (the FCRA ). Two of such cases were filed January 10 and January 16, 2007 in the United States District Court for the Northern District of California (case nos. C07-0203 & C07-0255, respectively). In late April 2007, each of these two lawsuits were voluntarily dismissed, without prejudice, by their respective plaintiff. The third lawsuit, filed on February 9, 2007 in the Central District of California (case no. CV-07-0972) remains active. This latter lawsuit alleges that we violated the FCRA by printing on receipts more than the last five digits of the credit or debit card numbers and/or the expiration date. The plaintiff purports to bring the action also on behalf of other customers who are similarly situated and seeks statutory and punitive damages, attorney's fees and injunctive relief.

We are also involved in various other legal proceedings arising in the normal course of business. We do not expect any of these matters nor the matters listed above, individually or in the aggregate, to have a material adverse effect on our business, financial condition or results of operations.

We intend to defend ourselves vigorously against these claims. However, the results of any litigation are inherently uncertain. We cannot assure you that we will be able to successfully defend ourselves in these lawsuits. Where required, and/or otherwise appropriate, we have recorded an estimate of potential liabilities that we believe is reasonable. Any estimates are revised as further information becomes available.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of our shareholders during the fourth quarter of fiscal 2007.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

The common stock trades on the Nasdaq National Market under the symbol BEBE. The following table sets forth the high and low sales of our common stock for the two years ended July 7, 2007, as reported by Nasdaq:

|                    | <b>High</b> | <b>Low</b> |
|--------------------|-------------|------------|
| <b>Fiscal 2006</b> |             |            |
| First Quarter      | \$ 30.30    | \$ 15.47   |
| Second Quarter     | 17.79       | 13.53      |
| Third Quarter      | 20.47       | 13.02      |
| Fourth Quarter     | 20.08       | 14.13      |
| <b>Fiscal 2007</b> |             |            |
| First Quarter      | \$ 25.44    | \$ 14.34   |
| Second Quarter     | 26.86       | 19.25      |
| Third Quarter      | 19.98       | 16.63      |
| Fourth Quarter     | 18.53       | 15.99      |

In November 2004 and April 2005, respectively, the Company declared 3-for-2 stock splits which became effective in, December 2004 and June 2005, respectively. All share and per share amounts included in this report have been adjusted for these stock splits.

As of August 31, 2007, the number of holders of record of our common stock was 75 and the number of beneficial holders of our common stock was approximately 22,000.

Declaration and payment of dividends is within the sole discretion of our Board of Directors, subject to limitations imposed by California law and compliance with our credit agreements, and will depend on our earnings, capital requirements, financial condition and such other factors as the Board of Directors deems relevant.

During fiscal 2007, we declared four quarterly dividends of \$0.05 each per common share.

**Stock Performance Graph**

The graph below compares the percentage changes in our cumulative total shareholder return on our common stock for the five-year period ended July 7, 2007, with (i) the cumulative total return of the S & P 500 Index ( S & P 500 ), the S & P Apparel, Accessories & Luxury Goods Index. The total shareholder return for our common stock assumes quarterly reinvestment of dividends.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***

Among bebe stores, inc., The S&P 500 Index  
And The S&P Apparel, Accessories & Luxury Goods Index

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\* \$100 invested on 6/30/02 in stock or index-including reinvestment of dividends. Fiscal year ending June 30.

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[www.researchdatagroup.com/S&P.htm](http://www.researchdatagroup.com/S&P.htm)

**ITEM 6. SELECTED FINANCIAL DATA****Selected Financial and Operating Data**

The following selected financial data is qualified by reference to, and should be read in conjunction with, our Consolidated Financial Statements and related Notes thereto and the other financial information appearing elsewhere in this report. These historical results are not necessarily indicative of results to be expected in the future. In November 2004 and April 2005, we declared 3-for-2 stock splits which became effective in December 2004 and June 2005, respectively. All share and per share amounts included herein have been adjusted for these stock splits.

|   | <b>Fiscal Year Ended</b>                             |                         |                         |                          |                          |
|---|--|-------------------------|-------------------------|--------------------------|--------------------------|
|   | <b>July 7,<br/>2007</b>                              | <b>July 1,<br/>2006</b> | <b>July 2,<br/>2005</b> | <b>June 30,<br/>2004</b> | <b>June 30,<br/>2003</b> |
|   | <b>(Dollars in thousands, except per share data)</b> |                         |                         |                          |                          |
| <b>Operating Results:</b>                         |  |                         |                         |                          |                          |
| Net sales   | \$ 670,912   | \$ 579,073              | \$ 509,527              | \$ 372,257               | \$ 323,549               |
| Cost of sales, including production and occupancy | 349,095  | 292,592                 | 256,560                 | 197,269                  | 179,058                  |
| Gross margin                                      | 321,817  | 286,481                 | 252,967                 | 174,988                  | 144,491                  |
| Selling, general and administrative expenses      | 216,560  | 181,986                 | 151,087                 | 122,278                  | 115,851                  |
| Income from operations                            | 105,257  | 104,495                 | 101,880                 | 52,710                   | 28,640                   |
| Interest and other income, net                    | 13,120   | 10,408                  | 5,013                   | 1,959                    | 2,199                    |
| Income before income taxes                        | 118,377  | 114,903                 | 106,893                 | 54,669                   | 30,839                   |
| Provision for income taxes                        | 41,099   | 41,096                  | 40,561                  | 20,899                   | 11,560                   |
| Net income  | \$ 77,278  | \$ 73,807               | \$ 66,332               | \$ 33,770                | \$ 19,279                |
| Basic income per share                            | \$ 0.83  | \$ 0.81                 | \$ 0.74                 | \$ 0.39                  | \$ 0.22                  |
| Diluted income per share                          | \$ 0.81  | \$ 0.79                 | \$ 0.71                 | \$ 0.38                  | \$ 0.22                  |
| Basic weighted average shares outstanding         | 92,810   | 91,373                  | 89,591                  | 87,334                   | 86,549                   |
| Diluted weighted average shares outstanding       | 94,973   | 93,795                  | 93,453                  | 89,395                   | 87,419                   |
| <b>Statistics:</b>                                |  |                         |                         |                          |                          |
| <b>Number of stores:</b>                          |  |                         |                         |                          |                          |
| Opened during period                              | 36   | 31                      | 21                      | 20                       | 20                       |
| Closed during the period                          | 5  | 3                       | 6                       | 1                        | 5                        |
| Open at end of period                             | 273  | 242                     | 214                     | 199                      | 180                      |
| Net sales per average store(1)                    | \$ 2,417   | \$ 2,437                | \$ 2,347                | \$ 1,900                 | \$ 1,770                 |
| Comparable store sales increase (decrease)(2)     | 2.9  | % 6.1                   | % 25.7                  | % 9.5                    | % (6.8)%                 |

|   | <b>As of<br/>July 7,<br/>2007</b> | <b>July 1,<br/>2006</b> | <b>July 2,<br/>2005</b> | <b>June 30,<br/>2004</b> | <b>June 30,<br/>2003</b> |
|---|-----------------------------------|-------------------------|-------------------------|--------------------------|--------------------------|
|   | <b>(Dollars in thousands)</b>     |                         |                         |                          |                          |
| <b>Balance Sheet Data:</b>                |                                   |                         |                         |                          |                          |
| Working capital                           | \$ 403,612                        | \$ 330,269              | \$ 275,717              | \$ 188,164               | \$ 149,840               |
| Total assets                              | 607,028                           | 500,909                 | 407,546                 | 296,736                  | 241,978                  |
| Long-term debt, including current portion | 260                               | 509                     | 393                     |                          |                          |
| Shareholders' equity                      | 504,590                           | 408,224                 | 333,243                 | 244,420                  | 201,345                  |

(1) Based on the sum of average monthly sales for the period.

(2) Comparable store sales are calculated by including the net sales of stores that have been open at least one year. Therefore, a store is included in the comparable store sales base beginning with its thirteenth month. Stores that have been expanded or remodeled by 15 percent or more or have been permanently relocated are excluded from the comparable store sales base. In addition, comparable store sales are calculated using a same day sales comparison. On-line and international licensee store sales are not included in the comparable store sales calculation.

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## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and related Notes thereto included elsewhere in this report. The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under "Risks Factors" under Item 1A of this report.

### Critical Accounting Policies

Management's Discussion and Analysis of Financial Condition and Results of Operations are based upon our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America.

The preparation of these financial statements requires the appropriate application of certain accounting policies, many of which require us to make estimates and assumptions about future events and their impact on amounts reported in our financial statements and related notes. Since future events and their impact cannot be determined with certainty, the actual results will inevitably differ from our estimates. Such differences could be material to the financial statements. We believe our application of accounting policies, and the estimates inherently required therein, are reasonable. These accounting policies and estimates are constantly reevaluated, and adjustments are made when facts and circumstances dictate a change. Our accounting policies are more fully described in Note 1 to our financial statements included in this report.

We have identified certain critical accounting policies, which are described below.

*Revenue recognition.* We recognize revenue at the time the products are received by the customers in accordance with the provisions of Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements as amended by SAB No. 104, Revenue Recognition. We recognize revenue for store sales at the point at which the customer receives and pays for the merchandise at the register. For on-line sales, we recognize revenue at the time the customer receives the product. We estimate and defer revenue and the related product costs for shipments that are in transit to the customer. Customers typically receive goods within one week of shipment. We reflect amounts related to shipping billed to customers in net sales and the related costs in cost of goods sold. Sales tax collected from customers on retail sales are recorded net of retail sales at the time of the transaction.

We record a reserve for estimated product returns based on historical return trends. If actual returns are greater than those projected, we may include additional sales returns in the future.

Discounts offered to customers consist primarily of point of sale markdowns and are recorded at the time of the related sale as a reduction of revenue.

We include the value of points and rewards earned by our loyalty program members as a liability and a reduction of revenue at the time the points and rewards are earned based on historical conversion and redemption rates. The associated revenue is recognized when the rewards are redeemed or expire.

We carry gift certificates sold as a liability and recognize revenue when the gift certificate is redeemed. Similarly, customers may receive a store credit in exchange for returned goods. We carry store credits as a liability until redeemed. We recognize unredeemed store credits and gift certificates as revenue three and four years, respectively, after issuance.

We record royalty revenue from product licensees as earned.

We recognize wholesale licensee revenue from sale of product to international licensee operated bebe stores as earned, the stores are excluded from comparable store sales.

*Stock Based Compensation.* We account for stock options and awards issued to employees in accordance with the fair value recognition provisions of Financial Accounting Standards Board ( FASB ) Statement No. 123(R) ( SFAS No. 123(R) ), Share-Based Payment, using the modified prospective transition method. Under SFAS No. 123(R), stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. We determine the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values.

*Inventories.* We state inventories at the lower of weighted average cost or market. We determine market based on the estimated net realizable value, which is generally the merchandise selling price. To ensure that our raw material is properly valued we age the fabric inventory and record a reserve in accordance with our established policy, which is based on historical experience. To ensure our finished goods inventory is properly valued, we review the age and turnover of our inventory and record a reserve if the selling price is marked down below cost. These assumptions can have an impact on current and future operating results and financial position. We estimate shrinkage for the period between the last physical count and balance sheet date based on historic shrinkage trends.

*Long-lived assets.* We review long-lived assets for impairment whenever events or changes in circumstances, such as store closures or poor performing stores, indicate that the carrying value of an asset may not be recoverable. If the undiscounted cash flows from the long-lived assets are less than the carrying value we record an impairment charge equal to the difference between the carrying value and the asset's estimated fair value. In addition, at the time a decision is made to close a store, we record an impairment charge, if appropriate, or accelerate depreciation over the revised useful life of the asset. Historically, our impairment charges have been immaterial. During fiscal 2007, we did not record a charge for the impairment of store assets. During fiscal 2006 and 2005, we recorded charges for the impairment of store assets of \$73,000 and \$112,000, respectively. We believe at this time that the long-lived assets carrying values and useful lives continue to be appropriate.

*Accrued Litigation.* We accrue estimates of probable liabilities associated with lawsuits and claims. The results of any litigation are inherently uncertain. As information becomes available, we assess the potential liabilities related to pending litigation and may revise our estimates as necessary. Such revisions of estimates could materially impact the results of operations and financial position.

*Self-Insurance.* We use a combination of insurance and self-insurance for employee related health care benefits. We record self-insurance liabilities based on claims filed and an estimate of those claims incurred but not reported. Any projection of losses concerning our liability is subject to a high degree of variability. Among the causes of this variability are unpredictable external factors affecting future inflation rates, changes in severity, benefit level changes, medical costs and claim settlement patterns. Should a different amount of claims occur compared to what was estimated or costs of the claims increase or decrease beyond what was anticipated, we may need to adjust reserves in the future.

*Income Taxes.* We accrue liabilities for estimates of probable settlements of domestic and foreign tax audits. At any one time, many tax years may be subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. Our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings. We record a valuation allowance against our deferred tax assets arising from foreign tax credit carryforwards as the utilization of some of these credits is not assured.

***Recent Accounting Pronouncements***

In July 2006, the FASB issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . FIN 48 clarifies the accounting for

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uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 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. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are in the process of determining the impact that the adoption of FIN 48 will have on our financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly does not require any new fair value measurements. The provisions of SFAS No. 157 are to be applied prospectively as of the beginning of the fiscal year in which it is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007. We are in the process of determining the impact that the adoption of SFAS No. 157 will have on our financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently in the process of assessing the impact the adoption of SFAS No. 159 will have on our financial position and results of operations.

## Results of Operations

Our fiscal year ends on the first Saturday after June 30. Fiscal 2007, 2006 and 2005 included 53, 52 and 52 weeks, respectively.

The following table sets forth certain financial data as a percentage of net sales for the periods indicated:

|  | Fiscal Year Ended |                 |                 |
|--|-------------------|-----------------|-----------------|
|  | July 7,<br>2007   | July 1,<br>2006 | July 2,<br>2005 |
| <b>Statement of Operating Data:</b>                  |                   |                 |                 |
| Net sales  | 100.0 %           | 100.0 %         | 100.0 %         |
| Cost of sales, including production and occupancy(1) | 52.0              | 50.5            | 50.4            |
| Gross margin   | 48.0              | 49.5            | 49.6            |
| Selling, general and administrative expenses(2)      | 32.3              | 31.4            | 29.6            |
| Income from operations                               | 15.7              | 18.1            | 20.0            |
| Interest and other income, net                       | 2.0               | 1.8             | 1.0             |
| Income before income taxes                           | 17.7              | 19.9            | 21.0            |
| Provision for income taxes                           | 6.1               | 7.1             | 8.0             |
| Net income   | 11.6 %            | 12.8 %          | 13.0 %          |

(1) Cost of sales includes the cost of merchandise, occupancy costs and production costs.

(2) Selling, general and administrative expenses primarily consist of non-occupancy store costs, corporate overhead and advertising costs.

**Fiscal years Ended July 7, 2007 and July 1, 2006**

*Net Sales.* Net sales increased to \$670.9 million during the year ended July 7, 2007 from \$579.1 million in fiscal 2006, an increase of \$91.8 million, or 15.9%. An increase in comparable store sales of 2.9% versus the prior year contributed \$14.9 million to the increase in sales. The remaining increase in sales of \$76.9 million was generated by stores not included in the comparable store sales base and year over year increases in on-line sales of \$6.6 million, wholesale sales to international licensees of \$3.9 million and one additional week in fiscal January 2007 which totaled \$8.6 million. The increase in comparable store sales performance was largely due to customer acceptance of our product offering in the first two quarters of the fiscal year. Comparable store sales for the year exclude the additional week in fiscal January 2007. Net sales included a reduction of \$1.8 million associated with the customer loyalty program in the current year compared to \$2.4 million for the comparable period of the prior year.

*Gross Margin.* Gross margin increased to \$321.8 million for the year ended July 7, 2007 from \$286.5 million in fiscal 2006, an increase of \$35.3 million, or 12.3%. As a percentage of net sales, gross margin of 48.0% was lower than prior year at 49.5% primarily due to higher markdowns and unfavorable occupancy leverage, partially offset by higher initial markups.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses, which primarily consist of non-occupancy store costs, corporate overhead and advertising costs, increased to \$216.6 million during fiscal 2007 from \$182.0 million in fiscal 2006, an increase of \$34.6 million, or 19.0%. As a percentage of net sales, these expenses increased to 32.3% during fiscal 2007 from 31.4% in fiscal 2006. This increase as a percentage of net sales was primarily due to store compensation and depreciation.

*Interest and Other Income, Net.* We generated \$13.1 million of interest and other income, net of other expenses, during fiscal 2007 as compared to \$10.4 million in fiscal 2006. The increase in interest and other income resulted from the continued increase of average cash and equivalents and marketable securities balances due to positive operating results and increased interest rates.

*Provision for Income Taxes.* Our effective tax rate was 34.7% for fiscal 2007 as compared to 35.8% for fiscal 2006. The lower effective tax rate for 2007 was primarily attributable to an increase in tax exempt interest

**Fiscal years Ended July 1, 2006 and July 2, 2005**

*Net Sales.* Net sales increased to \$579.1 million during the year ended July 1, 2006 from \$509.5 million in fiscal 2005, an increase of \$69.6 million, or 13.7%. An increase in comparable store sales of 6.1% versus the prior year contributed \$27.3 million to the increase in sales. The remaining increase in sales of \$42.3 million was generated by stores not included in the comparable store sales base and year over year increases in on-line sales and wholesale sales to international licensees. The increase in comparable store sales performance was largely due to customer acceptance of our product offering. Net sales include a reduction of \$2.4 million associated with the customer loyalty program in the current year compared to \$0 for the comparable period of the prior year. The Loyalty Program started in August 2005.

*Gross Margin.* Gross margin increased to \$286.5 million for the year ended July 1, 2006 from \$253.0 million in fiscal 2005, an increase of \$33.5 million, or 13.2%. As a percentage of net sales, gross margin of 49.5% was consistent with 49.6% in the prior year, due to a lower merchandise margin offset by favorable occupancy leverage. In the prior year we recorded lease accounting adjustments of \$3.2 million which had a 0.7% impact on gross margin.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses, which primarily consist of non-occupancy store costs, corporate overhead and advertising costs, increased to \$182.0 million during fiscal 2006

from \$151.1 million in fiscal 2005, an increase of \$30.9 million, or 20.5%. As a percentage of net sales, these expenses increased to 31.4% during fiscal 2006 from 29.6% in

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fiscal 2005. This increase as a percentage of net sales was primarily due to stock based compensation and a negotiated legal settlement, together representing 1.7% of sales, as well as increased advertising expenses offset by lower compensation and variable expenses.

*Interest and Other Income, Net.* We generated \$10.4 million of interest and other income, net of other expenses, during fiscal 2006 as compared to \$5.0 million in fiscal 2005. The increase in interest and other income resulted from the continued increase of average cash and equivalents and marketable securities balances due to positive operating results and increased interest rates.

*Provision for Income Taxes.* Our effective tax rate was 35.8% for fiscal 2006 as compared to 38.0% for fiscal 2005. The lower effective tax rate for 2006 was primarily attributable to an increase in tax exempt interest.

#### **Seasonality of Business and Quarterly Results**

Our business varies with general seasonal trends that are characteristic of the retail and apparel industries. As a result, our typical store generates a higher percentage of our annual net sales and profitability in the second quarter of our fiscal year (which includes the holiday selling season) compared to other quarters of our fiscal year. If for any reason our sales were below seasonal norms during the second quarter of our fiscal year, our annual operating results would be negatively impacted. Because of the seasonality of our business, results for any quarter are not necessarily indicative of results that may be achieved for a full fiscal year.

#### **Liquidity and Capital Resources**

Our working capital requirements vary widely throughout the year and generally peak in the first and second fiscal quarters. At July 7, 2007, we had approximately \$392.7 million of cash and equivalents and short-term marketable securities on hand. In addition, we had a revolving line of credit, under which we could borrow or issue letters of credit up to a combined total of \$25.0 million, which expires March 31, 2009. As of July 7, 2007, there were no cash borrowings outstanding, and there were \$0.9 million of letters of credit outstanding.

Net cash provided by operating activities in fiscal 2007, 2006 and 2005 was \$100.5 million, \$92.6 million and \$91.7 million, respectively. The increase of \$7.9 million for fiscal 2007 over fiscal 2006 was primarily due to increases in net earnings of \$3.5 million, non-cash compensation expense of \$1.6 million, depreciation and amortization expense of \$4.1 million and deferred rent of \$3.6 million, offset by changes in working capital of \$5.0 million.

Net cash used by investing activities was \$80.1 million, \$76.1 million and \$98.7 million in fiscal 2007, 2006 and 2005, respectively. The increase in cash used by investing activities in 2007 was primarily a result of an increase in the purchase of property, plant and equipment of \$11.8 million, offset by a decrease in net purchases of marketable securities of \$7.5 million and proceeds from sales of equipment of .3 million.

Capital expenditures of \$43.5 million in 2007 comprise \$26.4 million related to the opening of new stores, \$10.6 million related to the relocation and expansion of existing stores, \$2.5 million related to investments in management information systems and \$4 million on other projects. Capital expenditures of \$31.4 million in 2006 comprise \$19.0 million related to the opening of new stores, \$6.8 million related to the relocation and expansion of existing stores and \$5.6 million related to investments in management information systems, improvements to our facilities and other projects.

## Edgar Filing: bebe stores, inc. - Form 10-K

We opened 36, 31 and 21 new stores in fiscal 2007, 2006 and 2005, respectively, and we expect to open 40 stores in fiscal 2008. In fiscal year 2008, we expect capital expenditures of approximately \$26.3 million for new stores and relocation and expansion of existing stores and approximately \$18.7 million for investments in information systems and other capital expenditures.

During fiscal 2007, the average bebe and BEBE SPORT new store construction costs before tenant allowances were \$682,000, and the average gross inventory investment per store was \$91,000.

Net cash provided by financing activities was \$1.4 million in fiscal 2007 compared to net cash used by financing activities of \$5.1 million in fiscal 2006. In fiscal 2007, the proceeds from stock options exercised and the related tax benefits exceeded the payment of dividends. Net cash used by financing activities of \$5.1 million in fiscal 2006 compared to net cash provided by financing activities of \$7.5 million in fiscal 2005. In fiscal 2006, the payment of dividends exceeded the proceeds from stock options exercised and the related tax benefits.

We believe that our cash on hand, together with our cash flow from operations, will be sufficient to meet our capital and operating requirements through fiscal 2008. Our future capital requirements, however, will depend on numerous factors, including without limitation, the size and number of new and expanded stores, investment costs for management information systems, potential acquisitions and/or joint ventures, repurchase of stock and future results of operations.

On September 13, 2007, we entered into an agreement with our former Vice Chairperson, Neda Mashouf, to repurchase 5 million shares of our common stock beneficially owned by Ms. Mashouf at a price per share of \$13.39, an aggregate purchase price of \$66,950,000. We expect the transaction to close prior to September 21, 2007.

### Summary Disclosures about Contractual Obligations and Commercial Commitments:

The following tables summarize our significant contractual obligations and commercial commitments as of July 7, 2007 (in thousands):

|   | Amount of commitment expiration period |                     |                   |                  | After<br>5 years  |
|---|--|---------------------|-------------------|------------------|-------------------|
|   | Total                                  | Less than<br>1 year | 1-3 years         | 4 - 5 years      |                   |
| <b>OTHER COMMERCIAL COMMITMENTS</b>                             |  |                     |                   |                  |                   |
| Operating leases  | \$ 446,672                             | \$ 58,103           | \$ 110,910        | \$ 93,770        | \$ 183,889        |
| Capital leases  | 266                                    | 228                 | 38                |                  |                   |
| Trade letters of credit   | 937                                    | 937                 |                   |                  |                   |
| Unconditional purchase obligations(1)                           | 76,060                                 | 76,060              |                   |                  |                   |
| <b>Total Contractual Obligations and Commercial Commitments</b> | <b>\$ 523,935</b>                      | <b>\$ 135,328</b>   | <b>\$ 110,948</b> | <b>\$ 93,770</b> | <b>\$ 183,889</b> |

(1) Unconditional purchase obligations are defined as agreements to purchase goods or services that are enforceable and legally binding on us and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Included in the purchase obligations category above are commitments for inventory purchases, capital expenditures, information technology and professional services. Most arrangements are cancelable without a significant penalty and with short notice, usually 30 to 90 days. We excluded amounts reflected on the consolidated balance sheet as accounts payable and accrued liabilities from the table above.

As of July 7, 2007, there were no cash borrowings outstanding, and there were \$0.9 million of letters of credit outstanding under the line of credit.



**Inflation**

We do not believe that inflation has had a material effect on the results of operations in the recent past. However, we cannot assure that our business will not be affected by inflation in the future.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risks, which include changes in U.S. interest rates and, to a lesser extent, foreign exchange rates. We do not engage in financial transactions for trading or speculative purposes.

*Interest Rate Risk.*

We currently maintain a portfolio of variable investments consisting of cash equivalents and short-term marketable securities. Marketable securities consist of closed-end variable interest rate funds that invest primarily in tax-exempt municipal bonds. Due to the variable nature of these investments, their value is typically not subject to market rate changes. According to our investment policy, we may invest in taxable and tax exempt instruments. In addition, the policy establishes limits on credit quality, maturity, issuer and type of instrument. Marketable securities are classified as available for sale. We do not use derivative financial instruments in our investment portfolio.

All highly liquid investments with a maturity of three months or less at the date of purchase are considered to be cash equivalents. Investments are considered short-term marketable securities if the original maturity is between three months and twelve months, or long-term marketable securities if the original maturity is greater than twelve months. Auction rate securities have stated maturities beyond one year but are priced and traded as short-term instruments due to the liquidity provided through the interest rate reset mechanism and are classified as short-term when they represent investments of cash that are intended for use in current operations.

The following table lists our cash equivalents and short-term marketable securities at July 7, 2007:

|                                  | <b>Book<br/>Value</b>         |   | <b>Fair<br/>Value</b> |
|----------------------------------|-------------------------------|---|-----------------------|
|                                  | <b>(Dollars in thousands)</b> |   |                       |
| Cash equivalents                 | \$ 40,846                     |   | \$ 40,846             |
| Weighted average interest rate   | 3.52                          | % |                       |
| Short-term marketable securities | \$ 327,100                    |   | \$ 327,100            |
| Weighted average interest rate   | 3.91                          | % |                       |
| Total                            | \$ 367,946                    |   | \$ 367,946            |

The interest payable on our bank line of credit is based on variable interest rates and therefore affected by changes in market interest rates. If interest rates rose significantly, our results from operations and cash flows would not be affected since we have no outstanding borrowings.

*Foreign Currency Risks.*

We enter into a significant amount of purchase obligations outside of the United States, substantially all of which are negotiated and settled in U.S. Dollars. Fluctuations in exchange rates can impact our financial condition and results of operations. We also operate a subsidiary for which the functional currency is the Canadian dollar. In accordance with SFAS No. 52, Foreign Currency Translation, assets and liabilities of Canada's operations are translated into U.S. dollars at year-end rates, while income and expenses are translated at the weighted average exchange rates for the year. The related translation adjustments are recorded in accumulated other comprehensive income as a separate component of shareholder's equity. We do not hedge against foreign currency risks and believe that foreign currency exchange risk is immaterial.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Information with respect to this item is set forth in Index to Consolidated Financial Statements.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES***Evaluation of Disclosure Controls and Procedures.*

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective at the reasonable level of assurance to ensure that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and accumulated and communicated to our management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely discussions regarding required disclosure.

*Internal Control over Financial Reporting*

Management's report on our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) in the Exchange Act), and the related report of our independent registered public accounting firm, are included on pages F-2 and F-3 of this Annual Report on Form 10-K, under the headings, Management's Annual Report on Internal Control Over Financial Reporting and Report of Independent Registered Public Accounting Firm, and are incorporated herein by reference.

*Changes in Internal Control over Financial Reporting*

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15(f) or 15d-15(f) that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**ITEM 9B. OTHER INFORMATION**

On September 10, 2007, the Compensation and Management Development Committee (the Compensation Committee) of the Board of Directors of the Company met and adjusted the base salaries of the Company's Named Executive Officers. The fiscal 2008 salaries for the Named Executive Officers are set forth in the table below.

| Named<br>Executive Officer | Fiscal 2008<br>Base<br>Salary |
|----------------------------|-------------------------------|
| 1. Manny Mashouf           | \$ 120,000                    |
| 2. Gregory Scott           | \$ 600,000                    |
| 3. Barbara Wambach         | \$ 391,500                    |
| 4. Walter Parks            | \$ 387,600                    |
| 5. Susan Powers            | \$ 350,000                    |
| 6. Larry Smith             | \$ 249,812                    |



Base salaries may be adjusted from time to time as determined by the Compensation Committee.

On September 10, 2007, the Compensation Committee approved a fiscal 2008 cash incentive plan. The cash incentive plan has multiple performance criteria for an individual award, including (1) individual management bonus objectives (MBOs) such as, total corporate or divisional sales, comparable sales, operating profit, gross margin, inventory shrink and (2) an additional performance target for divisional income and/or corporate net income. Any bonus award under the cash incentive plan for any participant is dependent on the participant's individual MBOs being achieved, and that if all MBOs are achieved for an individual officer, a percentage of the total award is payable depending on the officer's position, with the remaining percentage of the individual's potential total award payable if the divisional income and/or corporate net income target is also achieved. The size of the corporate net income and/or divisional income target bonus awards will vary within a specified range depending on the actual level of performance achieved. Participants included the named executive officers as well as other management and key employees. The plan is administered by the Compensation Committee.

The Compensation Committee also approved a fiscal 2008 performance based restricted stock incentive plan. The restricted stock units (RSUs) incentive award for any individual is to be granted upon the successful achievement of specified performance criteria for fiscal 2008 approved by the Compensation Committee, such as corporate net income, total corporate sales, divisional comparable sales and comparable sales gross margin dollars. The RSUs will be awarded, if at all, by the Compensation Committee on determination of achievement of the performance targets for fiscal 2008. The RSU opportunity for each officer is a range depending on performance achieved in fiscal 2008 for the applicable factors. The vesting of any RSUs awarded upon achievement of the fiscal 2008 performance targets is over two years from the grant date, and vesting 50% per year on the anniversary of the grant date.

### **PART III**

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

Information regarding our executive officers required by Item 401 of Regulation S-K is included under Item 1 of Part I of this report under the caption "Executive Officers and Directors of the Registrant" and incorporated herein by reference.

Information with respect to our directors required by Item 401 of Regulation S-K is incorporated by reference from the section under the caption of "Proposal No. 1 Election of Directors" in our definitive Proxy Statement to be filed with the SEC not later than 120 days after the end of our fiscal year.

Information with respect to compliance with Section 16(a) of the Exchange Act required by Item 405 of Regulation S-K is incorporated by reference from the section under the caption "Section 16(A) Beneficial Ownership Reporting Compliance" in our definitive Proxy Statement to be filed with the SEC not later than 120 days after the end of our fiscal year.

Information with respect to our code of ethics required by Item 406 of Regulation S-K is incorporated by reference from the section under the caption "Committee Charters and Other Corporate Governance Materials" in our definitive Proxy Statement to be filed with the SEC not later than 120 days after the end of our fiscal year.

#### **ITEM 11. EXECUTIVE COMPENSATION**

Information with respect to executive compensation required by Item 401 of Regulation S-K incorporated by reference from the section under the caption of "Executive Compensation and Other Matters" in our definitive Proxy Statement to be filed with the SEC not later than 120 days after the end of our fiscal year.

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

Information with respect to security ownership of beneficial owners and related stockholder matters required by Item 201(d) and Item 403 of Regulation S-K is incorporated by reference from the section under the captions Equity Compensation Plan Information and Security Ownership of Certain Beneficial Owners and Management in our definitive Proxy Statement to be filed with the SEC not later than 120 days after the end of our fiscal year.

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

Information with respect to certain relationships and related transactions required by Item 404 of Regulation S-K is incorporated by reference from the section under the caption Certain Relationships and Related Transactions in our definitive Proxy Statement to be filed with the SEC not later than 120 days after the end of our fiscal year.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information with required by Item 9(e) of Schedule 14A is incorporated by reference from the section under the caption Ratification and Appointment of Independent Auditors in our definitive Proxy Statement to be filed with the SEC not later than 120 days after the end of our fiscal year.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

- (a)
1. **The financial statements listed in the Index to Consolidated Financial Statements at page F-1 are filed as a part of this report.**
  2. **Financial statement schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.**
  3. **Exhibits included or incorporated herein: See Index to Exhibits.**
- (b) Exhibits

**EXHIBIT**

**NUMBER**

**DESCRIPTION OF DOCUMENT**

|             |  |
|-------------|--|
| 3.1(h)      | Amended and Restated Articles of Incorporation of Registrant.  |
| 3.2(f)      | Amended and Restated Bylaws of Registrant.   |
| 4.1(a)      | Specimen certificate representing the Common Stock (in standard printer form, not provided).   |
| 10.1(i)(*)  | 1997 Stock Plan.   |
| 10.2(a)(*)  | 1998 Stock Purchase Plan.  |
| 10.3(a)(*)  | Form of Indemnification Agreement.   |
| 10.6(b)     | Standard Industrial/Commercial-Tenant Lease-Net dated November 30, 1998 between Registrant and Far Western Land and Investment Company, Inc., (lease for additional building to house administrative departments in Brisbane, California). |
| 10.8(c)     | Form of Retail Store License Agreement between Registrant and [company].   |
| 10.9(d)     | Amendment No. 1 to Lease Agreement (amendment to Standard Industrial/Commercial-Tenant Lease-Net dated November 30, 1998 between Registrant and Far Western Land and Investment Company, Inc.)   |
| 10.10(e)    | Lease Agreement dated October 24, 2000, as amended, between Registrant and Lincoln PO Benicia Limited Partnership.   |
| 10.11(e)    | Lease Agreement dated November 3, 2000, as amended, between Registrant and Stanley Hirsh and Anita Hirsh as trustees, D/B/A Mercantile Center.   |
| 10.12(e)    | Form of Restricted Stock Units Agreement.  |
| 10.17(f)    | Standard Offer, Agreement and Escrow Instructions for Purchase of Real Estate dated January 20, 2004 by and among bebe stores, inc. and 10345 Olympic LLC.   |
| 10.18(g)    | Business Loan Agreement dated March 28, 2003, as amended, between Registrant and Bank of America N.A.  |
| 10.19(h)(*) | Management Bonus Plan  |
| 10.20(j)    | Third Amendment to Business Loan Agreement between Registrant and Bank of America N.A.   |
| 10.21(k)(*) | bebe stores, inc. Form of Stock Option Agreement   |
| 10.22(l)(*) | bebe stores, inc. Form of Restricted Stock Unit Agreement  |
| 10.23(*)    | Employee Transition Agreement with Thomas B. Curtis  |

|          |   |
|----------|---|
| 10.24(*) | Compensation Agreement with Erin Stern                    |
| 10.25(*) | Compensation Agreement with Susan Peterson                |
| 21.1     | Subsidiaries of Registrant.                               |
| 23.1     | Consent of Independent Registered Public Accounting Firm. |
| 24.1     | Power of Attorney (see signature page).                   |
| 31.1     | Section 302 Certification of Chief Executive Officer.     |
| 31.2     | Section 302 Certification of Chief Financial Officer.     |
| 32.1     | Section 906 Certification of Chief Executive Officer.     |
| 32.2     | Section 906 Certification of Chief Financial Officer.     |

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(a) Incorporated by reference from exhibits of the same number in Registrant's Registration Statement on Form S-1 (Reg. No. 333-50333), effective June 16, 1998.

(b) Incorporated by reference from exhibits of the same number in Registrant's Quarterly Report on Form 10-Q filed on February 16, 1999.

(c) Incorporated by reference from exhibits of the same number in Registrant's Annual Report on Form 10-K filed on September 28, 1999.

(d) Incorporated by reference from exhibits of the same number in Registrant's Annual Report on Form 10-K filed on September 28, 2000.

(e) Incorporated by reference from exhibits of the same number in Registrant's Annual Report on Form 10-K filed on September 29, 2003.

(f) Incorporated by reference from exhibits of the same number in Registrant's Annual Report on Form 10-K filed on September 13, 2004.

(g) Incorporated by reference from exhibit of the same number in Registrant's Current Report on Form 8-K filed on September 20, 2004.

(h) Incorporated by reference from exhibit of the same number in Registrant's Annual Report on Form 10-K filed on September 14, 2005.

(i) Incorporated by reference from exhibit 99.2 to Registrant's Current Report on Form 8-K filed on November 23, 2005.

(j) Incorporated by reference from exhibit 99.1 to Registrant's Current Report on Form 8-K filed on November 23, 2005.

(k) Incorporated by reference from exhibit 99.3 to Registrant's Current Report on Form 8-K filed on November 23, 2005.

(l) Incorporated by reference from exhibit 99.4 to Registrant's Current Report on Form 8-K filed on November 23, 2005.

(\*) Indicates management contracts or compensatory plans or arrangements required to be filed as exhibits to this report on Form 10-K.





**SIGNATURES**

Pursuant to the requirements of the Exchange Act of 1934, as amended, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Brisbane, State of California, on the 14th day of September 2007.

bebe stores, inc.

By:

Gregory Scott  
*Chief Executive Officer*  
*(Principal Executive Officer)*

**POWER OF ATTORNEY**

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Gregory Scott and Walter Parks, and each of them acting individually, as his true and lawful attorneys-in-fact and agents, each with full power of substitution, for him in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that said attorneys-in-fact and agents, or his or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Exchange Act, this Annual Report on Form 10-K has been signed by the following persons in the capacities and on the dates indicated:

| <b>Name</b>                              | <b>Title</b>  | <b>Date</b>        |
|--|---|--------------------|
| /s/ GREGORY SCOTT<br>Gregory Scott       | Chief Executive Officer (Principal Executive Officer) and Director                | September 14, 2007 |
| /s/ WALTER PARKS<br>Walter Parks         | Chief Operating Officer and Chief Financial Officer (Principal Financial Officer) | September 14, 2007 |
| /s/ MANNY MASHOUF<br>Manny Mashouf       | Chairman of the Board   | September 14, 2007 |
| /s/ BARBARA BASS<br>Barbara Bass         | Director  | September 14, 2007 |
| /s/ CYNTHIA COHEN<br>Cynthia Cohen       | Director  | September 14, 2007 |
| /s/ CORRADO FEDERICO<br>Corrado Federico | Director  | September 14, 2007 |
| /s/ CADEN WANG<br>Caden Wang             | Director  | September 14, 2007 |

bebe stores, inc.

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

**YEARS ENDED JULY 7, 2007, JULY 1, 2006, AND JULY 2, 2005:**

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|--|-----|
| <u>Management's Annual Report on Internal Control over Financial Reporting</u>   | F-2 |
| <u>Report of Independent Registered Public Accounting Firm</u>   | F-3 |
| <u>Consolidated balance sheets as of July 7, 2007 and July 1, 2006.</u>  | F-5 |
| <u>Consolidated statements of income for the fiscal years ended July 7, 2007, July 1, 2006, and July 2, 2005</u>               | F-6 |
| <u>Consolidated statements of shareholders' equity for the fiscal years ended July 7, 2007, July 1, 2006, and July 2, 2005</u> | F-7 |
| <u>Consolidated statements of cash flows for the fiscal years ended July 7, 2007, July 1, 2006, and July 2, 2005</u>           | F-8 |
| <u>Notes to consolidated financial statements</u>  | F-9 |

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**MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The management of bebe stores, inc. is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. With the participation of the Chief Executive Officer and the Chief Financial Officer, our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework and criteria established in *Internal Control - Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, our management has concluded that our internal control over financial reporting was effective as of July 7, 2007.

bebe stores, inc.'s independent auditor, Deloitte & Touche LLP, an independent registered public accounting firm, has issued an audit report on our internal control over financial reporting. This audit report appears on page F-3 of this annual report on Form 10-K.

September 14, 2007

/s/ GREGORY SCOTT

Gregory Scott

*Chief Executive Officer and Director*

(Principal Executive Officer)

/s/ WALTER PARKS

Walter Parks

*Chief Operating Officer and Chief Financial Officer*

(Principal Financial Officer)

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of  
bebe stores, inc.:

We have audited the accompanying consolidated balance sheets of bebe stores, inc. and subsidiaries (the Company) as of July 7, 2007 and July 1, 2006, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three fiscal years in the period ended July 7, 2007. We also have audited the Company's internal control over financial reporting as of July 7, 2007, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of bebe stores, inc. and subsidiaries as of July 7, 2007 and July 1, 2006, and

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the results of their operations and their cash flows for each of the three fiscal years in the period ended July 7, 2007, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of July 7, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

As discussed in Note 1 to the Consolidated Financial Statements, on July 3, 2005, the Company changed its method of accounting for share-based payment arrangements to conform to Statement of Financial Accounting Standards No. 123(R), Share-Based Payment.

/s/ DELOITTE & TOUCHE LLP  
San Francisco, California  
September 14, 2007

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**bebe stores, inc.****CONSOLIDATED BALANCE SHEETS**

(Amounts in thousands, except share data)

|  | As of<br>July 7,<br>2007 | July 1,<br>2006 |
|--|--------------------------|-----------------|
| <b>Assets:</b>   |                          |                 |
| Current assets:  |                          |                 |
| Cash and equivalents   | \$ 65,603                | \$ 38,656       |
| Short-term marketable securities   | 327,100                  | 289,015         |
| Receivables (net of allowance of \$1,094 and \$897)  | 6,720                    | 5,682           |
| Inventories, net   | 44,064                   | 42,151          |
| Deferred income taxes, net   | 9,068                    | 6,779           |
| Prepaid and other  | 13,314                   | 7,023           |
| Total current assets   | 465,869                  | 389,306         |
| Property and equipment, net  | 116,595                  | 95,022          |
| Deferred income taxes, net   | 20,330                   | 13,243          |
| Other assets   | 4,234                    | 3,338           |
| Total assets   | \$ 607,028               | \$ 500,909      |
| <b>Liabilities and Shareholders Equity:</b>  |                          |                 |
| Current liabilities:   |                          |                 |
| Accounts payable   | \$ 28,052                | \$ 22,947       |
| Accrued liabilities  | 33,982                   | 35,841          |
| Current portion of capital leases  | 223                      | 249             |
| Total current liabilities  | 62,257                   | 59,037          |
| Long term portion of capital leases  | 38                       | 260             |
| Deferred rent and other lease incentives   | 40,143                   | 33,388          |
| Total liabilities  | 102,438                  | 92,685          |
| Commitments and contingencies (Notes 3 and 4)  |                          |                 |
| Shareholders equity:   |                          |                 |
| Preferred stock-authorized 1,000,000 shares at \$0.001 par value per share; no shares issued and outstanding                       |                          |                 |
| Common stock-authorized 135,000,000 shares at \$0.001 par value per share; issued and outstanding 93,543,604 and 91,744,090 shares |                          |                 |
|  | 94                       | 92              |
| Additional paid-in capital   | 126,744                  | 95,768          |
| Accumulated other comprehensive income   | 9,139                    | 2,418           |
| Retained earnings  | 368,613                  | 309,946         |
| Total shareholders equity  | 504,590                  | 408,224         |
| Total liabilities and shareholders equity  | \$ 607,028               | \$ 500,909      |

See accompanying notes to consolidated financial statements.

bebe stores, inc.

**CONSOLIDATED STATEMENTS OF INCOME**

(Amounts in thousands, except per share data)

|   | <b>Fiscal Year Ended</b> |                         |                         |
|---|--------------------------|-------------------------|-------------------------|
|   | <b>July 7,<br/>2007</b>  | <b>July 1,<br/>2006</b> | <b>July 2,<br/>2005</b> |
| Net sales   | \$ 670,912               | \$ 579,073              | \$ 509,527              |
| Cost of sales, including production and occupancy | 349,095                  | 292,592                 | 256,560                 |
| Gross margin                                      | 321,817                  | 286,481                 | 252,967                 |
| Selling, general and administrative expenses      | 216,560                  | 181,986                 | 151,087                 |
| Income from operations                            | 105,257                  | 104,495                 | 101,880                 |
| Interest and other income, net                    | 13,120                   | 10,408                  | 5,013                   |
| Income before income taxes                        | 118,377                  | 114,903                 | 106,893                 |
| Provision for income taxes                        | 41,099                   | 41,096                  | 40,561                  |
| Net income  | \$ 77,278                | \$ 73,807               | \$ 66,332               |
| Basic income per share                            | \$ 0.83                  | \$ 0.81                 | \$ 0.74                 |
| Diluted income per share                          | \$ 0.81                  | \$ 0.79                 | \$ 0.71                 |
| Basic weighted average shares outstanding         | 92,810                   | 91,373                  | 89,591                  |
| Diluted weighted average shares outstanding       | 94,973                   | 93,795                  | 93,453                  |

See accompanying notes to consolidated financial statements.

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## bebe stores, inc.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(Amounts in thousands)

|   | Common Stock<br>Number of<br>Shares | Common Stock<br>Amount | Additional<br>Paid-in<br>Capital | Deferred<br>Compensation | Accumulated<br>Other<br>Comprehensive<br>Income | Retained<br>Earnings | Total      | Comprehensive<br>Income |
|---|-------------------------------------|------------------------|----------------------------------|--------------------------|---|----------------------|------------|-------------------------|
| Balances as of June 30, 2004                                | 88,226                              | \$ 88                  | \$ 49,095                        | \$ (36 )                 | \$ 296  | \$ 194,977           | \$ 244,420 |                         |
| Net income  |                                     |                        |                                  |                          |   | 66,332               | 66,332     | \$ 66,332               |
| Foreign currency translation                                |                                     |                        |                                  |                          | 675   |                      | 675        | 675                     |
| Total comprehensive income                                  |                                     |                        |                                  |                          |   |                      |            | \$ 67,007               |
| Deferred compensation                                       |                                     |                        | 100                              | (100 )                   |   |                      |            |                         |
| Amortization of deferred compensation                       |                                     |                        |                                  | 101                      |   |                      | 101        |                         |
| Common stock issued under stock plans including tax benefit | 2,902                               | 3                      | 31,331                           |                          |   |                      | 31,334     |                         |
| Cash dividends declared                                     |                                     |                        |                                  |                          |   | (9,619 )             | (9,619 )   |                         |
| Balances as of July 2, 2005                                 | 91,128                              | 91                     | 80,526                           | (35 )                    | 971   | 251,690              | 333,243    |                         |
| Net income  |                                     |                        |                                  |                          |   | 73,807               | 73,807     | \$ 73,807               |
| Foreign currency translation                                |                                     |                        |                                  |                          | 1,447   |                      | 1,447      | 1,447                   |
| Total comprehensive income                                  |                                     |                        |                                  |                          |   |                      |            | \$ 75,284               |
| Deferred compensation                                       |                                     |                        | (35 )                            | 35                       |   |                      |            |                         |
| Stock based compensation                                    |                                     |                        | 9,199                            |                          |   |                      | 9,199      |                         |
| Common stock issued under stock plans including tax benefit | 616                                 | 1                      | 6,079                            |                          |   |                      | 6,080      |                         |
| Cash dividends declared                                     |                                     |                        |                                  |                          |   | (15,551 )            | (15,551 )  |                         |
| Balances as of July 1, 2006                                 | 91,744                              | 92                     | 95,768                           |                          | 2,418   | 309,946              | 408,224    |                         |
| Net income  |                                     |                        |                                  |                          |   | 77,278               | 77,278     | \$ 77,278               |
| Foreign currency translation                                |                                     |                        |                                  |                          | 6,721   |                      | 6,721      | 6,721                   |
| Total comprehensive income                                  |                                     |                        |                                  |                          |   |                      |            | \$ 83,999               |
| Stock based compensation                                    |                                     |                        | 10,818                           |                          |   |                      | 10,818     |                         |
| Common stock issued under stock plans including tax benefit | 1,800                               | 2                      | 20,158                           |                          |   |                      | 20,160     |                         |
| Cash dividends declared                                     |                                     |                        |                                  |                          |   | (18,611 )            | (18,611 )  |                         |
| Balances as of July 7, 2007                                 | 93,544                              | \$ 94                  | \$ 126,744                       | \$                       | \$ 9,139  | \$ 368,613           | \$ 504,590 |                         |

See accompanying notes to consolidated financial statements



## bebe stores, inc.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

|   | Fiscal Year Ended |                 |                 |
|---|-------------------|-----------------|-----------------|
|   | July 7,<br>2007   | July 1,<br>2006 | July 2,<br>2005 |
| Cash flows from operating activities:   |                   |                 |                 |
| Net income  | \$ 77,278         | \$ 73,807       | \$ 66,332       |
| Adjustments to reconcile net income to cash provided by operating activities: |                   |                 |                 |
| Non-cash compensation expense   | 10,818            | 9,198           | 703             |
| Depreciation and amortization   | 19,752            | 15,686          | 13,799          |
| Net loss on disposal of property  | 250               | 104             | 445             |
| Deferred income taxes   | (7,018 )          | (9,360 )        | (4,033 )        |
| Deferred rent   | 6,680             | 3,125           | 7,615           |
| Changes in operating assets and liabilities:                                  |                   |                 |                 |
| Receivables   | (1,340 )          | 1,469           | (3,581 )        |
| Inventories   | (1,831 )          | (10,248 )       | (6,204 )        |
| Prepaid expenses and other assets   | (9,632 )          | (379 )          | (5,151 )        |
| Accounts payable  | 5,507             | 2,254           | 5,369           |
| Accrued liabilities   | 7                 | 6,894           | 16,422          |
| Net cash provided by operating activities                                     | 100,471           | 92,550          | 91,716          |
| Cash flows from investing activities:   |                   |                 |                 |
| Purchase of property and equipment  | (43,243 )         | (31,361 )       | (23,300 )       |
| Proceeds from sales of equipment  | 1                 | 276             |                 |
| Purchase of marketable securities   | (371,970 )        | (414,229 )      | (330,168 )      |
| Proceeds from sales and maturities of marketable securities                   | 334,220           | 369,228         | 254,752         |
| Net cash used by investing activities   | (80,992 )         | (76,086 )       | (98,716 )       |
| Cash flows from financing activities:   |                   |                 |                 |
| Proceeds from stock options exercised   | 11,036            | 3,873           | 17,266          |
| Excess of tax benefit on stock options exercised                              | 9,124             | 2,206           |                 |
| Cash dividends paid   | (18,527 )         | (10,963 )       | (9,619 )        |
| Other   | (248 )            | (259 )          | (161 )          |
| Net cash (used) / provided by financing activities                            | 1,385             | (5,143 )        | 7,486           |
| Net increase in cash and equivalents  | 20,864            | 11,321          | 486             |
| Effect of exchange rate changes on cash                                       | 6,083             | 263             | 531             |
| Cash and equivalents:   |                   |                 |                 |
| Beginning of year   | 38,656            | 27,072          | 26,055          |
| End of year   | \$ 65,603         | \$ 38,656       | \$ 27,072       |
| Supplemental information:   |                   |                 |                 |
| Cash paid for interest  | \$ 12             | \$ 16           | \$ 15           |
| Cash paid for income taxes  | \$ 50,015         | \$ 48,670       | \$ 31,875       |

See accompanying notes to consolidated financial statements.

bebe stores, inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**1. Summary of Significant Accounting Policies**

*Nature of the business* bebe stores, inc. (the Company) designs, develops and produces a distinctive line of contemporary women's apparel and accessories, which it markets under the bebe, COLLECTION bebe, BEBE SPORT, bbsp and bebe O brand names. As of July 7, 2007, the Company operates 273 specialty retail stores located in 34 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Canada. In addition, the Company operated 14 licensed stores internationally and an on-line store at www.bebe.com.

The Company has one reportable segment and has three brands with product lines of a similar nature. Revenues of the Company's international wholesale licensee retail operations represented approximately one percent of total revenues for fiscal year 2007.

*Basis of financial statement presentation* **The** accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (GAAP).

*Stock splits* **In** November 2004 and April 2005, the Company declared 3-for-2 stock splits which became effective in December 2004 and June 2005, respectively. All share and per share amounts included herein have been adjusted to reflect these stock splits.

*Consolidation* The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany transactions and balances have been eliminated.

*Fiscal year* The Company's fiscal year ends on the first Saturday after June 30. Fiscal years 2007, 2006 and 2005 have 53, 52 and 52 weeks, respectively.

*Use of estimates* 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 and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Foreign currency adjustments* **The** Company enters into a significant amount of purchase obligations outside of the United States, substantially all of which are negotiated and settled in U.S. Dollars. The Company also operates a subsidiary for which the functional currency is the Canadian dollar. In accordance with SFAS No. 52, Foreign Currency Translation, assets and liabilities of Canada's operations are translated into U.S. dollars at year-end rates, while income and expenses are translated at the weighted average exchange rates for the year. The related translation adjustments are recorded in accumulated other comprehensive income as a separate component of shareholder's equity.

*Cash and equivalents* represent cash and short-term, highly liquid investments with original maturities of less than three months.

*Marketable securities* **The** Company's marketable securities are classified as available for sale and are carried at cost which approximates their fair market value. Marketable securities are considered short-term if the original maturity is between three months and twelve months, or long-term if the original maturity is greater than twelve months. Auction rate securities have stated maturities beyond one year but are priced and traded as short-term instruments due to the liquidity provided through the interest rate reset mechanism and are classified as short-term as they represent investments of cash that are intended for use in current operations.



bebe stores, inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. Summary of Significant Accounting Policies (Continued)

**Fair value of financial instruments** The carrying values of cash and equivalents, marketable securities, receivables and accounts payable approximate their estimated fair values.

**Concentration of credit risk** Financial instruments, which subject the Company to concentration of credit risk, consist principally of cash and equivalents and marketable securities. The Company invests its cash through financial institutions. Such investments may be in excess of FDIC insurance limits. The Company has not experienced any losses on its deposits of cash and equivalents to date.

**Inventories** are stated at the lower of weighted average cost or market. Cost includes certain indirect purchasing, merchandise handling and storage costs.

**Allowance for Doubtful Accounts**

The changes in the allowance for doubtful accounts are summarized below (in thousands):

|                              | <b>Fiscal Year Ended</b> |                         |                         |
|------------------------------|--------------------------|-------------------------|-------------------------|
|                              | <b>July 7,<br/>2007</b>  | <b>July 1,<br/>2006</b> | <b>July 2,<br/>2005</b> |
| Balance at beginning of year | \$ 897                   | \$ 843                  | \$ 632                  |
| Charged to cost and expense  | 711                      | 928                     | 848                     |
| Write offs                   | (514 )                   | (874 )                  | (637 )                  |
| Balance at end of year       | \$ 1,094                 | \$ 897                  | \$ 843                  |

**Property and equipment, net** are stated at cost. Depreciation and amortization on property and equipment is computed using the straight-line method over the following estimated useful lives.

| <b>Description</b>                          | <b>Term</b>                                     |
|---|---|
| Buildings                                   | 39.5 years                                      |
| Leasehold improvements                      | 10 years or term of lease, whichever is shorter |
| Furniture, fixtures, equipment and vehicles | 5   |
| Computer hardware and software              | 3   |

**Impairment of long-lived assets** The Company regularly reviews the carrying value of its long-lived assets. Whenever events or changes in circumstances indicate that the carrying amount of its assets might not be recoverable, the Company, using its best estimates based on reasonable and supportable assumptions and projections, has reviewed for impairment the carrying value of long-lived assets. Based on the review of certain underperforming stores, the Company did not record an impairment charge in 2007 and recorded impairment charges of \$73,000 and \$112,000 in 2006 and 2005, respectively.

**Lease Accounting** The Company leases retail stores and office space under operating leases. Costs associated with negotiating new store leases are capitalized in other assets and amortized over the lease term.

Many of the Company's operating leases contain predetermined fixed increases of the minimum rental rate during the initial lease term. For these leases, the Company recognizes the related rental expense on a straight-line basis over the lease term, commencing when possession of the property is taken



bebe stores, inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. Summary of Significant Accounting Policies (Continued)

from the landlord, which normally includes a construction period prior to the store opening. The Company records the difference between the recognized rent expense and the amounts paid as deferred rent.

The Company receives construction allowances from landlords, which are deferred and amortized on a straight-line basis over the lease term, including the construction period, as a reduction of rent expense. Construction allowances are recorded under deferred rent on the balance sheet.

**Revenue recognition** *The* Company recognizes revenue at the time the products are received by the customers in accordance with the provisions of Staff Accounting Bulletin ( SAB ) No. 101, Revenue Recognition in Financial Statements as amended by SAB No. 104, Revenue Recognition . Revenue is recognized for store sales at the point at which the customer receives and pays for the merchandise at the register. For on-line sales, revenue is recognized at the time the customer receives the product. We estimate, and defer, revenue and the related product costs for shipments that are in transit to the customer. Customers typically receive goods within a few days of shipment. Amounts related to shipping billed to customers are reflected in net sales and the related costs are reflected in cost of goods sold. Sales tax collected from customers on retail sales are recorded net of retail sales at the time of the transaction.

The Company records a reserve for estimated product returns based on historical return trends. If actual returns are greater than those projected, additional sales returns may be recorded in the future. The changes in the returns reserve are summarized below (in thousands):

|                              | Fiscal Year Ended |                 |                 |
|------------------------------|-------------------|-----------------|-----------------|
|                              | July 7,<br>2007   | July 1,<br>2006 | July 2,<br>2005 |
| Balance at beginning of year | \$ 983            | \$ 982          | \$ 572          |
| Charged to cost and expense  | 18,304            | 16,766          | 15,650          |
| Returns                      | (18,267 )         | (16,765 )       | (15,240 )       |
| Balance at end of year       | \$ 1,020          | \$ 983          | \$ 982          |

Discounts offered to customers consist primarily of point of sale markdowns and are recorded at the time of the related sale as a reduction of revenue.

The value of points and rewards earned by our loyalty program members are recorded as a liability and a reduction of revenue at the time the points and rewards are earned based on historical conversion and redemption rates. The associated revenue is recognized when the rewards are redeemed or expire.

Gift certificates sold are carried as a liability and revenue is recognized when the gift certificate is redeemed. Similarly, customers may receive a store credit in exchange for returned goods. Store credits are carried as a liability until redeemed. Unredeemed store credits and gift certificates are recognized as revenue three and four years, respectively, after issuance.

Royalty revenue from product licensees is recorded as earned.

Wholesale revenue from the sale of product to international licensee operated bebe stores is recognized at the time the licensee receives the shipment.

**Store preopening costs** associated with the opening or remodeling of stores, such as preopening rent and payroll, are expensed as incurred.



bebe stores, inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. Summary of Significant Accounting Policies (Continued)

*Apparel and accessory design activities are expensed as incurred.*

*Advertising costs* are charged to expense when the advertising takes place. Advertising costs were \$27.8 million, \$23.9 million and \$17.0 million, respectively, during fiscal 2007, 2006 and 2005.

*Income taxes* are accounted for using an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. In estimating future tax consequences, all expected future events then known to management are considered other than changes in the tax law or rates.

*Stock based compensation* Prior to July 3, 2005, the Company accounted for stock-based awards granted to employees and non-employee directors under our equity incentive plan, which is described more fully in Note 9, in accordance with the measurement and recognition provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, Financial Accounting Standards Board (FASB) Statement No. 123 Accounting for Stock-Based Compensation, and complied with the disclosure provisions of FASB Statement No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an Amendment of FASB Statement No. 123.

Effective July 3, 2005, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), Share-Based Payment, using the modified prospective transition method. Under this transition method, compensation cost in 2006 includes the portion vesting in the period for (1) all share-based payments granted prior to, but not vested as of July 2, 2005, based on the grant date fair value estimated in accordance with the original provisions of FASB Statement No. 123 and (2) all share-based payments granted subsequent to July 2, 2005, based on the grant date fair value estimated in accordance with the provisions of FASB Statement No. 123(R). Results for prior periods have not been restated.

Had stock-based employee compensation expense been determined based upon the fair values at the grant dates for awards under the Company's stock plan in accordance with FASB Statement No. 123(R) in fiscal year 2005, the Company's pro forma net earnings, basic and diluted earnings per common share would have been as follows:

|   | <b>Fiscal Year Ended<br/>July 2, 2005<br/>(Dollars in<br/>thousands, except<br/>per share amounts)</b> |
|---|--|
| As reported   | \$ 66,332  |
| Add: Stock-based employee compensation expense included in reported net income, net of income tax   | 412  |
| Deduct: Stock based employee compensation determined under the fair value method, net of income tax | (7,049 )   |
| Pro forma   | \$ 59,695  |
| Basic EPS, as reported  | \$ 0.74  |
| Basic EPS, pro forma  | \$ 0.67  |
| Diluted EPS, as reported  | \$ 0.71  |
| Diluted EPS, pro forma  | \$ 0.64  |



bebe stores, inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. Summary of Significant Accounting Policies (Continued)

**Earnings per share** Basic earnings per share (EPS) is computed as net earnings divided by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur from common shares issuable through the exercise of outstanding dilutive stock options.

The following is a reconciliation of the number of shares used in the basic and diluted earnings per share computations:

|   | Fiscal Year Ended |                 |                 |
|---|-------------------|-----------------|-----------------|
|   | July 7,<br>2007   | July 1,<br>2006 | July 2,<br>2005 |
|   | (in thousands)    |                 |                 |
| Basic weighted average number of shares outstanding       | 92,810            | 91,373          | 89,591          |
| Incremental shares from assumed issuance of stock options | 2,163             | 2,422           | 3,862           |
| Diluted weighted average number of shares outstanding     | 94,973            | 93,795          | 93,453          |

The number of incremental shares from the assumed issuance of stock options is calculated by applying the treasury stock method.

Excluded from the computation of the number of diluted weighted average shares outstanding were antidilutive options of 1.7 million, 1.3 million and 0.3 million for the fiscal years ended July 7, 2007, July 1, 2006, and July 2, 2005, respectively.

**Comprehensive income** consists of net income and other comprehensive income (income, expenses, gains and losses that bypass the income statement and are reported directly as a separate component of equity). The Company's comprehensive income equals net income plus foreign currency translation adjustments for all periods presented. Such components of comprehensive income are shown in the Consolidated Statements of Shareholders' Equity.

**Recent Accounting Pronouncements**

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. FIN 48 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. FIN 48 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. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is in the process of determining the impact that the adoption of FIN 48 will have on its financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly does not require any new fair value measurements. The provisions of SFAS No. 157 are to be applied prospectively as of the beginning of the fiscal year in which it is initially applied, with any transition.

bebe stores, inc.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**1. Summary of Significant Accounting Policies (Continued)**

adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007. The Company is in the process of determining the impact that the adoption of SFAS No. 157 will have on its financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently in the process of assessing the impact the adoption of SFAS No. 159 will have on its financial position and results of operations.

**2. Inventories**

The Company's inventories consist of:

|                                | As of<br>July 7,<br>2007 | July 1,<br>2006 |
|--------------------------------|--------------------------|-----------------|
|                                | (Dollars in thousands)   |                 |
| Raw materials                  | \$ 7,136                 | \$ 10,417       |
| Merchandise available for sale | 36,928                   | 31,734          |
| Inventories                    | \$ 44,064                | \$ 42,151       |

**3. Credit Facilities**

The Company has an unsecured commercial line of credit agreement with a bank, which provides for borrowings and issuance of letters of credit of up to \$25.0 million and expires on March 31, 2009. The outstanding balance bears interest at either the bank's reference rate (which was 8.25% as of July 7, 2007 and July 1, 2006) or the LIBOR rate plus 1.75 percentage points. As of July 7, 2007 and July 1, 2006, there were no outstanding cash borrowings, and there was \$0.9 million and \$3.3 million, respectively, of letters of credit outstanding.

This credit facility requires the Company to comply with certain financial covenants, including amounts for minimum tangible net worth, unencumbered liquid assets and profitability, and certain restrictions on making loans and investments.

**4. Lease Obligations**

The Company leases its retail store locations, corporate headquarters and distribution center, and accounts for these leases as operating leases. The Company recognizes rent expense on a straight-line basis over the term of the lease, taking into account, when applicable, lessor incentives for tenant improvements, periods where no rent payment is required and escalations in rent payments over the term of the lease. Deferred rent is recognized for the difference between the rent expense recognized on a straight-line basis and the payments made per the terms of the lease. Store leases typically provide for payment by the Company of certain operating expenses, real estate taxes and additional rent based on a percentage of net sales if a specified net sales target is exceeded. In addition, certain leases have escalation clauses and provide for terms of renewal and/or early termination based on the net sales volumes achieved.

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bebe stores, inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 4. Lease Obligations (Continued)

Rent expense under operating leases for the fiscal years ended July 7, 2007, July 1, 2006, and July 2, 2005 was \$75.7 million, \$61.0 million and \$56.8 million, respectively. Rent expense included percentage rent and other lease-required expenses for fiscal years 2007, 2006 and 2005 of \$27.6 million, \$22.3 million and \$18.7 million, respectively.

The Company leases certain equipment under capital leases. Net assets held under capital leases included in property and equipment as of July 7, 2007 and July 1, 2006 were \$0.2 million and \$0.5 million, respectively.

Future minimum lease payments at July 7, 2007 are as follows:

| Fiscal year                             | Operating<br>Leases    | Capital<br>Leases |
|---|------------------------|-------------------|
|   | (Dollars in thousands) |                   |
| 2008                                    | \$ 58,103              | \$ 228            |
| 2009                                    | 57,070                 | 38                |
| 2010                                    | 53,840                 |                   |
| 2011                                    | 49,357                 |                   |
| 2012                                    | 44,413                 |                   |
| Thereafter                              | 183,889                |                   |
| Total minimum lease payments            | \$ 446,672             | \$ 266            |
| Less amounts representing interest      |                        | (5 )              |
| Present value of minimum lease payments |                        | \$ 261            |

## 5. Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

|                                     | As of<br>July 7,<br>2007 | July 1,<br>2006 |
|-------------------------------------|--------------------------|-----------------|
| Gift certificates and store credits | \$ 8,081                 | \$ 6,719        |
| Income taxes payable                |                          | 5,365           |
| Dividend payable                    | 4,677                    | 4,588           |
| Employee compensation               | 5,750                    | 3,901           |
| Sales/use tax payable               | 3,607                    | 3,365           |
| Deferred revenue                    | 4,180                    | 2,427           |
| Other                               | 7,687                    | 9,476           |
| Total                               | \$ 33,982                | \$ 35,841       |

## bebe stores, inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 6. Income Taxes

Significant components of the provision for income taxes are as follows:

|           | Fiscal Year Ended      |                 |                 |
|-----------|------------------------|-----------------|-----------------|
|           | July 7,<br>2007        | July 1,<br>2006 | July 2,<br>2005 |
|           | (Dollars in thousands) |                 |                 |
| Current:  |                        |                 |                 |
| Federal   | \$ 40,077              | \$ 41,200       | \$ 37,040       |
| State     | 7,040                  | 7,165           | 6,625           |
| Foreign   | 1,000                  | 2,169           | 929             |
|           | 48,117                 | 50,534          | 44,594          |
| Deferred  |                        |                 |                 |
| Federal   | (6,166 )               | (8,594 )        | (3,311 )        |
| State     | (797 )                 | (618 )          | (842 )          |
| Foreign   | (55 )                  | (226 )          | 120             |
|           | (7,018 )               | (9,438 )        | (4,033 )        |
| Provision | \$ 41,099              | \$ 41,096       | \$ 40,561       |

The components of earnings from continuing operations before income taxes are as follows:

|               | Fiscal Years Ended |                 |                 |
|---------------|--------------------|-----------------|-----------------|
|               | July 7,<br>2007    | July 1,<br>2006 | July 2,<br>2005 |
|               | (in thousands)     |                 |                 |
| United States | \$ 113,500         | \$ 108,895      | \$ 104,454      |
| Foreign       | 4,877              | 6,008           | 2,439           |
| Total         | \$ 118,377         | \$ 114,903      | \$ 106,893      |

A reconciliation of the federal statutory tax rate with the Company's effective income tax rate is as follows:

|                                    | Fiscal Year Ended |                 |                 |
|------------------------------------|-------------------|-----------------|-----------------|
|                                    | July 7,<br>2007   | July 1,<br>2006 | July 2,<br>2005 |
| Federal statutory rate             | 35.0 %            | 35.0 %          | 35.0 %          |
| State rate, net of federal benefit | 3.2               | 3.5             | 3.9             |
| Tax-exempt interest                | (3.2 )            | (2.4 )          | (1.2 )          |
| Other                              | (0.3 )            | (0.3 )          | 0.3             |
| Effective tax rate                 | 34.7 %            | 35.8 %          | 38.0 %          |

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax reporting purposes.

**bebe stores, inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. Income Taxes (Continued)**

Significant components of the Company's deferred tax assets (liabilities) are as follows:

|                                     | <b>July 7,<br/>2007</b>       | <b>July 1,<br/>2006</b> |
|-------------------------------------|-------------------------------|-------------------------|
|                                     | <b>(Dollars in thousands)</b> |                         |
| <b>Current</b>                      |                               |                         |
| Gift certificates and store credits | \$ 3,214                      | \$ 2,696                |
| Inventory                           | 2,499                         | 1,530                   |
| Other accrued expenses              | 1,102                         | 1,010                   |
| Deferred revenue                    | 1,488                         | 973                     |
| Accrued vacation                    | 679                           | 558                     |
| State taxes                         | (62 )                         | 515                     |
| Prepaid expenses                    | (235 )                        | (669 )                  |
| Other                               | 434                           | 166                     |
| <b>Total Current</b>                | <b>9,119</b>                  | <b>6,779</b>            |
| <b>Non-Current</b>                  |                               |                         |
| Basis difference in fixed assets    | 10,509                        | 8,196                   |
| Deferred rent                       | 5,850                         | 4,961                   |
| Stock based compensation            | 5,482                         | 2,563                   |
| Foreign tax credit                  | 1,142                         | 2,353                   |
| Construction allowance              | (5,172 )                      | (4,284 )                |
| Other                               | 2,634                         | 281                     |
| <b>Total Non-Current</b>            | <b>20,445</b>                 | <b>14,070</b>           |
| <b>Valuation allowance</b>          | <b>(166 )</b>                 | <b>(827 )</b>           |
| <b>Deferred tax assets, net</b>     | <b>\$ 29,398</b>              | <b>\$ 20,022</b>        |

The Company has foreign tax credit carry forwards of approximately \$1,142 thousand which will expire at various dates from fiscal year 2010 to fiscal year 2017. Utilization of these credits will require sufficient foreign source income in future years. A valuation allowance of approximately \$166 thousand has been established related to these foreign tax credit carry forwards as the utilization of such amount is not assured.

bebe stores, inc.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****7. Property and Equipment**

Property and equipment consist of the following:

|                                   | As of<br>July 7,<br>2007<br>(in thousands) | July 1,<br>2006 |
|-----------------------------------|--|-----------------|
| Leasehold Improvements            | \$ 124,367                                 | \$ 96,787       |
| Furniture, Fixtures and Equipment | 37,918                                     | 29,568          |
| Computer Hardware and Software    | 31,889                                     | 27,578          |
| Land and Buildings                | 10,942                                     | 10,942          |
| Construction in Progress          | 10,293                                     | 14,339          |
| Total                             | 215,409                                    | 179,214         |
| Less: Accumulated Depreciation    | (98,814 )                                  | (84,192 )       |
| Property and Equipment, net       | \$ 116,595                                 | \$ 95,022       |

Construction in progress consists primarily of construction costs related to facilities that will open subsequent to year end and information technology projects.

**8. Employee Benefit Plan**

Employees are eligible to participate in the Company's 401(k) plan if they have been employed by the Company for one year, have reached age 21 and work at least 1,000 hours annually. Generally, employees can defer up to 75% of their gross wages up to the maximum limit allowable under the Internal Revenue Code. The employer can make a discretionary matching contribution for the employee. Employer contributions to the plan for the years ended July 7, 2007, July 1, 2006, and July 2, 2005 were \$219 thousand, \$233 thousand and \$194 thousand, respectively.

**9. Shareholders Equity****Preferred Stock**

The Company is authorized to issue up to 1,000,000 shares of \$0.001 par value preferred stock and to fix the rights, preferences, privileges and restrictions including voting rights, of these shares without any further vote or approval by the shareholders. No preferred stock has been issued to date.

**Common Stock Plans**

The 1997 Stock Plan as amended (the "Stock Plan") provides for the grant of incentive stock options, non-qualified stock options, stock purchase rights, stock awards and restricted stock units ("RSU"). Although the Stock Plan allows for stock options and related awards to be granted at prices below fair market value, the Company has historically granted such options at the fair market value of the stock on the date of grant. Stock options and related awards have a maximum term of ten years. Options and restricted stock units granted to employees generally vest over four years with 20% of the award vested in each of the first and second years and 30% vested in each of the remaining two years. Options granted to directors generally vest over four years with 20% of the award vested in each of the first and second years and 30% vested in each of the remaining two years. Restricted stock units awarded to directors generally vest over a period of one year from the date of grant. As of July 7, 2007, the Company has

## bebe stores, inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 9. Shareholders Equity (Continued)

7,710,070 shares of common stock authorized and unissued under the Stock Plan and there were 1,544,739 shares available for future grant.

The following table summarizes information about stock options outstanding at July 7, 2007:

| Exercise Prices    | Options Outstanding      |   |                                       | Options Vested and Exercisable |                                       |
|--------------------|--------------------------|---|---------------------------------------|--------------------------------|---------------------------------------|
|                    | Number<br>(In thousands) | Weighted<br>Average<br>Remaining Life<br>(in years) | Weighted<br>Average Exercise<br>Price | Number<br>(In thousands)       | Weighted<br>Average<br>Exercise Price |
| \$2.87 to \$8.57   | 1,168                    | 5.73  | \$ 6.32                               | 954                            | \$ 6.02                               |
| \$8.63 to \$8.63   | 2,405                    | 6.62  | 8.63                                  | 1,783                          | 8.63                                  |
| \$8.92 to \$18.29  | 1,459                    | 7.85  | 14.98                                 | 515                            | 13.43                                 |
| \$18.72 to \$27.69 | 1,063                    | 8.89  | 21.45                                 | 131                            | 21.75                                 |
| \$28.43 to \$28.43 | 3                        | 8.02  | 28.43                                 | 1                              | 28.43                                 |
|                    | 6,098                    | 7.14  | \$ 11.95                              | 3,384                          | \$ 9.14                               |

As of July 7, 2007, July 1, 2006 and July 2, 2005 there were approximately 3,384,000, 3,174,000 and 1,703,000 options exercisable at weighted average exercise prices per share of \$9.14, \$7.29 and \$5.37, respectively.

The following table summarizes stock option activity:

|                           | Shares<br>Outstanding<br>(Amounts in<br>thousands) | Weighted<br>Average<br>Exercise Price<br>of Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Average<br>Intrinsic Value<br>(in thousands) |
|---------------------------|--|---|---|--|
| Oustanding, June 30, 2004 | 10,120   | \$ 6.78   |   |  |
| Granted                   | 1,173  | 16.32   |   |  |
| Exercised                 | (2,854 )   | 6.00  |   |  |
| Cancelled                 | (776 )   | 7.32  |   |  |
| Oustanding, July 2, 2005  | 7,663  | 8.48  |   |  |
| Granted                   | 868  | 17.29   |   |  |
| Exercised                 | (605 )   | 6.10  |   |  |
| Cancelled                 | (576 )   | 10.14   |   |  |
| Oustanding, July 1, 2006  | 7,350  | 9.59  |   |  |
| Granted                   | 1,062  | 20.62   |   |  |
| Exercised                 | (1,777 )   | 6.12  |   |  |
| Cancelled                 | (537 )   | 15.81   |   |  |
| Oustanding, July 7, 2007  | 6,098  | \$ 11.95  | 7.14  | \$ 34,359                                    |
| Exercisable, July 7, 2007 | 3,384  | \$ 9.14   | 6.44  | \$ 26,139                                    |

Intrinsic value for stock options is defined as the difference between the current market value and the grant price. For the year ended July 7, 2007, the total intrinsic value of stock options exercised was \$26.7 million. Cash received from stock options exercised during the year ended July 7, 2007 was \$10.9 million and the actual tax benefit realized for tax deductions from stock options exercised totaled \$25.2 million.

bebe stores, inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 9. Shareholders Equity (Continued)

The following table summarizes RSU activity:

|                          | Shares<br>(In thousands) | Weighted<br>Average Grant<br>Date Fair Value<br>Per Share |
|--------------------------|--------------------------|---|
| Nonvested, June 30, 2004 | 27                       | \$ 7.63   |
| Granted                  | 35                       | 19.04   |
| Vested                   | (27 )                    | 15.91   |
| Nonvested, July 2, 2005  | 35                       | 16.05   |
| Granted                  | 32                       | 15.98   |
| Cancelled                | (2 )                     | 18.29   |
| Vested                   | (1 )                     | 16.05   |
| Nonvested, July 1, 2006  | 64                       | 15.89   |
| Granted                  | 40                       | 19.67   |
| Cancelled                | (23 )                    | 16.66   |
| Vested                   | (14 )                    | 21.20   |
| Nonvested, July 7, 2007  | 67                       | \$ 20.68  |

**Stock based compensation**

For the fiscal years ended July 7, 2007 and July 1, 2006, the Company recognized share-based compensation expense of \$10.8 million and \$9.0 million, respectively, as a component of selling, general and administrative expenses. As of July 7, 2007, there was \$12.5 million (before any related tax benefit) of total unrecognized compensation cost related to nonvested share-based compensation that is expected to be recognized over a weighted-average period of 2.8 years.

Prior to the adoption of FASB Statement No. 123(R), the Company presented all benefits of tax deductions resulting from the exercise of share-based compensation as operating cash flows in the Statements of Cash Flows. FASB Statement No. 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. For the year ended July 7, 2007, the Company reported \$9.1 million of excess tax benefits as a financing cash inflow.

The fair value of each option grant was estimated on the date of the grant using the Black-Scholes valuation model. The expected life of the options represents the period of time the options are expected to be outstanding and is based on historical trends. For the years ended July 7, 2007 and July 1, 2006, expected stock price volatility is based on an average of the historical volatility of the Company's stock for a period approximating the expected life and the implied volatility based on traded options of the Company's stock. For the year ended July 2, 2005, expected stock price volatility was based on historical volatility only. The expected dividend yield is based on the Company's most recent annual dividend payout. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and has a term that approximates the expected life.



bebe stores, inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Shareholders Equity (Continued)

The following table presents the weighted average assumptions used in the option pricing model for the stock options granted in the years ended July 7, 2007, July 1, 2006 and July 2, 2005:

|                               | July 7,<br>2007 | July 1,<br>2006 | July 2,<br>2005<br>(Pro forma) |
|-------------------------------|-----------------|-----------------|--------------------------------|
| Expected dividend rate        | 0.9 %           | 1.0 %           | 0.6 %                          |
| Volatility                    | 47.8 %          | 52.5 %          | 69.1 %                         |
| Risk-free interest rate       | 4.7 %           | 4.3 %           | 3.5 %                          |
| Expected lives (years)        | 4.1             | 4.4             | 5.6                            |
| Fair value per option granted | \$ 8.72         | \$ 7.87         | \$ 9.79                        |

Refer to Note 1 for the Company's pro forma net earnings, basic and diluted earnings per common share had stock-based employee compensation expense been determined based upon the fair values at the grant dates for awards under the Stock Plan in accordance with FASB Statement No. 123 in the year ended July 2, 2005.

**Stock Purchase Plan**

The 1998 Employee Stock Purchase Plan (the Plan) has a total of 2,531,250 shares of common stock reserved for issuance. The Plan allows eligible employees to purchase our common stock in an amount, which may not exceed 10% of the employee's compensation. Through April 30, 2005, the Plan was implemented in sequential 24-month offerings, each offering generally comprised of eight, three-month purchase periods, with shares purchased on the last day of each purchase period (a Purchase Date). The price at which stock was purchased was equal to 85% of the lower of fair market value of our common stock on the first and last day of the offering period or the Purchase Date. Beginning with the May 1, 2005 purchase period, the Plan is implemented in three-month purchase periods. The price at which stock may be purchased is equal to 95% of the fair market value of our common stock on the Purchase Date. During the years ended July 7, 2007, July 1, 2006 and July 2, 2005 there were 9,200, 11,191 and 17,332 shares issued, respectively.

**10. Litigation**

As of the date of this filing, the Company is involved in ongoing legal proceedings as described below.

A former employee sued the Company in a complaint filed on April 28, 2005 in the United States District Court for the Northern District of California (case No. C050177) alleging violations under the Fair Labor Standards Act, specifically that the Company obligated her to buy and wear its brand clothing as a uniform, without reimbursement or credit, and the net effect of deducting the value of such required purchases from her wages would often result in her not being paid minimum wages. The plaintiff purports to bring the action also on behalf of a class of hourly, non-managerial employees who are similarly situated. The lawsuit seeks compensatory, statutory and injunctive relief. The Company has negotiated a confidential settlement in this case which remains subject to court approval. One objection to the settlement has been filed by the plaintiff in the lawsuit described in the next paragraph of this section. The Company has accrued an amount that it believes reasonably estimates the potential liability, which did not have a material impact on our financial position or results of operations.

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**bebe stores, inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**10. Litigation (Continued)**

A former employee sued the Company in a complaint filed July 27, 2006 in the Superior Court of California, San Mateo County (case No. CIV 456550) alleging a failure to pay all wages, failure to pay overtime wages, failure to pay minimum wages, failure to provide meal periods, violation of Labor Code §450, violation of Labor Code §2802 and California Code of Regulations §11040(9)(A), statutory wage violations (late payment of wages), unlawful business practices under Business and Professions Code §16720 and §17200, conversion of wages and violation of Civil Code §52.1. The plaintiff purports to bring the action also on behalf of current and former California Company employees who are similarly situated. The lawsuit seeks compensatory, statutory, punitive, restitution and injunctive relief. Due to certain similarities in claims between this action and the one previously mentioned (Case No. C050177), the parties and the Court have postponed active litigation and discovery until such time as the previously mentioned case resolves the claims in common. Notwithstanding, the Court in this case has set a hearing in June, 2008 regarding whether class certification would be appropriate if, and to the extent, any claim(s) in this case remain(s) active at that time.

A customer sued the Company in a complaint filed December 14, 2006 in the Superior Court of Contra Costa County (case no. C06-02630) alleging that we utilized a certain type of preprinted credit card form in a return transaction in violation of California Civil Code §1747.08. The plaintiff purports to bring the action also on behalf of other customers who are similarly situated. The lawsuit seeks compensatory, statutory, and injunctive relief. The parties have begun discovery and a case management conference is set for later this month.

Three customers filed separate complaints alleging the Company violated The Fair Credit Reporting Act (the FCRA ). Two of such cases were filed January 10 and January 16, 2007 in the United States District Court for the Northern District of California (case nos. C07-0203 & C07-0255, respectively). In late April 2007, each of these two lawsuits were voluntarily dismissed, without prejudice, by their respective plaintiff. The third lawsuit, filed on February 9, 2007 in the Central District of California (case no. CV-07-0972) remains active. This latter lawsuit alleges that the Company violated the FCRA by printing on receipts more than the last five digits of the credit or debit card numbers and/or the expiration date. The plaintiff purports to bring the action also on behalf of other customers who are similarly situated and seeks statutory and punitive damages, attorney's fees and injunctive relief.

The Company is also involved in various other legal proceedings arising in the normal course of business. None of these matters nor the matters listed above are expected, individually or in the aggregate, to have a material adverse effect on its business, financial condition or results of operations.

The Company intends to defend itself vigorously against these claims. However, the results of any litigation are inherently uncertain. The Company cannot assure that we will be able to successfully defend itself in these lawsuits. Where required, and/or otherwise appropriate, The Company has recorded an estimate of potential liabilities that it believes is reasonable. Any estimates are revised as further information becomes available.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**11. Quarterly Financial Information (Unaudited)**

The quarterly financial information presented below reflects all adjustments which, in the opinion of the Company's management, are of a normal and recurring nature necessary to present fairly the results of operations for the periods presented.

|  | <b>2007 Quarter Ended</b>                    |                    |                |               |
|--|--|--------------------|----------------|---------------|
|  | <b>September 30</b>                          | <b>December 30</b> | <b>April 7</b> | <b>July 7</b> |
|  | <b>(in thousands, except per share data)</b> |                    |                |               |
| Net sales                                    | \$ 157,059                                   | \$ 196,802         | \$ 154,354     | \$ 168,698    |
| Gross margin                                 | 79,286                                       | 94,345             | 69,852         | 78,335        |
| Selling, general and administrative expenses | 50,290                                       | 58,948             | 54,126         | 53,194        |
| Income from operations                       | 28,996                                       | 35,397             | 15,726         | 25,141        |
| Income before income taxes                   | 32,169                                       | 37,894             | 20,156         | 28,162        |
| Net income                                   | 20,427                                       | 24,273             | 12,928         | 19,656        |
| Basic income per share                       | \$ 0.22                                      | \$ 0.26            | \$ 0.14        | \$ 0.21       |
| Diluted income per share                     | \$ 0.22                                      | \$ 0.26            | \$ 0.14        | \$ 0.21       |

|  | <b>2006 Quarter Ended</b>                    |                    |                |               |
|--|--|--------------------|----------------|---------------|
|  | <b>October 1</b>                             | <b>December 31</b> | <b>April 1</b> | <b>July 1</b> |
|  | <b>(in thousands, except per share data)</b> |                    |                |               |
| Net sales                                    | \$ 126,155                                   | \$ 167,895         | \$ 132,812     | \$ 152,211    |
| Gross margin                                 | 62,203                                       | 85,139             | 62,236         | 76,903        |
| Selling, general and administrative expenses | 42,249                                       | 46,916             | 44,721         | 48,100        |
| Income from operations                       | 19,954                                       | 38,223             | 17,515         | 28,803        |
| Income before income taxes                   | 22,069                                       | 40,468             | 20,329         | 32,037        |
| Net income                                   | 13,573                                       | 25,009             | 13,299         | 21,926        |
| Basic income per share                       | \$ 0.15                                      | \$ 0.27            | \$ 0.15        | \$ 0.24       |
| Diluted income per share                     | \$ 0.14                                      | \$ 0.27            | \$ 0.14        | \$ 0.23       |

**12. Subsequent Event**

On September 13, 2007, the Company entered into an agreement with the Company's former Vice Chairperson, Neda Mashouf, to repurchase 5 million shares of its common stock beneficially owned by Ms. Mashouf at a price per share of \$13.39, an aggregate purchase price of \$66,950,000. The Company expects the transaction to close prior to September 21, 2007.

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**INDEX TO EXHIBITS**

**EXHIBIT**

| <b>NUMBER</b> | <b>DESCRIPTION OF DOCUMENT</b>   |
|---------------|--|
| 3.1(h)        | Amended and Restated Articles of Incorporation of Registrant.  |
| 3.2(f)        | Amended and Restated Bylaws of Registrant.   |
| 4.1(a)        | Specimen certificate representing the Common Stock (in standard printer form, not provided).   |
| 10.1(i)(*)    | 1997 Stock Plan.   |
| 10.2(a)(*)    | 1998 Stock Purchase Plan.  |
| 10.3(a)(*)    | Form of Indemnification Agreement.   |
| 10.6(b)       | Standard Industrial/Commercial-Tenant Lease-Net dated November 30, 1998 between Registrant and Far Western Land and Investment Company, Inc., (lease for additional building to house administrative departments in Brisbane, California). |
| 10.8(c)       | Form of Retail Store License Agreement between Registrant and [company].   |
| 10.9(d)       | Amendment No. 1 to Lease Agreement (amendment to Standard Industrial/Commercial-Tenant Lease-Net dated November 30, 1998 between Registrant and Far Western Land and Investment Company, Inc.)   |
| 10.10(e)      | Lease Agreement dated October 24, 2000, as amended, between Registrant and Lincoln PO Benicia Limited Partnership.   |
| 10.11(e)      | Lease Agreement dated November 3, 2000, as amended, between Registrant and Stanley Hirsh and Anita Hirsh as trustees, D/B/A Mercantile Center.   |
| 10.12(e)      | Form of Restricted Stock Units Agreement.  |
| 10.17(f)      | Standard Offer, Agreement and Escrow Instructions for Purchase of Real Estate dated January 20, 2004 by and among bebe stores, inc. and 10345 Olympic LLC.   |
| 10.18(g)      | Business Loan Agreement dated March 28, 2003, as amended, between Registrant and Bank of America N.A.  |
| 10.19(h)(*)   | Management Bonus Plan  |
| 10.20(j)      | Third Amendment to Business Loan Agreement between Registrant and bank of America N.A.   |
| 10.21(k)(*)   | bebe stores, inc. Form of Stock Option Agreement   |
| 10.22(l)(*)   | bebe stores, inc. Form of Restricted Stock Unit Agreement  |
| 10.23(*)      | Employee Transition Agreement with Thomas B. Curtis  |
| 10.24(*)      | Compensation Agreement with Erin Stern   |
| 10.25(*)      | Compensation Agreement with Susan Peterson   |
| 21.1          | Subsidiaries of Registrant.  |
| 23.1          | Consent of Independent Registered Public Accounting Firm.  |
| 24.1          | Power of Attorney (see signature page).  |
| 31.1          | Section 302 Certification of Chief Executive Officer.  |
| 31.2          | Section 302 Certification of Chief Financial Officer.  |
| 32.1          | Section 906 Certification of Chief Executive Officer.  |
| 32.2          | Section 906 Certification of Chief Financial Officer.  |

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(a) Incorporated by reference from exhibits of the same number in Registrant's Registration Statement on Form S-1 (Reg. No. 333-50333), effective June 16, 1998.

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(b) Incorporated by reference from exhibits of the same number in Registrant's Quarterly Report on Form 10-Q filed on February 16, 1999.

(c) Incorporated by reference from exhibits of the same number in Registrant's Annual Report on Form 10-K filed on September 28, 1999.

(d) Incorporated by reference from exhibits of the same number in Registrant's Annual Report on Form 10-K filed on September 28, 2000.

(e) Incorporated by reference from exhibits of the same number in Registrant's Annual Report on Form 10-K filed on September 29, 2003.

(f) Incorporated by reference from exhibits of the same number in Registrant's Annual Report on Form 10-K filed on September 13, 2004.

(g) Incorporated by reference from exhibit of the same number in Registrant's Current Report on Form 8-K filed on September 20, 2004.

(h) Incorporated by reference from exhibit of the same number in Registrant's Annual Report on Form 10-K filed on September 14, 2005

(i) Incorporated by reference from exhibit 99.2 to Registrant's Current Report on Form 8-K filed on November 23, 2005.

(j) Incorporated by reference from exhibit 99.1 to Registrant's Current Report on Form 8-K filed on November 23, 2005.

(k) Incorporated by reference from exhibit 99.3 to Registrant's Current Report on Form 8-K filed on November 23, 2005.

(l) Incorporated by reference from exhibit 99.4 to Registrant's Current Report on Form 8-K filed on November 23, 2005.

(\*) Indicates management contracts or compensatory plans or arrangements required to be filed as exhibits to this report on Form 10-K.

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