MICHAELS STORES INC
Form 10-Q
November 18, 2011
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, DC 20549**

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# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended October 29, 2011**

**OR**

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

**For the transition period from to**

**Commission file number 001-09338**

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# MICHAELS STORES, INC.

(Exact name of registrant as specified in its charter)

| **Delaware** | **75-1943604** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. employer identification number) |

**8000 Bent Branch Drive**

**Irving, Texas 75063**

(Address of principal executive offices, including zip code)

**(972) 409-1300**

(Registrant s telephone number, including area code)

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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 x No o

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

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

| Large accelerated filer o | Accelerated filer o |
|---|---|
| Non-accelerated filer x<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

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

As of November 14, 2011, 118,697,395 shares of the Registrant s Common Stock were outstanding.

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**MICHAELS STORES, INC.**

**FORM 10-Q**


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**MICHAELS STORES, INC.**

**Part I FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**MICHAELS STORES, INC.**

**CONSOLIDATED BALANCE SHEETS**

**(In millions, except share data)**

**(Unaudited)**

| | October 29, 2011 | January 29, 2011 | October 30, 2010 |
|---|---|---|---|
| **ASSETS** | | | |
| **Current assets:** | | | |
| Cash and equivalents | $ 111 | $ 319 | $ 115 |
| Merchandise inventories | 1,019 | 826 | 1,004 |
| Prepaid expenses and other | 80 | 73 | 78 |
| Deferred income taxes | 56 | 56 | 41 |
| Income tax receivable | 12 | 1 | 48 |
| Total current assets | 1,278 | 1,275 | 1,286 |
| **Property and equipment, at cost** | 1,402 | 1,329 | 1,304 |
| Less accumulated depreciation | (1,086) | (1,028) | (1,002) |
| Property and equipment, net | 316 | 301 | 302 |
| **Goodwill** | 95 | 95 | 95 |
| **Debt issuance costs, net of accumulated amortization of $71, $60, and $57, respectively** | 58 | 72 | 78 |
| **Deferred income taxes** | 18 | 18 | 8 |
| **Other assets** | 5 | 9 | 7 |
| Total non-current assets | 176 | 194 | 188 |
| Total assets | $ 1,770 | $ 1,770 | $ 1,776 |
| | | | |
| **LIABILITIES AND STOCKHOLDERS DEFICIT** | | | |
| **Current liabilities:** | | | |
| Accounts payable | $ 348 | $ 273 | $ 324 |
| Accrued liabilities and other | 405 | 384 | 361 |
| Current portion of long-term debt | 135 | 1 | 1 |
| Income taxes payable | 7 | 29 | 2 |
| Total current liabilities | 895 | 687 | 688 |
| **Long-term debt** | 3,376 | 3,667 | 3,764 |
| **Deferred income taxes** | 4 | 4 | 2 |
| **Other long-term liabilities** | 77 | 76 | 86 |
| Total long-term liabilities | 3,457 | 3,747 | 3,852 |
| | 4,352 | 4,434 | 4,540 |
| **Commitments and contingencies** | | | |

| **Stockholders deficit:** | | | |
| --- | --- | --- | --- |
| Common Stock, $0.10 par value, 220,000,000 shares authorized; 118,284,809 shares issued and outstanding at October 29, 2011; 118,419,850 shares issued and outstanding at January 29, 2011; 118,419,850 shares issued and outstanding at October 30, 2010 | 12 | 12 | 12 |
| Additional paid-in capital | 46 | 43 | 41 |
| Accumulated deficit | (2,647) | (2,726) | (2,824) |
| Accumulated other comprehensive income | 7 | 7 | 7 |
| Total stockholders deficit | (2,582) | (2,664) | (2,764) |
| Total liabilities and stockholders deficit | $ 1,770 | $ 1,770 | $ 1,776 |

See accompanying notes to consolidated financial statements.

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**MICHAELS STORES, INC.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**(In millions)**

**(Unaudited)**

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | October 29, 2011 | October 30, 2010 | October 29, 2011 | October 30, 2010 |
| **Net sales** | $ 996 | $ 968 | $ 2,806 | $ 2,700 |
| Cost of sales and occupancy expense | 594 | 592 | 1,683 | 1,659 |
| **Gross profit** | 402 | 376 | 1,123 | 1,041 |
| Selling, general, and administrative expense | 279 | 269 | 774 | 747 |
| Related party expenses | 3 | 3 | 10 | 10 |
| Store pre-opening costs | 2 | 2 | 4 | 3 |
| **Operating income** | 118 | 102 | 335 | 281 |
| Interest expense | 62 | 69 | 188 | 207 |
| Loss on early extinguishment of debt | 1 | 53 | 16 | 53 |
| Other (income) and expense, net | 4 | 1 | 4 | 12 |
| **Income (loss) before income taxes** | 51 | (21) | 127 | 9 |
| Provision (benefit) for income taxes | 19 | (9) | 48 | 9 |
| **Net income (loss)** | $ 32 | $ (12) | $ 79 | $ |

See accompanying notes to consolidated financial statements.

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**MICHAELS STORES, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(In millions)**

**(Unaudited)**

| | **Nine Months Ended** | |
|---|---|---|
| | **October 29, 2011** | **October 30, 2010** |
| **Operating activities:** | | |
| Net income | $ 79 | $ |
| Adjustments: | | |
| Depreciation and amortization | 75 | 77 |
| Share-based compensation | 7 | 6 |
| Debt issuance costs amortization | 13 | 14 |
| Accretion of long-term debt | 35 | 37 |
| Change in fair value of interest rate cap | 4 | 15 |
| Change in fair value of contingent consideration | (1) | |
| Loss on early extinguishment of debt | 16 | 53 |
| Changes in assets and liabilities: | | |
| Merchandise inventories | (193) | (131) |
| Prepaid expenses and other | (8) | (6) |
| Accounts payable | 85 | 97 |
| Accrued interest | 16 | (9) |
| Accrued liabilities and other | 2 | 18 |
| Income taxes payable | (33) | (57) |
| Other long-term liabilities | 2 | 1 |
| Net cash provided by operating activities | 99 | 115 |
| | | |
| **Investing activities:** | | |
| Business Acquisition | | (2) |
| Additions to property and equipment | (84) | (61) |
| Net cash used in investing activities | (84) | (63) |
| | | |
| **Financing activities:** | | |
| Issuance of senior notes due 2018 | | 794 |
| Repayments on senior notes due 2014 | | (791) |
| Repurchase of subordinated discount notes due 2016 | (148) | |
| Repayments on senior secured term loan facility | (50) | (118) |
| Repurchase of senior subordinated notes due 2016 | (7) | |
| Borrowings on asset-based revolving credit facility | 102 | 48 |
| Payments on asset-based revolving credit facility | (102) | (48) |
| Payment of debt issuance costs | | (34) |
| Repurchase of Common Stock | (7) | |
| Proceeds from stock options exercised | 2 | |
| Change in cash overdraft | (13) | (4) |
| Other | | (1) |
| Net cash used in financing activities | (223) | (154) |
| | | |
| **Decrease in cash and equivalents** | (208) | (102) |
| **Cash and equivalents at beginning of period** | 319 | 217 |

| | | | | |
|---|---|---|---|---|
| **Cash and equivalents at end of period** | $ | 111 | $ | 115 |
| | | | | |
| **Supplemental Cash Flow Information:** | | | | |
| Cash paid for interest | $ | 123 | $ | 164 |
| Cash paid for income taxes | $ | 83 | $ | 64 |
| Non-cash investing activity: | | | | |
| Contingent consideration liability | $ | | $ | 4 |

See accompanying notes to consolidated financial statements.

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**MICHAELS STORES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**For the Quarter and Nine months Ended October 29, 2011**

**(Unaudited)**

## Note 1. Summary of Significant Accounting Policies

*Basis of Presentation*

The consolidated financial statements include the accounts of Michaels Stores, Inc. and our wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated. All expressions of the Company , us, we, our, and all similar expressions are references to Michaels Stores, Inc. and our consolidated, wholly-owned subsidiaries, unless otherwise expressly stated or the context otherwise requires.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. Therefore, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended January 29, 2011.

The balance sheet at January 29, 2011 has been derived from the audited financial statements at that date, but does not include all of the information and notes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring accruals and other items) considered necessary for a fair presentation have been included.

Because of the seasonal nature of our business, the results of operations for the quarter ended October 29, 2011 are not indicative of the results to be expected for the entire year.

We report on the basis of a 52 or 53-week fiscal year, which ends on the Saturday closest to January 31. All references herein to fiscal 2011 relate to the 52 weeks ending January 28, 2012, and all references to fiscal 2010 relate to the 52 weeks ended January 29, 2011. In addition, all references herein to the third quarter of fiscal 2011 relate to the 13 weeks ended October 29, 2011, and all references to the third quarter of fiscal 2010 relate to the 13 weeks ended October 30, 2010. Finally, all references to the nine months ended October 29, 2011 relate to the 39 weeks ended October 29, 2011, and the nine months ended October 30, 2010 relate to the 39 weeks ended October 30, 2010.

*Recent Accounting Pronouncements*

In January 2010, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2010-06, *Improving Disclosures About Fair Value Measurements* an amendment to Accounting Standards Codification ( ASC ) topic 820, *Fair Value Measurements and Disclosures.* ASU 2010-06 expands disclosure requirements related to fair value measurements including (i) separately disclosing the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describing the reasons for the transfers and (ii) presenting separate information for Level 3 activity pertaining to gross purchases, sales, issuances, and settlements. The new disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the Level 3 activity disclosures, which are effective for fiscal years beginning after December 15, 2010. We adopted all requirements of ASU 2010-06 related to significant transfers in and out of Level 1 and Level 2 fair value measurements on January 31, 2010, with no material impact on our consolidated financial statements. We adopted the new disclosure requirements related to the Level 3 activity on January 30, 2011, with no material impact on our consolidated financial statements. See Note 6 for further information regarding fair value measurements.

In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*, an amendment to ASC topic 220, *Comprehensive Income*. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of shareholders equity. Instead, comprehensive income must be reported in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. The amended guidance, which must be applied retroactively, is effective for interim and annual periods beginning after December 15, 2011, with earlier adoption permitted. We will adopt all requirements of ASU 2011-05 on January 29, 2012, the beginning of our 2012 fiscal year.

In September 2011, the FASB issued ASU No. 2011-08, *Intangibles Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. ASU 2011-08 allows entities testing for goodwill impairment to have the option of performing a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If an entity believes, as a result of its qualitative assessment, it is more-likely-than-not the fair value of a reporting unit is less than its carrying amount, the currently prescribed two-step goodwill impairment test must be performed. Otherwise, no further testing is required. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. We plan to early adopt ASU 2011-08 in the fourth quarter of fiscal 2011.

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**Note 2.  Share-Based Compensation**

The 2006 Equity Incentive Plan (  2006 Plan  ) provides for the grant of share-based awards exercisable for up to 14.2 million shares of Common Stock. As of October 29, 2011, there were 10.7 million stock option awards outstanding. In addition, there were a total of 579,661 shares of restricted stock outstanding under the 2006 Plan, of which 167,075 are vested. Under the 2006 Plan, there are 2.7 million shares of Common Stock remaining available for grant. The table below sets forth a summary of stock option activity for the nine months ended October 29, 2011:

| | Nine Months Ended October 29, 2011 (in millions) |
|---|---|
| Outstanding at beginning of period | 10.9 |
| Granted | 0.2 |
| Exercised | (0.1) |
| Cancelled/Forfeited | (0.3) |
| Outstanding at end of period | 10.7 |

Generally, awards granted under the 2006 Plan vest ratably over five years and expire eight years from the grant date. The exercise prices of the options ranged from $7.50 per share to $22.50 per share, as determined by the Board of Directors. Share-based compensation expense associated with the stock options and the restricted stock was $3 million and $2 million for the third quarter of fiscal 2011 and fiscal 2010, respectively, and $7 million and $6 million for the nine months ended October 29, 2011 and October 30, 2010, respectively.

**Note 3.  Debt**

Our outstanding debt is detailed in the table below.  We were in compliance with the terms and conditions of all debt agreements for all periods presented.

| | October 29, 2011 | January 29, 2011 (in millions) | October 30, 2010 | Interest Rate |
|---|---|---|---|---|
| Senior secured term loan | $ 1,996 | $ 2,046 | $ 2,156 | Variable |
| Senior notes | 795 | 794 | 794 | 7.750% |
| Senior subordinated notes | 393 | 400 | 400 | 11.375% |
| Subordinated discount notes | 327 | 427 | 414 | 13.000% |
| Asset-based revolving credit facility | | | | Variable |
| Other | | 1 | 1 | 5.970% |
| Total debt | 3,511 | 3,668 | 3,765 | |
| Less current portion | 135 | 1 | 1 | |
| Long-term debt | $ 3,376 | $ 3,667 | $ 3,764 | |

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*7¾% Senior Notes due 2018*

On October 21, 2010, we issued $800.0 million aggregate principal amount of 7¾% Senior Notes that mature on November 1, 2018 (the 2018 Senior Notes ), which were sold at a discounted price of 99.262% of face value, resulting in an effective interest rate of 77/8%. The 2018 Senior Notes are guaranteed, jointly and severally, on an unsecured senior basis, by each of our subsidiaries that guarantee indebtedness under our senior secured asset-based revolving credit facility and senior secured term loan facility.

In connection with the issuance of the 2018 Senior Notes, we entered into a registration rights agreement. Under the terms of the registration rights agreement, we were required to file, and did initially file on April 28, 2011, an exchange offer registration statement, as amended (the Exchange Offer Registration Statement ), enabling holders to exchange the 2018 Senior Notes for registered notes with terms identical in all material respects to the terms of the 2018 Senior Notes, except the exchange notes would be freely tradable. We also agreed to use our reasonable best efforts to have the Exchange Offer Registration Statement declared effective by the Securities and Exchange Commission (the SEC ) no later than 360 days after the date of the issuance of the 2018 Senior Notes. On June 20, 2011, the Exchange Offer Registration Statement was declared effective by the SEC. We completed the exchange offer on August 1, 2011.

*113/8% Senior Subordinated Notes due 2016*

During the third quarter of fiscal 2011, we completed open market repurchases of our outstanding 113/8% Senior Subordinated Notes due 2016 ( Senior Subordinated Notes ) totaling $7 million. Pursuant to the terms of the repurchases, we agreed to pay the holders of the Senior Subordinated Notes face value plus a purchase premium. In accordance with ASC 470, *Debt,* we recorded a loss related to the early extinguishment of the repurchased Senior Subordinated Notes, which was immaterial to the consolidated financial statements.

*13% Subordinated Discount Notes due 2016*

During the third quarter of fiscal 2011, we completed open market repurchases of our outstanding 13% Subordinated Discount Notes due 2016 ( Subordinated Discount Notes ) totaling $18 million. During the first nine months of fiscal 2011, we completed open market repurchases of our outstanding Subordinated Discount Notes totaling $142 million face value, or $134 million accreted value. Pursuant to the terms of the repurchases, we agreed to pay the holders of the Subordinated Discount Notes face value plus a purchase premium.

In accordance with ASC 470, we recorded a loss of $1 million and $16 million during the third quarter and nine months ended October 29, 2011, respectively, related to the early extinguishment of the repurchased Subordinated Discount Notes. The $1 million loss is for the purchase premiums paid. The $16 million loss is comprised of $10 million to recognize the unrealized interest accretion and the write off of related debt issuance costs, as well as $6 million in purchase premiums.

On May 1, 2012, and, if necessary, any interest payment date thereafter prior to the maturity date of the Subordinated Discount Notes, we are required to redeem a portion of each Subordinated Discount Note outstanding on such date equal to an amount sufficient, but not in excess of the amount necessary, to ensure that such Subordinated Discount Note will not be an applicable high yield discount obligation ( AHYDO ) within the

meaning of Section 163(i)(1) of the Internal Revenue Code of 1986, as amended. These redemptions are to be at a price equal to 100% of the Accreted Value of such portion as of the date of redemption. As of October 29, 2011, the payment required to ensure the Subordinated Discount Notes will not be an AHYDO was $135 million and is classified as Current portion of long-term debt on the Consolidated Balance Sheets.

*Senior Secured Asset-Based Revolving Credit Facility*

Our senior secured asset-based revolving credit facility, provides an aggregate amount of $850 million in tranche A commitments, which are scheduled to terminate on the earlier of April 15, 2014, or 45 days prior to the maturity date of any class of term loans in the Company s senior secured term loan facility. On April 8, 2011, the Company elected to permanently terminate $50 million in commitments under a last out tranche.

The borrowing base under the senior secured asset-based revolving credit facility equals the sum of (i) 90% of eligible credit card receivables and debit card receivables; (ii) between 85% and 87.5% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit; and (iii) a percentage of eligible in-transit inventory, less certain reserves. As of October 29, 2011, the borrowing base was $802 million, of which we had no outstanding borrowings, $55 million of outstanding letters of credit, and $747 million of excess availability.

**Note 4. Comprehensive Income (Loss)**

Our comprehensive income (loss), net of related tax, is as follows:

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | October 29, 2011 | October 30, 2010 | October 29, 2011 | October 30, 2010 |
| | (in millions) | | | |
| Net income (loss) | $ 32 | $ (12) | $ 79 | $ |
| Other comprehensive income: | | | | |
| Foreign currency translation adjustment and other | (1) | | | 1 |
| Comprehensive income | $ 31 | $ (12) | $ 79 | $ 1 |

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Accumulated other comprehensive income, net of tax, is reflected in the Consolidated Balance Sheets as follows:

| | Foreign Currency Translation and Other (in millions) |
|---|---|
| Balance at January 29, 2011 | $ 7 |
| Foreign currency translation adjustment | |
| Balance at October 29, 2011 | $ 7 |

**Note 5. Derivative Instruments**

We are exposed to fluctuations in interest rates on our senior secured term loan facility. During fiscal 2009, we purchased an interest rate derivative with the objective to cap our exposure to interest rate increases on our senior secured term loan facility that result from fluctuations in the three-month LIBOR rate. The cap limits our interest exposure on a notional value of $2.0 billion to the lesser of the three-month LIBOR rate or 7.0%. The term of the cap extends to the first quarter of fiscal 2015. The interest rate cap does not qualify for hedge accounting under ASC 815, *Derivatives and Hedging*. The fair value of the cap as of October 29, 2011, January 29, 2011 and October 30, 2010 was $2 million, $6 million and $3 million, respectively, and is included in Other assets on the Consolidated Balance Sheets. The change in fair value of the cap for the quarter and nine months ended October 29, 2011 resulted in a loss of $1 million and a loss of $4 million, respectively. The change in fair value of the cap for the quarter and nine months ended October 30, 2010, resulted in a loss of $2 million and a loss of $15 million, respectively. These amounts are recorded in Other (income) and expense, net in the Consolidated Statements of Operations.

**Note 6. Fair Value Measurements**

As defined in ASC 820, *Fair Value Measurements and Disclosures*, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 establishes a three-level valuation hierarchy for fair value measurements. These valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions. These two types of inputs create the following fair value hierarchy:

- Level 1 Quoted prices for *identical* instruments in active markets;
- Level 2 Quoted prices for *similar* instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose significant inputs are observable; and
- Level 3 Instruments whose significant inputs are *unobservable.*

The following table presents net financial assets (liabilities) accounted for at fair value on a recurring basis as of October 29, 2011 (in millions):

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Interest Rate Cap | $ | $ 2 | $ | $ 2 |
| Contingent consideration | $ | $ | $ (3) | $ (3) |

The interest rate cap is measured using widely accepted valuation techniques including a discounted cash flow analysis on the expected cash flows. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The fair value of the interest rate cap is determined using the market standard methodology of discounting the future expected variable cash receipts that would occur if variable interest rates rise above the strike rate of the cap. The variable cash receipts are based on an expectation of future interest rates (forward curves) derived from observable market interest rate curves. See Note 5 for additional information on our derivative instruments.

In connection with the acquisition of certain assets of ScrapHD, the Company has a contingent obligation, to be paid in cash, to the owners of ScrapHD based on future operating performance, up to $10 million. The fair value of this contingent consideration is determined using an expected present value technique. Expected operating results are determined using the probability-weighted average of possible outcomes that would occur should certain financial metrics be reached. There is no market data available to use in valuing the contingent consideration; therefore, the Company developed its own assumptions related to the future financial performance of the business to estimate the fair value of the liability which was then discounted to present value using the weighted average cost of capital. The weighted average cost of capital was derived from comparable companies and management s estimates. The contingent consideration was established at the time of acquisition and will be evaluated at each reporting period. We reduced the fair value of our contingent consideration liability from $4 million as of January 29, 2011 to $3 million as of July 30, 2011. The $1 million gain from the change in the fair value of the contingent consideration is recorded in Selling, general, and administrative expense on the Consolidated Statements of Operations. The liability is recorded in Other long-term liabilities on the Consolidated Balance Sheets. There have been no material changes to the fair value since July 30, 2011.

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We apply fair value techniques on a non-recurring basis for the establishment of potential impairment loss related to goodwill pursuant to ASC 350, *Intangibles Goodwill and Other* and determining the fair value of long-lived assets pursuant to ASC 360, *Property, Plant, and Equipment.* During the quarter and nine months ended October 29, 2011, there were no events or changes in circumstances indicating the carrying amounts of our long-lived assets may not be recoverable.

The table below provides the carrying and fair values of our loan and notes as of October 29, 2011. The fair value of these debt instruments was determined based on quoted market prices or recent trades.

| | Carrying Value | Fair Value |
|---|---|---|
| | (in millions) | |
| Senior secured term loan | $ 1,996 | $ 1,968 |
| Senior notes | 795 | 816 |
| Senior subordinated notes | 393 | 417 |
| Subordinated discount notes | 327 | 349 |

**Note 7. Income Taxes**

During the third quarter of fiscal 2011, we recorded a tax provision of $19 million at an effective tax rate of 36.8%. During the third quarter of fiscal 2010, we recorded a tax benefit of $9 million at an effective rate of 41.4%. The higher effective tax rate in fiscal 2010 was driven primarily by the impact of discrete items for the quarter.

The effective tax rate was 37.7% for the first nine months of fiscal 2011. For the first nine months of fiscal 2010, we recorded a tax provision of $9 million, of which $5 million was to correct the federal deferred tax liability relating to state income taxes and $1 million related to other discrete items. We currently estimate our annualized effective tax rate for fiscal 2011 to be 37.6%.

**Note 8. Commitments and Contingencies**

We are involved in ongoing legal and regulatory proceedings. Other than those described in the following paragraphs, there were no material changes to our disclosures of commitments and contingencies from our Annual Report on Form 10-K for the fiscal year ended January 29, 2011 and our Quarterly Reports on Form 10-Q for the quarterly periods ended April 30, 2011 and July 30, 2011.

*Employee Claims*

*Rea Claim*

On September 15, 2011, the Company was served with a lawsuit filed on September 13, 2011 in the California Superior Court in and for the County of Orange ( Superior Court ) by four former store managers as a purported class action proceeding on behalf of themselves and certain former and current store managers employed by Michaels stores in California. We removed the lawsuit to the United States District Court for the Central District of California on October 17, 2011, which removal is being contested by plaintiffs. The lawsuit alleges that the Company stores improperly classified its store managers as exempt employees and as such failed to pay all wages, overtime, waiting time penalties and failed to provide accurate wage statements. The lawsuit also alleges that the foregoing conduct was in breach of various laws, including California s unfair competition law. The plaintiffs have pled less than five million dollars in damages, penalties, costs of suit and attorneys fees, exclusive of interest. We believe we have meritorious defenses and intend to defend the lawsuit vigorously.

*Consumer Class Action Claims*

*Zip Code Claims*

On August 15, 2008, Linda Carson, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the Superior Court of California, County of San Diego ( San Diego Superior Court ), on behalf of herself and all similarly-situated California consumers. The Carson lawsuit alleges that Michaels unlawfully requested and recorded personally identifiable information (i.e., her zip code) as part of a credit card transaction. The plaintiff sought statutory penalties, costs, interest, and attorneys fees. We contested certification of this claim as a class action and filed a motion to dismiss the claim. On March 9, 2009, the Court dismissed the case with prejudice. The plaintiff appealed this decision to the California Court of Appeal for the Fourth District, San Diego. On

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July 22, 2010, the Court of Appeal upheld the dismissal of the case. The plaintiff appealed this decision to the Supreme Court of California ( California Supreme Court ). On September 29, 2010, the California Supreme Court granted the plaintiff s petition for review; however, it stayed any further proceedings in the case until another similar zip code case pending before the court, Pineda v. Williams-Sonoma, was decided. On February 10, 2011, the California Supreme Court ruled, in the Williams-Sonoma case, that zip codes are personally identifiable information and therefore the Song-Beverly Credit Card Act of 1971, as amended ( Song Act ) prohibits businesses from requesting or requiring zip codes in connection with a credit card transaction. On or about April 6, 2011, the Supreme Court transferred the Carson case back to the Court of Appeal with directions to the Court to reconsider its decision in light of Pineda decision. Upon reconsideration the Court of Appeal remanded the case back to the San Diego Superior Court. We are reviewing the matter in light of this recent decision and, at this time, we are unable to estimate a range of loss, if any, in this case.

Additionally, since the California Supreme Court decision on February 10, 2011, three additional purported class action lawsuits alleging violations of the Song Act have been filed against the Company: Carolyn Austin v. Michaels Stores, Inc. and Tiffany Heon v. Michaels Stores, Inc., both in the San Diego Superior Court and Sandra A. Rubinstein v. Michaels Stores, Inc. in the Superior Court of California, County of Los Angeles, Central Division. Unopposed motions to coordinate these actions have been filed and an order recommending the coordination has been entered. Also, relying in part on the California Supreme Court decision, an additional purported class action lawsuit was filed on May 20, 2011 against the Company: Melissa Tyler v. Michaels Stores, Inc. in the United States District Court-District of Massachusetts, alleging violation of a similar Massachusetts statute regarding the collection of personally identifiable information in connection with a credit card transaction. A hearing was held on October 20, 2011 on our Motion to Dismiss the claims and the decision is pending. We intend to vigorously defend each of these cases and we are unable, at this time, to estimate a range of loss, if any.

*Gift Card Claims*

On April 9, 2010, Ross Rattray, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the San Diego Superior Court, on behalf of himself and all similarly-situated California consumers. The Rattray lawsuit alleges causes of action for unlawful and unfair business practices and false advertising under the California Business and Professions Code, and a violation of the Consumer Legal Remedies Act, for misrepresentation that Michaels gift cards are not redeemable for cash and for failure to disclose that the plaintiff could redeem the unused cash balance on a gift card when the value fell below $10.00. On March 15, 2011, the matter was mediated and a tentative settlement agreement was reached with the plaintiff. The settlement was approved by the Court and was finalized on October 21, 2011, for an immaterial amount.

*Data Breach Claims*

*Payment Card Terminal Tampering*

On May 3, 2011, we were advised by the U.S. Secret Service that they were investigating certain fraudulent debit card transactions that occurred on accounts that had been used for legitimate purchases in selected Michaels stores. A subsequent internal investigation revealed that approximately 90 payment card terminals in certain Michaels stores had been physically tampered with, potentially resulting in customer debit and credit card information to be compromised. We have since removed and replaced approximately 7,200 payment card terminals comparable to the identified tampered payment card terminals from our Michaels stores. The Company continues to cooperate with various governmental entities and law enforcement authorities in investigating the payment card terminal tampering, but we do not know the full extent of any fraudulent use of such information.

On May 18, 2011, Brandi F. Ramundo, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the United States District Court for the Northern District of Illinois, on behalf of herself and all similarly-situated U.S. consumers. The Ramundo lawsuit alleges that Michaels failed to take commercially reasonable steps to protect consumer financial data, and was in breach of contract and various laws, including the Federal Stored Communications Act and the Illinois Consumer Fraud and Deceptive Practices Act. The plaintiff seeks compensatory, statutory and punitive damages, costs, credit card fraud monitoring services, interest and attorneys fees. Subsequently three additional purported class action lawsuits significantly mirroring the claims in the Ramundo complaint were filed against the Company: Mary Allen v. Michaels Stores, Inc., Kimberly Siprut v. Michaels Stores, Inc., and Jeremy Williams v. Michaels Stores, Inc., all in the United States District Court for the Northern District of Illinois. On June 8, 2011, an order was entered consolidating all four matters, which also provided for future consolidation of all related actions subsequently filed or transferred. On July 8, 2011, a Consolidated Amended Class Action Complaint styled In Re Michaels Stores Pin Pad Litigation ( In Re Michaels Stores Consolidated Complaint ) was filed in the United States District Court for the Northern District of Illinois and on August 8, 2011, we filed a Motion to Dismiss the In Re Michaels Stores Consolidated Complaint. A hearing on this motion was held on October 27, 2011 and the decision is pending. On August 25, 2011, subsequent to the filing of the Consolidated Complaint and our Motion to Dismiss, a fifth class action, Sherry v. Michaels Stores, Inc., was filed in the United States District Court for the Northern District of Illinois. On September 29, 2011, the Sherry case was reassigned and consolidated into the Consolidated Complaint. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We are unable to estimate a range of loss, if any, in the case.

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Two additional purported class action lawsuits significantly mirroring the claims in the In Re Michaels Stores Consolidated Complaint have been filed against the Company in New Jersey: Sara Rosenfeld and Ilana Soffer v. Michaels Stores, Inc. filed in the Superior Court of New Jersey on July 7, 2011, removed to the United States District Court of New Jersey on August 5, 2011, and transferred to the Northern District of Illinois on September 9, 2011 and reassigned and consolidated into the Consolidated Complaint; and Lori Wilson v. Michaels Stores, Inc. filed in the Superior Court of New Jersey on August 10, 2011. We have requested that the Wilson case be transferred and consolidated as well by filing the request with the Judicial Panel on Multi-District Litigation. We believe we have meritorious defenses and intend to defend the lawsuits vigorously. We are unable to estimate a range of loss, if any, in these cases.

*General*

We are a defendant from time to time in lawsuits incidental to our business. Based on currently available information, we believe that resolution of all known contingencies is uncertain. There can be no assurance that future costs of such litigation would not be material to our financial position, results of operations, or cash flows.

**Note 9. Segments and Geographic Information**

We consider our Michaels and Aaron Brothers operations to be our operating segments for purposes of determining reportable segments based on the criteria of ASC 280, *Segment Reporting*. We determined that our Michaels and Aaron Brothers operating segments have similar economic characteristics and meet the aggregation criteria set forth in ASC 280. Therefore, we combine both operating segments into one reporting segment.

Our chief operating decision makers evaluate historical operating performance, plan and forecast future periods operating performance based on earnings before interest, income taxes, depreciation and amortization ( EBITDA ). We believe EBITDA represents the financial measure that more closely reflects the operating effectiveness of factors over which management has control. As such, an element of base incentive compensation targets for certain management personnel are based on EBITDA. A reconciliation of EBITDA to income before income taxes is presented below.

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | October 29, 2011 | October 30, 2010 | October 29, 2011 | October 30, 2010 |
| | (in millions) | | | |
| Income (loss) before income taxes | $ 51 | $ (21) | $ 127 | $ 9 |
| Interest expense | 62 | 69 | 188 | 207 |
| Loss on early extinguishment of debt | 1 | 53 | 16 | 53 |
| Depreciation and amortization | 25 | 25 | 75 | 77 |
| EBITDA | $ 139 | $ 126 | $ 406 | $ 346 |

Our sales and assets by country are as follows:

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | October 29, 2011 | October 30, 2010 | October 29, 2011 | October 30, 2010 |
| | (in millions) | | | |
| **Net Sales:** | | | | |
| United States | $ 906 | $ 882 | $ 2,551 | $ 2,467 |
| Canada | 90 | 86 | 255 | 233 |
| Consolidated Total | $ 996 | $ 968 | $ 2,806 | $ 2,700 |
| | | | | |
| **Total Assets:** | | | | |
| United States | $ 1,660 | $ 1,678 | $ 1,660 | $ 1,678 |
| Canada | 110 | 98 | 110 | 98 |
| Consolidated Total | $ 1,770 | $ 1,776 | $ 1,770 | $ 1,776 |

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**Note 10. Related Party Transactions**

We pay annual management fees to Bain Capital Partners, LLC and The Blackstone Group (collectively, together with their applicable affiliates, the Sponsors ) and Highfields Capital Management LP in the amount of $12 million and $1 million, respectively. We recognized $3 million of expense related to annual management fees during the third quarter of each of fiscal 2011 and fiscal 2010 and $10 million during each of the nine months ended October 29, 2011 and October 30, 2010. These expenses are included in related party expenses on the Consolidated Statements of Operations.

Bain Capital owns a majority equity position in an external vendor we utilized to print our circular advertisements. During the first quarter of fiscal 2011, we stopped utilizing this vendor for these services. Payments associated with this vendor during the third quarter of fiscal 2010 were $9 million. Payments for the nine months ended October 29, 2011 and October 30, 2010 were $6 million and $24 million, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations.

Bain Capital owns a majority equity position in an external vendor we began utilizing for print procurement services during the fourth quarter of fiscal 2010. Payments associated with this vendor during the three and nine months ended October 29, 2011, were $1 million and $3 million, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations.

The Blackstone Group owns a majority equity position in an external vendor we utilize to count our store inventory. Payments associated with this vendor during the third quarter of each of fiscal 2011 and fiscal 2010 were $2 million. Payments for each of the nine months ended October 29, 2011 and October 30, 2010 were $6 million. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations.

The Blackstone Group owns a majority equity position in an external vendor we utilize for all of the candy-type items in our stores. Payments associated with this vendor during the third quarter of fiscal 2011 and fiscal 2010 were $4 million and $5 million, respectively. Payments for the nine months ended October 29, 2011, and October 30, 2010, were $17 million and $14 million, respectively. These expenses are recognized in cost of sales as the sales are recorded.

The Blackstone Group owns a partially equity position in an external vendor we utilize for hospitality services. Payments associated with this vendor during the third quarter and nine months ended October 29, 2011 were $1 million. These expenses are included in selling, general, and administrative expense on the Consolidated Statements of Operations.

During the second quarter of fiscal 2011, The Blackstone Group acquired a majority equity position in a vendor we utilize to lease certain properties. Payments associated with this vendor during the three and nine months ended October 29, 2011, were $1 million and $2 million, respectively. These expenses are included in cost of sales and occupancy expense on the Consolidated Statements of Operations.

The Company periodically provides officers of Michaels Stores, Inc. and its subsidiaries the opportunity to purchase shares of our Common Stock. There were no shares sold to officers during first nine months of each of fiscal 2011 and fiscal 2010. Also, during the third quarter of

fiscal 2011 and the nine months ended October 29, 2011, we repurchased 17,333 and 192,001 shares, respectively, from officers who are no longer with the Company. There were no shares repurchased during the first nine months of fiscal 2010.

**Note 11. Condensed Consolidating Financial Information**

All obligations of Michaels Stores, Inc. under the Senior notes, Senior subordinated notes, Subordinated discount notes, senior secured term loan facility, and senior secured asset-based revolving credit facility are guaranteed by each of our subsidiaries other than Aaron Brothers Card Services, LLC and Artistree of Canada, ULC. As of October 29, 2011, the financial statements of Aaron Brothers Card Services, LLC and Artistree of Canada, ULC were immaterial. Each subsidiary guarantor is 100% owned by the parent and all guarantees are joint and several.

The following condensed consolidating financial information represents the financial information of Michaels Stores, Inc. and its wholly-owned subsidiary guarantors, prepared on the equity basis of accounting. The information is presented in accordance with the requirements of Rule 3-10 under the SEC s Regulation S-X. The financial information may not necessarily be indicative of results of operations, cash flows, or financial position had the subsidiary guarantors operated as independent entities.

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**Supplemental Condensed Consolidating Balance Sheet**

| | October 29, 2011 | | | |
|---|---|---|---|---|
| | Parent Company | Guarantor Subsidiaries | Eliminations | Consolidated |
| | (in millions) | | | |
| **ASSETS** | | | | |
| **Current assets:** | | | | |
| Cash and equivalents | $ 97 | $ 14 | $ | $ 111 |
| Merchandise inventories | 677 | 342 | | 1,019 |
| Intercompany receivables | | 512 | (512) | |
| Other | 125 | 23 | | 148 |
| Total current assets | 899 | 891 | (512) | 1,278 |
| **Property and equipment, net** | 251 | 65 | | 316 |
| **Goodwill** | 95 | | | 95 |
| **Investment in subsidiaries** | 481 | | (481) | |
| **Other assets** | 80 | 1 | | 81 |
| Total assets | $ 1,806 | $ 957 | $ (993) | $ 1,770 |
| | | | | |
| **LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY** | | | | |
| **Current liabilities:** | | | | |
| Accounts payable | $ 9 | $ 339 | $ | $ 348 |
| Accrued liabilities and other | 280 | 125 | | 405 |
| Current portion of long-term debt | 135 | | | 135 |
| Intercompany payable | 512 | | (512) | |
| Other | 7 | | | 7 |
| Total current liabilities | 943 | 464 | (512) | 895 |
| **Long-term debt** | 3,376 | | | 3,376 |
| **Other long-term liabilities** | 69 | 12 | | |