MICHAELS STORES INC
Form 10-Q/A
December 09, 2013
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q/A

(Mark One)

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

For the quarterly period ended August 3, 2013

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

MICHAELS STORES, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**75-1943604** (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)

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 o 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 (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 August 26, 2013, 100 shares of the Registrant s Common Stock were outstanding.

*The Registrant has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, but is not required to file such reports under such sections.

Table of Contents

Explanatory Note

Michaels Stores, Inc. (Company) is filing this Amendment No. 1 (Form 10-Q/A) to its Quarterly Report on Form 10-Q for the quarter ended August 3, 2013, filed with the Securities and Exchange Commission (SEC) on August 30, 2013 (the Form 10-Q), for the purpose of correcting historical share-based compensation expense caused by the Company s repurchase of shares that had not been held for at least six months following the exercise of stock options under its equity incentive plans. Since the participants held such shares for less than six months following exercise (immature shares), liability accounting applies to the plan.

The Company has determined its previously issued unaudited interim consolidated financial statements for the three and six month periods ended August 3, 2013 and July 28, 2012, contained an error with respect to ASC 718, *Compensation Stock Compensation.* Specifically, former participants in the Company s Equity Incentive Plan and its successor Plan (The Michaels Companies, Inc. (Parent) Equity Incentive Plan, together the Plan) exercised stock options upon their termination from the Company, and the Company repurchased the immature shares. The Company consistently repurchased shares in this manner and therefore, under accounting rules, established a pattern of repurchasing immature shares during the third quarter of 2011. The Company determined all stock options should have been treated as liability awards in accordance with the rules of ASC 718-10-25-9. Under liability accounting, the Company re-measures the fair value of stock compensation each period and recognizes changes in fair value as awards vest and until the award is settled. The Company originally recognized expense ratably over the vesting period based on the grant date fair value of the option in accordance with the fixed method of accounting. The Company determined the accounting error was material to fiscal 2011 and fiscal 2012 financial statements and those financial statements required restatement. As a result, the Company is also restating its financial statements for the three and six months ended August 3, 2013 and July 28, 2012. The impact to share-based compensation expense for the three and six months ended August 3, 2013 was $7 million ($5, Net of tax) and $12 million ($8, Net of tax), respectively. For the three and six months ended July 28, 2012 the impact was $6 million ($4, Net of tax) and $9 million ($5, Net of tax), respectively. As part of the restatement, the Company also recorded other adjustments related to merchandise inventories and the reserve for closed facilities which were previously determined to be immaterial to the respective periods. In total, the adjustments resulted in a decline of net income by $3 million and $4 million for the three and six month periods ended August 3, 2013, respectively, and by $4 million and $6 million for the three and six month periods ended July 28, 2012.

In connection with the restatement of our consolidated financial statements described herein, management re-evaluated the Company s internal controls over financial reporting and disclosure controls and share repurchase procedures. It was determined a material weakness existed beginning in the third quarter of 2011 due to management s failure to identify the accounting implications under ASC 718 related to the Company s practice of repurchasing immature shares following option exercises by employees upon termination of employment, as well as its failure to follow internal controls relating to the repurchase of shares. For a discussion of management s consideration of the Company s internal control over financial reporting and the material weakness identified, see Item 4.

For convenience of the reader, this amended filing sets forth the original filing, in its entirety. The following items have been amended principally as a result of, and to reflect, the restatement:

Part I, Item 1	- Financial Statements (unaudited)
Part I, Item 2	- Management s Discussion and Analysis of Financial Condition and Results of Operations
Part I, Item 4	- Controls and Procedures

In accordance with applicable SEC rules, this Amended Filing includes new certifications as required by Rule 12b-15 under the Securities Exchange Act of 1934, as amended (the Exchange Act) from our Chief Executive Officer and Chief Financial Officer dated as of the date of filing of this Amended Filing.

The remaining items contained within this amended report consist of all other items originally contained in the Form 10-Q and are included for the convenience of the reader. The sections of the Form 10-Q which were not amended are unchanged and continue in full force and effect as originally filed. This amended report speaks as of the date of the original filing and has not been updated to reflect events occurring subsequent to the original filing other than those associated with the restatement of our financial statements.

Table of Contents

MICHAELS STORES, INC.

FORM 10-Q

Table of Contents

MICHAELS STORES, INC.

Part I FINANCIAL INFORMATION

Item 1. Financial Statements.

MICHAELS STORES, INC.

CONSOLIDATED BALANCE SHEETS

(in millions, except share data)

(Unaudited)

	August 3, 2013 (Restated)	February 2, 2013 (Restated)	July 28, 2012 (Restated)
ASSETS			
Current assets:			
Cash and equivalents	$ 51	$ 56	$ 113
Merchandise inventories	909	862	925
Prepaid expenses and other	96	86	89
Deferred income taxes	38	37	42
Income tax receivable	36	3	27
Total current assets	1,130	1,044	1,196
Property and equipment, at cost	1,542	1,502	1,438
Less accumulated depreciation and amortization	(1,195)	(1,164)	(1,112)
Property and equipment, net	347	338	326
Goodwill	94	94	95
Debt issuance costs, net of accumulated amortization of $54, $54, and $82, respectively	40	46	51
Deferred income taxes	29	30	32
Other assets	5	3	3
Total non-current assets	168	173	181
Total assets	$ 1,645	$ 1,555	$ 1,703
LIABILITIES AND STOCKHOLDERS DEFICIT			
Current liabilities:			
Accounts payable	$ 289	$ 263	$ 277
Accrued liabilities and other	335	367	353
Share-based compensation liability	19	35	29
Current portion of long-term debt	238	150	1
Deferred income taxes	4	4	1
Income taxes payable		37	
Total current liabilities	885	856	661
Long-term debt	2,882	2,891	3,363
Deferred income taxes	2	2	11
Share-based compensation liability	26	27	23

Other long-term liabilities		81		83		86
Total long-term liabilities		2,991		3,003		3,483
Total liabilities		3,876		3,859		4,144
Commitments and contingencies						
Stockholders deficit:						
Common Stock, $0.10 par value, 100 shares authorized; 100 shares issued and outstanding						
Additional paid-in capital		61		49		52
Accumulated deficit		(2,296)		(2,359)		(2,499)
Accumulated other comprehensive income		4		6		6
Total stockholders deficit		(2,231)		(2,304)		(2,441)
Total liabilities and stockholders deficit	$	1,645	$	1,555	$	1,703

See accompanying notes to consolidated financial statements.

Table of Contents

MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(Unaudited)

	Quarter Ended		Six Months Ended	
	August 3, 2013	July 28, 2012 (Restated)	August 3, 2013	July 28, 2012 (Restated)
Net sales	$ 904	$ 892	$ 1,897	$ 1,870
Cost of sales and occupancy expense	567	557	1,151	1,124
Gross profit	337	335	746	746
Selling, general, and administrative expense	254	251	526	510
Share-based compensation	8	3	11	7
Related party expenses	3	4	7	7
Store pre-opening costs	1	1	3	2
Operating income	71	76	199	220
Interest expense	45	61	92	127
Refinancing costs and losses on early extinguishment of debt			7	
Other (income) and expense, net	1		1	(1)
Income before income taxes	25	15	99	94
Provision for income taxes	8	6	36	34
Net income	17	9	63	60
Other comprehensive income, net of tax:				
Foreign currency translation adjustment and other	(1)	(2)	(2)	
Comprehensive income	$ 16	$ 7	$ 61	$ 60

See accompanying notes to consolidated financial statements.

Table of Contents

MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(Unaudited)

	Six Months Ended	
	August 3, 2013	July 28, 2012
		(Restated)
Operating activities:		
Net income	$ 63	$ 60
Adjustments:		
Depreciation and amortization	50	46
Share-based compensation	13	11
Debt issuance costs amortization	4	8
Refinancing costs and losses on early extinguishment of debt	7	
Changes in assets and liabilities:		
Merchandise inventories	(47)	(82)
Prepaid expenses and other	(13)	(9)
Accounts payable	43	(23)
Accrued interest	(2)	(4)
Accrued liabilities and other	(59)	(42)
Income taxes	(71)	(46)
Other long-term liabilities	(2)	1
Net cash used in operating activities	(14)	(80)
Investing activities:		
Additions to property and equipment	(50)	(45)
Net cash used in investing activities	(50)	(45)
Financing activities:		
Redemption of senior subordinated notes due 2016	(142)	
Repurchase of subordinated discount notes due 2016		(127)
Repayments on senior secured term loan facility	(4)	
Borrowings on asset-based revolving credit facility	375	
Payments on asset-based revolving credit facility	(154)	
Payment of capital leases	(2)	(1)
Change in cash overdraft	(14)	(5)
Net cash provided by (used in) financing activities	59	(133)
Net decrease in cash and equivalents	(5)	(258)
Cash and equivalents at beginning of period	56	371
Cash and equivalents at end of period	$ 51	$ 113
Supplemental Cash Flow Information:		
Cash paid for interest	$ 89	$ 122
Cash paid for income taxes	$ 109	$ 80

See accompanying notes to consolidated financial statements.

6

Table of Contents

MICHAELS STORES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Quarter and Six Months Ended August 3, 2013

(Unaudited)

Note 1. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of Michaels Stores, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated. All expressions of the Company , Michaels , us, we, our, and all similar expressions are references to Michaels Stores, Inc. and its 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 (GAAP) 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 GAAP 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 February 2, 2013.

The balance sheet at February 2, 2013 has been derived from the restated audited financial statements at that date, but does not include all of the information and notes required by GAAP 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 August 3, 2013 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 2013 relate to the 52 weeks ending February 1, 2014, and all references to fiscal 2012 relate to the 53 weeks ended February 2, 2013. In addition, all references herein to the second quarter of fiscal 2013 relate to the 13 weeks ended August 3, 2013, and all references to the second quarter of fiscal 2012 relate to the 13 weeks ended July 28, 2012. Finally, all references to the six months ended August 3, 2013 relate to the 26 weeks ended August 3, 2013, and the six months ended July 28, 2012 relate to the 26 weeks ended July 28, 2012.

Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss or a Tax Credit Carryforward Exists. ASU 2013-11 requires unrecognized tax benefits to be presented as a decrease in a net operating loss, similar tax loss or tax credit carryforward if certain criteria are met. ASU 2013-11, which is prospective, is effective for reporting periods beginning after December 15, 2013, with earlier adoption permitted. Retrospective application is also permitted. We are still evaluating the standard to determine when we will adopt the standard but we do not believe the implementation of this standard will result in a material impact to our financial statements.

Table of Contents

Note 2. Restatement Share-based Compensation

The Company has determined its previously issued unaudited interim consolidated financial statements for the three and six month periods ended August 3, 2013 and July 28, 2012, contained an error with respect to Accounting Standards Codification (ASC) 718, *Compensation Stock Compensation*. Specifically, former participants in the Company s Equity Incentive Plan and its successor Plan (The Michaels Companies, Inc. (Parent) Equity Incentive Plan, together the Plan) exercised stock options upon their termination from the Company, and the Company repurchased the immature shares. The Company consistently repurchased shares in this manner and therefore, under accounting rules, established a pattern of repurchasing immature shares during the third quarter of 2011. The Company determined all stock options should have been treated as liability awards in accordance with the rules of ASC 718-10-25-9. Under liability accounting, the Company re-measures the fair value of stock compensation each period and recognizes changes in fair value as awards vest and until the award is settled. The Company originally recognized expense ratably over the vesting period based on the grant date fair value of the option in accordance with the fixed method of accounting. The Company determined the accounting error was material to fiscal 2011 and fiscal 2012 financial statements and those financial statements required restatement. As a result, the Company is also restating its financial statements for the three and six months ended August 3, 2013 and July 28, 2012. The impact to share-based compensation expense for the three and six months ended August 3, 2013, was $7 million ($5, net of tax) and $12 million ($8, net of tax), respectively. The impact to share-based compensation expense for the three and six months ended July 28, 2012, was $6 million ($4, net of tax) and $9 million ($5, net of tax), respectively. As part of the restatement, the Company also recorded other adjustments related to merchandise inventories and the reserve for closed facilities which were previously determined to be immaterial to the respective periods. In total, the adjustments resulted in a decline of Net income by $3 and $4 million for the three and six months ended August 3, 2013, and $4 and $6 million for the three and six months ended July 28, 2012.

The following footnotes have been restated:

- Note 6 Income Taxes
- Note 9 Segments and Geographic Information
- Note 11 Condensed Consolidating Financial Information

The following tables illustrate the correction as associated with certain line items in the unaudited interim consolidated financial statements (amounts in millions):

	Consolidated Balance Sheet As of August 3, 2013			
	As Reported	Share-based compensation Adjustment	Other Adjustments	As Restated
Merchandise inventories	$ 905	$ 4	$	$ 909
Deferred income taxes	37	1		38
Income tax receivable	34	2		36
Total current assets	1,123	7		1,130

Deferred income taxes	13	16		29
Total non-current assets	152	16		168
Accrued liabilities and other	338	(3)		335
Share-based compensation liability		19		19
Income taxes payable	1	(1)		
Total current liabilities	870	15		885
Share-based compensation liability		26		26
Total long-term liabilities	2,965	26		2,991
Additional paid-in capital	60	1		61
Accumulated deficit	(2,277)	(19)		(2,296)
Total stockholders deficit	(2,213)	(18)		(2,231)

Consolidated Balance Sheet
As of July 28, 2012

	As Reported	Share-based compensation Adjustment	Other Adjustments	As Restated
Merchandise inventories	$ 922	$ 3	$	$ 925
Total current assets	1,193	3		1,196
Deferred income taxes	18	14		32
Total non-current assets	167	14		181
Accrued liabilities and other	351	2		353
Share-based compensation liability		29		29
Income taxes payable	2	(2)		
Total current liabilities	632	29		661
Share-based compensation liability		23		23
Total long-term liabilities	3,460	23		3,483
Additional paid-in capital	62	(10)		52
Accumulated deficit	(2,474)	(25)		(2,499)
Total stockholders deficit	(2,406)	(35)		(2,441)

Consolidated Statements of Comprehensive Income
Quarter Ended August 3, 2013

	As Reported	Share-based compensation Adjustment	Other Adjustments	As Restated
Cost of sales and occupancy expense	$ 567	$ 1	$ (1)	$ 567
Gross Profit	337	(1)	1	337
Selling, general and administrative expense	258	(2)	(2)	254
Share-based compensation		8		8
Operating income	75	(7)	3	71
Income before income taxes	29	(7)	3	25
Provision for income taxes	9	(2)	1	8
Net income	20	(5)	2	17
Comprehensive income	19	(5)	2	16

Table of Contents

	Consolidated Statements of Comprehensive Income Six Months Ended August 3, 2013			
	As Reported	Share-based compensation Adjustment	Other Adjustments	As Restated
Cost of sales and occupancy expense	$ 1,153	$ 2	$ (4)	$ 1,151
Gross Profit	744	(2)	4	746
Selling, general and administrative expense	529	(1)	(2)	526
Share-based compensation		11		11
Operating income	205	(12)	6	199
Income before income taxes	105	(12)	6	99
Provision for income taxes	38	(4)	2	36
Net income	67	(8)	4	63
Comprehensive income	65	(8)	4	61

	Consolidated Statements of Comprehensive Income Quarter Ended July 28, 2012			
	As Reported	Share-based compensation Adjustment	Other Adjustments	As Restated
Cost of sales and occupancy expense	$ 553	$ 4	$	$ 557
Gross Profit	339	(4)		335
Selling, general and administrative expense	252	(1)		251
Share-based compensation		3		3
Operating income	82	(6)		76
Income before income taxes	21	(6)		15
Provision for income taxes	8	(2)		6
Net income	13	(4)		9
Comprehensive income	11	(4)		7

	Consolidated Statements of Comprehensive Income Six Months Ended July 28, 2012			
	As Reported	Share-based compensation Adjustment	Other Adjustments	As Restated
Cost of sales and occupancy expense	$ 1,119	$ 4	$ 1	$ 1,124
Gross Profit	751	(4)	(1)	746
Selling, general and administrative expense	512	(2)		510
Share-based compensation		7		7
Operating income	230	(9)	(1)	220
Income before income taxes	104	(9)	(1)	94
Provision for income taxes	38	(4)		34
Net income	66	(5)	(1)	60
Comprehensive income	66	(5)	(1)	60

	Cash Flow Data Six Months Ended August 3, 2013			
	As Reported	Share-based compensation Adjustment	Other Adjustments	As Restated
Operating Activities:				
Net income	$ 67	(7)	3	$ 63

Share-based compensation	1	12		13
Merchandise inventories	(40)	(2)	(5)	(47)
Accrued liabilities and other	(38)	(21)		(59)
Income taxes	(71)	(2)	2	(71)
Net cash provided by (used in) operating activities	6	(20)		(14)
Repurchase of common stock	(45)	45		
Proceeds from stock options exercised	25	(25)		
Net cash provided by financing activities	39	20		59

Cash Flow Data
Six Months Ended July 28, 2012

	As Reported	Share-based compensation Adjustment	Other Adjustments	As Restated
Operating Activities:				
Net income	$ 66	(5)	(1)	$ 60
Share-based compensation	3	8		11
Merchandise inventories	(82)	(1)	1	(82)
Income taxes	(43)	(3)		(46)
Net cash used in operating activities	(79)	(1)		(80)
Repurchase of common stock	(3)	3		
Proceeds from stock options exercised	2	(2)		
Net cash provided by (used in) financing activities	(134)	1		(133)

Table of Contents

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.

	August 3, 2013	February 2, 2013 (in millions)	July 28, 2012	Interest Rate
Senior secured term loan	$ 1,636	$ 1,640	$ 1,996	Variable
Senior notes	1,007	1,007	795	7.750%
Senior subordinated notes	255	393	393	11.375%
Subordinated discount notes			180	13.000%
Asset-based revolving credit facility	222	1		Variable
Total debt	3,120	3,041	3,364	
Less current portion	238	150	1	
Long-term debt	$ 2,882	$ 2,891	$ 3,363	

113/8% Senior Subordinated Notes due 2016

On January 28, 2013, we caused to be delivered to the holders of our outstanding 113/8% Senior Subordinated Notes due November 1, 2016 (the Senior Subordinated Notes) an irrevocable notice relating to the redemption of $137 million in aggregate principal amount of the Senior Subordinated Notes. On February 27, 2013, we redeemed the $137 million of Senior Subordinated Notes at a redemption price equal to 103.792%. In accordance with Accounting Standards Codification (ASC) 470 *Debt*, we recorded a loss on early extinguishment of debt of approximately $7 million related to the partial redemption of our Senior Subordinated Notes. The $7 million loss is comprised of a $5 million redemption premium and $2 million to write off related debt issuance costs.

Restated Revolving Credit Facility

As of August 3, 2013, the borrowing base of our restated senior secured asset-based revolving credit facility (the Restated Revolving Credit Facility) was $650 million, of which we had $222 million in borrowings, $61 million of outstanding letters of credit and the unused borrowing capacity was $367 million.

Restated Term Loan Credit Facility

The Company is required to make scheduled quarterly payments, each equal to 0.25% of the original principal amount of the term loans, subject to adjustments relating to the incurrence of additional term loans under the Restated Term Loan Credit Facility, for the first six years and three quarters, with the balance paid on January 28, 2020. The Company paid $4 million for the quarter ended August 3, 2013 and the current portion of debt includes $16 million that will be paid during the next four quarters.

Note 4. Comprehensive Income

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 February 2, 2013	$ 6
Foreign currency translation adjustment	(2)
Balance at August 3, 2013	$ 4

Note 5. 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 less transparent active market data, as well as internal 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 with significant unobservable inputs.

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 six months ended August 3, 2013, there were no material events or changes in circumstances indicating the carrying amounts of our goodwill or long-lived assets may not be recoverable.

The table below provides the carrying and fair values of our senior secured term loan facility (Restated Term Loan Credit Facility), our 7 3/4% Senior Notes that mature in 2018 (2018 Senior Notes) and our Senior Subordinated Notes, (together, with our 2018 Senior Notes, our notes) as of August 3, 2013. The fair value of our Restated Term Loan Credit Facility was determined based on quoted market prices of similar instruments which are considered Level 2 inputs within the fair value hierarchy. The fair value of our notes was determined based on recent trades which are considered Level 1 inputs within the fair value hierarchy.

	Carrying Value (in millions)	Fair Value
Senior secured term loan	$ 1,636	$ 1,645
Senior notes	1,007	1,079
Senior subordinated notes	255	267

10

Table of Contents

Note 6. Income Taxes

The effective tax rate was 32.0% for the second quarter of fiscal 2013. The effective tax rate was 40.0% for the second quarter of fiscal 2012. The current year tax rate is lower than the prior year tax rate due primarily to the realization of state tax credits this year.

The effective tax rate was 36.4% for the first six months of fiscal 2013. The effective tax rate was 36.2% for the first six months of fiscal 2012. The rate was higher than the prior year six month tax rate due primarily to the realization of state tax credits this year partly offset by the prior year favorable impact related to our reserve for uncertain tax positions. We currently estimate our annualized effective tax rate for fiscal 2013 to be 37.4%.

Note 7. 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 February 2, 2013 and our Quarterly Report on Form 10-Q for the quarterly period ended May 4, 2013.

Consumer Class Action Claims

Massachusetts Zip Code Claims

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 U.S. District Court-District of Massachusetts, alleging violation of a Massachusetts statute regarding the collection of personally identification information in connection with a credit card transaction. On March 11, 2013, the Massachusetts Supreme Judicial Court ruled on certified questions on the interpretation of the statute and remanded the case to the U.S. District Court for further proceedings. Following the Judicial Court s decision, an additional purported class action lawsuit asserting the same allegations in Tyler was filed in the U.S. District Court-District of Massachusetts by Susan D Esposito, and the two cases have been consolidated. On August 12, 2013, a tentative settlement that is subject to Court approval was reached for an amount that will not have a material effect on our Consolidated Financial Statements.

Governmental inquiries and related matters

Non-U.S. trust inquiry

In early 2005, the District Attorney s office of the County of New York and the SEC opened inquiries concerning non-U.S. trusts that directly or indirectly held shares of Michaels common stock and common stock options. On July 29, 2010, the SEC filed a civil enforcement action in federal district court for the Southern District of New York against Charles Wyly, Sam Wyly, the Wylys attorney Michael French, and others alleging, among other things, violations of various federal securities laws, including those governing ownership reporting and trading of securities, in connection with the non-U.S. trusts and their subsidiaries. Additional information may be obtained at the SEC s website. Sam Wyly, the estate of Charles Wyly and Mr. French, also a former director of the Company, have requested indemnification from the Company for certain legal costs with respect to these matters. The Company has resolved all claims with regards to Sam Wyly and the estate of Charles Wyly for an immaterial amount.

On April 12, 2012, Mr. French filed a lawsuit against the Company and the non-U.S. trusts in the District Court of Dallas County, Texas. The matter was dismissed as to the non-U.S. trusts. Mr. French seeks damages from the Company for breach of contract, attorneys fees and costs related to the Company s alleged indemnification obligations to Mr. French and attorneys fees and costs related to the lawsuit. On August 9, 2013, the dispute was settled for an amount that will not have a material effect on our Consolidated Financial Statements.

General

In addition to the litigation discussed above, we are, and in the future, may be involved in various other lawsuits, claims and proceedings incident to the ordinary course of business. The results of litigation are inherently unpredictable. Any claims against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in diversion of significant resources.

Table of Contents

ASC 450, *Contingencies,* governs the disclosure and recognition of loss contingencies, including potential losses from litigation and regulatory matters. It imposes different requirements for the recognition and disclosure of loss contingencies based on the likelihood of occurrence of the contingent future event or events. It distinguishes among degrees of likelihood using the following three terms: probable , meaning that the future event or events are likely to occur ; remote , meaning that the chance of the future event or events occurring is slight ; and reasonably possible , meaning that the chance of the future event or events occurring is more than remote but less than likely . In accordance with ASC 450, the Company accrues for a loss contingency when we conclude that the likelihood of a loss is probable and the amount of the loss can be reasonably estimated. When the loss cannot be reasonably estimated we estimate the range of amounts, and if no amount in the range constitutes a better estimate than any other amount, we accrue for the amount at the low end of the range. We adjust our accruals from time to time as we receive additional information, but the loss we incur may be significantly greater than or less than the amount we have accrued. We disclose loss contingencies if there is at least a reasonable possibility that a material loss has been incurred. No accrual or disclosure is required for losses that are remote.

For some of the matters disclosed above, as well as other matters previously disclosed in the Company s filings with the Securities and Exchange Commission (SEC), the Company is currently able to estimate a reasonably possible loss or range of loss in excess of amounts accrued (if any). For some of the matters included within this estimation, an accrual has been made because a loss is believed to be both probable and reasonably estimable, but an exposure to loss exists in excess of the amount accrued; in these cases, the estimate reflects the reasonably possible range of loss in excess of the accrued amount. For other matters included within this estimation, no accrual has been made because a loss, although estimable, is believed to be reasonably possible, but not probable; in these cases the estimate reflects the reasonably possible loss or range of loss within the ranges identified. For the various ranges identified, the aggregate of these estimated amounts is approximately $10 million, which is also inclusive of amounts accrued by the Company.

For other matters disclosed above or as previously disclosed in the Company s filings with the SEC, the Company is not currently able to estimate the reasonably possible loss or range of loss, and has indicated such. Many of these matters remain in preliminary stages (even in some cases where a substantial period of time has passed since the commencement of the matter), with few or no substantive legal decisions by the court defining the scope of the claims, the class (if any), or the potentially available damages, and fact discovery is still in progress or has not yet begun. For all these reasons, the Company cannot at this time estimate the reasonably possible loss or range of loss, if any, for these matters.

It is the opinion of the Company s management, based on current knowledge and after taking into account its current legal accruals, the eventual outcome of all matters described in this Note would not be likely to have a material impact on the consolidated financial condition of the Company. Nonetheless, given the substantial or indeterminate amounts sought in certain of these matters, and the inherent unpredictability of such matters, an adverse outcome in certain of these matters could, from time to time, have a material effect on the Company s consolidated results of operations or cash flows in particular quarterly or annual periods.

Note 8. The Michaels Companies and its Subsidiaries

In July 2013, Michaels was reorganized into a holding company structure (Reorganization). The Michaels Companies, Inc. (Parent), Michaels FinCo Holdings, LLC (FinCo Holdings), Michaels FinCo, Inc. (FinCo Inc) and Michaels Funding, Inc. (Holdings) and Michaels Stores Merger Co, Inc. (MergerCo) were formed in connection with the Reorganization: (i) MergerCo was merged with and into Michaels with Michaels being the surviving corporation; (ii) each share of Michaels common stock was converted into the right to receive one share of Parent common stock, subject to the same vesting conditions, if any, as applied to the share so converted, and each such share of Michaels common stock was cancelled and retired and ceased to exist; and (iii) each option to purchase one or more shares of common stock of Michaels was assumed by Parent and converted into an option to purchase an equivalent number of shares of common stock of Parent with the remaining terms of each such option remaining unchanged except as was necessary to reflect the Reorganization. Approximately 118 million shares of Michaels common stock were converted into Parent common stock. The Michaels shares were then cancelled and retired and an amount equal to the par value of the original shares was transferred from the common stock account to paid-in capital. Michaels then issued 100 shares of stock with a $0.10 par value to Holdings. In addition, common stock issued and outstanding and additional paid-in capital for February 2, 2013 and July 28, 2012 on the Consolidated Balance Sheets have been adjusted to reflect this transaction as if it happened prior to those dates.

As a result of the Reorganization, FinCo Holdings is wholly owned by the Parent. FinCo Inc and Holdings are wholly owned by FinCo Holdings. Michaels is wholly owned by Holdings.

Subsequent to the Reorganization, on July 29, 2013, FinCo Holdings and FinCo Inc issued $800 million aggregate principal amount of 7.50%/8.25% PIK Toggle Notes due 2018 (PIK Notes). The PIK Notes were issued in a private transaction. Interest payments on the PIK Notes are due February 1 and August 1 of each year until maturity. The first two interest payments and the last interest payment are required to be paid entirely in cash. All other interest payments must be made in cash, except that all or a portion of the interest on the PIK Notes may be paid by increasing the principal amount of the outstanding PIK Notes or by issuing additional PIK Notes depending on the amount of cash dividends that can be paid by the Company under our credit agreements governing our Senior Secured Credit Facilities, the terms of the indentures governing our outstanding notes and the terms of our other indebtedness outstanding at the time. The proceeds from the debt issuance were about $782 million, after deducting the initial purchasers discount and estimated fees and expenses. FinCo Holdings distributed the net proceeds to Parent and the proceeds were used to fund a cash dividend to the Parent s equity and equity-award holders and pay related fees and expenses.

Table of Contents

The PIK Notes are senior unsecured obligations of FinCo Holdings and FinCo Inc and are not guaranteed by the Company or any of the Company s subsidiaries. In addition, neither the PIK Notes nor the dividend transaction is reflected in the financial statements of the Company. If interest on the PIK Notes is paid in cash, annual interest payments will total $60 million or a total of approximately $301 million from July 29, 2013 until August, 1, 2018, the maturity date. Any cash interest payments will be funded by the Company through a cash dividend to Holdings.

Note 9. Segments and Geographic Information

We consider our Michaels U.S., Michaels Canada, Aaron Brothers and online scrapbooking business 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 U.S., Michaels Canada, and Aaron Brothers operating segments have similar economic characteristics and meet the aggregation criteria set forth in ASC 280. Therefore, we combine those operating segments into one reporting segment. During the second quarter of 2013, the online scrapbooking business was discontinued; as an operating segment, it is immaterial to the financial statements as a whole.

Our sales and assets by country are as follows:

	Quarter Ended		Six Months Ended	
	August 3, 2013	July 28, 2012	August 3, 2013	July 28, 2012
	(in millions)			
Net Sales:				
United States	$ 819	$ 812	$ 1,717	$ 1,703
Canada	85	80	180	167
Consolidated Total	$ 904	$ 892	$ 1,897	$ 1,870

	August 3, 2013	February 2, 2013	July 28, 2012
		(in millions)	
	(Restated)	(Restated)	(Restated)
Total Assets:			
United States	$ 1,522	$ 1,446	$ 1,586
Canada	123	109	117
Consolidated Total	$ 1,645	$ 1,555	$ 1,703

Our chief operating decision makers evaluate historical operating performance, plan and forecast future periods operating performance based on earnings before interest, income taxes, depreciation, amortization, and refinancing costs and losses on early extinguishment of debt (EBITDA (excluding refinancing costs and losses on early extinguishment of debt)). We believe EBITDA (excluding refinancing costs and losses on early extinguishment of debt) 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 (excluding refinancing costs and losses on early extinguishment of debt). A reconciliation of EBITDA (excluding refinancing costs and losses on early extinguishment of debt) to Net income is presented below.

	Quarter Ended		Six Months Ended	
	August 3, 2013	July 28, 2012	August 3, 2013	July 28, 2012
	(Restated)		(Restated)	

				(in millions)				
Net income	$	17	$	9	$	63	$	60
Interest expense		45		61		92		127
Refinancing costs and losses on early extinguishments of debt						7		
Provision for income taxes		8		6		36		34
Depreciation and amortization		25		22		50		46
EBITDA (excluding refinancing costs and losses on early extinguishments of debt)	$	95	$	98	$	248	$	267

Table of Contents

Note 10. Related Party Transactions

We pay annual management fees to Bain Capital Partners, LLC (Bain Capital) and The Blackstone Group L.P. (The Blackstone Group and, together with Bain Capital, the Sponsors) and Highfields Capital Management LP in the amount of $12 million and $1 million, respectively. We recognized $3 million and $4 million of expense related to annual management fees during the second quarter of fiscal 2013 and fiscal 2012, respectively and $7 million during the six months ended August 3, 2013 and July 28, 2012, respectively. These expenses are included in related party expenses on the Consolidated Statements of Comprehensive Income.

Bain Capital owns a majority equity position in LogicSource, an external vendor we utilize for print procurement services. Payments associated with this vendor during the second quarters of fiscal 2013 and fiscal 2012 were $1 million and were $2 million and $3 million during the six months ended August 3, 2013 and July 28, 2012, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Comprehensive Income.

The Blackstone Group owns a majority equity position in Brixmor Properties Group, a vendor we utilize to lease certain properties. Payments associated with this vendor during each of the second quarters of fiscal 2013 and fiscal 2012 were $1 million and were $2 million during the six months ended August 3, 2013 and July 28, 2012. These expenses are included in Cost of sales and occupancy expense in the Consolidated Statements of Comprehensive Income.

The Blackstone Group owns a majority equity position in RGIS, an external vendor we utilize to count our store inventory. Payments associated with this vendor during the second quarters of fiscal 2013 and fiscal 2012 were $2 million and $1 million, respectively and were $3 million during the six months ended August 3, 2013 and July 28, 2012. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Comprehensive Income.

The Blackstone Group owns a majority equity position in Vistar, an external vendor we utilize for all of the candy-type items in our stores. Payments associated with this vendor during the second quarter of fiscal 2013 and fiscal 2012 were $6 million and were $12 million and $11 million during the six months ended August 3, 2013 and July 28, 2012, respectively. These expenses are recognized in cost of sales as the sales are recorded.

Our current directors (other than Jill A. Greenthal and Carl S. Rubin) are affiliates of Bain Capital or The Blackstone Group. As such, some or all of such directors may have an indirect material interest in payments with respect to debt securities of the Company that have been purchased by affiliates of Bain Capital and The Blackstone Group. As of August 3, 2013, affiliates of The Blackstone Group held $38 million of our Restated Term Loan Credit Facility.

As a result of the Reorganization discussed in Note 8, at August 3, 2013, the Company has recorded a receivable from Parent of $4 million for payments made by the Company related to the repurchase of stock issued by Parent as a result of a stock option exercise by an employee of the Company. Amounts paid by the Company on Parent s behalf related to the dividend payment discussed in Note 8 and the stock option exercise discussed above were $20 million for the six months ended August 3, 2013.

Note 11. Condensed Consolidating Financial Information

All obligations of the Company under its notes, the Restated Revolving Credit Facility and the Restated Term Loan Credit Facility are guaranteed by each of its subsidiaries other than Aaron Brothers Card Services, LLC, Artistree of Canada, ULC and Michaels Stores of Puerto Rico, LLC and will be guaranteed by its direct parent, Holdings. As of August 3, 2013, the financial statements of Aaron Brothers Card Services, LLC, Artistree of Canada, ULC and Michaels Stores of Puerto Rico, LLC were immaterial. Each subsidiary guarantor is 100% owned, directly or indirectly, by the Company and such guarantees of each subsidiary guarantor are (and the guarantee of Holdings will be) joint and several and full and unconditional.

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.

Table of Contents

Supplemental Condensed Consolidating Balance Sheet

	August 3, 2013			
	Parent Company (Restated)	Guarantor Subsidiaries	Eliminations	Consolidated (Restated)
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 28	$ 23	$	$ 51
Merchandise inventories	619	290		909
Intercompany receivables		484	(484)	
Other	142	28		170
Total current assets	789	825	(484)	1,130
Property and equipment, net	274	73		347
Goodwill	94			94
Investment in subsidiaries	453		(453)	
Other assets	72	2		74
Total assets	$ 1,682	$ 900	$ (937)	$ 1,645
LIABILITIES AND STOCKHOLDERS DEFICIT				
Current liabilities:				
Accounts payable	$ 5	$ 284	$	$ 289
Accrued liabilities and other	205	130		335
Share-based compensation liability	6	13		19
Current portion of long-term debt	238			238
Intercompany payable	484		(484)	
Other	4			4
Total current liabilities	942	427	(484)	885
Long-term debt	2,882			2,882
Share-based compensation liability	17	9		26
Other long-term liabilities	72	11		83
Total stockholders deficit	(2,231)	453	(453)	(2,231)
Total liabilities and stockholders deficit	$ 1,682	$ 900	$ (937)	$ 1,645

Table of Contents

Supplemental Condensed Consolidating Balance Sheet

	February 2, 2013			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(Restated) (In millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 37	$ 19	$	$ 56
Merchandise inventories	591	271		862
Intercompany receivables		329	(329)	
Other	105	21		126
Total current assets	733	640	(329)	1,044
Property and equipment, net	271	67		338
Goodwill, net	94			94
Investment in subsidiaries	284		(284)	
Other assets	76	3		79
Total assets	$ 1,458	$ 710	$ (613)	$ 1,555
LIABILITIES AND STOCKHOLDERS DEFICIT				
Current liabilities:				
Accounts payable	5	258		263
Accrued liabilities and other	235	132		367
Share-based Compensation	22	13		35
Current portion of long-term debt	150			150
Intercompany payable	329		(329)	
Other	36	5		41
Total current liabilities	777	408	(329)	856
Long-term debt	2,891			2,891
Other long-term liabilities	73	12		85
Share based Compensation	21	6		27
Total stockholders deficit	(2,304)	284	(284)	(2,304)
Total liabilities and stockholders deficit	$ 1,458	$ 710	$ (613)	$ 1,555

Table of Contents

Supplemental Condensed Consolidating Balance Sheet

	July 28, 2012			
	Parent Company (Restated)	Guarantor Subsidiaries	Eliminations	Consolidated (Restated)
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 93	$ 20	$	$ 113
Merchandise inventories	603	322		925
Intercompany receivables		556	(556)	
Other	135	23		158
Total current assets	831	921	(556)	1,196
Property and equipment, net	265	61		326
Goodwill	95			95
Investment in subsidiaries	569		(569)	
Other assets	83	3		86
Total assets	$ 1,843	$ 985	$ (1,125)	$ 1,703
LIABILITIES AND STOCKHOLDERS DEFICIT				
Current liabilities:				
Accounts payable	$ 8	$ 269	$	$ 277
Accrued liabilities and other	234	119		353
Share-based compensation liability	19	10		29
Current portion of long-term debt	1			1
Intercompany payable	556		(556)	
Other	1			1
Total current liabilities	819	398	(556)	661
Long-term debt	3,363			3,363
Share-based compensation liability	16	7		23
Other long-term liabilities	86	11		97
Total stockholders deficit	(2,441)	569	(569)	(2,441)
Total liabilities and stockholders deficit	$ 1,843	$ 985	$ (1,125)	$ 1,703

Table of Contents

Supplemental