

PARTY CITY CORP
Form 10-Q/A
July 09, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q/ A

(Amendment No. 1)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

**For the quarterly period ended
December 27, 2003**

**Commission file number
0-27826**

Party City Corporation

(Exact name of registrant as specified in its charter)

Delaware
*(State or other jurisdiction of
incorporation or organization)*

22-3033692
*(I.R.S. Employer
Identification No.)*

**400 Commons Way
Rockaway, New Jersey**
(Address of Principal Executive Offices)

07866
(Zip Code)

(Registrant's telephone number, including area code)

973-983-0888

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No:

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

The number of outstanding shares of the Registrant's classes of common stock, \$0.01 par value, as of February 2, 2004 and June 4, 2004 were 16,979,839 and 17,053,694, respectively.

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PART I.

FINANCIAL INFORMATION

Explanatory Note

We are filing this Amendment No. 1 on Form 10-Q/ A (Form 10-Q/ A), which amends and restates our Quarterly Report on Form 10-Q for the three and six months ended December 27, 2003 that was originally filed on February 10, 2004 (the Original 10-Q), primarily to reflect a restatement of our condensed consolidated statements of cash flows related to our cash overdraft. Previously, the change in the cash overdraft account was classified from year to year in net cash provided by (used in) operating activities, rather than being classified in net cash provided by (used in) financing activities. The prior treatment resulted in (i) lower net cash provided by operating activities and lower net cash used in financing activities of approximately \$4,077,000 for the six months ended December 27, 2003 and (ii) higher net cash provided by operating activities and higher net cash used in financing activities of approximately \$3,569,000 for the six months ended December 28, 2002. In this on Form 10-Q/ A, we have restated our condensed consolidated statements of cash flows for the six months ended December 27, 2003 and December 28, 2002 to reflect this change in cash overdraft account as a financing activity rather than an operating activity. For further discussion, see Part I, Item 1. Financial Statements Note 11. Restatement of Statements of Cash Flows and Item 4. Controls and Procedures.

In addition, pursuant to comments from the Securities and Exchange Commission (the SEC), we agreed to make certain revisions in our future filings, which we made in our Quarterly Report on Form 10-Q for the nine months ended March 27, 2004 and have made in this Form 10-Q/ A. We have also updated a limited set of disclosure statements throughout this Form 10-Q/ A that we previously provided in the Original 10-Q as of February 2, 2004, the latest practicable date for which such information was available as of the filing of the Original 10-Q. The explanatory caption at the beginning of each revised item of this Form 10-Q/ A sets forth the limited nature of the revisions therein.

The following sections of this Form 10-Q/ A have been revised from the Original 10-Q:

Part I, Item 1. Financial Statements

Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Part I, Item 4. Controls and Procedures

Part II, Item 1. Legal Proceedings

Report of Independent Registered Public Accounting Firm

Signature Page

Exhibit 31 and 32 Certifications

Except as set forth above, this Form 10-Q/ A continues to speak as of the date of the filing of the Original 10-Q, February 10, 2004, and we have not updated the disclosures contained herein to reflect any events that have occurred thereafter. For a discussion of events and developments thereafter, please see our reports filed with the SEC since February 10, 2004.

Our Quarterly Report on Form 10-Q/ A for the fiscal quarter ended September 27, 2003 and our Annual Report on Form 10-K/ A for the fiscal year ended June 28, 2003 will also be restated in a similar fashion and will be filed simultaneously with this Form 10-Q/ A. We are not amending any reports affected by the restatement prior to the Annual Report of Form 10-K/ A for the fiscal year ended June 28, 2003; therefore, the consolidated statements of cash flows and related financial information included in such reports should no longer be relied upon and are hereby superseded.

Table of Contents**Item 1. Financial Statements****PARTY CITY CORPORATION AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share information)****(Unaudited)**

	<u>December 27, 2003</u>	<u>December 28, 2002</u>	<u>June 28, 2003(1)</u>
ASSETS			
Current assets:			
Cash and cash equivalents	\$ 20,550	\$ 3,273	\$ 3,372
Merchandise inventory	60,281	69,189	65,908
Other current assets, net	25,263	26,339	21,900
	<u>106,094</u>	<u>98,801</u>	<u>91,180</u>
Total current assets	106,094	98,801	91,180
Property and equipment, net	48,715	55,878	52,819
Goodwill	18,614	19,172	18,614
Other assets	5,201	4,087	5,386
	<u>178,624</u>	<u>177,938</u>	<u>167,999</u>
Total assets	\$ 178,624	\$ 177,938	\$ 167,999
LIABILITIES AND STOCKHOLDERS EQUITY			
Current liabilities:			
Accounts payable	\$ 34,458	\$ 44,890	\$ 37,960
Accrued expenses and other current liabilities	36,062	28,656	24,998
Cash overdraft		6,654	4,126
Advances under Loan Agreement		4,114	11,229
	<u>70,520</u>	<u>84,314</u>	<u>78,313</u>
Total current liabilities	70,520	84,314	78,313
Long-term liabilities:			
Deferred rent and other long-term liabilities	9,905	10,683	10,264
Commitments and contingencies			
Stockholders' equity:			
Common stock, \$0.01 par value, 40,000,000 shares authorized; 17,721,850, 17,113,873 and 17,296,807 shares issued, respectively	177	171	173
Additional paid-in capital	44,611	41,366	43,178
Retained earnings	59,351	43,233	42,011
Treasury stock, at cost (747,012, 284,000 and 747,012 shares, respectively)	(5,940)	(1,829)	(5,940)
	<u>98,199</u>	<u>82,941</u>	<u>79,422</u>
Total stockholders' equity	98,199	82,941	79,422
	<u>178,624</u>	<u>177,938</u>	<u>167,999</u>
Total liabilities and stockholders' equity	\$ 178,624	\$ 177,938	\$ 167,999

(1) The June 28, 2003 condensed consolidated balance sheet was derived from the Company's audited consolidated financial statements.

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See accompanying notes to condensed consolidated financial statements.

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	Quarter Ended		Six Months Ended	
	December 27, 2003	December 28, 2002	December 27, 2003	December 28, 2002
Revenues:				
Net sales	\$ 175,304	\$ 161,648	\$ 277,924	\$ 252,772
Royalty fees	7,216	6,503	11,123	10,150
Franchise fees	40	40	488	275
Total revenues	182,560	168,191	289,535	263,197
Expenses:				
Cost of goods sold and occupancy costs	104,705	95,974	179,033	160,399
Company-owned stores operating and selling expense	36,290	34,288	62,169	57,986
Franchise expense	1,562	1,646	3,221	3,208
General and administrative expense	7,498	8,403	15,657	15,705
Total expenses	150,055	140,311	260,080	237,298
Operating income	32,505	27,880	29,455	25,899
Interest income	(26)	(17)	(30)	(24)
Interest expense	138	2,841	342	3,733
Interest expense, net	112	2,824	312	3,709
Income before income taxes	32,393	25,056	29,143	22,190
Provision for income taxes	13,103	10,006	11,803	8,876
Net income	\$ 19,290	\$ 15,050	\$ 17,340	\$ 13,314
Basic earnings per share	\$ 1.14	\$ 0.90	\$ 1.03	\$ 0.80
Weighted average shares outstanding basic	16,867	16,803	16,856	16,600
Diluted earnings per share	\$ 0.98	\$ 0.76	\$ 0.88	\$ 0.67
Weighted average shares outstanding diluted	19,624	19,896	19,620	19,904

See accompanying notes to condensed consolidated financial statements.

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PARTY CITY CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended December 27, 2003	Six Months Ended December 28, 2002
	(As restated, see Note 11)	(As restated, see Note 11)
Cash flow from operating activities:		
Net income	\$ 17,340	\$ 13,314
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,692	7,133
Non-cash interest and financing costs	80	1,554
Deferred rent	(240)	387
Equity based compensation	148	752
Provision for doubtful accounts	(140)	(602)
Other	10	44
Changes in assets and liabilities:		
Merchandise inventory	5,627	(12,915)
Accounts payable, accrued expenses and other current liabilities	7,514	14,387
Other long-term liabilities	(119)	
Other current assets and other assets	(3,188)	(7,708)
Net cash provided by operating activities	34,724	16,346
Cash flow from investing activities:		
Purchases of property and equipment	(3,529)	(13,444)
Stores acquired		(1,758)
Net cash used in investing activities	(3,529)	(15,202)
Cash flow from financing activities:		
Net (payments on) proceeds from Loan Agreement	(11,229)	4,114
Cash overdrafts	(4,077)	3,569
Proceeds from exercise of stock options and warrants	1,289	1,276
Payments of Senior Notes		(10,207)
Payments of financing costs		(90)
Net cash used in financing activities	(14,017)	(1,338)
Net increase (decrease) in cash and cash equivalents	17,178	(194)
Cash and cash equivalents, beginning of period	3,372	3,467
Cash and cash equivalents, end of period	\$ 20,550	\$ 3,273
Supplemental disclosure of cash flow information:		
Income taxes paid	\$ 1,047	\$ 2,414
Interest paid	262	2,651
Supplemental disclosure of non-cash financing activity:		
Issuance of shares under employee stock purchase plan	\$ 244	\$ 265
Issuance of shares under management stock purchase plan	99	282

See accompanying notes to condensed consolidated financial statements.

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. Basis of Presentation**

The condensed consolidated financial statements are unaudited. In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments (consisting only of normal recurring accruals) necessary to present fairly the financial position of the Company as of December 27, 2003 and December 28, 2002 and the results of operations for the quarters and six months ended December 27, 2003 and December 28, 2002 and cash flows for the six months ended December 27, 2003 and December 28, 2002. Because of the seasonality of the party goods industry, operating results of the Company on a quarterly or six month basis may not be indicative of operating results for the full fiscal year.

These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended June 28, 2003, which are included in the Company's Annual Report on Form 10-K/A with respect to such period filed with the Securities and Exchange Commission. All significant intercompany accounts and transactions have been eliminated. The June 28, 2003 condensed consolidated balance sheet amounts are derived from the Company's audited consolidated financial statements.

The Company's Fiscal Year (Fiscal Year or Fiscal) refers to the 52 or 53 weeks, as applicable, ending the Saturday nearest to June 30. The year ended July 3, 2004 (Fiscal 2004) is a 53 week year as compared to the years ended June 28, 2003 (Fiscal 2003) and June 29, 2002 (Fiscal 2002), which were each 52 week years.

Certain reclassifications have been made to the condensed consolidated financial statements in prior periods to conform to the current period presentation.

2. Stock-Based Compensation

The Company periodically grants stock options to employees. Pursuant to Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), the Company accounts for stock-based employee compensation arrangements using the intrinsic value method. If the options are granted to employees below fair market value, compensation expense is recognized. The Company has adopted the disclosure only provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock Based Compensation (SFAS No. 123), as amended by SFAS No. 148, Accounting for Stock Based Compensation Transition and Disclosure, an Amendment of SFAS No. 123. If compensation cost for the Company's plans had been determined in accordance with the fair value method prescribed by SFAS No. 123, the Company's net income would have been (in thousands, except per share data):

	Quarter Ended		Six Months Ended	
	December 27, 2003	December 28, 2002	December 27, 2003	December 28, 2002
Net income as reported	\$ 19,290	\$ 15,050	\$ 17,340	\$ 13,314
Add: Stock-based employee compensation expense determined under APB 25, net of taxes	14	40	36	122
Deduct: Total stock based employee compensation expense determined under fair value based method, net of taxes	(521)	(666)	(550)	(823)
Pro-forma net income	\$ 18,783	\$ 14,424	\$ 16,826	\$ 12,613

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Quarter Ended		Six Months Ended	
	December 27, 2003	December 28, 2002	December 27, 2003	December 28, 2002
Basic and diluted earnings per share:				
Basic earnings per share as reported	\$ 1.14	\$ 0.90	\$ 1.03	\$ 0.80
Basic earnings per share pro forma	\$ 1.11	\$ 0.86	\$ 1.00	\$ 0.76
Diluted earnings per share as reported	\$ 0.98	\$ 0.76	\$ 0.88	\$ 0.67
Diluted earnings per share pro forma	\$ 0.96	\$ 0.72	\$ 0.86	\$ 0.63

The weighted average fair value of options granted during the second quarter of Fiscal 2004 and 2003 was \$6.48 and \$6.25, respectively.

The weighted average fair value of options granted during the six months ended Fiscal 2004 and 2003 was \$5.15 and \$7.53, respectively.

3. Earnings Per Share

The following table sets forth the computations of basic and diluted earnings per share (in thousands, except per share amounts):

	Quarter Ended		Six Months Ended	
	December 27, 2003	December 28, 2002	December 27, 2003	December 28, 2002
Net income	\$ 19,290	\$ 15,050	\$ 17,340	\$ 13,314
Earnings per share basic	\$ 1.14	\$ 0.90	\$ 1.03	\$ 0.80
Earnings per share diluted	\$ 0.98	\$ 0.76	\$ 0.88	\$ 0.67
Weighted average common shares outstanding	16,867	16,803	16,856	16,600
Dilutive effect of warrants	2,301	2,284	2,278	2,424
Dilutive effect of stock options	439(a)	724(b)	464(a)	789(b)
Restricted stock units	17	85	22	91
Weighted average common shares and common equivalent shares outstanding	19,624	19,896	19,620	19,904

(a) Options to purchase 577,908 and 703,391 shares of common stock at prices ranging from \$13.80 to \$30.88 per share were outstanding for the quarter and six months ended December 27, 2003 but were not included in the computation of earnings per share because to do so would have been antidilutive.

(b) Options to purchase 701,069 and 534,358 shares of common stock at prices ranging from \$13.83 to \$32.50 per share were outstanding for the quarter and six months ended December 28, 2002 but were not included in the computation of earnings per share because to do so would have been antidilutive.

4. Financing Agreements

In January 2003, the Company entered into a \$65 million revolving credit facility (Loan Agreement) with Wells Fargo Retail Finance, LLC, as the arranger, collateral agent and administrative agent, and Fleet Retail Finance, Inc., as the documentation agent. Under the terms of the Loan

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Agreement, the Company may borrow amounts based on a percentage of its eligible inventory and credit card receivables, subject to certain borrowing conditions and customary sub-limits, reserves and other limitations. Interest on advances is charged, at the Company's option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50%, and is currently at 1.25%, per annum or (ii) at the prime rate less the applicable margin,

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

which was initially set at and is currently 0.25% per annum, totaling 3.75% at December 27, 2003. The term of the Loan Agreement is through April 30, 2006 and is secured by a lien on substantially all of the Company's assets. The Company had a standby letter of credit of \$3.7 million outstanding at December 27, 2003. At December 27, 2003 and February 2, 2004, the Company had no borrowings outstanding under the Loan Agreement. Based on a percentage of current eligible inventory and credit card receivables, the Company had \$19.2 million available to be borrowed under the Loan Agreement at February 2, 2004.

5. Stockholders' Equity

Shares Outstanding

The Company's authorized capital stock was increased from 25,000,000 shares to 40,000,000 shares of its common stock, \$0.01 par value per share, at the annual shareholders' meeting on November 12, 2003. At December 27, 2003 and December 28, 2002 there were 17,721,850 shares and 17,113,873 shares, respectively, of the Company's common stock issued.

Stock Repurchase

In September 2001, the Board of Directors authorized the Company to repurchase up to \$15 million of its outstanding common stock. Stock repurchases are made at the discretion of management. There was no stock repurchase activity during the first six months of Fiscal 2004 and during the first six months of Fiscal 2003. As of December 27, 2003, the Company had purchased 747,012 shares for an aggregate amount of \$5.9 million or 39.6% of the total amount authorized to be purchased.

Warrants

There were no warrant exercises in the first six months of Fiscal 2004. In the first six months of Fiscal 2003, 688,000 warrants to purchase the Company's common stock were exercised. This included an exercise of 458,667 warrants for which proceeds of \$490,774 were received and a cashless exercise of the remaining 229,333 warrants for which the warrant holders received 213,792 shares of common stock. The remaining 15,541 shares were surrendered in connection with this exercise. These 15,541 shares of the Company's common stock had a market value of \$245,386 at the time of surrender.

6. Legal Proceedings

A lawsuit was filed on September 25, 2001 against the Company in Los Angeles Superior Court by an assistant manager in one of the Company's California stores for himself and on behalf of other members of an alleged class of Party City store managers (the "Class") who claim the Company misclassified the Class members as exempt from California overtime wage and hour laws. The Class members seek the disgorgement of overtime wages allegedly owed by the Company to them but not paid and they also seek punitive damages and statutory penalties. If a class is certified, liability is found, and a judgment is entered, such a judgment may adversely affect the Company.

In addition to the foregoing, from time to time the Company is involved in routine litigation incidental to the conduct of the business, which is not, individually or in the aggregate, material to the Company.

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The following table contains key financial information of the Company's business segments (in thousands):

	Quarter Ended December 27, 2003	Quarter Ended December 28, 2002	Six Months Ended December 27, 2003	Six Months Ended December 28, 2002
Retail:				
Net sales	\$ 175,304	\$ 161,648	\$ 277,924	\$ 252,772
Cost of goods sold and occupancy costs	104,705	95,974	179,033	160,399
Gross profit	70,599	65,674	98,891	92,373
Store operating and selling expense	36,290	34,288	62,169	57,986
Company-owned stores profit contribution	34,309	31,386	36,722	34,387
General and administrative expense	7,498	8,403	15,657	15,705
Retail profit contribution	\$ 26,811	\$ 22,983	\$ 21,065	\$ 18,682
Identifiable assets	\$ 160,245	\$ 157,390	\$ 160,245	\$ 157,390
Depreciation/amortization	\$ 2,558	\$ 2,333	\$ 4,976	\$ 4,367
Capital expenditures	\$ 526	\$ 3,994	\$ 986	\$ 13,824
Franchise:				
Royalty fees	\$ 7,216	\$ 6,503	\$ 11,123	\$ 10,150
Franchise fees	40	40	488	275
Total franchise revenues	7,256	6,543	11,611	10,425
Total franchise expense	1,562	1,646	3,221	3,208
Franchise profit contribution	5,694	4,897	\$ 8,390	\$ 7,217
Identifiable assets	\$ 3,079	\$ 3,998	\$ 3,079	\$ 3,998
Depreciation/amortization				
Capital expenditures				
Operating income	\$ 32,505	\$ 27,880	\$ 29,455	\$ 25,899
Interest expense, net	112	2,824	312	3,709
Income before income taxes	32,393	25,056	29,143	22,190
Provision for income taxes	13,103	10,006	11,803	8,876
Net income	\$ 19,290	\$ 15,050	\$ 17,340	\$ 13,314

8. Acquisitions of Stores

During Fiscal 2003, the Company acquired two stores from a franchisee. The aggregate consideration paid in connection with this acquisition was \$1,603,000. The consolidated balance sheets include allocations of the purchase price related to this transaction of approximately \$1,002,000 in goodwill, \$195,000 in fixed assets and \$406,000 in inventory.

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In Fiscal 2002, the Company completed the acquisition of thirteen stores in the Seattle, Washington market from Paper Warehouse, Inc. The conversion of these locations to the Party City store format was completed and all stores were opened by the first quarter of Fiscal 2003. Additional goodwill of \$155,000 was recorded in Fiscal 2003 related to the completion of the conversion of these locations.

The acquisitions have been accounted for under the purchase method of accounting. The results of operations of the acquired stores are included in the financial statements from the date the stores were opened.

The purchase price of these acquisitions was determined by applying a multiple to the acquired business proforma earnings before depreciation, amortization, and taxes. The range of multiples the Company uses has generally resulted in an acceptable return on its investment compared to the opening of a new site as the customer and sales base is established.

All of the Company's recorded goodwill is associated with its retail segment. There were no changes in the carrying amount of goodwill of \$18.6 million for the six months ended December 27, 2003.

Assuming the stores acquired during the six months ended December 28, 2002 were acquired on June 30, 2002, the beginning of Fiscal 2003, the pro forma results would have been as follows (in thousands, except per share amounts):

	Quarter Ended		Six Months Ended	
	December 27, 2003	December 28, 2002	December 27, 2003	December 28, 2002
Net sales	\$ 175,304	\$ 161,648	\$ 277,924	\$ 254,221
Net income	\$ 19,290	\$ 15,050	\$ 17,340	\$ 13,391
Earnings per share basic	\$ 1.14	\$ 0.90	\$ 1.03	\$ 0.81
Earnings per share diluted	\$ 0.98	\$ 0.76	\$ 0.88	\$ 0.67

9. Guarantees

In November 2002, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 45, Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. The Interpretation elaborates on the existing disclosure requirements for most guarantees, including loan guarantees such as standby letters of credit. It also clarifies that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under the guarantee and must disclose that information in its interim and annual financial statements. The provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor's obligations do not apply to product warranties or to guarantees accounted for as derivatives. The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 31, 2002.

The Company has unconditionally guaranteed the lease payments of 24 leases associated with franchise stores and locations sublet. The majority of the guarantees were given when the Company sold stores in 1999 as part of its restructuring. The guarantees continue until the expiration date of the leases, which range from 2004 through 2011. The maximum amount of the guarantees may vary, but is limited to the sum of the total amount due under the lease. As of December 27, 2003, the maximum aggregate amount of the guarantees was approximately \$18.5 million.

10. Recent Accounting Pronouncements

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). FIN 46 addresses how to identify variable interest entities and provides guidance as to how a company may assess its interests in a variable interest entity for purposes

of deciding whether

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consolidation of that entity is required. FIN 46 is effective for all variable interest entities created after January 31, 2003. The Company is required to adopt the provisions of FIN 46 for any variable interest entity created prior to February 1, 2003 by the end of the current fiscal year. The Company has evaluated the accounting provisions of the interpretations and determined that there was no material impact on its financial condition, results of operations or cash flows, since the Company is not the primary beneficiary of any variable interest entities.

11. Restatement of Statements of Cash Flows

Subsequent to the issuance of the condensed consolidated financial statements for the period ended December 27, 2003 the Company determined that the cash flow related to the Company's cash overdraft should have been classified as a financing activity rather than an operating activity. As a result, the condensed consolidated statements of cash flows for the six months ended December 27, 2003 and December 28, 2002 have been restated to reflect the cash flows related to the Company's cash overdraft as a financing activity rather than an operating activity. A summary of the effect of the restatement on cash flows provided by (used in) operating and financing activities is as follows (in thousands):

	As Previously Reported	As Restated
Six months ended December 27, 2003:		
Cash flows provided by operating activities	\$ 30,647	\$ 34,724
Cash flows used in financing activities	\$ (9,940)	\$ (14,017)
Six months ended December 28, 2002:		
Cash flows provided by operating activities	\$ 19,915	\$ 16,346
Cash flows used in financing activities	\$ (4,907)	\$ (1,338)

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This section has been updated to give effect to the restatement as discussed in Note 11 to the condensed consolidated financial statements included in Item 1, and should be read in conjunction with the accompanying condensed consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America.

*Pursuant to SEC comments, we agreed to make certain revisions in our future filings, which we made in our Quarterly Report on Form 10-Q for the three months ended March 27, 2004 and have made herein. Except for the formatting revisions we made pursuant to SEC comments, we did not alter the presentation herein to conform to the improved format we set forth in our Quarterly Report on Form 10-Q for the three months ended March 27, 2004. We have also updated certain disclosure statements in *Liquidity and Capital Resources* that were made as of February 2, 2004, the latest practicable date for which such information was available as of the filing of the Original 10-Q.*

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the appropriate application of certain accounting policies, many of which require estimates and assumptions about future events and their impact on amounts reported in the financial statements and related notes. Since future events and their impact cannot be determined with certainty, the actual results will inevitably differ from our estimates. Such differences could be material to the consolidated financial statements.

We believe our application of accounting policies, and the estimates inherently required by the policies, are reasonable. These accounting policies and estimates are constantly reevaluated and adjustments are made when facts and circumstances dictate a change. Historically, we have found the application of accounting policies to be appropriate and actual results generally do not differ materially from those determined using necessary estimates.

Our accounting policies are more fully described in Note 1 to the consolidated financial statements contained in our Annual Report on Form 10-K/ A filed with the SEC. We have identified certain critical accounting policies that are described below.

Merchandise inventory. Inventory is valued using the cost method which values inventory at the lower of the actual cost or market, at the individual item level. Cost is determined using the weighted average method. Inventory levels are reviewed to identify slow-moving and closeout merchandise that will no longer be carried. Market is determined by the estimated net realizable value, based upon the merchandise selling price.

Finite long-lived assets. In the evaluation of the fair value and future benefits of finite long-lived assets, we perform an analysis of the anticipated undiscounted future net cash flows of the related finite long-lived assets. Various factors including future sales growth and profit margins are included in this analysis. To the extent these future projections or strategies change, the conclusion regarding impairment may differ from the current estimates.

Insurance accruals. Our consolidated balance sheets include liabilities with respect to self-insured workers' compensation and general liability claims. We estimate the required liability of such claims utilizing an actuarial method, based upon various assumptions, which include, but are not limited to, our historical loss experience, projected loss development factors, actual payroll and other data. The required liability is also subject to adjustment in the future based upon changes in claims experience, including changes in the number of incidents (frequency) and changes in the ultimate cost per incident (severity).

Goodwill. All of our goodwill is associated with our retail segment. We evaluate goodwill annually or whenever events and changes in circumstances suggest that the carrying amount may not be recoverable from its estimated future cash flows. In making this assessment, management relies on a number of factors including operating results, business plans, economic projections, anticipated future cash flows and marketplace data. A change in these underlying assumptions may cause a change in the results of the tests and, as

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such, could cause fair value to be less than the carrying value. In such event, we would then be required to record a charge, which would impact earnings.

Sales Returns. We estimate future sales returns and, when material, record a provision in the period that the related sales are recorded based on historical information. Should actual returns differ from our estimates, we would be required to revise estimated sales returns.

Store Closure Costs. We record estimated store closure costs, estimated lease commitment costs net of estimated sublease income and other miscellaneous store closing costs, when the liability is incurred. Such estimates may be subject to change should actual costs differ.

Results of Operations

	Quarter Ended December 27, 2003(b)	Quarter Ended December 28, 2002(b)	Six Months Ended December 27, 2003(b)	Six Months Ended December 28, 2002(b)
	(As restated)	(As restated)	(As restated)	(As restated)
Statement of Operations Data:				
Total revenues	\$ 182,560	\$ 168,191	\$ 289,535	\$ 263,197
Company-owned stores:				
Net sales	\$ 175,304	\$ 161,648	\$ 277,924	\$ 252,772
Cost of goods sold and occupancy costs	104,705	95,974	179,033	160,399
Gross profit	70,599	65,674	98,891	92,373
Store operating and selling expense	36,290	34,288	62,169	57,986
Company-owned stores profit contribution	34,309	31,386	36,722	34,387
General and administrative expense	7,498	8,403	15,657	15,705
Company-owned profit contribution	26,811	22,983	21,065	18,682
Franchise stores:				
Royalty fees	7,216	6,503	11,123	10,150
Franchise fees	40	40	488	275
Total franchise revenues	7,256	6,543	11,611	10,425
Total franchise expense	1,562	1,646	3,221	3,208
Franchise profit contribution	5,694	4,897	8,390	7,217
Operating income	32,505	27,880	29,455	25,899
Interest expense, net	112	2,824	312	3,709
Income before income taxes	32,393	25,056	29,143	22,190
Provision for income taxes	13,103	10,006	11,803	8,876
Net income	\$ 19,290	\$ 15,050	\$ 17,340	\$ 13,314
Basic earnings per share	\$ 1.14	\$ 0.90	\$ 1.03	\$ 0.80
Diluted earnings per share	\$ 0.98	\$ 0.76	\$ 0.88	\$ 0.67

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Weighted average shares outstanding basic	16,867	16,803	16,856	16,600
Weighted average shares outstanding diluted	19,624	19,896		