

PARTY CITY CORP  
Form 10-Q  
May 12, 2005

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**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**Form 10-Q**  
**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)**  
**OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended**  
**April 2, 2005**

**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:

As of April 29, 2005, there were 17,244,592 shares of common stock, \$0.01 par value, outstanding.

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References throughout this document to the Company include Party City Corporation and its wholly-owned subsidiary. In accordance with the Securities and Exchange Commission's Plain English guidelines, this Quarterly Report on Form 10-Q has been written in the first person. In this document the words we, our, ours and us refer only to Party City Corporation and its wholly-owned subsidiary and not to any other person.

Our website [www.partycity.com](http://www.partycity.com) provides access, free of charge, to our Securities and Exchange Commission (the SEC) reports, as soon as reasonably practicable after we electronically file such reports with, or furnish such reports to, the SEC, including proxy statements, Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to these reports. The reference to Party City's website address in this Quarterly Report on Form 10-Q is not intended to function as a hyperlink and the information contained on such website is not part of this Quarterly Report on Form 10-Q.

You may also read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You may obtain information on the operations of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains a website that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC, including us, at <http://www.sec.gov>.

### **Forward-Looking Statements**

This Quarterly Report on Form 10-Q (including the information incorporated herein by reference) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. The statements may be identified by forward-looking terminology such as estimate, project, expect, believe, may, intend or similar statements or variations of such terms. Forward-

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looking statements involve known and unknown risks and uncertainties, which may cause our actual results in future periods to differ materially from forecasted results. Those risks and uncertainties include, among other things, the effect of price and product competition in the party goods industry in general and in our specific market areas, our ability to anticipate customer demand for products and to design and develop products that will appeal to our customers, our ability to open new stores successfully, our ability to continue to successfully implement our distribution system and to implement our merchandise replenishment and other software systems, the availability and terms of capital to fund capital improvements, acquisitions and ongoing operations, our ability to manage successfully our franchise program, our ability to improve our fundamental business processes, including, but not limited to inventory sourcing, to reduce costs throughout our organization, our ability to attract and retain qualified personnel, changes in costs of goods and services and economic conditions in general and/or to identify, execute and integrate acquisitions and to realize synergies. See Part I, Item 1. Business-Risk Factors in our 2004 10-K for further information on such risks and uncertainties. Furthermore, additional information concerning certain risks and uncertainties that could cause our actual results to differ materially from those projected or suggested may be identified from time to time in our SEC filings and our public announcements. You are cautioned not to place undue reliance on such forward-looking statements, which are made as of the date of this release, and we have no obligation or intention to update or revise such forward-looking statements.

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**PART I.**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**PARTY CITY CORPORATION AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

	April 2, 2005	July 3, 2004	March 27, 2004
(In thousands, except share amounts) (Unaudited)			
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$ 14,253	\$ 27,845	\$ 15,773
Merchandise inventory	86,966	57,357	61,104
Deferred income taxes	10,570	9,298	7,428
Due from franchisees	7,533	2,206	2,137
Other current assets, net	9,325	9,165	10,005
Total current assets	128,647	105,871	96,447
Property and equipment, net	45,359	48,762	49,242
Goodwill	18,499	18,614	18,614
Other assets	5,935	4,170	5,117
Total assets	\$ 198,440	\$ 177,417	\$ 169,420
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>			
Current liabilities:			
Accounts payable	\$ 57,201	\$ 38,364	\$ 35,796
Accrued expenses and other current liabilities	28,850	32,689	30,705
Total current liabilities	86,051	71,053	66,501
Long-term liabilities:			
Deferred rent and other long-term liabilities	9,779	9,526	9,818
Commitments and contingencies (see Notes 7 and 9)			
Stockholders' equity:			
Common stock, \$0.01 par value; 40,000,000 shares authorized; 17,986,354 shares issued and 17,239,342 shares outstanding at April 2, 2005; 17,835,778 shares issued and 17,088,766 shares outstanding at July 3, 2004; and 17,760,444 shares issued and 17,013,432 shares outstanding at March 27, 2004	180	178	178
Additional paid-in capital	48,067	46,683	45,073
Retained earnings	60,303	55,917	53,790
Treasury stock, at cost (747,012 shares)	(5,940)	(5,940)	(5,940)

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Total stockholders' equity	102,610	96,838	93,101
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Total liabilities and stockholders' equity	\$ 198,440	\$ 177,417	\$ 169,420
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See accompanying notes to condensed consolidated financial statements.

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**PARTY CITY CORPORATION AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

	Fiscal Quarter Ended		Nine Months Ended	
	April 2, 2005	March 27, 2004	April 2, 2005	March 27, 2004
(In thousands, except per share amounts) (Unaudited)				
Revenues:				
Net sales	\$ 90,980	\$ 97,662	\$ 356,361	\$ 375,586
Royalty fees	3,763	3,806	15,101	14,929
Net sales to franchisees	6,677		6,677	
Franchise fees		80	120	568
Total revenues	101,420	101,548	378,259	391,083
Expenses:				
Cost of goods sold and occupancy costs	70,062	71,432	242,803	250,465
Cost of goods sold to franchisees	5,608		5,608	
Company-owned store operating and selling expense	24,407	24,754	84,943	86,923
Franchise transportation and other selling expenses	931		931	
Other franchise expense	2,335	2,024	5,955	5,245
General and administrative expense	10,283	8,506	30,666	24,163
Litigation charge		4,100		4,100
Total expenses	113,626	110,816	370,906	370,896
Operating (loss) income	(12,206)	(9,268)	7,353	20,187
Interest income	(166)	(29)	(385)	(59)
Interest expense	122	108	373	450
Interest (income) expense, net	(44)	79	(12)	391
(Loss) income before income taxes	(12,162)	(9,347)	7,365	19,796
(Benefit) provision for income taxes	(4,929)	(3,786)	2,979	8,017
Net (loss) income	\$ (7,233)	\$ (5,561)	\$ 4,386	\$ 11,779
Basic (loss) earnings per share	\$ (0.42)	\$ (0.33)	\$ 0.26	\$ 0.70
Weighted average shares outstanding basic	17,231	16,992	17,171	16,871
Diluted (loss) earnings per share	\$ (0.42)	\$ (0.33)	\$ 0.22	\$ 0.60
	17,231	16,992	19,827	19,630

Weighted average shares outstanding  
diluted

See accompanying notes to condensed consolidated financial statements.



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**PARTY CITY CORPORATION AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Nine Months Ended	
	April 2, 2005	March 27, 2004
	(In thousands) (Unaudited)	
Cash flow from operating activities:		
Net income	\$ 4,386	\$ 11,779
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	12,963	12,306
Impairment of assets	161	
Amortization of financing costs	120	120
Deferred rent	(328)	(326)
Deferred taxes	(2,074)	
Stock-based compensation	43	418
Provision for doubtful accounts	231	(82)
Other	(90)	13
Changes in assets and liabilities:		
Merchandise Inventory	(29,609)	4,804
Accounts payable	18,837	(2,163)
Accrued expenses and other current liabilities	(2,985)	5,601
Other long-term liabilities	7	(119)
Other current assets and other assets	(7,451)	2,456
Net cash (used in) provided by operating activities	(5,789)	34,807
Cash flow from investing activities:		
Purchase of short-term investments	(123,125)	
Sale of short-term investments	123,125	
Purchases of property and equipment	(8,855)	(8,638)
Proceeds from the sale of assets	250	
Net cash used in investing activities	(8,605)	(8,638)
Cash flow from financing activities:		
Proceeds from exercise of stock options	900	1,482
Repayment of capital lease	(98)	
Net payments on Loan Agreement		(11,229)
Change in cash overdrafts		(4,021)
Net cash provided by (used in) financing activities	802	(13,768)
Net (decrease) increase in cash and cash equivalents	(13,592)	12,401
Cash and cash equivalents, beginning of period	27,845	3,372
Cash and cash equivalents, end of period	\$ 14,253	\$ 15,773

Supplemental disclosure of cash flow information:

Income taxes paid	\$	6,408	\$	7,707
Interest paid	\$	253	\$	330
Tax-effect on non-qualified stock options	\$	154	\$	

Supplemental disclosure of non-cash financing activity:

Issuance of shares under employee stock purchase plan	\$	236	\$	244
Issuance of shares under management stock purchase plan	\$	53	\$	99
Capital lease obligation used to purchase fixed assets for the logistics initiative	\$	851	\$	

See accompanying notes to condensed consolidated financial statements.

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**PARTY CITY CORPORATION AND SUBSIDIARY  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

Party City Corporation (together with its wholly-owned subsidiary, the Company) is incorporated in the State of Delaware and operates retail party supply stores within the United States and sells franchises on an individual store and area basis throughout the United States and Puerto Rico. The condensed consolidated unaudited financial statements have been prepared in accordance with the rules and regulations established by the Securities and Exchange Commission (the SEC). In the opinion of management, the accompanying condensed consolidated unaudited financial statements fairly present, in all material respects, the financial position of the Company as of April 2, 2005 and March 27, 2004 and the results of operations for the quarters and nine months ended April 2, 2005 and March 27, 2004 and cash flows for the nine months ended April 2, 2005 and March 27, 2004. All significant intercompany accounts and transactions have been eliminated. Because of the seasonality of the party goods industry, operating results of the Company on a quarterly basis may not be indicative of operating results for the full fiscal year.

These condensed consolidated unaudited financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended July 3, 2004, which are included in the Company's Annual Report on Form 10-K filed with the SEC on September 14, 2004 (the 2004 10-K). The July 3, 2004 condensed consolidated unaudited balance sheet amounts included herein are derived from the Company's audited consolidated financial statements.

The Company's fiscal year ends the Saturday nearest to June 30. As used herein, the term Fiscal Year or Fiscal refers to the 52- or 53-week period, as applicable, ending the Saturday nearest to June 30. Fiscal 2005 is a 52-week period ending July 2, 2005, while Fiscal 2004 is a 53-week period that ended July 3, 2004. However, the financial results for the fiscal quarter ended and nine months ended April 2, 2005 and March 27, 2004 are each based on a 13-week period and 39-week period, respectively.

We have made certain reclassifications to prior period information to conform to the current period presentation. Auction rate securities, which were previously recorded in cash and cash equivalents in our interim fiscal 2004 consolidated financial statements, have been included in short-term investments in the accompanying consolidated financial statements due to their liquidity and pricing reset feature. Prior period quarterly information will be reclassified to conform to the current year presentation. There will be no impact on net income, stockholders' equity, debt covenants or cash flow from operations as a result of this reclassification.

**2. Accounting Policies**

The Company's significant accounting policies are described in Note 1 to the consolidated financial statements included in the 2004 10-K.

During the first quarter of Fiscal 2005, the Company launched its logistics initiative, which includes modifying its business operations to vertically integrate certain logistics and distribution activities, and therefore adopted a new specific accounting policy for the treatment of the costs associated with the distribution network. The Company has outsourced the operations of its distribution network to a third party. Distribution costs include the third party fees and expenses of operating the distribution centers and the freight expense relating to transporting merchandise to the Company-owned stores. These distribution costs are initially capitalized into merchandise inventory and expensed when the merchandise is sold.

During the third quarter of Fiscal 2005, the Company began providing product and logistics services through its distribution network to all of its franchise operators. Revenues and expenses associated with servicing the franchisees through the distribution network include product sales and fixed and variable distribution center expenses, transportation and other selling expenses, respectively. As defined in the Emerging Issues Task Force (EITF) EITF 99-19 Reporting Revenue Gross as a Principal Versus Net as an Agent, the Company records revenues and expenses related to servicing its franchisees on a gross basis

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**PARTY CITY CORPORATION AND SUBSIDIARY**

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

because the Company acts as a principal in the transaction, takes title to the products, and holds inventory ownership risk.

*Short-Term Investments.* Although the Company did not have a balance of short-term investments as of April 2, 2005, the Company purchased and subsequently sold short-term investments during this fiscal year, which consisted of auction rate debt and preferred stock securities. Auction rate securities are term securities earning income at a rate that is periodically reset, typically within 35 days, to reflect current market conditions through an auction process. These securities are classified as available-for-sale securities under the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Accordingly, these short-term investments are recorded at fair-value, with any related unrealized gains and losses included as a separate component of stockholders' equity, net of tax. Realized gains and losses and investment income are included in earnings. Although the Company had no short-term investments at April 2, 2005, as mentioned above, the year to date investment activity on a cumulative basis is presented in the Cash Flows from Investing Activities.

**3. Stock-Based Compensation**

The Company periodically grants stock options to employees. In December 2004, the Financial Accounting Standards Board (the FASB) published Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment* (SFAS No. 123R), an amendment of FASB Statements No. 123 and No. 95. Under SFAS No. 123R, all forms of share-based payment to employees, including employee stock options, would be treated as compensation and recognized in the income statement. SFAS No. 123R is effective beginning the first quarter of Fiscal 2006. The Company is continuing to evaluate the full impact of SFAS No. 123R for its adoption in the first quarter of fiscal 2006. We currently account for stock options under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25).

Pursuant to APB No. 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 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 (SFAS No. 148). If

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compensation cost for the Company's stock option plans had been determined in accordance with the fair value method prescribed by SFAS No. 148, the Company's net (loss) income would have been:

	<b>Fiscal Quarter Ended</b>		<b>Nine Months Ended</b>	
	<b>April 2, 2005</b>	<b>March 27, 2004</b>	<b>April 2, 2005</b>	<b>March 27, 2004</b>
<b>(In thousands, except per share amounts)</b>				
Net (loss) income as reported	\$ (7,233)	\$ (5,561)	\$ 4,386	\$ 11,779
Add: Stock-based employee compensation expense determined under APB 25, net of tax	33	161	43	249
Deduct: Total stock-based employee compensation expense determined under fair value based method of SFAS No. 148, net of tax(1)	(766)	(533)	(1,796)	(1,526)
Pro forma net (loss) income	\$ (7,966)	\$ (5,933)	\$ 2,633	\$ 10,502
<b>Basic and diluted (loss) earnings per share:</b>				
Basic (loss) earnings per share as reported	\$ (0.42)	\$ (0.33)	\$ 0.26	\$ 0.70
Basic (loss) earnings per share pro forma	\$ (0.46)	\$ (0.35)	\$ 0.15	\$ 0.62
Diluted (loss) earnings per share as reported	\$ (0.42)	\$ (0.33)	\$ 0.22	\$ 0.60
Diluted (loss) earnings per share pro forma	\$ (0.46)	\$ (0.35)	\$ 0.13	