UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 30, 2011

OR

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

For the transition period from to

Commission file number 001-09338

MICHAELS STORES, INC.

(Exact name of registrant as specified in its charter)

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

8000 Bent Branch Drive

Irving, Texas 75063

(Address of principal executive offices, including zip code)

(972) 409-1300

(Registrant s telephone number, including area code)

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 22, 2011, 118,714,729 shares of the Registrant s Common Stock were outstanding.

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*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.

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MICHAELS STORES, INC.

FORM 10-Q

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MICHAELS STORES, INC.

Part I FINANCIAL INFORMATION

Item 1. Financial Statements.

MICHAELS STORES, INC.

CONSOLIDATED BALANCE SHEETS

(In millions, except share data)

(Unaudited)

	July 30, 2011	January 29, 2011	July 31, 2010
ASSETS			
Current assets:			
Cash and equivalents	$ 27	$ 319	$ 69
Merchandise inventories	897	826	888
Prepaid expenses and other	79	73	70
Deferred income taxes	56	56	42
Income tax receivable	27	1	31
Total current assets	1,086	1,275	1,100
Property and equipment, at cost	1,376	1,329	1,276
Less accumulated depreciation	(1,066)	(1,028)	(981)
Property and equipment, net	310	301	295
Goodwill	95	95	94
Debt issuance costs, net of accumulated amortization of $66, $60, and $65, respectively	62	72	80
Deferred income taxes	18	18	8
Other assets	6	9	7
Total non-current assets	181	194	189
Total assets	$ 1,577	$ 1,770	$ 1,584
LIABILITIES AND STOCKHOLDERS DEFICIT			
Current liabilities:			
Accounts payable	$ 250	$ 273	$ 222
Accrued liabilities and other	332	384	321
Current portion of long-term debt	140	1	1
Income taxes payable	4	29	1
Total current liabilities	726	687	545
Long-term debt	3,387	3,667	3,707
Deferred income taxes	4	4	2
Other long-term liabilities	75	76	84
Total long-term liabilities	3,466	3,747	3,793
	4,192	4,434	4,338
Commitments and contingencies			

Stockholders deficit:						
Common Stock, $0.10 par value, 220,000,000 shares authorized; 118,294,503 shares issued and outstanding at July 30, 2011; 118,419,850 shares issued and outstanding at January 29, 2011; 118,389,571 shares issued and outstanding at July 31, 2010		12		12		12
Additional paid-in capital		44		43		39
Accumulated deficit		(2,679)		(2,726)		(2,812)
Accumulated other comprehensive income		8		7		7
Total stockholders deficit		(2,615)		(2,664)		(2,754)
Total liabilities and stockholders deficit	$	1,577	$	1,770	$	1,584

See accompanying notes to consolidated financial statements.

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MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions)

(Unaudited)

	Quarter Ended		Six Months Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
Net sales	$ 857	$ 831	$ 1,810	$ 1,732
Cost of sales and occupancy expense	529	520	1,089	1,067
Gross profit	328	311	721	665
Selling, general, and administrative expense	241	233	495	478
Related party expenses	4	4	7	7
Store pre-opening costs	1		2	1
Operating income	82	74	217	179
Interest expense	61	70	126	138
Loss on early extinguishment of debt	4		15	
Other (income) and expense, net	1	4		11
Income before income taxes	16		76	30
Provision for income taxes	6	1	29	18
Net income (loss)	$ 10	$ (1)	$ 47	$ 12

See accompanying notes to consolidated financial statements.

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MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Unaudited)

	Six Months Ended	
	July 30, 2011	**July 31, 2010**
Operating activities:		
Net income	$ 47	$ 12
Adjustments:		
Depreciation and amortization	50	52
Share-based compensation	4	4
Debt issuance costs amortization	8	9
Accretion of long-term debt	24	24
Change in fair value of interest rate cap	3	13
Change in fair value of contingent consideration	(1)	
Loss on early extinguishment of debt	15	
Changes in assets and liabilities:		
Merchandise inventories	(71)	(15)
Prepaid expenses and other	(6)	2
Accounts payable	(12)	(9)
Accrued interest	(10)	(2)
Accrued liabilities and other	(48)	(29)
Income taxes payable	(51)	(41)
Other long-term liabilities		3
Net cash (used in) provided by operating activities	(48)	23
Investing activities:		
Additions to property and equipment	(46)	(33)
Net cash used in investing activities	(46)	(33)
Financing activities:		
Borrowings on asset-based revolving credit facility	2	48
Payments on asset-based revolving credit facility		(48)
Repurchase of subordinated discount notes due 2016	(129)	
Repayments on senior secured term loan facility	(50)	(118)
Payment of debt issuance costs		(19)
Repurchase of Common Stock	(5)	
Proceeds from stock options exercised	1	
Change in cash overdraft	(17)	
Other		(1)
Net cash used in financing activities	(198)	(138)
Decrease in cash and equivalents	(292)	(148)
Cash and equivalents at beginning of period	319	217
Cash and equivalents at end of period	$ 27	$ 69
Supplemental Cash Flow Information:		
Cash paid for interest	$ 103	$ 105

Cash paid for income taxes	$	75	$	58

See accompanying notes to consolidated financial statements.

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MICHAELS STORES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Quarter and Six Months Ended July 30, 2011

(Unaudited)

Note 1. Summary of Significant Accounting Policies

Basis of Presentation

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

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

The balance sheet at January 29, 2011 has been derived from the audited financial statements at that date, but does not include all of the information and notes required by generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 29, 2011.

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 July 30, 2011 are not indicative of the results to be expected for the entire year.

We report on the basis of a 52 or 53-week fiscal year, which ends on the Saturday closest to January 31. All references herein to fiscal 2011 relate to the 52 weeks ending January 28, 2012, and all references to fiscal 2010 relate to the 52 weeks ended January 29, 2011. In addition, all references herein to the second quarter of fiscal 2011 relate to the 13 weeks ended July 30, 2011, and all references to the second quarter of fiscal 2010 relate to the 13 weeks ended July 31, 2010. Finally, all references to the six months ended July 30, 2011 relate to the 26 weeks ended

July 30, 2011, and the six months ended July 31, 2010 relate to the 26 weeks ended July 31, 2010.

Recent Accounting Pronouncements

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

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

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Note 2. Share-Based Compensation

The 2006 Equity Incentive Plan (2006 Plan) provides for the grant of share-based awards exercisable for up to 14.2 million shares of Common Stock. As of July 30, 2011, there were 10.7 million stock option awards outstanding. In addition, there were a total of 579,661 shares of restricted stock outstanding under the 2006 Plan, of which 159,435 are vested. 2.8 million shares of Common Stock remain available for grant under the 2006 Plan. The table below sets forth a summary of stock option activity for the six months ended July 30, 2011:

	Six Months Ended July 30, 2011 (in millions)
Outstanding at beginning of period	10.9
Granted	0.1
Exercised	(0.1)
Cancelled/Forfeited	(0.2)
Outstanding at end of period	10.7

Generally, awards granted under the 2006 Plan vest ratably over five years and expire eight years from the grant date. The exercise prices of the options ranged from $7.50 per share to $22.50 per share, as determined by the Board of Directors. Share-based compensation expense associated with the stock options and the restricted stock was $2 million for the second quarter of each of fiscal 2011 and fiscal 2010 and $4 million during each of the six months ended July 30, 2011 and July 31, 2010.

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.

	July 30, 2011	January 29, 2011 (in millions)	July 31, 2010	Interest Rate
Senior secured term loan	$ 1,996	$ 2,046	$ 2,156	Variable
Senior notes due 2014			750	10.000%
Senior notes due 2018	795	794		7.750%
Senior subordinated notes	400	400	400	11.375%
Subordinated discount notes	334	427	401	13.000%
Asset-based revolving credit facility	2			Variable
Other		1	1	5.970%
Total debt	3,527	3,668	3,708	
Less current portion	140	1	1	
Long-term debt	$ 3,387	$ 3,667	$ 3,707	

73/4% Senior Notes due 2018

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

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

13% Subordinated Discount Notes due 2016

During the second quarter of fiscal 2011, we completed open market repurchases of our outstanding 13% Subordinated Discount Notes due 2016 (Subordinated Discount Notes) totaling $31 million face value, or $29 million accreted value. During the first six months of fiscal 2011, we completed open market repurchases of our outstanding Subordinated Discount Notes totaling $124 million face value, or $116 million accreted value. Pursuant to the terms of the repurchases, we agreed to pay the holders of the Subordinated Discount Notes face value plus a purchase premium.

In accordance with ASC 470, *Debt,* we recorded a loss of $4 million and $15 million during the second quarter and first six months of fiscal 2011, respectively, related to the early extinguishment of the repurchased Subordinated Discount Notes. The $4 million loss is comprised of $2 million to recognize the unrealized interest accretion and write off of related debt issuance costs, as well as $2 million in purchase premiums. The $15 million loss is comprised of $10 million to recognize the unrealized interest accretion and write off of related debt issuance costs, as well as $5 million in purchase premiums.

Senior Secured Asset-Based Revolving Credit Facility

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

The borrowing base under the senior secured asset-based revolving credit facility equals the sum of (i) 90% of eligible credit card receivables and debit card receivables; (ii) between 85% and 87.5% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit; and (iii) a percentage of eligible in-transit inventory, less certain reserves. As of July 30, 2011, the borrowing base was $642 million, of which we had $2 million of outstanding borrowings, $58 million of outstanding letters of credit, and $582 million of excess availability.

Note 4. Comprehensive Income (Loss)

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

	Quarter Ended		Six Months Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
		(in millions)		
Net income (loss)	$ 10	$ (1)	$ 47	$ 12
Other comprehensive income:				
Foreign currency translation adjustment and other			1	1
Comprehensive income	$ 10	$ (1)	$ 48	$ 13

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

		Foreign Currency Translation and Other (in millions)
Balance at January 29, 2011	$	7
Foreign currency translation adjustment		1
Balance at July 30, 2011	$	8

Note 5. Derivative Instruments

We are exposed to fluctuations in interest rates on our senior secured term loan facility. During fiscal 2009, we purchased an interest rate derivative with the objective to cap our exposure to interest rate increases on our senior secured term loan facility that result from fluctuations in the three-month LIBOR rate. The cap limits our interest exposure on a notional value of $2.0 billion to the lesser of the three-month LIBOR rate or 7.0%. The term of the cap extends to the first quarter of fiscal 2015. The interest rate cap does not qualify for hedge accounting under ASC 815, *Derivatives and Hedging*. The fair value of the cap as of July 30, 2011, January 29, 2011 and July 31, 2010 was $3 million, $6 million and $5 million, respectively, and is included in Other assets on the Consolidated Balance Sheets. The change in fair value of the cap for the quarter and six months ended July 30, 2011 resulted in a loss of $1 million and a loss of $3 million, respectively. The change in fair value of the cap for the quarter and six months ended July 31, 2010, resulted in a loss of $3 million and a loss of $13 million, respectively. These amounts are recorded in Other (income) and expense, net in the Consolidated Statements of Operations.

Note 6. Fair Value Measurements

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

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

The following table presents net financial assets (liabilities) accounted for at fair value on a recurring basis as of July 30, 2011 (in millions):

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

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

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

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We apply fair value techniques on a non-recurring basis for the establishment of potential impairment loss related to goodwill pursuant to ASC 350, *Intangibles Goodwill and Other* and determining the fair value of long-lived assets pursuant to ASC 360, *Property, Plant, and Equipment.* During the quarter and six months ended July 30, 2011, there were no events or changes in circumstances indicating the carrying amounts of our long-lived assets may not be recoverable.

The table below provides the carrying and fair values of our loan and notes as of July 30, 2011. The fair value of these debt instruments was determined based on quoted market prices or recent trades.

		Carrying Value		Fair Value
		(in millions)		
Senior secured term loan	$	1,996	$	1,971
Senior notes		795		799
Senior subordinated notes		400		429
Subordinated discount notes		334		356

Note 7. Income Taxes

The effective tax rate was 36.7 % for the second quarter of fiscal 2011. During the second quarter of fiscal 2010, we recorded a tax provision of $1 million, primarily due to additional expense related to discrete items. As a result of our low income base for the second quarter of fiscal 2010, our effective rate was highly sensitive to changes caused by discrete items and permanent differences (i.e. differences between book income and tax income that are not expected to reverse in future periods).

The effective tax rate was 38.3 % for the first six months of fiscal 2011. The effective tax rate was 59.8% for the first six months of fiscal 2010. The higher rate in fiscal 2010 was due primarily to additional expense to correct the federal deferred tax liability relating to state income taxes. We currently estimate our annualized effective tax rate for fiscal 2011 to be 37.8%.

Note 8. Commitments and Contingencies

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

Employee Claims

Ragano Claim

On July 11, 2011, the Company was served with a lawsuit filed on July 5, 2011 in the California Superior Court in and for the County of San Mateo by Anita Ragano, as a purported class action proceeding on behalf of Ragano and all current and former hourly retail employees employed by Michaels stores in California. We removed the matter to the United States District Court for the Northern District of California on August 9, 2011. The lawsuit alleges that Michaels stores failed to pay all wages and overtime, failed to provide its hourly employees with adequate meal and rest breaks (or compensation in lieu thereof), failed to timely pay final wages, unlawfully withheld wages and failed to provide accurate wage statements and further alleges that the foregoing conduct was in breach of various laws, including California s unfair competition law. The plaintiff seeks injunctive relief, compensatory damages, meal and rest break penalties, waiting time penalties, interest, and attorneys fees and costs. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We are unable to estimate a range of loss, if any, in this case.

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Consumer Class Action Claims

Zip Code Claims

On August 15, 2008, Linda Carson, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the Superior Court of California, County of San Diego (San Diego Superior Court), on behalf of herself and all similarly-situated California consumers. The Carson lawsuit alleges that Michaels unlawfully requested and recorded personally identifiable information (i.e., her zip code) as part of a credit card transaction. The plaintiff sought statutory penalties, costs, interest, and attorneys fees. We contested certification of this claim as a class action and filed a motion to dismiss the claim. On March 9, 2009, the Court dismissed the case with prejudice. The plaintiff appealed this decision to the California Court of Appeal for the Fourth District, San Diego. On July 22, 2010, the Court of Appeal upheld the dismissal of the case. The plaintiff appealed this decision to the Supreme Court of California (California Supreme Court). On September 29, 2010, the California Supreme Court granted the plaintiff s petition for review; however, it stayed any further proceedings in the case until another similar zip code case pending before the court, Pineda v. Williams-Sonoma, was decided. On February 10, 2011, the California Supreme Court ruled, in the Williams-Sonoma case, that zip codes are personally identifiable information and therefore the Song-Beverly Credit Card Act of 1971, as amended (Song Act) prohibits businesses from requesting or requiring zip codes in connection with a credit card transaction. On or about April 6, 2011, the Supreme Court transferred the Carson case back to the Court of Appeal with directions to the Court to reconsider its decision in light of Pineda decision. Upon reconsideration the Court of Appeal remanded the case back to the San Diego Superior Court. We are reviewing the matter in light of this recent decision and, at this time, we are unable to estimate a range of loss, if any, in this case. Additionally, since the California Supreme Court decision on February 10, 2011, three additional purported class action lawsuits alleging violations of the Song Act have been filed against the Company: Carolyn Austin v. Michaels Stores, Inc. and Tiffany Heon v. Michaels Stores, Inc., both in the San Diego Superior Court and Sandra A. Rubinstein v. Michaels Stores, Inc. in the Superior Court of California, County of Los Angeles, Central Division. Unopposed motions to coordinate these actions have been filed. Also, relying in part on the California Supreme Court decision, an additional purported class action lawsuit was filed on May 20, 2011 against the Company: Melissa Tyler v. Michaels Stores, Inc. in the United States District Court-District of Massachusetts, alleging violation of a similar Massachusetts statute regarding the collection of personally identifiable information in connection with a credit card transaction. A Motion to Dismiss the claims was filed and is currently pending. We intend to vigorously defend each of these cases and we are unable, at this time, to estimate a range of loss, if any.

Gift Card Claims

On April 9, 2010, Ross Rattray, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the San Diego Superior Court, on behalf of himself and all similarly-situated California consumers. The Rattray lawsuit alleges causes of action for unlawful and unfair business practices and false advertising under the California Business and Professions Code, and a violation of the Consumer Legal Remedies Act, for misrepresentation that Michaels gift cards are not redeemable for cash and for failure to disclose that the plaintiff could redeem the unused cash balance on a gift card when the value fell below $10.00. On March 15, 2011, the matter was mediated and a tentative settlement agreement was reached with the plaintiff for an immaterial amount, which continues to be subject to Court approval. Subsequently, on April 25, 2011, Shirley Polak and Billie Lavrov, consumers, filed a purported class action proceeding against Michaels Stores, Inc. in the County of Los Angeles Superior Court, on behalf of themselves and all similarly-situated California consumers. The Polak/ Lavrov complaint significantly mirrors the claims in the Rattray case and the matter was settled for an immaterial amount.

Data Breach Claims

Payment Card Terminal Tampering

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

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On May 18, 2011, Brandi F. Ramundo, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the United States District Court for the Northern District of Illinois, on behalf of herself and all similarly-situated U.S. consumers. The Ramundo lawsuit alleges that Michaels failed to take commercially reasonable steps to protect consumer financial data, and was in breach of contract and various laws, including the Federal Stored Communications Act and the Illinois Consumer Fraud and Deceptive Practices Act. The plaintiff seeks compensatory, statutory and punitive damages, costs, credit card fraud monitoring services, interest and attorneys fees. Subsequently three additional purported class action lawsuits significantly mirroring the claims in the Ramundo complaint were filed against the Company: Mary Allen v. Michaels Stores, Inc., Kimberly Siprut v. Michaels Stores, Inc., and Jeremy Williams v. Michaels Stores, Inc., all in the United States District Court for the Northern District of Illinois. On July 8, 2011, a Consolidated Amended Class Action Complaint styled In re Michaels Stores Pin Pad Litigation (In Re Michaels Stores Consolidated Complaint) was filed in the United States District Court for the Northern District of Illinois and on August 8, 2011, we filed a Motion to Dismiss the In Re Michaels Stores Consolidated Complaint. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We are unable to estimate a range of loss, if any, in the case.

Two additional purported class action lawsuits significantly mirroring the claims in the In Re Michaels Stores Consolidated Complaint have been filed against the Company in New Jersey: Sara Rosenfeld and Ilana Soffer v. Michaels Stores, Inc. filed in the Superior Court of New Jersey on July 7, 2011 and removed to the United States District Court of New Jersey on August 5, 2011; and Lori Wilson v. Michaels Stores, Inc. filed in the Superior Court of New Jersey on August 10, 2011. We believe we have meritorious defenses and intend to defend the lawsuits vigorously. We are unable to estimate a range of loss, if any, in these cases.

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Pricing and Promotions Inquiry

On or about February 11, 2011, the Company received a notice of investigation and a subpoena from the New York State Attorney General requiring the production of certain documents relating to the frequency of the Company s pricing promotions and advertisements. We have fully cooperated in the investigation and implemented certain modifications to our custom framing promotional activities in connection with the same. We have settled the matter with the New York State Attorney General s office through the payment of a fine and other consideration pursuant to an Assurance of Discontinuance, the amounts of which are not considered to be material by the Company.

General

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

Note 9. Segments and Geographic Information

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

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

	Quarter Ended		**Six Months Ended**	
	July 30, 2011	**July 31, 2010**	**July 30, 2011**	**July 31, 2010**
	(in millions)			
Income before income taxes	$ 16	$	$ 76	$ 30
Interest expense	61	70	126	138
Loss on early extinguishment of debt	4		15	
Depreciation and amortization	25	26	50	52
EBITDA	$ 106	$ 96	$ 267	$ 220

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Our sales and assets by country are as follows:

	Quarter Ended		Six Months Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
	(in millions)			
Net Sales:				
United States	$ 778	$ 760	$ 1,645	$ 1,585
Canada	79	71	165	147
Consolidated Total	$ 857	$ 831	$ 1,810	$ 1,732
Total Assets:				
United States	$ 1,492	$ 1,506	$ 1,492	$ 1,506
Canada	85	78	85	78
Consolidated Total	$ 1,577	$ 1,584	$ 1,577	$ 1,584

Note 10. Related Party Transactions

We pay annual management fees to Bain Capital Partners, LLC and The Blackstone Group (collectively, together with their applicable affiliates, the Sponsors) and Highfields Capital Management LP in the amount of $12 million and $1 million, respectively. We recognized $4 million of expense related to annual management fees during the second quarter of each of fiscal 2011 and fiscal 2010, respectively, and $7 million during each of the six months ended July 30, 2011 and July 31, 2010. These expenses are included in related party expenses on the Consolidated Statements of Operations.

Bain Capital owns a majority equity position in an external vendor we utilized to print our circular advertisements. During the first quarter of fiscal 2011, we stopped utilizing this vendor for these services. Payments associated with this vendor during the second quarter of fiscal 2010 were $5 million. Payments for the six months ended July 30, 2011 and July 31, 2010 were $6 million and $14 million, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations.

Bain Capital owns a majority equity position in an external vendor we began utilizing for print procurement services during the fourth quarter of fiscal 2010. Payments associated with this vendor during the three and six months ended July 30, 2011, were $1 million and $2 million, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations.

The Blackstone Group owns a majority equity position in an external vendor we utilize to count our store inventory. Payments associated with this vendor during the second quarter fiscal 2011 and fiscal 2010 were $2 million and $1 million, respectively. Payments for each of the six months ended July 30, 2011 and July 31, 2010 were $4 million and $3 million, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations.

The Blackstone Group owns a majority equity position in an external vendor we utilize for all of the candy-type items in our stores. Payments associated with this vendor during the second quarter of fiscal 2011 and fiscal 2010 were $6 million and $5 million, respectively. Payments for the six months ended July 30, 2011, and July 31, 2010, were $12 million and $9 million, respectively. These expenses are recognized in cost of sales as the sales are recorded.

The Company periodically provides officers of Michaels Stores, Inc. and its subsidiaries the opportunity to purchase shares of our Common Stock. There were no shares sold to officers during first six months of each of fiscal 2011 and fiscal 2010. Also, during the second quarter of fiscal 2011 and the six months ended July 30, 2011, we repurchased 169,334 and 174,667 shares, respectively, from officers who are no longer with the Company. There were no shares repurchased during the first six months of fiscal 2010.

Note 11. Condensed Consolidating Financial Information

All obligations of Michaels Stores, Inc. under the Senior notes, Senior subordinated notes, Subordinated discount notes, senior secured term loan facility, and senior secured asset-based revolving credit facility are guaranteed by each of our subsidiaries other than Aaron Brothers Card Services, LLC and Artistree of Canada, ULC. As of July 30, 2011, the financial statements of Aaron Brothers Card Services, LLC and Artistree of Canada, ULC were immaterial. Each subsidiary guarantor is 100% owned by the parent and all guarantees are joint and several.

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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.

Supplemental Condensed Consolidating Balance Sheet

	July 30, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 27	$	$	$ 27
Merchandise inventories	583	314		897
Intercompany receivables		416	(416)	
Other	138	24		162
Total current assets	748	754	(416)	1,086
Property and equipment, net	245	65		310
Goodwill	95			95
Investment in subsidiaries	454		(454)	
Other assets	85	1		86
Total assets	$ 1,627	$ 820	$ (870)	$ 1,577
LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY				
Current liabilities:				
Accounts payable	$ 1	$ 249	$	$ 250
Accrued liabilities and other	227	105		332
Current portion of long-term debt	140			140
Intercompany payable	416		(416)	
Other	4			4
Total current liabilities	788	354	(416)	726
Long-term debt	3,387			3,387
Other long-term liabilities	67	12		79
Total stockholders (deficit) equity	(2,615)	454	(454)	(2,615)
Total liabilities and stockholders (deficit) equity	$ 1,627	$ 820	$ (870)	$ 1,577

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Supplemental Condensed Consolidating Balance Sheet

	January 29, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 309	$ 10	$	$ 319
Merchandise inventories	571	255		826
Intercompany receivables		348	(348)	
Other	113	17		130
Total current assets	993	630	(348)	$ 1,275
Property and equipment, net	234	67		301
Goodwill	95			95
Investment in subsidiaries	295		(295)	
Other assets	98	1		99
Total assets	$ 1,715	$ 698	$ (643)	$ 1,770
LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY				
Current liabilities:				
Accounts payable	$ 7	$ 266	$	$ 273
Accrued liabilities and other	262	122		384
Current portion of long-term debt	1			1
Intercompany payable	348		(348)	
Other	26	3		29
Total current liabilities	644	391	(348)	687
Long-term debt	3,667			3,667
Deferred income taxes	2	2		4
Other long-term liabilities	66	10		76
Total stockholders (deficit) equity	(2,664)	295	(295)	(2,664)
Total liabilities and stockholders (deficit) equity	$ 1,715	$ 698	$ (643)	$ 1,770

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Supplemental Condensed Consolidating Balance Sheet

	July 31, 2010			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 60	$ 9	$	$ 69
Merchandise inventories	588	300		888
Intercompany receivables		364	(364)	
Other	127	16		143
Total current assets	775	689	(364)	1,100
Property and equipment, net	226	69		295
Goodwill, net	94			94
Investment in subsidiaries	434		(434)	
Other assets	94	1		95
Total assets	$ 1,623	$ 759	$ (798)	$ 1,584
LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY				
Current liabilities:				
Accounts payable	$ (2)	$ 224	$	$ 222
Accrued liabilities and other	231	90		321
Current portion of long-term debt	1			1
Intercompany payable	364		(364)	
Other	1			1
Total current liabilities	595	314	(364)	545
Long-term debt	3,707			3,707
Other long-term liabilities	75	11		86
Total stockholders (deficit) equity	(2,754)	434	(434)	(2,754)
Total liabilities and stockholders (deficit) equity	$ 1,623	$ 759	$ (798)	$ 1,584

Supplemental Condensed Consolidating Statement of Operations

	Quarter Ended July 30, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	$ 744	$ 491	$ (378)	$ 857
Cost of sales and occupancy expense	494	413	(378)	529
Gross profit	250	78		328
Selling, general, and administrative expense	209	32		241
Related party expenses	4			4
Store pre-opening costs	1			1
Operating income	36	46		82
Interest expense	61			61
Loss on early extinguishment of debt	4			4
Other (income) and expense, net	1			1
Intercompany charges (income)	15	(15)		

Equity in earnings of subsidiaries		61				(61)		
Income before income taxes		16		61		(61)		16
Provision for income taxes		6		23		(23)		6
Net income	$	10	$	38	$	(38)	$	10

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Supplemental Condensed Consolidating Statement of Operations

	Quarter Ended July 31, 2010			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	$ 724	$ 481	$ (374)	$ 831
Cost of sales and occupancy expense	493	401	(374)	520
Gross profit	231	80		311
Selling, general, and administrative expense	202	31		233
Related party expenses	4			4
Store pre-opening costs				
Operating income	25	49		74
Interest expense	70			70
Other (income) and expense, net	4			4
Intercompany charges (income)	15	(15)		
Equity in earnings of subsidiaries	64		(64)	
Income before income taxes		64	(64)	
Provision for income taxes	1	26	(26)	1
Net loss	$ (1)	$ 38	$ (38)	$ (1)

Supplemental Condensed Consolidating Statement of Operations

	Six Months Ended July 30, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	$ 1,582	$ 1,018	$ (790)	$ 1,810
Cost of sales and occupancy expense	1,034	845	(790)	1,089
Gross profit	548	173		721
Selling, general, and administrative expense	430	65		495
Related party expenses	7			7
Store pre-opening costs	2			2
Operating income	109	108		217
Interest expense	126			126
Loss on early extinguishment of debt	15			15
Other (income) and expense, net	3	(3)		
Intercompany charges (income)	32	(32)		
Equity in earnings of subsidiaries	143		(143)	
Income before income taxes	76	143	(143)	76
Provision for income taxes	29	54	(54)	29
Net income	$ 47	$ 89	$ (89)	$ 47

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Supplemental Condensed Consolidating Statement of Operations

	Six Months Ended July 31, 2010			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
		(in millions)		
Net sales	$ 1,518	$ 965	$ (751)	$ 1,732
Cost of sales and occupancy expense	1,021	797	(751)	1,067
Gross profit	497	168		665
Selling, general, and administrative expense	414	64		478
Related party expenses	7			7
Store pre-opening costs	1			1
Operating income	75	104		179
Interest expense	138			138
Other (income) and expense, net	14	(3)		11
Intercompany charges (income)	31	(31)		
Equity in earnings of subsidiaries	138		(138)	
Income before income taxes	30	138	(138)	30
Provision for income taxes	18	57	(57)	18
Net income	$ 12	$ 81	$ (81)	$ 12

Supplemental Condensed Consolidating Statement of Cash Flows

	Six Months Ended July 30, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
		(in millions)		
Operating activities:				
Net cash used in operating activities	$ (47)	$ 50	$ (51)	$ (48)
Investing activities:				
Cash paid for property and equipment	(37)	(9)		(46)
Net cash used in investing activities	(37)	(9)		(46)
Financing activities:				
Net repayments of long-term debt	(177)			(177)
Intercompany dividends		(51)	51	
Other financing activities	(21)			(21)
Net cash used in financing activities	(198)	(51)	51	(198)
Decrease in cash and equivalents	(282)	(10)		(292)
Beginning cash and equivalents	309	10		319
Ending cash and equivalents	$ 27	$	$	$ 27

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Supplemental Condensed Consolidating Statement of Cash Flows

	Six Months Ended July 31, 2010			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating activities:				
Net cash provided by operating activities	$ 22	$ 54	$ (53)	$ 23
Investing activities:				
Cash paid for property and equipment	(31)	(2)		(33)
Net cash used in investing activities	(31)	(2)		(33)
Financing activities:				
Net repayments of long-term debt	(118)			(118)
Intercompany dividends		(53)	53	
Other financing activities	(20)			(20)
Net cash used in financing activities	(138)	(53)	53	(138)
Decrease in cash and equivalents	(147)	(1)		(148)
Beginning cash and equivalents	207	10		217
Ending cash and equivalents	$ 60	$ 9	$	$ 69

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

All expressions of the Company , 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.

Disclosure Regarding Forward-Looking Information

The following discussion should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. The following discussion, as well as other portions of this Quarterly Report on Form 10-Q, contains forward-looking statements that reflect our plans, estimates, and beliefs. Any statements contained herein (including, but not limited to, statements to the effect that Michaels or its management anticipates, plans, estimates, expects, believes, and other similar expressions) that a not statements of historical fact should be considered forward-looking statements and should be read in conjunction with our consolidated financial statements and related notes in our Annual Report on Form 10-K for the fiscal year ended January 29, 2011. Such forward-looking statements are based upon management s current knowledge and assumptions about future events and involve risks and uncertainties that could cause actual results, performance or achievements to be materially different from anticipated results, prospects, performance or achievements expressed or implied by such forward-looking statements. Such risks and uncertainties include, but are not limited to:

- risks related to general economic conditions; if recovery from the economic downturn continues to be slow or prolonged, it could continue to adversely affect consumer confidence and retail spending, decreasing demand for our merchandise and adversely impact our results of operations, cash flows and financial condition;

- our reliance on foreign suppliers increases our risk of obtaining adequate, timely, and cost-effective product supplies;

- significant increases in inflation or commodity prices such as petroleum, natural gas, electricity, steel and paper may adversely affect our costs, including cost of merchandise;

- risks related to our substantial indebtedness, as our leverage could adversely affect our ability to raise additional capital to fund our operations, limit our ability to react to changes in the economy or our industry, expose us to interest rate risk to the extent of our variable rate debt and prevent us from meeting our obligations under our notes and credit facilities;

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- restrictions in our debt agreements that limit our flexibility in operating our business, as our senior secured credit facilities and the indentures governing our notes contain various covenants that limit our ability to engage in specified types of transactions and require that we maintain specified financial ratios upon the occurrence of certain events;

- our ability to open new stores and increase comparable store sales growth, as our growth depends on our strategy of increasing the number and productivity of our stores and if we are unable to continue this strategy, our ability to increase our sales, profitability, and cash flow could be impaired;

- how well we manage our business;

- changes in customer demand could materially adversely affect our sales, results of operations, and cash flow;

- unexpected or unfavorable consumer responses to our promotional or merchandising programs could materially adversely affect our sales, results of operations, cash flow and financial condition;

- changes in newspaper subscription rates may result in reduced exposure to our circular advertisements;

- improvements to our supply chain may not be fully successful;

- our suppliers may fail us;

- risks associated with the vendors from whom our products are sourced could materially adversely affect our revenue and gross profit;

- product recalls and/or product liability, as well as changes in product safety and other consumer protection laws, may adversely impact our operations, merchandise offerings, reputation, results of operation, cash flow, and financial condition;

- we have co-sourced certain of our information technology, accounts payable, payroll, accounting and human resources functions, and may co-source other administrative functions, which makes us more dependent upon third parties;

- our information systems may prove inadequate;

- failure to adequately maintain security and prevent unauthorized access to electronic and other confidential information and data breaches such as the recent payment card terminal tampering could materially adversely affect our financial condition and results of operations;

- changes in regulations or enforcement may adversely impact our business;

- a weak fourth quarter would materially adversely affect our results of operations;

- competition could negatively impact our business; and

- the interests of our controlling stockholders may conflict with the interests of our creditors.

For more details on factors that may cause actual results to differ materially from such forward-looking statements, please see Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended January 29, 2011, and other reports from time to time filed with or furnished to the SEC. We disclaim any intention to, and undertake no obligation to, update or revise any forward-looking statement.

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General

We report on the basis of a 52 or 53-week fiscal year, which ends on the Saturday closest to January 31. All references herein to fiscal 2011 relate to the 52 weeks ending January 28, 2012 and all references to fiscal 2010 relate to the 52 weeks ended January 29, 2011. In addition, all references herein to the second quarter of fiscal 2011 relate to the 13 weeks ended July 30, 2011 and all references to the second quarter of fiscal 2010 relate to the 13 weeks ended July 31, 2010. Finally, all references to the six months ended July 30, 2011 relate to the 26 weeks ended July 30, 2011, and the six months ended July 31, 2010 relate to the 26 weeks ended July 31, 2010.

The following table sets forth certain of our unaudited operating data:

	Quarter Ended		Six Months Ended	
	July 30, 2011	**July 31, 2010**	**July 30, 2011**	**July 31, 2010**
Michaels stores:				
Retail stores open at beginning of period	1,049	1,028	1,045	1,023
Retail stores opened during the period	5	5	10	10
Retail stores opened (relocations) during the period	4		8	7
Retail stores closed during the period			(1)	
Retail stores closed (relocations) during the period	(4)		(8)	(7)
Retail stores open at end of period	1,054	1,033	1,054	1,033
Aaron Brothers stores:				
Retail stores open at beginning of period	136	146	137	152
Retail stores closed during the period		(1)	(1)	(7)
Retail stores open at end of period	136	145	136	145
Total store count at end of period	1,190	1,178	1,190	1,178
Other operating data:				
Average inventory per Michaels store (in thousands) (1)	$ 816	$ 823	$ 816	$ 823
Comparable store sales increase (2)	1.8%	2.3%	3.1%	3.6%

(1) The calculation of average inventory per Michaels store excludes our Aaron Brothers stores.

(2) Comparable store sales increase represents the increase in net sales for Michaels and Aaron Brothers stores open the same number of months in the indicated period and the comparable period of the previous year, including stores that were relocated or expanded during either period. A store is deemed to become comparable in its 14th month of operation in order to eliminate grand opening sales distortions. A store temporarily closed more than 2 weeks due to a catastrophic event is not considered comparable during the month it closed. If a store is closed longer than 2 weeks but less than 2 months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than 2 months becomes comparable in its 14th month of operation after its reopening.

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Results of Operations

The following table sets forth the percentage relationship to net sales of each line item of our unaudited consolidated Statements of Operations. This table should be read in conjunction with the following discussion and with our consolidated financial statements, including the related notes, contained herein.

	Quarter Ended		Six Months Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales and occupancy expense	61.7	62.5	60.2	61.6
Gross profit	38.3	37.5	39.8	38.4
Selling, general, and administrative expense	28.1	28.0	27.3	27.6
Related party expenses	0.5	0.5	0.4	0.4
Store pre-opening costs	0.1	0.1	0.1	0.1
Operating income	9.6	8.9	12.0	10.3
Interest expense	7.1	8.4	7.0	8.0
Loss on early extinguishment of debt	0.5		0.8	
Other (income) and expense, net	0.1	0.5		0.6
Income before income taxes	1.9		4.2	1.7
Provision for income taxes	0.7	0.1	1.6	1.0%
Net income (loss)	1.2%	(0.1)%	2.6%	0.7

Quarter Ended July 30, 2011 Compared to the Quarter Ended July 31, 2010

Net Sales Net sales increased for the second quarter of fiscal 2011 by $26 million, or 3.1%, over the second quarter of fiscal 2010 due primarily to a $15 million increase in comparable store sales. Comparable store sales increased 1.8% driven by a 2.6% increase in average ticket, partially offset by a 0.8% decrease in customer traffic. The fluctuation in the exchange rates between the United States and Canadian dollars positively impacted the average ticket by 60 basis points. Comparable store sales growth was strongest in our bakeware, apparel crafts, and impulse categories. In addition, sales from our non-comparable new stores provided incremental revenue of $11 million.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $9 million to $529 million in the second quarter of fiscal 2011 from $520 million in the second quarter of fiscal 2010 due primarily to a $7 million increase in occupancy costs as a result of opening new stores and higher rent for existing stores, a $7 million increase in freight and distribution costs, and a $6 million increase in merchandise costs associated with higher sales. These amounts were partially offset by a $9 million reduction from improved inventory management.

Cost of sales and occupancy expense decreased 80 basis points as a percentage of net sales to 61.7% for the second quarter of fiscal 2011 from 62.5% for the second quarter of fiscal 2010. Merchandise cost decreased 80 basis points driven by our direct import initiative and improved pricing and promotion management, while increased focus on inventory management contributed 120 basis points to the reduction in cost of sales. These amounts were partially offset by an 80 basis point increase in freight and distribution costs, as well as a 30 basis point increase in occupancy costs for the reasons indicated above.

Selling, General and Administrative Expense Selling, general and administrative expense was $241 million in the second quarter of fiscal 2011 compared to $233 million in the second quarter of fiscal 2010. Selling, general and administrative expense increased $8 million driven by a $6 million increase in store costs related to operating 21 additional Michaels stores during the second quarter of fiscal 2011 and a $3 million increase in advertising due to digital and targeted marketing campaigns that did not occur last year. These amounts were partially offset by a $2 million decrease in bonus expense due to a lower percentage of profitability levels earned during the second quarter of fiscal 2011 compared to the second quarter of fiscal 2010. As a percentage of net sales, selling, general and administrative expense increased 10 basis points due to an increase in advertising for the reasons indicated above.

Related Party Expenses Related party expenses were $4 million in the second quarter of each of fiscal 2011 and fiscal 2010, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, LP.

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Interest Expense Interest expense decreased $9 million to $61 million in the second quarter of fiscal 2011 from $70 million in the second quarter of fiscal 2010. The decrease is attributable to a lower average interest rate and a $181 million reduction in our total debt outstanding.

Loss on Early Extinguishment of Debt We recorded a loss of $4 million related to the early extinguishment of $31 million face value, or $29 million accreted value, of our 13% Subordinated Discount Notes during the second quarter of fiscal 2011. The $4 million loss is comprised of $2 million to recognize the unrealized interest accretion and write off of related debt issuance costs, as well as $2 million of purchase premiums. See Note 3 to the consolidated financial statements for further discussion.

Other(Income) and Expense, net Other expense in the second quarter of fiscal 2011 is related to a $1 million unfavorable change in the fair value of the interest rate cap as more fully described in Note 5 to the consolidated financial statements. Other expense in the second quarter of fiscal 2010 was related to a $3 million unfavorable change in the fair value of the interest rate cap and $1 million in foreign exchange rate losses.

Provision for Income Taxes The effective tax rate was 36.7 % for the second quarter of fiscal 2011. During the second quarter of fiscal 2010, we recorded a tax provision of $1 million, primarily due to additional expense related to discrete items. As a result of our low income base for the second quarter of fiscal 2010, our effective rate was highly sensitive to changes caused by discrete items and permanent differences (i.e. differences between book income and tax income that are not expected to reverse in future periods).

Six Months Ended July 30, 2011 Compared to the Six Months Ended July 31, 2010

Net Sales Net sales increased for the first six months of fiscal 2011 by $78 million, or 4.5%, over the first six months of fiscal 2010 due primarily to a $54 million increase in comparable store sales. Comparable store sales increased 3.1% due to an increase in average ticket of 2.0%, an increase in the customer traffic of 0.9%, and a positive impact of 0.2% related to deferred custom framing revenue. The fluctuation in the exchange rates between the United States and Canadian dollars positively impacted the average ticket by 50 basis points. Comparable store sales growth was strongest in our bakeware, home accents, and scrapbook accessories categories. In addition, sales from our non-comparable new stores provided incremental revenue of $24 million.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $22 million to $1.089 billion for the first six months of fiscal 2011 from $1.067 billion for the first six months of fiscal 2010 due primarily to a $20 million increase in merchandise costs associated with higher sales, a $12 million increase in occupancy costs as a result of opening new stores and higher rent for existing stores, and a $12 million increase in freight and distribution costs. These amounts were partially offset by a $14 million reduction from improved inventory management and a $6 million increase in vendor allowances recognized due to timing of receipt.

Cost of sales and occupancy expense decreased 140 basis points as a percentage of net sales to 60.2% for the first six months of fiscal 2011 from 61.6% for the first six months of fiscal 2010. Merchandise cost decreased 100 basis points driven by our direct import initiative and improved pricing and promotion management, while increased focus on inventory management and the timing of the recognition of vendor allowances contributed 90 basis points and 30 basis points to the reduction in cost of sales, respectively. These amounts were partially offset by a 70 basis point increase in freight and distribution costs.

Selling, General, and Administrative Expense Selling, general and administrative expense was $495 million for the first six months of fiscal 2011 compared to $478 million for the first six months of fiscal 2010. Selling, general and administrative expense increased $17 million driven by an $11 million increase in store costs related to operating 21 additional Michaels stores during the first six months of fiscal 2011 and a $5 million increase in advertising due to digital and targeted marketing campaigns that did not occur last year. As a percentage of net sales, selling, general and administrative expense decreased 30 basis points due to increased leverage of payroll and group insurance expense from higher comparable store sales.

Related Party Expenses Related party expenses were $7 million for the first six months of each of fiscal 2011 and fiscal 2010, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, LP.

Interest Expense Interest expense decreased $12 million for the first six months of fiscal 2011 compared to the first six months of 2010 due to a lower average interest rate and a $181 million reduction in our total debt outstanding.

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Loss on Early Extinguishment of Debt We recorded a loss of $15 million related to the early extinguishment of $124 million face value, or $116 million accreted value, of our 13% Subordinated Discount Notes during the first six months of fiscal 2011. The $15 million loss is comprised of $10 million to recognize the unrealized interest accretion and write off of related debt issuance costs, as well as $5 million of purchase premiums. See Note 3 to the consolidated financial statements for further discussion.

Other (Income) and Expense, net Other expense for the first six months of fiscal 2011 is related to a $3 million unfavorable change in the fair value of our interest rate cap offset by $3 million related to foreign exchange rate gains. Other expense for the first six months of fiscal 2010 was related to a $13 million unfavorable change in the fair value of the interest rate cap, partially offset by $2 million related to foreign exchange rate gains.

Provision for Income Taxes The effective tax rate was 38.3 % for the first six months of fiscal 2011. The effective tax rate was 59.8% for the first six months of fiscal 2010. The higher rate in fiscal 2010 was due primarily to additional expense to correct the federal deferred tax liability relating to state income taxes. We currently estimate our annualized effective tax rate for fiscal 2011 to be 37.8%.

Liquidity and Capital Resources

We require cash principally for day-to-day operations, to finance capital investments, to purchase inventory, to service our outstanding debt, and for seasonal working capital needs. We expect that our available cash, cash flow generated from operating activities, and funds available under our senior secured asset-based revolving credit facility will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and growth for the foreseeable future. Our senior secured asset-based revolving credit facility provides senior secured financing of up to $850 million, subject to a borrowing base. As of July 30, 2011, the borrowing base was $642 million, which supported $2 million of outstanding borrowings, $58 million of outstanding letters of credit and provided $582 million of excess availability. Our cash and equivalents decreased $292 million from $319 million at January 29, 2011, to $27 million at July 30, 2011.

We and our subsidiaries, affiliates, and significant shareholders may continue from time to time seek to retire or purchase our outstanding debt through cash purchases and/or exchanges, in open market purchases, privately negotiated transactions, by tender offer or otherwise. Such repurchases or exchanges, if any, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors.

Cash Flow from Operating Activities

Cash flow used in operating activities during the first six months of fiscal 2011 was $48 million compared to cash provided by operating activities of $23 million during the first six months of fiscal 2010. The $71 million change was primarily due to a $56 million decrease from the timing of inventory purchases and a $16 million decrease as a result of the timing of sales tax payments. In addition, the timing of payments related to accounts payable and accrued liabilities resulted in a decrease of $16 million. These amounts were partially offset by an increase in net income of $25 million before the consideration of the $10 million adverse impact of the change in the fair value of the interest rate cap.

Average inventory per Michaels store (including supporting distribution centers) decreased 0.9% from $823,000 at July 31, 2010 to $816,000 at July 30, 2011 primarily due to a planned reduction of store inventory levels, partially offset by higher freight costs. We anticipate average inventory per Michaels store at the end of fiscal 2011 to be down compared to the end of fiscal 2010.

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Cash Flow from Investing Activities

Cash flow used in investing activities represents the following capital expenditure activities:

	Six Months Ended July 30, 2011	Six Months Ended July 31, 2010
	(in millions)	
New and relocated stores and stores not yet opened (1)	$ 12	$ 11
Existing stores	9	10
Information systems	20	9
Corporate and other	5	3
	$ 46	$ 33

(1) In the first six months of fiscal 2011, we incurred capital expenditures related to the opening of ten Michaels stores in addition to the relocation of eight Michaels stores. In the first six months of fiscal 2010, we incurred capital expenditures related to the opening of ten Michaels stores in addition to the relocation of seven Michaels stores.

Cash Flow from Financing Activities

Cash flow used in financing activities during the first six months of fiscal 2011 was $198 million compared to $138 million during the first six months of fiscal 2010. Cash flow used in financing activities for the first six months of fiscal 2011 was impacted by the repurchases of $124 million face value of our 13% Subordinated Discount Notes, for which we paid $5 million in purchase premiums and third party fees. We also made a voluntary prepayment of $50 million on our senior secured term loan facility during the first quarter of fiscal 2011. In the first quarter of fiscal 2010, we made an excess cash flow payment on our senior secured term loan facility of $118 million and paid $19 million in debt issuance costs related to the amendment to the senior secured asset-based revolving credit facility. In addition, we had a $17 million increase from the timing of outstanding checks presented for payment.

As noted above, during the first six months of fiscal 2011, we completed open market repurchases of our outstanding 13% Subordinated Discount Notes due 2016 totaling $124 million face value, or $116 million accreted value. Pursuant to the terms of the repurchases, we agreed to pay the holders of the Subordinated Discount Notes face value plus a purchase premium.

In accordance with ASC 470, we recorded a loss of $15 million in the first six months of fiscal 2011 related to the early extinguishment of the repurchased Subordinated Discount Notes. The $15 million loss is comprised of $10 million to recognize the unrealized interest accretion and write off of related debt issuance costs, as well as $5 million in purchase premiums.

Non-GAAP Measures

The following table sets forth the Company s Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA). The Company defines EBITDA as net income before interest, income taxes, discontinued operations, depreciation and amortization. Additionally, the table presents Adjusted Earnings before Interest, Taxes, Depreciation and Amortization (Adjusted EBITDA). The Company defines Adjusted EBITDA as EBITDA adjusted for certain defined amounts that are added to, or subtracted from, EBITDA (collectively, the Adjustments) in accordance with the Company s $2.4 billion senior secured term loan facility and $850 million senior secured asset-based revolving credit facilities. The Adjustments are described in further detail in the table, and the footnotes to the table below.

The Company has presented EBITDA and Adjusted EBITDA to provide investors with additional information to evaluate our operating performance and our ability to service our debt. The Company uses EBITDA, among other metrics, to evaluate operating performance, to plan and forecast future periods operating performance and as an element of its incentive compensation targets. Adjusted EBITDA is a required calculation under the Company s senior secured term loan facility and its senior secured asset-based revolving credit facilities. As it relates to the senior secured term loan facility, Adjusted EBITDA is used in the calculations of fixed charge coverage and leverage ratios, which, under certain circumstances may result in limitations on the Company s ability to make restricted payments as well as the determination of mandatory repayments of the loans. Under the senior secured asset-based revolving facility, Adjusted EBITDA is used in the calculation of fixed charge coverage ratios, which under certain circumstances, may restrict the Company s ability to make certain payments (characterized as restricted payments), investments (including acquisitions) and debt repayments.

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As EBITDA and Adjusted EBITDA are not measures of operating performance or liquidity calculated in accordance with U.S. generally accepted accounting principles (GAAP), these measures should not be considered in isolation of, or as a substitute for, net income, as an indicator of operating performance, or net cash provided by operating activities as an indicator of liquidity. Our computation of EBITDA and Adjusted EBITDA may differ from similarly titled measures used by other companies. As EBITDA and Adjusted EBITDA exclude certain financial information compared with net income and net cash provided by operating activities, the most directly comparable GAAP financial measures, users of this financial information should consider the types of events and transactions which are excluded.

The table below shows a reconciliation of EBITDA and Adjusted EBITDA to net income and net cash provided by operating activities.

	Quarter Ended		Six Months Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
	(in millions)			
Net cash provided by operating activities	$ (67)	$ (4)	$ (48)	$ 23
Depreciation and amortization	(25)	(26)	(50)	(52)
Share-based compensation	(2)	(2)	(4)	(4)
Debt issuance costs amortization	(4)	(4)	(8)	(9)
Accretion of long-term debt	(11)	(12)	(24)	(24)
Change in fair value of interest rate cap	(1)	(3)	(3)	(13)
Change in fair value of contingent consideration	1		1	
Loss on early extinguishment of debt	(4)		(15)	
Changes in assets and liabilities	123	50	198	91
Net income (loss)	10	(1)	47	12
Interest expense	61	70	126	138
Loss on early extinguishment of debt	4		15	
Income tax provision	6	1	29	18
Depreciation and amortization	25	26	50	52
EBITDA	106	96	267	220
Adjustments:				
Share-based compensation	2	2	4	4
Sponsor Fees	4	4	7	7
Termination expense			1	
Pre-opening costs	1		2	1
Multi-year initiatives (1)	1			