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

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q/ A

(Amendment No. 1)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended December 27, 2003	**Commission file number 0-27826**

Party City Corporation

(Exact name of registrant as specified in its charter)

Delaware	**22-3033692**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
400 Commons Way Rockaway, New Jersey	**07866**
(Address of Principal Executive Offices)	*(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 þ No: o

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

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

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

TABLE OF CONTENTS

1

Table of Contents

PART I.

FINANCIAL INFORMATION

Explanatory Note

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

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

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

Part I, Item 1. Financial Statements

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

Part I, Item 4. Controls and Procedures

Part II, Item 1. Legal Proceedings

Report of Independent Registered Public Accounting Firm

Signature Page

Exhibit 31 and 32 Certifications

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

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

Table of Contents

Item 1. *Financial Statements*

PARTY CITY CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share information)

(Unaudited)

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

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

See accompanying notes to condensed consolidated financial statements.

Table of Contents

PARTY CITY CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

(Unaudited)

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

See accompanying notes to condensed consolidated financial statements.

4

Table of Contents

PARTY CITY CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

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

Issuance of warrants	245

See accompanying notes to condensed consolidated financial statements.

Table of Contents

PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

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

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

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

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

2. Stock-Based Compensation

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

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

6

Table of Contents

PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

3. Earnings Per Share

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

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

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

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

4. Financing Agreements

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

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

Table of Contents

PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

5. Stockholders Equity

Shares Outstanding

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

Stock Repurchase

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

Warrants

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

6. Legal Proceedings

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

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

Table of Contents

PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Segment Information

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

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

8. Acquisitions of Stores

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

PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

9. Guarantees

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

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

10. Recent Accounting Pronouncements

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

Table of Contents

PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

11. Restatement of Statements of Cash Flows

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

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

Table of Contents

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

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

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

Critical Accounting Policies and Estimates

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

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

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

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

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

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

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

Table of Contents

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

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

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

Results of Operations

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

Weighted average shares outstanding basic	16,867	16,803	16,856	16,600
Weighted average shares outstanding diluted	19,624	19,896	19,620	19,904

Table of Contents

	Quarter Ended December 27, 2003(b)	Quarter Ended December 28, 2002(b)	Six Months Ended December 27, 2003(b)	Six Months Ended December 28, 2002(b)
	(As restated)	(As restated)	(As restated)	(As restated)
Operating Data:				
Number of Company-owned stores (end of period)	247	239	247	239
Increase in Company-owned same store sales	3.7%	1.9%	3.8%	2.5%
Number of franchise stores (end of period)	254	240	254	240
Increase in franchise same store sales	7.0%	2.9%	5.7%	4.0%
Other Information:				
Depreciation and amortization	$ 3,890	$ 3,761	$ 7,692	$ 7,133
Cash flow used in:				
Investing activities	(2,081)	(4,817)	(3,529)	(15,202)
Financing activities	(15,901)	(18,617)	(14,017)	(1,338)
Balance Sheet Data:				
Working capital	$ 35,574	$ 14,487	$ 35,574	$ 14,487
Total assets	178,624	177,938	178,624	177,938
Borrowings		4,114		4,114
Stockholders equity	98,199	82,941	98,199	82,941
EBITDA(a)	36,395	31,641	37,147	33,032
Most directly comparable GAAP measures:				
Net income	19,290	15,050	17,340	13,314
Cash flows provided by operating activities	33,929	21,466	34,724	16,346

(a) Our definition of EBITDA is earnings before interest, taxes, depreciation and amortization. We believe EBITDA provides additional information for determining our ability to meet future debt service requirements. EBITDA should not be construed as a substitute for net income or net cash provided by operating activities (all as determined in accordance with generally accepted accounting principles) for the purpose of analyzing our operating performance, financial position and cash flows as EBITDA is not defined by generally accepted accounting principles. We have presented EBITDA, however, because it is commonly used by certain investors and analysts to analyze and compare companies on the basis of operating performance and to determine a company s ability to service and/ or incur debt. Our computation of EBITDA may not be comparable to similar titled measures of other companies.

Because we also consider EBITDA useful as an operating measure, a reconciliation of EBITDA to net income follows for the periods indicated:

	Quarter Ended December 27, 2003	Quarter Ended December 28, 2002	Six Months Ended December 27, 2003	Six Months Ended December 28, 2002
EBITDA	$ 36,395	$ 31,641	$ 37,147	$33,032
Depreciation and amortization	(3,890)	(3,761)	(7,692)	(7,133)
Interest expense, net	(112)	(2,824)	(312)	(3,709)
Provision for income taxes	(13,103)	(10,006)	(11,803)	(8,876)
Net income	$ 19,290	$ 15,050	$ 17,340	$13,314

Table of Contents

Because we also consider EBITDA useful as a liquidity measure, we present the following reconciliation of EBITDA to our net cash provided by operating activities:

	Quarter Ended December 27, 2003	Quarter Ended December 28, 2002	Six Months Ended December 27, 2003	Six Months Ended December 28, 2002
EBITDA	$ 36,395	$ 31,641	$ 37,147	$ 33,032
Interest expense, net	(112)	(2,824)	(312)	(3,709)
Provision for income taxes	(13,103)	(10,006)	(11,803)	(8,876)
Non-cash interest	40	1,304	80	1,554
Deferred rent	(117)	128	(240)	387
Stock based compensation	24	614	148	752
Provision for doubtful accounts	(77)	(301)	(140)	(602)
Other	6	356	10	44
Changes in assets and liabilities:				
Accounts payable, accrued expenses and other current liabilities	(19,192)	(20,212)	7,514	14,387
Merchandise inventory	32,946	25,572	5,627	(12,915)
Other long-term liabilities	(12)	(37)	(119)	
Other current assets and other assets	(2,869)	(4,769)	(3,188)	(7,708)
Net cash provided by operating activities	$ 33,929	$ 21,466	$ 34,724	$ 16,346

We use EBITDA to determine our executive compensation which bases incentive compensation payments on our EBITDA performance measured against budget. EBITDA is also widely used by us and others in our industry to evaluate and price potential acquisitions.

EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are:

EBITDA does not reflect our current or future requirements for capital expenditures or contractual commitments;

EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

EBITDA does not reflect the interest expense, or the cash requirements necessary to service interest or principal payments, on our debts;

Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and EBITDA does not reflect any cash requirements for such replacements; and

Other companies in our industry may calculate EBITDA differently than we do, limiting its usefulness as a comparative measure.

Because of these limitations, EBITDA should not be considered as a measure of discretionary cash available to us to invest in the growth of our business. We compensate for these limitations by relying primarily on our GAAP results and using EBITDA only supplementally.

(b) See Note 11 to the condensed consolidated financial statements included in Item 1.

Other Information:

	Quarter Ended		Six Months Ended	
	December 27, 2003	December 28, 2002	December 27, 2003	December 28, 2002
Store Data:				
Company-owned:				
Stores open at beginning of period	247	234	242	209
Stores opened		5	6	28
Stores closed			(1)	
Stores acquired from franchisees				2
Stores open at end of period	247	239	247	239
Average Company-owned stores open in period	247	236	245	230
Franchise:				
Stores open at beginning of period	253	247	241	242
Stores opened	1	1	13	8
Stores closed		(8)		(8)
Stores sold to Company				(2)
Stores open at end of period	254	240	254	240
Average franchise stores open in period	253	247	251	245
Total stores chainwide	501	479	501	479

General

Net Sales. Net sales include same store sales and new store sales. Same store sales include sales for those stores that were in operation for a full period in both the current month and the corresponding month for the prior year. New store sales include sales in the current fiscal year from stores opened during the previous fiscal year before they are considered same stores, and new stores opened in the current fiscal year.

Cost of goods sold and occupancy costs. Cost of goods sold and occupancy costs includes the cost of merchandise, freight to the stores and store occupancy costs. Store occupancy costs include rent, common area maintenance, real estate taxes, repairs and maintenance, depreciation, insurance and utilities.

Store operating and selling expenses. Store operating and selling expenses consist of selling and store management payroll, employee benefits, medical insurance, employment taxes, advertising, pre-opening expenses which are expensed when incurred and other store level expenses.

General and administrative expenses. General and administrative expenses include payroll and employee benefits, employment taxes, management information systems, marketing, insurance, legal and other corporate level expenses. Corporate level expenses are primarily attributable to our corporate office in Rockaway, New Jersey, and district and regional offices throughout the country.

Franchising. Franchising revenue is composed of the initial franchise fees, which are recorded as revenue when a franchise store opens, plus ongoing royalty fees, which are generally 4.0% of the store s net sales. Franchise expenses include direct and indirect expenses. The direct expenses include salaries, travel and other direct expenses of the franchise operations department in addition to legal fees, bad debt expense, insurance expense and other miscellaneous charges. The indirect expenses include pro-rata allocations of corporate expenses for salaries, including bonuses, occupancy and depreciation, based on time spent on franchise support.

Table of Contents

Interest expense. Interest and debt expense includes interest relating to our senior notes and credit facility. Interest also includes amortization of financing intangibles, bank service charges and interest on capital lease obligations.

Quarter Ended December 27, 2003 Compared to Quarter Ended December 28, 2002

Retail. Net sales from Company-owned stores increased 8.4% to $175.3 million for the second quarter of Fiscal 2004 from $161.6 million for the second quarter of the prior fiscal year. Of the 8.4% increase in net sales, 3.7% resulted from a same store sales increase and the remaining 4.7% related to the stores that have not been open for one year. The customer count in company-owned stores, on a same store basis, increased 1.5%, and the average sale increased 2.2%. With nine stores joining the same store sales group during this quarter of Fiscal 2004, same store sales increased 4.9% in the western region, 4.0% in the eastern region and 2.6% in the central region. Same store sales for Company-owned stores increased 1.9% for the second quarter of Fiscal 2003. The Company opened no new stores during the second quarter of Fiscal 2004 and five in the same period last year.

Gross profit, which is net sales minus cost of goods sold and occupancy costs, increased 7.5% to $70.6 million in the second quarter of Fiscal 2004 from $65.7 million in the same period last year. The increase was primarily due to increased sales volume. Gross margin as a percent of sales was 40.3% for the second quarter of Fiscal 2004 compared with 40.6% for the same period last year.

Store operating and selling expenses increased 5.8% to $36.3 million for the second quarter of Fiscal 2004 from $34.3 million in the same period last year. The increase in store operating expenses of $2.0 million is attributable to same store sales increases and increased expenses related to the additional stores opened since the same period last year. Store operating and selling expenses were 20.7% and 21.2% of sales for the second quarter of Fiscal 2004 and Fiscal 2003, respectively. The decrease as a percent of sales is due mainly to a decrease in store opening expenses. For the second quarter of Fiscal 2004, operating expenses as a percent of sales were 19.9% for mature stores compared to 24.7% for our stores open for less than 24 months, including stores acquired in the Seattle Market.

The pre-opening expenses incurred in the second quarter of Fiscal 2004 for the new stores and stores to be opened later in the fiscal year amounted to $20,000 compared with $314,000 incurred during the same period last year.

Company-owned store profit contribution, which is gross profit minus store operating and selling expenses, was $34.3 million for the second quarter of Fiscal 2004 compared with $31.4 million for the same period last year. The improvement over the prior year is primarily the result of same store sales increases and the increase in the number of stores. Store profit contribution as a percent of sales was 19.6% for the second quarter of Fiscal 2004 compared with 19.4% in the same period last year. New stores in their first or second Halloween season reported store contribution of $3.3 million, an increase of $2.9 million over the comparable period last year. Of this $2.9 million increase, $400,000 was attributable to the 12 stores in the Seattle market acquired in 2002.

General and administrative expenses decreased 10.8% to $7.5 million in the second quarter of Fiscal 2004 from $8.4 million in the same period last year. General and administrative expenses were 4.3% and 5.2% of sales for the second quarter of Fiscal 2004 and Fiscal 2003, respectively. This decrease is primarily due to unusual expenses associated with the Company s new logistics initiative and professional fees related to the implementation of a new information system incurred in the second quarter of Fiscal 2003 which were not incurred in Fiscal 2004.

Franchising. Franchise fees recognized on one store opening was $40,000 in the second quarter of Fiscal 2004 and $40,000 for one store opening in the same period last year. Royalty fees increased 10.9% to $7.2 million in the second quarter of Fiscal 2004 from $6.5 million in the same period last year. This was primarily due to an increased franchise store base and a same store sales increase of 7.0% for the franchise stores in the second quarter of Fiscal 2004, as compared with 2.9% for the same period last year.

Table of Contents

Expenses attributable to franchise revenue decreased 5.1% to $1.6 million for the second quarter of Fiscal 2004 from $1.6 million for the second quarter of the prior fiscal year. As a percentage of franchise revenue, franchise expenses were 21.5% and 25.2% for the second quarter of Fiscal 2004 and Fiscal 2003, respectively.

Franchise profit contribution, which is franchise revenue minus expenses related to franchise revenue, increased 16.3% to $5.7 million in second quarter of Fiscal 2004 from $4.9 million in the same period last year. The increase in franchise profit contribution is due to the increase in royalty fees combined with a decrease in franchise expenses.

Interest Expense. Interest expense decreased to $112,000 for the second quarter of Fiscal 2004 from $2.8 million in the same period last year. This decrease in interest expense is due to the repurchase of outstanding senior notes in the second quarter of Fiscal 2003. The repurchase of these notes was completed using working capital and borrowings under the Company s asset-based revolving credit agreement.

Income Taxes. An income tax expense of $13.1 million or 40.5% of pre-tax income, and $10.0 million or 39.9% of pre-tax income was recorded in the second quarter of Fiscal 2004 and Fiscal 2003, respectively. The change in tax rate from 39.9% to 40.5% is due to an increase in the overall state tax rate.

Net Income. As a result of the above factors, net income increased to $19.3 million, or $0.98 per diluted share, in the second quarter of Fiscal 2004, as compared to net income of $15.1 million, or $0.76 per diluted share in Fiscal 2003. Weighted average diluted shares outstanding decreased to 19.6 million in the second quarter of Fiscal 2004 from 19.9 million in the same period last year. This decrease is mainly due to the 463,000 shares of company stock that were purchased by the Company during the third quarter of Fiscal 2003, the warrant and stock option exercises during the twelve months ending December 27, 2003.

Six Months Ended December 27, 2003 Compared with Six Months Ended December 28, 2002

Retail. Net sales from Company-owned stores increased 10.0% to $277.9 million for the six-months ended December 27, 2003 from $252.8 million for the same period last year. Of the 10.0% increase in net sales, 3.8% resulted from a same store sales increase and the remaining 6.2% related to the stores that have not been open for one year. The customer count in company-owned stores, on a same store basis, increased 1.4%, and the average sale increased 2.2%. With 31 stores joining the same store sales group during the six months ended December 27, 2003, same store sales increased 4.6% in the western region, 4.3% in the eastern region and 2.8% in the central region. Same store sales for Company-owned stores increased 2.5% for the same period last year. The Company opened six new stores and closed one store during the six-months ended December 27, 2003 and opened 28 stores, acquired two stores from franchises and closed no stores during the same period last year.

Gross profit, which is net sales minus cost of goods sold and occupancy costs, increased 7.1% to $98.9 million in the six-months ended December 27, 2003 from $92.4 million in the same period last year. The increase was primarily due to increased sales volume. Gross margin as a percent of sales was 35.6% for the six-months ended December 27, 2003 compared with 36.5% for the same period last year. The decrease in gross margin percent was related primarily to a high level of promotional activity in July and August, the continued emphasis on the clearance of discontinued merchandise as part of the Company s strategic focus.

Store operating and selling expenses increased 7.2% to $62.2 million for the six-months ended December 27, 2003 from $58.0 million in the same period last year. The increase in store operating expenses is attributable to increased expenses related to the additional stores opened since the same period last year. Store operating and selling expenses were 22.4% and 22.9% of sales for the six-months ended December 27, 2003 and December 28, 2002, respectively. The decrease as a percent of sales is due mainly to a decrease in store opening expenses. For the first six months of Fiscal 2004, operating expenses as a percent of sales were 21.4% for mature stores compared to 27.0% for our stores open for less than 24 months, including stores acquired in the Seattle Market.

The pre-opening expenses incurred in the six-months ended December 27, 2003 for the new stores and stores to be opened later in the fiscal year amounted to $323,000 compared with $796,000 incurred during the same time period last year.

Table of Contents

Company-owned store profit contribution, which is gross profit minus store operating and selling expenses, was $36.7 million for the six-months ended December 27, 2003 compared with $34.4 million for the same period last year. The improvement over the prior year is primarily the result of same store sales increases and the increase in the number of stores. Store profit contribution as a percent of sales was 13.2% for the six-months ended December 27, 2003 compared with 13.6% of sales in the same period last year due to the decrease in gross margin as described above. New stores in their first or second Halloween season reported store contribution of $1.3 million, an increase of $3.7 million over the comparable period last year. Of this $3.7 million increase, approximately $900,000 was attributable to our Seattle stores.

General and administrative expenses decreased 0.3% to $15.7 million in the six-months ended December 27, 2003 from $15.7 million in the same period last year. General and administrative expenses were 5.6% and 6.2% of sales for the six-months ended December 27, 2003 and December 28, 2002, respectively. This decrease as a percent of sales is primarily due to unusual expenses associated with the Company s new logistics initiative and professional fees related to the implementation of a new information system incurred during the six months ended December 27, 2002 which were not incurred during the same time period this year.

Franchising. Franchising fees recognized on 13 store openings was $488,000 in the six-months ended December 27, 2003 as compared with $275,000 recognized for eight store openings in the same period last year. Royalty fees increased 9.6% to $11.1 million in the six-months ended December 27, 2003 from $10.2 million in the same period last year. This was primarily due to an increased franchise store base and a same store sales increase of 5.7% for the franchise stores in the six-months ended December 27, 2003, as compared with 4.0% for the same period last year.

Expenses attributable to franchise revenue for the six-months ended December 27, 2003 remained relatively flat with last year at $3.2 million. As a percentage of franchise revenue, franchise expenses were 27.7% and 30.8% for the six-months ended December 27, 2003 and December 28, 2002, respectively.

Franchise profit contribution, which is franchise revenue minus expenses related to franchise revenue, increased 16.3% to $8.4 million for the six months ended December 27, 2003 from $7.2 million in the same period last year. The increase in franchise profit contribution is due to the increase in royalty fees as well as a decrease in franchise expenses.

Interest Expense. Interest expense decreased to $312,000 for the six-months ended December 27, 2003 from $3.7 million in the same period last year. This decrease in interest expense is due to the repurchase of outstanding senior notes. The repurchase of these notes was completed using working capital and borrowings under the Company s asset-based revolving credit agreement.

Income Taxes. An income tax expense of $11.8 million or 40.5% of pre-tax income, and $8.9 million or 40.0% of pre-tax income, was recorded in the six-months ended December 27, 2003 and December 28, 2002, respectively. The change in tax rate from 40.0% to 40.5% is due to an increase in the overall state tax rate.

Net Income. As a result of the above factors, net income increased to $17.3 million or $0.88 per diluted share in the six-months ended December 27, 2003, as compared to net income of $13.3 million, or $0.67 per diluted share in the same period last year. Weighted average diluted shares outstanding decreased to 19.6 million in the six-months ended December 27, 2003 from 19.9 million in the same period last year. This decrease is mainly due to the 463,000 shares of company stock that were purchased by the Company during the third quarter of Fiscal 2003, the warrant and stock option exercises during the twelve months ending December 27, 2003 and a slight decrease in average stock price for the six months ending December 27, 2003.

Liquidity and Capital Resources

The Company s cash requirements are primarily for working capital, the opening of new stores, the improvement and expansion of existing facilities and the improvement of information systems. Historically, these cash requirements have been met through cash flow from operating activities and borrowings under our credit facilities. At December 27, 2003, working capital was $35.6 million compared to $14.5 million in the same period last year.

Table of Contents

Operating Activities. For the six months ended December 27, 2003, cash provided by operating activities was $34.7 million, compared to $16.3 million for the same period last year. The increase in cash provided by operating activities was primarily attributable to a decrease in inventory. The decrease in average inventory level per store of 15.7% from the same period last year was attributed to management s efforts to control inventory and enable the Company to focus on product assortment, merchandise presentation and identify and discontinue slower moving SKU s. There was also an increase in net income and a decrease in accounts payable and other current liabilities.

Investing Activities. Cash used in investing activities for the six months ended December 27, 2003 was $3.5 million compared to $15.2 million in the same period in the last fiscal year. The decrease in cash used in investing activities was primarily attributable to the opening of six Company-owned stores this year as compared with 28 new store openings and the acquisition of two stores from a franchisee during the same period last year.

Financing Activities. Cash used in financing activities was $14.0 million for the six months ended December 27, 2003 compared with $1.3 million for the same period last year. Cash generated from operating activities was used to pay down our revolving credit facility.

Loan Agreement. At December 27, 2003, the Company had no balance outstanding under the Loan Agreement. Under the terms of the Loan Agreement, the Company may from time to time borrow amounts based on a percentage of its eligible inventory, up to a maximum of $65 million at any time outstanding. Advances bear interest, at the Company s option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50% and is currently at 1.25%, per annum or (ii) at the prime rate less the applicable margin, which was initially set at and is currently 0.25% per annum, totaling 3.75% at December 27, 2003. The term of the Loan Agreement is three years, and is secured by a lien on substantially all of the assets of the Company. At December 27, 2003, February 2, 2004 and June 4, 2004, the Company had no borrowings outstanding under the Loan Agreement. Based on a percentage of current eligible inventory and credit card receivables, the Company had $19.2 million and $19.4 million available to be borrowed under the Loan Agreement at February 2, 2004 and June 4, 2004, respectively.

Company management currently believes that the cash generated by operating activities, together with the borrowing availability under the Loan Agreement, will be sufficient to meet the Company s working capital needs for the next twelve months, including planned new store openings. The Company is currently free of debt. This permits the Company to consider a wide variety of corporate initiatives intended to improve shareholder value, although there is no assurance that any specific initiative will be pursued or consummated.

Contractual Obligations and Commercial Commitments

To facilitate an understanding of our contractual obligations and commercial commitments, the following data is provided as of December 27, 2003:

	Payments Due By Period (in thousands)				
	Total	**1 Year**	**2-3 Years**	**4-5 Years**	**After 5 Years**
Contractual Obligations:					
Operating leases	$244,830	$46,229	$86,258	$81,701	$30,642
Severance Arrangements	13	13			
Capital lease Obligations	10	10			
Total Contractual Obligations	$244,853	$46,252	$86,258	$81,701	$30,642

As of December 27, 2003 and February 2, 2004, we had a contingent liability related to severance payments for 14 employees. The total contingent liability ranged from zero to approximately $2.0 million. As of June 4, 2004, we had a contingent liability related to severance payments to 15 employees which ranged from zero to approximately $2.1 million. As of December 27, 2003, February 2, 2004, and June 4, 2004, we were contingently liable under a standby letter of credit of $3.7 million pursuant to the Loan Agreement.

Table of Contents

Off-Balance Sheet Arrangements

We have not created, and are not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating our business.

Recent Accounting Pronouncements

In January 2003, the FASB issued FASB Interpretation 46, Consolidation of Variable Interest Entities (FIN 46). FIN 46 addresses how to identify variable interest entities and provides guidance as to how a company may assess its interests in a variable interest entity for purposes of deciding whether consolidation of that entity is required. FIN 46 is effective for all variable interest entities created after January 31, 2003. The Company is required to adopt the provisions of FIN 46 for any variable interest entity created prior to February 1, 2003 by the end of the current fiscal year. We have evaluated the accounting provisions of the interpretations and we have determined that there was no material impact on our financial condition, results of operations or cash flows, since we are not the primary beneficiary of any variable interest entities.

Forward-Looking Statements

This Form 10-Q/ A (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 are made a number of times throughout the document and may be identified by forward-looking terminology as estimate, project, expect, believe, may, will, intend or similar statements or variations of terms. Such forward-looking statements are based on many assumptions that are subject to certain risks and uncertainties, and include among others, the following: levels of sales, store traffic, acceptance of product offerings, competitive pressures from other party supplies retailers and other retailers, availability of qualified personnel, availability of suitable future store locations, schedules of store expansion plans and other factors beyond our control. As a result of the foregoing risks and uncertainties, actual results and performance may differ materially from those projected or suggested herein. 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 Securities and Exchange Commission filings and our public announcements.

Item 3. ***Quantitative and Qualitative Disclosures About Market Risk***

We, in the normal course of doing business, are exposed to interest rate change and market risk. As borrowing patterns are cyclical, we borrow only during certain times of the year. Therefore, a sudden increase in interest rates (which under the Loan Agreement is dependent on, at the Company s option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50% per annum, and is currently at 1.25% per annum, or (ii) at the prime rate less the applicable margin, which was set initially at and is 0.25% per annum) may, during peak borrowing, have a negative impact on short-term results.

Item 4. ***Controls and Procedures***

This section has been updated for events and developments occurring subsequent to the filing of the Original 10-Q through June 4, 2004.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We regularly evaluate our internal control over financial reporting and discuss these matters with our independent accountants, Deloitte & Touche LLP, and our audit committee. We concluded in May 2004 that there was a reportable condition (as defined under standards established by the American Institute of Certified Public Accountants) in our internal control over financial reporting relating to the classification of a financing activity on the cash flow statement. Previously, the change in the cash overdraft account was classified from year to year in net cash provided by operating activities, rather than being classified in net cash used in financing activities. The prior treatment resulted in (i) lower net cash provided by operating activities and lower net cash used in financing activities of approximately $4,077,000 for the six months ended December 27, 2003 and (ii) higher net cash provided by operating activities and higher net cash used in financing activities of approximately $3,569,000 for the six months ended December 28, 2002. Although the dollar amounts relating to the reportable condition were immaterial to our results of operations, financial condition and liquidity, our management, the audit committee and our independent accountants reviewed and analyzed our internal controls, procedures and policies in response to this reportable condition. As a result, we enhanced our internal controls over financial reporting, including hiring additional financing and accounting staff, enhancing the training of our finance and accounting staff and requiring periodic review of a wider variety of current technical accounting literature.

In this Quarterly Report on Form 10-Q/ A, we have restated our consolidated statements of cash flows for the three and six months ended December 27, 2003 and December 28, 2002 to reflect the cash flow related to our cash overdraft in the condensed consolidated statements of cash flows as a financing activity rather than an operating activity. While the restatement did not have any effect on our operating or net income or on our condensed consolidated balance sheets, it did affect two line items in our condensed consolidated statements of cash flows: (i) accounts payable, accrued expenses and other current liabilities relating to net cash provided by operating activities and (ii) cash overdrafts relating to net cash used in financing activities.

As required by Rule 13a-15(b) under the Exchange Act and in light of the restatement of our condensed consolidated statements of cash flows, we conducted an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report and as of June 4, 2004. Based on the foregoing, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the reportable condition had been remediated and that our disclosure controls and procedures were effective at the reasonable assurance level as of the end of the period covered by this report and as of June 4, 2004.

Other than as described above, there has been no change in our internal control over financial reporting during the second quarter ended December 27, 2003 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. In addition, other than as described above, since the most recent evaluation date, there have been no significant changes in our internal control structure, policies and procedures or in other areas that could significantly affect our internal control over financial reporting.

PART II.

OTHER INFORMATION

Item 1. ***Legal Proceedings***

This section has been updated for events and developments occurring subsequent to the filing of the Original 10-Q through June 4, 2004.

A lawsuit was filed on September 25, 2001 against us in Los Angeles Superior Court by an assistant manager in one of our California stores for himself and on behalf of other members of an alleged class of Party City store managers (the Class) who claim we misclassified the Class members as exempt from California overtime wage and hour laws. The Class members sought the disgorgement of overtime wages allegedly owed by us to them but not paid and they also sought punitive damages and statutory penalties.

On March 30, 2004, the parties reached an agreement-in-principle to settle this lawsuit for $5.5 million on a claims made basis, which means that a payout to class members will only occur when claims are actually made by Class members. Previously, the Company recorded a pre-tax charge of $1.4 million related to this lawsuit. In connection with the agreement-in-principle, the Company recorded an additional pre-tax charge of $4.1 million during the third quarter of Fiscal 2004 to fully cover the settlement payments, attorneys fees and the estimated expenses of administering the settlement. The settlement provided for pursuant to the agreement-in-principle is subject to certain conditions, including the negotiation and execution of a definitive settlement agreement and the approval of the terms of the definitive settlement agreement by the Superior Court after notice to the members of the class who have the right to object. There can be no assurance that all of these conditions will be satisfied. If a final settlement is not consummated and the lawsuit is continued, a class is certified, liability is found and a judgment is entered, such judgment may adversely affect the Company.

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

Item 2. ***Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities***

None

Item 3. ***Defaults Upon Senior Securities***

None

Item 4. ***Submission of Matters to a Vote of Security Holders***

The Company s 2003 Annual Meeting of Stockholders was held on Wednesday, November 12, 2003 for the following purposes:

1. To elect eight directors to the Board of Directors who shall serve until the 2004 Annual Meeting of Stockholders, or until their successors are elected and qualified (Proposal 1).

The voting as to Proposal 1 was as follows:

Name	For	Against
Ralph D. Dillon	13,956,159	597,819
Richard H. Griner	13,956,159	597,819
L.R. Jalenak, Jr.	13,818,261	735,717
Franklin R. Johnson	13,956,111	597,867
Howard Levkowitz	13,643,053	910,919
Nancy Pedot	13,888,111	665,867
Walter J. Salmon	13,943,059	610,919
Michael E. Tennenbaum	13,497,361	1,056,657

2. To approve an amendment to the Company s Certificate of Incorporation increasing the number of the Company s authorized shares of Common Stock from 25,000,000 to 40,000,000 (Proposal 2).

The voting as to Proposal 2 was as follows:

For	Against	Abstained
13,512,000	1,035,303	6,605

3. To approve an amendment and restatement of the Company s 1999 Stock Incentive Plan, increasing the number of shares of the Company s common stock issuable pursuant to options and awards granted under the plan from 2,000,000 to 7,500,000, and increasing the limit on the number of shares of the Company s

Table of Contents

common stock which may be subject to options or stock appreciation rights granted to a single participant in any given year from 400,000 to 750,000 (Proposal 3). The voting as to Proposal 3 was as follows:

For	Against	Abstained	Broker Non-Vote
7,167,274	3,606,793	7,671	3,772,240

Item 5. ***Other Information***

None

Item 6. ***Exhibits and Reports on Form 8-K***

(a) The exhibits required to be filed as part of this report on Form 10-Q/ A are listed in the attached Exhibit Index.

(b) Reports on Form 8-K:

The Company furnished a Current Report on Form 8-K dated November 12, 2003 in reference to a press release dated November 12, 2003 reporting certain information regarding the Company s sales results for the five week period ended November 1, 2003, which includes the Halloween selling season.

The Company furnished a Current Report on Form 8-K dated November 7, 2003 in reference to a press release dated November 7, 2003 reporting certain information regarding the Company s operating results for the first quarter ended September 27, 2003.

The Company furnished a Current Report on Form 8-K dated October 9, 2003 in reference to a press release dated October 9, 2003 reporting certain information regarding the Company s sales results for the first quarter ended September 27, 2003.

EXHIBIT INDEX

Exhibit No.	
3.1	Certificate of Incorporation of the Company.
3.2	Bylaws of the Company as amended, incorporated by reference from the Company s Quarterly Report on Form 10-Q as filed with the Commission on November 12, 2003 (the November 2003 10-Q).
4.1	Specimen stock certificate evidencing the Common Stock, incorporated by reference from the Company s Registration Statement as amended on Form S-1 Number 333-00350 as filed with the Commission on January 18, 1996 (the S-1).
4.2	Form of Amended and Restated Warrant, incorporated by reference from the Company s Current Report on Form 8-K as filed with the Commission on January 19, 2000 (the January 2000 8-K).
4.3	Form of Securities Purchase Agreement, dated as of August 16, 1999, by and between the Company and each of the Investors, incorporated by reference from the Company s Current Report on Form 8-K as filed with the Commission on August 25, 1999 (the August 1999 8-K).
4.4	First Amendment to Securities Purchase Agreement, dated as of January 14, 2000, by and between the Company and each of the Investors, incorporated by reference from the January 2000 8-K.
4.5	Second Amendment to Securities Purchase Agreement, dated as of April 1, 2001, by and among the Company and each of the Investors, incorporated by reference from the Company s Quarterly Report on Form 10-Q as filed with the Commission on May 15, 2001 (the May 2001 10-Q).
10.1	Form of Unit Franchise Agreement entered into by the Company and franchisees, incorporated by reference from the S-1.
10.2	Option Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futterman, incorporated by reference from Amendment No. 1 to Schedule 13D as filed by Jack Futterman with the Commission on June 17, 1999 (Futterman s 13D).
10.3	Stock Pledge Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futterman, incorporated by reference from Futterman s 13D.
10.4	Amended and Restated Investor Rights Agreement, dated as of August 18, 2003, by and among the Company and the Investors, incorporated by reference from the Company s Annual Report on Form 10-K as filed with the Commission on September 26, 2003 (the September 2003 10-K).
10.5	Description of oral consulting agreement between the Company and Ralph Dillon, incorporated by reference from the Company s Quarterly Report on Form 10-Q as filed with the Commission on February 13, 2001.
10.6	General Release and Severance Agreement of James Shea, dated as of May 28, 2003, by and between the Company and James Shea, incorporated by reference from the September 2003 10-K.
10.7	Separation Agreement of Andrew Bailen, dated as of July 14, 2003, by and between the Company and Andrew Bailen, incorporated by reference from the September 2003 10-K.
10.8	Separation Agreement of Thomas Larson, dated as of August 26, 2002, by and between the Company and Thomas Larson, incorporated by reference from the September 2003 10-K.
10.9	Employment Agreement of Steven Skiba, dated as of November 29, 2002, by and between the Company and Steven Skiba, incorporated by reference from the September 2003 10-K.
10.10	Employment Agreement of Linda Siluk, dated as of November 7, 2003, by and between the Company and Linda M. Siluk, incorporated by reference from the November 2003 10-Q.
10.11	Employment Agreement of Warren Jeffrey, dated as of November 7, 2003, by and between the Company and Warren Jeffery, incorporated by reference from the November 2003 10-Q.
10.12	Employment Agreement of Richard H. Griner dated as of January 12, 2004, by and between the Company and Richard H. Griner, incorporated by reference from the Company s Quarterly Report on Form 10-Q as filed with the Commission on February 10, 2004.
10.13	Management Stock Purchase Plan of the Company, incorporated by reference from the Registration of Form S-8 as filed with the Commission on July 23, 2001.

Table of Contents

Exhibit No.	
10.14	Employee Stock Purchase Plan of the Company, incorporated by reference from the Company s Definitive Proxy Statement for the 2001 Annual Meeting of Stockholders, included within Form 14-A as filed with the Commission on October 18, 2001.
10.15	Amended and Restated 1994 Stock Option Plan, incorporated by reference from the Registration of Form S-8 as filed with the Commission on January 9, 1997.
10.16	1999 Stock Incentive Plan (Amended and Restated as of October 17, 2003), incorporated by reference from the Company s Definitive Proxy Statement for the 2003 Annual Meeting of Stockholders included within Form 14-A as filed with the Commission on October 20, 2003.
10.17	Loan and Security Agreement (the Loan Agreement), dated January 9, 2003, by and between the Company and Wells Fargo Retail Finance, LLC (WFRF), as the arranger, collateral agent and administrative agent, and Fleet Retail Finance, Inc., as the documentation agent, incorporated by reference from the Company s Current Report on Form 8-K as filed with the Commission on January 10, 2003.
10.18	Stock Pledge Agreement, dated January 9, 2003, by and among the Company, Party City Michigan, Inc. (PCMI) and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement, incorporated by reference from the September 2003 10-K.
10.19	Trademark Security Agreement, dated January 9, 2003, by and between the Company and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement, incorporated by reference from the September 2003 10-K.
10.20	Copyright Security Agreement, dated January 9, 2003, by and between the Company and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement, incorporated by reference from the September 2003 10-K.
10.21	Guaranty and Security Agreement, dated January 9, 2003, by and between PCMI and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement, incorporated by reference from the September 2003 10-K.
*15.1	Awareness Letter of Deloitte & Touche LLP.
21.1	Subsidiaries.
*31.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*31.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
*32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Included herein.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PARTY CITY CORPORATION

By /s/ NANCY PEDOT

(Nancy Pedot)
Chief Executive Officer

By /s/ LINDA M. SILUK

(Linda M. Siluk)
Chief Financial Officer

Date: July 9, 2004

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Party City Corporation
Rockaway, New Jersey

We have reviewed the accompanying condensed consolidated balance sheets of Party City Corporation and subsidiary as of December 27, 2003 and December 28, 2002, and the related condensed consolidated statements of income for the quarter and six-month periods then ended, and of cash flows for the six-month period then ended. These interim financial statements are the responsibility of the Company s management.

We conducted our review in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Party City Corporation and subsidiary as of June 28, 2003, and the related consolidated statements of income, shareholders equity, and cash flows for the year then ended (not presented herein); and in our report dated August 21, 2003 (June 30, 2004 as to the effects of the restatement discussed in Note 17), we expressed an unqualified opinion (which reports contain an explanatory paragraph that describes the adoption of a new accounting pronouncement) on those financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 28, 2003 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

As discussed in Note 11, the condensed consolidated statements of cash flows for the six-month periods ended December 27, 2003 and December 28, 2002 have been restated.

DELOITTE & TOUCHE LLP

Parsippany, New Jersey
February 9, 2004
(June 30, 2004 as to the effects of
the restatement discussed in Note 11)