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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549**

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended July 28, 2012

OR

**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

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**MICHAELS STORES, INC.**

(Exact name of registrant as specified in its charter)

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

**75-1943604**  
(I.R.S. employer  
identification number)

**8000 Bent Branch Drive**  
**Irving, Texas 75063**  
(Address of principal executive offices, including zip code)

**(972) 409-1300**  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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  No

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

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of August 20, 2012, 118,450,164 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)**

	<u>July 28, 2012</u>	<u>January 28, 2012</u>	<u>July 30, 2011</u>
<b>ASSETS</b>			
<b>Current assets:</b>			
Cash and equivalents.....	\$ 113	\$ 371	\$ 27
Merchandise inventories .....	922	840	897
Prepaid expenses and other .....	89	80	79
Deferred income taxes .....	42	42	52
Income tax receivable .....	27	1	27
Total current assets .....	<u>1,193</u>	<u>1,334</u>	<u>1,082</u>
<b>Property and equipment, at cost</b> .....	<u>1,438</u>	<u>1,391</u>	<u>1,376</u>
Less accumulated depreciation and amortization.....	<u>(1,112)</u>	<u>(1,079)</u>	<u>(1,066)</u>
Property and equipment, net .....	<u>326</u>	<u>312</u>	<u>310</u>
<b>Goodwill</b> .....	<u>95</u>	<u>95</u>	<u>95</u>
<b>Debt issuance costs, net of accumulated amortization of \$82, \$74, and \$66, respectively</b> .....	<u>51</u>	<u>59</u>	<u>62</u>
<b>Deferred income taxes</b> .....	<u>18</u>	<u>18</u>	<u>32</u>
<b>Other assets</b> .....	<u>3</u>	<u>4</u>	<u>6</u>
Total non-current assets .....	<u>167</u>	<u>176</u>	<u>195</u>
Total assets.....	<u>\$ 1,686</u>	<u>\$ 1,822</u>	<u>\$ 1,587</u>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>			
<b>Current liabilities:</b>			
Accounts payable.....	\$ 277	\$ 301	\$ 250
Accrued liabilities and other .....	351	389	332
Current portion of long-term debt.....	1	127	140
Deferred income taxes .....	1	1	—
Income taxes payable .....	2	19	2
Total current liabilities .....	<u>632</u>	<u>837</u>	<u>724</u>
<b>Long-term debt</b> .....	<u>3,363</u>	<u>3,363</u>	<u>3,387</u>
<b>Deferred income taxes</b> .....	<u>11</u>	<u>11</u>	<u>4</u>
<b>Other long-term liabilities</b> .....	<u>86</u>	<u>85</u>	<u>77</u>
Total long-term liabilities.....	<u>3,460</u>	<u>3,459</u>	<u>3,468</u>
Total liabilities .....	<u>4,092</u>	<u>4,296</u>	<u>4,192</u>
<b>Commitments and contingencies</b> .....			
<b>Stockholders' deficit:</b>			
Common Stock, \$0.10 par value, 220,000,000 shares authorized; 118,414,920 shares issued and outstanding at July 28, 2012; 118,265,885 shares issued and outstanding at January 28, 2012; 118,294,503 shares issued and outstanding at July 30, 2011 .....	12	12	12
Additional paid-in capital .....	50	48	44
Accumulated deficit .....	(2,474)	(2,540)	(2,669)
Accumulated other comprehensive income .....	6	6	8
Total stockholders' deficit .....	<u>(2,406)</u>	<u>(2,474)</u>	<u>(2,605)</u>
Total liabilities and stockholders' deficit.....	<u>\$ 1,686</u>	<u>\$ 1,822</u>	<u>\$ 1,587</u>

See accompanying notes to consolidated financial statements.

**MICHAELS STORES, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME**  
(in millions)  
(Unaudited)

	Quarter Ended		Six Months Ended	
	July 28, 2012	July 30, 2011	July 28, 2012	July 30, 2011
<b>Net sales</b> .....	\$ 892	\$ 857	\$ 1,870	\$ 1,810
Cost of sales and occupancy expense .....	553	529	1,119	1,089
<b>Gross profit</b> .....	339	328	751	721
Selling, general, and administrative expense .....	252	241	512	495
Related party expenses.....	4	4	7	7
Store pre-opening costs.....	1	1	2	2
<b>Operating income</b> .....	82	82	230	217
Interest expense.....	61	61	127	126
Loss on early extinguishment of debt .....	—	4	—	15
Other (income) and expense, net.....	—	1	(1)	—
<b>Income before income taxes</b> .....	21	16	104	76
Provision for income taxes.....	8	6	38	29
<b>Net income</b> .....	13	10	66	47
Other comprehensive income, net of tax: .....				
Foreign currency translation adjustment.....	(2)	—	—	1
<b>Comprehensive income</b> .....	\$ 11	\$ 10	\$ 66	\$ 48

See accompanying notes to consolidated financial statements.

**MICHAELS STORES, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in millions)  
(Unaudited)

	Six Months Ended	
	July 28, 2012	July 30, 2011
<b>Operating activities:</b>		
Net income .....	\$ 66	\$ 47
Adjustments:		
Depreciation and amortization .....	46	50
Share-based compensation .....	3	4
Debt issuance costs amortization .....	8	8
Accretion of long-term debt .....	—	24
Change in fair value of interest rate cap .....	—	3
Change in fair value of contingent consideration .....	—	(1)
Loss on early extinguishment of debt .....	—	15
Changes in assets and liabilities:		
Merchandise inventories .....	(82)	(71)
Prepaid expenses and other .....	(9)	(6)
Accounts payable .....	(23)	(12)
Accrued interest .....	(4)	(10)
Accrued liabilities and other .....	(42)	(48)
Income taxes payable .....	(43)	(51)
Other long-term liabilities .....	1	—
Net cash used in operating activities .....	(79)	(48)
<b>Investing activities:</b>		
Additions to property and equipment .....	(45)	(46)
Net cash used in investing activities .....	(45)	(46)
<b>Financing activities:</b>		
Repurchase of subordinated discount notes due 2016 .....	(127)	(129)
Repayments on senior secured term loan facility .....	—	(50)
Borrowings on asset-based revolving credit facility .....	—	2
Repurchase of Common Stock .....	(3)	(5)
Proceeds from stock options exercised .....	2	1
Payment of capital leases .....	(1)	—
Change in cash overdraft .....	(5)	(17)
Net cash used in financing activities .....	(134)	(198)
<b>Decrease in cash and equivalents .....</b>	<b>(258)</b>	<b>(292)</b>
<b>Cash and equivalents at beginning of period .....</b>	<b>371</b>	<b>319</b>
<b>Cash and equivalents at end of period .....</b>	<b>\$ 113</b>	<b>\$ 27</b>
<b>Supplemental Cash Flow Information:</b>		
Cash paid for interest .....	\$ 122	\$ 103
Cash paid for income taxes .....	\$ 80	\$ 75

See accompanying notes to consolidated financial statements.

**MICHAELS STORES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Quarter and Six Months Ended July 28, 2012**  
**(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 28, 2012.

The balance sheet at January 28, 2012 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.

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 28, 2012 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 2012” relate to the 53 weeks ending February 2, 2013, and all references to “fiscal 2011” relate to the 52 weeks ended January 28, 2012. In addition, all references herein to “the second quarter of fiscal 2012” relate to the 13 weeks ended July 28, 2012, and all references to “the second quarter of fiscal 2011” relate to the 13 weeks ended July 30, 2011. Finally, all references to “the six months ended July 28, 2012” relate to the 26 weeks ended July 28, 2012, and “the six months ended July 30, 2011” relate to the 26 weeks ended July 30, 2011.

*Recent Accounting Pronouncements*

In May 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-04, “*Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs*,” an amendment to ASC topic 820, “*Fair Value Measurements*.” ASU 2011-04 conforms certain sections of Accounting Standards Codification (“ASC”) 820 to International Financial Reporting Standards in order to provide a single converged guidance on the measurement of fair value. The ASU also requires new quantitative and qualitative disclosures about the sensitivity of recurring Level 3 measurement disclosures, as well as transfers between Level 1 and Level 2 of the fair value hierarchy. The amended guidance is effective for interim and annual periods beginning after December 15, 2011. We adopted all requirements of ASU 2011-04 on January 29, 2012, with no material impact on our consolidated financial statements.

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. In December 2011, the FASB issued ASU No. 2011-12, “*Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*,” which indefinitely defers the provisions in ASU 2011-05 requiring reclassification adjustments out of other comprehensive income to be presented on the face of the financial statements. The other portions of ASU 2011-05 remain unchanged. These standards, which must be applied retroactively, are effective for interim and annual periods beginning after December 15, 2011, with earlier adoption permitted. We adopted all requirements of these standards on January 29, 2012, the beginning of our 2012 fiscal year.

## Note 2. 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.

	<u>July 28, 2012</u>	<u>January 28, 2012</u> (in millions)	<u>July 30, 2011</u>	<u>Interest Rate</u>
Senior secured term loan.....	\$ 1,996	\$ 1,996	\$ 1,996	Variable
Senior notes due 2018.....	795	795	795	7.750%
Senior subordinated notes .....	393	393	400	11.375%
Subordinated discount notes .....	180	306	334	13.000%
Asset-based revolving credit facility.....	<u>—</u>	<u>—</u>	<u>2</u>	Variable
Total debt.....	3,364	3,490	3,527	
Less current portion .....	<u>1</u>	<u>127</u>	<u>140</u>	
Long-term debt .....	<u>\$ 3,363</u>	<u>\$ 3,363</u>	<u>\$ 3,387</u>	

### 13% Subordinated Discount Notes due 2016

On May 1, 2012, as required pursuant to the indenture governing our Subordinated Discount Notes (“Subordinated Discount Notes Indenture”), we redeemed that portion of each Subordinated Discount Note outstanding on such date equal to the amount sufficient, but not in excess of the amount necessary, to ensure that such Subordinated Discount Note will not be an applicable high yield discount obligation (“AHYDO”) within the meaning of Section 163(i)(1) of the Internal Revenue Code of 1986, as amended. These redemptions were at a price equal to 100% of the Accreted Value (as defined in the Subordinated Discount Notes Indenture) of such portion as of the date of redemption. The aggregate payment of \$127 million made on May 1, 2012, was required to ensure the Subordinated Discount Notes would not be AHYDO instruments.

### Senior Secured Asset-Based Revolving Credit Facility

Our senior secured asset-based revolving credit facility provides an aggregate amount of \$850 million in commitments, subject to a borrowing base, 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. As of July 28, 2012, the borrowing base was \$690 million, of which we had no outstanding borrowings, \$63 million of outstanding letters of credit, and \$627 million of excess availability.

## Note 3. Comprehensive Income

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

	<u>Foreign Currency Translation and Other</u> (in millions)
Balance at January 28, 2012 .....	\$ 6
Foreign currency translation adjustment.....	<u>—</u>
Balance at July 28, 2012 .....	<u>\$ 6</u>

## Note 4. 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”). 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 28, 2012 and January 28, 2012 was nominal and is included in Other assets on the Consolidated Balance Sheets. The fair value of the cap as of July 30, 2011 was \$3 million. The change in fair value of the cap for the quarter and six months ended July 28, 2012

resulted in a minimal loss and a minimal gain, respectively. 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. These amounts are recorded in Other (income) and expense, net in the Consolidated Statements of Operations and Comprehensive Income.

#### Note 5. Fair Value Measurements

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

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

During the first quarter of 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 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 derivative, 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 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. These factors are considered Level 2 inputs within the fair value hierarchy. As of July 28, 2012, the fair value of the cap was nominal. See Note 4 for additional information on our derivative instruments.

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 ended July 28, 2012, 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 senior secured term loan and notes as of July 28, 2012. The fair value of our senior secured term loan was determined based on quoted market prices and is considered Level 2 inputs within the fair value hierarchy. The fair value of our notes was determined based on recent trades and are considered Level 1 inputs within the fair value hierarchy.

	<u>Carrying Value</u>	<u>Fair Value</u>
	(in millions)	
Senior secured term loan.....	\$ 1,996	\$ 2,005
Senior notes .....	795	853
Senior subordinated notes .....	393	418
Subordinated discount notes ...	180	193

#### Note 6. Income Taxes

The effective tax rate was 40.1% for the second quarter of fiscal 2012. The effective tax rate was 36.7% for the second quarter of fiscal 2011. As a result of our low income base for the second quarter of each of fiscal 2012 and fiscal 2011, our effective rate is 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 36.6% for the first six months of fiscal 2012. The effective tax rate was 38.3% for the first six months of fiscal 2011. The rate was lower than the prior year six month tax rate due primarily to a favorable impact related to our reserve for uncertain tax positions. We currently estimate our annualized effective tax rate for fiscal 2012 to be 37.6%.



## **Note 7. Commitments and Contingencies**

We are involved in ongoing legal and regulatory proceedings. Other than those described in the following paragraphs, there were no material changes to our disclosures of commitments and contingencies from our Annual Report on Form 10-K for the fiscal year ended January 28, 2012 and our Quarterly Report on Form 10-Q for the quarterly period ended April 28, 2012.

### **Employee Claims**

#### *Ragano Claim*

On July 11, 2011, the Company was served with a lawsuit filed 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 herself and all current and former hourly retail employees employed by Michaels stores in California. We removed the matter to the U.S. District Court for the Northern District of California on August 9, 2011. The complaint was subsequently amended to add an additional named plaintiff, Terri McDonald. 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 plaintiffs seek injunctive relief, compensatory damages, meal and rest break penalties, waiting time penalties, interest, and attorneys' fees and costs. On August 10, 2012, we reached a tentative class-wide settlement with plaintiffs that is subject to the Court's approval. The settlement, if approved, will not have a material effect on our consolidated financial statements.

#### *Tijero and Godfrey Consolidated Claim*

On February 12, 2010, the Company and its wholly owned subsidiary, Aaron Brothers, was served with a lawsuit filed in the California Superior Court in and for the County of Alameda by Jose Tijero, a former assistant manager for Aaron Brothers, as a purported class action proceeding on behalf of himself and all current and former hourly retail employees employed by Aaron Brothers in California. On July 12, 2010, Aaron Brothers was served with a lawsuit filed in the California Superior Court in and for the County of Orange by Amanda Godfrey, a former Aaron Brothers' hourly employee alleging similar allegations as in the Tijero suit. On October 15, 2010, the cases were consolidated against Aaron Brothers and re-filed in the U.S. District Court—Northern District of California. These suits allege that Aaron Brothers 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. On April 4, 2012, we reached a class-wide settlement with plaintiffs that is subject to the Court's approval. A preliminary hearing on the settlement is scheduled for September 11, 2012. The settlement, if approved, will not have a material effect on our consolidated financial statements, and has already been accrued as of July 28, 2012.

#### *Irene Barreras Claim*

On July 24, 2012, Irene Barreras, a former employee, filed a purported class action proceeding against Michaels Stores, Inc. in the Superior Court of the State of California for the County of Alameda ("Alameda Superior Court"), alleging unfair business competition and unjust enrichment, wrongful termination, disability discrimination, failure to prevent discrimination, failure to engage in the interactive process, and failure to accommodate mental or physical disabilities. The suit is brought on Ms. Barreras' behalf and on behalf of a class of all retail store employees who were terminated from July 24, 2008 to the present, allegedly due to Michaels refusal to engage in the interactive process with, or provide accommodations to, the terminated employees who did not meet the qualifications for medical leaves. The plaintiff seeks injunctive relief, compensatory damages, punitive damages, consequential damages, general damages, interest, attorneys' fees and costs. We intend to remove the suit to the United States District Court, Northern District of California. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of the lawsuit will have a material effect on our consolidated financial statements.

### **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 Appeals for the Fourth District, San Diego. On July 22, 2010, the Court of Appeals 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 Appeals with directions to the Court to reconsider its decision in light of the Pineda decision. Upon reconsideration, the Court of Appeals remanded the case back to the San Diego Superior Court on May 31, 2011.

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. The Rubinstein case was transferred to the San Diego Superior Court. An order coordinating the cases has been entered and plaintiffs filed a Consolidated Complaint on April 24, 2012. A hearing on Plaintiffs Motion for Certification is set for March 8, 2013. Plaintiffs seek damages, civil penalties, common settlement fund recovery, attorney fees, costs of suit and prejudgment interest.

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 U.S. District Court-District of Massachusetts, alleging violation of a similar Massachusetts statute, Mass. Gen. Laws ch. 93, section 105(a) (“Statute”), regarding the collection of personally identifiable information in connection with a credit card transaction. A hearing was held on October 20, 2011 on our Motion to Dismiss the claims. On January 6, 2012, the Court granted our Motion to Dismiss. However, the Court certified questions of law to the Massachusetts Supreme Judicial Court regarding the interpretation of the Statute. Briefing to the Supreme Judicial Court is complete and a hearing on the matter is expected to be scheduled in October, 2012.

We intend to vigorously defend each of these zip code claim cases and we are unable, at this time, to estimate a range of loss, if any.

#### *Pricing and Promotion*

On April 30, 2012, William J. Henry, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the Court of Common Pleas, Lake County, Ohio, on behalf of himself and all similarly-situated Ohio consumers who purchased framing products and/or services from Michaels during weeks where Michaels was advertising a discount for framing products and/or services. The lawsuit alleges that Michaels advertised discounts on its framing products and/or services without actually providing a discount to its customers. The plaintiff claims violation of Ohio law ORC 1345.01 et seq., breach of contract, unjust enrichment and fraud. The plaintiff has alleged damages, penalties and fees not to exceed \$5 million, exclusive of interest and costs. We filed a Motion to Dismiss on July 3, 2012 and the motion is pending. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of this lawsuit will have a material effect on our consolidated financial statements.

#### *Website Tracking and Coding*

On June 19, 2012, Jerome Jurgens, a citizen of Missouri, filed a purported class action proceeding against Michaels Stores, Inc. in the 25th Judicial Circuit Court, Phelps County, Missouri, on behalf of himself, Wendy Poepsel and all other similarly-situated Missouri individuals who, on or after June 19, 2007, accessed the Michaels website and had Flash cookies attach to their computers. Plaintiffs allege that Michaels, through the use of its website, makes use of cookies in order to ascertain user’s web browsing habits. Specifically, the plaintiffs allege violations of the Missouri Computer Tampering and Merchandising Practices Act statutes, as well as common law claims of conversion, trespass to chattels, invasion of privacy and unjust enrichment are alleging damages, penalties and fees not to exceed \$5 million, inclusive of costs and attorneys’ fees. We filed a Motion to Dismiss on August 8, 2012 and the motion is pending. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of this lawsuit will have a material effect on our consolidated financial statements.

## 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 7,100 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.

On May 18, 2011, Brandi F. Ramundo, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the U.S. 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 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 two additional purported class action lawsuits significantly mirroring the claims in the Ramundo complaint were filed against the Company: Mary Allen v. Michaels Stores, Inc., and Kimberly Siprut v. Michaels Stores, Inc., both in the U.S. District Court for the Northern District of Illinois. On June 8, 2011, an order was entered consolidating these matters, which also provided for consolidation of all related actions subsequently filed in or transferred to 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 U.S. District Court for the Northern District of Illinois. On August 8, 2011, we filed a Motion to Dismiss the In Re Michaels Stores Consolidated Complaint. On November 23, 2011, the Court dismissed the Stored Communications Act and negligence claims under Illinois law, but denied the motion as to the breach of implied contract and Illinois Consumer Fraud and Deceptive Practices Act claims.

Four other substantially similar putative class action lawsuits have also been filed. Jeremy Williams v. Michaels Stores, Inc. and Fred Sherry v. Michaels Stores, Inc., were filed in the U.S. District Court for the Northern District of Illinois. Sara Rosenfeld and Ilana Soffer v. Michaels Stores, Inc. and Lori Wilson v. Michaels Stores, Inc. were both filed in New Jersey state court, removed to the United States District Court for the District of New Jersey, and transferred to the United States District Court for the Northern District of Illinois. The New Jersey cases assert negligence and New Jersey Consumer Fraud Act claims. All four cases are subject to the consolidation order. The Court has held that Michaels is not required to respond to those complaints.

On August 20, 2012, we reached a tentative class-wide settlement with plaintiffs that is subject to the Court's approval. The settlement, if approved, will not have a material effect on our consolidated financial statements.

### *General*

In addition to the litigation discussed above, we are, and in the future, may be involved in various other lawsuits, claims and proceedings incidental to the ordinary course of business.

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

For some of the matters disclosed above, as well as other matters previously disclosed in the Company's filings with the Securities and Exchange Commission, the Company is currently able to estimate a reasonably possible loss or range of loss in excess of amounts accrued (if any). For some of the matters included within this estimation, an accrual has been made because a loss is believed to be both probable and reasonably estimable, but an exposure to loss exists in excess of the amount accrued; in these cases, the estimate reflects the reasonably possible range of loss in excess of the accrued amount. For other matters included within this

estimation, no accrual has been made because a loss, although estimable, is believed to be reasonably possible, but not probable; in these cases the estimate reflects the reasonably possible loss or range of loss within the ranges identified. For the various ranges identified, the aggregate of these estimated amounts is approximately \$17 million, which is also inclusive of amounts accrued by the Company.

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

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

#### Note 8. Segments and Geographic Information

We consider our Michaels — U.S., Michaels — Canada, 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 operating segments have similar economic characteristics and meet the aggregation criteria set forth in ASC 280. Therefore, we combine all operating segments into one reporting segment.

Our sales and assets by country are as follows:

	Quarter Ended		Six Months Ended	
	July 28, 2012	July 30, 2011	July 28, 2012	July 30, 2011
	(in millions)			
<b>Net Sales:</b>				
United States .....	\$ 812	\$ 778	\$ 1,703	\$ 1,645
Canada .....	80	79	167	165
Consolidated Total .....	<u>\$ 892</u>	<u>\$ 857</u>	<u>\$ 1,870</u>	<u>\$ 1,810</u>
	July 28, 2012	January 28, 2012	July 30, 2011	
	(in millions)			
<b>Total Assets:</b>				
United States.....	\$ 1,569	\$ 1,713	\$ 1,502	
Canada.....	117	109	85	
Consolidated Total .....	<u>\$ 1,686</u>	<u>\$ 1,822</u>	<u>\$ 1,587</u>	

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

	Quarter Ended		Six Months Ended	
	July 28, 2012	July 30, 2011	July 28, 2012	July 30, 2011
	(in millions)			
Net income .....	\$ 13	\$ 10	\$ 66	\$ 47
Interest expense.....	61	61	127	126
Loss on early extinguishment of debt .....	—	4	—	15
Provision for income taxes.....	8	6	38	29
Depreciation and amortization .....	22	25	46	50
EBITDA (excluding loss on early extinguishment of debt).....	<u>\$ 104</u>	<u>\$ 106</u>	<u>\$ 277</u>	<u>\$ 267</u>

## **Note 9. Related Party Transactions**

We pay annual management fees to Bain Capital Partners, LLC (“Bain Capital”) and The Blackstone Group L.P. (“The Blackstone Group”) and 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 2012 and fiscal 2011, respectively, and \$7 million during each of the six months ended July 28, 2012 and July 30, 2011. These expenses are included in related party expenses on the Consolidated Statements of Operations and Comprehensive Income.

Bain Capital owns a majority equity position in LogicSource, an external vendor we utilize for print procurement services. Payments associated with this vendor during the quarter and six months ended July 28, 2012, were \$1 million and \$3 million, respectively. Payments associated with this vendor during the quarter 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 and Comprehensive Income.

Bain Capital owns a majority equity position in Unisource, 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 for the six months ended July 30, 2011 were \$6 million. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations and Comprehensive Income.

During the second quarter of fiscal 2011, The Blackstone Group acquired a majority equity position in Centro Properties Group, a vendor we utilize to lease certain properties. Payments associated with this vendor during the second quarter of each of fiscal 2012 and fiscal 2011 were \$1 million. Payments for the six months ended July 28, 2012, and July 30, 2011, were \$2 million and \$1 million, respectively. These expenses are included in Cost of sales and occupancy expense in the Consolidated Statements of Operations and Comprehensive Income.

The Blackstone Group owns a majority equity position in RGIS, an external vendor we utilize to count our store inventory. Payments associated with this vendor during the second quarter fiscal 2012 and fiscal 2011 were \$1 million and \$2 million, respectively. Payments for each of the six months ended July 28, 2012 and July 30, 2011 were \$3 million and \$4 million, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations and Comprehensive Income.

The Blackstone Group owns a majority equity position in Vistar, an external vendor we utilize for all of the candy-type items in our stores. Payments associated with this vendor during the second quarter of each of fiscal 2012 and fiscal 2011 were \$6 million. Payments for the six months ended July 28, 2012, and July 30, 2011, were \$11 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 2012 and fiscal 2011. Also, during the second quarter and six months ended July 28, 2012, we repurchased 5,333 shares from officers who are no longer with the Company. 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.

Our current directors (other than Jill A. Greenthal) are affiliates of Bain Capital or The Blackstone Group. As such, some or all of such directors may have an indirect material interest in payments with respect to debt securities of the Company that have been purchased by affiliates of Bain Capital and The Blackstone Group. As of July 28, 2012, affiliates of The Blackstone Group held \$51 million of our senior secured term loan.

## **Note 10. 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 28, 2012, 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 and full and unconditional.

The following condensed consolidating financial information represents the financial information of Michaels Stores, Inc. and its wholly-owned subsidiary guarantors, prepared on the equity basis of accounting. The information is presented in accordance with the requirements of Rule 3-10 under the SEC's Regulation S-X. The financial information may not necessarily be indicative of results of operations, cash flows, or financial position had the subsidiary guarantors operated as independent entities.

### Supplemental Condensed Consolidating Balance Sheet

	July 28, 2012			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>ASSETS</b>				
<b>Current assets:</b>				
Cash and equivalents.....	\$ 93	\$ 20	\$ —	\$ 113
Merchandise inventories .....	600	322	—	922
Intercompany receivables .....	—	556	(556)	—
Other .....	135	23	—	158
Total current assets .....	828	921	(556)	1,193
<b>Property and equipment, net</b> .....	265	61	—	326
<b>Goodwill</b> .....	95	—	—	95
<b>Investment in subsidiaries</b> .....	586	—	(586)	—
<b>Other assets</b> .....	69	3	—	72
Total assets.....	<u>\$ 1,843</u>	<u>\$ 985</u>	<u>\$ (1,142)</u>	<u>\$ 1,686</u>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>				
<b>Current liabilities:</b>				
Accounts payable.....	\$ 8	\$ 269	\$ —	\$ 277
Accrued liabilities and other .....	232	119	—	351
Current portion of long-term debt.....	1	—	—	1
Intercompany payable.....	556	—	(556)	—
Other .....	3	—	—	3
Total current liabilities .....	800	388	(556)	632
<b>Long-term debt</b> .....	3,363	—	—	3,363
<b>Other long-term liabilities</b> .....	86	11	—	97
<b>Total stockholders' deficit</b> .....	(2,406)	586	(586)	(2,406)
Total liabilities and stockholders' deficit.....	<u>\$ 1,843</u>	<u>\$ 985</u>	<u>\$ (1,142)</u>	<u>\$ 1,686</u>

## Supplemental Condensed Consolidating Balance Sheet

	January 28, 2012			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>ASSETS</b>				
<b>Current assets:</b>				
Cash and equivalents.....	\$ 363	\$ 8	\$ —	\$ 371
Merchandise inventories .....	554	286	—	840
Intercompany receivables .....	—	466	(466)	—
Other .....	103	20	—	123
Total current assets .....	1,020	780	(466)	1,334
<b>Property and equipment, net</b> .....	249	63	—	312
<b>Goodwill</b> .....	95	—	—	95
<b>Investment in subsidiaries</b> .....	410	—	(410)	—
<b>Other assets</b> .....	78	3	—	81
Total assets.....	\$ 1,852	\$ 846	\$ (876)	\$ 1,822
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>				
<b>Current liabilities:</b>				
Accounts payable.....	\$ 9	\$ 292	\$ —	\$ 301
Accrued liabilities and other .....	257	132	—	389
Current portion of long-term debt.....	127	—	—	127
Intercompany payable.....	466	—	(466)	—
Other .....	19	1	—	20
Total current liabilities .....	878	425	(466)	837
<b>Long-term debt</b> .....	3,363	—	—	3,363
<b>Other long-term liabilities</b> .....	85	11	—	96
<b>Total stockholders' deficit</b> .....	(2,474)	410	(410)	(2,474)
Total liabilities and stockholders' deficit.....	\$ 1,852	\$ 846	\$ (876)	\$ 1,822

## Supplemental Condensed Consolidating Balance Sheet

	July 30, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>ASSETS</b>				
<b>Current assets:</b>				
Cash and equivalents.....	\$ 27	\$ —	\$ —	\$ 27
Merchandise inventories.....	583	314	—	897
Intercompany receivables.....	—	416	(416)	—
Other.....	134	24	—	158
Total current assets.....	744	754	(416)	1,082
<b>Property and equipment, net</b> .....	245	65	—	310
<b>Goodwill</b> .....	95	—	—	95
<b>Investment in subsidiaries</b> .....	454	—	(454)	—
<b>Other assets</b> .....	99	1	—	100
<b>Total assets</b> .....	\$ 1,637	\$ 820	\$ (870)	\$ 1,587
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>				
<b>Current liabilities:</b>				
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.....	2	—	—	2
Total current liabilities.....	786	354	(416)	724
<b>Long-term debt</b> .....	3,387	—	—	3,387
<b>Other long-term liabilities</b> .....	69	12	—	81
<b>Total stockholders' deficit</b> .....	(2,605)	454	(454)	(2,605)
<b>Total liabilities and stockholders' deficit</b> .....	\$ 1,637	\$ 820	\$ (870)	\$ 1,587

## Supplemental Condensed Consolidating Statement of Operations and Comprehensive Income

	Quarter Ended July 28, 2012			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>Net sales</b> .....	\$ 777	\$ 521	\$ (406)	\$ 892
Cost of sales and occupancy expense.....	515	444	(406)	553
<b>Gross profit</b> .....	262	77	—	339
Selling, general, and administrative expense.....	219	33	—	252
Related party expenses.....	4	—	—	4
Store pre-opening costs.....	1	—	—	1
<b>Operating income</b> .....	38	44	—	82
Interest expense.....	61	—	—	61
Loss on early extinguishment of debt.....	—	—	—	—
Other (income) and expense, net.....	—	—	—	—
Intercompany charges (income).....	15	(15)	—	—
Equity in earnings of subsidiaries.....	59	—	(59)	—
<b>Income before income taxes</b> .....	21	59	(59)	21
Provision for income taxes.....	8	22	(22)	8
<b>Net income</b> .....	13	37	(37)	13
Other comprehensive income, net of tax:				
Foreign currency translation adjustment.....	(2)	—	—	(2)
<b>Comprehensive income</b> .....	\$ 11	\$ 37	\$ (37)	\$ 11



## Supplemental Condensed Consolidating Statement of Operations and Comprehensive Income

	Quarter Ended July 30, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>Net sales</b> .....	\$ 744	\$ 491	\$ (378)	\$ 857
Cost of sales and occupancy expense .....	494	413	(378)	529
<b>Gross profit</b> .....	250	78	—	328
Selling, general, and administrative expense .....	209	32	—	241
Related party expenses.....	4	—	—	4
Store pre-opening costs.....	1	—	—	1
<b>Operating income</b> .....	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)	—
<b>Income before income taxes</b> .....	16	61	(61)	16
Provision for income taxes.....	6	23	(23)	6
<b>Net income</b> .....	10	38	(38)	10
<b>Comprehensive income</b> .....	\$ 10	\$ 38	\$ (38)	\$ 10

## Supplemental Condensed Consolidating Statement of Operations and Comprehensive Income

	Six Months Ended July 28, 2012			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>Net sales</b> .....	\$ 1,638	\$ 1,070	\$ (838)	\$ 1,870
Cost of sales and occupancy expense .....	1,051	906	(838)	1,119
<b>Gross profit</b> .....	587	164	—	751
Selling, general, and administrative expense .....	444	68	—	512
Related party expenses.....	7	—	—	7
Store pre-opening costs.....	2	—	—	2
<b>Operating income</b> .....	134	96	—	230
Interest expense.....	127	—	—	127
Loss on early extinguishment of debt .....	—	—	—	—
Other (income) and expense, net.....	—	(1)	—	(1)
Intercompany charges (income).....	32	(32)	—	—
Equity in earnings of subsidiaries .....	129	—	(129)	—
<b>Income before income taxes</b> .....	104	129	(129)	104
Provision for income taxes.....	38	47	(47)	38
<b>Net income</b> .....	66	82	(82)	66
<b>Comprehensive income</b> .....	\$ 66	\$ 82	\$ (82)	\$ 66

## Supplemental Condensed Consolidating Statement of Operations and Comprehensive Income

	Six Months Ended July 30, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>Net sales</b> .....	\$ 1,582	\$ 1,018	\$ (790)	\$ 1,810
Cost of sales and occupancy expense .....	1,034	845	(790)	1,089
<b>Gross profit</b> .....	548	173	—	721
Selling, general, and administrative expense .....	430	65	—	495
Related party expenses.....	7	—	—	7
Store pre-opening costs.....	2	—	—	2
<b>Operating income</b> .....	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)	—
<b>Income before income taxes</b> .....	76	143	(143)	76
Provision for income taxes.....	29	54	(54)	29
<b>Net income</b> .....	47	89	(89)	47
Other comprehensive income, net of tax:				
Foreign currency translation adjustment.....	1	—	—	1
<b>Comprehensive income</b> .....	\$ 48	\$ 89	\$ (89)	\$ 48

## Supplemental Condensed Consolidating Statement of Cash Flows

	Six Months Ended July 28, 2012			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>Operating activities:</b>				
Net cash used in operating activities .....	\$ (98)	\$ 68	\$ (49)	\$ (79)
<b>Investing activities:</b>				
Cash paid for property and equipment .....	(38)	(7)	—	(45)
Net cash used in investing activities .....	(38)	(7)	—	(45)
<b>Financing activities:</b>				
Net repayments of long-term debt .....	(127)	—	—	(127)
Intercompany dividends.....	—	(49)	49	—
Other financing activities.....	(7)	—	—	(7)
Net cash used in financing activities .....	(134)	(49)	49	(134)
<b>Decrease in cash and equivalents</b> .....	(270)	12	—	(258)
<b>Beginning cash and equivalents</b> .....	363	8	—	371
<b>Ending cash and equivalents</b> .....	\$ 93	\$ 20	\$ —	\$ 113

## Supplemental Condensed Consolidating Statement of Cash Flows

	Six Months Ended July 30, 2011			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
<b>Operating activities:</b>				
Net cash used in operating activities.....	\$ (47)	\$ 50	\$ (51)	\$ (48)
<b>Investing activities:</b>				
Cash paid for property and equipment.....	(37)	(9)	—	(46)
Net cash used in investing activities.....	(37)	(9)	—	(46)
<b>Financing activities:</b>				
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)
<b>Decrease in cash and equivalents.....</b>	<b>(282)</b>	<b>(10)</b>	<b>—</b>	<b>(292)</b>
<b>Beginning cash and equivalents.....</b>	<b>309</b>	<b>10</b>	<b>—</b>	<b>319</b>
<b>Ending cash and equivalents.....</b>	<b>\$ 27</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 27</b>

### 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 are 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 28, 2012. 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;
- 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;
- 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;
- damage to the reputation of the Michaels brand or our private and exclusive brands could adversely affect our sales;
- 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;
- 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;
- 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;
- improvements to our supply chain may not be fully successful;
- changes in customer demand could materially adversely affect our sales, results of operations, and cash flow;
- how well we manage our business;
- competition could negatively impact our business;
- failure to adequately maintain security and prevent unauthorized access to electronic and other confidential information and data breaches could materially adversely affect our financial condition and results of operations;
- our information systems may prove inadequate;
- a weak fourth quarter would materially adversely affect our results of operations;
- changes in newspaper subscription rates may result in reduced exposure to our circular advertisements;
- changes in regulations or enforcement may adversely impact our business;
- 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;
- disruptions in the capital markets could increase our costs of doing business;
- our real estate leases generally obligate us for long periods, which subjects us to various financial risks;
- 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;
- we are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiary;
- we are dependent upon the services of our senior management team;
- failure to attract and retain quality sales, distribution center and other associates in appropriate numbers as well as experienced buying and management personnel could adversely affect our performance;
- our results may be adversely affected by serious disruptions or catastrophic events, including geo-political events and weather; 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 herein and Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended January 28, 2012, 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.

## 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 2012” relate to the 53 weeks ending February 2, 2013 and all references to “fiscal 2011” relate to the 52 weeks ended January 28, 2012. In addition, all references herein to “the second quarter of fiscal 2012” relate to the 13 weeks ended July 28, 2012 and all references to “the second quarter of fiscal 2011” relate to the 13 weeks ended July 30, 2011. Finally, all references to “the six months ended July 28, 2012” relate to the 26 weeks ended July 28, 2012, and “the six months ended July 30, 2011” relate to the 26 weeks ended July 30, 2011.

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

	Quarter Ended		Six Months Ended	
	July 28, 2012	July 30, 2011	July 28, 2012	July 30, 2011
<b>Michaels stores:</b>				
Retail stores open at beginning of period.....	1,066	1,049	1,064	1,045
Retail stores opened during the period.....	8	5	10	10
Retail stores opened (relocations) during the period.....	4	4	10	8
Retail stores closed during the period.....	—	—	—	(1)
Retail stores closed (relocations) during the period.....	(4)	(4)	(10)	(8)
Retail stores open at end of period.....	<u>1,074</u>	<u>1,054</u>	<u>1,074</u>	<u>1,054</u>
<b>Aaron Brothers stores:</b>				
Retail stores open at beginning of period.....	130	136	134	137
Retail stores closed during the period.....	(2)	—	(6)	(1)
Retail stores open at end of period.....	<u>128</u>	<u>136</u>	<u>128</u>	<u>136</u>
Total store count at end of period.....	<u>1,202</u>	<u>1,190</u>	<u>1,202</u>	<u>1,190</u>
<b>Other operating data:</b>				
Average inventory per Michaels store (in thousands) (1).....	\$ 823	\$ 816	\$ 823	\$ 816
Comparable store sales increase (2).....	2.9%	1.8%	2.1%	3.1%

(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 two weeks is not considered comparable during the month it closed. If a store is closed longer than two weeks but less than two months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than two months becomes comparable in its 14th month of operation after its reopening.

## 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 and Comprehensive Income. 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 28, 2012	July 30, 2011	July 28, 2012	July 30, 2011
<b>Net sales</b> .....	100.0%	100.0%	100.0%	100.0%
Cost of sales and occupancy expense .....	62.0	61.7	59.8	60.2
<b>Gross profit</b> .....	38.0	38.3	40.2	39.8
Selling, general, and administrative expense .....	28.3	28.1	27.4	27.3
Related party expenses .....	0.5	0.5	0.4	0.4
Store pre-opening costs.....	0.1	0.1	0.1	0.1
<b>Operating income</b> .....	9.1	9.6	12.3	12.0
Interest expense .....	6.8	7.1	6.8	7.0
Loss on early extinguishment of debt .....	—	0.5	—	0.8
Other (income) and expense, net .....	—	0.1	—	—
<b>Income before income taxes</b> .....	2.3	1.9	5.5	4.2
Provision for income taxes .....	0.9	0.7	2.0	1.6
<b>Net income</b> .....	1.4%	1.2%	3.5%	2.6%

### *Quarter Ended July 28, 2012 Compared to the Quarter Ended July 30, 2011*

*Net Sales*—Net sales increased for the second quarter of fiscal 2012 by \$35 million, or 4.1%, over the second quarter of fiscal 2011 due primarily to a \$24 million increase in comparable store sales. Comparable store sales increased 2.9% driven by a 3.0% increase in customer transactions and a positive impact of 0.9% from deferred custom framing revenue, partially offset by a 1.0% decrease in the average ticket. The fluctuation in the exchange rates between the United States and Canadian dollars adversely impacted the average ticket by 40 basis points. The Company experienced its strongest sales increase for the quarter in custom framing within our framing department. In addition, sales from our non-comparable stores provided incremental revenue of \$11 million.

*Cost of Sales and Occupancy Expense*—Cost of sales and occupancy expense increased \$24 million to \$553 million in the second quarter of fiscal 2012 from \$529 million in the second quarter of fiscal 2011 due primarily to a \$13 million increase in merchandise costs associated with higher sales and a \$6 million increase as a result of unfavorable shrink experience in the second quarter of fiscal 2012. In addition, our inventory markdown expense increased \$3 million mainly due to an increase in discontinued stock keeping units associated with planned merchandise resets.

Cost of sales and occupancy expense increased 30 basis points as a percentage of Net sales to 62.0% for the second quarter of fiscal 2012 from 61.7% for the second quarter of fiscal 2011. The unfavorable shrink experience and the increase in inventory markdown expense contributed 60 basis points and 40 basis points, respectively, to the increase in cost of sales. In addition, we had a 30 basis point increase from the timing of the recognition of vendor allowances and a 20 basis point increase in freight and distribution costs. These amounts were partially offset by a 40 basis point decrease in merchandise costs driven by our direct import and private brand initiatives, as well as improved pricing and promotion management. Additionally, occupancy costs decreased 50 basis points due to increased leverage on higher comparable store sales and we had a 30 basis point decrease from improved efficiencies in our vertically integrated framing operations.

*Selling, General and Administrative Expense*—Selling, general and administrative expense was \$252 million in the second quarter of fiscal 2012 compared to \$241 million in the second quarter of fiscal 2011. Selling, general and administrative expense increased \$11 million driven by an increase in store payroll and benefits expense. Specifically, the increase was the result of \$4 million in incremental costs for operating 20 additional Michaels stores, \$4 million in labor for merchandise resets and training for our new store labor model, \$2 million due to increased group insurance claims, and \$1 million from an increase in the average hourly wage rate. As a percentage of Net sales, Selling, general and administrative expense increased 20 basis points due to a 30 basis point increase in store payroll and a 20 basis point increase in group insurance for the reasons indicated above. These amounts were partially offset by a 20 basis point decrease in advertising expense from a reduction in the number of newspaper circulars.

*Related Party Expenses*—Related party expenses were \$4 million in the second quarter of each of fiscal 2012 and fiscal 2011, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, LP.

*Interest Expense*—Interest expense in the second quarter of fiscal 2012 was consistent with the second quarter of fiscal 2011 at \$61 million due to a higher average interest rate associated with our amended senior secured term loan facility, offset by a \$163 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 was 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.

*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.

*Provision for Income Taxes*—The effective tax rate was 40.1% for the second quarter of fiscal 2012. The effective tax rate was 36.7% for the second quarter of fiscal 2011. As a result of our low income base for the second quarter of each of fiscal 2012 and fiscal 2011, our effective rate is 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 28, 2012 Compared to the Six Months Ended July 30, 2011*

*Net Sales*—Net sales increased for the first six months of fiscal 2012 by \$60 million, or 3.3%, over the first six months of fiscal 2011 due primarily to a \$39 million increase in comparable store sales. Comparable store sales increased 2.1% due to an increase in customer transactions of 2.7%, partially offset by a decrease in the average ticket of 0.6%. The fluctuation in the exchange rates between the United States and Canadian dollars adversely impacted the average ticket by 30 basis points. The Company experienced its strongest sales increase for the first six months of fiscal 2012 in decorative art within our general and children's crafts department. In addition, sales from our non-comparable stores provided incremental revenue of \$21 million.

*Cost of Sales and Occupancy Expense*—Cost of sales and occupancy expense increased \$30 million to \$1.119 billion for the first six months of fiscal 2012 from \$1.089 billion for the first six months of fiscal 2011 due primarily to a \$14 million increase in merchandise costs associated with higher sales, a \$7 million increase from the timing of the recognition of vendor allowances and a \$7 million increase in freight and distribution costs.

Cost of sales and occupancy expense decreased 40 basis points as a percentage of Net sales to 59.8% for the first six months of fiscal 2012 from 60.2% for the first six months of fiscal 2011. Merchandise cost decreased 80 basis points driven by our direct import and private brand initiatives, as well as improved pricing and promotion management. In addition, occupancy costs decreased 50 basis points due to increased leverage on higher comparable store sales. These amounts were partially offset by a 50 basis point increase from the timing of the recognition of vendor allowances and a 40 basis point increase in freight and distribution costs.

*Selling, General, and Administrative Expense*—Selling, general and administrative expense was \$512 million for the first six months of fiscal 2012 compared to \$495 million for the first six months of fiscal 2011. Selling, general and administrative expense increased \$17 million driven by a n increase in store payroll and benefits expense. Specifically, the increase was the result of \$6 million in incremental costs for operating 20 additional Michaels stores, \$6 million in labor for merchandise resets and training for our new store labor model, \$4 million due to increased group insurance claims, and \$1 million from an increase in the average hourly wage rate. As a percentage of Net sales, Selling, general and administrative expense increased 10 basis points due to a 30 basis point increase in store payroll and a 20 basis point increase in group insurance for the reasons indicated above. These amounts were partially offset by a 30 basis point decrease in advertising expense from a reduction in the number of newspaper circulars.

*Related Party Expenses*—Related party expenses were \$7 million for the first six months of each of fiscal 2012 and fiscal 2011, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, LP.

*Interest Expense*—Interest expense increased \$1 million for the first six months of fiscal 2012 compared to the first six months of 2011 due to a higher average interest rate associated with our amended senior secured term loan facility, partially offset by a \$163 million reduction in our total debt outstanding.

*Loss on Early Extinguishment of Debt*—During the first six months of fiscal 2011, 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. 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.

*Other (Income) and Expense, net*—Other income for the first six months of fiscal 2012 is related primarily to a \$1 million foreign exchange rate gain. 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.

*Provision for Income Taxes*—The effective tax rate was 36.6% for the first six months of fiscal 2012. The effective tax rate was 38.3% for the first six months of fiscal 2011. The rate was lower than the prior year six month tax rate due primarily to a favorable impact related to our reserve for uncertain tax positions. We currently estimate our annualized effective tax rate for fiscal 2012 to be 37.6%.

## 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 28, 2012, the borrowing base was \$690 million, of which we had no outstanding borrowings, \$63 million of outstanding letters of credit and \$627 million of excess availability. Our cash and equivalents decreased \$258 million from \$371 million at January 28, 2012, to \$113 million at July 28, 2012.

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 2012 was \$79 million compared to \$48 million during the first six months of fiscal 2011. The \$31 million change was primarily due to a \$24 million decrease in non-cash accretion as our Subordinated Discount Notes were fully accreted as of November 1, 2011. In addition, we had an \$11 million decrease from the timing of inventory purchases and an \$11 million decrease as a result of the timing of accounts payable. These amounts were partially offset by an increase of \$8 million from the timing of income tax payments and a \$4 million increase in Net income before the consideration of the \$15 million loss on the extinguished Subordinated Discount Notes in the first six months of fiscal 2011.

Average inventory per Michaels store (including supporting distribution centers) increased 0.8% from \$816,000 at July 30, 2011 to \$823,000 at July 28, 2012 primarily due to the timing of seasonal purchases. We anticipate average inventory per Michaels store at the end of fiscal 2012 to be flat compared to the end of fiscal 2011.

### *Cash Flow from Investing Activities*

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

	<b>Six Months Ended</b>	
	<b>July 28, 2012</b>	<b>July 30, 2011</b>
	(in millions)	
New and relocated stores and stores not yet opened (1)....	\$ 15	\$ 12
Existing stores .....	8	9
Information systems .....	16	20
Corporate and other .....	6	5
	<u>\$ 45</u>	<u>\$ 46</u>

- (1) In the first six months of fiscal 2012, we incurred capital expenditures related to the opening of ten Michaels stores in addition to the relocation of ten Michaels stores. 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.



### *Cash Flow from Financing Activities*

Cash flow used in financing activities during the first six months of fiscal 2012 was \$134 million compared to \$198 million during the first six months of fiscal 2011. The \$64 million dollar decrease was due in part to the repurchase of \$124 million face value of our Subordinated Discount Notes in the first half of fiscal 2011, for which we paid \$5 million in purchase premiums and third party fees. In addition, we made a voluntary prepayment of \$50 million on our senior secured term loan facility. These amounts were partially offset by the \$127 million AHYDO payment made on our Subordinated Discount Notes during the second quarter of fiscal 2012.

### **Non-GAAP Measures**

The following table sets forth the Company's Earnings before Interest, Taxes, Depreciation, Amortization, and Loss on early extinguishment of debt ("EBITDA excluding loss on early extinguishment of debt"). The Company defines EBITDA (excluding loss on early extinguishment of debt) as Net income before interest, income taxes, depreciation, amortization and loss on early extinguishment of debt. Additionally, the table presents Adjusted Earnings before Interest, Taxes, Depreciation and Amortization ("Adjusted EBITDA"). The Company defines Adjusted EBITDA as EBITDA (excluding loss on early extinguishment of debt) adjusted for certain defined amounts that are added to, or subtracted from, EBITDA (excluding loss on early extinguishment of debt) (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 (excluding loss on early extinguishment of debt) 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 (excluding loss on early extinguishment of debt), 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.

As EBITDA (excluding loss on early extinguishment of debt) 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 (excluding loss on early extinguishment of debt) and Adjusted EBITDA may differ from similarly titled measures used by other companies. As EBITDA (excluding loss on early extinguishment of debt) 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 (excluding loss on early extinguishment of debt) and Adjusted EBITDA to Net income and Net cash provided by operating activities.

	Quarter Ended		Six Months Ended	
	July 28, 2012	July 30, 2011	July 28, 2012	July 30, 2011
	(in millions)			
Net cash used in operating activities.....	\$ (120)	\$ (67)	\$ (79)	\$ (48)
Depreciation and amortization.....	(22)	(25)	(46)	(50)
Share-based compensation.....	(2)	(2)	(3)	(4)
Debt issuance costs amortization.....	(4)	(4)	(8)	(8)
Accretion of long-term debt.....	—	(11)	—	(24)
Change in fair value of interest rate cap.....	—	(1)	—	(3)
Change in fair value of contingent consideration.....	—	1	—	1
Loss on early extinguishment of debt.....	—	(4)	—	(15)
Changes in assets and liabilities.....	161	123	202	198
Net income.....	13	10	66	47
Interest expense.....	61	61	127	126
Loss on early extinguishment of debt.....	—	4	—	15
Provision for income taxes.....	8	6	38	29
Depreciation and amortization.....	22	25	46	50
EBITDA (excluding loss on early extinguishment of debt).....	104	106	277	267
Adjustments:				
Share-based compensation.....	2	2	3	4
Sponsor fees.....	4	4	7	7
Termination expense.....	—	—	—	1
Store pre-opening costs.....	1	1	2	2
Store remodel costs.....	—	1	—	1
Foreign currency transaction gains.....	—	—	(1)	(3)
Store closing costs.....	2	1	2	1
Gain on contingent consideration.....	—	(1)	—	(1)
Loss on interest rate cap.....	—	1	—	3
Other (1).....	2	1	2	2
Adjusted EBITDA.....	<u>\$ 115</u>	<u>\$ 116</u>	<u>\$ 292</u>	<u>\$ 284</u>

(1) Other adjustments relate to items such as the moving & relocation expenses, franchise taxes, foreign currency hedge and legal settlements

## Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-04, “*Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs*,” an amendment to ASC topic 820, “*Fair Value Measurements*.” ASU 2011-04 conforms certain sections of Accounting Standards Codification (“ASC”) 820 to International Financial Reporting Standards in order to provide a single converged guidance on the measurement of fair value. The ASU also requires new quantitative and qualitative disclosures about the sensitivity of recurring Level 3 measurement disclosures, as well as transfers between Level 1 and Level 2 of the fair value hierarchy. The amended guidance is effective for interim and annual periods beginning after December 15, 2011. We adopted all requirements of ASU 2011-04 on January 29, 2012, with no material impact on our consolidated financial statements.

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. In December 2011, the FASB issued ASU No. 2011-12, “*Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*,” which indefinitely defers the provisions in ASU 2011-05 requiring reclassification adjustments out of other comprehensive income to be presented on the face of the financial statements. The other portions of ASU

2011-05 remain unchanged. These standards, which must be applied retroactively, are effective for interim and annual periods beginning after December 15, 2011, with earlier adoption permitted. We adopted all requirements of these standards on January 29, 2012, the beginning of our 2012 fiscal year.

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

We are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiaries. Our sales, costs and expenses of our Canadian subsidiaries, when translated into U.S. dollars, can fluctuate due to exchange rate movement. As of July 28, 2012, a 10% increase or decrease in the exchange rate of the U.S. and Canadian dollar would have a \$1 million impact on net income.

We have market risk exposure arising from changes in interest rates on our senior secured term loan facility. The interest rates on our Senior Credit Facilities will reprice periodically, which will impact our earnings and cash flow. The interest rates on our notes are fixed. Based on our overall interest rate exposure to variable rate debt outstanding as of July 28, 2012, a 1% increase or decrease in interest rates would increase or decrease income before income taxes by \$20 million. A 1% increase in interest rates would decrease the fair value of our long-term fixed rate debt by \$32 million. A 1% decrease in interest rates would increase the fair value of our long-term fixed rate debt by \$33 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

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

#### *Evaluation of Disclosure Controls and Procedures*

We maintain a set of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated by the SEC under the Securities Exchange Act of 1934) that are designed to provide reasonable assurance that information, which is required to be timely disclosed, is accumulated and communicated to management in a timely fashion. We note that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

An evaluation was carried out under the supervision and with the participation of our management, including the members of our interim Office of the Chief Executive Officer (“CEO Office”) and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the members of the CEO Office and our Chief Financial Officer concluded that our disclosure controls are effective to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Securities and Exchange Act of 1934, as amended, is accumulated and communicated to management, including our CEO Office and our Chief Financial Officer, to allow timely decisions regarding required disclosure and are effective to provide reasonable assurance that such information is recorded, processed, summarized and reported within the time periods specified by the SEC’s rules and forms.

#### *Change in Internal Control Over Financial Reporting*

There has not been any change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) as promulgated by the SEC under the Securities Exchange Act of 1934) during the quarter covered by this Quarterly Report on Form 10-Q that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **MICHAELS STORES, INC.** **Part II—OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

Information regarding legal proceedings is incorporated herein by reference from Note 7 to our Consolidated Financial Statements.

### **Item 1A. Risk Factors.**

Information regarding the Company’s risk factors appears in Item 1A. Risk Factors disclosed in our Annual Report on Form 10-K for the fiscal year ended January 28, 2012.

There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended January 28, 2012 other than the risk factors set forth below:

*We are dependent upon the services of our senior management team, and the failure to attract and retain such individuals could adversely affect our operations*

We are dependent on the services, abilities and experience of our executive officers. The permanent loss of the services of any of these senior executives and any change in the composition of our senior management team could have a negative impact on our ability to execute on our business and operating strategies.

We have recently experienced a significant change in our executive leadership. On July 19, 2012, John B. Menzer resigned as Chief Executive Officer to focus on recovery and rehabilitation from the stroke he suffered in April. Previously, the Board of Directors of the Company established an interim Office of the Chief Executive Officer (the “CEO Office”) comprised of Charles M. Sonstebly and Lewis S. Klessel, and temporarily transferred Mr. Menzer’s responsibilities to the CEO Office. Messrs. Sonstebly and Klessel will continue to execute the responsibilities of the Company’s principal executive officer through the CEO Office, until the Company’s search for a new Chief Executive Officer is completed. Our inability to identify, hire and subsequently integrate a new Chief Executive Officer could adversely impact our business, financial condition and results of operations.

## **Item 6. Exhibits.**

(a) Exhibits:

<b>Exhibit Number</b>	<b>Description of Exhibit</b>
31.1	Certifications of Lewis S. Klessel pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certifications of Charles M. Sonstebly pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

**MICHAELS STORES, INC.  
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.

MICHAELS STORES, INC.

By: /s/ Charles M. Sonsteby  
Charles M. Sonsteby  
Member of the Interim Office of the Chief Executive Officer,  
Chief Administrative Officer & Chief Financial Officer  
(Principal Executive Officer and Principal Financial Officer)

Dated: August 23, 2012

## INDEX TO EXHIBITS

<b>Exhibit Number</b>	<b>Description of Exhibit</b>
31.1	Certifications of Lewis S. Klessel pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certifications of Charles M. Sonstebly pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

## CERTIFICATIONS

I, Lewis S. Klessel, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Michaels Stores, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 23, 2012

/s/ Lewis S. Klessel

Lewis S. Klessel

Member of the Interim Office of the Chief Executive Officer &  
Interim Chief Operating Officer  
(Principal Executive Officer)

## CERTIFICATIONS

I, Charles M. Sonsteby, certify that

1. I have reviewed this quarterly report on Form 10-Q of Michaels Stores, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 23, 2012

/s/ Charles M. Sonsteby

Charles M. Sonsteby  
Member of the Interim Office of the Chief Executive Officer,  
Chief Administrative Officer & Chief Financial Officer  
(Principal Executive Officer and Principal Financial Officer)



**CERTIFICATION PURSUANT TO 18 U.S.C. § 1350,  
AS ADOPTED PURSUANT TO § 906  
OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the filing of the Quarterly Report on Form 10-Q of Michaels Stores, Inc., a Delaware corporation (the “Company”), for the period ended July 28, 2012, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), each of the undersigned officers of the Company certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to such officer’s knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 23, 2012

/s/ Lewis S. Klessel

Lewis S. Klessel  
Member of the Interim Office of the Chief Executive Officer &  
Interim Chief Operating Officer  
(Principal Executive Officer)

/s/ Charles M. Sonsteby

Charles M. Sonsteby  
Member of the Interim Office of the Chief Executive Officer,  
Chief Administrative Officer & Chief Financial Officer  
(Principal Executive Officer and Principal Financial Officer)

The foregoing certification is being furnished solely pursuant to 18 U.S.C. § 1350 and is not being filed as part of the Report or as a separate disclosure document.