

MICHAELS STORES INC
Form 10-K
April 02, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended January 31, 2009

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

MICHAELS STORES, INC.

Edgar Filing: MICHAELS STORES INC - Form 10-K

(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)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

None

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Edgar Filing: MICHAELS STORES INC - Form 10-K

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
Non-accelerated filer
(Do not check if a smaller reporting company)

Accelerated filer
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

The aggregate market value of the registrant's voting and non-voting common equity held by non-affiliates of the registrant is zero. The registrant's common equity is not publicly traded.

As of March 30, 2009, 118,497,202 shares of the Registrant's Common Stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

PART I

ITEM 1. Business.

The following discussion, as well as other portions of this Annual Report on Form 10-K, 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. Our actual results could materially differ from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this Annual Report on Form 10-K, and particularly in Item 1A. Risk Factors and Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations. Unless the context otherwise indicates, references in this Annual Report on Form 10-K to we, our, us, the Company and Michaels means Michaels Stores, Inc., together with its subsidiaries.

General

With approximately \$3.8 billion in sales in fiscal 2008, Michaels Stores, Inc., together with its subsidiaries, is the largest arts and crafts specialty retailer in North America providing materials, ideas and education for creative activities. Our mission is to help our customers express themselves creatively. Through our broad product assortments, project sheets, displays, online ideas and creative offerings, we offer a shopping experience that encourages creativity. We also offer a variety of classes, demonstrations, and family-focused events to inspire our customers with product ideas and information.

Michaels Stores, Inc. was incorporated in Delaware in 1983, and as of March 30, 2009, we operate 1,015 Michaels retail stores in 49 states, as well as in Canada, averaging 18,300 square feet of selling space per store. Our stores offer arts and crafts supplies and products for the crafter and do-it-yourself home decorator. We also operate 157 Aaron Brothers stores as of March 30, 2009, in 9 states, averaging 5,500 square feet of selling space per store, offering photo frames, a full line of ready-made frames, custom framing services, and a wide selection of art supplies.

On October 16, 2007, we announced plans to align resources around our core retail chains, Michaels and Aaron Brothers stores. As a result, we discontinued our concept businesses, Recollections and Star Decorators Wholesale (Star). As of the end of fiscal 2007, we had closed all 11 Recollections and three of the four Star locations. The Star Decorators Wholesale Los Angeles store, the sole remaining Star location, is now being operated as a Michaels store. The operations of Recollections and Star have been reflected as discontinued operations.

We provide links to our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, free of charge on our Internet website at www.michaels.com under the heading "Corporate Information". These links are automatically updated, so the filings are available immediately after they are made publicly available by the Securities and Exchange Commission (the "SEC"). These filings are also available through the SEC's EDGAR system at www.sec.gov.

Industry Overview

We are the largest specialty retailer in North America providing materials, project ideas, and education for creative activities in arts and crafts, home décor, and scrapbooking. We believe we are well positioned to benefit from favorable demographics, particularly a more affluent baby boomer population, and an increasing focus on savings and home-based, family activities. According to industry consumer participation surveys from December 2007 and 2008, approximately 56% of U.S. households participate in an arts and crafts category and our typical customer is:

- **Female** 90% are women and 63% are married.
- **Young** 71% of crafters are under 55, with 46% of them between the ages of 35 and 54.
- **Middle class** 64% of our crafters have household incomes greater than \$50,000, with a median income of about \$65,000.
- **Loyal** Most crafters shop for craft supplies at least twice a month, with approximately half of their visits to Michaels.

In a February 2009 survey of 500 customer households, 84% said they would like to spend more time on arts and crafts activities and 83% think making homemade gifts and spending time with their families are two of the bright spots that have emerged during this rough economy.

We compete across many segments of the industry, including adult and kids crafts, scrapbooking and paper crafting, jewelry making, fine art, home accents, floral, gift wrapping supplies, candles, photo frames, and custom framing. Industry association and analyst research reports estimate that our total addressable market size is about \$31 billion annually, of which \$27 billion is associated with the core arts and crafts market and \$4 billion is associated with the framing market.

The market in which we compete is highly fragmented, containing stores across the nation operated primarily by small, independent retailers along with a few regional chains. We believe customers tend to choose where to shop based upon store location, breadth of selection, price, quality of merchandise, availability of product, and customer service. We compete with many different types of retailers and classify our competition within the following categories:

- *Mass merchandisers.* This category includes companies such as Wal-Mart Stores, Inc., Target Corporation, and other mass merchandisers. These retailers typically dedicate only a small portion of their selling space to a limited selection of home accents, arts and crafts supplies, and seasonal merchandise, but they do seek to capitalize on the latest trends by stocking products that are complimentary to those trends and their current merchandise offerings. These mass merchandisers generally have limited customer service staffs with varying amounts of experience in crafting projects.
- *Multi-store chains.* This category includes several multi-store chains, each operating more than 30 stores, and comprises: Hobby Lobby, which operates approximately 414 stores in 33 states, primarily in the Midwestern and Southern United States; A.C. Moore Arts & Crafts, Inc., which operates approximately 132 stores primarily in the mid-Atlantic and Northeast regions; Jo-Ann Stores, Inc., which operates approximately 209 large-format stores across the country; and Garden Ridge Corporation, which operates approximately 43 stores in 18 states, primarily in the Midwestern and Southern United States. We believe all of these chains are significantly smaller than Michaels with respect to number of stores and total net sales.
- *Small, local specialty retailers.* This category includes local Mom & Pop arts and crafts retailers and custom framing shops. Typically, these are single store operations managed by the owner. These stores generally have limited resources for advertising, purchasing, and distribution. Many of these stores have established a loyal customer base within a given community and compete with us based on relationships and customer service.

Business Strategy

We continue to strive toward increasing sales and productivity by strengthening our position as the largest arts and crafts retailer in North America through the following strategies:

- ***Forming stronger relationships with our customers.*** We actively solicit our customers' feedback regarding their decision to shop at Michaels and perceptions of our store environment, product selection, and pricing. This allows us to understand our customers' purchasing habits and shopping carts. We use this information to respond to our customers' preferences for an enhanced in-store experience by providing the customer with continuous improvement in merchandise assortments, creative ideas, and inspiration.
- ***Improving our merchandise assortment.*** We attempt to provide merchandise assortments that inspire creativity and fun within the categories we carry. We are also focused on introducing newness within our categories through merchandise resets. We will continue to refine our merchandise assortment and introduce new products based on results from consumer insight and through detailed SKU analysis derived from our perpetual inventory system. We can test new merchandising assortments in selected markets before implementing regional or national rollouts. Our assortments include highly differentiated and exclusive product lines, which we believe help us further maximize our opportunities within arts and crafts trends.
- ***Ideas and inspiration.*** We believe that our customer experience can be a key advantage that differentiates us from our competitors and is a critical component of our merchandising strategy. Many of the craft supplies sold in our Michaels stores can be assembled into unique end products with an appropriate amount of guidance and direction. Accordingly, we have displays in every store to stimulate new project ideas and we supply free project sheets with detailed instructions on how to assemble the finished product. We also offer project sheets on our Internet site, www.michaels.com. During the 2008 holiday season, we launched a holiday gift and décor idea website, www.WhereCreativityHappens.com, that featured weekly webisodes demonstrating techniques to make holidays easy, provide gift ideas, and more. In addition, we offer a variety of classes, demonstrations, and family-focused events to inspire our customers with product ideas and information. We believe this strategy enhances incremental sales, drives frequency of customer visits, and is core to our brand positioning.

- ***Improving marketing effectiveness.***

- *Improving marketing execution.* We are focused on marketing strategies and vehicles that will drive customer traffic and demand for our products. In order to successfully retain existing customers and attract high value new customers, we utilize a diversified marketing mix including print, direct mail, e-mail, various in-store promotional activities, magazine, online advertising, and our website, Michaels.com. We believe that our circular advertising, primarily distributed through Sunday newspapers, is our most productive and cost efficient form of advertising. The circulars advertise numerous products in order to emphasize the wide selection and competitive price of products available at Michaels stores. We believe that our ability to distribute circulars throughout the year in each of our markets provides us with an advantage over our smaller competitors and it reinforces and strengthens our brand. We will continue to focus on optimizing circular advertising by reviewing the frequency and breadth of our print circular program while still utilizing targeted, direct mailing campaigns. We have developed a weekly email campaign that includes coupons, project ideas and identifies hot items of the week. We will continue to evaluate alternative forms of advertising and marketing vehicles including loyalty programs, targeted marketing campaigns, and partnership marketing.

- *Pricing and promotional strategy.* We are working to develop an integrated pricing and promotion strategy based on customer behavior, while improving our long-term organizational capabilities, processes, and tools. Our promotion activity is item-price based, with promotions spanning across categories and with limited regional differentiation. We believe we can improve margins by applying more sophisticated pricing models and regional promotion programs, with a focus on the optimization of item-specific promotional prices and improvements in clearance pricing through enhanced merchandise planning and merchandising systems upgrades. We further believe the identification of promotional items that drive customer traffic will add consumers to the base market as we seek to feature those promotional items more often. We are currently utilizing and refining a promotion optimization system that enables us to improve our clearance pricing decisions.

- ***Enhancing the in-store environment.***

- *Visual merchandising.* We promote an environment whereby our customers rely on us for ideas, inspiration, and information. We expect to make it easier and more exciting to shop our stores with improved store designs that include an emphasis on inspirational activities and ideas in our feature space, less clutter in the drive aisles, and more visually appealing layouts. Based on consumer responses, we further refined our standardization/remodel program to continue enhancement of the in-store experience. In fiscal 2008, we opened five new stores and remodeled 19 stores in our new prototype format. We continue to refine this format based upon customer feedback and operating results and expect to incorporate successful components into our store opening and remodel program.

- *The in-store experience.* In support of our ongoing commitment to improve the in-store experience, we successfully implemented an automated labor scheduling module in all stores during the 2008 fiscal year. This module utilizes individual store attributes, along with the store's unique customer shopping patterns, to create a schedule that

optimizes labor hours in every store. In addition, we launched an internet based CRM (customer relationship management) platform that we are using to gain feedback from our consumers relative to their in-store experience. Store service targets have been established based upon this feedback. We believe that overall service levels will continue to improve in fiscal 2009 as a result of these two programs.

- *Pursuing global sourcing.*

- *Product sourcing.* Historically, we have sourced our product primarily through a network of domestic vendors, many of whom import the merchandise from China and other countries outside the United States. In fiscal 2006, we undertook an effort to increase the amount of products sourced directly from overseas manufacturers, thereby providing the opportunity to expand our margins. Initially, we have focused on products manufactured in China and have engaged agents to assist us, when appropriate, in our global sourcing efforts. In fiscal 2008, we increased the products sourced directly from international manufacturers, directly or with assistance from agents, to 10% of total purchases from 7% in fiscal 2007. In fiscal 2009, we anticipate our direct import business will continue to increase significantly. We will continue to expand our globally sourced assortment as we believe this presents a significant long-term opportunity to enhance our margin, improve our product quality, and mitigate external cost pressures and supply chain risks. The fulfillment of this objective is dependent upon several factors,

including our product development capabilities, establishment of key processes, implementation of new technology and upgrade of existing technology, distribution center capacity, a strong vendor base, and proprietary brand development.

- *Proprietary Brand Development.* To maximize the benefits of global sourcing, this strategic initiative is supported by proprietary brand development. Currently, we sell numerous products under hundreds of collection, brand and sub-brand names. Strong, mission-specific proprietary brands will help drive differentiation, improve our image assortment, and provide the framework for Michaels to more effectively market our globally sourced products. We have completed the development of a consumer-insight driven global brand architecture. We believe this will strengthen our value proposition in the marketplace, differentiate Michaels from its competitors, enhance consumer loyalty, and increase market share by supporting Michaels' position in selection, newness, and value. In fiscal 2008, we began introducing our proprietary brands, which included products in scrapbooking, framing, and general and children's crafts. In fiscal 2009, we will continue our brand development and expect to double the number of products offered in our proprietary brands.

- *Growth opportunities.*

- *Organic growth through new Michaels store openings.* We believe the combined United States and Canadian markets can support a total of 1,200 to 1,400 Michaels stores. Given the current economic conditions, our real estate activity is being reevaluated. We will focus on limited store openings during fiscal 2009, as we expect to open approximately 20 to 25 new Michaels stores during the fiscal year, funded primarily through cash provided by operating activities and additional borrowings under our revolving credit facility. We also intend to preserve flexibility to take advantage of the current real estate marketplace.

- *Process and profit improvement.*

- *Co-sourcing and process reengineering.* On January 16, 2009, we entered into a Master Service Agreement with Tata America International Corporation, operating as TCS America, to co-source various functions, initially including portions of our Information Technology, Information Services and Accounts Payable functions. During the first half of fiscal 2009, we expect to complete the transition of these areas to TCS through its offshore location in India. We will continue to evaluate our non-core activities to identify other opportunities for co-sourcing. On-going, TCS will be providing these functions with Michaels oversight. We expect that over the term of the contract, we will realize significant cost savings and improved execution. In addition, we have identified certain areas throughout the organization where we believe that we have opportunities to improve processes and enhance operational efficiencies. We will partner with TCS to streamline these operations, bringing additional best practices to our business.

- *Non-merchandise procurement.* As part of our profit improvement initiative, we are evaluating our non-merchandise procurement activities to identify potential cost savings through the consolidation of spending and

consistent contract management.

Merchandising

Our Michaels store merchandising strategy is to provide a broad selection of products in a convenient location with an appealing store environment. Each Michaels store offers approximately 37,000 basic SKUs in a number of product categories. The following table shows a breakdown of sales for Michaels stores by department as a percentage of total sales:

	Fiscal Year		
	2008	2007	2006
General and children's crafts	42%	41%	41%
Home décor and seasonal	23	25	26
Framing	18	18	17
Scrapbooking	17	16	16
	100%	100%	100%

During the Christmas selling season, a significant portion of floor and shelf space in a typical Michaels store is devoted to Christmas crafts, Christmas decorations, gift making, and gift giving merchandise. Because of the project-oriented nature of many of these products, the Christmas selling season begins in August and extends through December. Accordingly, a fully developed seasonal

merchandising program, including inventory, merchandise layout, and instructional ideas, is implemented during the third quarter of each fiscal year in every Michaels store. This program requires additional inventory investment so that stores are fully stocked during the peak selling season to meet higher demand from increased customer traffic.

We routinely identify merchandise that requires some price reduction to accelerate sales of the product. The need for this reduction is generally attributable to clearance of seasonal merchandise or product that is being displaced from its assigned location in the store to make room for new merchandise. Additional SKUs that are candidates for repricing are identified using our point of sale (POS) and perpetual inventory data. In each case, the appropriate repricing is determined at our corporate office. Price changes are transmitted electronically to the store through the point of sale system and instructions are provided to our stores regarding product placement, signage, and display in order to ensure that product is effectively cleared.

Our Aaron Brothers stores offer on average approximately 6,900 SKUs, including photo frames, a full line of ready-made frames, art prints, framed art, and a wide selection of art supplies and custom framing services. The merchandising strategy for our Aaron Brothers stores is to provide a unique, upscale framing assortment and shopping experience. In addition, we strive to provide a fashion forward framing merchandise selection in an appealing environment with attentive customer service.

Purchasing and Inventory Management

We purchase merchandise from approximately 950 vendors. We believe that our buying power and ability to make centralized purchases enable us to acquire products on favorable terms. Central merchandising management teams negotiate with vendors in an attempt to obtain the lowest net merchandise costs and improve control over product mix and inventory levels. In fiscal 2008, our top 10 vendors accounted for approximately 32% of total purchases with no single vendor accounting for more than 10% of total purchases.

In addition to purchasing from outside vendors, our Michaels and Aaron Brothers stores purchase custom frames, framing supplies, mats, and art prints from our framing operation, Artistree, which consists of a manufacturing facility and three regional processing centers to support our retail stores.

Substantially all of the products sold in Michaels stores are manufactured in Asia, Canada, Mexico, and the United States. Goods manufactured in Asia generally require long lead times and are ordered four to six months in advance of delivery. Those products are either imported directly by us or acquired from distributors based in the United States and their purchase prices are denominated in United States dollars.

Our primary objectives for inventory management are (1) maximizing the efficiency of the flow of product to the stores, (2) maintaining high store in-stock levels, (3) enhancing store labor efficiency, (4) reducing clearance inventory levels, and (5) optimizing our overall investment in inventory. We manage our inventory in several ways, including: in-store management using a handheld radio frequency device (RF gun); daily tracking of inventory positions utilizing our perpetual inventory and automated replenishment systems; the use of merchandise planograms to control the merchandise assortment and presentation; and the review of item-level sales information in order to track the performance and sell-through of seasonal and promotional items. The data that we obtain from our POS system is an integral component in the inventory management process. In addition, store and distribution center inventories are verified through periodic physical and cycle counts conducted throughout the year on a rotating systematic schedule.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Our perpetual inventory and automated merchandise replenishment systems provide the capability to achieve our inventory management objectives. Our automated replenishment system uses perpetual inventory records to analyze individual store/SKU on-hand quantities, as well as other pertinent information such as sales forecast, seasonal selling patterns, promotional events, and vendor lead times, to generate recommended merchandise reorder information. These recommended orders are reviewed daily and purchase orders are delivered electronically to our vendors and our distribution centers. In addition to improving our store in-stock position, these systems enable us to better forecast merchandise ordering quantities for our vendors and give us the ability to identify, order, and replenish the stores' merchandise using less store associate labor. These systems also allow us to react more quickly to selling trends and allow our store associates to devote more time to customer service, thereby improving inventory productivity and sales opportunities.

We manage the distribution of seasonal merchandise to our stores by allocating seasonal merchandise based on prior year sales and current store sales trends. For a discussion of the seasonal nature of our business, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Seasonality.

Artistree

We currently operate a vertically integrated framing operation that leverages Artistree, our wholly-owned manufacturing subsidiary, across our Michaels and Aaron Brothers store networks. Artistree supplies high quality custom and specialty framing merchandise, including art prints and precut mats.

Our moulding manufacturing plant, located in Kernersville, North Carolina, converts lumber into finished frame moulding that is supplied to our three regional processing centers for custom framing orders for our stores. We manufacture approximately 15% of the moulding we process, import another 40% from quality manufacturers in Indonesia, Malaysia, China, and Italy, and purchase the balance from distributors. We directly source metal moulding for processing in our regional centers. The custom framing orders are processed (frames cut and joined, along with cutting mats and foamboard backing) and shipped to our stores where the custom frame order is completed for customer pick-up.

Our regional processing centers are located in City of Industry, California; Coppell, Texas; and Kernersville, North Carolina. Our art prints and pre-cut mats, along with our custom frame supplies, are packaged and distributed out of our Coppell regional processing center. Combined, these facilities occupy approximately 476,000 square feet and, in fiscal 2008, processed over 25 million linear feet of frame moulding and 5 million individually custom cut mats for our Michaels and Aaron Brothers stores.

We believe Artistree provides a competitive advantage to our Michaels and Aaron Brothers stores. Based on the benefits we have received from this vertically integrated solution, we continue to evaluate additional future vertical integration opportunities leveraging our strong framing operations.

Distribution

We currently operate a distribution network for supplying our stores with merchandise. Approximately 80% of Michaels stores merchandise receipts, consisting of both seasonal and basic SKUs, are shipped through the distribution network with the remainder shipped directly from vendors. Approximately 58% of Aaron Brothers stores merchandise, consisting of both seasonal and basic SKUs, is shipped through the distribution network with the remainder shipped directly from vendors. Our seven distribution centers are located in California, Florida, Illinois, Pennsylvania, Texas, and Washington. Since fiscal 2004, we have increased the capacity of our distribution centers by approximately 53% to a total of 4.6 million square feet through the opening of three new distribution centers, expansion of one center and closure of one center. In addition, we currently utilize one third-party warehouse to store and supply our seasonal merchandise in preparation for the holiday season.

In fiscal 2005, we implemented a number of enhancements to our distribution network. We refer to the improved network as our Hybrid distribution network. In total, approximately 130 vendors (formerly direct-to-store vendors) were converted into the distribution network, and as of August 2008, all planned conversions were complete. Under our hybrid-distribution method, all distribution centers stock our fast-selling SKUs with slower-selling SKUs only stocked in the distribution center closest to the vendor. This method reduces costs associated with drop-shipping products directly to store locations. This reduction in direct deliveries from vendors to our stores has resulted in the following benefits to our supply chain:

- Product cost reductions shared with our vendors;

- Reduced transportation costs, partially offset by additional handling costs;
- More efficient store labor involved in merchandise receipt processing; and
- Improved service levels to our stores.

Michaels stores generally receive deliveries from the distribution centers weekly through an internal transportation distribution network using a dedicated fleet of trucks and contract carriers. Aaron Brothers stores receive merchandise on a weekly or biweekly basis from a dedicated 174,000 square foot distribution center located in the Los Angeles, California area.

Store Expansion and Relocation

The following table shows our store growth for the last five years:

	2008	2007	Fiscal Year (1) 2006	2005	2004
Michaels stores:					
Retail stores open at beginning of year	963	921	886	845	805
Retail stores opened during the year	51	45	43	46	45
Retail stores opened (relocations) during the year	11	11	7	18	30
Retail stores closed during the year	(5)	(3)	(8)	(5)	(5)
Retail stores closed (relocations) during the year	(11)	(11)	(7)	(18)	(30)
Retail stores open at end of year	1,009	963	921	886	845
Aaron Brothers stores:					
Retail stores open at beginning of year	166	166	166	164	158
Retail stores opened during the year		2	1	2	7
Retail stores opened (relocations) during the year	1				1
Retail stores closed during the year	(5)	(2)	(1)		(1)
Retail stores closed (relocations) during the year	(1)				(1)
Retail stores open at end of year	161	166	166	166	164
Total store count at end of year	1,170	1,129	1,087	1,052	1,009

(1) In fiscal years 2006 and prior, the Star Decorators Wholesale Los Angeles store is retroactively presented as a Michaels store.

We plan to open approximately 20 to 25 Michaels stores in fiscal 2009. The anticipated opening of Michaels stores and the rate at which stores are opened will depend upon a number of factors, including the current economic environment, success of existing stores, the availability and the cost of capital for expansion, the availability of suitable store sites, and the ability to hire and train qualified managers.

We have developed a standardized store opening procedure that allows for the efficient opening of new stores and their integration into our information and distribution systems. We develop the floor plan and merchandise layout and organize the advertising and promotions in connection with the opening of each new store. In addition, we maintain qualified store opening teams to provide new store personnel with in-store training.

Costs for opening stores at particular locations depend upon the type of building, the general cost levels in the area, store size, operating format, and the time of the year the store is opened. In fiscal 2008, the average net cost of opening a new Michaels store included approximately \$0.7 million of leasehold improvements, furniture, fixtures and equipment, and pre-opening costs, and an estimated initial inventory investment, net of accounts payable, of approximately \$0.4 million.

Edgar Filing: MICHAELS STORES INC - Form 10-K

In addition to new store openings, we continue to pursue a store relocation program to improve the quality and performance of our existing store base as well as perform remodels of existing stores. In fiscal 2008, we relocated 11 Michaels stores and remodeled 20 Michaels stores. We plan to relocate approximately five Michaels stores and remodel one Michaels store during fiscal 2009.

During fiscal 2009, we anticipate closing 5 to 15 Michaels stores and 5 to 10 Aaron Brothers stores. Many of our store closings are stores that have reached the end of their lease term.

Investment in Information Technology

We are committed to using information technology to increase operating efficiencies, improve merchandise selection and flow, and improve our ability to satisfy the needs of our customers. Between fiscal 1998 and fiscal 2008, we invested heavily in POS, perpetual inventory, automated replenishment, distribution, and seasonal allocation systems. These systems have significantly improved our ability to more accurately forecast, manage, and analyze our inventory levels, margins and merchandise ordering quantities and have created efficiencies within our stores, distribution centers, and corporate office. While we have seen significant benefits with these systems, we believe there are additional benefits to be realized as we further refine the usage and integration among our systems.

We completed a significant upgrade of our merchandising systems in fiscal 2008. With this upgrade we implemented a new price management system as well as a new purchase order system. In 2008, we implemented a pilot promotion optimization system that is scheduled to be deployed in the first quarter of 2009. This system will provide us greater capability to maximize the benefit of our promotional activities.

In fiscal 2008, we completed the roll out of a new labor management system in our regional distribution centers. This system supports our efforts to improve the productivity in our distribution centers by tracking associate activities to pre-determined standards. We also completed the upgrade of our Warehouse Management system in the regional distribution centers.

In fiscal 2006, we began the rollout of a store labor management system, with time and attendance functionality being implemented in all Michaels stores. In fiscal 2007, we began a store rollout of a labor forecasting and scheduling system. The implementation for the entire chain was completed in fiscal 2008. Also in fiscal 2008, we implemented a new payroll forecasting system and a new labor standards system. Together, we expect these systems to provide us with detailed information to better manage our labor force and serve our customers, with improvements in labor efficiency and utilization over the next several years.

We also implemented a new data warehouse system in fiscal 2006 that is our central source for certain business reporting processes and is designed to be highly scalable in order to support future growth and information needs. In fiscal 2007, we expanded our data warehouse by adding transaction level sales data from our POS system, which further improves our ability to analyze and make decisions about our marketing initiatives.

In fiscal 2008, we began the implementation of a supply chain management tool to support our Global Sourcing initiative. The web-based system will be used both by our Sourcing department and by our vendors and agents as the central repository for quotes and critical path management. The implementation of this system is expected to be completed in fiscal 2009.

Other projects completed in fiscal 2008 include improvements to our Michaels POS system to add enhanced pricing functionality, new Internet microsites to expand Michaels.com in support of new direct marketing programs, and an upgraded POS system for our Aaron Brothers stores.

As part of the co-sourcing agreement entered into with TCS, certain IT services for application support, application development, technology infrastructure and our call center are being transitioned to TCS. This transition is expected to be completed by June 2009.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Other projects planned for fiscal 2009 include an upgrade to our Warehouse Management System, implementation of an automated POS sales tax update system, enhancements to our POS system to enable additional promotional program functionality and improvements to our in-store custom framing ordering system.

Foreign Sales

All of our current international business is in Canada and accounted for approximately 8% of total sales in fiscal 2008 and fiscal 2007, and approximately 7% of total sales in fiscal 2006. During the last three years, 7% or less of our assets have been located outside of the United States.

Service Marks

The names Michaels, Michaels.com, Michaels The Arts and Crafts Store, Aaron Brothers, Aaron Brothers Art & Framing, Artistree, Art Frame & Design, Recollections, and the Michaels logo are each federally registered service marks.

Employees

As of March 30, 2009, we employed approximately 39,000 associates, approximately 27,600 of whom were employed on a part-time basis. The number of part-time associates substantially increases during the Christmas selling season. Of our full-time associates, approximately 2,900 are engaged in various executive, operating, training, distribution, and administrative functions in our corporate and division offices and distribution centers, and the remainder are engaged in store operations. None of our associates are members of labor unions in association with their Michaels employment.

ITEM 1A. Risk Factors.

Our financial performance is subject to various risks and uncertainties. The risks described below are those which we believe are the material risks we face. Any of the risk factors described below could significantly and adversely affect our business, prospects, financial condition, and results of operations.

We Face Risks Related to the Effect of General Economic Conditions and the Current Financial Crisis

If the worldwide economic downturn continues or deteriorates further, it could continue to adversely impact our results of operations, cash flows and financial condition. Our stores offer arts and crafts supplies and products and custom framing for the crafter and do-it-yourself home decorator, which some customers may perceive as discretionary. Pressure on discretionary income brought on by current economic conditions, including housing market declines and rising energy prices, may cause consumers to reduce the amount they spend on discretionary items. The downturn in the economy may continue to adversely affect consumer confidence and retail spending, decreasing demand for our merchandise. Current economic conditions also make it difficult for us to accurately forecast future demand trends, which could cause us to purchase excess inventories, resulting in increases in our inventory carrying cost, or insufficient inventories, resulting in our inability to satisfy our customer demand and potentially lose market share. In addition, as discussed under Liquidity and Capital Resources, we believe that our current liquidity resources are adequate for the foreseeable future. Although the Company does not anticipate needing additional sources of capital in the near term, continued disruption in the capital markets could make it difficult for us to raise additional capital, when needed, or to eventually refinance our existing indebtedness, on acceptable terms or at all. Similarly, if our suppliers face challenges in obtaining credit when needed or otherwise face difficult business conditions, they may become unable to offer us the merchandise we use in our business thereby causing reductions in our revenues, or they may demand more favorable payment terms, all of which could adversely affect our results of operations, cash flows and financial condition.

We Face Risks Related to Our Substantial Indebtedness

Our substantial 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 high degree of leverage could have important consequences to us, including:

- making it more difficult for us to make payments on our debt;
- increasing our vulnerability to general economic and industry conditions;
- requiring a substantial portion of cash flow from operations to be dedicated to the payment of principal and interest on our debt, thereby reducing our ability to use our cash flow to fund our operations, capital expenditures, and future business opportunities;
- exposing us to the risk of increased interest rates as certain of our borrowings under our senior secured credit facilities are at variable rates;
- restricting us from making strategic acquisitions or causing us to make non-strategic divestitures;
- limiting our ability to obtain additional financing for working capital, capital expenditures, product development, debt service requirements, acquisitions, and general corporate or other purposes; and
- limiting our ability to adjust to changing market conditions and placing us at a competitive disadvantage compared to our competitors who are less highly leveraged.

We and our subsidiaries may be able to incur substantial additional indebtedness in the future, subject to the restrictions

contained in our senior secured credit facilities and the indentures governing our notes. In addition, our senior secured credit facilities and indentures governing our notes do not restrict our owners from creating new holding companies that may be able to incur indebtedness without regard to the restrictions set forth in our credit facilities and indentures. If new indebtedness is added to our current debt levels, the related risks that we now face could intensify.

Our Debt Agreements Contain Restrictions That Limit Our Flexibility in Operating Our Business

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. These covenants limit our ability and the ability of our restricted subsidiaries to, among other things:

- incur additional debt;
- pay dividends or distributions on our capital stock or repurchase our capital stock;
- issue stock of subsidiaries;
- make certain investments;
- create liens on our assets to secure debt;
- enter into transactions with affiliates;
- merge or consolidate with another company; and
- sell or otherwise transfer assets.

In addition, under our senior secured credit facilities, we are required to maintain specified financial ratios upon the occurrence of certain events. Our ability to meet those tests can be affected by events beyond our control, and we cannot assure that we will meet them. A breach of any of these covenants could result in a default under our senior secured credit facilities. Upon the occurrence of an event of default under our senior secured credit facilities, the lenders could elect to declare all amounts outstanding under our senior secured credit facilities to be immediately

Edgar Filing: MICHAELS STORES INC - Form 10-K

due and payable and terminate all commitments to extend further credit. If we were unable to repay those amounts, the lenders under our senior secured credit facilities could proceed against the collateral granted to them to secure that indebtedness. We have pledged a significant portion of our assets as collateral under our senior secured credit facilities. If the lenders under our senior secured credit facilities accelerate the repayment of borrowings, we cannot assure that we will have sufficient assets to repay our senior secured credit facilities, as well as our unsecured indebtedness, including the notes.

Our senior secured asset-based revolving credit facility permits us to borrow up to \$1.0 billion; however, our ability to borrow thereunder is limited by a borrowing base, which at any time will equal the sum of 90% of eligible credit card receivables and debit card receivables plus between 85% and 87.5% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit plus a percentage of eligible in-transit inventory to be agreed upon, less certain reserves, and the sum of an additional 10% appraised net orderly liquidation value of eligible inventory and of eligible letters of credit plus an additional 5% of eligible credit card receivables and debit card receivables under a last out tranche. In addition, our ability to borrow under this facility is limited by a minimum liquidity condition, providing that, if excess availability is less than \$75.0 million at any time, we are not permitted to borrow any additional amounts under the senior secured asset-based revolving credit facility unless our pro forma Consolidated Fixed Charge Coverage Ratio (as defined in the credit agreement for our senior secured asset-based revolving credit facility) is at least 1.1 to 1.0. Moreover, our senior secured asset-based revolving credit facility provides discretion to the agent bank acting on behalf of the lenders to impose additional availability reserves, which could materially impair the amount of borrowings that would otherwise be available to us. There can be no assurance that the agent bank will not impose such reserves or, were it to do so, that the resulting impact of this action would not materially and adversely impair our liquidity.

Our Growth Depends on Our Ability to Open New Stores

One of our key business strategies is to expand our base of retail stores. If we are unable to continue this strategy, our ability to increase our sales, profitability, and cash flow could be impaired. To the extent that we are unable to open new stores as we anticipate, our sales growth would come only from increases in comparable store sales. Growth in profitability in that case would depend significantly on our ability to reduce our costs as a percentage of our sales. We may be unable to continue our store growth strategy if we cannot identify suitable sites for additional stores, negotiate acceptable leases, access sufficient capital to support store growth, or hire and train a sufficient number of qualified associates.

Our Success Will Depend on How Well We Manage Our Business

Even if we are able to substantially continue our strategy of expanding our store base, or additionally, to expand our business through acquisitions or vertical integration opportunities, we may experience problems, which may prevent any significant increase in profitability or negatively impact our cash flow. For example:

- the costs of opening and operating new stores may offset the increased sales generated by the additional stores;
- the closure of unsuccessful stores may result in the retention of liability for expensive leases;
- a significant portion of our management's time and energy may be consumed with issues unrelated to advancing our core business strategy, which could possibly result in a deterioration of our operating results;
- our expansion may outpace our planned technological advances and current systems with the possible consequences of breakdowns in our supply chain management and reduced effectiveness of our operational systems and controls;
- the implementation of future operational efficiency initiatives, which may include the consolidation of certain operations and/or the possible co-sourcing of selected functions, may not produce the desired reduction in costs and may result in disruptions arising from such actions;
- we may be unable to hire, train, and retain qualified employees, including management and senior executives, and significant turnover could be disruptive to our core business strategy and operations, which may negatively impact our operating results;
- failure to maintain stable relations with our labor force could possibly result in a deterioration of our operating results;
- our suppliers may be unable to meet the increased demand of additional stores in a timely manner; and

- we may be unable to expand our existing distribution centers or use third-party distribution centers on a cost-effective basis to provide merchandise for sale by our new stores.

Changes in Customer Demands Could Materially Adversely Affect Our Sales, Operating Results, and Cash Flow

Our success depends on our ability to anticipate and respond in a timely manner to changing customer demands and preferences for products and supplies used in creative activities. If we misjudge the market, we may significantly overstock unpopular products and be forced to take significant inventory markdowns, which would have a negative impact on our operating results and cash flow. Also, shortages of key items could have a material adverse impact on our operating results. In addition, adverse weather conditions, unfavorable economic trends, and consumer confidence volatility could have a material adverse impact on our sales and operating results.

Unexpected or Unfavorable Consumer Responses to Our Promotional or Merchandising Programs Could Materially Adversely Affect Our Sales, Operating Results, and Cash Flow

Brand recognition, quality, and price have a significant influence on consumers' choices among competing products and brands. Advertising, promotion, merchandising, and the pace and timing of new product introductions also have a significant impact on consumers' buying decisions. If we misjudge consumer responses to our existing or future promotional activities, this could have a material adverse impact on our financial condition and operating results.

We believe improvements in our merchandise offering help drive sales at our stores. We could be materially adversely affected by poor operational execution of changes to our merchandise offering or by unexpected consumer responses to changes in our merchandise offering.

Changes in Newspaper Subscription Rates May Result in Reduced Exposure to Our Circular Advertisements

The majority of our promotional activities utilize circular advertisements in local newspapers. A continued decline in consumer subscriptions of these newspapers could reduce the frequency with which consumers receive our circular advertisements, thereby negatively affecting sales, operating results, and cash flow.

Improvements to Our Supply Chain May Not Be Fully Successful

An important part of our efforts to achieve efficiencies, cost reductions, and sales and cash flow growth is the identification and implementation of improvements to our supply chain, including merchandise ordering, transportation, and receipt processing. During fiscal 2009, we will continue to implement enhancements to our distribution systems and processes, which are designed to improve efficiency through the supply chain and at our stores. Significant changes to our supply chain could have a material adverse impact on our operating results.

Our Suppliers May Fail Us

Many of our suppliers are small firms that produce a limited number of items. Given their limited resources, these firms are susceptible to cash flow issues, production difficulties, quality control issues, and problems in delivering agreed-upon quantities on schedule. We may not be able, if necessary, to return products to these suppliers and obtain refunds of our purchase price or obtain reimbursement or indemnification from them if their products prove defective. In addition, these suppliers may be unable to withstand a downturn in economic conditions. Significant failures on the part of our key suppliers could have a material adverse effect on our operating results.

In addition, many of these suppliers require extensive advance notice of our requirements in order to supply products in the quantities we desire. This long lead time requires us to place orders far in advance of the time when certain products will be offered for sale, exposing us to risk of shifts in demand.

Our Reliance on Foreign Suppliers Increases Our Risk of Obtaining Adequate, Timely, and Cost-Effective Product Supplies

We rely to a significant extent on foreign manufacturers of various products that we sell. In addition, many of our domestic suppliers purchase a portion of their products from foreign sources. This reliance increases the risk that we will not have adequate and timely supplies of various products due to local political, economic, social, or environmental conditions (including acts of terrorism, the outbreak of war, or the occurrence of natural disaster), transportation delays (including dock strikes and other work stoppages), restrictive actions by foreign governments, or changes in United States laws and regulations affecting imports or domestic distribution. Reliance on foreign manufacturers also increases our exposure to fluctuations in exchange rates and trade infringement claims and reduces our ability to return product for various reasons.

All of our products manufactured overseas and imported into the United States are subject to duties collected by the United States Customs Service. We may be subjected to additional duties, significant monetary penalties, the seizure and the forfeiture of the products we are attempting to import, or the loss of import privileges if we or our suppliers are found to be in violation of U.S. laws and regulations applicable to the importation of our products.

Risks Associated With the Vendors from Whom our Products are Sourced Could Materially Adversely Affect our Revenue and Gross Profit

The products we sell are sourced from a wide variety of domestic and international vendors. Global sourcing has become an increasingly important part of our business, as we have undertaken efforts to increase the amount of product we source directly from overseas manufacturers.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Our ability to find qualified vendors who meet our standards and supply products in a timely and efficient manner is a significant challenge, especially with respect to goods sourced from outside the U.S. Any issues related to the transition from domestic to international vendors could 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 and Financial Position

We are subject to regulations by a variety of state and international regulatory authorities, including the Consumer Product Safety Commission. In fiscal 2008, we purchased merchandise from approximately 950 vendors. Since a majority of our merchandise is manufactured in foreign countries, one or more of our vendors might not adhere to product safety requirements or our quality control standards, and we might not identify the deficiency before merchandise ships to our stores. Any issues of product safety, including but not limited to those manufactured in foreign countries, could cause us to recall some of those products. If our vendors fail to manufacture or import merchandise that adheres to our quality control standards, our reputation and brands could be damaged, potentially leading to increases in customer litigation against us. Furthermore, to the extent we are unable to replace any recalled products, we may have to reduce our merchandise offerings, resulting in a decrease in sales, especially if a recall occurs near or during a seasonal period. If our vendors are unable or unwilling to recall products failing to meet our quality standards, we may be required to recall those products at a substantial cost to us. Moreover, changes in product safety or other consumer protection laws could lead to increased costs to us for certain merchandise, or additional labor costs associated with readying merchandise for sale. Long lead times on merchandise ordering cycles increase the difficulty for us to plan and prepare for potential changes to applicable laws. The recently enacted Consumer Product Safety Improvement Act of 2008 imposes significant new requirements on manufacturing, importing, testing and labeling requirements for our products. In the event that we are unable to timely comply with regulatory changes, significant fines or penalties could result, and could adversely affect our reputation, financial position, earnings or cash flow.

Edgar Filing: MICHAELS STORES INC - Form 10-K

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

Any future increases in commodity prices or inflation may adversely affect our costs, including cost of merchandise and distribution costs. Furthermore, the trucking industry may experience a shortage of drivers, which could be exacerbated by higher fuel prices. Our operating results may be adversely affected if we are unable to secure adequate trucking resources to fulfill our delivery schedules to the stores, particularly as we deliver our fall and Christmas seasonal merchandise.

We Are Co-sourcing Certain of Our Information Technology and Accounts Payable Functions and May Co-source Other Administrative Functions, Which Will Make Us More Dependent Upon Third Parties

We signed a contract during the fourth quarter of fiscal 2008 with a third-party service provider to co-source a significant portion of our information technology (IT) and accounts payable (AP) functions. This co-sourcing initiative is a component of our ongoing strategy to increase our IT capabilities, monitor our costs, seek additional cost savings and increase efficiencies. These functions will generally be performed in an offshore location, with Michaels oversight. As a result, we will be relying on third parties to ensure that our IT and AP needs are sufficiently met. This reliance subjects us to risks arising from the loss of control over IT and AP processes, changes in pricing that may affect our operating results, and potentially, termination of provision of these services by our supplier. If our service providers fail to perform, we may have difficulty arranging for an alternative supplier or rebuilding our own internal resources, and we could incur significant costs, all of which may have a significant adverse effect on our business. We may co-source other administrative functions in the future, which would further increase our reliance on third parties. Further, the use of offshore service providers may expose us to risks related to local political, economic, social or environmental conditions (including acts of terrorism, the outbreak of war, the occurrence of natural disaster), restrictive actions by foreign governments or changes in United States laws and regulations.

Our Information Systems May Prove Inadequate

We depend on our management information systems for many aspects of our business. We will be materially adversely affected if our management information systems are disrupted or we are unable to improve, upgrade, maintain, and expand our systems.

We May Fail to Optimize or Adequately Maintain Our Perpetual Inventory and Automated Replenishment Systems

We believe our perpetual inventory, automated replenishment, and weighted average cost stock ledger systems are necessary to properly forecast, manage, and analyze our inventory levels, margins, and merchandise ordering quantities. We may fail to properly optimize the effectiveness of these systems, or to adequately support and maintain the systems, which could have a material adverse impact on our financial condition and operating results.

Failure to Adequately Maintain the Security of Our Electronic and Other Confidential Information Could Materially Adversely Affect Our Financial Condition and Operating Results

Edgar Filing: MICHAELS STORES INC - Form 10-K

We have become increasingly centralized and dependent upon automated information technology processes. In addition, a portion of our business operations is conducted over the Internet, increasing the risk of viruses that could cause system failures and disruptions of operations. Any failure to maintain the security of our customers' confidential information, or data belonging to ourselves or our suppliers, could put us at a competitive disadvantage, result in deterioration in our customers' confidence in us, subject us to potential litigation and liability, and fines and penalties, resulting in a possible material adverse impact on our financial condition and operating results. Even though we are compliant with the requirements of the payment card industry, we may not be able to maintain such compliance, and even with continued compliance, unauthorized access of our electronic and other confidential information may occur.

If the Employee Free Choice Act Is Adopted, It Would Be Easier for Our Employees to Obtain Union Representation and Our Businesses Could Be Adversely Impacted

Currently, none of our employees are represented by unions. However, our employees have the right at any time under the National Labor Relations Act to form or affiliate with a union. If some or all of our workforce were to become unionized and the terms of the collective bargaining agreement were significantly different from our current compensation arrangements, it could increase our costs and adversely impact our profitability.

The Employee Free Choice Act of 2007: H.R. 800 (EFCA) was passed in the U.S. House of Representatives last year and the same legislation has been introduced again in 2009 as H.R. 1409 and S. 560. This bill or a variation of it could be enacted in the future and could have an adverse impact on our businesses. The EFCA aims to amend the National Labor Relations Act, by making it easier for workers to obtain union representation and increasing the penalties employers may incur if they engage in labor practices in violation of the National Labor Relations Act. As currently drafted, the EFCA requires the National Labor Relations Board (NLRB) to review petitions filed by employees for the purpose of creating a labor organization and to certify a bargaining representative without directing an election if a majority of the bargaining unit employees have authorized designation of the representative. The EFCA also requires the parties to begin bargaining within 10 days of the receipt of the petition, or a later date if mutually agreed upon. In addition, if the union and employer cannot agree upon the terms of a first collective bargaining agreement within 90 days, which can be extended by mutual agreement, either party can request federal mediation, which could lead to binding arbitration if an agreement still cannot be reached after an additional 30 days. EFCA would also require the NLRB to seek a federal injunction against an employer whenever there is reasonable cause to believe that the employer has discharged or discriminated against an employee to encourage or discourage membership in the labor organization, threatened to discharge or otherwise discriminate against an employee in order to interfere with, restrain, or coerce employees in the exercise of guaranteed collective bargaining rights, or engaged in any other related unfair labor practice that significantly interferes with, restrains, or coerces employees in the exercise of such guaranteed rights. The EFCA adds additional remedies for such violations, including back pay plus liquidated damages and civil penalties to be determined by the NLRB not to exceed \$20,000 per infraction.

A Weak Fourth Quarter Would Materially Adversely Affect Our Operating Results

Our business is highly seasonal. Our inventories and short-term borrowings grow in the second and third fiscal quarters as we prepare for our peak selling season in the third and fourth fiscal quarters. Our most important quarter in terms of sales, profitability, and cash flow historically has been the fourth fiscal quarter. If for any reason our fourth fiscal quarter results were substantially below expectations, our operating results for the full year would be materially adversely affected, and we could have substantial excess inventory, especially in seasonal merchandise, that is difficult to liquidate.

Competition Could Negatively Impact Our Operations

The retail arts and crafts industry is competitive, which could result in the reduction of our prices and our loss of market share. We must remain competitive in the areas of quality, price, breadth of selection, customer service, and convenience. We compete with mass merchants (e.g., Wal-Mart Stores, Inc. and Target Corporation), who dedicate a portion of their selling space to a limited selection of craft supplies and seasonal and holiday merchandise, regional chains, and local merchants. We also compete with specialty arts and crafts retailers, which include Hobby Lobby, A.C. Moore Arts & Crafts, Inc., Jo-Ann Stores, Inc., and Garden Ridge Corporation. Some of our competitors, particularly the mass merchants, are larger and have greater financial resources than we do. In addition, alternative methods of selling crafts, such as over the Internet, could result in additional competitors in the future and increased price competition since our customers could more readily comparison shop. Furthermore, we ultimately compete with alternative sources of entertainment and leisure for our customers.

The Interests of Our Controlling Stockholders May Conflict with the Interests of Our Creditors

The Sponsors (as defined in Note 4 to the consolidated financial statements) indirectly own over 93% of the Company's Common Stock. The interests of these funds as equity holders may conflict with those of our creditors. The controlling stockholders may have an incentive to increase the value of their investment or cause us to distribute funds at the expense of our financial condition, which could affect our ability to make payments on the outstanding notes. In addition, these funds have the power to elect a majority of our board of directors and appoint new officers and management and, therefore, effectively control many other major decisions regarding our operations. In addition, our Sponsors have in the past and may continue to purchase our debt which could adversely affect the liquidity of the remaining debt of any series.

ITEM 1B. Unresolved Staff Comments.

Not applicable.

ITEM 2. Properties.

We lease substantially all of the sites for our Michaels and Aaron Brothers stores, with the majority of our stores having initial lease terms of approximately 10 years. The leases are generally renewable, with increases in lease rental rates. Lessors have made leasehold improvements to prepare our stores for opening under a majority of our existing leases. As of January 31, 2009, in connection with stores that we plan to open or relocate in future fiscal years, we had signed 6 leases for Michaels stores.

As of March 30, 2009, we lease and occupy the following non-store facilities:

	Square Footage
Distribution centers:	
Centralia, Washington	718,000
City of Commerce, California (Aaron Brothers)	174,000
Hazleton, Pennsylvania	1,005,000
Jacksonville, Florida	791,000
Lancaster, California	763,000
New Lenox, Illinois	693,000
Tarrant County, Texas	433,000
	4,577,000
Artistree:	
City of Industry, California (regional processing center)	90,000
Coppell, Texas (regional processing and fulfillment operations center)	230,000
Kernersville, North Carolina (manufacturing plant and regional processing center)	156,000
	476,000
Office space:	
Coppell, Texas (corporate satellite office)	67,000
Grand Prairie, Texas (corporate processing center)	35,000
Irving, Texas (corporate headquarters)	217,000
	319,000
Coppell, Texas (new store staging warehouse)	29,000
Dallas, Texas (warehouse)	70,000
	5,471,000

Edgar Filing: MICHAELS STORES INC - Form 10-K

The following table indicates the number of our retail stores and wholesale operations located in each state or province as of March 30, 2009:

State/Province	Number of Stores		Total
	Michaels	Aaron Brothers	
Alabama	10		10
Alaska	3		3
Alberta	15		15
Arizona	27	9	36
Arkansas	3		3
British Columbia	14		14
California	129	95	224
Colorado	21	7	28
Connecticut	13		13
Delaware	4		4
Florida	68		68
Georgia	29	4	33
Idaho	6	1	7
Illinois	38		38
Indiana	15		15
Iowa	7		7
Kansas	8		8
Kentucky	7		7
Louisiana	11		11
Maine	2		2
Manitoba	3		3
Maryland	22		22
Massachusetts	22		22
Michigan	36		36
Minnesota	22		22
Mississippi	3		3
Missouri	19		19
Montana	4		4
Nebraska	4		4
Nevada	11	6	17
New Brunswick	3		3
Newfoundland and Labrador	1		1
New Hampshire	7		7
New Jersey	27		27
New Mexico	3		3
New York	48		48
North Carolina	29		29
North Dakota	2		2
Nova Scotia	3		3
Ohio	31		31
Oklahoma	7		7
Ontario	32		32
Oregon	15	3	18
Pennsylvania	42		42
Prince Edward Island	1		1
Rhode Island	3		3
Saskatchewan	2		2
South Carolina	9		9
South Dakota	2		2
Tennessee	13		13
Texas	69	22	91

Edgar Filing: MICHAELS STORES INC - Form 10-K

Utah	11		11
Vermont	2		2
Virginia	32		32
Washington	22	10	32
West Virginia	4		4
Wisconsin	18		18
Wyoming	1		1
Total	1,015	157	1,172

ITEM 3. Legal Proceedings.

Employee Class Action Claims

Cotton Claim

On December 20, 2002, James Cotton, a former store manager of Michaels of Canada, ULC, our wholly-owned subsidiary, and Suzette Kennedy, a former assistant manager of Michaels of Canada, commenced a purported class proceeding against Michaels of Canada and Michaels Stores, Inc. on behalf of themselves and current and former employees employed in Canada. The Cotton claim was filed in the Ontario Superior Court of Justice and alleges that the defendants violated employment standards legislation in Ontario and other provinces and territories of Canada by failing to pay overtime compensation as required by that legislation. The Cotton claim also alleges that this conduct was in breach of the contracts of employment of those individuals. The Cotton claim seeks a declaration that the defendants have acted in breach of applicable legislation, payment to current and former employees for overtime, damages for breach of contract, punitive, aggravated and exemplary damages, interest, and costs. In May of 2005, the plaintiffs delivered material in support of their request that this action be certified as a class proceeding. Michaels filed and served its responding materials opposing class certification on January 31, 2006. The parties have reached a tentative agreement to settle the case which is subject to Court approval. The settlement will not have a material effect on our business. Subsequently a motion to dismiss the case was filed and it is expected that the Court will issue an order dismissing the case during fiscal 2009.

DeJoseph Claim

On December 29, 2006, John DeJoseph, a former Michaels store manager in Valencia, California, commenced a purported class action proceeding against Michaels Stores, Inc. on behalf of himself and current and former salaried store managers employed in California from May 10, 2002 to the present. The DeJoseph suit was filed in the Superior Court of California, County of Los Angeles. The DeJoseph suit alleges that Michaels failed to pay overtime wages, provide meal periods, accurately record hours worked, provide itemized employee wage statements, and that Michaels unlawfully made deductions from employees' earnings. The DeJoseph suit additionally alleges that the foregoing conduct was in breach of California's unfair competition law. The plaintiff seeks injunctive relief, damages for unpaid wages, penalties, restitution, interest, and attorneys' fees and costs. In April 2008, the Court certified the class as to monetary relief for the overtime claim, but denied certification as to the wage statement and meal break claims plus the injunctive relief portion of the overtime claim. In March 2009, the Court reconsidered and de-certified the class with respect to the overtime claims. The case will proceed with the three individual plaintiffs. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We are unable to estimate a range of loss, if any, in this case.

Consumer Class Action Claims

Carson Claim

On August 15, 2008, Linda Carson, a consumer, filed a purported class action proceeding in Superior Court of California, County of San Diego. Carson filed this action against Michaels Stores, Inc., on behalf of herself and all similarly-situated California consumers. The Carson suit 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.

Governmental Inquiries and Related Matters

Non-U.S. Trust Inquiry

In early 2005, the District Attorney's office of the County of New York and the SEC opened inquiries concerning non-U.S. trusts that directly or indirectly held shares of Michaels Common Stock and Common Stock options. A federal grand jury requested information with respect to the same facts. We are cooperating in these inquiries and have provided information in response to the requests.

Certain of these trusts and corporate subsidiaries of the trusts acquired securities of Michaels in transactions directly or indirectly with Charles J. Wyly, Jr. and Sam Wyly, who were, respectively, Chairman and Vice Chairman of the Board of Directors prior to the consummation of the Merger, or with other Wyly family members. In addition, subsidiaries of certain of these trusts acquired securities directly from us in private placement transactions in 1996 and 1997 and upon the exercise of stock options transferred, directly or indirectly, to the trusts or their subsidiaries by Charles Wyly, Sam Wyly, or other Wyly family members.

Edgar Filing: MICHAELS STORES INC - Form 10-K

We understand that Charles Wyly and Sam Wyly and/or certain of their family members are beneficiaries of irrevocable non-U.S. trusts. The 1996 and 1997 private placement sales by us of Michaels securities to subsidiaries of certain of these trusts were disclosed by us in filings with the SEC. The transfer by Charles Wyly and/or Sam Wyly (or by other Wyly family members or family-related entities) of Michaels securities to certain of these trusts and subsidiaries was also disclosed in filings with the SEC by us and/or by Charles Wyly and Sam Wyly. Based on information provided to us, our SEC filings prior to 2005 did not report securities owned by the non-U.S. trusts or their corporate subsidiaries as beneficially owned by Charles Wyly and Sam Wyly.

Charles Wyly and Sam Wyly filed an amended Schedule 13D with the SEC on April 8, 2005, stating that they may be deemed the beneficial owners of Michaels securities held directly or indirectly by the non-U.S. trusts. In our 2005 and 2006 proxy statements, we included the securities held in the non-U.S. trusts or their separate subsidiaries, as reported by the Wylys, in the beneficial ownership table of our principal stockholders and management, with appropriate footnotes.

Stock Options Inquiry

On June 15, 2006, following Michaels' announcement that its Audit Committee had initiated an internal review, referred to below, into the Company's historical stock options practices, Michaels received a letter from the Division of Enforcement of the SEC requesting that the Company preserve all documents concerning its granting of stock options from 1990 through the present and stating that the SEC intended to request production of such documents in the future. In a letter dated November 15, 2006, the Division requested the documents. A June 16, 2006 grand jury subpoena issued by the U.S. District Court for the Southern District of New York requesting documents relating to the granting of stock options during the period 1996 to the present was withdrawn in connection with a July 27, 2006 grand jury subpoena issued by the U.S. District Court for the Northern District of Texas on behalf of the Fraud section of the Department of Justice requesting documents relating to the granting of stock options during the same period. We are cooperating in these inquiries and have provided information in response to the requests.

The Company's Audit Committee conducted an internal review into the Company's historical stock options practices, including a review of the Company's underlying option grant documentation and procedures and related accounting. The Audit Committee's internal review was conducted with the assistance of independent legal counsel and outside accounting experts. The Company voluntarily reported the commencement of this review to the SEC.

The Audit Committee review focused principally on the question of whether there may have been intentional wrongdoing in the Company's historical stock options granting practices. On August 25, 2006, the Audit Committee's independent legal counsel presented to the Audit Committee its final report, which stated that the investigation did not support a conclusion that there was intentional misconduct. Based on the independent counsel report, the Audit Committee concluded that the results of the investigation did not support a finding of intentional misconduct.

The Company also conducted a separate internal review of historical stock option practices and related accounting issues from 1990 through the Merger date. In this review, the Company was advised, with respect to specific Delaware law issues, by independent Delaware counsel and, with respect to specific Texas law issues, by independent Texas counsel. Management of the Company discussed its internal review and related judgments with the Company's independent registered public accounting firm and the Board of Directors and Audit Committee. Notwithstanding that the Audit Committee concluded that the results of the investigation did not support a finding of intentional misconduct, the Company identified accounting issues related to certain of the stock option grants prior to October 2001. As a result, and as previously reported in our Annual Report on Form 10-K for fiscal year 2006, in fiscal 2007 we made adjustments to our beginning retained earnings balance for fiscal 2002 by recording additional non-cash compensation cost of approximately \$27 million, net of income tax benefits of approximately \$13 million.

General

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

ITEM 4. Submission of Matters to a Vote of Security Holders.

By a written consent dated January 13, 2009, holders of 93.14% of the common stock of the Company voted their shares to elect Gerry Murphy to the Board. The affirmative vote of more than 50% of the stockholders was required to take such action.

PART II

ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market Information

Prior to the Merger, our Common Stock was listed on the New York Stock Exchange under the ticker symbol **MIK**. Subsequent to the Merger, our Common Stock is privately held and there is no established public trading market for our stock.

Holders

As of March 30, 2009, there were 36 holders of record of our Common Stock.

ITEM 6. Selected Financial Data.

The following financial information for the five most recent fiscal years has been derived from our consolidated financial statements. This information should be read in conjunction with the consolidated financial statements and related notes thereto included elsewhere herein. The selected financial data for fiscal years 2006 and prior reflect adjustments to reclassify the operations of Star Decorators Wholesale and Recollections as discontinued operations.

	2008	2007	Fiscal Year 2006 (5)	2005	2004
Results of Operations Data (in millions):					
Net sales	\$ 3,817	\$ 3,862	\$ 3,843	\$ 3,659	\$ 3,383
Operating income	304	354	208	387	347
(Loss) income before discontinued operations and cumulative effect of accounting change	(5)	(22)	44	232	207
Cumulative effect of accounting change, net of income tax (1)				(7)	
Discontinued operations loss, net of income tax		(10)	(3)	(4)	(3)
Net (loss) income	(5)	(32)	41	221	204
Per Share Data:					
Basic earnings per common share before discontinued operations and cumulative effect of accounting change (2) (7)	n/a	n/a	n/a	\$ 0.58	\$ 0.52
Diluted earnings per common share before discontinued operations and cumulative effect of accounting change (2) (7)	n/a	n/a	n/a	0.57	0.51
Dividends per common share (2)	\$ 0.00	\$ 0.00	\$ 0.12	0.13	0.09
Balance Sheet Data (in millions):					
Cash and equivalents	\$ 33	\$ 29	\$ 30	\$ 452	\$ 536
Merchandise inventories	900	845	840	776	785
Total current assets	1,049	980	1,000	1,315	1,482
Total assets	1,625	1,614	1,693	1,876	2,022
Total current liabilities	681	679	742	497	512
Long-term debt	3,756	3,741	3,729		200
Total liabilities	4,512	4,506	4,568	588	814
Stockholders' (deficit) equity (7)	(2,887)	(2,892)	(2,875)	1,288	1,208
Other Financial Data (in millions):					
Cash flow from operating activities	\$ 59	\$ 268	\$ 157	\$ 364	\$ 431
Cash flow from investing activities	(85)	(100)	(143)	(68)	(145)
Cash flow from financing activities	30	(169)	(436)	(379)	(93)
Other Operating Data:					
Average net sales per selling square foot (3) (6)	\$ 206	\$ 217	\$ 224	\$ 221	\$ 216
Comparable store sales (decrease) increase (4)	(4.6)%	(0.7)%	0.2%	3.6%	4.9%

Edgar Filing: MICHAELS STORES INC - Form 10-K

Total selling square footage (in millions)	19	19	18	17	17
Stores Open at End of Year:					
Michaels (6)	1,009	963	921	886	845
Aaron Brothers	161	166	166	166	164
Total stores open at end of year	1,170	1,129	1,087	1,052	1,009

Edgar Filing: MICHAELS STORES INC - Form 10-K

(1) We changed our method of accounting for merchandise inventories from a retail inventory method to the weighted average cost method in the fourth quarter of fiscal 2005. As a result, we recorded a non-cash charge of \$7 million, net of income tax, in fiscal 2005 for the cumulative effect of accounting change on prior fiscal years.

(2) The per share amounts in the table were retroactively adjusted to reflect the two-for-one Common Stock split and the 2.9333-for-one Common Stock split effected in the form of stock dividends to stockholders of record as of the close of business on September 27, 2004 and January 26, 2007, respectively.

Edgar Filing: MICHAELS STORES INC - Form 10-K

- (3) The calculation of average net sales per selling square foot includes only Michaels stores open longer than 36 months, and excludes Aaron Brothers stores.
- (4) Comparable store sales increase (decrease) represents the increase (decrease) in net sales for stores open the same number of months in the indicated and comparable period of the previous year, including stores that were relocated or expanded during either period. A store is deemed to become comparable in its 14th month of operation in order to eliminate grand opening sales distortions. A store temporarily closed more than 2 weeks due to a catastrophic event is not considered comparable during the month it closed. If a store is closed longer than 2 weeks but less than 2 months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than 2 months becomes comparable in its 14th month of operation after its reopening. These percentages for fiscal years 2007 and prior have been adjusted to exclude Star Decorators Wholesale and Recollections.
- (5) Fiscal 2006 operational data, excluding comparable store sales, includes the 53rd week, which had net sales of approximately \$59 million.
- (6) For fiscal years 2007 and prior, the Star Decorators Wholesale Los Angeles store has been retroactively presented as a Michaels store.
- (7) In fiscal 2006, we were acquired through a merger transaction by affiliates of two private investment firms, Bain Capital Partners, LLC and The Blackstone Group, with certain shares retained by affiliates of Highfields Capital Partners. As a result of the merger, Michaels Holdings, LLC, an entity controlled by Bain and Blackstone, owns approximately 93% of our outstanding Common Stock, which is no longer publicly traded. We accounted for the merger as a leveraged recapitalization and financed the merger by the issuance of debt. See Note 4 to our consolidated financial statements for further information.

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K. The following discussion, as well as other portions of this Annual Report on Form 10-K, 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, intends, 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 contained elsewhere in this report. Specific examples of forward-looking statements include, but are not limited to, statements regarding our forecasts of financial performance, capital expenditures, working capital requirements, workers' compensation claims exposure and forecasts of effective tax rate. Our actual results could materially differ from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this Annual Report on Form 10-K, and particularly in Item 1A. Risk Factors.

Overview

Edgar Filing: MICHAELS STORES INC - Form 10-K

We are the largest arts and crafts specialty retailer in North America, with sales of approximately \$3.8 billion in the United States and Canada. Our primary retail business is our operation of 1,015 Michaels stores across North America. We also operate 157 Aaron Brothers stores, a custom frame, framing, and art supply chain (all store counts are as of March 30, 2009).

Our mission is to help our customers express themselves creatively. Through our broad product assortments, educational in-store events, project sheets and displays, and on-line information, we offer a shopping experience that encourages creativity in the areas of arts, crafts, floral displays, framing, home accents, and children's hobbies and activities.

In recent years, we have focused on improving store operations, global sourcing, and inventory management capabilities while continuing a strong store growth program. Examples of our accomplishments include the following:

- expansion of our distribution network,
- implementation of perpetual inventory and automated replenishment systems along with a weighted average cost stock ledger,
- use of standardized store opening/relocation and merchandising processes,
- implementation of financial and human resources management systems, and

- consistent store growth

In fiscal 2009, we will continue to focus on strategic initiatives such as:

- enhancing the in-store experience,
- testing new merchandise assortments,
- targeted marketing programs,
- continued growth of global sourcing,
- store expansion, and
- process and profit improvement.

We believe these initiatives will allow us to increase our market share and overall profitability.

The Merger

On October 31, 2006, substantially all of the Common Stock of Michaels Stores, Inc. was acquired through a merger transaction (the Merger) by affiliates of two private investment firms, Bain Capital Partners, LLC and The Blackstone Group (collectively, together with their applicable affiliates, the Sponsors), with certain shares retained by affiliates of Highfields Capital Partners (a then-existing shareholder of Michaels Stores, Inc.). As a result of the Merger, Michaels Holdings LLC, an entity controlled by the Sponsors, owns over 93% of our outstanding Common Stock, which is no longer publicly traded. We accounted for the Merger as a leveraged recapitalization whereby the historical book value of the assets and liabilities of Michaels will be maintained with no push down accounting required.

The Merger was financed by the issuance of debt as described in the Liquidity and Capital Resources section below, as well as:

- Equity investments from the Sponsors and the retention of certain shares held by affiliates of Highfields Capital Partners, and
- Our available cash as of the date of the Merger.

The Merger occurred simultaneously with the closing of the financing and equity transactions referred to above as well as the termination of our previous \$300 million senior unsecured credit facility with Bank of America, N.A (Credit Agreement). For further description of the financing transactions, see the Liquidity and Capital Resources section below.

In connection with the completion of the Merger, we entered into management agreements with each of the Sponsors pursuant to which the Sponsors will provide management services to us until December 31, 2016, with evergreen extensions thereafter. Pursuant to these agreements, the Sponsors will receive an aggregate annual management fee equal to \$12 million and reimbursement for out-of-pocket expenses in connection with the provision of services pursuant to the agreements. In addition, pursuant to these agreements, the Sponsors received, in connection with the completion of the Merger, aggregate transaction fees of approximately \$60 million in connection with services provided by them related to the Merger, and we directly reimbursed the Sponsors, or paid on their behalf, fees incurred by them in connection with the Merger. Finally, the management agreements provide that the Sponsors are entitled to receive fees in connection with certain subsequent financing, acquisition, disposition and change of control transactions of 1% of the gross transaction value of any such transaction. The management agreements include customary exculpation and indemnification provisions in favor of the Sponsors. The management agreements may be terminated by the Sponsors at any time and terminate automatically upon an initial public offering or a change of control unless we and the Sponsors determine otherwise. Upon termination, each provider of management services will be entitled to a termination fee calculated based on the present value of the annual fees due during the remaining period from the date of termination to the tenth anniversary of the date of the Merger.

In connection with the completion of the Merger, we entered into a management agreement with Highfields Capital Management LP, an affiliate of the Highfields Capital Partners, that provides for an annual management fee of \$1.0 million for services that Highfields Capital Management LP renders to us following the completion of the Merger.

Critical Accounting Policies and Estimates

We have prepared our financial statements in conformity with U.S. generally accepted accounting principles, and these financial statements necessarily include some amounts that are based on our informed judgments and estimates. Our senior management has discussed the development and selection of these critical accounting estimates, and the disclosure in this section of this report regarding them, with the Audit Committee of our Board of Directors. Our significant accounting policies are discussed in Note 1 of Notes to Consolidated Financial Statements. Our critical accounting policies represent those policies that are subject to judgments and uncertainties. As discussed below, our financial position and results of operations may be materially different when reported under different conditions or when using different assumptions in the application of these policies. In the event estimates or assumptions prove to be different from actual amounts, adjustments are made in subsequent periods to reflect more current information. Our critical accounting policies include:

Merchandise Inventories Merchandise inventories at Michaels stores are valued at the lower of cost or market, with cost determined using a weighted average method. Cost is calculated based upon the purchase order cost of an item at the time it is received by us, and also includes the cost of warehousing, handling, purchasing, and importing the inventory, as well as inbound and outbound transportation, partially offset by vendor allowances. This net inventory cost is recognized through cost of sales when the inventory is sold. Due to systems limitations, it is impracticable for us to assign specific costs and allowances to individual units of inventory. As such, to match net inventory costs against the related revenues, we must use all available information to appropriately estimate the net inventory costs to be deferred and recognized each period. Significant changes to our estimate of when inventory is sold could materially affect the amount of the deferral, and subsequent income statement recognition, of the net inventory costs.

Vendor allowances, which primarily represent volume rebates and cooperative advertising funds, are recorded as a reduction of the cost of the merchandise inventories. We generally earn vendor allowances as a consistent percentage of certain merchandise purchases with no minimum purchase requirements. Typically, our vendor allowance programs extend for a period of 12 months. We recognized vendor allowances of \$149 million, or 3.9% of net sales, in fiscal year 2008, \$141 million, or 3.7% of net sales, in fiscal year 2007, and \$144 million, or 3.7% of net sales, in fiscal 2006. During the three fiscal years ended January 31, 2009, the number of vendors from which vendor allowances were received ranged from approximately 740 to 790. We did not have any material vendor allowance programs in fiscal 2008, 2007 and 2006 that were based on purchase volume milestones.

We utilize perpetual inventory records to value inventory in our stores. Physical inventory counts are performed in a significant number of stores during each fiscal quarter by a third party inventory counting service, with substantially all stores open longer than one year subject to at least one annual count. We adjust our perpetual records based on the results of the physical counts.

We maintain a provision for estimated shrinkage based on the actual historical results of our physical inventories. We compare our estimates to the actual results of the physical inventory counts as they are taken and adjust the shrink estimates accordingly. We also evaluate our merchandise to ensure that the expected net realizable value of the merchandise held at the end of a fiscal period exceeds cost. In the event that the expected net realizable value is less than cost, we accordingly reduce the value of that inventory.

Goodwill We perform impairment tests of goodwill, annually or whenever events or circumstances change to indicate that the remaining net book value may not be recovered through sale or use, by comparing the book values of our reporting units to their estimated fair values. The estimated fair values of our reporting units are computed using estimates that include a discount factor in valuing future cash flows. There are assumptions and estimates underlying the determination of fair value and any resulting impairment loss. Another estimate using different, but still reasonable, assumptions could produce different results. During fiscal 2008, there was no impairment charge taken on our goodwill. During the fourth quarter of fiscal 2007, we recognized an impairment charge of \$22 million for our Aaron Brothers goodwill. See Note 3 to our consolidated financial statements for further information.

Impairment of Long-Lived Assets We evaluate long-lived assets, other than goodwill and assets with indefinite lives, for indicators of impairment whenever events or changes in circumstances indicate their carrying amounts may not be recoverable. Management's judgments regarding the existence of impairment indicators are based on market conditions and our operational performance, such as operating income and cash flows. The evaluation for long-lived assets is performed at the lowest level of identifiable cash flows, which is generally at the individual store level. Our evaluation requires consideration of a number of factors including changes in demographics and uncertain future events. Accordingly our accounting estimates may change from period to period. These factors could cause management to conclude that impairment indicators exist and require that tests be performed, which could result in a determination that the value of long-lived assets is impaired, resulting in a writedown to fair value.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Reserve for Closed Facilities We maintain a reserve for future rental obligations, carrying costs, and other closing costs related to closed facilities, primarily closed and relocated stores. In accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 146, *Costs Associated With Disposal Activities*, we recognize exit costs for any store closures at the time the store is closed. Such costs are recorded within the Cost of sales and occupancy expense line item on our Consolidated Statements of Operations.

Edgar Filing: MICHAELS STORES INC - Form 10-K

The cost of closing a store or facility is calculated as the lesser of the present value of future rental obligations remaining under the lease (less estimated sublease rental income) or the lease termination fee. The determination of the reserves is dependent on our ability to make reasonable estimates of costs to be incurred post-closure and of rental income to be received from subleases. In planning our store closures, we generally try to time our exits as close to the lease termination date as possible to minimize the need for sublease income to offset any remaining lease obligation. The reserves could vary materially if market conditions were to vary significantly from our assumptions.

Self-Insurance We have insurance coverage for losses in excess of self-insurance limits for medical liability, general liability and workers compensation claims. Historically, it has been infrequent for incurred claims to exceed these self-insurance limits.

Self-insurance reserves are established for health care, fleet liability, general liability and workers compensation claims. These reserves are determined through actuarial studies, based on actual claims experience and an estimate of claims incurred but not reported. Actuarial projections of losses for general liability and workers compensation claims are subject to a high degree of variability.

Revenue Recognition Revenue from sales of our merchandise is recognized at the time of the merchandise sale, excluding revenue from the sale of custom frames, which is recognized at the time of delivery. Revenue is presented net of sales taxes collected. We allow for merchandise to be returned under most circumstances and provide for a reserve of estimated returns. When calculating our deferred framing revenue, we currently estimate the length of time between the customer placing the order at the store and customer pick-up based on the best available information from our systems. A significant change in the length of time between the custom frame order and customer pick-up or a significant change in the underlying trends of our sales returns may materially affect our future operating results.

We record a gift card liability on the date we issue the gift card to the customer. We record revenue and reduce the gift card liability as the customer redeems the gift card. We escheat the value of unredeemed gift cards where required by law. Any remaining liabilities not subject to escheatment are evaluated to determine whether the likelihood of the gift card being redeemed is remote (gift card breakage). We recognize gift card breakage as revenue, by applying our estimate of the rate of gift card breakage over the period of estimated performance (approximately 36 months as of the end of fiscal 2008). Our estimates of the gift card breakage rate are applied to the estimated amount of gift cards that are expected to go unused that are not subject to escheatment and are based on customers' historical redemption rates and patterns, which may not be indicative of future redemption rates and patterns.

Share-Based Compensation Expenses SFAS No. 123(R), *Share-Based Payment*, requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair value over the requisite service period. Compensation cost is based on the grant date fair value of the award and ratably recognized as an expense over the effective vesting period. Determining fair value of our stock options requires judgment, including estimating the fair value at the date of grant, expected terms of the options, expected volatility of our Common Stock share price, expected dividends, and forfeitures. The fair value of stock options is estimated at the date of grant using the Black-Scholes-Merton option valuation model.

Income Taxes We record income tax expense using the liability method for taxes and are subject to income tax in many jurisdictions, including the United States, various states and localities, and Canada. A current tax liability or asset is recognized for the estimated taxes payable or refundable on the tax returns for the current year and a deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards. Deferred tax assets and liabilities are measured using enacted income tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates is recognized as income or expense in the period that includes the enactment date. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized. In evaluating our ability to realize our deferred tax asset, we considered the following sources of future taxable income:

- Future reversals of existing taxable temporary differences;
- Future taxable income, exclusive of reversing temporary differences and carryforwards;
- Taxable income in prior carryback years; and
- Tax-planning strategies.

Our evaluation regarding whether a valuation allowance is required or should be adjusted also considers, among other things, the

nature, frequency, and severity of recent losses, forecasts of future profitability and the duration of statutory carryforward periods. Our forecasts of future profitability represents our best estimate of these future events. If different assumptions had been used, our tax expense, assets, and liabilities could have varied from recorded amounts.

After conducting this assessment, the valuation allowance recorded against our deferred tax assets was \$13 million and \$11 million as of January 31, 2009 and February 2, 2008, respectively. If actual results differ from estimated results or if we adjust these assumptions in the future, we may need to adjust our deferred tax assets or liabilities, which could impact our effective tax rate. Given our capital structure, we will continue to experience volatility in our effective tax rate over the near term.

General

Our business is highly seasonal, with higher sales in the third and fourth fiscal quarters. For the last ten fiscal years, our fourth quarter, which includes the Christmas selling season, has accounted for approximately 35% of our sales and approximately 51% of our operating income.

We continue to develop a fully integrated pricing and promotion strategy and will refine our existing strategy in future periods. A significant component of our pricing and promotion strategy involves changes in the breadth and depth of our promotional programs. Given the current soft macroeconomic and retail environments, sales declines could adversely affect operating income due to a deleveraging of operating expenses. As a result, our historical trends may not be indicative of future results.

We report on the basis of a 52 or 53-week fiscal year, which ends on the Saturday closest to January 31. References to fiscal year mean the year in which that fiscal year began. Fiscal 2008 ended on January 31, 2009, fiscal 2007 ended on February 2, 2008, and fiscal 2006 ended on February 3, 2007. Fiscal years 2008 and 2007 contained 52 weeks, while fiscal year 2006 contained 53 weeks.

Accounting Items

Fiscal 2007

Discontinued Operations On October 16, 2007, we announced plans to align resources around our core retail chains, Michaels and Aaron Brothers stores. As a result, we discontinued our concept businesses, Recollections and Star Decorators Wholesale (Star). As of the end of fiscal 2007, we had closed 11 Recollections and three of the four Star locations. The remaining location, Star Decorators Wholesale in Los Angeles, is being operated as a Michaels store.

Goodwill Impairment During the fourth quarter of fiscal 2007, in connection with our annual impairment test, we recorded a goodwill impairment charge of \$22 million related to our Aaron Brothers reporting unit. The impairment charge represents the net carrying value of the Aaron Brothers goodwill. During fiscal 2007, Aaron Brothers experienced a decline in sales and profitability. These declines, coupled with our near-term financial forecasts, the decline of the retail segment of the U.S. economy, and our ongoing reassessment of expansion opportunities resulted in an estimated fair value that was lower than the carrying value of the reporting unit. The resulting allocation of the estimated fair

value to the reporting unit's assets and liabilities indicated that a full impairment of goodwill was required.

Our fair value assessment was based on a combination of present value cash flow analysis, observable earnings multiples of other publicly-traded specialty retail companies, and use of earnings multiples resulting from market transactions of other specialty retail companies.

Fiscal 2006

Merger Expenses During fiscal 2006, we expensed approximately \$240 million of Merger-related costs, of which \$205 million was classified as transaction expenses and \$34 million was classified as related party expenses in our Consolidated Statement of Operations; the remaining \$1 million was classified as interest expense. Of the \$240 million recorded in fiscal 2006, \$218 million was recorded in our fourth quarter of fiscal 2006. Approximately \$138 million of the \$240 million consisted of compensation expense (primarily share-based compensation) and \$100 million was related to investment banking, legal, accounting, and other professional fees.

We capitalized \$125 million of costs related to the issuance of our various debt instruments, which are more fully described in "Liquidity and Capital Resources" below. These costs are being amortized over the lives of the respective debt instruments and recognized as a component of interest expense in our Consolidated Statement of Operations.

As certain of the Merger expenses were not deductible for tax purposes, we incurred permanent differences which adversely impacted our effective tax rate, resulting in an effective tax rate for fiscal 2006 of 61.7%.

Results of Operations

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

	Fiscal Year		
	2008	2007	2006
Net sales	100.0%	100.0%	100.0%
Cost of sales and occupancy expense	63.7	61.7	61.5
Gross profit	36.3	38.3	38.5
Selling, general, and administrative expense	27.8	27.2	26.6
Transaction expenses		0.7	5.3
Goodwill impairment		0.5	
Related party expenses	0.4	0.5	1.0
Store pre-opening costs	0.1	0.2	0.2
Operating income	8.0	9.2	5.4
Interest expense	7.9	9.8	2.7
Other (income) and expense, net	0.1	(0.2)	(0.3)
(Loss) income before income taxes and discontinued operations		(0.4)	3.0
Provision for income taxes	0.1	0.1	1.8
(Loss) income before discontinued operations	(0.1)	(0.5)	1.2
Discontinued operations loss, net of income tax		(0.3)	(0.1)
Net (loss) income	(0.1)%	(0.8)%	1.1%

Fiscal 2008 Compared to Fiscal 2007

Net Sales Net sales decreased for fiscal 2008 by \$45 million, or 1.2%, from fiscal 2007 due primarily to a decline in comparable store sales. Our comparable store sales decreased 4.6%, or \$177 million, reflecting decreases in the average ticket and customer transactions of 2.5% and 2.1%, respectively. The fluctuation in the exchange rates between the US and Canadian dollars adversely impacted the comparable store sales by 20 basis points. The decrease in comparable store sales was partly offset by non-comparable new stores. Sales at stores opened during fiscal 2008 provided incremental revenue of \$132 million.

We continue to evaluate all options available to us for our Aaron Brothers concept, which range from refining the concept to possible store rationalization. Certain of these options, if enacted, may result in material charges to our Consolidated Statement of Operations in future periods.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased \$48 million to \$2.431 billion in fiscal 2008 from \$2.383 billion in fiscal 2007. As a percentage of net sales, cost of sales and occupancy expense increased 200 basis points as we realized a decline in merchandise margins of 110 basis points due to increased levels of promotional activity in response to the softness in the economic environment, particularly in the last half of the year in order to maximize gross margin dollars and reduce our inventory exposure. Occupancy costs increased

Edgar Filing: MICHAELS STORES INC - Form 10-K

90 basis points, as a percentage of net sales, on a 3.6% increase in the number of stores due to a deleveraging of fixed costs on a decline in comparable store sales and overall average store volume.

Selling, General, and Administrative Expense Selling, general, and administrative expense was \$1.060 billion in fiscal 2008 compared to \$1.051 billion in fiscal 2007. The \$9 million expense increase was primarily due to increases in store count and higher corporate and store payroll. The increase was partially offset by reduced bonus expense. As a percentage of net sales, selling, general, and administrative expense increased 60 basis points from 27.2% of sales in fiscal 2007 to 27.8% of sales in fiscal 2008 primarily due

Edgar Filing: MICHAELS STORES INC - Form 10-K

to decreased leverage associated with the decline in comparable store sales and an increase in planned in-store investments, corporate payroll and severance expense, partially offset by a reduction in bonus expense.

Transaction Expenses Transaction expenses of \$29 million incurred during fiscal 2007 relate primarily to bonus arrangements associated with the change in control that were ratably recognized for a period of one year following the Merger date, as well as other compensation expenses arising from change in control agreements.

Related Party Expenses Related party expenses were \$16 million for fiscal 2008 compared to \$17 million in fiscal 2007 consisting primarily of \$14 million of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, LP during each year of fiscal 2008 and 2007. Related party expenses in fiscal 2008 and fiscal 2007 also include \$2 million and \$3 million, respectively, of amortization expense related to the Separation Agreements as more fully described in Note 15 to the consolidated financial statements.

Interest Expense Interest expense decreased from \$378 million in fiscal 2007 to \$302 million in fiscal 2008, primarily due to a lower average interest rate related to our variable-rate debt.

Provision for Income Taxes The tax rate for fiscal 2008 was unfavorably impacted by non-deductible severance payments. The tax rate in fiscal 2007 was unfavorably impacted primarily by non-deductible severance payments and the write-off of goodwill.

Fiscal 2007 Compared to Fiscal 2006

Net Sales Net sales increased for fiscal 2007 by \$19 million, or 0.5%, over fiscal 2006 due primarily to non-comparable sales. Non-comparable sales are largely comprised of sales generated by new stores, as well as other non-recurring events such as the 53rd week of 2006. Our fiscal 2007 comparable store sales decreased 0.7%, or \$26 million, reflecting decreases in customer transactions and custom framing deliveries of 3.2% and 0.1%, respectively, partially offset by increases in the average ticket of 2.6%. The fluctuation in the exchange rates between the US and Canadian dollars favorably impacted comparable store sales by 50 basis points.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased \$19 million due to a 3.9% increase in the number of stores operated in fiscal 2007. Store cost of sales as a percentage of net sales improved 30 basis points as we realized improved margins from a reduction in breadth and depth of promotional programs and continued benefits from ongoing sourcing initiatives, partially offset by lower sell-through of seasonal products. Conversely, occupancy costs deleveraged, due to negative comparable-store sales performance.

The following table details the change in cost of sales and occupancy expense, as a percentage of net sales, from fiscal 2006 to 2007:

	Increase/(Decrease)
Cost of sales	(0.3)%
Occupancy costs	0.5%
Total decrease	0.2%

Edgar Filing: MICHAELS STORES INC - Form 10-K

Selling, General, and Administrative Expense Selling, general, and administrative expense was \$1.051 billion in fiscal 2007 compared to \$1.023 billion in fiscal 2006. The \$28 million expense increase was primarily due to an increase in the number of stores we operate compared to last year and additional advertising costs and other expenses resulting from our strategic initiatives. These strategic initiatives include our pricing and promotion strategy, consumer insight research, and product sourcing.

As a percentage of net sales, selling, general, and administrative expense increased 60 basis points from 26.6% of sales in fiscal 2006 to 27.2% of sales in fiscal 2007 primarily due to consulting fees and higher advertising expense.

Transaction Expenses Transaction expenses of \$29 million incurred during fiscal 2007 relate primarily to bonus arrangements associated with the change in control that were ratably recognized for a period of one year following the Merger date, as well as other compensation expenses arising from change in control agreements. Transaction expenses incurred during fiscal 2006 of \$205 million related primarily to \$137 million of share-based compensation with the remainder related to investment banking, legal, accounting, and other professional fees associated with the Merger.

Related Party Expenses Related party expenses were \$17 million for fiscal 2007 and consisted primarily of \$14 million of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, LP. Related party expenses in fiscal 2007 also include \$3.0 million of amortization expense related to the Separation Agreements as more fully described in Note 15 to the consolidated financial statements. Related party expenses for fiscal 2006 resulted primarily from the Merger with approximately \$27 million of transaction and management fees paid to our Sponsors, and \$9 million related to various professional fees paid on behalf of our Sponsors.

Interest Expense Interest expense increased from \$105 million in fiscal 2006 to \$378 million in fiscal 2007. This increase was due to the debt issued associated with the Merger.

Provision for Income Taxes The tax rate in fiscal 2007 was unfavorably impacted primarily by non-deductible severance payments and the write-off of goodwill. The tax rate in fiscal 2006 was unfavorably impacted by certain non-deductible Merger-related expenses.

Liquidity and Capital Resources

Our cash and equivalents increased \$4 million from \$29 million at the end of fiscal 2007 to \$33 million at the end of fiscal 2008. We require cash principally for day-to-day operations, to finance capital investments, inventory for new stores, and inventory replenishment for existing stores, to service our outstanding debt, and for seasonal working capital needs. An affiliate of our significant shareholders has purchased a portion of our outstanding debt through privately negotiated transactions (see Item 13. Certain Relationships and Related Transactions, and Director Independence), and we and our subsidiaries, affiliates, and significant shareholders may from time to time in the future seek to retire or purchase additional amounts of our outstanding debt (including publicly issued 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. As described below under Cash Flow from Investing Activities, we took certain actions in fiscal 2008, and plan to take certain actions in fiscal 2009, to preserve liquidity, and we expect that our available cash, cash flow generated from operating activities, and funds available under our Asset-based revolving credit facility will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and future growth for the foreseeable future.

As of March 30, 2009, our borrowing base under our Asset-based revolving credit facility was \$758 million and we had \$594 million of excess availability under that facility.

Cash Flow from Operating Activities

Cash flow provided by operating activities in fiscal 2008 was \$59 million compared to \$268 million in fiscal 2007. The decrease is primarily due to the timing of interest payments in fiscal 2008 and a 6.5% increase in inventories compared to fiscal 2007. The increase in inventory is attributable to a 3.6% increase in our ending store count, and a 2.3% increase in our average Michaels store inventory (including supporting distribution centers). The increase in average per store inventory is due, in part, to new products to be introduced in the first half of fiscal 2009.

Cash Flow from Investing Activities

Edgar Filing: MICHAELS STORES INC - Form 10-K

Cash flow used in investing activities was attributable to the following capital expenditure activities:

	2008	Fiscal Year 2007 (In millions)		2006
New and relocated stores and stores not yet opened (1)	\$ 31	\$ 27	\$ 31	\$ 31
Existing stores	26	26	49	49
Distribution system expansion (2)	3	18	25	25
Information systems	24	26	33	33
Corporate and other	1	3	5	5
	\$ 85	\$ 100	\$ 143	\$ 143

(1) In fiscal 2008, capital expenditures primarily related to the opening of 51 Michaels stores and the relocation of 11 Michaels stores and one Aaron Brothers store. In fiscal 2007, capital expenditures primarily related to the opening of 45 Michaels stores, two Aaron Brothers stores, and the relocation of 11 Michaels stores. In fiscal 2006, capital expenditures primarily related to the opening of 43 Michaels stores, one Aaron Brothers store and the relocation of seven Michaels stores.

(2) The change in capital expenditures related to the distribution system is primarily related to 2006 and 2007 expenditures associated with our Hybrid distribution network.

Capital expenditures in 2008 were lower than 2007 primarily as a result of the completion of our Centralia, Washington distribution center in fiscal 2007 and decisions to defer non-critical projects where possible in order to preserve liquidity. Also, in fiscal 2008, we remodeled fewer stores than in fiscal 2007.

Given the current soft macroeconomic environment, we currently estimate that our capital expenditures will be reduced to approximately \$50 million to \$60 million in fiscal 2009. We plan to open 20 to 25 stores and invest selectively in the infrastructure required to support our long-term goals.

Cash Flow from Financing Activities

Subsequent to the Merger, cash flows from financing activities are related primarily to borrowings and repayments under our revolving credit facility and principal payments under our term loan facility. Prior to the Merger, cash flows from financing activities primarily related to payments of dividends, repurchases of common stock and repayments of debt. See the *Debt* section below concerning further sources and uses of cash related to financing activities.

Debt

Prior to the Merger, our primary sources of short-term liquidity were cash generated by operations and proceeds from stock option exercises. Subsequent to the Merger, our primary sources of short-term liquidity are cash generated by operations and borrowings under the asset-based revolving credit facility.

To finance the Merger, we issued 10% Senior Notes due 2014, 113/8% Senior Subordinated Notes due 2016, and 13% Subordinated Discount Notes due 2016 (collectively, the *Notes*). We also executed an asset-based revolving credit facility as well as a senior secured term loan facility (collectively, the *Senior Credit Facilities*). Borrowings under our asset-based revolving credit facility are influenced by a number of factors as more fully described below.

Notes

On October 31, 2006, we issued (i) \$750 million in principal amount of 10% Senior Notes due November 1, 2014; (ii) \$400 million in principal amount at maturity of 113/8% Senior Subordinated Notes due November 1, 2016; and (iii) \$469 million in principal amount of 13% Subordinated Discount Notes due November 1, 2016. Interest on the Senior Notes and the Senior Subordinated Notes is payable semi-annually in arrears on each May 1 and November 1, commencing on May 1, 2007. No cash interest is payable on the Subordinated Discount Notes prior to November 1, 2011. Beginning on November 1, 2011, cash interest will accrue on the Subordinated Discount Notes and is payable

Edgar Filing: MICHAELS STORES INC - Form 10-K

semi-annually in arrears on each May 1 and November 1 (the first cash interest payment is May 1, 2012). The Senior Notes are guaranteed, jointly and severally, on an unsecured basis, the Senior Subordinated Notes are guaranteed, jointly and severally, on an unsecured senior subordinated basis, and the Subordinated Discount Notes are guaranteed, jointly and severally, on an unsecured subordinated basis, in each case, by each of our subsidiaries, other than Aaron Brothers Card Services, LLC.

The indentures governing the Notes contain covenants limiting, among other things, the Company's ability and the ability of the Company's restricted subsidiaries to:

- incur additional debt;
- pay dividends or distributions on the Company's capital stock or repurchase the Company's capital stock;
- issue stock of subsidiaries;
- make certain investments;
- create liens on the Company's assets to secure debt;
- enter into transactions with affiliates;
- merge or consolidate with another company; and
- sell or otherwise transfer assets.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Prior to November 1, 2009, we may redeem up to 35% of the aggregate principal amount of each of the Notes with the net cash proceeds of one or more Equity Offerings (as defined in the indentures governing the Notes) at redemption prices that include a premium and subject to certain other terms and conditions, as described in the applicable indenture. The Notes are also redeemable in whole or in part, at our option, at any time at redemption prices that include varying premiums until a certain date. In addition, upon a change of control, we are required to make an offer to redeem all of the Notes at a premium with accrued and unpaid interest.

Asset-based revolving credit facility

On October 31, 2006, we executed a senior secured asset-based revolving credit facility with Banc of America Securities LLC and other lenders (Asset-based revolving credit facility). The Asset-based revolving credit facility provides senior secured financing of up to \$1.0 billion, subject to a borrowing base as described below. As of January 31, 2009, the borrowing base was \$747 million, of which we borrowed \$148 million. Borrowing capacity is available for letters of credit and borrowings on same-day notice.

The borrowing base equals the sum of (i) 90% of eligible credit card receivables and debit card receivables; (ii) between 85% and 87.5% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit; (iii) a percentage of eligible in-transit inventory, less certain reserves; and, (iv) the sum of an additional 10% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit plus an additional 5% of eligible credit card receivables and debit card receivables (collectively, the last out tranche), up to a maximum amount of \$100 million.

The Asset-based revolving credit facility provides us with the right to request up to \$200 million of additional commitments under this facility. The lenders under this facility are not under any obligation to provide any such additional commitments, and any increase in commitments is subject to customary conditions precedent. If we were to request any such additional commitments, and the existing lenders or new lenders were to agree to provide such commitments, the facility size could be increased to up to \$1.2 billion, but our ability to borrow under this facility would still be limited by the amount of the borrowing base.

Borrowings under the Asset-based revolving credit facility bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Bank of America, N.A. and (2) the federal funds effective rate plus 1/2 of 1% or (b) a LIBOR rate subject to certain adjustments, in each case plus an applicable margin. The initial applicable margin for borrowings is 0.50% for base rate borrowings and 1.50% for LIBOR borrowings. With respect to any last out tranche borrowings, the initial applicable margin is 1.50% for base rate borrowings and 2.50% for LIBOR borrowings. The applicable margin is subject to adjustment each fiscal quarter based on the excess availability under the Asset-based revolving credit facility. Swingline Loans bear interest at a rate per annum equal to the base rate plus the applicable margin.

We are required to pay a commitment fee of 0.25% per annum on the unutilized commitments under Asset-based revolving credit facility. We must also pay customary letter of credit fees and agency fees.

If, at any time, the aggregate amount of outstanding loans, unreimbursed letter of credit drawings and undrawn letters of credit under the Asset-based revolving credit facility exceeds the lesser of (i) the commitment amount or (ii) the borrowing base, we will be required to repay outstanding loans and cash collateralize letters of credit in an aggregate amount equal to such excess, with no reduction of the commitment amount. If the amount available under the Asset-based revolving credit facility is less than \$100 million for five consecutive business days, or a payment or bankruptcy event of default has occurred, we will be required to repay outstanding loans and cash collateralize letters of credit with

Edgar Filing: MICHAELS STORES INC - Form 10-K

the cash we are required to deposit daily in a collection account maintained with the agent under the Asset-based revolving credit facility. We may voluntarily reduce the unutilized portion of the commitment amount and repay outstanding loans at any time without premium or penalty other than customary breakage costs with respect to LIBOR loans. There is no scheduled amortization under the Asset-based revolving credit facility; the principal amount of the loans outstanding is due and payable in full on October 31, 2011.

The Asset-based revolving credit facility contains a number of covenants that, among other things and subject to certain exceptions, restricts the Company's ability and the ability of its subsidiaries to:

- incur additional indebtedness;
- pay dividends on the Company's capital stock or redeem, repurchase or retire the Company's capital stock or its other indebtedness;
- make investments, loans, advances and acquisitions;

- create restrictions on the payment of dividends or other amounts to the Company from its restricted subsidiaries;
- engage in transactions with affiliates of the Company;
- sell assets, including capital stock of the Company's subsidiaries;
- consolidate or merge; and
- create liens.

The covenants limiting dividends and other restricted payments; investments, loans, advances and acquisitions; and prepayments or redemptions of indebtedness, each permit the restricted actions in an unlimited amount, subject to the satisfaction of certain payment conditions, principally that we must have at least \$125 million of pro forma excess availability under the Asset-based revolving credit facility and that we must be in pro forma compliance with the fixed charge coverage ratio described in the next paragraph.

Although the Asset-based revolving credit facility does not require us to comply with any financial ratio maintenance covenants, if we have less than \$75 million of excess availability under the Asset-based revolving credit facility at any time, we are not permitted to borrow any additional amounts unless our pro forma consolidated fixed charge coverage ratio (as defined in the Asset-based revolving credit facility) is at least 1.1 to 1.0. The Asset-based revolving credit facility also contains certain customary affirmative covenants and events of default.

Senior secured term loan facility

On October 31, 2006, we executed a \$2.4 billion senior secured term loan facility with Deutsche Bank Securities Inc., and other lenders. The full amount was borrowed on October 31, 2006. We are required to make scheduled quarterly payments, each equal to 0.25% of the original principal amount of the term loans, for the first six years and three quarters, with the balance payable on October 31, 2013. Borrowings under the Senior secured term loan facility bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Deutsche Bank and (2) the federal funds effective rate plus 1/2 of 1% or (b) a LIBOR rate, subject to certain adjustments, in each case plus an applicable margin. At issuance, the applicable margin was 2.00% with respect to base rate borrowings and 3.00% with respect to LIBOR borrowings, subject to downward adjustment based on the leverage and ratings thresholds set forth in the Senior secured term loan facility. During the fourth quarter of fiscal 2006, we amended the Senior secured term loan facility such that the applicable margin with respect to the LIBOR borrowings was lowered from 3.00% to 2.75%. On May 10, 2007, we amended the Senior secured term loan facility to reduce the applicable margin to 1.25% with respect to base rate borrowings and 2.25% with respect to LIBOR borrowings. Finally, the amendment eliminated the requirement that we maintain a specified consolidated secured debt ratio.

The Senior secured term loan facility requires us to prepay outstanding term loans with (a) 100% of the net proceeds of any debt issued by us or our subsidiaries (with exceptions for certain debt permitted to be incurred under the Senior secured term loan facility) and (b) commencing with the fiscal year ended February 2, 2008, 50% (which percentage will be reduced to 25% if our total leverage ratio is less than a 6.00:1.00 and will be reduced to 0% if our total leverage ratio is less than 5.00:1.00) of our annual Excess Cash Flow (as defined in the Senior secured term loan facility). We must also offer to prepay outstanding term loans at 100% of the principal amount to be prepaid, plus accrued and unpaid interest, with the proceeds of certain asset sales or casualty events under certain circumstances. We may voluntarily prepay outstanding loans under the Senior secured term loan facility at any time without premium or penalty other than customary breakage costs with respect to LIBOR loans.

Edgar Filing: MICHAELS STORES INC - Form 10-K

The Senior secured term loan facility contains a number of negative covenants that are substantially similar to, but more restrictive in certain respects than, those governing the Notes as well as certain other customary affirmative and negative covenants and events of default. As of January 31, 2009, we were in compliance with all covenants.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements as defined in Item 303(a)(4)(ii) of Regulation S-K.

Contractual Obligations

All of our significant contractual obligations are recorded on our Consolidated Balance Sheets or disclosed in our Notes to Consolidated Financial Statements.

We do not typically enter into off-balance sheet arrangements, except for arrangements related to operating lease commitments, service contract commitments, and letters of credit, as disclosed in the table below. Neither do we typically issue guarantees to third parties.

Edgar Filing: MICHAELS STORES INC - Form 10-K

As of January 31, 2009, our contractual obligations were as follows:

	Payments Due By Fiscal Year				
	Total	Less Than 1 Year	1-3 Years (In millions)	3-5 Years	More Than 5 Years
Operating lease commitments (1)	\$ 1,614	\$ 325	\$ 544	\$ 372	\$ 373
Other commitments (2)	33	22	6	5	
Purchase obligations (3)	40	40			
Total debt (4)	4,066	173	49	2,420	1,424
Interest payments (5)	1,200	184	363	389	264
	\$ 6,953	\$ 744	\$ 962	\$ 3,186	\$ 2,061

Edgar Filing: MICHAELS STORES INC - Form 10-K

- (1) Our operating lease commitments generally include non-cancelable leases for property and equipment used in our operations. Excluded from our operating lease commitments are amounts related to insurance, taxes, and common area maintenance associated with property and equipment. Such amounts historically represented approximately 32% of the total lease obligation over the previous three fiscal years.
- (2) Other commitments primarily include service contract obligations. Values within the Other commitments line item were calculated based on the time period remaining in the contract or to the earliest possible date of termination, if permitted to be terminated by Michaels upon notice, whichever is shorter.
- (3) Purchase obligations represent legally binding commitments to purchase merchandise inventories, which are made in the normal course of business to meet operational requirements.
- (4) Included in Total debt are the payments required under the terms of our 13% Subordinated Discount Notes due in 2016. These payments include \$137 million of additional interest accretion, which has not been recognized as of January 31, 2009. See Note 6 to the consolidated financial statements.
- (5) Interest payments associated with long-term debt. Debt associated with our Senior secured term loan facility was approximately \$2.3 billion, which contains a variable interest rate. The interest payments in the table for the Senior secured term loan facility were based on the indexed interest rate in effect at January 31, 2009. Approximately \$1.5 billion of debt was subject to fixed interest rates.

Additional information regarding our long-term debt and commitments and contingencies is provided in Note 6 and Note 12, respectively, of Notes to Consolidated Financial Statements.

Seasonality

Our business is highly seasonal, with higher sales in the third and fourth fiscal quarters. For the last ten fiscal years, our fourth quarter, which includes the Christmas selling season, has accounted for approximately 35% of our sales and approximately 51% of our operating income.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, *Fair Value Measurements*, which is intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. SFAS 157 was originally effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In November 2007, the FASB placed a one year deferral for the implementation of SFAS 157 for nonfinancial assets and liabilities; however, SFAS 157 is effective for fiscal years beginning after November 15, 2007 for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. We adopted all requirements of SFAS 157 as they relate to financial assets and liabilities on February 3, 2008. See Note 10 to our consolidated financial statements for further information on the impact of this standard to financial assets and liabilities. The requirements related to nonfinancial assets and liabilities will be adopted on February 1, 2009, as allowed by SFAS 157. We are currently

assessing the impact of adopting SFAS 157 for nonfinancial assets and liabilities on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits companies to measure certain financial instruments and other items at fair value (at specified measurement dates) that are not currently required to be measured at fair value. Any unrealized gains or losses applicable to those items measured at fair value shall be reported in earnings. The decision to apply fair value is generally made on an instrument by instrument basis, is irrevocable, and is applied only to an entire instrument. We adopted SFAS 159 on February 3, 2008, and there was no impact on our consolidated financial statements as we did not choose to measure any eligible financial assets or liabilities at fair value.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141, *Business Combinations*. The statement retains the purchase method of accounting used in business combinations but replaces SFAS 141 by establishing principles and requirements for the recognition and measurement of assets, liabilities and goodwill, including the requirement that most transaction costs and restructuring costs be expensed. In addition, the statement requires disclosures to enable users to evaluate the nature and financial effects of the business combination. SFAS 141 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will adopt SFAS 141R on February 1, 2009 for acquisitions on or after this date.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133*. SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative data about the fair value of, and gains and losses on, derivative contracts, and details of credit-risk-related contingent features in hedged positions. The statement also requires enhanced disclosures regarding how and why entities use derivative instruments, how derivative instruments and related hedged items are accounted for in accordance with SFAS 133 and its related interpretation, and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We will adopt the new disclosure requirements of SFAS 161 in the first quarter of fiscal 2009.

ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk.

We are exposed to fluctuations in exchange rates between the US and Canadian dollar, which is the functional currency of our Canadian subsidiary. During the second quarter of fiscal 2008, we executed foreign currency forward contracts to mitigate the effects of currency fluctuations, which we designated as a cash flow hedge. The objective of the forward contracts is to hedge intercompany payments for forecasted purchases of inventory by our Canadian subsidiary, which are denominated in US dollars. The term of this cash flow hedge extends through the first quarter of fiscal 2009.

To achieve our objective and to minimize the risk of ineffectiveness, the notional values represent a portion of our Canadian subsidiary's forecasted intercompany purchases. Hedge ineffectiveness is recorded in Other income in the Consolidated Statement of Operations, as required. For the year ended January 31, 2009, the ineffective portion of the hedge was immaterial.

For the portion of the hedge that is effective the change in fair value of that hedge will initially be recorded in Accumulated other comprehensive income in the Consolidated Statement of Stockholders' (Deficit) Equity. As the underlying inventory is sold to our customers, amounts will be reclassified from Accumulated other comprehensive income to Cost of sales and occupancy expense in the Consolidated Statement of Operations. We also classify the cash flows from derivative instruments in prepaid and other in the Consolidated Statement of Cash Flows. The change in fair value of the hedge for the year ended January 31, 2009 was \$2 million.

Edgar Filing: MICHAELS STORES INC - Form 10-K

The table below provides the remaining quarterly notional values and the average CAD/USD exchange rate associated with the hedge (dollars in millions).

Settlement Period	Outstanding Notional Amount		Contract Rate
	CAD Amount	USD Amount	
Quarter 1, 2009	\$ 12.2	\$ 12.2	1.001

We invest cash balances in excess of operating requirements primarily in money market mutual funds and short-term interest-bearing securities, generally with maturities of 90 days or less. Due to the short-term nature of our investments, the fair value of our cash and equivalents at January 31, 2009 approximated carrying value.

We have market risk exposure arising from changes in interest rates on our Senior Credit Facilities. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources for further detail. 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 issued in connection with the Merger are fixed. Based on our overall interest rate exposure to variable rate debt outstanding as of January 31, 2009, a 1% increase or decrease in interest rates would increase or decrease pre-tax earnings by \$24 million. A 1% increase in interest rates would decrease the fair value of our long-term fixed rate debt by approximately \$15 million. A 1% decrease in interest rates would increase the fair value of our long-term fixed rate debt by approximately \$16 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

During the first quarter of fiscal 2009, we purchased an interest rate cap to hedge the variability of cash flows associated with our interest payments on our Senior secured term loan that result from fluctuations in the three-month LIBOR rate. The cap limits our interest exposure on a notional value of \$2.0 billion to the lesser of the three-month Libor rate or 7.0%. The term of the cap is from April 15, 2009 through April 15, 2015.

ITEM 8. Consolidated Financial Statements and Supplementary Data.

The Consolidated Financial Statements and Supplementary Data are included as an annex to this Annual Report on Form 10-K. See the Index to Consolidated Financial Statements and Supplementary Data on page F-1.

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

Not applicable.

ITEM 9A. Controls and Procedures.

Included in this Annual Report on Form 10-K are certifications of our Chief Executive Officer and our Chief Financial Officer, which are required in accordance with Rule 15d-14 of the Securities Exchange Act of 1934. This section includes information concerning the controls and controls evaluation referred to in the certifications. Page F-3 of this Report includes the attestation report of Ernst & Young LLP, our independent registered public accounting firm, regarding its audit of the effectiveness of our internal control over financial reporting. This section should be read in conjunction with the Ernst & Young attestation for a complete understanding of this section.

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). An evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer

Edgar Filing: MICHAELS STORES INC - Form 10-K

concluded that our disclosure controls and procedures 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 is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. 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.

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 our most recently completed fiscal quarter, the fourth quarter of fiscal 2008, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the

transactions and dispositions of the assets of the company, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the company, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and, even when determined to be effective, can only provide reasonable, not absolute, assurance with respect to financial statement preparation and presentation. Projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate as a result of changes in conditions or deterioration in the degree of compliance.

Management assessed the effectiveness of our internal control over financial reporting as of January 31, 2009. Management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its *Internal Control - Integrated Framework*. Management's assessment included the evaluation of such elements as the design and operating effectiveness of financial reporting controls, process documentation, accounting policies, and the overall control environment. This assessment is supported by testing and monitoring performed or supervised by our Internal Control organization.

Based on our assessment, management believes that we maintained effective internal control over financial reporting as of January 31, 2009, the end of the fiscal year. The independent registered public accounting firm, Ernst & Young LLP, issued an attestation report on the effectiveness of our internal control over financial reporting. The Ernst & Young LLP report is included on Page F-3 of this Annual Report on Form 10-K.

ITEM 9B. Other Information.

On March 10, 2009, we filed a Current Report on Form 8-K pursuant to Item 2.02 regarding our issuance of a press release announcing our financial condition and results of operations as of and for the fiscal year and fourth quarter ended January 31, 2009. Subsequently, we have modified the manner in which we have accounted for the pending settlement with the Internal Revenue Service primarily related to stock options.

As a result of this change, the consolidated financial statements for the fiscal year ended January 31, 2009, now reflect a provision for income taxes of \$3 million compared to a benefit for income taxes of \$6 million as previously announced. The change had no effect on operating income or EBITDA. The following table sets forth the impact of this change on the amounts we previously announced (in millions).

	As Previously Announced	As Currently Reported
Consolidated Statements of Operations		
(Benefit) provision for income taxes	\$ (6)	\$ 3
(Loss) income before discontinued operations	4	(5)
Net (loss) income	4	(5)
Consolidated Balance Sheets		
Additional paid-in capital	19	27
Accumulated deficit	(2,923)	(2,931)

Consolidated Statements of Cash Flows

Net (loss) income	4	(5)
Net cash provided by operating activities	68	59
Tax benefit from stock options	0	9
Net cash provided by (used in) financing activities	21	30

PART III**ITEM 10. Directors, Executive Officers and Corporate Governance****DIRECTORS AND EXECUTIVE OFFICERS****Directors**

Our current directors serve for a period of three years and until their successors are duly elected and qualified or until the earlier of their resignation, death or removal.

On September 30, 2008, David McVeigh resigned as a director. By a written consent dated January 13, 2009, the stockholders of the Company elected Gerry Murphy to the Board to fill the vacancy created by the resignation of Mr. McVeigh. On January 13, 2009, Matthew Kabaker resigned as a director. By a written consent dated March 11, 2009, the stockholders of the Company elected Peter Wallace to the Board to fill the vacancy created by the resignation of Mr. Kabaker.

Four of our current directors are affiliates of Bain, while the remaining four are affiliates of Blackstone. Taking into account the direct affiliation that each member of our Board has with either Bain or Blackstone, no current director of the Company is deemed to be independent under our previously adopted independence standards.

Set forth below is information concerning each of our directors, including their ages as of March 30, 2009, present principal occupations, other business experiences during the last five years, membership on committees of the Board and public company directorships and certain other directorships. Except for Messrs. Murphy and Wallace (see above), each of the directors listed below has served on our Board since October 31, 2006.

Name	Age	Position	Committee Membership
Josh Bekenstein	50	Director	
Michael S. Chae	40	Director	Compensation Committee
Todd M. Cook	37	Director	Audit Committee
Gerry M. Murphy	53	Director	
Lewis S. Klessel	41	Director	Audit Committee
Matthew S. Levin	43	Director	Compensation Committee
James A. Quella	58	Director	Audit Committee
Peter F. Wallace	33	Director	Audit Committee

Mr. Bekenstein is a managing director at Bain Capital Partners. Prior to joining Bain Capital Partners in 1984, Mr. Bekenstein spent several years at Bain & Company, where he was involved with companies in a variety of industries. Mr. Bekenstein received an M.B.A. from Harvard

Edgar Filing: MICHAELS STORES INC - Form 10-K

Business School and a B.A. from Yale University. Mr. Bekenstein serves as a director of several corporations, including Bombardier Recreational Products Inc., Dollarama Capital Corporation, Toys R Us, Inc., Burlington Coat Factory Warehouse Corporation and Bright Horizons Family Solutions Inc.

Mr. Chae is a senior managing director at The Blackstone Group in the private equity group. Prior to becoming a senior managing director in January 2005, Mr. Chae was a principal of Blackstone from 2000 to 2004. Mr. Chae graduated magna cum laude from Harvard College, and received an M.Phil from Cambridge University and a J.D. from Yale Law School. He serves as a director of Hilton Hotels Corp., Universal Orlando, The Nielsen Company and The Weather Channel Companies.

Mr. Cook is a managing director of Bain Capital Partners. Prior to becoming a managing director in December, 2008, Mr. Cook served in various capacities, most recently as a principal of Bain Capital Partners from 2003 to 2008. Prior to joining Bain Capital Partners in 1996, Mr. Cook was a consultant at Bain & Company. Mr. Cook received an M.B.A. from Stanford University Graduate School of Business where he was an Arjay Miller Scholar. He also holds a B.E. in electrical engineering and a B.A. in economics from Dartmouth College. Mr. Cook serves as a director of Dollarama Capital Corporation and Dunkin Brands Inc.

Mr. Murphy is a senior managing director at The Blackstone Group in the private equity group, which he joined in 2008. Before joining Blackstone, Mr. Murphy spent five years as CEO of Kingfisher, a FTSE 100 company and the leading home improvement retailer in Europe and Asia. He has also served as CEO of Carlton Communications plc, Exel plc and Greencore Group plc. Mr. Murphy serves as a director of United Biscuits Topco Limited, Kleopatra Acquisition Corp., Abbey National plc, Reckitt Benckiser Group plc, Hornbach Holding AG and for the Advisory Board of KP Germany Zweite GmbH. Mr. Murphy received his BSc and PhD in food technology from University College Cork and a 1st Class MBS in marketing from University College Dublin.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Mr. Klessel is an operating partner at Bain Capital Partners. Prior to joining Bain Capital Partners, Mr. Klessel held a variety of operating and strategy leadership positions from 1997 to 2005 at The Home Depot, Inc., most recently as President of Maintenance Warehouse, a wholly-owned subsidiary that distributed maintenance products to facility management customers in the multi-housing, lodging, health-care and commercial sectors. Mr. Klessel received an M.B.A. from Harvard Business School where he was a Baker Scholar, and a B.S. from the Wharton School at the University of Pennsylvania. Mr. Klessel serves as a director of HD Supply, Inc.

Mr. Levin is a managing director at Bain Capital Partners. Prior to joining Bain Capital Partners in 2000, Mr. Levin was a consultant at Bain & Company where he consulted in the consumer products and manufacturing industries. Mr. Levin received an M.B.A. from Harvard Business School where he was a Baker Scholar. He received a B.S. from the University of California at Berkeley. Mr. Levin serves as a board member of several corporations, including Bombardier Recreational Products Inc., Dollarama Capital Corporation, Guitar Center, Inc., Toys R Us, Inc. and Unisource Worldwide, Inc.

Mr. Quella is a senior managing director and senior operating partner at Blackstone in the private equity group. Prior to joining Blackstone in 2004, Mr. Quella was a managing director and senior operating partner with DLJ Merchant Banking Partners-CSFB Private Equity from June 2000 to February 2004. Prior to that, Mr. Quella worked at Mercer Management Consulting and Strategic Planning Associates. Mr. Quella received a B.A. in International Studies from the University of Chicago/University of Wisconsin-Madison and an M.B.A. from the University of Chicago. Mr. Quella serves as a director of Graham Packaging Company, L.P., The Nielsen Company, Intelnet Global Services, Vanguard Health Systems, Inc. and Freescale Semiconductor, Inc.

Mr. Wallace is a managing director at Blackstone in the private equity group, which he joined in 1997. Mr. Wallace received a B.A. in Government from Harvard College. Mr. Wallace serves on the Board of Directors of AlliedBarton Security Services, Crestwood Midstream Partners and The Weather Channel Companies.

Executive Officers

Our current executive officers, their ages as of March 30, 2009, and their business experience during at least the past five years are set forth below. On March 4, 2009, Brian Cornell informed the Company that he would be resigning as Chief Executive Officer. Mr. Cornell's resignation will be effective as of April 2, 2009, on the terms set forth in his employment agreement. On March 9, 2009, the Company announced that it had appointed Mr. John B. Menzer as the new Chief Executive Officer of the Company. Mr. Menzer will commence his employment with the Company no later than April 15, 2009. Prior to joining the Company, Mr. Menzer (age 57) served as Vice Chairman and Chief Administrative Officer of Wal-Mart Stores, Inc. from September 2005 to March 2008, Executive Vice President, President and Chief Executive Officer of Wal-Mart International from June 1999 to September 2005 and Executive Vice President and Chief Financial Officer of Wal-Mart Stores, Inc. from September 1995 to June 1999. Mr. Menzer serves as a director of Emerson Electric Co. No arrangement or understanding exists between Mr. Menzer and any other person pursuant to which Mr. Menzer was selected as an officer of the Company.

Name	Age	Position
Brian C. Cornell	50	Chief Executive Officer
Shelley G. Broader	44	President and Chief Operating Officer
Elaine D. Crowley	50	Executive Vice President Chief Financial Officer
Stuart W. Aitken	37	Executive Vice President Chief Marketing Officer
Nicholas E. Crombie	58	Executive Vice President Store Operations
Thomas C. DeCaro	54	Executive Vice President Supply Chain
Philo T. Pappas	50	Executive Vice President Category Management
Weizhing Wilson Zhu	56	Executive Vice President Global Sourcing

Edgar Filing: MICHAELS STORES INC - Form 10-K

Shawn E. Hearn	43	Senior Vice President	Human Resources
Michael J. Jones	45	Senior Vice President	Chief Information Officer
Michael J. Veitenheimer	52	Senior Vice President	General Counsel and Secretary

Edgar Filing: MICHAELS STORES INC - Form 10-K

Mr. Cornell was named Chief Executive Officer in June 2007. Prior to joining Michaels, he served as Executive Vice President and Chief Marketing Officer of Safeway, Inc. since April 2004. Prior to joining Safeway, Mr. Cornell served as President of Pepsi-Cola North America's (PCNA) Food Services Division and Senior Vice President of Sales for PCNA, a role he assumed in March 2003. Prior to joining PCNA, Mr. Cornell was Regional President of PepsiCo Beverages International's European business and President of Tropicana Products International based in Belgium. Mr. Cornell joined PepsiCo, Inc. when it acquired Tropicana from Seagram Company in 1998. Mr. Cornell serves on the Board of Directors of Home Depot, Inc.

Ms. Broader was named President and Chief Operating Officer in June 2008. Prior to joining Michaels, she served as President and Chief Executive Officer of Sweetbay Supermarkets, Inc., formerly doing business as Kash n Karry Food Stores, Inc., part of the U.S. division of Brussels based Delhaize Group since March 2006. Ms. Broader previously served as President and Chief Operating Officer of Sweetbay Supermarkets from June 2003 to March 2006. Prior to joining Sweetbay Supermarkets, Ms Broader served in various management positions at Hannaford Bros. Co. from April 1991 to June 2003, most recently as Senior Vice President, Business Strategy, Marketing and Communications. She serves on the Board of Directors, and is a member of the Audit Committee, of Raymond James Financial, Inc.

Ms. Crowley was named Executive Vice President Chief Financial Officer in August 2008. Prior to joining Michaels, she served in various capacities at The Bombay Company, Inc. since August 1990, including as Chief Financial Officer and Treasurer since December 2000 and as Senior Vice President, Chief Financial Officer and Treasurer since February 2002. On September 20, 2007, The Bombay Company, Inc. and its U.S. wholly-owned subsidiaries filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court, Northern District of Texas, Fort Worth Division. Prior to joining The Bombay Company, Ms. Crowley was with Price Waterhouse from 1981 to 1990.

Mr. Aitken was promoted to Executive Vice President Chief Marketing Officer in May 2008. Prior to his promotion, Mr. Aitken had served as Senior Vice President Consumer Strategy and Marketing since joining the Company in December 2007. Prior to joining Michaels, Mr. Aitken served in various management positions at Safeway, Inc. from May 1999 to December 2007, most recently as Group Vice President of Marketing Strategies with responsibilities that included loyalty marketing, category management strategy, space planning, datamining, segmentation and innovation.

Mr. Crombie was promoted to Executive Vice President Store Operations in May 2007. Prior to his promotion, he served as Zone Vice President of Stores for Michaels Stores, Inc. since January 2002. Prior to joining the Company, Mr. Crombie was Area Vice President, Mid-South for CVS from February 1999 to January 2002. From January 1996 until February 1999, he was employed by Caldor, Inc. with store operations responsibilities, including Regional Vice President. From November 1988 to January 1996, he was Director of Sales and Marketing and General Merchandising Manager for Major Appliances at Lechmere, Inc.

Mr. DeCaro was promoted to Executive Vice President Supply Chain in June 2005. Prior to his promotion, Mr. DeCaro had served as Senior Vice President Inventory Management since joining us in August 2000. From April 1998 until joining the Company, he was Vice President Merchandise for The Walt Disney Company. Prior to this, he held the position of Senior Vice President Merchandise Planning and Allocation for Kohl's Department Stores from February 1996 to April 1998. In addition, Mr. DeCaro has held various positions in Merchandise Planning and Allocation and Finance for The Disney Store, The Limited Stores, May Department Stores, and Sanger Harris Department Stores.

Mr. Pappas was named Executive Vice President Category Management in February 2009. Prior to joining Michaels, he served as Chief Merchandising Officer at Tweeter Home Entertainment Group, Inc. from April 2003 to October 2008. On June 11, 2007, Tweeter and each of its subsidiaries filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware in Wilmington, Delaware. Prior to joining Tweeter, Mr. Pappas served in various management positions at Staples, Inc. from November 1994 to April 2003, most recently as Senior Vice President of Merchandising.

Mr. Zhu was promoted to Executive Vice President - Global Sourcing in May 2008. Prior to his promotion, Mr. Zhu had served as Senior Vice President - Strategic Sourcing since joining the Company in April 2007. From March 2003 until April 2007, he was Vice President, Private Brand Development and Global Sourcing at Office Depot, Inc. Prior to joining Office Depot, Mr. Zhu served as Vice President, Global Sourcing for Hudson's Bay Company in Canada from March 2001 to March 2003. In addition, Mr. Zhu has held various management positions at Saks, Inc., Edison Brothers Stores, and Nulook Fashions.

Mr. Hearn was named Senior Vice President - Human Resources in February 2007. Prior to his promotion, Mr. Hearn had served as Vice President, Field Human Resources since joining Michaels in November 2002. Prior to joining Michaels, he served in various

operations, marketing, and human resource management positions at KMart Corporation from August 1981 to October 2002, most recently as Vice President, Advertising.

Mr. Jones was named Senior Vice President Chief Information Officer in September 2004. Prior to joining Michaels, he served in various management positions at Hollywood Entertainment Corporation from March 2002 to August 2004, most recently as Senior Vice President and Chief Information Officer. Prior to joining Hollywood, Mr. Jones served in various management positions at KMart Corporation from February 1996 to July 2001, most recently as Vice President for Information Technology and Change Management.

Mr. Veitenheimer was named Senior Vice President General Counsel and Secretary in January 2008. Prior to joining Michaels, Mr. Veitenheimer served as Senior Vice President of Law and Human Resources of The Bombay Company, Inc., from June 2007 to December 2007 after having served as a Senior Vice President since February 2006, its Secretary since July 1985 and its General Counsel since November 1983. On September 20, 2007, The Bombay Company, Inc. and its U.S. wholly-owned subsidiaries filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court, Northern District of Texas, Fort Worth Division. Prior to joining The Bombay Company, Mr. Veitenheimer was in private practice of law in Fort Worth, Texas.

CORPORATE GOVERNANCE

Our Board is responsible for governing Michaels business and affairs. Highlights of Michaels corporate governance practices are described below.

Board Committees

Currently, our Board has two active standing committees, each of which is required by its charter to consist of no fewer than two directors. The four members of the Audit Committee are Todd Cook (Chairman), Lewis Klessel, James Quella and Peter Wallace. The two members of the Compensation Committee are Michael Chae and Matthew Levin.

As a result of the Merger, the Company's Common Stock is held by a small number of stockholders, including funds managed by Bain and Blackstone (and other private equity funds) and certain members of our senior management. In addition, Bain and Blackstone have agreed that they will each have the right to proportional representation on our Board, which has resulted in half of our Board being associated with Bain, with the remaining half being associated with Blackstone. As the Company is now privately held and the members of our Board are selected by our Sponsors, the Board does not maintain policies and procedures by which Michaels stockholders may submit director candidates to the Board or the stockholders for consideration.

Compensation Committee

Please see Item 11. Executive Compensation Compensation Discussion and Analysis for a description of the roles and responsibilities of our Compensation Committee.

Audit Committee

Our Board of Directors has a separately designated audit committee. For most of fiscal year 2008, the Audit Committee consisted of four members: Matthew Kabaker (Chairman), Todd Cook, Lewis Klessel and David McVeigh. On September 30, 2008, Mr. McVeigh resigned as a director and on January 13, 2009, Mr. Kabaker resigned as a director. James Quella was appointed to the Audit Committee in January 2009, Peter Wallace was appointed to the Audit Committee in March 2009 and Mr. Cook was named Chairman of the Audit Committee upon the resignation of Mr. Kabaker. Our Board has determined that each member of the Audit Committee is financially literate and has sufficient business and financial expertise to effectively perform his duties as a member of the Audit Committee. As the Company is now privately held and controlled by our Sponsors, our Board has determined that it is not necessary to designate one or more of our Audit Committee members as an audit committee financial expert at this time. None of our Audit Committee members is an independent director due to their affiliations with the Sponsors. The current members of the Audit Committee are as follows:

Audit Committee

Todd M. Cook (Chairman)

Lewis S. Klessel

James A. Quella

Peter F. Wallace

Under its charter, the Audit Committee is generally responsible for overseeing Michaels' financial reporting process and assists the Board in fulfilling the Board's oversight responsibilities with respect to: (i) the integrity of Michaels' financial statements; (ii) Michaels' compliance with legal and regulatory requirements; (iii) the qualifications and independence of Michaels' independent registered public accounting firm; and (iv) the performance of the independent registered public accounting firm and of Michaels' internal audit function.

Code of Business Conduct and Ethics

We adopted a Code of Business Conduct and Ethics that applies to, among others, our principal executive officer, principal financial officer, and principal accounting officer or controller, or persons performing similar functions. A copy of our Code of Business Conduct and Ethics is available on our Internet website at www.michaels.com under Corporate Information. We will post any amendments to our Code of Business Conduct and Ethics, or waivers of the Code for our executive officers, on our Internet website at www.michaels.com under Corporate Information.

ITEM 11. Executive Compensation.

COMPENSATION DISCUSSION AND ANALYSIS

Introduction

The following Compensation Discussion and Analysis relates to compensation paid to our executive officers named in the Summary Compensation Table for fiscal 2008. Since completion of the Merger, our Compensation Committee has been comprised of Michael S. Chae and Matthew S. Levin, each of whom is affiliated with our current stockholders and, therefore, is not deemed an independent director. During fiscal year 2008, several events occurred which impacted management and compensation decisions. These included the hiring of a new President and Chief Operating Officer and a new Executive Vice President - Chief Financial Officer, the departure of the Company's former President and Chief Financial Officer, the end of the protection period under our Change in Control Agreements and the adoption of a new Officer Severance Pay Plan. Each of these events is more fully discussed below.

Compensation Program

Generally, our compensation program has continued the overall approach of our pre-Merger compensation program, modified as appropriate to reflect that we are now a privately-owned company with public debt. The principal guiding objectives of our executive officer compensation program are:

- attracting and retaining highly qualified individuals who make contributions that result in Michaels meeting its financial and strategic goals;
- motivating employees to exceptional levels of operating and financial performance; and
- aligning employee interests with the long-term goals of our stockholders.

Currently, the total compensation for our executive officers consists of three main components: base salary, annual cash incentive bonuses and long-term equity-based incentive compensation awards. The philosophy and the strategy of the cash incentive compensation program for our executive officers are to provide higher annual cash incentive compensation for exceptional corporate and financial performance. While the Compensation Committee takes into account tax and accounting considerations in structuring the components of our compensation program, these considerations are secondary to the primary objectives of the compensation program described above.

Compensation Strategy

The Compensation Committee approves and recommends to the Board the compensation for all executive officers. The Board is ultimately responsible for determining the compensation of our executive officers, although under our certificate of incorporation equity-based awards must also be approved by a majority of our stockholders. Both the Compensation Committee and the Board receive recommendations with respect to decisions regarding the executive officers, other than the Chief Executive Officer, by senior management, principally the Chief Executive Officer and the Senior Vice President – Human Resources. In determining compensation levels for the executive officers, the Compensation Committee considers the scope of an individual’s responsibilities, an individual’s performance and prior experience, the performance of the Company and the attainment of planned financial and strategic initiatives. These factors are evaluated by the Compensation Committee and the Board with no particular weight given to any one factor. The Compensation Committee considers overall past compensation and incentives in determining the compensation of executive officers and seeks to assure that the executives have appropriate incentives to achieve high levels of corporate performance. The Compensation Committee, through its members’ involvement in numerous other portfolio companies, has access to compensation-related information to assist the Committee with respect to the Company’s overall compensation program for employees generally, as well as compensation for executive officers. Recommendations to the Board by the Compensation Committee are therefore predominantly based on the experience of the members of the Compensation Committee and alignment with the overall strategic direction and goals of the Company.

Named Executive Officers

This Compensation Discussion and Analysis and the executive compensation discussion and tables that immediately follow describe the process, strategy and elements of the Company’s compensation plan as applied to certain of its executive officers. Those individuals include Brian C. Cornell, Chief Executive Officer, Shelley G. Broader, President and Chief Operating Officer, Elaine D. Crowley, Executive Vice President Chief Financial Officer, Stuart W. Aitken, Executive Vice President – Chief Marketing Officer, Thomas C. DeCaro, Executive Vice President Supply Chain, Jeffrey N. Boyer, who served as President and Chief Financial Officer for part of the year, Thomas M. Bazzone, who served as Executive Vice President – Specialty Businesses for part of the year, Harvey S. Kanter, who served as Executive Vice President – Managing Director for part of the year, and Lisa K. Klinger, who served as Interim Chief Financial Officer for part of the year. These officers are referred to as our Named Executive Officers.

Compensation Elements

Base Salaries

Base salaries for our executive officers are established based on the scope of their responsibilities, individual performance and prior experience, Michaels’ operating and financial performance and the attainment of planned financial and strategic initiatives, taking into account the knowledge of the members of the Compensation Committee regarding competitive market compensation paid by companies for similar positions. The Compensation Committee sets base salaries at a level designed to attract and retain highly qualified individuals who make contributions that result in Michaels meeting its operating and financial goals. Base salaries are reviewed and adjusted annually as deemed appropriate by the Compensation Committee. The Compensation Committee has discretion to adjust base salary during the fiscal year and exercised that discretion in fiscal 2008, as described below.

Edgar Filing: MICHAELS STORES INC - Form 10-K

On June 4, 2007, Mr. Cornell was named Chief Executive Officer of the Company. Pursuant to his negotiated employment agreement, Mr. Cornell's base salary was set at \$1,000,000, subject to increase from time to time by the Board of Directors, in its sole discretion. In setting Mr. Cornell's base salary, the Committee considered Mr. Cornell's compensation at his prior employer and the level of compensation needed to recruit Mr. Cornell to the Company. In the opinion of the members of the Compensation Committee, based on their experience with other companies, including other portfolio companies, this salary level represented a competitive market level for the position.

In March 2008, the Compensation Committee reviewed recommendations regarding 2008 annual base salary rates for the executive officer group based on the criteria set forth above. Pursuant to this review, the Compensation Committee determined that such salaries were generally appropriate for the position and responsibilities assigned to each executive officer. As such, the base salary increases below the level of Chief Executive Officer were adjusted within normal company merit guidelines. Mr. Cornell's base salary remained at \$1,000,000. Merit guidelines are determined by reviewing and participating in benchmark surveys, as well as giving consideration to the Company's overall budget for employee compensation. Based upon this information, the Company has

Edgar Filing: MICHAELS STORES INC - Form 10-K

utilized a 3.5% to 4% annual merit rate for the past several years. The resulting adjustments are reflected below.

Name	2007 Base Salary	2008 Base Salary
Jeffrey N. Boyer	\$ 625,000	\$ 640,625
Thomas M. Bazzone	361,550	374,204
Thomas C. DeCaro	335,075	348,478
Harvey S. Kanter	370,050	381,153

Neither Mr. Aitken nor Ms. Klinger was a member of the executive officer group in March 2008. Mr. Aitken was promoted to the position of Executive Vice President – Chief Marketing Officer in May 2008 and received an increase in his annual base salary from \$280,005 to \$325,000, in connection with his promotion. No adjustment was made to Ms. Klinger’s base salary of \$270,000 in connection with her service as Interim Chief Financial Officer.

In June 2008, Ms. Broader was named President and Chief Operating Officer of the Company. Pursuant to her offer letter with the Company, Ms. Broader’s base salary was set at \$625,000, with salary increases to be consistent with our policy of advancement on an individual merit basis. In setting Ms. Broader’s base salary, the Committee considered Ms. Broader’s compensation at her prior employer and the level of compensation needed to recruit Ms. Broader to the Company.

In August 2008, Ms. Crowley was named Executive Vice President – Chief Financial Officer of the Company. Pursuant to her offer letter with the Company, Ms. Crowley’s base salary was set at \$300,000, with salary increases to be consistent with our policy of advancement on an individual merit basis. In setting Ms. Crowley’s base salary, the Committee considered Ms. Crowley’s compensation at her prior employer and the level of compensation needed to recruit Ms. Crowley to the Company.

In the opinion of the members of the Compensation Committee, based on their experience with other companies, including other portfolio companies, the salary levels for Ms. Broader and Ms. Crowley represented a competitive market level for their positions.

Annual Bonuses

In April 2008, the Compensation Committee recommended and the Board approved the Fiscal Year 2008 Bonus Plan (the “Bonus Plan”) for the Named Executive Officers to provide financial incentives to those and other members of management who were in positions to make important contributions to Michaels’ success. The structure of the Bonus Plan and the specific objectives relating to bonus payments were proposed by the Company’s Chief Executive Officer and Senior Vice President – Human Resources and were reviewed and adjusted by the Compensation Committee. The Bonus Plan tied 75% of the available bonus to Michaels’ attainment of a financial objective (which included consolidated earnings before interest, taxes, depreciation and amortization (EBITDA), less an inventory charge), and 25% of the available bonus to the individual’s job performance. In addition, for Mr. Bazzone, our Executive Vice President – Specialty Businesses, the objectives included business unit EBITDA. Under the Bonus Plan, before any business unit or individual performance payout would be earned, the actual results of the financial objective (EBITDA, less an inventory charge) were required to meet the threshold established by the Compensation Committee. Each participating Named Executive Officer was entitled to a bonus equal to a certain percentage of that executive officer’s base salary. The Compensation Committee set threshold, target and maximum performance levels for each position. The final award depended on the actual level of performance achieved; however, the Compensation Committee retained discretion to make adjustments in its sole discretion. The target levels of performance for the bonus goals were set at levels that the Compensation Committee and the Board believed to be reasonably achievable in view of Michaels’ historical annual performance. Additional specific information regarding the targets and objectives is set forth below in the discussion of fiscal 2008 results.

Lisa Klinger's bonus in fiscal 2008 was established based on her position as Senior Vice President Finance and Treasurer, and was not modified in connection with her service as Interim Chief Financial Officer. Ms. Klinger's target annual bonus opportunity was set pursuant to the Bonus Plan at 40% of her base salary. In connection with Mr. Aitken's promotion in May 2008, the Board adjusted his target annual bonus opportunity under the Bonus Plan to 50% of his new base salary. Pursuant to Mr. Aitken's offer letter from the Company effective December 2007, Mr. Aitken was guaranteed a bonus of \$110,000 for fiscal year 2008. Pursuant to Ms. Broader's offer letter from the Company, Ms. Broader's target annual bonus opportunity pursuant to the Bonus Plan was set at 70% of base salary, prorated to the commencement of her employment. Ms. Broader's target bonus of \$255,208 was guaranteed for fiscal 2008. Pursuant to Ms. Crowley's offer letter from the Company, Ms. Crowley's target annual bonus opportunity pursuant to the Bonus Plan was set at 50% of base salary, prorated to the commencement of her employment.

Edgar Filing: MICHAELS STORES INC - Form 10-K

The target percentages set for fiscal 2008 and the threshold, target and maximum payments for each of the Named Executive Officers for fiscal 2008 were as follows:

	Brian C. Cornell	Shelley G. Broader (1)	Elaine D. Crowley (1)	Stuart W. Aitken	Thomas C. DeCaro	Jeffrey N. Boyer	Thomas M. Bazzone	Harvey S. Kanter	Lisa K. Klinger
Percentage of Base Salary									
Target	100%	70%	50%	50%	50%	70%	50%	50%	40%
Threshold	35%	24.5%	17.5%	17.5%	17.5%	24.5%	17.5%	17.5%	14%
Maximum	200%	140%	100%	100%	100%	140%	100%	100%	80%
Financial Weightings									
Overall Company Results	75%	75%	75%	75%	75%	75%	25%	75%	75%
Division/Dept. Results							50%		
Individual Performance	25%	25%	25%	25%	25%	25%	25%	25%	25%

(1) Bonuses for Ms. Broader and Ms. Crowley were prorated based on the commencement date of their employment.

Provided that the EBITDA threshold is met, individual performance accounts for up to 25% of target bonus for each of the Named Executive Officers. Each officer is evaluated annually based upon competencies and pre-established individual objectives. Performance against these measures is determined by the Compensation Committee on a scaled rating of Exceeds Expectations, Solid Performance or Mixed Performance. No specified weighting is given to each measure and considerable discretion resides with the Compensation Committee in its evaluation of personal performances.

In March 2009, the Compensation Committee reviewed the Company's financial results as applicable to the pre-established fiscal 2008 annual bonus opportunities for the Named Executive Officers. As described previously, the financial objective of Company performance that was applicable to all the named executive officers was EBITDA, less an inventory charge. For fiscal 2008, the EBITDA-adjusted goal for target-level bonuses was \$488.7 million and the threshold set by the Compensation Committee and approved by the Board at the beginning of the year was \$452.7 million, which represented approximately 94% of target. For the fiscal year, the Company did not achieve its EBITDA threshold. As a result, with the exception of guaranteed bonuses of \$255,208 and \$110,000 awarded to Ms. Broader and Mr. Aitken respectively, no bonuses were paid to the Named Executive Officers for fiscal 2008. Such guaranteed bonuses are listed in the Summary Compensation Table under the heading Bonus.

Long-Term Equity-Based Compensation

On February 15, 2007, our Board and stockholders approved the Michaels Stores, Inc. 2006 Equity Incentive Plan, as well as certain specific grants under the plan to key employees. In addition, the stockholders granted the Board authority to make plan grants to other eligible participants in the future. The plan has been established to advance the interests of Michaels and its affiliates by providing for the grant of equity-based awards to eligible participants (key employees and directors of, and consultants and advisors to, Michaels or its affiliates). Awards under the plan are intended to align the long-term incentives of our executives and stockholders. Grants are awarded when an executive is hired and are adjusted for subsequent promotions.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Each option is divided into six tranches with escalating exercise prices. Grants are made at or above fair market value. Currently, the lowest exercise price is \$15.00 per share, which was determined by the Board to be the fair market value per share of our Common Stock on the date that the 2006 Equity Incentive Plan was adopted and continues to be at or above fair market value. Each tranche vests 20% on each of the first through fifth anniversaries of the grant date and all unvested options vest immediately upon a change of control, as defined in the Amended and Restated Stockholders Agreement dated February 16, 2007 among Michaels and its stockholders. The amounts of awards were based on each Named Executive Officer's position at Michaels and the total target compensation packages deemed appropriate for such positions. The Compensation Committee and the Board felt these awards were reasonable and consistent with the nature of the individuals' responsibilities and satisfied the goals of competitive compensation and the retention of key executive officers. The tranche structure of the option awards, with increasing exercise prices in each tranche, is designed to incentivize long-term performance by tying the value of the options to long-term increases in the value of our Common Stock.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Ms. Broader and Ms. Crowley were hired, and Mr. Aitken was promoted to an Executive Vice President, during fiscal 2008. As a result, the following options were granted to Named Executive Officers in fiscal year 2008:

Name	Total Shares	Number of Shares of Common Stock Underlying Stock Options					
		Tranche 1 (Exercise Price \$15.00 Per Share)	Tranche 2 (Exercise Price \$22.50 Per Share)	Tranche 3 (Exercise Price \$30.00 Per Share)	Tranche 4 (Exercise Price \$37.50 Per Share)	Tranche 5 (Exercise Price \$45.00 Per Share)	Tranche 6 (Exercise Price \$52.50 Per Share)
Shelley G. Broader	567,648	189,216	189,216	47,304	47,304	47,304	47,304
Elaine D. Crowley	454,192	151,398	151,398	37,849	37,849	37,849	37,849
Stuart W. Aitken	170,320	56,774	56,774	14,193	14,193	14,193	14,193

Ms. Broader was also granted a restricted stock award pursuant to the 2006 Equity Incentive Plan in fiscal 2008. The restricted stock award covers 54,134 shares with 20% vesting on each of the first five anniversaries from June 23, 2008 (vesting would accelerate in the event of Ms. Broader's death or disability). In the judgment of the Compensation Committee and the Board, the restricted stock award was appropriate for Ms. Broader's position and was instrumental to the Company's successful recruiting of Ms. Broader as President and Chief Operating Officer.

Other Benefits and Perquisites

Our Named Executive Officers also receive certain other benefits and perquisites. During fiscal 2008, these benefits included annual matching contributions to executive officers' 401(k) accounts and variable universal life plan accounts, the payment of life insurance premiums, Company-paid medical benefits and, in some cases, reimbursement for income taxes on taxable benefits. Effective March 1, 2009, the Company suspended the variable universal life plan account match for its highly compensated employees. Our Chief Executive Officer and President and Chief Operating Officer and former President and Chief Financial Officer, were also entitled to the use of Company-owned or leased automobiles. The Compensation Committee and the Board believe these benefits and perquisites are reasonable and consistent with the nature of the individual's responsibilities, provide a competitive level of total compensation to our executives and serve as an important element in retaining those individuals. The cost to Michaels of these benefits to the Named Executive Officers is set forth in the Summary Compensation Table under the column All Other Compensation and detail about each element is set forth in the table presented in footnote 3 to the Summary Compensation Table.

Employment and Change in Control Severance Agreements

Mr. Cornell has an employment agreement with Michaels that was entered at the time of his appointment which includes certain severance benefits in the event of termination other than for cause or by Mr. Cornell for good reason, as such terms are defined in the agreement. The specific terms of Mr. Cornell's employment agreement are discussed following the Summary Compensation Table and also in the section entitled Executive and Director Compensation - Potential Payments Upon Termination or Change in Control. On March 4, 2009, Mr. Cornell informed the Company that he would be resigning as the Chief Executive Officer. Mr. Cornell's resignation will be effective as of April 2, 2009. The benefits payable to him pursuant to his employment agreement may be found in the sections entitled Cornell Employment Agreement and Executive and Director Compensation - Potential Payments Upon a Change in Control.

On April 26, 2006, to encourage the then Named Executive Officers and other members of management to remain with Michaels during the strategic alternatives process that led to the completion of the Merger on October 31, 2006, the Board approved change in control severance agreements with Messrs. Boyer, DeCaro, Bazzone and Kanter. A more detailed description of these agreements may be found in the section

Edgar Filing: MICHAELS STORES INC - Form 10-K

entitled Executive and Director Compensation Potential Payments Upon a Change in Control. The protection period under our Change in Control Agreements ended on October 31, 2008.

Mr. Boyer was separated from the Company on April 4, 2008, and his change in control benefits were triggered. Pursuant to his agreement, Mr. Boyer was paid: (i) three times the sum of his annual base salary plus the greater of his average annual bonus or target

bonus; (ii) his prorated target annual bonus for fiscal 2008; (iii) three years of continued welfare benefits and fringe benefits for Mr. Boyer, subject to certain limitations and restrictions; (iv) a credit representing three years of participation in the Company's savings and retirement plans; and (v) outplacement counseling not to exceed \$50,000. Mr. Boyer executed a Separation Agreement and Release, which included, in addition to a release of all claims against the Company, a forfeiture of all outstanding stock options and a confidentiality, non-solicitation and non-interference agreement. The actual amounts paid to Mr. Boyer are set forth in the section entitled Executive and Director Compensation Potential Payments Upon a Change in Control, and are reflected in the Summary Compensation Table under the heading All Other Compensation.

Messrs. Bazzone and Kanter were also separated from the Company on May 25, 2008 and July 2, 2008, respectively, and their change in control benefits were triggered. Pursuant to their agreements, each of Messrs. Bazzone and Kanter were paid: (i) two times the sum of their annual base salary plus the greater of their average annual bonus or target bonus; (ii) their prorated target annual bonus for fiscal 2008; (iii) two years of continued welfare benefits and fringe benefits for themselves and their spouses and dependants, subject to certain limitations and restrictions; (iv) a credit representing two years of participation in the Company's savings and retirement plans; and (v) outplacement counseling not to exceed \$50,000. Each of Messrs. Bazzone and Kanter executed a Separation Agreement and Release, which included, in addition to a release of all claims against the Company, a forfeiture of all outstanding stock options and a confidentiality, non-solicitation and non-interference agreement. The actual amounts paid to Messrs. Bazzone and Kanter are set forth in the section entitled Executive and Director Compensation Potential Payments Upon a Change in Control, and are reflected in the Summary Compensation Table under the heading All Other Compensation.

In April 2008, the Board approved the Company's Officer Severance Pay Plan (the OSPP), which was amended in July 2008. The OSPP was established by the Company to provide certain severance benefits, subject to the terms and conditions of the OSPP, to designated officers (those with a position of Vice President or above, or an equivalent title as approved by the Compensation Committee, and excluding the Chief Executive Officer) in the event that their employment is permanently terminated as a result of a Qualifying Termination (as defined in the OSPP and described below). A more detailed description of the OSPP may be found in the section entitled Executive and Director Compensation Potential Payments Upon a Change in Control. None of the Named Executive Officers received a payment under the OSPP during fiscal 2008.

IRS Limits on Deductibility

Following the Merger, the equity securities of Michaels are no longer publicly traded; accordingly, Section 162(m) of the Internal Revenue Code no longer applies to Michaels.

COMPENSATION COMMITTEE REPORT

The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) of Regulation S-K with management and, based on such review and discussion, the Compensation Committee recommended to the Board that the Compensation Discussion and Analysis be included in this Annual Report on Form 10-K.

THE COMPENSATION COMMITTEE

Michael S. Chae

Matthew S. Levin

EXECUTIVE AND DIRECTOR COMPENSATION

Summary Compensation Table

According to SEC rules, the Summary Compensation Table shall include each of the following: (i) all individuals serving as principal executive officer or acting in a similar capacity during the last completed fiscal year; (ii) all individuals serving as principal financial officer or acting in a similar capacity during the last completed fiscal year; (iii) the three most highly compensated executive officers other than the principal executive officer and principal financial officer who were serving as executive officers at the end of the last completed fiscal year; and (iv) up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year. The following table summarizes the compensation for the fiscal years indicated paid to or earned by the following persons who were previously defined as Named Executive Officers: Brian C. Cornell (who served as principal executive officer), Elaine D. Crowley (who, beginning on August 18, 2008, served as principal financial officer), Jeffrey N. Boyer (who served as principal financial officer during a portion of the year), Lisa K. Klinger (who served as interim principal financial officer during a portion of the year), Shelley G. Broader, Stuart W. Aitken and Thomas C. DeCaro (the three other most highly compensated individuals who were serving as executive officers at the end of fiscal 2008), and Thomas M. Bazzone and Harvey S. Kanter (who would have been among the three most highly compensated executive officers other than the principal executive officer and principal financial officer if they had they been executive officers at the end of the fiscal year).

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$) (1)	Option Awards (\$) (1)	Non-Equity Incentive Plan Compensation (\$) (2)	All Other Compensation (\$) (3)	Total (\$)
Brian C. Cornell, <i>Chief Executive Officer</i> (4)	2008	1,000,000		999,998	2,039,825		130,397	4,170,220
	2007	607,692	2,500,000	749,998	1,330,320	538,533	92,341	5,818,884
Shelley G. Broader <i>President and Chief Operating Officer</i> (5)	2008	372,596	755,208(6)	121,802	390,320		395,734	2,035,660
Elaine D. Crowley <i>Executive Vice President Chief Financial Officer</i> (7)	2008	132,692	150,000(8)		199,257		117,039	598,988
Stuart W. Aitken <i>Executive Vice President Chief Marketing Officer</i>	2008	310,385	110,000(9)		317,585		189,265	927,235
Thomas C. DeCaro, <i>Executive Vice President Supply Chain</i>	2008	346,416			349,577		70,661	766,654
	2007	335,075			349,577	131,852	187,266	1,003,770
	2006	275,731			256,295	151,250	452,220	1,135,496
Jeffrey N. Boyer, <i>Former President and Chief Financial Officer</i> (10)	2008	157,752				N/A	5,026,010	5,183,762
	2007	625,000			1,179,825	244,063	205,968	2,254,856
	2006	499,039			329,288	480,208	709,889	2,018,424
Thomas M. Bazzone, <i>Former Executive Vice President Specialty Businesses</i> (11)	2008	190,426				N/A	1,860,961	2,051,387
	2007	361,550			349,577	63,741	213,278	988,146
	2006	339,346	35,292		422,578	157,198	952,210	1,906,624
Harvey S. Kanter, <i>Former Executive Vice President Managing Director</i> (12)	2008	163,947				N/A	1,347,825	1,511,772
	2007	370,052			349,577	93,031	215,828	1,028,488
	2006	330,529			317,108	188,573	534,492	1,370,702

Edgar Filing: MICHAELS STORES INC - Form 10-K

Lisa K. Klinger <i>Former Senior Vice President Finance and Treasurer (13)</i>	2008	269,481	218,487	57,137	545,105
---	------	---------	---------	--------	---------

(1) Amounts set forth in the Stock Awards and Option Awards columns represent the aggregate amount recognized for financial statement reporting purposes with respect to the Named Executive Officers for the fiscal year indicated, disregarding the estimate of forfeitures related to service-based vesting conditions, but otherwise computed in accordance with the Statement of Financial Accounting Standards (SFAS) No. 123, as amended by SFAS No 123(R), Share-Based Payment (SFAS 123(R)), based on the assumptions set forth in Note 8 of Notes to Consolidated Financial Statements contained in this Annual Report on Form 10-K.

(2) As discussed in further detail in the preceding section Compensation Discussion and Analysis Compensation Elements Annual Bonuses , only guaranteed bonuses were payable pursuant to the Bonus Plan for fiscal year 2008, and such guaranteed amounts are set forth under the Bonus column.

(3) The table below reflects the fiscal 2008 components of this column.

	Brian C. Cornell	Shelley G. Broader	Elaine D. Crowley	Stuart W. Aitken	Thomas C. DeCaro	Jeffrey N. Boyer	Thomas M. Bazzone	Harvey S. Kanter	Lisa K. Klinger
Medical Benefits (\$)	45,095	27,927	19,948	45,095	45,095	3,263	14,600	12,160	45,407
Insurance Premiums (\$)	3,122	1,275	1,263	1,897	3,924	2,337	1,436	1,826	1,796
Company Contributions to 401(k) and Group Universal Life Plan (\$)	40,416			2,759	14,291	3,517	14,418	14,854	6,862
Change in Control and Severance Payments (\$) (a)						5,005,351(b)	1,823,557(c)	1,311,784(d)	
Tax Reimbursement (\$) (e)	22,001	233,473	95,570	29,987	7,093	1,112	6,950	7,201	2,814
Relocation (\$)	300	127,860		109,269					
Auto (\$)	19,463	4,941				10,430			
Other (\$) (f)		258	258	258	258				258
Total Other	130,397	395,734	117,039	189,265	70,661	5,026,010	1,860,961	1,347,825	57,137

(a) The amounts in this row reflect the dollar amounts received by the Named Executive Officers pursuant to Change in Control Agreements entered into in April 2006, which were triggered by the Merger and such executive s subsequent departure from the Company.

(b) In connection with Mr. Boyer s separation, he received (A) change in control cash payments totaling \$3,343,362, including his prorated 2008 target bonus of \$76,173; (B) a company-owned vehicle valued at \$79,200, and \$3,500 for the remaining value owed to Mr. Boyer pursuant to Company s Policy Regarding Company Cars; (C) continuation of health and welfare benefits and payments of \$12,972; (D) a payment of \$100,301 representing contributions to retirement plans calculated as 3% of the change in control cash payments; (E) office equipment valued at \$700; (F) cost attributable to miscellaneous gifts by Mr. Boyer paid for by the Company of \$390; and (G) tax reimbursements totaling \$1,464,926.

(c) In connection with Mr. Bazzone s separation, he received (A) change in control cash payments totaling \$1,200,016, including his prorated 2008 target bonus of \$77,404; (B) continuation of health and welfare benefits and payments of \$31,135; (C) a payment of \$36,000 representing contributions to retirement plans calculated as 3% of the change in control cash payments; (D) \$25,000 in outplacement services; (E) office equipment valued at \$700; and (F) tax reimbursements totaling \$530,706.

(d) In connection with Mr. Kanter s separation, he received (A) change in control cash payments totaling \$1,202,459, including his prorated 2008 target bonus of \$59,000; (B) continuation of health and welfare benefits and payments of \$33,185; (C) a payment of \$36,074 representing

Edgar Filing: MICHAELS STORES INC - Form 10-K

contributions to retirement plans calculated as 3% of the change in control cash payments; (D) \$25,000 in outplacement services; (E) \$8,875 in legal expenses; (F) office equipment valued at \$700; and (G) tax reimbursements totaling \$5,491.

(e) Reimbursement of income taxes is related to signing bonus, relocation, legal expenses, executive gifts, long-term disability insurance premiums and Company matching contributions under the Group Universal Life Plan. Messrs. Boyer, Bazzone and Kanter's tax reimbursement related to their change in control and severance is included under Change in Control and Severance Payments, as specified in notes (b), (c) and (d) above.

(f) The amounts in this column reflect for Ms. Broader, Ms. Crowley, Mr. Aitken, Mr. DeCaro and Ms. Klinger the cost attributable to executive gifts.

- (4) Mr. Cornell became our Chief Executive Officer on June 4, 2007, and his compensation for fiscal 2007 reflects a partial fiscal year.
- (5) Ms. Broader became our President and Chief Operating Officer on June 23, 2008, and her compensation reflects a partial fiscal year.
- (6) Represents signing bonus of \$500,000 and guaranteed fiscal year 2008 bonus of \$255,208 provided to Ms. Broader pursuant to her offer letter.
- (7) Ms. Crowley became our Executive Vice President-Chief Financial Officer on August 18, 2008, and her compensation reflects a partial fiscal year.
- (8) Represents signing bonus provided to Ms. Crowley pursuant to her offer letter.
- (9) Represents guaranteed fiscal year 2008 bonus provided to Mr. Aitken.
- (10) Mr. Boyer served as President and Chief Financial Officer until April 4, 2008 when he separated from the Company.
- (11) Mr. Bazzone served as Executive Vice President-Specialty Business until July 2, 2008 when he separated from the Company.
- (12) Mr. Kanter served as Executive Vice President-Managing Director until May 25, 2008 when he separated from the Company.
- (13) Ms. Klinger served as Interim Chief Financial Officer from April 5, 2008 to August 17, 2008. She continued to serve as Senior Vice President-Finance and Treasurer until February 20, 2009 when she separated from the Company.

Grants of Plan-Based Awards for Fiscal 2008

The following table sets forth the plan-based awards granted to Named Executive Officers pursuant to Company plans during fiscal 2008.

Grants of Plan-Based Awards (1)

Name and Principal Position	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards (2)			All Other Stock Awards: Number Shares of Stock (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards (\$/Sh)(3)	Grant Date Fair Value of Stock and Option Awards (\$)(4)
		Threshold (\$)	Target (\$)	Maximum (\$)				
Brian C. Cornell, Chief Executive Officer	N/A	350,000	1,000,000	2,000,000				
Shelley G. Broader, President and Chief Operating Officer (5)	N/A	89,323	255,208	510,417				
	7/28/2008				54,134		812,010	
	7/28/2008					189,216	15.00	1,191,153
	7/28/2008					189,216	22.50	828,198
	7/28/2008					47,304	30.00	169,538
	7/28/2008					47,304	37.50	149,008
	7/28/2008					47,304	45.00	135,857
	7/28/2008					47,304	52.50	128,383
Elaine D. Crowley, Executive Vice President Chief Financial Officer (6)	N/A	21,875	62,500	125,000				
	9/12/2008					151,398	15.00	926,541
	9/12/2008					151,398	22.50	632,238
	9/12/2008					37,849	30.00	126,870
	9/12/2008					37,849	37.50	111,541
	9/12/2008					37,849	45.00	101,133
	9/12/2008					37,849	52.50	94,244
Stuart W. Aitken, Executive Vice President Chief Marketing Officer (7)	N/A	56,875	162,500	325,000				
	6/4/2008					56,774	15.00	298,654
	6/4/2008					56,774	22.50	177,362
	6/4/2008					14,193	30.00	32,474
	6/4/2008					14,193	37.50	25,902
	6/4/2008					14,193	45.00	22,070
	6/4/2008					14,193	52.50	19,217
Thomas C. DeCaro, Executive Vice President Supply Chain	N/A	60,984	174,239	348,478				
Jeffrey N. Boyer, Former President and Chief Financial Officer	N/A	26,661	76,173	152,346				
Thomas M. Bazzone, Former Executive Vice President Specialty Businesses	N/A	27,091	77,404	154,808				
Harvey S. Kanter, Former Executive Vice President Managing Director	N/A	20,650	59,000	118,001				
Lisa K. Klinger								

Edgar Filing: MICHAELS STORES INC - Form 10-K

<i>Former Senior Vice President Finance and Treasurer</i>	N/A	37,800	108,000	216,000
---	-----	--------	---------	---------

-
- (1) All equity awards noted below were granted under the 2006 Equity Incentive Plan.
 - (2) The threshold, target and maximum amounts in these columns have been provided in accordance with Item 402(d) of Regulation S-K and show the range of payouts targeted for fiscal 2008 for performance under the Bonus Plan as discussed in further detail in Compensation Discussion and Analysis Compensation Elements Annual Bonuses. For Ms. Broader, Ms. Crowley, Mr. Boyer, Mr. Bazzone and Mr. Kanter, these amounts reflect pro rated values for the partial year each executive was employed. Only guaranteed bonuses are payable pursuant to the Bonus Plan for fiscal year 2008 which have been previously approved and are expected to be paid in April 2009, as reflected in the Summary Compensation Table in the column entitled Bonus.
 - (3) All grants of stock options under the 2006 Equity Incentive Plan have an exercise price equal to or greater than the fair market value of our Common Stock on the date of grant. Because the Company is a privately-held company and there is no market for our Common Stock, the fair market value of our Common Stock is determined by our Board of Directors based on available information that is material to the value of our Common Stock, including the value of the Company immediately prior to the Merger, subsequent third party valuation reports, the principal amount of the Company's indebtedness, the Company's actual and projected financial results, and fluctuations in the market value of publicly-traded companies in the retail industry.
 - (4) The amounts in this column represent the fair value of the award on the date of the grant as calculated in accordance with SFAS No. 123(R).
 - (5) Stock options were granted to Ms. Broader on July 28, 2008, and vest at the rate of 20% per year on each of the first through fifth anniversaries of June 23, 2008, or earlier upon a change in control (as defined in the Stockholders Agreement). Ms. Broader's restricted stock awards vest 20% on June 23, 2009, June 23, 2010, June 23, 2011, June 23, 2012, and June 23, 2013.
 - (6) Stock options were granted to Ms. Crowley on September 12, 2008, and vest at the rate of 20% per year on each of the first through fifth anniversaries of September 12, 2008, or earlier upon a change in control (as defined in the Stockholders Agreement).
 - (7) Stock options were granted to Mr. Aitken June 4, 2008, and vest at the rate of 20% per year on each of the first through fifth anniversaries of June 4, 2008, or earlier upon a change in control (as defined in the Stockholders Agreement).

Cornell Employment Agreement

The compensation for Brian C. Cornell described in the Summary Compensation Table and the Grants of Plan-Based Awards Table above, were in accordance with the terms of his employment agreement with Michaels, pursuant to which he serves as Chief Executive Officer of Michaels. The agreement became effective June 4, 2007. The agreement provides for an annual base salary of \$1,000,000. Mr. Cornell was eligible for an annual bonus for each completed fiscal year during his employment, with a target amount of 100% of his base salary and a maximum bonus potential of 200% of his base salary, based on performance targets established by the Board, with the actual amount of any bonus being in the sole discretion of the Board. As an inducement to enter into the employment agreement, in connection with the commencement of his employment Mr. Cornell was paid a signing bonus of \$2,500,000 and granted 133,333 shares of restricted stock. In addition, in connection with the commencement of his employment Mr. Cornell was granted an option to purchase 2,270,966 shares of Common Stock. For a more detailed description of the restricted stock and options grants, see the Outstanding Equity Awards at Fiscal Year-End table below. Mr. Cornell was also entitled to participate in benefit plans standard for Michaels' senior executive officers, including life insurance plans.

On March 4, 2009, Mr. Cornell informed the Company that he would be resigning as Chief Executive Officer. Mr. Cornell's employment agreement states that he is required to give the Company 60 days prior written notice of resignation and the Board may, at its election, choose to waive Mr. Cornell's notice obligation but is still required to pay him for the applicable notice period. The Board waived a portion of the notice period and Mr. Cornell's resignation shall be effective April 2, 2009 and he will be paid only through that date. Any restricted shares or stock options held by Mr. Cornell that are unvested as of the effective date of his resignation, will be cancelled pursuant to the terms of the 2006 Equity Incentive Plan and Mr. Cornell's restricted stock and option agreements.

Outstanding Equity Awards at Fiscal Year-End

Name and Principal Position	Number of Securities Underlying Unexercised Options Exercisable	Option Awards			Stock Awards	
		Number of Securities Underlying Unexercised Options Unexercisable	Option Exercise Price	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested	Market Value of Shares or Units of Stock That Have Not Vested (\$)
Brian C. Cornell <i>Chief Executive Officer (1)</i>					66,666	284,664
	151,398	605,591	15.00	6/3/2015		
	151,398	605,591	22.50	6/3/2015		
	37,849	151,398	30.00	6/3/2015		
	37,849	151,398	37.50	6/3/2015		
	37,849	151,398	45.00	6/3/2015		
	37,849	151,398	52.50	6/3/2015		
Shelley G. Broader <i>President and Chief Operating Officer (2)</i>					54,134	231,152
		189,216	15.00	7/27/2016		
		189,216	22.50	7/27/2016		
		47,304	30.00	7/27/2016		
		47,304	37.50	7/27/2016		
		47,304	45.00	7/27/2016		
		47,304	52.50	7/27/2016		
Elaine D. Crowley <i>Executive Vice President Chief Financial Officer (3)</i>					N/A	N/A
		151,398	15.00	9/11/2016		
		151,398	22.50	9/11/2016		
		37,849	30.00	9/11/2016		
		37,849	37.50	9/11/2016		
		37,849	45.00	9/11/2016		
		37,849	52.50	9/11/2016		
Stuart W. Aitken <i>Executive Vice President Chief Marketing Officer (4)</i>					N/A	N/A
		56,774	15.00	6/3/2016		
		56,774	22.50	6/3/2016		
		14,193	30.00	6/3/2016		
		14,193	37.50	6/3/2016		
		14,193	45.00	6/3/2016		
		14,193	52.50	6/3/2016		
	18,925	75,699	15.00	12/17/2015		
	18,925	75,699	22.50	12/17/2015		
	4,731	18,925	30.00	12/17/2015		
	4,731	18,925	37.50	12/17/2015		
	4,731	18,925	45.00	12/17/2015		
	4,731	18,925	52.50	12/17/2015		

Edgar Filing: MICHAELS STORES INC - Form 10-K

Thomas C. DeCaro, <i>Executive Vice President Supply Chain (5)</i>	30,280	121,118	15.00	2/15/2015	N/A	N/A
	30,280	121,118	22.50	2/15/2015		
	7,570	30,279	30.00	2/15/2015		
	7,570	30,279	37.50	2/15/2015		
	7,570	30,279	45.00	2/15/2015		
	7,570	30,279	52.50	2/15/2015		
Jeffrey N. Boyer, <i>Former President and Chief Financial Officer (6)</i>	N/A	N/A	N/A	N/A	N/A	N/A
Thomas M. Bazzone, <i>Former Executive Vice President Specialty Businesses(7)</i>	N/A	N/A	N/A	N/A	N/A	N/A
Harvey S. Kanter, <i>Former Executive Vice President Managing Director (8)</i>	N/A	N/A	N/A	N/A	N/A	N/A
Lisa K. Klinger <i>Former Senior Vice President Finance and Treasurer (9)</i>					N/A	N/A
	18,925	75,699	15.00	2/15/2015		
	18,925	75,699	22.50	2/15/2015		
	4,731	18,925	30.00	2/15/2015		
	4,731	18,925	37.50	2/15/2015		
	4,731	18,925	45.00	2/15/2015		
	4,731	18,925	52.50	2/15/2015		

- (1) Stock options were granted to Mr. Cornell on June 4, 2007, and vest at the rate of 20% per year on each of the first through fifth anniversaries of February 16, 2007, or earlier upon a change in control (as defined in the Stockholders Agreement). Mr. Cornell's restricted stock award vested as to 50% of the shares on June 4, 2008 and the remaining 50% of the shares are scheduled to vest on June 4, 2009. On March 4, 2009, Mr. Cornell informed the Company that he would be resigning as Chief Executive Officer effective April 2, 2009. Any restricted shares or stock options held by Mr. Cornell that are unvested as of the effective date of his resignation, will be cancelled pursuant to the terms of the 2006 Equity Incentive Plan and Mr. Cornell's restricted stock and option agreements.
- (2) Stock options were granted to Ms. Broader on July 28, 2008, and vest at the rate of 20% per year on each of the first through fifth anniversaries of June 23, 2008, or earlier upon a change in control (as defined in the Stockholders Agreement). Ms. Broader's restricted stock award vests 20% on June 23, 2009, June 23, 2010, June 23, 2011, June 23, 2012, and June 23, 2013.
- (3) Stock options were granted to Ms. Crowley on September 12, 2008, and vest at the rate of 20% per year on each of the first through fifth anniversaries of September 12, 2008, or earlier upon a change in control (as defined in the Stockholders Agreement).
- (4) Stock options were granted to Mr. Aitken on December 18, 2007 and June 4, 2008, and vest at the rate of 20% per year on each of the first through fifth anniversaries of December 18, 2007 and June 4, 2008, respectively, or earlier upon a change in control (as defined in the Stockholders Agreement).
- (5) Stock options were granted to Mr. DeCaro on February 16, 2007, and vest at the rate of 20% per year on each of the first through fifth anniversaries of February 16, 2007, or earlier upon a change in control (as defined in the Stockholders Agreement).
- (6) Mr. Boyer separated from the Company on April 4, 2008, and all options previously granted to him were cancelled.

- (7) Mr. Bazzone separated from the Company on July 2, 2008, and all options previously granted to him were cancelled.
- (8) Mr. Kanter separated from the Company on May 25, 2008, and all options previously granted to him were cancelled.
- (9) Stock options were granted to Ms. Klinger on February 16, 2007, and vest at the rate of 20% per year on each of the first through fifth anniversaries of February 16, 2007, respectively, or earlier upon a change in control (as defined in the Stockholders Agreement). Ms. Klinger separated from the Company on February 20, 2009 and has until 60 days from such date to exercise 113,549 options that were vested as of February 20, 2009.

Option Exercises and Stock Vested for Fiscal 2008

The following table shows the number of stock awards held by our named executive officers that vested during fiscal year 2008. No stock options were exercised during fiscal year 2008.

Name	Option Awards		Stock Awards	
	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise (\$)	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting (\$)
Brian C. Cornell <i>Chief Executive Officer</i>			66,667	1,000,005(1)
Shelley G. Broader <i>President and Chief Operating Officer</i>				
Elaine D. Crowley <i>Executive Vice President</i> <i>Chief Financial Officer</i>				
Stuart W. Aitken <i>Executive Vice President</i> <i>Chief Marketing Officer</i>				
Thomas C. DeCaro, <i>Executive Vice President</i> <i>Supply Chain</i>				
Jeffrey N. Boyer, <i>Former President and Chief Financial Officer</i>				
Thomas M. Bazzone, <i>Former Executive Vice President</i> <i>Specialty Businesses</i>				
Harvey S. Kanter, <i>Former Executive Vice President</i> <i>Managing Director</i>				
Lisa K. Klinger <i>Former Senior Vice President</i> <i>Finance and Treasurer</i>				

(1) The shares were valued on the June 4, 2008 vesting date for Mr. Cornell's restricted shares.

Pension Benefits

The Company has no pension plans.

Nonqualified Deferred Compensation for Fiscal 2008

The Company has no nonqualified deferred compensation plans.

Potential Payments Upon Termination Or Change In Control

The rights to payments upon termination or change in control of each of the Named Executive Officers is governed by agreements between such officer and the Company. Mr. Cornell's employment contract, which commenced June 4, 2007, specifies certain benefits that are payable to him in the event of termination. Mr. DeCaro, Executive Vice President - Supply Chain, as well as Messrs. Boyer, Bazzone and Kanter (each of whom separated from the Company during the first half of fiscal 2008), were parties to Change in Control Agreements entered into on April 26, 2006, which specified benefits upon termination on or prior to October 31, 2008 (the second anniversary of the Merger). Ms. Broader, Ms. Crowley, Mr. Aitken, Mr. DeCaro and Ms. Klinger, participate in the OSPP, adopted by the Board in April 2008 and amended in July 2008.

Rights and Potential Payments on Termination for Cause, Death, Disability and Voluntary Resignation

Cause. Each of the respective agreements and the OSPP provides that no payments or benefits are due to the Named Executive Officer in the event of a termination for cause except amounts accrued and payable to such executive through the termination date.

Death. In the event that a termination results from the death of an officer, each Named Executive Officer is provided a life insurance policy by the Company with a \$1 million benefit, which would be payable to the officer's beneficiaries. Under the Stockholders Agreement, upon any termination of a Named Executive Officer's employment by reason of the executive's death, the executive's estate has the option to sell to the Company all or any portion of the vested shares of the Common Stock owned by the Named Executive Officer within 60 days after the date of termination, at the fair market value of the shares as of the date they are repurchased. In addition, Mr. Cornell's unvested restricted stock and Ms. Broader's unvested restricted stock would vest, and had estimated values of \$284,664 and \$231,152, respectively, as of the last day of fiscal 2008.

Disability. In the event a Named Executive Officer becomes disabled, which causes his or her termination, the Company provides an executive long-term disability policy for the benefit of such executives which would provide disability benefits after 90 days in the amount of 67% of monthly compensation up to \$20,000 per month. This benefit generally continues until the disability is resolved or age 65. Mr. Cornell's employment agreement further provides that he would be paid his full salary for the 90 days prior to the commencement of disability benefits, which equates to \$246,575 (based on his fiscal 2008 base salary). Under the Stockholders Agreement, upon any termination of a Named Executive Officer's employment by reason of the executive's disability, the executive has the option to sell to the Company all or any portion of the vested shares of the Common Stock owned by the Named Executive Officer within 60 days after the date of termination, at the fair market value of the shares as of the date they are repurchased. In addition, Mr. Cornell's unvested restricted stock and Ms. Broader's unvested restricted stock would vest and had estimated values of \$284,664 and \$231,152, respectively, as of the last day of fiscal 2008.

Voluntary Resignation. In the event of a voluntary resignation of any of the Named Executive Officers, there are no payments or benefits that continue beyond what is accrued and payable through the termination date. Mr. Cornell's agreement states that he is required to give the Company 60 days prior written notice of resignation and the Board may, at its election, choose to waive Mr. Cornell's notice obligation but is still required to pay him for the applicable notice period. In connection with Mr. Cornell's notice of resignation on March 4, 2009, the Board waived a portion of the notice period and Mr. Cornell's resignation is to be effective April 2, 2009. Due to his voluntary resignation, Mr. Cornell will be paid his normal base salary through the effective date of his resignation and will be provided normal benefits through the effective date of his resignation.

Rights and Potential Payments Upon a Change in Control or Termination Without Cause or With Good Reason

Change in Control Agreements

Prior to the Merger, Michaels entered into Change in Control Agreements with Messrs. Boyer, Bazzone, DeCaro, and Kanter on April 26, 2006. Under the Change in Control Agreements, because a change in control (as defined in the Change in Control Agreements) occurred on October 31, 2006 as a result of the Merger, the executive became immediately entitled to the following benefits:

- Accelerated vesting of all equity-based compensation awards;
- Continued employment with Michaels in an equivalent position for two years following the change in control, unless earlier terminated;
- Base compensation, cash bonus awards, long-term incentive opportunities and retirement, welfare and fringe benefits for two years following the change in control (unless earlier terminated) at levels at least equal to the compensation and benefits received by the executive immediately prior to the change in control; and
- Comprehensive officer liability insurance coverage and continued indemnification rights.

Executives who are party to a Change in Control Agreement are also entitled to severance benefits if the executive's employment is terminated under certain circumstances after a change in control. Under the Change in Control Agreements, the Merger constituted a change in control, and an executive is entitled to those severance benefits if, during the two-year period after October 31, 2006, the executive is terminated without cause (termination with cause includes conviction of a felony involving moral turpitude or misappropriation of assets, fraud or willful misconduct that is materially detrimental to the Company, and willful and continued failure to perform the executive's duties) or resigns for good reason (which includes significant changes in an executive's duties, responsibilities or reporting relationships, failure to provide equivalent compensation and benefits and being required to relocate 50 or more miles). If terminated or separated from Michaels under those circumstances, the executive would be entitled to the following additional benefits under the Change in Control Agreement:

- a lump-sum cash severance payment equal to two times (three times for our then co-Presidents) the sum of (i) the executive's base salary in effect on the date of termination and (ii) the greater of the average annual incentive award for the previous three fiscal years and the target annual bonus for the year of termination;
- a prorated target annual bonus for the year of termination;
- the continuation of welfare and fringe benefits for two years (three years for our then co-Presidents) after termination of employment;

- the accelerated vesting of all equity-based compensation awards and the termination of any restrictions and forfeiture provisions related to such awards, except for stock options granted under the 2006 Equity Incentive Plan through the date of this filing;
- two additional years (three additional years for our then co-Presidents) of service credit (or payment in lieu) for purposes of computing the executive's accrued benefits under our Retirement Plans; and
- reimbursement for the cost of executive level outplacement services (subject to a \$50,000 ceiling).

In order to obtain severance benefits under a Change in Control Agreement, an executive must first execute a separation agreement with Michaels that includes a waiver and release of any and all claims against Michaels and a commitment that, for one year following termination, the executive will not solicit or hire any employee of Michaels or its subsidiaries and will not interfere with any relationship between Michaels and its employees, customers or suppliers. In addition to the foregoing, in accordance with the Change in Control Agreements, Michaels will make certain tax gross-up payments to address taxes, interest and penalties that may be imposed under applicable tax laws in connection with golden parachute payments and will reimburse the executive for certain legal fees and related expenses.

On October 31, 2008, the protection period under the Change in Control Agreements ended. None of the current executive officers of the Company, including Mr. DeCaro, have any existing rights to severance payments under the Change in Control Agreements. In fiscal year 2008, each of Messrs. Boyer, Bazzone and Kanter received severance payments under the Change in Control Agreements as a result of their separation from the Company prior to October 31, 2008.

Cornell Employment Agreement

Mr. Cornell joined the Company on June 4, 2007, and was not a party to a Change in Control Agreement. However, Mr. Cornell has an employment agreement that provides benefits to him in the event of a termination of his employment without cause or by him for good reason. In either circumstance, for the two-year period following the date of termination he would be entitled to receive a severance benefit equal to (i) his base salary at the rate in effect on the date of termination, (ii) the amount of his annual target bonus for the year of termination and (iii) continued medical benefits. These benefits are contingent on Mr. Cornell signing and returning to the Company a timely and effective release of claims in the form provided by the Company. The severance pay is payable on a pro-rated basis at the Company's regular payroll periods and in accordance with its normal payroll practices.

Pursuant to Mr. Cornell's agreement, cause shall mean the following events or conditions, as determined by the Board in its reasonable judgment: (i) the refusal or failure to perform (other than by reason of disability), or material negligence in the performance of, his duties and responsibilities to the Company or any of its Affiliates (as defined in Mr. Cornell's agreement), or refusal or failure to follow or carry out any reasonable direction of the Board, and the continuance of such refusal, failure or negligence for a period of 10 days after notice; (ii) the material breach of any provision of any material agreement between Mr. Cornell and the Company or any of its Affiliates; (iii) fraud, embezzlement, theft or other dishonesty with respect to the Company or any of its Affiliates; (iv) the conviction of, or plea of nolo contendere to any felony or any other crime involving dishonesty or moral turpitude; and (v) any other conduct that involves a breach of fiduciary obligation.

The term good reason is defined as (i) removal without Mr. Cornell's consent from the position of Chief Executive Officer, (ii) a material diminution in the nature or scope of his responsibilities, duties or authority which is not cured within a specified notice period but provided however that the Company's failure to continue Mr. Cornell's appointment or election as a director or officer of any of its Affiliates, a change in reporting relationships resulting from the direct or indirect control of the Company (or successor corporation) by another corporation or other entity and any diminution of the business of the Company or any of its Affiliates or any sale or transfer of equity, property or other assets of the Company or any of its Affiliates shall not constitute good reason; or (iii) the material failure of the Company to provide him the base salary and benefits in accordance with the terms of the agreement, excluding an inadvertent failure which is cured within a specified notice period.

In addition to an employment agreement, Mr. Cornell entered agreements providing for his restricted stock grant and his stock option grant. These agreements provide that in the event of a change in control, Mr. Cornell's restricted stock and stock options immediately vest. However, had a change of control occurred on the last day of fiscal year 2008, although vested, the stock options would have had no value because the lowest exercise price of \$15.00 per share was above the stock price as of such date.

Mr. Cornell is subject to confidentiality covenants. In addition, Mr. Cornell is subject to non-competition and non-solicitations restrictions for a period of two years following resignation. The employment agreement provides no change in control severance benefits.

On March 4, 2009, Mr. Cornell informed the Company that he would be resigning as Chief Executive Officer effective April 2, 2009. Any restricted shares or stock options held by Mr. Cornell that are unvested as of the effective date of his resignation, will be cancelled pursuant to the terms of the 2006 Equity Incentive Plan and Mr. Cornell's restricted stock and option agreements. Due to his voluntary resignation,

Mr. Cornell will be paid his normal base salary and will be provided normal benefits through the effective date of his resignation.

Officer Severance Pay Plan

In April 2008, the Board approved the OSPP, which was amended in July 2008. The OSPP was established by the Company to provide certain severance benefits, subject to the terms and conditions of the OSPP, to designated officers (those with a position of Vice President or above, or an equivalent title as approved by the Compensation Committee, and excluding the Chief Executive

Officer) in the event that their employment is permanently terminated as a result of a Qualifying Termination. For purposes of the OSPP, an executive is subject to a Qualifying Termination if:

- the executive is on active payroll or is on an approved leave of absence with a right to reinstatement at the time their employment terminates;
- the executive's employment is terminated by the Company other than for Cause (which includes a failure to perform - or material negligence in the performance of - the executive's duties, a material breach of a material agreement between the executive and the Company, fraud, embezzlement, theft, other dishonesty, the conviction of or plea of guilty or *nolo contendere* to a crime involving dishonesty of moral turpitude, breach of a fiduciary duty to the Company or violation of Company policy that inflicts damage to the Company) and other than a result of death or disability;
- the executive is not offered, nor has accepted, other employment with (1) an affiliate of the Company, (2) a successor of the Company, or (3) a purchaser of some or all of the assets of the Company: (a) in a position which the executive is qualified to perform regardless of whether the executive is subject to, among other things, a new job title, different reporting relationships or a modification of the executive's duties and responsibilities; (b) that, when compared with the executive's last position with the Company, provides a comparable base salary and bonus opportunity; and (c) there is no change in the executive's principal place of employment to a location more than 35 miles from the executive's principal place of employment immediately prior to the Qualifying Termination; and
- the executive continues employment until the termination date designated by the Company or such earlier date to which the Company agrees, and, during the period from the date the executive receives notice of termination until the termination date, the executive continues to perform to the reasonable satisfaction of the Company.

Executives subject to a Qualifying Termination are entitled to the following benefits:

- severance pay at the following levels: (i) for the position of Vice President with less than two years of service, six months of base salary continuation; (ii) for the position of Vice President with two or more years of service, twelve months of base salary continuation; (iii) for the position of Senior Vice President, Executive Vice President or President with less than two years of service, twelve months of base salary continuation; and (iv) for the position of Senior Vice President, Executive Vice President or President with two or more years of service, eighteen months of base salary continuation;
- a prorated target annual bonus for the year of termination; and

- the continuation of welfare and fringe benefits for the salary continuation period.

In order to obtain severance benefits under the OSPP, an executive must first execute a severance agreement and release with Michaels that includes a waiver and release of any and all claims against Michaels and a commitment that, for one year following termination, the executive will not solicit or hire any employee or distributor or vendor of Michaels or its subsidiaries and will not directly or indirectly compete with, or join an organization that directly or indirectly competes with, Michaels. Additionally, an executive officer will not be eligible for benefits under the OSPP if he or she is eligible for severance pay or other termination benefits (other than incidental perquisites such as continued use of a Company vehicle or an air travel allowance) under any other severance pay plan or under any employment agreement or other agreement with the Company or any of its affiliates.

Equity Plans

Each of the Named Executive Officers currently employed with the Company have entered into stock option agreements that provide for vesting upon a change in control. Additionally, Ms. Broader has a restricted stock agreement that provides that her restricted stock shall vest upon a change in control. However, had a change of control occurred on the last day of fiscal year 2008, although vested, the stock options would have had no value because the lowest exercise price of \$15.00 per share was above the stock price as of such date.

Estimated Separation Payments

The table below reflects the amount of compensation payable under Mr. Cornell's employment agreement (including his Stock Option Agreement and Restricted Stock Agreement) and under the OSPP described above to each of the Named Executive Officers other than Mr. Cornell as of the end of fiscal 2008 in the event of involuntary termination without cause or resignation for good reason. The amounts shown, except for Messrs. Boyer, Bazzone and Kanter and Ms. Klinger, assume that such termination was effective as of the last day of the prior fiscal year, January 31, 2009. For Messrs. Boyer, Bazzone and Kanter, the amounts shown are the actual amounts they were paid, or credited for, as a result of their separation from the Company during fiscal 2008. For Ms. Klinger, the amounts shown are the actual amounts she was paid, or credited for, as a result of her separation on February 20, 2009, as well as amounts expected to be paid for continuing benefits during her 18 month severance period pursuant to the OSPP. The actual amounts, or value, to be paid to the other Named Executive Officers can only be determined at the time of such executive's separation from the Company.

	Executive Payments and Benefits upon Termination Without Cause or by Executive with Good Reason (\$)
<i>Brian C. Cornell (1)</i>	
Salary	2,000,000
Bonus	2,000,000
Restricted Stock	284,664
Retirement Benefits	
Welfare Benefits	104,864(2)
Automobile	40,946(3)
Outplacement	
Tax Reimbursements	
Total	4,430,474
<i>Shelley G. Broader</i>	
Salary	625,000
Bonus	268,493
Restricted Stock	231,152
Retirement Benefits	
Welfare Benefits (4)	57,744
Automobile	
Tax Reimbursements	
Total	1,182,389
<i>Elaine D. Crowley</i>	
Salary	300,000
Bonus	69,041
Retirement Benefits	
Welfare Benefits (4)	57,587
Outplacement	
Tax Reimbursements	
Total	426,628
<i>Stuart W. Aitken</i>	
Salary	325,000
Bonus	162,500
Retirement Benefits	
Welfare Benefits (4)	57,655
Outplacement	
Tax Reimbursements	
Total	545,155

Edgar Filing: MICHAELS STORES INC - Form 10-K

Thomas C. DeCaro	
Salary	522,717
Bonus	174,239
Retirement Benefits	
Welfare Benefits (4)	86,523
Outplacement	
Tax Reimbursements	
Total	783,479
Jeffrey N. Boyer	
Salary	1,921,876
Bonus	1,421,486(5)
Retirement Benefits (6)	100,301
Welfare Benefits (7)	14,062
Automobile	82,700(8)
Outplacement	
Tax Reimbursements	1,464,926
Total	5,005,351(9)
Thomas M. Bazzone	
Salary	748,408
Bonus	451,608(10)
Retirement Benefits (6)	36,000
Welfare Benefits (7)	31,835
Outplacement	25,000
Tax Reimbursements	530,706
Total	1,823,557
Harvey S. Kanter	
Salary	762,306
Bonus	440,153(11)
Retirement Benefits (6)	36,074
Welfare Benefits (7)	42,760
Outplacement	25,000
Tax Reimbursements	5,491
Total	1,311,784(12)
Lisa K. Klinger	
Salary	405,000
Bonus	5,940(13)
Retirement Benefits	
Welfare Benefits (14)	86,529
Outplacement	
Tax Reimbursements	
Total	497,469

-
- (1) On March 4, 2009, Mr. Cornell informed the Company that he would be resigning as Chief Executive Officer effective April 2, 2009. Because his resignation will be a voluntary resignation other than for good reason, Mr. Cornell will not be eligible for the compensation set forth in the above table.
 - (2) Represents estimated cost of two years of continued benefits, including medical, long-term disability, life insurance, and executive and spouse physicals.
 - (3) Represents personal use of automobile for 24 months.
 - (4) Represents the value of total fiscal 2008 medical, dental and vision actual costs plus a 15% trend factor of benefits for the number of years of severance for each of Ms. Broader, Ms. Crowley, Mr. Aitken and Mr. DeCaro, as applicable.

(5) Includes \$76,173 for prorated fiscal 2008 bonus.

Edgar Filing: MICHAELS STORES INC - Form 10-K

- (6) Calculated as 3% of total payment of base salary and bonus payments for Company matching contribution to retirement plans.
- (7) Represents continued benefits, including medical, long-term disability, life insurance, and executive and spouse physicals, office equipment, reimbursement for legal expenses, and, in the case of Mr. Boyer, the cost attributable to miscellaneous gifts by Mr. Boyer paid for by the Company. For a further description of these benefits see footnote 3 to the Summary Compensation Table.
- (8) Represents a company-owned vehicle valued at \$79,200 and \$3,500 for the remaining value owed to Mr. Boyer pursuant to Company's Policy Regarding Company Cars.
- (9) Excludes \$1,000,000 that the Company paid to Mr. Boyer to acquire shares of his Common Stock (see Share Repurchase Rights below).
- (10) Includes \$77,404 for prorated fiscal 2008 bonus.
- (11) Includes \$59,000 for prorated fiscal 2008 bonus.
- (12) Excludes \$300,000 that the Company paid to Mr. Kanter to acquire shares of his Common Stock (see Share Repurchase Rights below).
- (13) Represents \$5,940 for prorated fiscal 2009 bonus pursuant to the OSPP.
- (14) Represents \$1,200 paid to Ms. Klinger for welfare benefits on the termination date and \$85,059 for the value of total fiscal 2008 medical, dental and vision actual costs plus a 15% trend factor of benefits expected to be paid during her 18 month severance period pursuant to the OSPP.

Share Repurchase Rights

Under the Stockholders Agreement, upon any termination of a Named Executive Officer's employment by reason of the executive's death or disability, the executive or his/her estate has the option to sell to the Company all or any portion of the vested shares of the Common Stock owned by the Named Executive Officer within 60 days after the date of termination, at the fair market value of the shares as of the date they are repurchased.

Upon termination of a Named Executive Officer's employment for any reason, the Company has the option to purchase all or any portion of the executive's shares that were originally purchased from the Company, at the fair market value of the shares. If the Company elects to purchase the executive's shares, it must deliver notice to the executive no later than 240 days after (but not before the date that is one day after the six-month anniversary of) the later of (i) the date of termination or (ii) the exercise of any option originally granted to the executive or the date upon which any unvested shares granted to the executive become vested shares. With respect to those shares issued to a Named Executive Officer directly or indirectly pursuant to an incentive plan, the Company may purchase all or any portion of the executive's shares at the fair market value of the shares (upon delivery of the notice as described in the immediately preceding sentence), if the executive's employment is terminated due to death, disability, by the Company without cause or by the executive for good reason (or in circumstances in which the Company would have no grounds to terminate the executive for cause). If the Named Executive Officer's employment is terminated by the Company for cause, the Company may purchase all or any portion of the executive's shares at the lesser of the cost or the fair market value of the shares.

Assuming a repurchase of the shares on the last day of fiscal 2008, the Named Executive Officers (or their estates) would have received the following amounts for their shares: Brian C. Cornell, \$1,138,668; Shelley G. Broader, \$231,152; Elaine D. Crowley, \$0; Stuart W. Aitken, \$0; Thomas C. DeCaro, \$113,868; Jeffrey N. Boyer, \$1,000,000, which is the actual amount he was paid for his shares upon separation from the Company on April 4, 2008; Thomas M. Bazzone, \$0; Harvey S. Kanter, \$300,000, which is the actual amount he was paid for his shares upon separation from the Company on May 25, 2008; and Lisa K. Klinger, \$22,776.

Director Compensation for Fiscal 2008

The current directors are not paid any fees for services as directors and they do not receive reimbursement for their expenses.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

PRINCIPAL STOCKHOLDERS AND MANAGEMENT OWNERSHIP

Edgar Filing: MICHAELS STORES INC - Form 10-K

The following table presents information regarding the number of shares of Michaels Common Stock beneficially owned as of March 30, 2009 (unless otherwise indicated) by each of Michaels' directors and the Named Executive Officers (as defined in Item 11. Executive Compensation Compensation Discussion and Analysis Executive and Director Compensation Summary Compensation Table), and the current directors and executive officers of Michaels as a group. In addition, the table presents information about each person or entity known to Michaels to beneficially own 5% or more of Michaels Common Stock. Unless otherwise indicated by footnote, the beneficial owner exercises sole voting and investment power over the shares noted below. The percentage of beneficial ownership for our directors and executive officers, both individually and as a group, is calculated based on 120,975,951 shares of Michaels Common Stock outstanding as of March 30, 2009. Other than beneficial ownership information relating to the Company's executive officers, the beneficial ownership information set forth below was provided by or on behalf of our Directors, our Sponsors, and Highfields, and the Company has not independently verified the accuracy or completeness of the information so provided.

Name of Beneficial Owner	Amount and Nature of Beneficial Ownership (1)	Percent of Class (1)
Josh Bekenstein		*
Michaels S. Chae		*
Todd Cook		*
Lewis Klessel		*
Matthew S. Levin		*
Gerry Murphy		*
James A. Quella		*
Peter Wallace		*
Brian C. Cornell	1,175,053(4)	*
Shelley G. Broader	54,134	*
Elaine D. Crowley		*
Stuart W. Aitken	56,774(5)	*
Thomas C. Decaro	208,343(6)	*
Jeffrey N. Boyer	(7)	*
Thomas M. Bazzone	(8)	*
Harvey S. Kanter	(9)	*
Lisa K. Klinger	118,882(10)	*
Michaels Holdings, LLC (2) (3)	110,373,482	91.2%
Bain Capital Investors, LLC and related funds (2)	110,373,482	91.2%
Affiliates of The Blackstone Group, L.P. (3)	110,373,482	91.2%
Highfields Capital Management, L.P. and related funds (11)	7,333,250	6.1%
All current directors and executive officers as a group (19 persons)	2,078,000(12)	1.7%

* Less than one percent.

(1) Pursuant to Rule 13d-3 under the Securities Exchange Act of 1934, a person has beneficial ownership of any securities as to which such person, directly or indirectly, through any contract, arrangement, undertaking, relationship or otherwise has or shares voting power and/or investment power or as to which such person has the right to acquire such voting and/or investment power within 60 days. Percentage of beneficial ownership by a person as of a particular date is calculated by dividing the number of shares beneficially owned by such person by the sum of the number of shares outstanding as of such date and the number of unissued shares as to which such person has the right to acquire voting and/or investment power within 60 days. Unless otherwise indicated, the number of shares shown includes outstanding shares of Common Stock owned as of March 30, 2009 by the person indicated.

(2) Includes the 110,373,482 shares owned by Michaels Holdings LLC over which Bain Capital Investors, LLC and related funds may be deemed, as a result of their ownership of 50% of Michaels Holdings LLC's total outstanding shares and certain

Edgar Filing: MICHAELS STORES INC - Form 10-K

provisions of Michaels Holdings LLC's operating agreement, to have shared voting and dispositive power. Bain Capital Investors, LLC (BCI) is the administrative member of and makes investment and voting decisions on behalf of Bain Capital Integral Investors 2006, LLC. Investment and voting decisions by BCI are made jointly by three or more individuals who are managing directors of the entity, and therefore no individual managing director of BCI is the beneficial owner of the shares ultimately of Michaels Common Stock directly owned by Michaels Holdings LLC. Messrs. Bekenstein, Cook and Levin are Managing Directors and Members of BCI, and they may therefore be deemed to share voting and dispositive power with respect to all the shares of Common Stock beneficially owned by Bain Capital Integral Investors 2006, LLC. Messrs. Bekenstein, Cook and Levin disclaim beneficial ownership of any shares beneficially owned by BCI. Mr. Klessel does not have voting or dispositive power over any shares of Common Stock that may be deemed to be beneficially owned by BCI. The address of Messrs. Bekenstein, Cook and Levin, and each of the Bain entities is c/o Bain Capital Partners, LLC, 111 Huntington Avenue, Boston, Massachusetts 02199.

(3) Includes the 110,373,482 shares owned by Michaels Holdings LLC over which affiliates of The Blackstone Group L.P. may be deemed, as a result of their ownership of 50% of Michaels Holdings LLC's total outstanding shares and certain provisions of Michaels Holdings LLC's operating agreement, to have shared voting and dispositive power. Affiliates of The Blackstone Group L.P. include Blackstone Capital Partners V L.P., BCP V-S L.P., Blackstone Family Investment Partnership V L.P., Blackstone Family Investment Partnership V-A L.P., Blackstone Participation Partnership V L.P. and BCP V Co-Investors L.P. (collectively, the Blackstone Funds). Blackstone Management Associates V L.L.C. (BMA V) is the general partner of each of the Blackstone Funds. BMA V L.L.C. (BMA) is the sole member of BMA V, and may, therefore, be deemed to have shared voting and investment power over the shares. Investment and voting decisions by BMA are made jointly by three or more individuals who are managing directors, and therefore no individual managing director of BMA is the beneficial owner of the shares of Michaels Common Stock directly owned by Michaels Holdings LLC. Messrs. Chae, Murphy and Quella are members of BMA, and they may therefore be deemed to share voting and dispositive power with respect to the shares. Messrs. Chae, Murphy and Quella disclaim any beneficial ownership of any shares beneficially owned by BMA. Mr. Wallace does not have voting or dispositive power over any shares of Common Stock that may be deemed beneficially owned by Blackstone. The address of Messrs. Chae, Murphy and Quella, and each of the Blackstone entities is c/o The Blackstone Group, L.P., 345 Park Avenue, New York, New York 10154.

(4) Includes 454,193 stock options that vested on February 16, 2008 and 454,193 stock options that vested on February 16, 2009.

(5) Includes 56,774 stock options that vested on December 18, 2008.

(6) Includes 90,838 stock options that vested on February 16, 2008 and 90,838 stock options that vested on February 16, 2009.

(7) Mr. Boyer separated from the Company on April 4, 2008.

(8) Mr. Bazzone separated from the Company on July 2, 2008.

(9) Mr. Kanter separated from the Company on May 25, 2008.

Edgar Filing: MICHAELS STORES INC - Form 10-K

(10) Includes 56,774 stock options that vested on February 16, 2008 and 56,774 stock options that vested on February 16, 2009. Ms. Klinger separated from the Company on February 20, 2009. Pursuant to the terms of the 2006 Equity Incentive Plan, she has 60 days from such date to exercise her vested options.

(11) The address of Highfields Capital Management, LP and its related funds is 200 Clarendon Street, Boston, Massachusetts 02116.

(12) Consistent with the disclaimers of beneficial ownership of Messrs. Bekenstein, Cook, Levin, Chae, Murphy and Quella contained in notes (2) and (3) above, this number does not include the 110,373,482 shares of Michaels Common Stock that may be deemed to be beneficially owned by each of (a) Bain Capital Investors, LLC and related funds and (b) Affiliates of The Blackstone Group. The total includes 1,691,866 vested options held by executive officers of the Company.

EQUITY COMPENSATION PLAN INFORMATION

Edgar Filing: MICHAELS STORES INC - Form 10-K

On February 15, 2007, the Board of Directors and stockholders approved the 2006 Equity Incentive Plan, as well as certain specific grants under the plan to key employees. In addition, the stockholders granted the Board authority to make plan grants to other eligible participants in the future, which has occurred. The following table gives information about equity awards under the above-mentioned plan as of March 30, 2009.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	10,287,462	\$ 26.25	3,869,504
Equity compensation not approved by security holders	N/A	N/A	N/A
Total	10,287,462	\$ 26.25	3,869,504

ITEM 13. Certain Relationships and Related Transactions, and Director Independence.

We pay an annual management fee to the Sponsors in the amount of \$12 million and an annual management fee to Highfields Capital Management LP in the amount of \$1 million.

We have a participation agreement with CoreTrust Purchasing Group (CPG), which designates CPG as our exclusive supplier of certain non-merchandise supplies and equipment. In exchange, we are offered non-merchandise supplies and equipment from a variety of vendors at a pre-determined price. We do not pay any fees to participate in this group arrangement, and we can terminate our participation at any time prior to the expiration of the agreement without penalty. The vendors separately pay fees to CPG for access to CPG s consortium of customers. The Blackstone Group, one of our Sponsors, entered into an agreement with CPG whereby The Blackstone Group receives a portion of the gross fees vendors pay to CPG based on the volume of purchases made by us and other participants.

Bain Capital owns an approximate 55% ownership stake in an external vendor we utilize to print our circular advertisements. Payments associated with this vendor during fiscal 2008 were \$43.5 million. We currently anticipate that our payments to this vendor in fiscal 2009 will be commensurate with those in fiscal 2008.

The Blackstone Group owns an approximate 65% interest in an external vendor we utilize to count our store inventory. Payments associated with this vendor during fiscal 2008 were \$5.6 million. We currently anticipate that our payments to this vendor in fiscal 2009 will be \$7.5 million.

Bain Capital owns an approximate 26% ownership stake in an external vendor we utilize for non-merchandise supplies. Payments associated with this vendor during fiscal 2008 were approximately \$2.8 million. We currently anticipate that our payments to this vendor in fiscal 2009 will be commensurate with those in fiscal 2008.

During the first quarter of fiscal 2008, The Blackstone Group acquired an approximate 72% ownership stake in an external vendor we utilize for all of the candy-type items in our stores. Payments associated with this vendor during fiscal 2008 were \$18.3 million. We currently anticipate that our payments to this vendor in fiscal 2009 will be commensurate with those in fiscal 2008.

During the second quarter of fiscal 2008, the Company entered into an agreement with Equity Healthcare LLC (Equity Healthcare), an affiliate of The Blackstone Group, who negotiates with providers of standard administrative services for health benefit plans and related services. Equity Healthcare also provides quality of service monitoring. Because of the combined purchasing power of its client participants, Equity Healthcare is able to negotiate pricing terms for providers that are believed to be more favorable than the companies could obtain for themselves on an individual basis. For this service, Equity Healthcare receives a fee of \$2 per employee per month (PEPM Fee) from the Company. As the Company had 6,793 employees enrolled in health and welfare benefit plans as of January 2009, the annual amount payable by the Company under the agreement would be \$0.2 million.

Equity Healthcare may also receive a fee from one or more of the health plans that have entered into a contract with Equity Healthcare (Health Plan Fees) if the total number of employees from The Blackstone Group portfolio companies (which includes the Company) joining such health plans exceeds specified thresholds. If and when Equity Healthcare reaches the point at which the aggregate of its receipts from the PEPM Fee and the Health Plan Fees have covered all of its allocated costs, it will apply the incremental revenues derived from all such fees to (a) reduce the PEPM Fee; (b) avoid or reduce an increase in the PEPM Fee that might otherwise occur on renewal of the agreement between Equity Healthcare and the Company; or (c) arrange for additional services to the Company at no cost or reduced cost.

The Blackstone Group owns an approximate 6% ownership stake in an external vendor we utilize for waste management services. Payments associated with this vendor during fiscal 2008 were \$3.4 million. We currently anticipate that our payments to this vendor in fiscal 2009 will be \$5.5 million.

The Blackstone Group owns an approximate 99% ownership stake in an external vendor we utilize as our preferred hotel provider. Payments associated with this vendor during fiscal 2008 were \$0.4 million. We currently anticipate that our payments to this vendor in fiscal 2009 will be commensurate with those in fiscal 2008.

The Blackstone Group owns an approximate 13% ownership stake in an external vendor we utilize for certain integrated software and processing services. Payments associated with this vendor during fiscal 2008 were \$0.2 million. We currently anticipate that our payments to this vendor in fiscal 2009 will be commensurate with those in fiscal 2008.

Our current directors are affiliates of Bain Capital or The Blackstone Group. As such, some or all of our directors may have an indirect material interest in payments with respect to debt securities of the Company that have been purchased, or for which transactions are pending, by affiliates of Bain Capital and The Blackstone Group. As of the date hereof, such affiliates beneficially own or will own approximately \$233.3 million face amount of our Subordinated Discount Notes due 2016.

The Company has not adopted any formal policies or procedures for the review, approval or ratification of certain related-party transactions that may be required to be reported under the SEC disclosure rules. Such transactions, if and when they are proposed or have occurred, have traditionally been (and will continue to be) reviewed by our Board on a case-by-case basis. The Board may consider any relevant factors when reviewing the appropriateness of a related-party transaction, including (i) the importance of the transaction to the Company, (ii) the amount involved in the proposed transaction, (iii) the specific interest of the director or executive officer (or immediate family members of same) in the proposed transaction, and (iv) the overall fairness of the terms of the transaction to the Company.

As discussed in Item 10 above, no current director of our Board is deemed to be independent under our previously adopted independence standards. See Item 10. Directors and Executive Officers of the Registrant.

ITEM 14. Principal Accountant Fees and Services.

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM S FEES

Edgar Filing: MICHAELS STORES INC - Form 10-K

The following table presents fees for professional audit services rendered by Ernst & Young LLP for the audit of Michaels' annual financial statements for each of fiscal 2008 and 2007, and fees billed for other services rendered by Ernst & Young LLP (in thousands).

	2008		2007
Audit Fees (1)	\$ 1,190	\$	1,258
Audit-Related Fees (2)	54		45

(1) Audit Fees consist principally of fees for the audit of our annual financial statements and review of our financial statements included in our quarterly reports on Form 10-Q for those years, audit services provided in connection with compliance with the requirements of the Sarbanes-Oxley Act of 2002, and fees incurred in connection with the filing of registration statements with the SEC.

(2) Audit-Related Fees for fiscal 2008 and fiscal 2007 consist principally of fees related to employee benefit plans and statutory audits.

The Audit Committee Charter requires that the Audit Committee pre-approve all audit and non-audit engagements, fees, terms and services in a manner consistent with the Sarbanes-Oxley Act of 2002 and all rules and applicable listing standards promulgated by the SEC, except that such non-audit services need not be pre-approved if (i) the aggregate amount of all such non-audit services provided to Michaels constitutes not more than 5% of the total amount of fees paid by Michaels to its independent registered public accounting firm during the fiscal year in which the non-audit services are provided, (ii) such services were not recognized by Michaels at the time of engagement to be non-audit services, and (iii) such services were promptly brought to the attention of the Audit Committee and approved by the Audit Committee prior to completion of the audit. The Audit Committee Charter permits the Audit Committee, at the time of the annual audit engagement, to pre-approve audit fees of up to 15% of the engagement fees for unanticipated additional audit costs within the scope of the audit. Any additional audit fees must be approved by the Chairman of the Audit Committee or any other member of the Audit Committee to whom the Audit Committee delegates such authority. The Audit Committee may delegate the authority to grant any pre-approvals to one or more members of the Audit Committee, provided that such member(s) reports any pre-approvals to the Audit Committee at its next scheduled meeting. The services performed by Ernst & Young LLP in fiscal 2008 and 2007 were approved in accordance with the policies and procedures established by the Audit Committee.

PART IV

ITEM 15. Exhibits and Financial Statement Schedules.

a) The following documents are filed as a part of this report:

(1) Consolidated Financial Statements:

See Index to Consolidated Financial Statements and Supplementary Data on page F-1.

(2) Exhibits:

The exhibits listed below and on the accompanying Index to Exhibits immediately following the financial statement schedules are filed or incorporated by reference into this Annual Report on Form 10-K.

EXHIBIT INDEX

Exhibit Number	Description of Exhibit
2.1	Agreement and Plan of Merger, dated as of June 30, 2006, among Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC, Blackstone Paste Finco, LLC and Michaels Stores, Inc. (previously filed as Exhibit 2.1 to Form 8-K filed by Registrant on July 6, 2006, SEC File No. 001-09338).
2.2	First Amendment to Agreement and Plan of Merger, dated as of September 1, 2006, among Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC, Blackstone Paste Finco, LLC and Michaels Stores, Inc. (previously filed as Exhibit 2.1 to Form 8-K filed by Registrant on September 5, 2006, SEC File No. 001-09338).
3.1	Amended and Restated Certificate of Incorporation of Michaels Stores, Inc. (previously filed as Exhibit 3.1 to Form 10-K filed by Registrant on May 3, 2007, SEC File No. 001-09338).
3.2	Amended and Restated Bylaws of Michaels Stores, Inc. (previously filed as Exhibit 3.2 to Form 8-K filed by Registrant on November 6, 2006, SEC File No. 001-09338).
4.1	Senior Indenture, dated as of October 31, 2006, among Michaels Stores, Inc., the guarantors named therein and Wells Fargo Bank, National Association, as trustee (previously filed as Exhibit 4.1 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
4.2	Senior Subordinated Indenture, dated as of October 31, 2006, among Michaels Stores, Inc., the guarantors named therein and Wells Fargo Bank, National Association, as trustee (previously filed as Exhibit 4.2 to Form 10-Q filed by Registrant on

Edgar Filing: MICHAELS STORES INC - Form 10-K

December 7, 2006, SEC File No. 001-09338).

- 4.3 Subordinated Discount Indenture, dated as of October 31, 2006, among Michaels Stores, Inc., the guarantors named therein and Wells Fargo Bank, National Association, as trustee (previously filed as Exhibit 4.3 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
- 4.4 Registration Rights Agreement, dated as of October 31, 2006, among Michaels Stores, Inc. and certain stockholders thereof (previously filed as Exhibit 4.7 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
- 10.1 Michaels Stores, Inc. 2006 Equity Incentive Plan (previously filed as Exhibit 10.1 to Form 8-K filed by Registrant on February 21, 2007, SEC File No. 001-09338).*
- 10.2 Form of Stock Option Agreement under the Registrant's 2006 Equity Incentive Plan (previously filed as Exhibit 10.2 to Form 8-K filed by Registrant on February 21, 2007, SEC File No. 001-09338).*
- 10.3 Form of Restricted Stock Award Agreement under the Michaels Stores, Inc. 2006 Equity Incentive Plan (previously filed as Exhibit 10.3 to Form 10-Q filed by the Registrant on June 6, 2008, SEC File No. 001-09338).*
- 10.4 Form of Change in Control Severance Agreement (previously filed as Exhibit 10.2 to Form 10-Q filed by Registrant on June 13, 2006, SEC File No. 001-09338).*

Edgar Filing: MICHAELS STORES INC - Form 10-K

- 10.5 Form of Change in Control Retention Bonus Plan (previously filed as Exhibit 10.3 to Form 10-Q filed by Registrant on June 13, 2006, SEC File No. 001-09338).*
- 10.6 Fiscal Year 2008 Bonus Plan Summary for Executive Officers (previously filed as Exhibit 10.1 to Form 8-K filed by Registrant on April 9, 2008, SEC File No. 001-09338).*
- 10.7 Form of Fiscal Year 2008 Bonus Plan (previously filed as Exhibit 10.1 to Form 10-Q filed by Registrant on June 6, 2008, SEC File No. 001-09338).*
- 10.8 Employment Agreement, dated June 4, 2007, between Michaels Stores, Inc. and Brian C. Cornell (previously filed as Exhibit 10.2 to Form 10-Q filed by Registrant on June 11, 2007, SEC File No. 001-09338).*
- 10.9 Letter Agreement, dated May 19, 2008, between Michaels Stores, Inc. and Shelley G. Broader (previously filed as Exhibit 10.4 to Form 10-Q filed by Registrant on June 6, 2008, SEC File No. 001-09338).*
- 10.10 Letter Agreement dated July 17, 2008, between Michaels Stores, Inc. and Elaine D. Crowley (previously filed as Exhibit 99.2 to Form 8-K filed by Registrant on July 24, 2008, SEC File No. 001-09338).*
- 10.11 Restricted Stock Award Agreement, dated June 4, 2007, between Michaels Stores, Inc. and Brian C. Cornell (previously filed as Exhibit 10.4 to Form 10-Q filed by Registrant on June 11, 2007, SEC File No. 001-09338).*
- 10.12 Stock Option Agreement, dated June 4, 2007, between Michaels Stores, Inc. and Brian C. Cornell (previously filed as Exhibit 10.5 to Form 10-Q filed by Registrant on June 11, 2007, SEC File No. 001-09338).*
- 10.13 Stockholders Agreement, dated as of October 31, 2006, among Michaels Stores, Inc. and certain stockholders thereof (previously filed as Exhibit 10.1 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
- 10.14 Amended and Restated Stockholders Agreement, dated as of February 16, 2007, among Michaels Stores, Inc. and certain stockholders thereof (previously filed as Exhibit 10.23 to Form 10-K filed by Registrant on May 3, 2007, SEC File No. 001-09338).
- 10.15 Management Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Bain Capital Partners, LLC and Blackstone Management Partners V LLC (previously filed as Exhibit 10.2 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).*
- 10.16 Management Agreement, dated as of October 31, 2006, between Michaels Stores, Inc. and Highfields Capital Management LP (previously filed as Exhibit 10.3 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).*
- 10.17 Michaels Stores, Inc. Amended Officer Severance Pay Plan (filed herewith).*
- 10.18 Separation and Release Agreement, dated April 9, 2008, between Michaels Stores, Inc. and Jeffrey N. Boyer (filed herewith).*
- 10.19 Separation and Release Agreement, dated May 27, 2008, between Michaels Stores, Inc. and Harvey S. Kanter (previously filed as Exhibit 10.5 to Form 10-Q filed by Registrant on June 6, 2008, SEC File No. 001-09338).*
- 10.20 Separation Agreement and Release, dated July 2, 2008, between Michaels Stores, Inc. and Thomas M. Bazzone (previously filed as Exhibit 10.5 to Form 8-K filed by Registrant on July 9, 2008, SEC File No. 001-09338).*
- 10.21 Separation Agreement, dated October 31, 2006, between Charles J. Wyly, Jr. and Michaels Stores, Inc. (previously filed as Exhibit 10.27 to Form 10-K filed by Registrant on May 3, 2007, SEC File No. 001-09338).*
- 10.22 Separation Agreement, dated October 31, 2006, between Sam Wyly and Michaels Stores, Inc. (previously filed as Exhibit 10.28 to Form 10-K filed by Registrant on May 3, 2007, SEC File No. 001-09338).*
- 10.23 Form of Director Indemnification Agreement between Michaels Stores, Inc. and certain directors thereof (previously filed as Exhibit 10.36 to Form 10-K filed by Registrant on March 30, 2006, SEC File No. 001-09338).

Edgar Filing: MICHAELS STORES INC - Form 10-K

- 10.24 Form of Officer Indemnification Agreement between Michaels Stores, Inc. and certain officers thereof (previously filed as Exhibit 10.37 to Form 10-K filed by Registrant on March 30, 2006, SEC File No. 001-09338).
- 10.25 Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., as lead borrower, the facility

Edgar Filing: MICHAELS STORES INC - Form 10-K

guarantors named therein, Bank of America, N.A., as administrative agent and collateral agent, Deutsche Bank Securities Inc., as syndication agent, Credit Suisse, JPMorgan Chase Bank, N.A., Wells Fargo Retail Finance, LLC, as co-documentation agents, the lenders named therein, and Banc of America Securities LLC, Deutsche Bank Securities Inc. and J.P. Morgan Securities Inc., as joint lead arrangers and joint bookrunners (previously filed as Exhibit 10.4 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).

- 10.26 Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Deutsche Bank AG New York Branch, as administrative agent, the other lenders named therein, JPMorgan Chase Bank, N.A., as syndication agent, and Bank of America, N.A. and Credit Suisse, as co-documentation agents, and Deutsche Bank Securities Inc., J.P. Morgan Securities Inc. and Banc of America Securities LLC as co-lead arrangers and joint bookrunners (previously filed as Exhibit 10.5 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
- 10.27 First Amendment to Credit Agreement, dated as of January 19, 2007, to the Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Deutsche Bank AG New York Branch, as administrative agent, the other lenders named therein, JPMorgan Chase Bank, N.A., as syndication agent, and Bank of America, N.A. and Credit Suisse, as co-documentation agents, and Deutsche Bank Securities Inc., J.P. Morgan Securities Inc. and Banc of America Securities LLC as co-lead arrangers and joint bookrunners (previously filed as Exhibit 10.1 to Form 8-K filed by Registrant on January 25, 2007, SEC File No. 001-09338).
- 10.28 Second Amendment to Credit Agreement, dated as of May 10, 2007, to the Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Deutsche Bank AG New York Branch, as administrative agent, the other lenders named therein, JPMorgan Chase Bank, N.A., as syndication agent, and Bank of America, N.A. and Credit Suisse, as co-documentation agents, and Deutsche Bank Securities Inc., J.P. Morgan Securities Inc. and Banc of America Securities LLC as co-lead arrangers and joint bookrunners (previously filed as Exhibit 10.1 to Form 8-K filed by Registrant on May 11, 2007, SEC File No. 001-09338).
- 10.29 Master Services Agreement, dated as of January 16, 2009, by and between Michaels Stores, Inc. and Tata America International Corporation (filed herewith).
- 10.30 Michaels Stores, Inc. Employees 401(k) Plan, effective March 1, 2009 (filed herewith).*
- 21.1 Subsidiaries of Michaels Stores, Inc. (previously filed as Exhibit 21.1 to Form 10-K filed by Registrant on April 11, 2005, SEC File No. 001-09338).
- 23.1 Consent of Independent Registered Public Accounting Firm (filed herewith).
- 31.1 Certifications of Brian C. Cornell pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
- 31.2 Certifications of Elaine D. Crowley 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).

* Management contract or compensatory plan or arrangement required to be filed as an exhibit to this Annual Report on Form 10-K.

MICHAELS STORES, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following Consolidated Financial Statements of Michaels Stores, Inc. are included in response to Item 8:

<u>Reports of Independent Registered Public Accounting Firm</u>	F-2
<u>Consolidated Balance Sheets at January 31, 2009 and February 2, 2008</u>	F-4
<u>Consolidated Statements of Operations for the fiscal years ended January 31, 2009, February 2, 2008, and February 3, 2007</u>	F-5
<u>Consolidated Statements of Cash Flows for the fiscal years ended January 31, 2009, February 2, 2008, and February 3, 2007</u>	F-6
<u>Consolidated Statements of Stockholders' (Deficit) Equity for the fiscal years ended January 31, 2009, February 2, 2008, and February 3, 2007</u>	F-7
<u>Notes to Consolidated Financial Statements for the fiscal years ended January 31, 2009, February 2, 2008, and February 3, 2007</u>	F-8
<u>Unaudited Supplemental Quarterly Financial Data for the fiscal years ended January 31, 2009 and February 2, 2008</u>	F-37

All schedules have been omitted because they are not applicable or the required information is included in the financial statements or the notes thereto.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Michaels Stores, Inc.

We have audited the accompanying consolidated balance sheets of Michaels Stores, Inc. as of January 31, 2009 and February 2, 2008, and the related consolidated statements of operations, stockholders' (deficit) equity, and cash flows for each of the three years in the period ended January 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Michaels Stores, Inc. at January 31, 2009 and February 2, 2008 and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 31, 2009, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 7 to the consolidated financial statements, in fiscal 2007, the Company changed its method of accounting for income tax uncertainties.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Michaels Stores, Inc.'s internal control over financial reporting as of January 31, 2009, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 1, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, TX

April 1, 2009

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Michaels Stores, Inc.

We have audited Michaels Stores, Inc.'s internal control over financial reporting as of January 31, 2009, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Michaels Stores, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management Report on Internal Control over Financial Reporting (see Item 9A). Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Michaels Stores, Inc. maintained, in all material respects, effective internal control over financial reporting as of January 31, 2009, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Michaels Stores, Inc. as of January 31, 2009 and February 2, 2008, and the related consolidated statements of operations, stockholders' (deficit) equity, and cash flows for each of the three years in the period ended January 31, 2009 of Michaels Stores, Inc. and our report dated April 1, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, TX

April 1, 2009

F-3

MICHAELS STORES, INC.
CONSOLIDATED BALANCE SHEETS

(In millions except share data)

	January 31, 2009	February 2, 2008
ASSETS		
Current assets:		
Cash and equivalents	\$ 33	\$ 29
Merchandise inventories	900	845
Prepaid expenses and other	73	70
Deferred income taxes	41	31
Income tax receivable	2	5
Total current assets	1,049	980
Property and equipment, at cost	1,214	1,155
Less accumulated depreciation	(832)	(722)
	382	433
Goodwill	94	94
Debt issuance costs, net of accumulated amortization of \$39 and \$22, respectively	86	103
Deferred income taxes	12	
Other assets	2	4
	194	201
Total assets	\$ 1,625	\$ 1,614
LIABILITIES AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	\$ 230	\$ 221
Accrued liabilities and other	275	332
Current portion of long-term debt	173	122
Income taxes payable	2	
Current liabilities - discontinued operations	1	4
Total current liabilities	681	679
Long-term debt	3,756	3,741
Deferred income taxes		4
Other long-term liabilities	74	80
Long-term liabilities - discontinued operations	1	2
Total long-term liabilities	3,831	3,827
	4,512	4,506
Commitments and contingencies		
Stockholders deficit:		
Common Stock, \$0.10 par value, 220,000,000 shares authorized; 118,376,402 shares issued and outstanding at January 31, 2009; 118,421,069 shares issued and outstanding at February 2, 2008	12	12
Additional paid-in capital	27	12
Accumulated deficit	(2,931)	(2,926)
Accumulated other comprehensive income	5	10
Total stockholders deficit	(2,887)	(2,892)
Total liabilities and stockholders deficit	\$ 1,625	\$ 1,614

See accompanying Notes to Consolidated Financial Statements.

MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions)

	2008	Fiscal Year 2007	2006
Net sales	\$ 3,817	\$ 3,862	\$ 3,843
Cost of sales and occupancy expense	2,431	2,383	2,364
Gross profit	1,386	1,479	1,479
Selling, general, and administrative expense	1,060	1,051	1,023
Transaction expenses		29	205
Goodwill impairment		22	
Related party expenses	16	17	38
Store pre-opening costs	6	6	5
Operating income	304	354	208
Interest expense	302	378	105
Other (income) and expense, net	4	(7)	(12)
(Loss) income before income taxes and discontinued operations	(2)	(17)	115
Provision for income taxes	3	5	71
(Loss) income before discontinued operations	(5)	(22)	44
Discontinued operations loss, net of income tax benefits of \$0, \$5 and \$2, respectively		(10)	(3)
Net (loss) income	\$ (5)	\$ (32)	\$ 41

See accompanying Notes to Consolidated Financial Statements.

MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

	2008	Fiscal Year 2007	2006
Operating activities:			
Net (loss) income	\$ (5)	\$ (32)	\$ 41
Adjustments:			
Depreciation and amortization	129	125	119
Share-based compensation	8	6	15
Tax benefits from stock options exercised			(12)
Impairment of discontinued operations		6	
Goodwill impairment		22	
Deferred financing costs amortization	17	17	5
Other		(1)	
Accretion of subordinated discount notes	39	35	6
Changes in assets and liabilities:			
Merchandise inventories	(67)	3	(63)
Prepaid expenses and other	3	3	(11)
Deferred income taxes and other	(24)	(19)	(26)
Accounts payable	5	23	31
Accrued interest	(40)	38	35
Accrued liabilities and other	(4)	8	8
Income taxes payable	5	21	26
Other long-term liabilities	(7)	13	(17)
Net cash provided by operating activities	59	268	157
Investing activities:			
Additions to property and equipment	(85)	(100)	(143)
Net cash used in investing activities	(85)	(100)	(143)
Financing activities:			
Issuance of Notes			1,400
Payment of debt issuance costs			(125)
Borrowings on asset-based revolving credit facility	922	919	1,005
Payments on asset-based revolving credit facility	(871)	(1,029)	(800)
Borrowings on senior secured term loan facility			2,400
Repayments on senior secured term loan facility	(24)	(24)	(55)
Equity investment of Sponsors			1,649
Payment for old Common Stock in the Merger			(5,806)
Equity investment of Management		8	
Cash dividends paid to stockholders			(58)
Repurchase of old Common Stock			(66)
Repurchase of new Common Stock	(2)	(1)	
Proceeds from stock options exercised			36
Tax benefits from stock options	9		12
Proceeds from issuance of old Common Stock and other			2
Payment of capital leases	(4)	(7)	
Change in cash overdraft		(37)	(32)
Other		2	2
Net cash provided by (used in) financing activities	30	(169)	(436)
Net increase (decrease) in cash and equivalents	4	(1)	(422)

Edgar Filing: MICHAELS STORES INC - Form 10-K

Cash and equivalents at beginning of period		29		30	452
Cash and equivalents at end of period	\$	33	\$	29	\$ 30
Supplemental Cash Flow Information:					
Cash paid for interest	\$	285	\$	288	\$ 55
Cash paid for income taxes	\$	15	\$	22	\$ 79

See accompanying Notes to Consolidated Financial Statements.

MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS (DEFICIT) EQUITY

For the Three Years Ended January 31, 2009

(In millions except share data)

	Number of Shares	Common Stock	Additional Paid-in Capital	Accumulated (Deficit)/ Retained Earnings	Treasury Stock, at Cost	Accumulated Other Comprehensive Income/ (Loss)	Total
Balance at January 28, 2006	390,093,783	\$ 39	\$ 388	\$ 881	\$ (28)	\$ 8	\$ 1,288
Comprehensive income:							
Net income				41			41
Foreign currency translation and other						(1)	(1)
Total comprehensive income							40
Exercise of stock options and other	7,344,606	1	37				38
Share based compensation			15				15
Tax benefit from exercise stock options			12				12
Dividends declared				(45)			(45)
Acquisition of treasury stock	(5,665,733)				(66)		(66)
Retirement of treasury stock		(1)	(93)		94		
Acquisition and retirement of treasury stock in connection with the Merger	(384,439,323)	(38)	(1,997)	(3,771)			(5,806)
Issuance of stock	110,640,063	11	1,648				1,659
Equity issuance costs			(10)				(10)
Balance at February 3, 2007	117,973,396	12		(2,894)		7	(2,875)
Comprehensive loss:							
Net loss				(32)			(32)
Foreign currency translation and other						3	3
Total comprehensive loss							(29)
Share based compensation and other			5				5
Repurchase of stock	(93,333)		(1)				(1)
Issuance of stock	541,006		8				8
Balance at February 2, 2008	118,421,069	12	12	(2,926)		10	(2,892)
Comprehensive loss:							
Net loss				(5)			(5)
Foreign currency translation and other						(5)	(5)
Total comprehensive loss							(10)
Share based compensation and other			7				7
Tax benefit from stock options			9				9
Repurchase of stock	(111,334)		(2)				(2)
Issuance of stock	66,667		1				1
Balance at January 31, 2009	118,376,402	\$ 12	\$ 27	\$ (2,931)	\$	\$ 5	\$ (2,887)

See accompanying Notes to Consolidated Financial Statements.

MICHAELS STORES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Description of Business

Michaels Stores, Inc. (together with its subsidiaries, unless the text otherwise indicates) owns and operates a chain of specialty retail stores in 49 states and Canada featuring arts, crafts, framing, floral, decorative wall décor, and seasonal merchandise for the hobbyist and do-it-yourself home decorator. Our wholly-owned subsidiary, Aaron Brothers, Inc., operates a chain of framing and art supply stores located in 9 states.

Fiscal Year

We report on the basis of a 52 or 53-week fiscal year, which ends on the Saturday closest to January 31. References to fiscal year mean the year in which that fiscal year began. Fiscal 2008 ended on January 31, 2009, fiscal 2007 ended on February 2, 2008, and fiscal 2006 ended on February 3, 2007. Fiscal year 2006 contained 53 weeks, while fiscal 2008 and 2007 each contained 52 weeks.

Consolidation

Our consolidated financial statements include the accounts of Michaels Stores, Inc. and all wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated.

Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Foreign Currency Translation

Edgar Filing: MICHAELS STORES INC - Form 10-K

The functional currency of our Canadian operations is the Canadian dollar. Translation adjustments result from translating our Canadian subsidiary's financial statements into U.S. dollars. Balance sheet accounts are translated at exchange rates in effect at the balance sheet date. Income statement accounts are translated at average exchange rates during the year. Resulting translation adjustments are recorded as a component of accumulated other comprehensive income (loss) in our Consolidated Statements of Stockholders' (Deficit) Equity and as a part of other (income) and expense in our Consolidated Statements of Operations. The cumulative translation adjustment in fiscal 2008 was \$2 million, net of deferred taxes of \$2 million, while in fiscal 2007, the cumulative translation adjustment was \$12 million, net of deferred taxes of \$8 million. In fiscal 2008 and fiscal 2006, transaction losses of \$4 million and \$1 million, respectively related to foreign currency exchange rates while fiscal 2007 results include transaction gains of \$7 million.

Cash and Equivalents

Cash and equivalents are comprised of highly liquid instruments with original maturities of three months or less and \$17 million of credit card clearing accounts as of January 31, 2009, and February 2, 2008. Cash equivalents are carried at cost, which approximates fair value. We record interest income earned from our cash and equivalents as a component of other (income) and expense, net, in our financial statements. In fiscal 2008, we had an immaterial amount of interest income. Interest income was \$1 million and \$10 million for fiscal 2007 and 2006, respectively.

Merchandise Inventories

We value our merchandise inventories at the lower of cost or market, with cost determined using a weighted average method. Cost is calculated based upon the purchase order cost of an item at the time it is received by us, and includes the cost of warehousing, handling, purchasing, and importing the inventory, as well as inbound and outbound transportation, partially offset by vendor allowances. This net inventory cost is recognized through cost of sales when the inventories are sold. Due to systems limitations, it is impracticable for us to assign specific costs and allowances to individual units of inventory. As such, to match net inventory costs against the related revenues, we must use all available information to appropriately estimate the net inventory costs to be deferred and recognized each period. Significant changes to our estimate of when inventory is sold could materially affect the amount of the deferral, and subsequent income statement recognition, of the net inventory costs.

Vendor allowances, which primarily represent volume rebates and cooperative advertising funds, are recorded as a reduction of the cost of the merchandise inventories. We generally earn vendor allowances as a consistent percentage of certain merchandise purchases with no minimum purchase requirements. Typically, our vendor allowance programs extend for a period of 12 months. We recognized vendor allowances of \$149 million, or 3.9% of net sales, in fiscal year 2008, \$141 million, or 3.7% of net sales, in fiscal year 2007, and \$144 million, or 3.7% of net sales, in fiscal 2006. During the three fiscal years ended January 31, 2009, the number of vendors from which vendor allowances were received ranged from approximately 740 to 790. We did not have any material vendor allowance programs in fiscal 2008, 2007, and 2006 that were based on purchase volume milestones.

We utilize perpetual inventory records to value inventory in our stores. Physical inventory counts are performed in a significant number of stores during each fiscal quarter by a third party inventory counting service, with substantially all stores open longer than one year subject to at least one annual count. We adjust our perpetual records based on the results of the physical counts.

We maintain a provision for estimated shrinkage based on the actual historical results of our physical inventories. We compare our estimates to the actual results of the physical inventory counts as they are taken and adjust the shrink estimates accordingly. We also evaluate our merchandise to ensure that the expected net realizable value of the merchandise held at the end of a fiscal period exceeds cost. In the event that the expected net realizable value is less than cost, we record adjustments to the value of inventory.

Property and Equipment

Property and equipment is recorded at cost. Depreciation is recorded on a straight-line basis over the estimated useful lives of the assets. Amortization of property under capital leases is on a straight-line basis over the lease term and is included in depreciation expense. We expense repairs and maintenance costs as incurred. We capitalize and depreciate significant renewals or betterments that substantially extend the life of the asset. Useful lives are generally estimated as follows (in years):

Buildings	30
Leasehold improvements	10*
Fixtures and equipment	8
Computer equipment	5

* We amortize leasehold improvements over the lesser of 10 years or the remaining lease term of the underlying facility.

Goodwill

Under the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*, we perform impairment tests of goodwill, annually or whenever events or circumstances change to indicate that the asset value may not be recovered, by comparing the book values of our reporting units to their estimated fair values. The estimated fair values of our reporting units are computed using estimates that include a discount factor in valuing future cash flows. There are assumptions and estimates underlying the determination of fair value and any resulting impairment loss. Another estimate using different, but still reasonable, assumptions could produce different results. We have performed the required impairment tests of goodwill and the tests have not resulted in an impairment charge in fiscal 2008 or fiscal 2006. In connection with our annual impairment test in fiscal 2007, we recorded a goodwill impairment charge of \$22 million related to our Aaron Brothers reporting unit. See Note 3 for further

information.

Impairment of Long-Lived Assets

When events or changes in circumstances occur that indicate the carrying value of our assets may not be recoverable, we evaluate our long-lived assets for impairment by comparing the carrying value of the assets with their estimated future undiscounted cash flows. If it is determined that an impairment loss has occurred, the loss would be recognized during that period. The impairment loss is calculated as the difference between asset carrying values and the present value of estimated net cash flows or comparable market values, giving consideration to recent operating performance and pricing trends. In fiscal 2008, we recorded an impairment loss of \$5 million related to underperforming stores, of which \$3 million is reflected in cost of sales and occupancy expense and \$2 million is

Edgar Filing: MICHAELS STORES INC - Form 10-K

reflected in selling, general and administrative expense on the Consolidated Statement of Operations. Our impairment analysis contains certain uncertainties including our estimate of future cash flows and discount rates. If actual results differ from these estimates, we may be exposed to additional impairment losses that may be material.

Reserve for Closed Facilities

We maintain a reserve for future rental obligations, carrying costs, and other costs related to closed facilities, primarily closed and relocated stores. In accordance with the provisions of SFAS No. 146, *Costs Associated With Disposal Activities*, we recognize exit costs for any store closures at the time the store is closed.

The cost of closing a store or facility is calculated based on management's estimate of costs to exit the lease, which generally represents the lesser of the present value of future rental obligations remaining under the lease (less estimated sublease rental income) or the lease termination fee.

The following is a detail of account activity related to closed facilities, excluding those related to the discontinued operations of Star Decorators Wholesale (Star) and Recollections as discussed in Note 2:

	2008	Fiscal Year 2007 (in millions)	2006
Balance at beginning of fiscal year	\$ 5	\$ 4	\$ 4
Additions (reductions) charged to costs and expenses	3	4	2
Payment of rental obligations and other	(3)	(3)	(2)
Balance at end of fiscal year	\$ 5	\$ 5	\$ 4

Insurance Liabilities

We use a combination of insurance and self-insurance for our workers' compensation, general liability, and employee-related health care plans. We pay premiums for these coverages, a portion of which are paid by our associates for health care costs. In addition, under our self-insurance, we pay all claims up to the limits provided for in our contracts. Liabilities associated with these plans are actuarially estimated, giving consideration to historical claims experience and industry trends. In the event our insurance carriers are unable to pay claims submitted to them, we would record a liability for such estimated payments we expect to incur.

Revenue Recognition

Revenue from sales of our merchandise is recognized at the time of the merchandise sale, excluding revenue from custom frames, which is recognized at the time of delivery. Revenue is presented net of sales taxes collected. We allow for merchandise to be returned under most circumstances and provide a reserve for estimated returns.

We record a gift card liability on the date we issue the gift card to the customer. We record revenue and reduce the gift card liability as the customer redeems the gift card. We escheat the value of unredeemed gift cards where required by law. Any remaining liabilities not subject to escheatment are evaluated to determine whether the likelihood of the gift card being redeemed is remote (gift card breakage). We recognize gift card breakage as revenue, by applying our estimate of the rate of gift card breakage over the period of estimated performance (approximately 36 months as of the end of fiscal 2008). Our estimates of the gift card breakage rate are applied to the estimated amount of gift cards that are expected to go unused that are not subject to escheatment and are based on customers' historical redemption rates and patterns, which may not be indicative of future redemption rates and patterns. During fiscal 2008, 2007 and 2006, we recognized approximately \$2 million, \$3 million and \$2 million, respectively, related to such gift card balances.

Costs of Sales and Occupancy Expenses

Included in our costs of sales are the following:

- purchase price or invoiced cost of merchandise, net of vendor allowances and rebates,
- inbound freight, inspection costs, and duties,
- warehousing, handling, and transporting costs (including internal transfer costs such as distribution center to store freight)

costs) and purchasing and receiving costs, and

- share-based compensation costs for those employees involved in preparing inventory for sale.

These costs are included in merchandise inventories and expensed as the merchandise is sold.

Included in our occupancy expenses are the following:

- store expenses such as rent, insurance, taxes, common area maintenance, utilities, repairs and maintenance,
- amortization of store buildings and leasehold improvements,
- store closure costs, and
- store remodel costs.

We record rent expense ratably over the term of the lease beginning with the date we take possession of or control the physical access to the premises. We record leasehold improvement reimbursements as a liability and ratably adjust the liability as a reduction to rent expense over the lease term beginning with the date we take possession of or control the physical access to the premises.

Selling, General, and Administrative Costs

Included in our selling, general, and administrative costs are store personnel costs (including share-based compensation), store operating expenses, advertising expenses, store depreciation expense, and corporate overhead costs.

Advertising costs are expensed in the period in which the advertising first occurs. Our cooperative advertising allowances are accounted for as a reduction in the purchase price of merchandise since an obligation to advertise specific product does not exist in our cooperative advertising arrangements.

Advertising expenses were \$176 million, \$173 million, and \$165 million for fiscal 2008, 2007, and 2006, respectively, and are included in selling, general, and administrative expense.

Store Pre-Opening Costs

We expense all start-up activity costs as incurred, which primarily include store pre-opening costs. Rent expense incurred prior to the store opening is recorded in cost of sales and occupancy expense on our Consolidated Statement of Operations.

Income Taxes

We record income tax expense using the liability method for taxes and are subject to income tax in many jurisdictions, including the United States, various states and localities, and Canada. A current tax liability or asset is recognized for the estimated taxes payable or refundable on the tax returns for the current year and a deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards. Deferred tax assets and liabilities are measured using enacted income tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates is recognized as income or expense in the period that includes the enactment date. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized. In evaluating our ability to realize our deferred tax asset, we considered the following sources of future taxable income:

- Future reversals of existing taxable temporary differences;
- Future taxable income, exclusive of reversing temporary differences and carryforwards;
- Taxable income in prior carryback years; and
- Tax-planning strategies.

Our evaluation regarding whether a valuation allowance is required or should be adjusted also considers, among other things, the nature, frequency, and severity of recent losses, forecasts of future profitability and the duration of statutory carryforward periods. Our forecasts of future profitability represents our best estimate of these future events. If different assumptions had been used, our tax expense, assets, and liabilities could have varied from recorded amounts.

After conducting this assessment, the valuation allowance recorded against our deferred tax assets was \$13 million and \$11

million as of January 31, 2009 and February 2, 2008, respectively. If actual results differ from estimated results or if we adjust these assumptions in the future, we may need to adjust our deferred tax assets or liabilities, which could impact our effective tax rate. Given our capital structure, we will continue to experience volatility in our effective tax rate over the near term.

Share-Based Compensation

SFAS No. 123(R), *Share-Based Payment*, requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair value over the requisite service period. Compensation cost is based on the grant date fair value of the award and ratably recognized as an expense over the effective vesting period.

Beginning with our adoption of SFAS No. 123(R), we report excess tax benefits as a cash inflow in the financing section of our statement of cash flows and would record a tax deficiency, if any, as a cash outflow from operating activities. For fiscal 2006, we reported \$83 million of excess tax benefits as a cash inflow to financing activities. For fiscal 2007, we did not have any tax benefits or tax deficiencies associated with share-based awards. For fiscal 2008, we reported \$9 million of excess tax benefits as a cash inflow to financing activities. The fiscal 2008 benefits relate to a favorable tax settlement with the IRS regarding stock options matters from prior years.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which is intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. SFAS 157 was originally effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In November 2007, the FASB placed a one year deferral for the implementation of SFAS 157 for nonfinancial assets and liabilities; however, SFAS 157 is effective for fiscal years beginning after November 15, 2007 for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. We adopted all requirements of SFAS 157 as they relate to financial assets and liabilities on February 3, 2008. See Note 10 for further information on the impact of this standard to financial assets and liabilities. The requirements related to nonfinancial assets and liabilities will be adopted on February 1, 2009, as allowed by SFAS 157. We are currently assessing the impact of adopting SFAS 157 for nonfinancial assets and liabilities on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits companies to measure certain financial instruments and other items at fair value (at specified measurement dates) that are not currently required to be measured at fair value. Any unrealized gains or losses applicable to those items measured at fair value shall be reported in earnings. The decision to apply fair value is generally made on an instrument by instrument basis, is irrevocable, and is applied only to an entire instrument. We adopted SFAS 159 on February 3, 2008, and there was no impact on our consolidated financial statements as we did not choose to measure any eligible financial assets or liabilities at fair value.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141, *Business Combinations*. The statement retains the purchase method of accounting used in business combinations but replaces SFAS 141 by establishing principles and requirements for the recognition and measurement of assets, liabilities and goodwill, including the requirement that most transaction costs and restructuring costs be expensed. In addition, the statement requires disclosures to enable users to evaluate the nature and financial effects of the business combination. SFAS 141 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will adopt SFAS 141R on February 1, 2009 for

acquisitions on or after this date.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of FASB Statement No. 133. SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative data about the fair value of, and gains and losses on, derivative contracts, and details of credit-risk-related contingent features in hedged positions. The statement also requires enhanced disclosures regarding how and why entities use derivative instruments, how derivative instruments and related hedged items are accounted for in accordance with SFAS 133 and its related interpretation, and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We will adopt the new disclosure requirements of SFAS 161 in the first quarter of fiscal 2009.

Note 2. Discontinued Operations

On October 16, 2007, we announced plans to align resources around our core retail chains, Michaels and Aaron Brothers stores. As a result, we discontinued our concept businesses, Recollections and Star. As of the end of fiscal 2007, we had closed 11 Recollections and three of the four Star locations. The remaining Star location was converted to a Michaels store.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, at the time of the announcement we performed impairment analyses for these stores. Based on estimated future cash flows, an impairment loss for property and equipment of \$6 million was recognized during the third quarter of fiscal 2007. Also, \$1 million of related severance and termination costs were recorded during the third quarter of fiscal 2007. During the fourth quarter of fiscal 2007, we recognized \$4 million of lease termination costs.

The following is a detail of liability account activity related to discontinued operations:

	2008	Fiscal Year (in millions)	2007
Balance at beginning of fiscal year	\$	6	\$
Additions (reductions) charged to costs and expenses			6
Payment of rental obligations and other		(3)	
Balance at end of fiscal year	\$	3	\$

As of the end of fiscal 2008, we have lease termination liabilities of \$2 million. As of the end of fiscal 2007, we had liabilities of \$4 million and \$1 million related to lease termination costs and severance and termination costs, respectively.

All costs associated with the disposal of these concept businesses are reflected in discontinued operations on the Consolidated Statements of Operations.

Note 3. Goodwill Impairment

During the fourth quarter of fiscal 2007, in connection with our annual impairment test, we recorded a goodwill impairment charge of \$22 million related to our Aaron Brothers reporting unit. The impairment charge represents the net carrying value of the Aaron Brothers goodwill. During fiscal 2007, Aaron Brothers experienced a significant decline in sales and profitability. These declines, coupled with our near-term financial forecasts, the deterioration of the retail segment of the U.S. economy, and our ongoing reassessment of expansion opportunities, resulted in an estimated fair value that was considerably lower than the carrying value of the reporting unit. The resulting allocation of the estimated fair value to the reporting unit's assets and liabilities indicated that a full impairment of goodwill was required.

Our fair value assessment was based on a combination of present value cash flow analysis, observable earnings multiples of other publicly-traded specialty retail companies, and use of earnings multiples resulting from market transactions of other specialty retail companies.

Note 4. Merger Transaction

On October 31, 2006, substantially all of the Common Stock of Michaels Stores, Inc. was acquired through a merger transaction (the Merger) by affiliates of two private investment firms, Bain Capital Partners, LLC and The Blackstone Group (collectively, together with their applicable affiliates, the Sponsors), with certain shares retained by affiliates of Highfields Capital Partners (a then-existing shareholder of Michaels Stores, Inc.). As a result of the Merger, Michaels Holdings LLC, an entity controlled by the Sponsors, owns approximately 93% of our outstanding Common Stock, which is no longer publicly traded. We accounted for the Merger as a leveraged recapitalization whereby the historical book value of the assets and liabilities of Michaels will be maintained with no push down accounting required.

The Merger consideration paid to then-existing equity holders was approximately \$5.8 billion, with fees and expenses totaling an additional \$240 million. The purchase price was funded by:

- Aggregate cash equity contribution by the Sponsors of approximately \$1.7 billion;
- Retention of certain shares held by affiliates of Highfields Capital Partners totaling \$110 million;

Edgar Filing: MICHAELS STORES INC - Form 10-K

- The issuance of the following debt (See Note 6 for further information concerning our issuance of debt):
- \$750 million of 10% Senior Notes due 2014;
- \$400 million of 113/8% Senior Subordinated Notes due 2016;
- \$250 million of 13% Subordinated Discount Notes due 2016;
- \$2.4 billion Senior secured term loan facility; and,
- \$400 million of borrowings under our Asset-based revolving credit facility.
- Our available cash as of the date of the Merger.

The Merger occurred simultaneously with the closing of the financing and equity transactions described above as well as the termination of our previous \$300 million senior unsecured credit facility with Bank of America, N.A. (Credit Agreement).

In connection with the completion of the Merger, we entered into management agreements with each of the Sponsors pursuant to which the Sponsors will provide management services to us until December 31, 2016, with evergreen extensions thereafter. Pursuant to these agreements, the Sponsors will receive an aggregate annual management fee equal to \$12 million and reimbursement for out-of-pocket expenses incurred by them in connection with the provision of services pursuant to the agreements. In addition, pursuant to these agreements, the Sponsors received, in connection with the completion of the Merger, aggregate transaction fees of approximately \$60 million in connection with services provided by them related to the Merger. Finally, the management agreements provide that the Sponsors are entitled to receive fees in connection with certain subsequent financing, acquisition, disposition and change of control transactions of 1% of the gross transaction value of any such transaction. The management agreements include customary exculpation and indemnification provisions in favor of the Sponsors. The management agreements may be terminated by the Sponsors at any time and terminate automatically upon an initial public offering or a change of control unless we and the Sponsors determine otherwise. Upon termination, each provider of management services will be entitled to a termination fee calculated based on the present value of the annual fees due during the remaining period from the date of termination to the tenth anniversary of the date of the Merger.

In connection with the completion of the Merger, we entered into a management agreement with Highfields Capital Management LP, an affiliate of the Highfields Capital Partners, that provides for an annual management fee of \$1 million for services that Highfields Capital Management LP renders to us following the completion of the Merger.

Edgar Filing: MICHAELS STORES INC - Form 10-K

During fiscal 2006, we expensed approximately \$240 million of Merger-related costs, of which \$205 million was classified as transaction expenses and \$34 million was classified as related party expenses in our Consolidated Statement of Operations; the remaining \$1 million was classified as interest expense. See Note 15 for further information concerning related party expenses. Of the \$240 million recorded in fiscal 2006, \$218 million was recorded in our fourth quarter of fiscal 2006. Approximately \$138 million of the \$240 million consisted of compensation expense (primarily share-based compensation) and \$100 million was related to investment banking, legal, accounting, and other professional fees.

We capitalized \$125 million of costs related to our issuance of various debt instruments. We amortize the deferred financing costs over the lives of the respective debt agreements (which range from five to ten years) and record the amortization to interest expense. As further described in Note 15 below, we paid \$3 million to each of Charles Wyly and Sam Wyly pursuant to a Separation Agreement. We capitalized the Separation Agreements and amortize them over their two year lives. Our expected amortization expense pertaining to the deferred financing costs and Separation Agreements for each of the next five fiscal years and thereafter is as follows:

	Fiscal Year (in millions)											
	2009		2010		2011		2012		2013	Thereafter		
Amortization Expense	\$	17	\$	17	\$	16	\$	14	\$	12	\$	10

F-14

Note 5. Detail of Certain Balance Sheet Accounts

	January 31, 2009	February 2, 2008
(In millions)		
Property and equipment:		
Land and buildings	\$ 2	\$ 2
Fixtures and equipment	910	864
Leasehold improvements	302	289
	\$ 1,214	\$ 1,155
Accrued liabilities and other:		
Salaries, bonuses, and other payroll-related costs	\$ 110	\$ 122
Accrued interest	32	72
Taxes, other than income and payroll	45	42
Gift certificate and gift card liability	22	23
Other	66	73
	\$ 275	\$ 332

Note 6. Debt

Our debt consisted of the following for fiscal 2008 and fiscal 2007:

	Interest Rate	Fiscal 2008	Fiscal 2007
(In millions)			
Senior notes	10.000%	\$ 750	\$ 750
Senior subordinated notes	11.375%	400	400
Subordinated discount notes	13.000%	332	293
Senior secured term loan	Variable	2,297	2,321
Asset-based revolving credit facility	Variable	148	97
Other	5.970%	2	2
Total debt		3,929	3,863
Less current portion		173	122
Long-term debt		\$ 3,756	\$ 3,741

10% Senior Notes due 2014

On October 31, 2006, we issued \$750 million in principal amount of 10% Senior Notes due November 1, 2014. Interest is payable semi-annually in arrears on each May 1 and November 1, commencing on May 1, 2007. The Senior Notes are guaranteed, jointly and severally, on an unsecured senior basis, by each of our subsidiaries, other than Aaron Brothers Card Services, LLC.

Edgar Filing: MICHAELS STORES INC - Form 10-K

The Senior Notes and the guarantees thereof are our and the guarantors' unsecured senior obligations and (i) rank senior in right of payment to all of our and the guarantors' existing and future debt and other obligations that are, by their terms, expressly subordinated in right of payment to the Senior Notes (including the Senior Subordinated Notes and the Subordinated Discount Notes described below); (ii) rank equally in right of payment to all of our and the guarantors' existing and future debt and other obligations that are not, by their terms, expressly subordinated in right of payment to the Senior Notes; and (iii) are effectively subordinated to all of our and the guarantors' existing and future secured debt (including obligations under the Senior Credit Facilities) to the extent of the value of the assets securing such debt.

At any time prior to November 1, 2010, we may redeem all or a part of the Senior Notes at a redemption price equal to the sum of (i) 100% of the principal amount of the Senior Notes redeemed; (ii) the Applicable Premium (as defined in the Senior Indenture); and

(iii) accrued and unpaid interest to the date of redemption.

On and after November 1, 2010, we may redeem all or part of the Senior Notes at the redemption prices (expressed as percentages of principal amount of the Senior Notes) set forth below, plus accrued and unpaid interest to the applicable date of redemption if redeemed during the twelve-month period beginning on November 1 of each of the years indicated below:

Year	Percentage
2010	105.000%
2011	102.500%
2012 and thereafter	100.000%

In addition, until November 1, 2009, we may, at our option, on one or more occasions redeem up to 35% of the aggregate principal amount of Senior Notes at a redemption price equal to 110.000% of the aggregate principal amount thereof, plus accrued and unpaid interest, to the applicable date of redemption, with the net cash proceeds of one or more Equity Offerings (as defined in the Senior Indenture); provided that at least 50% of the aggregate principal amount of Senior Notes remains outstanding immediately after the occurrence of each such redemption, and that each such redemption occurs within 90 days of the date of closing of each such Equity Offering.

Upon a change in control, we are required to offer to purchase all of the Senior Notes at a price in cash equal to 101% of the aggregate principal amount thereof, plus accrued and unpaid interest.

The Senior Indenture contains covenants limiting, among other things, the Company's ability and the ability of the Company's restricted subsidiaries to:

- incur additional debt;
- pay dividends or distributions on the Company's capital stock or repurchase the Company's capital stock;
- issue stock of subsidiaries;
- make certain investments;
- create liens on the Company's assets to secure debt;

Edgar Filing: MICHAELS STORES INC - Form 10-K

- enter into transactions with affiliates;
- merge or consolidate with another company; and
- sell or otherwise transfer assets.

113/8% Senior Subordinated Notes due 2016

Edgar Filing: MICHAELS STORES INC - Form 10-K

On October 31, 2006, we issued \$400 million in principal amount of 113/8% Senior Subordinated Notes due November 1, 2016. Interest is payable semi-annually in arrears on each May 1 and November 1, commencing on May 1, 2007. The Senior Subordinated Notes are guaranteed, jointly and severally, on an unsecured senior subordinated basis, by each of our subsidiaries, other than Aaron Brothers Card Services, LLC.

The Senior Subordinated Notes and the guarantees thereof are our and the guarantors' unsecured senior subordinated obligations and (i) are subordinated in right of payment to all of our and the guarantors' existing and future senior debt, including the Senior Credit Facilities and the Senior Notes; (ii) rank equally in right of payment to all of our and the guarantors' future senior subordinated debt; (iii) are effectively subordinated to all of our and the guarantors' existing and future secured debt (including the Senior Credit Facilities) to the extent of the value of the assets securing such debt; and (iv) rank senior in right of payment to all of our and the guarantors' existing and future debt and other obligations that are, by their terms, expressly subordinated in right of payment to the Senior Subordinated Notes, including the Subordinated Discount Notes.

Edgar Filing: MICHAELS STORES INC - Form 10-K

At any time prior to November 1, 2011, we may redeem all or a part of the Senior Subordinated Notes, at a redemption price equal to the sum of (i) 100% of the principal amount of Senior Subordinated Notes redeemed; (ii) the Applicable Premium (as defined in the Senior Subordinated Indenture); and (iii) accrued and unpaid interest to the date of redemption.

On and after November 1, 2011, we may redeem all or part of the Senior Subordinated Notes at the redemption prices (expressed as percentages of principal amount of the Senior Subordinated Notes) set forth below, plus accrued and unpaid interest to the applicable date of redemption if redeemed during the twelve-month period beginning on November 1 of each of the years indicated below:

Year	Percentage
2011	105.688%
2012	103.792%
2013	101.896%
2014 and thereafter	100.000%

In addition, until November 1, 2009, we may, at our option, on one or more occasions redeem up to 35% of the aggregate principal amount of Senior Subordinated Notes at a redemption price equal to 111.375% of the aggregate principal amount thereof, plus accrued and unpaid interest, to the applicable date of redemption, with the net cash proceeds of one or more Equity Offerings (as defined in the Senior Subordinated Indenture); provided that at least 50% of the aggregate principal amount of Senior Subordinated Notes remains outstanding immediately after the occurrence of each such redemption, and that each such redemption occurs within 90 days of the date of closing of each such Equity Offering.

Upon a change in control, we are required to offer to purchase all of the Senior Subordinated Notes at a price in cash equal to 101% of the aggregate principal amount thereof, plus accrued and unpaid interest. The Senior Subordinated Notes indenture contains restrictive covenants substantially similar to those of the Senior Notes described above.

13% Subordinated Discount Notes due 2016

On October 31, 2006, we issued \$469 million in principal amount at maturity of 13% Subordinated Discount Notes due on November 1, 2016. No cash interest is payable on the Subordinated Discount Notes prior to November 1, 2011. Beginning on November 1, 2011, cash interest will accrue and is payable semi-annually in arrears on each May 1 and November 1 (the first cash interest payment date is May 1, 2012). The Subordinated Discount Notes are guaranteed, jointly and severally, on an unsecured subordinated basis, by each of our subsidiaries, other than Aaron Brothers Card Services, LLC.

The Subordinated Discount Notes and the guarantees thereof are our and the guarantors' unsecured subordinated obligations and (i) are subordinated in right of payment to all of our and the guarantors' existing and future senior debt (including the Senior Credit Facilities, the Senior Notes and the Senior Subordinated Notes); and (ii) are effectively subordinated to all of our and the guarantors' secured debt (including the Senior Credit Facilities to the extent of the value of the assets securing such debt).

At any time prior to November 1, 2011, we may redeem all or part of the Subordinated Discount Notes at a redemption price equal to the sum of 100% of the Accreted Value (as defined in the Subordinated Discount Indenture) of the Subordinated Discount Notes redeemed plus the

Edgar Filing: MICHAELS STORES INC - Form 10-K

Applicable Premium (as defined in the Subordinated Discount Indenture) as of the date of redemption.

On and after November 1, 2011, we may redeem all or part of the Subordinated Discount Notes at the redemption prices (expressed as percentages of Accreted Value of the Subordinated Discount Notes to be redeemed) set forth below, plus accrued and unpaid interest (to the extent not already included in Accreted Value) as of the applicable date of redemption (if redeemed during the twelve-month period beginning on November 1 of each of the years indicated below:

F-17

Edgar Filing: MICHAELS STORES INC - Form 10-K

Year	Percentage
2011	106.500%
2012	104.333%
2013	102.167%
2014 and thereafter	100.000%

In addition, until November 1, 2009, we may, at our option, on one or more occasions redeem up to 35% of the aggregate principal amount of Subordinated Discount Notes at a redemption price equal to 113.000% of the Accreted Value thereof, with the net cash proceeds of one or more Equity Offerings (as defined in the Subordinated Discount Indenture); provided that at least 50% of the sum of the aggregate principal amount at maturity of Subordinated Discount Notes originally remains outstanding immediately after the occurrence of each such redemption, and that each such redemption occurs within 90 days of the date of closing of each such Equity Offering.

On May 1, 2012, and, if necessary, any interest payment date thereafter prior to the maturity date, we are required to redeem a portion of each Subordinated Discount Note outstanding on such date equal to an amount sufficient, but not in excess of the amount necessary, to ensure that a Subordinated Discount Note will not be an applicable high yield discount obligation within the meaning of Section 163(i)(1) of the Internal Revenue Code of 1986. These redemptions are to be at a price equal to 100% of the Accreted Value as of the date of redemption.

Upon a change in control, we are required to offer to purchase all of the Subordinated Discount Notes at a price in cash equal to 101% of the Accreted Value, plus accrued and unpaid interest. The Subordinated Discount indenture contains restrictive covenants substantially similar to those of the Senior Notes described above.

As of April 2, affiliates of the Sponsors own or have transactions pending, and will own approximately \$233 million of the outstanding Subordinated Discount Notes.

Asset-based revolving credit facility

On October 31, 2006, we executed a senior secured asset-based revolving credit facility with Banc of America, N.A. and other lenders (Asset-based revolving credit facility). The Asset-based revolving credit facility provides senior secured financing of up to \$1.0 billion, subject to a borrowing base as described below. As of January 31, 2009, the borrowing base was \$747 million, of which we borrowed \$148 million, which was classified as current debt on our balance sheet. Borrowing capacity is available for letters of credit and borrowings on same-day notice. Unused letters of credit as of January 31, 2009 totaled \$69 million, of which \$44 million relate to standby letters of credit.

The borrowing base equals the sum of (i) 90% of eligible credit card receivables and debit card receivables; (ii) between 85% and 87.5% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit; (iii) a percentage of eligible in-transit inventory, less certain reserves; and, (iv) the sum of an additional 10% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit plus an additional 5% of eligible credit card receivables and debit card receivables (collectively, the last out tranche), up to a maximum amount of \$100 million.

The Asset-based revolving credit facility provides us with the right to request up to \$200 million of additional commitments under this facility. The lenders under this facility are not under any obligation to provide any such additional commitments, and any increase in commitments is

Edgar Filing: MICHAELS STORES INC - Form 10-K

subject to customary conditions precedent. If we were to request any such additional commitments, and the existing lenders or new lenders were to agree to provide such commitments, the facility size could be increased to up to \$1.2 billion, but our ability to borrow under this facility would still be limited by the amount of the borrowing base.

Borrowings under the Asset-based revolving credit facility bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Bank of America, N.A. and (2) the federal funds effective rate plus 1/2 of 1% or (b) a LIBOR rate subject to certain adjustments, in each case plus an applicable margin. The initial applicable margin for borrowings is 0.50% for base rate borrowings and 1.50% for LIBOR borrowings. With respect to any last out tranche borrowings, the initial applicable margin is 1.50% for base rate borrowings and 2.50% for LIBOR borrowings. The applicable margin is subject to adjustment each fiscal quarter based on the excess availability under the Asset-based revolving credit facility. Swingline Loans bear interest at a rate per annum equal to the base rate plus the applicable margin.

We are required to pay a commitment fee of 0.25% per annum on the unutilized commitments under the Asset-based revolving credit facility. We must also pay customary letter of credit fees and agency fees.

Edgar Filing: MICHAELS STORES INC - Form 10-K

If, at any time, the aggregate amount of outstanding loans, unreimbursed letter of credit drawings and undrawn letters of credit under the Asset-based revolving credit facility exceeds the lesser of (i) the commitment amount or (ii) the borrowing base, we will be required to repay outstanding loans and cash collateralize letters of credit in an aggregate amount equal to such excess, with no reduction of the commitment amount. If the amount available under the Asset-based revolving credit facility is less than \$100.0 million for five consecutive business days, or a payment or bankruptcy event of default has occurred, we will be required to repay outstanding loans and cash collateralize letters of credit with the cash we are required to deposit daily in a collection account maintained with the agent under the Asset-based revolving credit facility. We may voluntarily reduce the unutilized portion of the commitment amount and repay outstanding loans at any time without premium or penalty other than customary breakage costs with respect to LIBOR loans. There is no scheduled amortization under the Asset-based revolving credit facility; the principal amount of the loans outstanding is due and payable in full on October 31, 2011.

All obligations under the Asset-based revolving credit facility are unconditionally guaranteed by all of our existing subsidiaries, except for Aaron Brothers Card Services, LLC, and are required to be guaranteed by certain of our future domestic wholly-owned subsidiaries. All obligations under the Asset-based revolving credit facility, and the guarantees of those obligations, are secured, subject to certain exceptions, by substantially all of our assets and the assets of our subsidiaries, excluding Aaron Brothers Card Services, LLC (the Subsidiary Guarantors), including:

- a first-priority security interest in personal property consisting of inventory and related accounts, cash, deposit accounts, all payments received by us or the Subsidiary Guarantors from credit card clearinghouses and processors or otherwise in respect of all credit card charges and debit card charges for sales of inventory by us and the Subsidiary Guarantors, and certain related assets and proceeds of the foregoing;
- a second-priority pledge of all of the capital stock held by us (excluding the stock of Michaels of Canada, ULC) and our Subsidiary Guarantors (which pledge, in the case of the capital stock of any foreign subsidiary, is limited to 65% of the voting stock of such foreign subsidiary and 100% of the non-voting stock of such subsidiary); and
- a second-priority security interest in, and mortgages on, substantially all other tangible and intangible assets of us and each Subsidiary Guarantor, including substantially all of our owned real property and equipment.

The Asset-based revolving credit facility contains a number of covenants that, among other things and subject to certain exceptions, restricts the Company's ability and the ability of its subsidiaries to:

- incur additional indebtedness;
- pay dividends on the Company's capital stock or redeem, repurchase or retire the Company's capital stock or its other indebtedness;
- make investments, loans, advances and acquisitions;

Edgar Filing: MICHAELS STORES INC - Form 10-K

- create restrictions on the payment of dividends or other amounts to the Company from its restricted subsidiaries;
- engage in transactions with affiliates of the Company;
- sell assets, including capital stock of the Company's subsidiaries;
- consolidate or merge; and
- create liens.

The covenants limiting dividends and other restricted payments, investments, loans, advances and acquisitions, and prepayments or redemptions of indebtedness, each permit the restricted actions in an unlimited amount, subject to the satisfaction of certain payment conditions, principally that we must have at least \$125 million of pro forma excess availability under the Asset-based revolving credit facility and that we must be in pro forma compliance with the fixed charge coverage ratio described in the next paragraph.

Although the Asset-based revolving credit facility does not require us to comply with any financial ratio maintenance covenants, if

we have less than \$75 million of excess availability under the Asset-based revolving credit facility at any time, we are not permitted to borrow any additional amounts unless our pro forma Consolidated Fixed Charge Coverage Ratio (as defined in the Asset-based revolving credit facility) is at least 1.1 to 1.0. The Asset-based revolving credit facility also contains certain customary affirmative covenants and events of default. Moreover, our senior secured asset-based revolving credit facility provides discretion to the agent bank acting on behalf of the lenders to impose additional availability reserves, which could materially impair the amount of borrowings that would otherwise be available to us. There can be no assurance that the agent bank will not impose such reserves or, were it to do so, that the resulting impact of this action would not materially and adversely impair our liquidity.

Senior secured term loan facility

On October 31, 2006, we executed a \$2.4 billion senior secured term loan facility with Deutsche Bank A.G. New York Branch, and other lenders. The full amount was borrowed on October 31, 2006. We are required to make scheduled quarterly payments, each equal to 0.25% of the original principal amount of the term loans, for the first six years and three quarters, with the balance payable on October 31, 2013.

Borrowings under the Senior secured term loan facility bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Deutsche Bank and (2) the federal funds effective rate plus 1/2 of 1% or (b) a LIBOR rate, subject to certain adjustments, in each case plus an applicable margin. At issuance date, the applicable margin was 2.00% with respect to base rate borrowings and 3.00% with respect to LIBOR borrowings, subject to downward adjustment based on the leverage and ratings thresholds set forth in the Senior secured term loan facility agreement. During the fourth quarter of fiscal 2006, we amended the Senior secured term loan facility such that the applicable margin with respect to the LIBOR borrowings was lowered from 3.00% to 2.75%.

On May 10, 2007, we amended the Senior secured term loan facility to reduce the applicable margin to 1.25% with respect to base rate borrowings and 2.25% with respect to LIBOR borrowings. The amendment also provides that if there is a repricing transaction that reduces the interest rate margins prior to May 10, 2008, then each lender will receive a fee equal to 1.0% of the principal amounts of loans that are repriced. Finally, the amendment eliminated the requirement that we maintain a specified consolidated secured debt ratio.

The Senior secured term loan facility requires us to prepay outstanding term loans with (a) 100% of the net proceeds of any debt issued by us or our subsidiaries (with exceptions for certain debt permitted to be incurred under the Senior secured term loan facility) and (b) commencing with the fiscal year ending February 2, 2008, 50% (which percentage will be reduced to 25% if our total leverage ratio is less than 6.00:1.00 and will be reduced to 0% if our total leverage ratio is less than 5.00:1.00) of our annual Excess Cash Flow (as defined in the Senior secured term loan facility). We must also offer to prepay outstanding term loans at 100% of the principal amount to be prepaid, plus accrued and unpaid interest, with the proceeds of certain asset sales or casualty events under certain circumstances. We may voluntarily prepay outstanding loans under the Senior secured term loan facility at any time without premium or penalty other than customary breakage costs with respect to LIBOR loans.

All obligations under the Senior secured term loan facility are unconditionally guaranteed by each direct and indirect wholly-owned subsidiary that guarantees the obligations of the Company under the Asset-based revolving credit facility. All obligations under the Senior secured term loan facility, and the guarantees of those obligations, are secured, subject to certain exceptions, by substantially all of our assets and the assets of the Subsidiary Guarantors, including:

- a first-priority pledge of all of the capital stock held by us (excluding the stock of Michaels of Canada, ULC) and the Subsidiary Guarantors (which pledge, in the case of any foreign subsidiary, is limited to 65% of the voting stock of such foreign subsidiary and 100% of the non-voting stock of such subsidiary);
- a first-priority security interest in, and mortgages on, substantially all other tangible and intangible assets of us and each Subsidiary Guarantor, including substantially all of our owned real property and equipment, but excluding, among other things, the collateral described in the following bullet point; and
- a second-priority security interest in personal property consisting of inventory and related accounts, cash, deposit accounts, all payments received by us or the Subsidiary Guarantors from credit card clearinghouses and processors or otherwise in respect of all credit card charges and debit card charges for sales of inventory by us and the Subsidiary Guarantors, and certain related assets and proceeds of the foregoing.

The Senior secured term loan facility contains a number of negative covenants that are substantially similar (but more restrictive in certain respects) to those governing the Senior Notes as well as certain other customary affirmative and negative covenants as well as events of default.

Edgar Filing: MICHAELS STORES INC - Form 10-K

The aggregate amounts of scheduled maturities of our debt for the next five years and thereafter are as follows:

Fiscal Year	Amount (In millions)
2009	\$ 173
2010	25
2011	24
2012	218
2013	2,202
Thereafter	1,424
Total debt payments	4,066
Less unrealized interest accretion on Subordinated Discount Notes	137
Total debt balance as of January 31, 2009	\$ 3,929

The weighted average interest rate of the current portion of our long-term debt as of January 31, 2009 was 2.3%.

The table below provides the carrying and fair values of our Senior and Subordinated term loan and notes. The fair value of these debt instruments was determined based on quoted market prices.

	Fair Value of Term Loan and Notes	
	Carrying Value	Fair Value
	(In millions)	
Senior Secured Term Loan	\$ 2,297	\$ 1,424
Senior Notes	750	341
Senior Subordinated Notes	400	124
Subordinated Discount Notes	332	47

Note 7. Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of deferred tax assets and liabilities as of the respective year-end balance sheets are as follows:

	Deferred Tax Asset (Liability)			
	January 31, 2009		February 2, 2008	
	Current	Noncurrent	Current	Noncurrent
	(In millions)			
Net operating loss, general business credit, foreign tax credit and alternative minimum tax credit carryforwards	\$	\$ 21	\$	\$ 16
Accrued expenses	16	1	17	2
Deferred rent		15		16
Other assets	17	8	10	7
State valuation allowance		(12)		(9)
Federal valuation allowance		(1)		(2)

Edgar Filing: MICHAELS STORES INC - Form 10-K

Property and equipment		(15)		(27)
Translation adjustment		(3)	1	(7)
Workers compensation	18		17	
Other deferred tax liabilities	(10)	(2)	(14)	
	\$ 41	\$ 12	\$ 31	\$ (4)
Net deferred tax assets		\$ 53		\$ 27

F-21

Edgar Filing: MICHAELS STORES INC - Form 10-K

The federal, state and international income tax provision is as follows:

	2008	Fiscal Year 2007 (In millions)	2006
Federal:			
Current	\$ 11	\$ (4)	\$ 34
Deferred	(18)	(7)	9
Total federal income tax provision	(7)	(11)	43
State:			
Current	9	8	13
Deferred	(8)	(6)	(2)
Total state income tax provision	1	2	11
International:			
Current	13	16	15
Deferred	(4)	(2)	2
Total international income tax provision	9	14	17
Total income tax provision	\$ 3	\$ 5	\$ 71

The reconciliation between the actual income tax provision and the income tax provision calculated by applying the federal statutory rate is as follows:

	2008	Fiscal Year 2007 (In millions)	2006
Income tax (benefit) provision at statutory rate	\$ (1)	\$ (6)	\$ 40
State income taxes, net of federal income tax effect	(3)	(1)	2
Non-deductible goodwill write-off		8	
Non-deductible severance payments	2	2	
Non-deductible merger related costs			25
Federal valuation allowance	(1)	2	
State valuation allowance	4	3	6
Other	2	(3)	(2)
Total income tax from continued operations	\$ 3	\$ 5	\$ 71

At January 31, 2009, we had state net operating loss carryforwards to reduce future taxable income of approximately \$268 million expiring at various dates between fiscal 2009 and fiscal 2029. The valuation allowance related to state operating loss carryforwards was increased to \$12 million in fiscal 2008 to reserve for state operating loss carryforwards, which we believe it is more likely than not that we will be unable to deduct these amounts. Additionally, due to credits utilized in fiscal 2008, we eliminated our valuation allowance related to general business credits and reduced our valuation allowance related to foreign tax credits \$1 million.

Uncertain Tax Positions

Edgar Filing: MICHAELS STORES INC - Form 10-K

We operate in a number of tax jurisdictions and are subject to examination of our income tax returns by tax authorities in those jurisdictions who may challenge any item on these tax returns. Because the tax matters challenged by tax authorities are typically complex, the ultimate outcome of these challenges is uncertain.

Through fiscal 2006, in accordance with prior accounting standards, we assessed the ultimate resolution of uncertain tax

matters as they arose and established reserves for tax contingencies when we believed an unfavorable outcome was probable and the liability could be reasonably estimated.

Effective February 4, 2007, we adopted the provisions of FIN 48, *Accounting for Uncertainty in Income Taxes*. In accordance with FIN No. 48, we recognized a cumulative-effect adjustment of \$1 million to the balance of Retained Earnings. A reconciliation of unrecognized tax benefits from the end of fiscal 2007 through the end of fiscal 2008 is as follows:

	Fiscal Year 2008 (In millions)	
Balance at February 2, 2008	\$	14
Additions based on tax positions related to the current year		
Additions for tax positions of prior years		1
Reductions for tax positions of prior years		(2)
Settlements with taxing authorities		(1)
Balance at January 31, 2009	\$	12

Included in the balance of unrecognized tax benefits at January 31, 2009, is \$13 million in unrecognized tax benefits, the recognition of which would have an effect on the effective tax rate. The amount differs from the gross unrecognized tax benefits presented in the table due to the increase in U.S. federal income taxes which would occur upon recognition of penalties and interest from uncertain tax positions, offset by the state tax benefits included therein.

Our policy continues to be to classify all income tax related interest and penalties as income tax expense. During the year ended January 31, 2009, we recognized \$1 million in income tax interest and penalties. As of January 31, 2009, we have an accrual of \$4 million for potential payment of interest and penalties.

We identified our federal tax return, Canadian tax return, and state tax returns in California, Florida, Illinois, Michigan, New York, North Carolina, Pennsylvania, and Texas as major tax jurisdictions. The periods subject to examination for our federal return are 2002 to present, 2004 to present for our Canadian return, and 2004 to present for all major state returns except for California, which has a period subject to examination from 1998 to present. We do not anticipate significant changes in unrecognized tax benefits during the coming fiscal year.

Note 8. Share-Based Compensation

On February 15, 2007, our stockholders and Board of Directors approved the 2006 Equity Incentive Plan (2006 Plan), which provides for the grant of share-based awards exercisable for up to 14.2 million shares of Common Stock. Generally, awards vest ratably over five years and expire eight years from the grant date. We plan to issue new shares of our Common Stock to satisfy share issuance upon option exercises. Share-based compensation expense for fiscal 2008 and fiscal 2007 was approximately \$8 million and \$6 million, respectively.

On June 30, 2006, the then-Board of Directors approved a resolution that provided for a contingent cash settlement feature within the options granted under the various previous plans. The cash settlement feature was contingent upon consummation of the Merger. On the Merger date, all options outstanding as of the Merger date were exchanged for the right to receive the excess of \$44.00 per share over the exercise price of the

Edgar Filing: MICHAELS STORES INC - Form 10-K

underlying option. As a result, our share-based compensation expense in fiscal 2006 was approximately \$134 million.

The fair value for options granted under SFAS No. 123(R) was estimated at the date of grant using the Black-Scholes-Merton option valuation model with the following assumptions:

F-23

Edgar Filing: MICHAELS STORES INC - Form 10-K

Assumptions (1)	2008	Fiscal Year 2007	2006
Risk-free interest rates (2)	1.9% - 3.6%	3.4% - 5.0%	4.6% - 4.9%
Expected dividend yield	0.0%	0.0%	1.0%
Expected volatility rates of our Common Stock (3)	31.1% - 43.6%	30.1% - 38.2%	22.6% - 30.6%
Expected life of options (in years) (4)	5.5 - 7.5	5.5 - 7.5	2.5 - 3.0

Edgar Filing: MICHAELS STORES INC - Form 10-K

- (1) Forfeitures were estimated based on historical experience and anticipated events.
- (2) Based on constant maturity interest rates for U.S. Treasury instruments with terms consistent with the expected lives of the awards.
- (3) We considered both the historical volatility as well as implied volatilities from the exchange-traded options on the common stock from a peer group of companies.
- (4) Expected lives were based on an analysis of historical exercise and post-vesting employment termination behavior.

Our fiscal 2008 stock option activity and other summary data are summarized in the following tables:

	Outstanding at Beginning of Year	Fiscal Year 2008 Activity			Outstanding at End of Year	Exercisable at End of Year
		Granted	Exercised	Forfeited/ Expired (In millions, except per share data)		
Number of options	11	3		(4)	10	1
Weighted average exercise price	\$ 26.25	\$ 26.25	\$	\$ 26.25	\$ 26.25	\$ 15.00
					As of January 31, 2009	
					Options Outstanding	Options Exercisable
Aggregate intrinsic value					\$	\$
Weighted average remaining life in years					6.5	6.2

As of the beginning of fiscal 2008, there were 11 million nonvested options with a weighted average fair value of \$3.82 per share. At the end of fiscal 2008, there were 9 million nonvested options with a weighted average fair value of \$3.95 per share.

	2008	Fiscal Year		2006
		2007		
(In millions, except per share data)				
Weighted average fair value of options granted during the year (per share)	\$ 4.26	\$ 3.82	\$	2.47
Total intrinsic value of options exercised during the year	\$	\$	\$	214
Total fair value of options that vested during the year	\$ 6	\$	\$	78

As of January 31, 2009, compensation cost not yet recognized related to nonvested awards totaled \$27 million and is expected to be recognized over a weighted average period of 3.5 years.

As of January 31, 2009, there are 120,800 shares of restricted stock outstanding.

Note 9. Derivative Instruments

We are exposed to fluctuations in exchange rates between the US and Canadian dollar, which is the functional currency of our Canadian subsidiary. During the second quarter of fiscal 2008, we executed foreign currency forward contracts to mitigate the effects of currency fluctuations, which we designated as a cash flow hedge. The objective of the forward contracts is to hedge intercompany payments for forecasted purchases of inventory by our Canadian subsidiary, which are denominated in US dollars. The term of this cash flow hedge extends through the first quarter of fiscal 2009.

To achieve our objective and to minimize the risk of ineffectiveness, the notional values represent a portion of our Canadian subsidiary's forecasted intercompany purchases. Hedge ineffectiveness is recorded in Other (income) and expense, net in the Consolidated Statement of Operations, as required. For the year ended January 31, 2009, the ineffective portion of the hedge was immaterial.

For the portion of the hedge that is effective, the change in fair value of that hedge will initially be recorded in Accumulated other comprehensive income in the Consolidated Statement of (Deficit) Equity. As the underlying inventory is sold to our customers, amounts will be reclassified from Accumulated other comprehensive income to Cost of sales and occupancy expense in the Consolidated Statement of Operations. We also classify the cash flows from derivative instruments in prepaid and other in the Consolidated Statement of Cash Flows. The change in fair value of the hedge for the year ended January 31, 2009 was \$2 million.

The table below provides the remaining quarterly notional values and the average CAD/USD exchange rate associated with the hedge (dollars in millions).

Settlement Period	Outstanding Notional Amount		Contract Rate
	CAD Amount	USD Amount	
Quarter 1, 2009	\$ 12.2	\$ 12.2	1.001

Note 10. Fair Value Measurements

As defined in SFAS No. 157, 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. SFAS No. 157 establishes a three-level valuation hierarchy for fair value measurements. These valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions. These two types of inputs create the following fair value hierarchy:

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

Edgar Filing: MICHAELS STORES INC - Form 10-K

The following table presents net financial assets (liabilities) accounted for at fair value on a recurring basis as of January 31, 2009 (in millions):

	Level 1	Level 2	Level 3	Total
Cash equivalents	\$ 3	\$	\$	\$ 3
Foreign Currency Derivative Instruments		2		2

Cash equivalents consist of highly liquid investments, with a maturity of 90 days or less at the date of purchase, including U.S. Treasury bills, various government obligations, and money market funds.

Derivatives in Level 2 are measured based on a variety of pricing factors, which include the market price of the derivative instrument available in the dealer-market, and have been corroborated with market data. See Note 9 for additional information on our derivative instruments.

Note 11. Retirement Plans

We sponsor a 401(k) Savings Plan for our eligible employees and certain of our subsidiaries. Participation in the 401(k) Savings Plan is voluntary and available to any employee who is 21 years of age and has completed 500 hours of service in a six-month

eligibility period. Participants may elect to contribute up to 15% of their considered compensation on a pre-tax basis and up to 10% on an after-tax basis. In accordance with the provisions of the 401(k) Savings Plan, we make a matching cash contribution to the account of each participant in an amount equal to 50% of the participant's pre-tax contributions that do not exceed 6% of the participant's considered compensation for the year. Matching contributions, and the actual earnings thereon, vest to the participants based on years of continuous service, with 100% vesting after three years. Our matching contribution expense, net of forfeitures, was \$3 million for each of fiscal 2008, 2007 and 2006.

Note 12. Commitments and Contingencies

Commitments

We operate stores and use distribution centers, office facilities, and equipment that are generally leased under non-cancelable operating leases, the majority of which provide for renewal options. Future minimum annual rental commitments for all non-cancelable operating leases as of January 31, 2009 are as follows (in millions):

	Operating Leases	
For the Fiscal Year:		
2009	\$	325
2010		293
2011		251
2012		207
2013		165
Thereafter		373
Total minimum rental commitments	\$	1,614

Rental expense applicable to non-cancelable operating leases was \$312 million, \$293 million, and \$280 million, in fiscal 2008, 2007, and 2006, respectively.

As of January 31, 2009, we had commitments outstanding for purchase obligations related to merchandise inventories of approximately \$40 million.

Employee Class Action Claims

Cotton Claim

On December 20, 2002, James Cotton, a former store manager of Michaels of Canada, ULC, our wholly-owned subsidiary, and Suzette Kennedy, a former assistant manager of Michaels of Canada, commenced a purported class proceeding against Michaels of Canada and Michaels Stores, Inc. on behalf of themselves and current and former employees employed in Canada. The Cotton claim was filed in the Ontario

Edgar Filing: MICHAELS STORES INC - Form 10-K

Superior Court of Justice and alleges that the defendants violated employment standards legislation in Ontario and other provinces and territories of Canada by failing to pay overtime compensation as required by that legislation. The Cotton claim also alleges that this conduct was in breach of the contracts of employment of those individuals. The Cotton claim seeks a declaration that the defendants have acted in breach of applicable legislation, payment to current and former employees for overtime, damages for breach of contract, punitive, aggravated and exemplary damages, interest, and costs. In May of 2005, the plaintiffs delivered material in support of their request that this action be certified as a class proceeding. Michaels filed and served its responding materials opposing class certification on January 31, 2006. The parties reached a settlement for an immaterial amount in February 2009. Subsequently a motion to dismiss the case was filed and it is expected that the Court will issue an order dismissing the case prior to the end of the first quarter of fiscal 2009.

DeJoseph Claim

On December 29, 2006, John DeJoseph, a former Michaels store manager in Valencia, California, commenced a purported class action proceeding against Michaels Stores, Inc. on behalf of himself and current and former salaried store managers employed in California from May 10, 2002 to the present. The DeJoseph suit was filed in the Superior Court of California, County of Los Angeles. The DeJoseph suit alleges that Michaels failed to pay overtime wages, provide meal periods, accurately record hours worked, provide itemized employee wage statements, and that Michaels unlawfully made deductions from employees' earnings. The DeJoseph suit additionally alleges that the foregoing conduct was in breach of California's unfair competition law. The plaintiff seeks injunctive relief, damages for unpaid wages, penalties, restitution, interest, and attorneys' fees and costs. In April 2008, the Court certified the class as to monetary relief for the overtime claim, but denied certification as to the wage statement and meal break claims plus the injunctive relief portion of the overtime claim. In March 2009 the Court reconsidered and de-certified the class with respect to the overtime claims. The case will proceed with the three individual plaintiffs. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We are unable to estimate a range of loss, if any, in this case.

Consumer Class Action Claims

Carson Claim

On August 15, 2008, Linda Carson, a consumer, filed a purported class action proceeding in Superior Court of California, County of San Diego. Carson filed this action against Michaels Stores, Inc., on behalf of herself and all similarly-situated California consumers. The Carson suit alleges that Michaels unlawfully requested and recorded personally identifiable information (i.e., her zip code) as part of a credit card transaction. The plaintiff seeks 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.

Governmental Inquiries and Related Matters

Non-U.S. Trust Inquiry

In early 2005, the District Attorney's office of the County of New York and the SEC opened inquiries concerning non-U.S. trusts that directly or indirectly held shares of Michaels Common Stock and Common Stock options. A federal grand jury requested information with respect to the same facts. We are cooperating in these inquiries and have provided information in response to the requests.

Certain of these trusts and corporate subsidiaries of the trusts acquired securities of Michaels in transactions directly or indirectly with Charles J. Wyly, Jr. and Sam Wyly, who were, respectively, Chairman and Vice Chairman of the Board of Directors prior to the consummation of the Merger, or with other Wyly family members. In addition, subsidiaries of certain of these trusts acquired securities directly from us in private placement transactions in 1996 and 1997 and upon the exercise of stock options transferred, directly or indirectly, to the trusts or their subsidiaries by Charles Wyly, Sam Wyly, or other Wyly family members.

We understand that Charles Wyly and Sam Wyly and/or certain of their family members are beneficiaries of irrevocable non-U.S. trusts. The 1996 and 1997 private placement sales by us of Michaels securities to subsidiaries of certain of these trusts were disclosed by us in filings with the SEC. The transfer by Charles Wyly and/or Sam Wyly (or by other Wyly family members or family-related entities) of Michaels securities to certain of these trusts and subsidiaries was also disclosed in filings with the SEC by us and/or by Charles Wyly and Sam Wyly. Based on information provided to us, our SEC filings prior to 2005 did not report securities owned by the non-U.S. trusts or their corporate subsidiaries as beneficially owned by Charles Wyly and Sam Wyly.

Charles Wyly and Sam Wyly filed an amended Schedule 13D with the SEC on April 8, 2005, stating that they may be deemed the beneficial owners of Michaels securities held directly or indirectly by the non-U.S. trusts. In our 2005 and 2006 proxy statements, we included the securities held in the non-U.S. trusts or their separate subsidiaries, as reported by the Wyllys, in the beneficial ownership table of our principal stockholders and management, with appropriate footnotes.

Stock Options Inquiry

Edgar Filing: MICHAELS STORES INC - Form 10-K

On June 15, 2006, following Michaels' announcement that its Audit Committee had initiated an internal review, referred to below, into the Company's historical stock options practices, Michaels received a letter from the Division of Enforcement of the SEC requesting that the Company preserve all documents concerning its granting of stock options from 1990 through the present and stating that the SEC intended to request production of such documents in the future. In a letter dated November 15, 2006, the Division requested the documents. A June 16, 2006 grand jury subpoena issued by the U.S. District Court for the Southern District of New York requesting documents relating to the granting of stock options during the period 1996 to the present was withdrawn in connection with a July 27, 2006 grand jury subpoena issued by the U.S. District Court for the Northern District of Texas on behalf of the Fraud section of the Department of Justice requesting documents relating to the granting of stock options during the same period. We are cooperating in these inquiries and have provided information in response to the requests.

The Company's Audit Committee conducted an internal review into the Company's historical stock options practices, including a review of the Company's underlying option grant documentation and procedures and related accounting. The Audit Committee's

internal review was conducted with the assistance of independent legal counsel and outside accounting experts. The Company voluntarily reported the commencement of this review to the SEC.

The Audit Committee review focused principally on the question of whether there may have been intentional wrongdoing in the Company's historical stock options granting practices. On August 25, 2006, the Audit Committee's independent legal counsel presented to the Audit Committee its final report, which stated that the investigation did not support a conclusion that there was intentional misconduct. Based on the independent counsel report, the Audit Committee concluded that the results of the investigation did not support a finding of intentional misconduct.

The Company also conducted a separate internal review of historical stock option practices and related accounting issues from 1990 through the Merger date. In this review, the Company was advised, with respect to specific Delaware law issues, by independent Delaware counsel and, with respect to specific Texas law issues, by independent Texas counsel. Management of the Company discussed its internal review and related judgments with the Company's independent registered public accounting firm and the Board of Directors and Audit Committee. Notwithstanding that the Audit Committee concluded that the results of the investigation did not support a finding of intentional misconduct, the Company identified accounting issues related to certain of the stock option grants prior to October 2001. As a result, and as previously reported in our Annual Report on Form 10-K for fiscal year 2006, in fiscal 2007 we made adjustments to our beginning retained earnings balance for fiscal 2002 by recording additional non-cash compensation cost of approximately \$27 million, net of income tax benefits of approximately \$13 million.

General

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

Note 13. Concentration of Credit Risk

We periodically invest our excess cash and equivalents in money market funds and trusts, which are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other financial or government institution. We also deposit a portion of our cash and equivalents with numerous federally-insured financial institutions, the balances of which often exceed \$250,000. The Federal Deposit Insurance Corporation insures each account up to a maximum of \$250,000 of the aggregate account balance with each institution. We believe counterparty default risk is low as we only use financial institutions with investment grade ratings or funds and trusts that invest in securities with investment grade ratings and that possess the necessary liquidity to satisfy our redemption needs.

Note 14. Segments and Geographic Information

We consider our Michaels and Aaron Brothers operations to be our operating segments for purposes of determining reportable segments based on the criteria of SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*. We determined that our Michaels and Aaron Brothers operating segments have similar economic characteristics and meet the aggregation criteria set forth in paragraph 17 of SFAS

Edgar Filing: MICHAELS STORES INC - Form 10-K

No. 131. Therefore, we combine both operating segments into one reporting segment.

The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies in Note 1.

Our chief operating decision makers evaluate historical operating performance and plan and forecast of future periods' operating performance based on earnings before interest, income taxes, discontinued operations, goodwill impairment, depreciation and amortization (EBITDA). In addition, an element of base incentive compensation targets for certain management personnel are based on EBITDA. A reconciliation of EBITDA to (loss)/income before income taxes and discontinued operations is presented below.

F-28

Edgar Filing: MICHAELS STORES INC - Form 10-K

	2008	Fiscal Year		2006
		2007		
(Loss) income before income taxes and discontinued operations	\$ (2)	\$ (17)	\$	115
Interest expense	302	378		105
Interest income		(1)		(10)
Depreciation and amortization	129	125		119
EBITDA	\$ 429	\$ 485	\$	329

Our sales and assets by country are as follows:

	Net Sales		Total Assets	
	(in millions)			
Fiscal 2008:				
United States	\$	3,517	\$	1,535
Canada		300		90
Consolidated total	\$	3,817	\$	1,625
Fiscal 2007:				
United States	\$	3,558	\$	1,507
Canada		304		107
Consolidated total	\$	3,862	\$	1,614
Fiscal 2006:				
United States	\$	3,578	\$	1,610
Canada		265		83
Consolidated total	\$	3,843	\$	1,693

We present assets based on their physical, geographic location. Certain assets located in the United States are also used to support our Canadian operations, but we do not allocate these assets to Canada.

Note 15. Related Party Transactions

We pay annual management fees to the Sponsors in the amount of \$12 million and an annual management fee to Highfields Capital Management LP in the amount of \$1 million. We recognized \$14 million, \$13 million and \$3 million of expense in fiscal 2008, 2007 and 2006, respectively, related to annual management fees.

As more fully described in Note 4, during fiscal 2006, we paid the Sponsors transaction fees totaling \$60 million in connection with services provided by them related to the Merger. We recognized \$24 million of the Sponsor transaction fees as an expense, capitalized \$27 million of the fees as debt issuance costs, and classified \$9 million as equity issuance costs. We also reimbursed the Sponsors, or paid on their behalf, Merger-related fees of \$15 million incurred by them. Of the \$15 million, we expensed \$9 million and capitalized \$6 million as debt issuance costs.

Edgar Filing: MICHAELS STORES INC - Form 10-K

Bain Capital owns a majority ownership stake in an external vendor we utilize to print our circular advertisements. Payments associated with this vendor during fiscal 2008, fiscal 2007 and fiscal 2006 were \$44 million, \$46 million and \$44 million, respectively, and are included in selling, general and administrative expense on the Consolidated Statements of Operations

During the first quarter of fiscal 2007, The Blackstone Group acquired a majority ownership stake in an external vendor we utilize to count our store inventory. Payments associated with this vendor during fiscal 2008 and fiscal 2007 were \$6 million and \$5 million, respectively, and are included in selling, general and administrative expense on the Consolidated Statements of Operations.

During the third quarter of fiscal 2007, Bain Capital acquired an ownership stake in an external vendor we utilize for non-merchandise supplies. Payments associated with this vendor during each of fiscal 2008 and fiscal 2007 were approximately \$3 million, and are included in selling, general and administrative expense on the Consolidated Statements of Operations.

During fiscal 2008, we began utilizing an external vendor for waste management services that is partially owned by The Blackstone Group. Payments associated with this vendor during fiscal 2008 were \$3 million, and are included in selling, general and administrative expense on the Consolidated Statements of Operations.

During the first quarter of fiscal 2008, The Blackstone Group acquired an ownership stake in an external vendor we utilize for all of the candy-type items in our stores. Payments associated with this vendor during fiscal 2008 were \$18 million, and are recognized in cost of sales as the sales are incurred.

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 fiscal 2008. During fiscal 2007, the Company sold 541,006 shares to officers. Also, during fiscal 2008 and fiscal 2007, we repurchased 111,334 shares and 93,333 shares, respectively, from officers who are no longer with the Company.

In connection with the consummation of the Merger, the Company entered into a Separation Agreement with each of Charles Wyly and Sam Wyly, executive officers and directors of the Company prior to the Merger. Under the Separation Agreements, each of Charles Wyly and Sam Wyly received a lump sum payment of \$3 million in exchange for his agreement to adhere to certain non-competition, non-solicitation and confidentiality restrictions. We amortized these Separation Agreements over two years.

Donald R. Miller, Jr., the son-in-law of Charles J. Wyly, Jr., was Vice President - Market Development of Michaels until his departure on November 1, 2006. In fiscal 2006, we paid Mr. Miller \$212,000 in salary. Mr. Miller also earned a fiscal 2006 cash bonus of \$80,153 and received \$177,470 in other fiscal 2006 compensation, including premium payments for life and long-term disability insurance, Company contributions to the 401(k) plan, medical benefits, other perquisites and personal benefits and tax gross-up payments. In addition, upon his resignation, Mr. Miller became entitled to severance benefits under a Change in Control Agreement dated April 26, 2006, and a bonus under a Change in Control Bonus Plan, the terms of each of which are described under Item 11. Executive Compensation - Executive and Director Compensation - Potential Payments upon Termination or Change in Control - Rights and Potential Payments Upon a Change in Control. Under the Change in Control Agreement and the Change in Control Bonus Plan, Mr. Miller was paid the aggregate amount of \$867,000 and became entitled to a continuation for two years of welfare and fringe benefits, at an estimated cost to the Company of \$73,493. Mr. Miller was also entitled to reimbursement for outplacement services of up to \$50,000.

Note 16. Condensed Consolidating Financial Information

All of the Company's obligations under the Senior Notes, Senior Subordinated Notes, Subordinated Discount Notes, Senior secured term loan, and Asset-based revolving credit facility are guaranteed by the Parent and Guarantor subsidiaries. Currently, Aaron Brothers Card Services, LLC is a non-guarantor subsidiary that was organized on July 11, 2008. As of January 31, 2009, the financial statements of Aaron Brothers Card Services, LLC were immaterial.

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 Statement of Operations

	Fiscal Year 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	\$ 3,356	\$ 2,206	\$ (1,745)	\$ 3,817
Cost of sales and occupancy expense	2,342	1,834	(1,745)	2,431
Gross profit	1,014	372		1,386
Selling, general, and administrative expense	934	126		1,060
Transaction expenses				
Related party expenses	16			16
Store pre-opening costs	6			6
Operating income	58	246		304
Interest expense	302			302
Other (income) and expense, net		4		4
Intercompany charges (income)	76	(76)		
Equity in earnings of subsidiaries	318		(318)	
(Loss) income before income taxes and discontinued operations	(2)	318	(318)	(2)
Provision for income taxes	3	123	(123)	3
(Loss) income before discontinued operations	(5)	195	(195)	(5)
Discontinued operations loss, net of income tax				
Net (loss) income	\$ (5)	\$ 195	\$ (195)	\$ (5)

Supplemental Condensed Consolidating Statement of Operations

	Fiscal Year 2007			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	\$ 3,383	\$ 2,012	\$ (1,533)	\$ 3,862
Cost of sales and occupancy expense	2,274	1,642	(1,533)	2,383
Gross profit	1,109	370		1,479
Selling, general, and administrative expense	918	133		1,051
Transaction expenses	29			29
Goodwill impairment		22		22
Related party expenses	17			17
Store pre-opening costs	5	1		6
Operating income	140	214		354
Interest expense	378			378
Other (income) and expense, net	(1)	(6)		(7)
Intercompany charges (income)	79	(79)		
Equity in earnings of subsidiaries	299		(299)	
(Loss) income before income taxes and discontinued operations	(17)	299	(299)	(17)
Provision for income taxes	5	120	(120)	5
(Loss) income before discontinued operations	(22)	179	(179)	(22)
Discontinued operations loss, net of income tax	(10)			(10)
Net (loss) income	\$ (32)	\$ 179	\$ (179)	\$ (32)

Supplemental Condensed Consolidating Statement of Operations

	Fiscal Year 2006			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	\$ 3,393	\$ 1,867	\$ (1,417)	\$ 3,843
Cost of sales and occupancy expense	2,281	1,500	(1,417)	2,364
Gross profit	1,112	367		1,479
Selling, general, and administrative expense	904	119		1,023
Transaction expenses	205			205
Goodwill impairment				
Related party expenses	38			38
Store pre-opening costs	4	1		5
Operating (loss) income	(39)	247		208
Interest expense	105			105
Other (income) and expense, net	(12)			(12)
Intercompany charges (income)	83	(83)		
Equity in earnings of subsidiaries	330		(330)	
Income (loss) before income taxes and discontinued operations	115	330	(330)	115
Provision (benefit) for income taxes	71	126	(126)	71
Income (loss) before discontinued operations	44	204	(204)	44
Discontinued operations loss, net of income tax	(3)			(3)
Net income (loss)	\$ 41	\$ 204	\$ (204)	\$ 41

Supplemental Condensed Consolidating Balance Sheet

	January 31, 2009				Consolidated
	Parent Company	Guarantor Subsidiaries	Eliminations (in millions)		
ASSETS					
Current assets:					
Cash and equivalents	\$ 26	\$ 7	\$	\$	33
Merchandise inventories	627	273			900
Intercompany receivables		387	(387)		
Other	62	54			116
Total current assets	715	721	(387)		1,049
Property and equipment, net	284	98			382
Goodwill, net	94				94
Investment in subsidiaries	488		(488)		
Other assets	80	20			100
Total assets	\$ 1,661	\$ 839	\$ (875)		\$ 1,625
LIABILITIES AND STOCKHOLDERS (DEFICIT)					
EQUITY					
Current liabilities:					
Accounts payable	\$ 15	\$ 215	\$	\$	230
Accrued liabilities and other	200	75			275
Current portion of long-term debt	173				173
Intercompany payable	387		(387)		
Other	(32)	35			3
Total current liabilities	743	325	(387)		681
Long-term debt	3,756				3,756
Other long-term liabilities	49	26			75
Total stockholders (deficit) equity	(2,887)	488	(488)		(2,887)
Total liabilities and stockholders (deficit) equity	\$ 1,661	\$ 839	\$ (875)		\$ 1,625

Supplemental Condensed Consolidating Balance Sheet

	Parent Company	February 2, 2008		Consolidated
		Guarantor Subsidiaries	Eliminations	
(in millions)				
ASSETS				
Current assets:				
Cash and equivalents	\$ 26	\$ 3	\$	\$ 29
Merchandise inventories	622	223		845
Intercompany receivables		250	(250)	
Other	61	45		106
Total current assets	709	521	(250)	980
Property and equipment, net	308	125		433
Goodwill, net	94			94
Investment in subsidiaries	325		(325)	
Other assets	91	16		107
Total assets	\$ 1,527	\$ 662	\$ (575)	\$ 1,614
LIABILITIES AND STOCKHOLDERS (DEFICIT)				
EQUITY				
Current liabilities:				
Accounts payable	\$ 29	\$ 192	\$	\$ 221
Accrued liabilities and other	249	83		332
Current portion of long-term debt	122			122
Intercompany payable	250		(250)	
Other	(37)	41		4
Total current liabilities	613	316	(250)	679
Long-term debt	3,741			3,741
Other long-term liabilities	65	21		86
Total stockholders (deficit) equity	(2,892)	325	(325)	(2,892)
Total liabilities and stockholders (deficit) equity	\$ 1,527	\$ 662	\$ (575)	\$ 1,614

Supplemental Condensed Consolidating Statement of Cash Flows

	Fiscal Year 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating activities:				
Net cash provided by operating activities	\$ 47	\$ 192	\$ (180)	\$ 59
Investing activities:				
Cash paid for property and equipment	(77)	(8)		(85)
Net cash used in investing activities	(77)	(8)		(85)
Financing activities:				
Net borrowings of long-term debt	27			27
Intercompany dividends		(180)	180	
Other financing activities	3			3
Net cash provided by (used in) financing activities	30	(180)	180	30
Increase in cash and equivalents		4		4
Beginning cash and equivalents	26	3		29
Ending cash and cash equivalents	\$ 26	\$ 7	\$	\$ 33

Supplemental Condensed Consolidating Statement of Cash Flows

	Fiscal Year 2007			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating activities:				
Net cash provided by operating activities	\$ 236	\$ 244	\$ (212)	\$ 268
Investing activities:				
Cash paid for property and equipment	(68)	(32)		(100)
Net cash used in investing activities	(68)	(32)		(100)
Financing activities:				
Net repayments of long-term debt	(134)			(134)
Intercompany dividends		(212)	212	
Other financing activities	(35)			(35)
Net cash used in financing activities	(169)	(212)	212	(169)
Decrease in cash and equivalents	(1)			(1)
Beginning cash and equivalents	27	3		30
Ending cash and equivalents	\$ 26	\$ 3	\$	\$ 29

Supplemental Condensed Consolidating Statement of Cash Flows

	Fiscal Year 2006			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating Activities:				
Net cash provided by operating activities	\$ 133	\$ 206	\$ (182)	\$ 157
Investing Activities:				
Cash paid for property and equipment	(108)	(35)		(143)
Net cash used in investing activities	(108)	(35)		(143)
Financing Activities:				
Net borrowing of long-term debt	3,825			3,825
Equity investment of the Sponsors	1,649			1,649
Payment for old Common Stock in the Merger	(5,806)			(5,806)
Cash dividends paid to stockholders	(58)			(58)
Intercompany dividends		(182)	182	
Repurchase of Old Common Stock	(66)			(66)
Other financing activities	50	(30)		20
Net cash used in financing activities	(406)	(212)	182	(436)
Decrease in cash and equivalents	(381)	(41)		(422)
Beginning cash and equivalents	408	44		452
Ending cash and equivalents	\$ 27	\$ 3	\$	\$ 30

Note 17. Subsequent Event

During the first quarter of fiscal 2009, we purchased an interest rate cap to hedge the variability of cash flows associated with our interest payments on our Senior secured term loan that result from fluctuations in the three-month LIBOR rate. The cap limits our interest exposure on a notional value of \$2.0 billion to the lesser of the three-month Libor rate or 7.0%. The term of the cap is from April 15, 2009 through April 15, 2015.

MICHAELS STORES, INC.

UNAUDITED SUPPLEMENTAL QUARTERLY FINANCIAL DATA

(in millions)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Fiscal 2008 (1):				
Net sales	\$ 847	\$ 796	\$ 906	\$ 1,268
Cost of sales and occupancy expense	521	518	584	808
Gross profit	326	278	322	460
Selling, general, and administrative expense	272	246	247	295
Operating income	48	27	68	161
(Loss) income before discontinued operations	(20)	(30)	(20)	65
Net (loss) income	(20)	(30)	(20)	65
Fiscal 2007 (2):				
Net sales	\$ 839	\$ 788	\$ 934	\$ 1,301
Cost of sales and occupancy expense	513	498	591	781
Gross profit	326	290	343	520
Selling, general, and administrative expense (3)	254	242	262	293
Operating income	60	27	67	200
(Loss) income before discontinued operations	(22)	(43)	(13)	56
Net (loss) income	(23)	(44)	(18)	53

We report on the basis of a 52 or 53-week fiscal year, which ends on the Saturday closest to January 31. Our interim periods each contain 13 weeks, with the first quarter ending on a Saturday 13 weeks after the end of our previous fiscal year. For fiscal years that contain 53 weeks, our fourth quarter contains 14 weeks.

- (1) See Item 9B. Other Information for a discussion of certain modifications made to our previously reported fiscal 2008 year end results.
- (2) Amounts have been adjusted from amounts previously reported on our Quarterly Reports on Form 10-Q to reflect discontinued operations, as applicable, for each period.
- (3) Fiscal 2007 selling, general, and administrative expense amounts have been adjusted from amounts previously reported on our Quarterly Reports on Form 10-Q to include expenses associated with an external vendor, owned by The Blackstone Group, who provides inventory count services. These expenses were previously reported as Related Party Expenses.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: April 2, 2009

MICHAELS STORES, INC.

By:

/s/ Elaine D. Crowley
 Elaine D. Crowley
 Executive Vice President - Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ Brian C. Cornell Brian C. Cornell	Chief Executive Officer (Principal Executive Officer)	April 2, 2009
/s/ Elaine D. Crowley Elaine D. Crowley	Executive Vice President - Chief Financial Officer (Principal Financial Officer)	April 2, 2009
/s/ Richard S. Jablonski Richard S. Jablonski	Vice President Finance and Controller (Principal Accounting Officer)	April 2, 2009
/s/ Josh Bekenstein Josh Bekenstein	Director	April 2, 2009
/s/ Michael S. Chae Michael S. Chae	Director	April 2, 2009
/s/ Gerry M. Murphy Gerry M. Murphy	Director	April 2, 2009
/s/ Todd M. Cook Todd M. Cook	Director	April 2, 2009
/s/ Lewis S. Klessel Lewis S. Klessel	Director	April 2, 2009
/s/ Matthew S. Levin Matthew S. Levin	Director	April 2, 2009
/s/ James A. Quella James A. Quella	Director	April 2, 2009
/s/ Peter F. Wallace Peter F. Wallace	Director	April 2, 2009

EXHIBIT INDEX

Exhibit Number	Description of Exhibit
2.1	Agreement and Plan of Merger, dated as of June 30, 2006, among Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC, Blackstone Paste Finco, LLC and Michaels Stores, Inc. (previously filed as Exhibit 2.1 to Form 8-K filed by Registrant on July 6, 2006, SEC File No. 001-09338).
2.2	First Amendment to Agreement and Plan of Merger, dated as of September 1, 2006, among Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC, Blackstone Paste Finco, LLC and Michaels Stores, Inc. (previously filed as Exhibit 2.1 to Form 8-K filed by Registrant on September 5, 2006, SEC File No. 001-09338).
3.1	Amended and Restated Certificate of Incorporation of Michaels Stores, Inc. (previously filed as Exhibit 3.1 to Form 10-K filed by Registrant on May 3, 2007, SEC File No. 001-09338).
3.2	Amended and Restated Bylaws of Michaels Stores, Inc. (previously filed as Exhibit 3.2 to Form 8-K filed by Registrant on November 6, 2006, SEC File No. 001-09338).
4.1	Senior Indenture, dated as of October 31, 2006, among Michaels Stores, Inc., the guarantors named therein and Wells Fargo Bank, National Association, as trustee (previously filed as Exhibit 4.1 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
4.2	Senior Subordinated Indenture, dated as of October 31, 2006, among Michaels Stores, Inc., the guarantors named therein and Wells Fargo Bank, National Association, as trustee (previously filed as Exhibit 4.2 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
4.3	Subordinated Discount Indenture, dated as of October 31, 2006, among Michaels Stores, Inc., the guarantors named therein and Wells Fargo Bank, National Association, as trustee (previously filed as Exhibit 4.3 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
4.4	Registration Rights Agreement, dated as of October 31, 2006, among Michaels Stores, Inc. and certain stockholders thereof (previously filed as Exhibit 4.7 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
10.1	Michaels Stores, Inc. 2006 Equity Incentive Plan (previously filed as Exhibit 10.1 to Form 8-K filed by Registrant on February 21, 2007, SEC File No. 001-09338).*
10.2	Form of Stock Option Agreement under the Registrant's 2006 Equity Incentive Plan (previously filed as Exhibit 10.2 to Form 8-K filed by Registrant on February 21, 2007, SEC File No. 001-09338).*
10.3	Form of Restricted Stock Award Agreement under the Michaels Stores, Inc. 2006 Equity Incentive Plan (previously filed as Exhibit 10.3 to Form 10-Q filed by the Registrant on June 6, 2008, SEC File No. 001-09338).*
10.4	Form of Change in Control Severance Agreement (previously filed as Exhibit 10.2 to Form 10-Q filed by Registrant on June 13, 2006, SEC File No. 001-09338).*
10.5	Form of Change in Control Retention Bonus Plan (previously filed as Exhibit 10.3 to Form 10-Q filed by Registrant on June 13, 2006, SEC File No. 001-09338).*
10.6	Fiscal Year 2008 Bonus Plan Summary for Executive Officers (previously filed as Exhibit 10.1 to Form 8-K filed by Registrant on April 9, 2008, SEC File No. 001-09338).*
10.7	Form of Fiscal Year 2008 Bonus Plan (previously filed as Exhibit 10.1 to Form 10-Q filed by Registrant on June 6, 2008, SEC File No. 001-09338).*
10.8	Employment Agreement, dated June 4, 2007, between Michaels Stores, Inc. and Brian C. Cornell (previously filed as Exhibit 10.2 to Form 10-Q filed by Registrant on June 11, 2007, SEC File No. 001-09338).*

Edgar Filing: MICHAELS STORES INC - Form 10-K

- 10.9 Letter Agreement, dated May 19, 2008, between Michaels Stores, Inc. and Shelley G. Broader (previously filed as Exhibit 10.4 to Form 10-Q filed by Registrant on June 6, 2008, SEC File No. 001-09338).*
- 10.10 Letter Agreement dated July 17, 2008, between Michaels Stores, Inc. and Elaine D. Crowley (previously filed as
-

Edgar Filing: MICHAELS STORES INC - Form 10-K

Exhibit 99.2 to Form 8-K filed by Registrant on July 24, 2008, SEC File No. 001-09338).*

- 10.11 Restricted Stock Award Agreement, dated June 4, 2007, between Michaels Stores, Inc. and Brian C. Cornell (previously filed as Exhibit 10.4 to Form 10-Q filed by Registrant on June 11, 2007, SEC File No. 001-09338).*
- 10.12 Stock Option Agreement, dated June 4, 2007, between Michaels Stores, Inc. and Brian C. Cornell (previously filed as Exhibit 10.5 to Form 10-Q filed by Registrant on June 11, 2007, SEC File No. 001-09338).*
- 10.13 Stockholders Agreement, dated as of October 31, 2006, among Michaels Stores, Inc. and certain stockholders thereof (previously filed as Exhibit 10.1 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
- 10.14 Amended and Restated Stockholders Agreement, dated as of February 16, 2007, among Michaels Stores, Inc. and certain stockholders thereof (previously filed as Exhibit 10.23 to Form 10-K filed by Registrant on May 3, 2007, SEC File No. 001-09338).
- 10.15 Management Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Bain Capital Partners, LLC and Blackstone Management Partners V LLC (previously filed as Exhibit 10.2 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).*
- 10.16 Management Agreement, dated as of October 31, 2006, between Michaels Stores, Inc. and Highfields Capital Management LP (previously filed as Exhibit 10.3 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).*
- 10.17 Michaels Stores, Inc. Amended Officer Severance Pay Plan (filed herewith).*
- 10.18 Separation and Release Agreement, dated April 9, 2008, between Michaels Stores, Inc. and Jeffrey N. Boyer (filed herewith).*
- 10.19 Separation and Release Agreement, dated May 27, 2008, between Michaels Stores, Inc. and Harvey S. Kanter (previously filed as Exhibit 10.5 to Form 10-Q filed by Registrant on June 6, 2008, SEC File No. 001-09338).*
- 10.20 Separation Agreement and Release, dated July 2, 2008, between Michaels Stores, Inc. and Thomas M. Bazzone (previously filed as Exhibit 10.5 to Form 8-K filed by Registrant on July 9, 2008, SEC File No. 001-09338).*
- 10.21 Separation Agreement, dated October 31, 2006, between Charles J. Wyly, Jr. and Michaels Stores, Inc. (previously filed as Exhibit 10.27 to Form 10-K filed by Registrant on May 3, 2007, SEC File No. 001-09338).*
- 10.22 Separation Agreement, dated October 31, 2006, between Sam Wyly and Michaels Stores, Inc. (previously filed as Exhibit 10.28 to Form 10-K filed by Registrant on May 3, 2007, SEC File No. 001-09338).*
- 10.23 Form of Director Indemnification Agreement between Michaels Stores, Inc. and certain directors thereof (previously filed as Exhibit 10.36 to Form 10-K filed by Registrant on March 30, 2006, SEC File No. 001-09338).
- 10.24 Form of Officer Indemnification Agreement between Michaels Stores, Inc. and certain officers thereof (previously filed as Exhibit 10.37 to Form 10-K filed by Registrant on March 30, 2006, SEC File No. 001-09338).
- 10.25 Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., as lead borrower, the facility guarantors named therein, Bank of America, N.A., as administrative agent and collateral agent, Deutsche Bank Securities Inc., as syndication agent, Credit Suisse, JPMorgan Chase Bank, N.A., Wells Fargo Retail Finance, LLC, as co-documentation agents, the lenders named therein, and Banc of America Securities LLC, Deutsche Bank Securities Inc. and J.P. Morgan Securities Inc., as joint lead arrangers and joint bookrunners (previously filed as Exhibit 10.4 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
- 10.26 Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Deutsche Bank AG New York Branch, as administrative agent, the other lenders named therein, JPMorgan Chase Bank, N.A., as syndication agent, and Bank of America, N.A. and Credit Suisse, as co-documentation agents, and Deutsche Bank Securities Inc., J.P. Morgan Securities Inc. and Banc of America Securities LLC as co-lead arrangers and joint bookrunners (previously filed as Exhibit 10.5 to Form 10-Q filed by Registrant on December 7, 2006, SEC File No. 001-09338).
- 10.27 First Amendment to Credit Agreement, dated as of January 19, 2007, to the Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Deutsche Bank AG New York Branch, as administrative agent, the other lenders named therein, JPMorgan Chase Bank, N.A., as syndication agent, and Bank of America, N.A. and Credit Suisse, as

Edgar Filing: MICHAELS STORES INC - Form 10-K

co-documentation agents, and Deutsche Bank Securities Inc., J.P. Morgan Securities Inc. and Banc of America Securities LLC as co-lead arrangers and joint bookrunners (previously filed as Exhibit 10.1 to Form 8-K filed by Registrant on January 25, 2007, SEC File No. 001-09338).

- 10.28 Second Amendment to Credit Agreement, dated as of May 10, 2007, to the Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Deutsche Bank AG New York Branch, as administrative agent, the other lenders named therein, JPMorgan Chase Bank, N.A., as syndication agent, and Bank of America, N.A. and Credit Suisse, as co-documentation agents, and Deutsche Bank Securities Inc., J.P. Morgan Securities Inc. and Banc of America Securities LLC as co-lead arrangers and joint bookrunners (previously filed as Exhibit 10.1 to Form 8-K filed by Registrant on May 11, 2007, SEC File No. 001-09338).
- 10.29 Master Services Agreement, dated as of January 16, 2009, by and between Michaels Stores, Inc. and Tata America International Corporation (filed herewith).
- 10.30 Michaels Stores, Inc. Employees 401(k) Plan, effective March 1, 2009 (filed herewith).*
- 21.1 Subsidiaries of Michaels Stores, Inc. (previously filed as Exhibit 21.1 to Form 10-K filed by Registrant on April 11, 2005, SEC File No. 001-09338).
- 23.1 Consent of Independent Registered Public Accounting Firm (filed herewith).
- 31.1 Certifications of Brian C. Cornell pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
- 31.2 Certifications of Elaine D. Crowley 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).

* Management contract or compensatory plan or arrangement required to be filed as an exhibit to this Annual Report on Form 10-K.
