AMERICAN GREETINGS CORP
Form 10-Q
July 08, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended May 31, 2005

OR

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

For the transition period from ______________________________ to ______________________________

Commission file number 1-13859

AMERICAN GREETINGS CORPORATION

(Exact name of registrant as specified in its charter)

Ohio	**34-0065325**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One American Road, Cleveland, Ohio	**44144**
(Address of principal executive offices)	(Zip Code)

(216) 252-7300

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been

subject to such filing requirements for the past 90 days. Yes þ No o
Yes þ No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in
Rule 12b-2 of the Exchange Act).
As of July 5, 2005, the number of shares outstanding of each of the issuer s classes of common stock was:

Class A Common	62,976,982
Class B Common	4,214,886

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

AMERICAN GREETINGS CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF INCOME

(Thousands of dollars except share and per share amounts)

	(Unaudited) Three Months Ended May 31, 2005	2004
Net sales	$ 443,276	$ 433,541
Costs and expenses:		
Material, labor and other production costs	180,473	181,615
Selling, distribution and marketing	155,274	146,652
Administrative and general	63,128	64,137
Interest expense	9,682	52,694
Other income net	(8,371)	(16,346)
Total costs and expenses	400,186	428,752
Income from continuing operations before income tax expense	43,090	4,789
Income tax expense	16,676	1,853
Income from continuing operations	26,414	2,936
Income from discontinued operations, net of tax		1,302
Net income	$ 26,414	$ 4,238
Earnings per share basic:		
Income from continuing operations	$ 0.39	$ 0.04
Income from discontinued operations		0.02
Net income	$ 0.39	$ 0.06
Earnings per share assuming dilution:		
Income from continuing operations	$ 0.35	$ 0.04
Income from discontinued operations		0.02

Net income	$	0.35	$	0.06
Average number of shares outstanding		68,595,786		68,000,691
Average number of shares outstanding assuming dilution		81,952,895		68,846,170
Dividends declared per share	$	0.08	$	

See notes to condensed consolidated financial statements (unaudited).

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AMERICAN GREETINGS CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(Thousands of dollars)

	(Unaudited) May 31, 2005	(Note 1) February 28, 2005	(Unaudited) May 31, 2004
ASSETS			
Current assets			
Cash and cash equivalents	$ 214,273	$ 250,267	$ 115,850
Short-term investments	208,750	208,740	
Trade accounts receivable, net	196,210	188,987	241,656
Inventories	233,933	222,874	254,035
Deferred and refundable income taxes	165,123	193,497	154,713
Assets of businesses held for sale			37,905
Prepaid expenses and other	210,043	204,253	220,773
Total current assets	1,228,332	1,268,618	1,024,932
Goodwill	263,823	270,057	220,316
Other assets	625,847	644,140	663,449
Property, plant and equipment at cost	989,983	995,281	987,875
Less accumulated depreciation	658,749	653,889	641,337
Property, plant and equipment net	331,234	341,392	346,538
	$ 2,449,236	$ 2,524,207	$ 2,255,235
LIABILITIES AND SHAREHOLDERS EQUITY			
Current liabilities			
Debt due within one year	$ 10,184	$	$
Accounts payable	117,247	143,041	112,294
Accrued liabilities	120,192	118,090	113,329
Accrued compensation and benefits	65,514	96,789	62,921
Income taxes	31,178	38,777	15,731
Liabilities of businesses held for sale			4,635
Other current liabilities	112,575	79,549	69,862
Total current liabilities	456,890	476,246	378,772
Long-term debt	476,159	486,099	483,783
Other liabilities	124,058	137,868	94,149
Deferred income taxes	34,612	37,214	27,300

Shareholders equity	1,357,517	1,386,780	1,271,231
	$ 2,449,236	$ 2,524,207	$ 2,255,235

See notes to condensed consolidated financial statements (unaudited).

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AMERICAN GREETINGS CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Thousands of dollars)

	(Unaudited) Three Months Ended May 31, 2005	2004
OPERATING ACTIVITIES:		
Net income	$ 26,414	$ 4,238
Income from discontinued operations		1,302
Income from continuing operations	26,414	2,936
Adjustments to reconcile to net cash provided by operating activities:		
Gain on sale of investment		(3,090)
Loss (gain) on sale of fixed assets	944	(21)
Loss on extinguishment of debt	862	39,024
Depreciation and amortization	14,646	14,091
Deferred income taxes	7,740	(7,192)
Changes in operating assets and liabilities, net of acquisitions:		
Increase in trade accounts receivable	(10,895)	(13,216)
Increase in inventories	(13,947)	(17,174)
Decrease in other current assets	14,360	7,946
Decrease in deferred costs net	25,147	33,274
Decrease in accounts payable and other liabilities	(48,193)	(28,145)
Other net	654	(4,882)
Cash Provided by Operating Activities	17,732	23,551
INVESTING ACTIVITIES:		
Proceeds from sale of short-term investments	575,785	
Purchases of short-term investments	(575,795)	
Property, plant & equipment additions	(8,607)	(4,403)
Proceeds from sale of fixed assets	36	104
Investment in corporate-owned life insurance	1,614	1,098
Other net	(1,205)	26,879
Cash (Used) Provided by Investing Activities	(8,172)	23,678
FINANCING ACTIVITIES:		
Reduction of long-term debt		(216,417)
Sale of stock under benefit plans	8,511	12,035
Purchase of treasury shares	(45,533)	(9,299)
Dividends to shareholders	(5,500)	
Cash Used by Financing Activities	(42,522)	(213,681)

CASH USED BY DISCONTINUED OPERATIONS		(1,342)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(3,032)	(1,806)
DECREASE IN CASH AND CASH EQUIVALENTS	(35,994)	(169,600)
Cash and Cash Equivalents at Beginning of Year	250,267	285,450
Cash and Cash Equivalents at End of Period	$ 214,273	$ 115,850

See notes to condensed consolidated financial statements (unaudited).

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AMERICAN GREETINGS CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Three Months Ended May 31, 2005 and 2004

Note 1 Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary to fairly present financial position, results of operations and cash flows for the period have been included.

These interim financial statements should be read in conjunction with the financial statements and notes thereto included in the Annual Report on Form 10-K for the year ended February 28, 2005 of American Greetings Corporation (the Corporation), from which the Condensed Consolidated Statement of Financial Position at February 28, 2005, presented herein, has been derived. Certain amounts in the prior year financial statements have been reclassified to conform to the 2006 presentation.

The Corporation s fiscal year ends on February 28 or 29. References to a particular year refer to the fiscal year ending in February of that year. For example, 2005 refers to the year ended February 28, 2005. For 2005, the Corporation s subsidiary, AG Interactive, was consolidated on a two-month lag corresponding with its fiscal year-end of December 31. For 2006, AG Interactive has changed its year-end to coincide with the Corporation s fiscal year-end. As a result, the fiscal quarter ended May 31, 2005 includes five months of AG Interactive s operations. The additional two months of activity generated revenues of approximately $11 million, but had no impact on segment earnings.

Note 2 Seasonal Nature of Business

A significant portion of the Corporation s business is seasonal in nature. Therefore, the results of operations for interim periods are not necessarily indicative of the results for the fiscal year taken as a whole.

Note 3 Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standards (SFAS) No. 151 (SFAS 151), Inventory Costs an amendment of ARB No. 43, Chapter 4. SFAS 151 seeks to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage) in the determination of inventory carrying costs. The statement requires such costs to be treated as a current period expense. SFAS

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151 also establishes the concept of normal capacity and requires the allocation of fixed production overhead to inventory based on the normal capacity of the production facilities. Any unallocated overhead would be treated as a current period expense in the period incurred. This statement is effective for fiscal years beginning after July 15, 2005. The Corporation does not believe that the adoption of SFAS 151 will have a significant impact on the Corporation s consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004) (SFAS 123(R)), Share-Based Payment. SFAS 123(R) requires that compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. SFAS 123(R) eliminates the alternative to use the intrinsic value method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. The Corporation is in the process of evaluating the impact that the adoption of this statement will have on the consolidated financial statements. It is, however, expected to reduce consolidated net income. This statement is effective for the first interim or annual period beginning after June 15, 2005. In April 2005, the Securities and Exchange Commission amended the compliance date of SFAS 123(R) through an amendment of Regulation S-X. The new effective date for the Corporation is March 1, 2006. Refer to Note 12 for the Corporation s current accounting for stock-based compensation.

Note 4 Other Income Net

	Three Months Ended May 31,	
(In thousands)	**2005**	**2004**
Royalty revenue	$ (5,679)	$ (10,483)
Foreign exchange loss (gain)	1,239	(305)
Interest income	(2,640)	(706)
Gain on sale of investment		(3,090)
Other	(1,291)	(1,762)
	$ (8,371)	$ (16,346)

Other includes, among other things, gains and losses on asset disposals and rental income. Proceeds of $19.1 million received from the sale of an investment in the prior year are included in Other net investing activities in the Condensed Consolidated Statement of Cash Flows for the period.

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Note 5 Earnings Per Share

The following table sets forth the computation of earnings per share and earnings per share - assuming dilution:

	Three Months Ended May 31, 2005	Three Months Ended May 31, 2004
Numerator (in thousands):		
Income from continuing operations	$ 26,414	$ 2,936
Add-back interest on convertible subordinated notes, net of tax	1,875	
Income from continuing operations assuming dilution	$ 28,289	$ 2,936
Denominator (in thousands):		
Weighted average shares outstanding	68,596	68,001
Effect of dilutive securities:		
Stock options	756	845
Deferred shares	10	
Convertible debt	12,591	
Weighted average shares outstanding assuming dilution	81,953	68,846
Income from continuing operations per share	$ 0.39	$ 0.04
Income from continuing operations per share assuming dilution	$ 0.35	$ 0.04

Approximately 2.7 million and 4.0 million stock options outstanding in the three month periods ended May 31, 2005 and 2004, respectively, were excluded because the effect would have been antidilutive. In addition, the effect of the convertible subordinated notes has been excluded for the three months ended May 31, 2004, because the effect would have been antidilutive. See Note 10 for further discussion.

Note 6 Comprehensive Income (Loss)

The Corporation s total comprehensive income (loss) is as follows:

(In thousands)	Three Months Ended May 31, 2005	Three Months Ended May 31, 2004
Net income	$ 26,414	$ 4,238
Other comprehensive income (loss):		
Foreign currency translation adjustments	(14,144)	(7,047)
Unrealized loss on securities	(1)	

Total comprehensive income (loss)	$	12,269	$	(2,809)

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Note 7 Trade Accounts Receivable, Net

Trade accounts receivable are reported net of certain allowances and discounts. The most significant of these are as follows:

(In thousands)	May 31, 2005	February 28, 2005	May 31, 2004
Allowance for seasonal sales returns	$ 85,425	$ 94,672	$ 86,773
Allowance for doubtful accounts	17,040	16,684	20,250
Allowance for cooperative advertising	19,145	23,571	20,914
Allowance for rebates	59,308	48,240	38,726
	$ 180,918	$ 183,167	$ 166,663

Note 8 Inventories

(In thousands)	May 31, 2005	February 28, 2005	May 31, 2004
Raw materials	$ 27,316	$ 23,241	$ 35,377
Work in process	24,139	19,719	25,165
Finished products	234,655	228,088	234,344
	286,110	271,048	294,886
Less LIFO reserve	76,673	75,890	71,440
	209,437	195,158	223,446
Display materials and factory supplies	24,496	27,716	30,589
Inventories	$ 233,933	$ 222,874	$ 254,035

The valuation of inventory under the Last-In, First-Out (LIFO) method is made at the end of each fiscal year based on inventory levels and costs at that time. Accordingly, interim LIFO calculations, by necessity, are based on estimates of expected fiscal year-end inventory levels and costs and are subject to final fiscal year-end LIFO inventory calculations.

Note 9 Deferred Costs

In the normal course of its business, the Corporation enters into agreements with certain customers for the supply of greeting cards and related products. Under these agreements, the customer typically receives from the Corporation a combination of cash payments, credits, discounts, allowances and other incentive considerations to be earned by the customer as product is purchased from the Corporation over the effective time period of the agreement to meet a minimum purchase volume commitment. In the event a contract is not completed, the Corporation has a claim for unearned advances under the agreement. The Corporation periodically reviews the progress toward the commitment and adjusts the estimated amortization period accordingly to match the costs with the revenue associated with the agreement. The agreements may or may not specify the Corporation as the sole supplier of social expression products to the customer.

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The Corporation classifies the total contractual amount of the incentive consideration committed to the customer but not yet earned as a deferred cost asset at the inception of an agreement, or any future amendments. Deferred costs estimated to be earned by the customer and charged to operations during the next twelve months are classified as Prepaid expenses and other in the Condensed Consolidated Statement of Financial Position, and the remaining amounts to be charged beyond the next twelve months are classified as Other assets.

A portion of the total consideration may be payable by the Corporation at the time the agreement is consummated. All future payment commitments are classified as liabilities at inception until paid. The payments that are expected to be made in the next twelve months are classified as Other current liabilities in the Condensed Consolidated Statement of Financial Position, and the remaining payment commitments beyond the next twelve months are classified as Other liabilities. The Corporation believes that it maintains adequate reserves for deferred costs related to supply agreements and does not expect that the non-completion of any particular contract would result in a material loss.

As of May 31, 2005, February 28, 2005 and May 31, 2004, deferred costs and future payment commitments are included in the following financial statement captions:

(In thousands)	May 31, 2005	February 28, 2005	May 31, 2004
Prepaid expenses and other	$ 158,055	$ 156,665	$ 173,710
Other assets	567,175	582,401	605,755
Deferred cost assets	725,230	739,066	779,465
Other current liabilities	(92,568)	(65,944)	(54,809)
Other liabilities	(81,921)	(95,452)	(68,154)
Deferred cost liabilities	(174,489)	(161,396)	(122,963)
Net deferred costs	$ 550,741	$ 577,670	$ 656,502

Note 10 Debt

On May 11, 2004, the Corporation amended and restated its senior secured credit facility. This facility was originally entered into on August 9, 2001, as a $350 million facility and was amended on July 22, 2002, to a $320 million facility. The amended and restated senior secured credit facility consists of a $200 million revolving facility maturing on May 10, 2008. There were no outstanding balances under this facility at May 31, 2005, February 28, 2005 or May 31, 2004.

The amended and restated credit facility is secured by the domestic assets of the Corporation and a 65% interest in the common stock of its foreign subsidiaries. The Corporation pays an annual commitment fee of 25 basis points on the undrawn portion of the facility. The facility contains various restrictive covenants. Some of these restrictions require that the Corporation meet specified periodic financial ratios, minimum net worth, maximum leverage, and interest coverage. The credit facility places certain restrictions on the Corporation s ability to incur additional indebtedness, to engage in acquisitions of other businesses, to repurchase its own capital stock and to

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pay shareholder dividends. These covenants are less restrictive than the covenants previously in place.

In April 2005, the Corporation amended its amended and restated senior secured credit facility dated May 11, 2004. The amendment, among other things, increases the maximum amount of dividends that the Corporation may pay to its shareholders, increases the maximum amount of its own capital stock that it may repurchase and extends the period during which the Corporation may repurchase its 11.75% senior subordinated notes due July 15, 2008.

The Corporation is also party to a three-year accounts receivable securitization financing agreement that provides for up to $200 million of financing and is secured by certain trade accounts receivable. Under the terms of the agreement, the Corporation transfers receivables to a wholly-owned consolidated subsidiary that in turn utilizes the receivables to secure borrowings through a credit facility with a financial institution. On August 2, 2004, the agreement was amended to extend the maturity date to August 1, 2007. The related interest rate is commercial paper-based. The Corporation pays an annual commitment fee of 25 basis points on the undrawn portion of the accounts receivable facility. There were no outstanding balances under this agreement at May 31, 2005, February 28, 2005 or May 31, 2004.

During the three months ended May 31, 2004, the Corporation commenced a cash tender offer for all of its outstanding 11.75% senior subordinated notes due July 15, 2008. As a result of this tender offer, a total of $186.2 million of these senior subordinated notes were repurchased and the Corporation recorded a charge of $39.0 million, included in Interest expense on the Condensed Consolidated Stateme