

CHILDRENS PLACE RETAIL STORES INC
Form 10-Q
December 05, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended October 28, 2006

☐

**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 0-23071

THE CHILDREN S PLACE RETAIL STORES, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
Incorporation or organization)

31-1241495

(I.R.S. employer
identification number)

**915 Secaucus Road
Secaucus, New Jersey**
(Address of Principal Executive Offices)

07094
(Zip Code)

(201) 558-2400

(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 ☐ No ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of an accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one).

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

The number of shares outstanding of the registrant's common stock with a par value of \$0.10 per share, as of October 6, 2007 was 29,083,916 shares.

**THE CHILDREN S PLACE RETAIL STORES, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE PERIOD ENDED OCTOBER 28, 2006**

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EXPLANATORY NOTE

The Children's Place Retail Stores, Inc. (the "Company") is restating its condensed consolidated financial statements to reflect additional stock-based compensation expense relating to stock option grants made in each year from the fiscal year ended January 31, 1998 ("fiscal 1997") through the first quarter of fiscal year ended February 3, 2007 ("fiscal 2006"). The Company also is restating its financial statements for all periods beginning with the fiscal year ended February 2, 2002 ("fiscal 2001") through the first quarter of fiscal 2006 to reflect the correction of other errors related to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for the Company's 52- and 53-week fiscal years. This Quarterly Report on Form 10-Q for the thirteen and thirty-nine weeks ended October 28, 2006 reflects the restatement of the Company's consolidated balance sheets as of January 28, 2006 ("fiscal 2005") and October 29, 2005, the related consolidated statements of income for the thirteen and thirty-nine weeks ended October 29, 2005 and the related consolidated statement of cash flows for the thirty-nine weeks ended October 29, 2005. Restated financial information for these periods is set forth in Note 2 "Restatement of Consolidated Financial Statements" in the unaudited condensed consolidated financial statements included in Item 1 of this report.

The Company has not amended and does not intend to amend its previously filed Annual Report on Form 10-K for fiscal 2005 or any other fiscal year or its previously filed Quarterly Reports on Form 10-Q for the first quarter of fiscal 2006 or the first three quarters of fiscal 2005 or any other fiscal quarter. The financial information that has been previously filed or otherwise reported for these periods is superseded by the information in this Quarterly Report on Form 10-Q and the quarterly and annual reports on Form 10-Q and 10-K, respectively, being filed concurrently with this Quarterly Report on Form 10-Q. Accordingly, as previously stated by the Company, the financial statements and related financial information contained in such previously filed reports should no longer be relied upon.

The aggregate impact of the stock-based compensation adjustments on the Company's consolidated statements of income, net of forfeitures of unvested awards and taxes, between the fiscal year ended January 30, 1999 ("fiscal 1998") and the first quarter of fiscal 2006 was a decrease in net income of approximately \$11.2 million. The aggregate impact of the other adjustments unrelated to stock options on the Company's consolidated statements of income, net of taxes, between fiscal 2001 and the first quarter of fiscal 2006 was an increase to net income of approximately \$1.7 million. Additionally, variable rate demand note balances as of April 29, 2006 have been reclassified from cash to short-term investments, and certain other balance sheet amounts have been reclassified. These reclassifications do not result in any additional charges in any period and do not affect working capital for the affected periods.

On September 8, 2006, December 8, 2006, April 5, 2007 and June 15, 2007, the Company filed notifications of late filings with the Securities and Exchange Commission ("SEC") on Form 12b-25, disclosing that, due to an ongoing investigation of its stock option granting practices, it was delaying the filing of its Quarterly Reports on Form 10-Q for the second and third quarters of fiscal 2006, its Annual Report on Form 10-K for fiscal 2006, and its Quarterly Report on Form 10-Q for the first quarter of the fiscal year ending February 2, 2008 ("fiscal 2007"), respectively. In addition, on September 14, 2007, the Company filed another notification of late filing with the SEC on Form 12b-25, disclosing that the Company's Board of Directors ("Board") was reviewing circumstances surrounding certain violations of the Company's policies and procedures by two executives of the Company and was considering the appropriate actions to take regarding these matters and, therefore, the Company would be delaying the filing of its Quarterly Report on Form 10-Q for the second quarter of fiscal 2007. The Company is filing its Annual Report on Form 10-K for fiscal 2006 with the SEC concurrently with this Quarterly Report on Form 10-Q and intends, in the near future, to file its Quarterly Reports on Form 10-Q for the first and second quarters of fiscal 2007.

Mr. Ezra Dabah resigned from his position as the Company's Chief Executive Officer ("CEO"), for various reasons, on September 24, 2007. Mr. Dabah remains a member of the Board of Directors (the "Board"). The Board has named Mr. Charles Crovitz, a current Board member, as interim CEO.

STOCK OPTION INVESTIGATION

Overview of the Investigation

In light of various media reports on stock option backdating at public companies and as recommended by the Audit Committee of the Company's Board, the Company undertook a preliminary review of its stock option granting

practices starting in June 2006. After considering the results of this preliminary review, on August 24, 2006, the Audit Committee retained the Company's outside counsel (Outside Counsel) to assist it with a formal review of the Company's stock option grants. On September 6, 2006, Outside Counsel issued to the Audit Committee a preliminary report concluding that there had been errors in the grant dates of options. The report also concluded that, aside from one grant as to which the report was inconclusive, the errors in stock option dating were unintentional. The Company announced the preliminary report and that, pending completion of its analysis of its accounting for stock option grants, the Company was delaying the filing of its Quarterly Report on Form 10-Q for the second quarter of fiscal 2006. The review of the Company's stock option grants continued and expanded into a full investigation. On or about September 14, 2006, the Company suspended all stock-based compensation activity, including granting stock options and other stock-based compensation and issuing shares pursuant to stock option exercises, pending completion of the review and the Company becoming current on its delinquent filings with the SEC.

In October 2006, the Audit Committee retained separate independent counsel that had not previously represented the Company (Independent Counsel) to advise the Audit Committee regarding the matters under investigation and a forensic accounting consulting firm was retained to assist in the investigation. On October 5, 2006, the Company announced that it expected to restate its financial statements and on October 11, 2006, the Company filed with the SEC a Current Report on Form 8-K disclosing that, because of issues with regard to its accounting for stock option grants, the Company's previously issued financial statements and other historical financial information and related disclosures for periods through the first quarter of fiscal 2006 should no longer be relied upon. On November 24, 2006, a two-member special committee of independent members of the Company's Board (Special Committee) was appointed by the Company's Board to supervise and complete the investigation commenced by the Audit Committee. On December 8, 2006 the Company filed a Form 12b-25 with the SEC disclosing that due to the ongoing investigation it was delaying the filing of its Quarterly Report on Form 10-Q for the third quarter of fiscal 2006.

During the period from September 17, 1997 (the day before the Company first became publicly held) through the most recent grant in February 2006 (Review Period), separate option grant authorizing actions were undertaken by the Company on 122 occasions. For convenience of reference, each of these occasions is referred to herein as a Recorded Grant (regardless of the number of people who received an option award on such occasion or any variations in terms of the awards so granted). At the request of Independent Counsel, the forensic accounting firm conducted an empirical assessment of all stock option grants during the Review Period to identify grants that might warrant further investigation. Using various statistical tests, twenty Recorded Grants were selected for detailed investigation, plus one additional Recorded Grant to a family member of the Company's former CEO. Overall, the investigation involved interviews of fourteen people, representing all the individuals involved in any material respect in the option granting process, and the review of tens of thousands of paper and electronic documents from the files (including office and personal computers) of such individuals and others and from other Company files (including e-mails and other documents recovered from the Company's electronic information system). A grant made to the Company's former CEO, Mr. Ezra Dabah, in connection with the Company's initial public offering of its shares (1997 CEO IPO Grant) also was subsequently investigated by Independent Counsel. As noted below, on September 24, 2007, Mr. Dabah resigned from his position as the Company's CEO, and Mr. Charles Crovitz, an independent Board member, was appointed interim CEO.

Findings of the Stock Option Investigation

On January 30, 2007, the Special Committee delivered its written report of investigation including recommendations (Report of Investigation) to the Board. The Board accepted the report and resolved to adopt the Special Committee's recommendations and to take the actions necessary to implement them. Key findings of the Report of Investigation, as disclosed in a Current Report on Form 8-K filed with the SEC on February 1, 2007, included:

- There was no conclusive evidence of intentional backdating of options or other misconduct in connection with the option granting process. There was no evidence of intent to mislead about option grant dates or exercise prices.
- No member of management and no director engaged in improper self-dealing in connection with the option grants made by the Company.

- All Company personnel cooperated fully with the investigation.
- The Company did not maintain appropriate governance and other internal controls, which resulted in errors in the dating of options and other irregularities in option grants. In many instances options were dated before all grant-making processes were finalized. Consequently, in such instances the option exercise price was lower than it should have been based on the trading price on the date the grant process was completed and incorrect charges were taken for the options for financial reporting purposes. Also, in a few instances, the Company may have selected grant dates with a view toward upcoming disclosures.

The Report of Investigation further concluded that, apart from some immaterial discrepancies in grants to non-executives representing less than 1.5% of the number of shares subject to options issued over the Review Period, there were no unauthorized grants. This conclusion was based on a comparison by the Company of its grant authorizing documentation to the Company's records of options issued, which correctly reflected the documented and authorized grants in terms of who received option grants and the number of options granted. However, subsequent to the Report of Investigation being issued, it was determined that certain unauthorized actions were taken in May 2004 relating to the 1997 CEO IPO Grant. These actions were ratified by the Board in 2007.

During the Review Period, the Company used the effective date reflected in its grant approval documentation as the grant date and in its accounting for option grants used such date as the measurement date under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). In many instances that date was an as of date on a unanimous written consent (UWC) of the Board or the Compensation Committee. Since the Company believed options were granted with exercise prices that equaled or exceeded their quoted market price at the date of grant, no compensation expense was recorded in the Company's financial statements for options granted prior to its adoption of Statement of Financial Accounting Standards No. 123 (Revised 2004), Accounting for Share-Based Payments (SFAS 123(R)) as of January 29, 2006, other than in connection with the acceleration of the vesting of options in fiscal 2005 and the acceleration of the vesting of options related to a terminated employee. However, the Report of Investigation concluded that, as a result of the inadequacy of the Company's governance, internal financial reporting and other controls over the option grant process, the measurement dates used by the Company for a significant portion of the stock options granted during the Review Period were incorrect, as the recipients of the grants, number of shares subject to the options granted and exercise prices were not approved and established with finality by the date the Company had recorded as the grant date.

The Company used available documentation and guidance set forth by the Office of the Chief Accountant of the SEC on September 19, 2006 (September 2006 OCA Guidance) to determine the revised measurement dates for option grants made during the Review Period. For a discussion of the Company's historical stock option granting process and use of available information to determine the revised measurement dates, refer to Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Restatement of Financial Statements and Note 2 Restatement of Consolidated Financial Statements in the accompanying unaudited condensed consolidated financial statements.

After completion of the Report of Investigation, the Company in reviewing its accounting for options became aware of certain inconsistencies in its records concerning the terms of the 1997 CEO IPO Grant. Under the direction of the Special Committee, Independent Counsel investigated the Company's treatment of these options and reported thereon to the Special Committee. On April 11, 2007, the Special Committee reported to the Board on the 1997 CEO IPO Grant. Based on the evidence assembled in Independent Counsel's investigation, the Special Committee found that there had been confusion, resulting in inconsistencies in the Company records, in connection with the implementation of the 1997 CEO IPO Grant and over the years with regard to the terms of this grant. In considering the results of the investigation into the 1997 CEO IPO Grant, the Special Committee reconsidered the key findings it had reached in the Report of Investigation, as described above, and concluded that the evidence from the additional investigation did not lead it to different findings. The Board concurred in this conclusion.

Inadequate Internal Controls

The Company is undertaking to remediate the material weakness in internal control over financial reporting related to stock option grants found by the Special Committee, as further discussed in Item 4. Controls and Procedures of this Quarterly Report on Form 10-Q. The Company has continued its suspension of the granting of all stock-based compensation, including stock options, as well as the exercise of any options, until these improved procedures have been instituted. Furthermore, the suspension of granting and exercise of stock options will continue until the Company becomes current with its SEC filings.

Resolution of Tax Consequences and Corrective Action Related to Discounted Options

Revision to the measurement dates of stock options often resulted in options with exercise prices below the fair market value of the related shares on the revised measurement date (discounted options). Individuals currently holding discounted options may incur an excise tax liability under Section 409A of the Internal Revenue Code of 1986, as amended (the Internal Revenue Code). As recommended by the Special Committee, in order to avoid any benefit from the errors made in dating of options to any person involved in the option granting process and, also, as part of the Company's efforts to address certain tax considerations associated with outstanding options granted with an exercise price below fair market value, the Company has taken the following actions:

- The Company and its directors (including Mr. Dabah, its former CEO), its President and its former Chief Administrative Officer have agreed to amend all discounted options held by them (other than those described in the next paragraph) to increase the exercise price to the average of the high and low trading price on the date determined by the Company to be the revised measurement date applicable to the option grant to be used for financial reporting purposes. In the few instances where these individuals have exercised options as to which a revised measurement date has been determined by the Company, the individuals have agreed to return to the Company the difference between the exercise price and the trading price on the revised measurement date.
- In the three instances where the Report of Investigation found that non-executive directors received options shortly before the public disclosure of positive information, the Company and these directors have further agreed to amend such options to increase the exercise price to the average of the high and low trading price over the balance of the calendar year following the recorded date of the grant.
- With respect to all other option grants, the Company has decided to honor the options as issued, consistent with the Special Committee's finding of no intentional misconduct on the part of management in the option granting process. Nevertheless, the Company and all members of senior management holding outstanding options have agreed to either amend their outstanding discounted options that vested after 2004 either to increase the exercise price to the average of the high and low trading price on the date determined by the Company to be the revised measurement date or to limit the exercise period of their options.

In addition, with respect to holders of discounted options that vested after 2004 who are employees at the time, other than members of senior management who have already agreed to amend their outstanding discounted options, the Company plans to offer as soon as practicable the opportunity to exchange their discounted options for options with the same terms except that the exercise price will be changed to the average of the high and low trading price on the revised measurement date. Option holders who agree to such amendment will receive a cash bonus in the amount of the increase in the exercise price.

The foregoing actions are expected to bring all outstanding options held by employees and non-employee directors into compliance with pertinent requirements relating to discounted options so that the 20% excise tax under Section 409A of the Internal Revenue Code does not apply to the options. To the extent such discounted options were exercised during fiscal 2006, the Company expects to bear the liability for, and has accrued during fiscal 2006, an amount estimated to equal the potential 20% excise tax under Section 409A that would be incurred by the recipient in connection with such option if such tax is applicable, and any related income tax liability that would be incurred by the recipient in respect of receiving from the Company such amount, if any.

OTHER ADJUSTMENTS

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As previously mentioned in the Explanatory Note in this Quarterly Report on Form 10-Q, in addition to the adjustments related to the stock option investigation, the restated condensed consolidated financial statements presented herein include other adjustments related to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for the Company's 52- and 53-week fiscal years. The aggregate impact of these adjustments on the Company's consolidated statements of income, net of taxes, between fiscal 2001 and the first quarter of fiscal 2006 was an increase to net income of approximately \$1.7 million. Additionally, variable rate demand note balances as of the quarter ended April 29, 2006 have been reclassified from cash to short-term investments, and certain other balance sheet amounts have been reclassified. These reclassifications do not result in any additional charges in any period and do not affect working capital for the affected periods. For further discussion of these adjustments, refer to Note 2 Restatement of Consolidated Financial Statements in the unaudited condensed consolidated financial statements included in Item 1 of this report and Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

CUMULATIVE ADJUSTMENTS

The following table summarizes the cumulative increase or decrease to net income from fiscal 1998 through the first quarter of fiscal 2006. These adjustments relate to the Company recognizing stock-based compensation expense as a result of determining revised measurement dates for past stock option grants as well as the other adjustments noted above (in thousands):

| Period Ended | Stock Option Related Adjustments | | | Other Adjustments(1) | | Net Other Adjustments | Total After Tax Adjustment |
|---------------------------------------|----------------------------------|-------------|--------------------------------------|-----------------------------|-------------------------|-----------------------|----------------------------|
| | Expense (Increase) | Tax Benefit | Net Stock Option Related Adjustments | Expense (Increase) Decrease | Tax Benefit (Provision) | | |
| January 30, 1999 (fiscal 1998) | \$ (59) | \$ 19 | \$ (40) | \$ | \$ | \$ | \$ (40) |
| January 29, 2000 (fiscal 1999) | (211) | 81 | (130) | | | | (130) |
| February 3, 2001 (fiscal 2000) | (386) | 131 | (255) | | | | (255) |
| February 2, 2002 (fiscal 2001) | (915) | 295 | (620) | 240 | (98) | 142 | (478) |
| February 1, 2003 (fiscal 2002) | (972) | 375 | (597) | 772 | (311) | 461 | (136) |
| January 31, 2004 (fiscal 2003) | (1,632) | 486 | (1,146) | 1,722 | (695) | 1,027 | (119) |
| January 29, 2005 (fiscal 2004) | (3,386) | 772 | (2,614) | 589 | (82) | 507 | (2,107) |
| January 28, 2006 (fiscal 2005)(2) | (8,927) | 3,956 | (4,971) | (853) | 218 | (635) | (5,606) |
| Cumulative effect at January 28, 2006 | \$ (16,488) | \$ 6,115 | \$ (10,373) | \$ 2,470 | \$ (968) | \$ 1,502 | \$ (8,871) |
| April 29, 2006 (Q1 fiscal 2006) | \$ (1,331) | \$ 544 | \$ (787) | \$ 327 | \$ (161) | \$ | |