

PARTY CITY CORP
Form 10-K
September 26, 2003

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the Fiscal Year Ended June 28, 2003

Commission File Number 0-27826

Party City Corporation

(Exact name of registrant as specified in its charter)

Delaware

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

22-3033692

*(I.R.S. Employer
Identification No.)*

400 Commons Way, Rockaway, NJ
(Address of principal executive offices)

07866
(Zip Code)

Registrant's telephone number, including area code:

(973) 983-0888

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange on Which Registered

None

None

Securities Registered Pursuant to Section 12(g) of the Act:

Common Stock, par value \$.01 per share

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 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.

The aggregate market value of voting stock held by non-affiliates of the Registrant on December 28, 2002, based on the closing sale price on such date, was approximately \$162,007,200.

The number of outstanding shares of the Registrant's classes of common stock, \$0.01 par value, as of September 19, 2003 was 17,488,237.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the 2003 Annual Meeting of Stockholders are incorporated by reference into Part III.

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CONSENT OF DELOITTE & TOUCHE LLP

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PART I

Forward-Looking Statements

This Form 10-K (including the information incorporated herein by reference) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. The statements are made a number of times throughout the document and may be identified by forward-looking terminology as estimate, project, expect, believe, may, will, intend or similar statements or variations of terms. Such forward-looking statements are based on many assumptions that are subject to certain risks and uncertainties, and include among others, the following: levels of sales, store traffic, acceptance of product offerings, competitive pressures from other party supplies retailers and other retailers, availability of qualified personnel, availability of suitable future store locations, schedules of store expansion plans and other factors beyond our control. As a result of the foregoing risks and uncertainties, actual results and performance may differ materially from those projected or suggested herein. Additional information concerning certain risks and uncertainties that could cause our actual results to differ materially from those projected or suggested may be identified from time to time in our Securities and Exchange Commission filings and our public announcements.

Item 1. Business

Party City Corporation is based in Rockaway, New Jersey and was incorporated in the State of Delaware in 1996. We operate retail party supplies stores within the continental United States and we sell franchises on an individual store and area franchise basis throughout the United States and Puerto Rico. As of December 2002, the franchise stores in Portugal and Spain are no longer franchises and no longer operate with the Party City name or logo.

General

We are a specialty retailer of party supplies with a network of 500 stores. At September 19, 2003, we owned and operated 247 stores in the United States and our franchisees operated an additional 253 stores in the United States, including 5 stores in Puerto Rico. We believe that we are America's largest party goods chain. We authorized our first franchise store in 1989 and opened our first Company-owned store in January 1994.

We operate and franchise party supplies stores that typically range in size from 10,000 square feet to 12,000 square feet. These stores offer a broad selection of brand name and private label merchandise for a wide variety of celebratory occasions, including birthday parties, weddings and baby showers, as well as holiday and seasonal events such as Halloween, Christmas, New Year's Eve, Graduation, Easter, Valentine's Day, Thanksgiving, St. Patrick's Day, the Super Bowl and the Fourth of July. We seek to offer customers a one-stop party store that provides a wide selection of merchandise at a compelling value. A key element of delivering customer satisfaction is stocking inventory in sufficient quantities to satisfy customer needs for parties of virtually all sizes and types.

Effective July 3, 1999, we changed our fiscal year end for financial reporting from December 31, to the Saturday nearest to June 30. As used herein, the term "Fiscal Year" refers to the 52 or 53 weeks, as applicable, ending the Saturday nearest to June 30, unless otherwise noted.

Industry Overview

Traditionally, the retail party supplies business has been fragmented, with consumers purchasing party-related products from single owner-operated party supplies stores and designated departments in drug stores, general mass merchandisers, supermarkets and department stores of local, regional and national chains.

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Business Strategy

Our objective is to maintain our position as a leading national chain of party supplies stores. Key components of our current strategy are:

Offer a Broad Selection of Merchandise in an Exciting Shopping Environment. We try to provide party-planners and party-goers with convenient one-stop shopping for party supplies and offer what we believe is one of the most extensive selections of party supplies available. A typical Party City store contains over 20,000 SKUs and offers a wide variety of patterns, colors and styles within each of the product categories that we carry. We have been expanding the range of items that we offer in order to create consumer loyalty and generate repeat business.

Establish Convenient Store Locations. While we believe that our stores typically are destination shopping locations, we seek to maximize customer traffic and quickly build the visibility of new stores by situating our stores in high traffic areas. Site selection criteria include: population density, demographics, traffic counts, location of complementary retailers, storefront visibility and presence (either in a stand-alone building or in dominant power strip shopping centers, which are generally anchored by a nationally recognized retailer, like Wal-Mart, Target or Kohl's Department Stores), competition, lease rates and accessible parking. We believe there are an extensive number of suitable domestic locations available for future stores.

Maintain Value Price Position. We use the aggregate buying power of our 500 Company-owned and franchise store network which allows the stores to offer a broad line of high quality merchandise at competitive prices. We believe we reinforce customers' expectations of savings by prominently displaying signs announcing our value pricing and savings opportunities. We also maintain a lowest price guaranty policy in Company-owned stores, and we suggest our franchisees adhere to such a policy. This policy guarantees that Party City stores will meet and discount the advertised prices of a competitor's products. We believe that this policy has helped foster our image of offering consumers exceptional value for their money.

Provide Excellent Customer Service. We view the quality of our customers' shopping experience as critical to our continued success and we are committed to making shopping in our stores an enjoyable experience. For example, at Halloween, our most important selling season, each store significantly increases the number of sales associates to ensure prompt service. We believe that the compensation of our store managers and other personnel is competitive and enables us to attract and retain well-qualified, motivated employees who are committed to providing excellent customer service.

Expansion Plans. Our long-term goal is to increase our market share in existing markets and penetrate new markets in order to expand our position as a leading retailer of party supplies merchandise. Our growth strategy is planned through the opening of both Company and franchise stores. We plan to open Company-owned and franchise stores to meet our growth objectives. In addition, the fragmented nature of the retail party supplies business may provide opportunities to grow through acquisition. We continuously evaluate acquisition opportunities; however, we have no present commitments or agreements with respect to material acquisitions. Franchise store growth is subject to the ability and interest on the part of the franchisees to open stores according to our expansion plans. In order to manage continued store growth, our management intends to continue to invest in our human resources and management information systems to further improve the infrastructure.

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As of September 19, 2003, there were 500 Party City stores open in the United States and Puerto Rico. Of these, 247 were Company-owned and 253 were operated by our franchisees. The following table shows the growth in Party City's network of stores for the Fiscal Years 1999 through 2003.

| | Fiscal Year | | | | |
|---|-------------|------------|------------|------------|------------|
| | 2003 | 2002 | 2001 | 2000 | 1999 |
| Company-owned: | | | | | |
| Stores open at beginning of fiscal year | 209 | 193 | 197 | 215 | 148 |
| Stores opened | 22 | 13 | | 2 | 63 |
| Stores closed | (2) | | (2) | (2) | |
| Stores acquired from franchisees | 2 | 3 | 1 | | 5 |
| External acquisitions | 11 | | | | |
| Stores sold to franchisees | | | (3) | (18) | (1) |
| Stores open at end of fiscal year | 242 | 209 | 193 | 197 | 215 |
| Franchise: | | | | | |
| Stores open at beginning of fiscal year | 242 | 261 | 211 | 178 | 160 |
| Stores opened | 9 | 19 | 51 | 18 | 23 |
| Stores closed(a) | (8) | (35) | (3) | (3) | (1) |
| Stores purchased by the Company | (2) | (3) | (1) | | (5) |
| Stores purchased by franchisees | | | 3 | 18 | 1 |
| Stores open at end of fiscal year | 241 | 242 | 261 | 211 | 178 |
| Total Company and franchise stores | 483 | 451 | 454 | 408 | 393 |

(a) Our Canadian master franchisee filed for bankruptcy protection under Canadian law, closing 28 stores in fiscal 2002.

As of June 28, 2003, Party City stores were located in the following states and geographic regions:

| | # of Stores |
|-------------|----------------|
| Alabama | 6 |
| Arizona | 9 |
| Arkansas | 3 |
| California | 65 |
| Colorado | 5 |
| Connecticut | 9 |
| Delaware | 1 |
| Florida | 50 |
| Georgia | 24 |
| Hawaii | 1 |
| Illinois | 20 |
| Indiana | 5 |
| Kansas | 4 |
| Kentucky | 1 |
| Louisiana | 11 |
| Maryland | 12 |

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| | |
|----------------|------------|
| Massachusetts | 5 |
| Michigan | 10 |
| Minnesota | 5 |
| Mississippi | 2 |
| Missouri | 5 |
| Nevada | 5 |
| New Jersey | 32 |
| New Mexico | 3 |
| New York | 46 |
| North Carolina | 15 |
| Ohio | 10 |
| Oregon | 4 |
| Pennsylvania | 24 |
| Rhode Island | 1 |
| South Carolina | 7 |
| Tennessee | 11 |
| Texas | 33 |
| Utah | 2 |
| Virginia | 13 |
| Washington | 18 |
| Wisconsin | 1 |
| Puerto Rico | 5 |
| | <hr/> |
| Total | 483 |

Merchandising

Store Layout.

Our stores are designed to give the shopper a feeling of excitement and create a festive atmosphere. Our goal is for the customer to be pleased by his or her shopping experience. To achieve this goal, we maintain a wide selection of party supplies in-stock. Party City stores range in size from 6,750 to 19,800 square feet with a typical store size between 10,000 and 12,000 square feet. The stores are divided into various sections of

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different categories of party supplies, displayed to emphasize value pricing and breadth of merchandise available. The floor plan is designed to impress the customer with the broad selection in each product category.

Product Categories.

The typical Party City store offers a broad selection of brand name and private label merchandise consisting of over 20,000 SKUs. Our product categories include the following:

Halloween. As a key component of our sales strategy, our Party City stores provide an extensive selection of costumes for Halloween through our Halloween Costume Warehouse® department. The stores also carry a broad array of decorations and accessories for the Halloween season. The Halloween merchandise is prominently displayed to provide an exciting and fun shopping experience for customers. The stores display Halloween-related merchandise throughout the year to position us as the customer's Halloween shopping resource.

Graduation. Customer purchases for graduation parties in the United States primarily occur during April, May and June. These purchases include decorations and tableware related to graduation parties.

Other Seasonal. Customer purchases made for seasonal holiday events compose a significant part of our business. The other seasonal category includes products for the Super Bowl, Valentine's Day, St. Patrick's Day, Fall, Thanksgiving, Passover, Easter, First Communion, the Fourth of July, Christmas, Hanukkah and New Year's Eve. Some of the major items within this category are tableware, decorations, cutouts, lights and balloons tailored to the particular event.

Baby Shower. We maintain a baby shower department, which includes tableware, decorations, balloons, favors, centerpieces and garlands.

Balloons. The balloon department carries a wide selection of basic and decorative latex balloons in various sizes, qualities, colors and package sizes. The balloon department also carries Mylar balloons in numerous sizes, shapes and designs relating to birthday, seasonal, anniversary and other themes.

Birthdays. The birthday product category includes a wide assortment of merchandise to fulfill customer needs for celebrating birthdays, including special ones such as first, sweet sixteen and other milestone birthdays such as 40th and 50th birthdays. Some of the products in this category include invitations, thank you cards, tableware, hats, horns, banners, cascades, balloons, novelty gifts, piñatas and candies.

Bridal/Wedding/Anniversary. This product category includes personalized invitations, tableware, balloons, favors, place setting cards, confetti, honeycomb bells and personalized ribbons. Personalized invitation books containing numerous samples of customizable invitations are carried from the leading invitation stationers at discounted prices.

Candy. The candy product category includes novelty and packaged candy sold to enhance parties or to be used as piñata fillers. Candy is sold both in individual units and in bulk packaging for customers' convenience.

Catering Supplies. Our stores offer a broad selection of catering supplies that consists of trays, platters, foil, bowls, warming racks and fuel.

Gift Wrap. This product category includes wide assortments of gift bags, bows, tissue paper, ribbons, printed bags and wrapping paper.

Greeting Cards. This product category includes greeting cards from quality national card vendors at discount prices.

Party Favors. We maintain a party favors department that includes a broad selection of packaged and bulk favors appealing to different age groups. The assortment includes different product lines varying in prices designed to offer customers a variety of purchasing options.

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General. We carry a range of brand name and private label merchandise, including tableware, table covers, cutlery, crepe paper, cups and tumblers.

Product Selection, Purchasing and Suppliers.

The following represents suppliers from whom we purchased at least 5% of our merchandise:

| Supplier | Fiscal 2003 | Fiscal 2002 | Fiscal 2001 |
|--------------------------|-------------|-------------|-------------|
| Amscan, Inc. | 23% | 23% | 23% |
| Unique Industries, Inc. | 8% | 7% | 7% |
| Hallmark Marketing Corp. | 6% | 6% | 6% |
| Rubies Costumes Co. Inc. | 6% | 7% | 7% |
| | — | — | — |
| Total | 43% | 43% | 43% |

The loss of any of these suppliers could materially adversely affect our business, results of operations and financial condition. We consider numerous factors in supplier selection, including, but not limited to, price, credit terms, product offerings and quality. We negotiate pricing with suppliers on behalf of all stores in our network (Company-owned and franchise). We believe that our buying power enables us to receive favorable pricing terms and enhances our ability to obtain high demand merchandise.

In order to maintain consistency throughout our store network, we have established an approved list of items that are permitted to be sold in Party City stores. Franchise stores must adhere to these guidelines according to the terms of their franchise agreements. We establish a standard store merchandise layout and presentation format to be followed by Company-owned and franchise stores. Any layout or format changes developed by us are communicated to the managers of stores on a periodic basis. All of the merchandise purchased by stores is shipped directly from suppliers to the stores.

Franchise Operations

As of September 19, 2003, the Company had 253 franchise stores throughout the United States and Puerto Rico. A Party City store run by a franchisee utilizes the Company's format, design specifications, methods, standards, operating procedures, systems and trademarks.

We receive revenue from our franchisees, consisting of an initial, one-time fee and an ongoing royalty fee. In addition, each franchisee has a mandated advertising budget, which consists of a minimum initial store opening promotion and ongoing local advertising and promotions. Further, the franchisee must pay an additional 1% of net sales to a Party City group advertising fund to cover common advertising materials related to the Party City store concept. Receipts and disbursements are not recorded as income or expense since the Company does not have full discretion over the use of the funds. We do not offer financing to our franchisees.

Current franchise agreements provide for an assigned area or territory that typically equals a three-mile radius from the franchisee's store location and the right to use the Party City logo and trademark The Discount Party Super Store®. In most stores, the franchisee or the majority shareholder of a corporate franchisee devotes full time to the management, operation and on-premises supervision of the stores.

Although such locations are generally obtained and secured by the franchisee, pursuant to the franchise agreement we must approve all site locations. As franchisor, we also supply valuable and proprietary information pertaining to the operation of the Party City store business, as well as advice regarding location, improvements and promotion. We also supply consultation in the areas of purchasing, inventory control, pricing, marketing, merchandising, hiring, training, improvements and new developments in the franchisee's business operations, and we provide assistance in opening and initially promoting the store.

We have increased our focus on the management of our franchise operations. Additionally, franchisees have been represented on several key operating committees, addressing issues such as merchandising, advertising and information systems initiatives.

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As of September 19, 2003, we had nine territory agreements with certain franchisees. These agreements grant the holder of the territory the right to open one or more stores within a stated time period.

Competition

We operate in highly competitive markets. Our stores compete with a variety of smaller and larger retailers, including, but not limited to, single owner-operated party supplies stores, specialty party supplies retailers (including superstores), designated departments in drug stores, general mass merchandisers, supermarkets and department stores of local, regional and national chains and catalog and Internet sites. Major chain competitors in our markets include iparty, Factory Card Outlet and Party America. Party America recently purchased 62 Paper Warehouse corporate stores and the franchising division. In addition, other stores or internet vendors may enter the market and become significant competitors in the future. Our stores compete, among other things, on the basis of location and store layout, product mix, selection, customer convenience and price. Many of our non-chain competitors in our markets have greater financial resources than we do.

Management believes that Party City stores maintain a leading position in the party supplies business by offering a wider breadth of merchandise, greater selection within merchandise classes and discount prices on most items in the stores. We believe that our significant buying power, which results from the size of our Party City store network, is an integral advantage.

Trademarks

We license a number of trademarks and service marks registered with the United States Patent and Trademark Office from our wholly owned subsidiary, including the marks Party City®, The Discount Party Super Store® and Halloween Costume Warehouse®.

Government Regulation

As a franchisor, we must comply with regulations adopted by the Federal Trade Commission, such as the Trade Regulation Rule on Franchising, which requires us to furnish prospective franchisees with a franchise offering circular. We also must comply with a number of state laws that regulate certain substantive aspects of the franchisor-franchisee relationship. For instance, state laws that regulate the offer and sale of franchises require us to register before the offer and sale of a franchise can be made in that state.

State laws that regulate the franchisor-franchisee relationship presently exist in a substantial number of states. Those laws regulate the franchise relationship, for example, by requiring the franchisor to deal with its franchisees in good faith, by prohibiting interference with the right of free association among franchisees and by regulating discrimination among franchisees with regard to charges, royalties or fees. In some cases, those laws also restrict a franchisor's rights with regard to the termination of a franchise agreement (for example, by requiring good cause to exist as a basis for the termination) by requiring the franchisor to give advance notice to the franchisee of the termination and give the franchisee an opportunity to cure any default, and by requiring the franchisor to repurchase the franchisee's inventory or provide other compensation. To date, those laws have not precluded us from seeking franchisees in any given area and have not had a material adverse effect on our operations.

Each Party City store must comply with applicable regulations adopted by federal agencies and with licensing and other regulations enforced by state and local health, sanitation, safety, fire and other departments. Difficulties or failures in obtaining the required licenses or approvals can delay and sometimes prevent the opening of a new store or shut down an existing store.

Party City stores must comply with applicable federal and state environmental regulations, but the cost of complying with those regulations to date has not been material. More stringent and varied requirements of local governmental bodies with respect to zoning, land use, and environmental factors can delay, and sometimes prevent, development of new stores in particular locations.

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We and our franchisees must comply with the Fair Labor Standards Act and various state laws governing various matters such as minimum wages, overtime and other working conditions. We and our franchisees must also comply with the provisions of the Americans with Disabilities Act. The Act requires that employers provide reasonable accommodation for employees with disabilities and that stores must be accessible to customers with disabilities.

Employees

As of September 19, 2003, we employed approximately 1,600 full-time and 4,300 part-time employees. We consider our relationships with our employees to be good. None of our employees is covered by a collective bargaining agreement.

Available Information

Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports are made available free of charge through the Investor Relations section of the Company's website at <http://www.partycity.com> as soon as reasonably practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission.

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Risk Factors

In addition to other matters identified or described by us from time to time in filings with the Securities and Exchange Commission, there are several important factors that could cause our future results to differ materially from historical results or trends, results anticipated or planned by us, or results that are reflected from time to time in any forward-looking statement that may be made by us or on our behalf. Some of these important factors, but not necessarily all of the important factors, are described below.

We may be unable to achieve our expansion plans for future growth.

During Fiscal 2003, we added 35 Company-owned stores by opening 22 stores and acquiring 13 stores, two of which we acquired from franchisees. Our continued growth will depend, in significant part, upon our ability to open such new stores in a timely manner and to operate them profitably. Our expansion is also dependent on the effective continuation and development of our franchise program. Furthermore, successful expansion is subject to various contingencies, many of which are beyond our control. These contingencies include, among others:

our ability and our franchisees ability to identify and secure suitable store sites on a timely basis;

our ability and our franchisees ability to negotiate advantageous lease terms;

our ability and our franchisees ability to complete any necessary construction or refurbishment of these sites; and

the successful integration of new stores into existing operations.

As our business grows, we will need to attract and retain additional qualified personnel in a timely manner and develop, train and manage an increasing number of management level and other employees. We cannot assure you that we will be able to attract and retain personnel as needed in the future. If we are not able to hire capable store managers and other store level personnel, we will not be able to open new stores as planned and our revenue growth and operating results will suffer.

We cannot give any assurances that we will be able to continue our expansion plans successfully, that we will be able to achieve results similar to those achieved with prior locations, or that we will be able to continue to manage our growth effectively. Our failure to achieve our expansion plans could materially adversely affect our business, results of operations and financial condition. In addition, we expect our operating margins will be impacted by new store openings because of the addition of pre-opening expenses and the lower sales volume characteristic of new stores. Furthermore, the opening of additional stores in existing markets may attract some of our customers away from our other stores already in operation and diminish their sales.

We may need to raise additional capital to fund our operations.

If we are unable to generate sufficient cash from operations, we may be required to adopt one or more alternatives to raise cash, such as incurring more indebtedness, selling our assets, seeking to raise additional debt or equity capital or restructuring. If adequate financing is unavailable or is unavailable on acceptable terms, we may be unable to develop or enhance our operations, products and services, take advantage of future opportunities or respond to competitive pressures.

An effective franchise program is key to our success.

Our growth and success depends in part upon our ability to contract with and retain qualified franchisees, as well as the ability of those franchisees to operate their stores and promote and develop our store concept. Although we have established criteria to evaluate prospective franchisees and our franchise agreements include certain operating standards, each franchisee operates independently. Various laws limit our ability to influence the day-to-day operations of franchise stores. We cannot assure you that our franchisees will be able to operate stores in a manner consistent with our concept and standards. As a result, our franchisees may operate their stores in a manner that reduces the gross revenues of these stores and therefore reduces our franchise revenue.

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A downturn in the economy may affect consumer purchases of discretionary items, which could reduce our sales.

In general, our sales represent discretionary spending by our customers. Discretionary spending is affected by many factors, including, among others, general business conditions, interest rates, the availability of consumer credit, taxation and consumer confidence in future economic conditions. Our customers' purchases of discretionary items, including our products, could decline during periods when disposable income is lower or during periods of actual or perceived unfavorable economic conditions. If this occurs, our revenues and profitability will decline. In addition, our sales could be adversely affected by a downturn in the economic conditions in the markets in which we operate.

Our inability to identify and anticipate changes in consumer demands and preferences and our inability to respond to such consumer demands in a timely manner could reduce our sales.

Our products appeal to a broad range of consumers whose preferences cannot be predicted with certainty and are subject to rapid change. Our success depends on our ability to identify product trends as well as to anticipate and respond to changing merchandise trends and consumer demand in a timely manner. We cannot assure you that we will be able to continue to offer assortments of products that appeal to our customers or that we will satisfy changing consumer demands in the future. Accordingly, if:

we are unable to identify and respond to emerging trends;

we miscalculate either the market for the merchandise in our stores or our customers' purchasing habits; or

consumer demand dramatically shifts away from disposable party supplies our business, results of operations and financial condition could be materially adversely affected. In addition, we may be faced with significant excess inventory of some products and missed opportunities for other products, which would decrease our profitability.

If we lose any of our key vendors or any of our key vendors fail to supply us with merchandise, we may not be able to meet the demands of our customers and our sales could decline.

Our business is dependent to a significant degree upon close relationships with vendors and our ability to purchase brand name and private label merchandise at competitive prices. During the fiscal year 2003, we purchased approximately 43% of the aggregate amount of our merchandise from four vendors. The loss of any of these key vendors could have a material adverse effect on our business, results of operations and financial condition. We cannot guarantee that we will be able to acquire such merchandise at competitive prices or on competitive terms in the future. In this regard, certain merchandise that is in high demand may be allocated by vendors based upon the vendors' internal criteria that are beyond our control, and consequently we may receive less product than we anticipated.

In addition, we believe many of our vendors source their products from China, Mexico and other foreign countries. A vendor could discontinue selling products manufactured in foreign countries at any time for reasons that may or may not be in our control, including foreign government regulations, political unrest, war, disruption or delays in shipments, changes in local economic conditions and trade issues. Our sales and profitability could decline if we are unable to promptly replace a vendor who is unwilling or unable to satisfy our requirements with a vendor providing equally appealing products.

We face a high level of competition in our markets.

We operate in highly competitive markets. Our stores compete with a variety of smaller and larger retailers, including, but not limited to, single owner-operated party supplies stores, specialty party supplies retailers (including superstores), designated departments in drug stores, general mass merchandisers, supermarkets and department stores of local, regional and national chains and catalog and Internet sites. Major chain competitors in our markets include iparty, Factory Card Outlet and Party America. Party

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America recently purchased 62 Paper Warehouse corporate stores and its franchising division. In addition, other stores or internet vendors may enter the market and become significant competitors in the future. Our stores compete, among other things, on the basis of location and store layout, product mix, selection, customer convenience and price. Many of our non-chain competitors in our markets have greater financial resources than we do.

As a result of this competition, we may need to spend more on advertising and promotion than we anticipate. We cannot guarantee that we will continue to be able to compete successfully against existing or future competitors. Expansion into markets served by our competitors, entry of new competitors or expansion of existing competitors into our markets could materially adversely affect our business, results of operations and financial condition.

Our operating results are subject to seasonal and quarterly fluctuations, which could cause the market price of our common stock to decline.

Our business is subject to substantial seasonal variations. Historically, we have realized a significant portion of our net sales, operating income, cash flow and net income in the second fiscal quarter of the year, principally due to the sales in October for the Halloween season and, to a lesser extent, due to sales for end of year holidays. We believe this general pattern will continue in the future. An economic downturn during this period could adversely affect us to a greater extent than if such downturn occurred at other times of the year. Our results of operations may also fluctuate significantly as a result of a variety of other factors, including the timing of new store openings, store closings and timing of the acquisition and disposition of stores.

In addition, we have opened six new Company-owned stores and closed one Company store through September 19, 2003 and plan to open four more new Company-owned stores for the remainder of Fiscal 2004. Our results of operations may vary significantly as a result of the timing of new store openings, the amount and timing of net sales contributed by new stores, the level of pre-opening expenses associated with new stores and the relative proportion of new stores to mature stores. Any significant decline in our results of operations as a result of these variations could adversely affect our stock price.

Failure to successfully utilize our information systems could cause interruptions to our business and impair our future growth.

We need quality and scalable management information systems to efficiently operate our stores and to successfully implement our new store growth strategy. Our systems include point of sale, integrated merchandising and financial systems. We anticipate that our systems initiatives, such as the installation of merchandising systems and inventory control systems, will serve to optimize our results by improving our data analysis. However, there can be no assurances that the systems will be as beneficial as predicted.

We depend on key personnel and may not be able to retain these employees or recruit additional qualified personnel, which could harm our business.

Our success depends to a large extent on the continued service of our executive management team. Departures by our executive officers could have a negative impact on our business, as we may not be able to find suitable management personnel to replace departing executives on a timely basis. Our Acting Chief Executive Officer, Nancy Pedot, who was appointed in April 2003 upon the resignation of the then current Chief Executive Officer James Shea, has informed the Company's Board of Directors that she does not wish to be a candidate for the Chief Executive Officer position on a permanent basis. As a result, we are currently conducting a search for a new Chief Executive Officer and there are no assurances as to when we will find a suitable candidate for this management position. We do not maintain key-man life insurance on any of our executive officers.

In addition, as our business expands, we believe that our future success will depend greatly on our continued ability to attract and retain highly skilled and qualified personnel. Although we generally have been able to meet our staffing requirements in the past, our inability to do so in the future at costs that are favorable

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to us, or at all, could impair our ability to increase revenue, and our customers could experience lower levels of customer care.

Our stock price may be volatile and could decline substantially.

The stock market has, from time to time, experienced extreme price and volume fluctuations. Many factors may cause the market price for our common stock to decline, including:

our operating results failing to meet the expectations of securities analysts or investors in any quarter;

downward revisions in securities analysts' estimates;

material announcements by us or our competitors;

governmental regulatory action; or

adverse changes in general market conditions or economic trends.

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Item 2. *Properties*

As of September 19, 2003, we leased all of our 247 Company-owned stores. We also lease our corporate headquarters property in Rockaway, New Jersey which lease will expire in 2004.

Of the leases for the Company owned stores, eight expire in Fiscal 2004, eleven expire in Fiscal 2005, six expire in Fiscal 2006 and the balance expire in Fiscal 2007 or thereafter. We have options to extend most of these leases for a minimum of five years.

Item 3. *Legal Proceedings*

Securities Litigation

We were named as a defendant in twelve class action complaints in the United States District Court for the District of New Jersey. A former Chief Executive Officer and a former Chief Financial Officer/ Executive Vice President of Operations were also named as defendants in these complaints. The complaints were filed as class actions on behalf of persons who purchased or acquired Party City common stock during various time periods between February 26, 1998 and March 18, 1999 (the "Class Period"). In October 1999, plaintiffs filed an amended class action complaint and, in February 2000, plaintiffs filed a second amended complaint, which alleged, among other things, violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder, and sought unspecified damages. The plaintiffs alleged that defendants issued a series of false and misleading statements and failed to disclose material facts concerning, among other things, Party City's financial condition, adequacy of internal controls and compliance with certain loan covenants during the Class period. The plaintiffs further alleged that because of the issuance of a series of false and misleading statements and/or the failure to disclose material facts, the price of Party City's common stock was artificially inflated.

In early 2000, defendants moved to dismiss the second amended complaint on the ground that it failed to state a cause of action. On May 29, 2001, the District Court issued an Opinion and Order dismissing the Complaint against all defendants with prejudice. On June 27, 2001, plaintiffs filed a Notice of Appeal to the United States Court of Appeals for the Third Circuit. In April 2002, the parties reached an agreement in principle to settle the action, and the Court of Appeals remanded the case to the District Court to supervise the implementation of the settlement. The terms of the settlement were contained in the agreement in principle, and included the settlement amount, of which our settlement contribution of \$380,000 was not material to our results of operations or financial condition.

On May 14, 2003, the District Court approved the terms of the definitive settlement agreement. Accordingly, in May 2003, we paid our contribution pursuant to the terms of the settlement agreement to close this matter.

Other

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

In addition to the foregoing, from time to time we are involved in routine litigation incidental to the conduct of the business. We are aware of no other material existing or threatened litigation to which we are or may be a party.

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

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended June 28, 2003.

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity and Related Stockholder Matters**

Our common stock has traded on the Nasdaq National Market under the symbol PCTY since its re-listing in July 2001. From July 1999 until its re-listing on the Nasdaq National Market, our common stock was traded on the OTC Bulletin Board, an electronic quotation service for NASD Market Makers. From March 1996 until July 1999 our common stock was traded on the Nasdaq National Market.

The following table sets forth the high and low trading prices of our common stock for each quarter of the latest two fiscal years.

| | <u>High</u> | <u>Low</u> |
|-----------------------|-------------|------------|
| Quarter Ended: | | |
| June 28, 2003 | \$ 10.91 | \$ 8.00 |
| March 29, 2003 | 12.70 | 7.17 |
| December 28, 2002 | 14.59 | 9.63 |
| September 28, 2002 | 16.98 | 12.73 |
| Quarter Ended: | | |
| June 29, 2002 | \$ 18.30 | \$ 12.61 |
| March 30, 2002 | 14.42 | 7.31 |
| December 29, 2001 | 7.75 | 5.50 |
| September 29, 2001 | 8.78 | 4.80 |

At September 19, 2003, the number of holders of record of our common stock was approximately 2,914.

Dividends

We have never paid cash dividends on our capital stock and do not intend to pay cash dividends in the foreseeable future. We expect that earnings will be retained for the continued growth and development of our business. Future dividends, if any, will depend upon our earnings, financial condition, working capital requirements, compliance with covenants in agreements to which we are or may be subject, future prospects and any other factors deemed relevant by our Board of Directors. Under various agreements to which we are a party, principally under the Loan Agreement with Wells Fargo, we currently are not permitted to pay any dividends. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources.

Equity Compensation Plan Information

The following sets forth certain information as of June 28, 2003 concerning our equity compensation plans:

| <u>Plan Category</u> | <u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u> | <u>Weighted-average exercise price of outstanding options, warrants and rights</u> | <u>Number of securities available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u> |
|---|--|--|--|
| (a) | (b) | (c) | |
| Equity compensation plans approved by security holders ¹ | 2,249,2762 | \$ 8.78 | 553,0783 |
| Equity compensation plans not approved by security holders ⁴ | 27,1685 | \$ 8.18 | 277,321 |

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|-------|-----------|--------|---------|
| Total | 2,276,444 | \$8.78 | 830,399 |
|-------|-----------|--------|---------|

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- (1) Consists of our Amended and Restated 1994 Stock Option Plan (the 1994 Plan), Amended and Restated 1999 Stock Incentive Plan (the 1999 Plan), and Employee Stock Purchase Plan (the ESPP).
- (2) Consists of 638,349 outstanding options for our common stock pursuant to the 1994 Plan, 1,583,140 outstanding options for our common stock pursuant to the 1999 Plan and 27,787 shares of our common stock which will be issued on January 1, 2004 pursuant to the ESPP. Under the ESPP, our employees have the opportunity to purchase shares of our common stock at a discount through accumulated payroll deductions. The shares which will be issued in January 2004 will have a purchase price of \$8.78 per share.
- (3) Consists of 407,135 options that remain available for issuance pursuant to the 1999 Plan and 145,943 shares of our common stock that remain available for issuance pursuant to the ESPP. No additional options may be issued under the 1994 Plan after September 4, 2000.
- (4) Consists of our Management Stock Purchase Plan. A description of our Management Stock Purchase Plan is contained in Note 9 to the consolidated financial statements located herein.
- (5) These shares will be issued in future periods as provided for in the Plan.

Table of Contents**Item 6. Selected Financial Data**

We have derived the selected financial data presented below from our audited consolidated financial statements for the fiscal years ended June 28, 2003, June 29, 2002, June 30, 2001, July 1, 2000 and December 31, 1998 and the six months ended July 3, 1999. The selected financial information presented below should be read in conjunction with such financial statements and notes thereto. The six months ended June 30, 1998 is unaudited and presented for comparative purposes.

SELECTED FINANCIAL DATA

| | Year Ended | | | | |
|---|------------------|------------------|------------------|-----------------|----------------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 | July 1, 2000 | December 31, 1998 |
| (in thousands, except per share and store data) | | | | | |
| Statement of Operations Data: | | | | | |
| Total revenues | \$482,620 | \$423,510 | \$395,900 | \$363,399 | \$294,334 |
| Company-owned stores: | | | | | |
| Net sales | \$464,258 | \$405,821 | \$380,671 | \$349,722 | \$282,923 |
| Cost of goods sold and occupancy costs | 311,170 | 263,980 | 252,320 | 240,356 | 194,761 |
| Gross profit | 153,088 | 141,841 | 128,351 | 109,366 | 88,162 |
| Store operating and selling expense | 108,294 | 91,576 | 88,128 | 83,470 | 73,970 |
| Company-owned stores profit contribution | 44,794 | 50,265 | 40,223 | 25,896 | 14,192 |
| General and administrative expense | 32,475 | 27,086 | 26,603 | 30,399 | 15,939 |
| Retail profit (loss) contribution | 12,319 | 23,179 | 13,620 | (4,503) | (1,747) |
| Franchise stores: | | | | | |
| Royalty fees | 18,007 | 17,048 | 14,604 | 13,187 | 10,841 |
| Franchise fees | 355 | 641 | 625 | 490 | 570 |
| Total franchise revenues | 18,362 | 17,689 | 15,229 | 13,677 | 11,411 |
| Total franchise expense | 6,538 | 6,563 | 4,937 | 4,406 | 4,114 |
| Franchise profit contribution | 11,824 | 11,126 | 10,292 | 9,271 | 7,297 |
| Operating income | 24,143 | 34,305 | 23,912 | 4,768 | 5,550 |
| Interest expense, net | 3,990 | 5,610 | 7,949 | 8,423 | 2,636 |
| Income (loss) before income taxes | 20,153 | 28,695 | 15,963 | (3,655) | 2,914 |
| Provision (benefit) for income taxes(a) | 8,061 | 11,503 | 6,002 | (4,636) | 1,127 |
| Net income | \$ 12,092 | \$ 17,192 | \$ 9,961 | \$ 981 | \$ 1,787 |
| Basic earnings per share | \$ 0.73 | \$ 1.32 | \$ 0.78 | \$ 0.08 | \$ 0.14 |
| Diluted earnings per share | \$ 0.62 | \$ 0.89 | \$ 0.56 | \$ 0.07 | \$ 0.14 |
| Weighted average shares outstanding basic | 16,602 | 13,068 | 12,723 | 12,611 | 12,411 |

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| | | | | | | |
|--|---------|----------|----------|----------|----------|----------|
| Weighted average shares outstanding | diluted | 19,646 | 19,313 | 17,819 | 14,283 | 12,704 |
| Operating Data: | | | | | | |
| Number of Company-owned stores (end of year) | | 242 | 209 | 193 | 197 | 207 |
| Increase in Company-owned same store sales | | 2.2% | 4.9% | 10.3% | 3.8% | 11.3% |
| Number of franchise stores (end of year) | | 241 | 242 | 261 | 211 | 167 |
| Increase in franchise same store sales | | 3.7% | 4.5% | 4.3% | 7.9% | 6.8% |
| Average sales per Company-owned store | | \$ 2,090 | \$ 2,044 | \$ 1,961 | \$ 1,810 | \$ 1,684 |

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| | Year Ended | | | | |
|---|------------------|------------------|------------------|-----------------|----------------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 | July 1, 2000 | December 31, 1998 |
| (in thousands, except per share and store data) | | | | | |
| Other Information: | | | | | |
| Depreciation and amortization | \$ 16,229 | \$ 12,156 | \$ 10,431 | \$ 10,757 | \$ 6,598 |
| Cash flow provided by (used in): | | | | | |
| Investing activities | \$ (22,234) | \$ (20,008) | \$ (15,664) | \$ 6,184 | \$ (39,094) |
| Financing activities | (1,990) | (20,494) | (8,099) | (23,038) | 45,448 |
| Balance Sheet Data: | | | | | |
| Working capital (deficiency) | \$ 12,867 | \$ 14,707 | \$ 8,784 | \$ 15,069 | \$ (15,039) |
| Total assets | 167,999 | 149,054 | 141,342 | 132,086 | 144,032 |
| Bank borrowings(c) | 11,229 | 8,915 | 16,006 | 29,547 | |
| Stockholders' equity | 79,422 | 67,599 | 51,090 | 40,861 | 49,368 |
| EBITDA: | | | | | |
| EBITDA(b) | \$ 40,372 | \$ 46,461 | \$ 34,343 | \$ 15,525 | \$ 12,148 |
| Most directly comparable GAAP measures: | | | | | |
| Net income | \$ 12,092 | \$ 17,192 | \$ 9,961 | \$ 981 | \$ 1,787 |
| Cash flows provided by (used in): | | | | | |
| Operating activities | \$ 24,129 | \$ 34,127 | \$ 29,655 | \$ 9,334 | \$ (2,697) |

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| | Six Months Ended | |
|---|------------------|---------------|
| | July 3, 1999 | June 30, 1998 |
| (In thousands, except per share data) | | |
| Statement of Operations Data: | | |
| Total revenues | \$ 156,509 | \$ 97,272 |
| Company-owned stores: | | |
| Net sales | \$ 151,349 | \$ 92,718 |
| Cost of goods sold and occupancy costs | 109,858 | 65,246 |
| Gross profit | 41,491 | 27,472 |
| Store operating and selling expenses | 42,052 | 24,111 |
| Company-owned stores (loss) profit contribution | (561) | 3,361 |
| General and administrative expenses | 15,856 | 5,615 |
| Retail loss | (16,417) | (2,254) |
| Franchise stores: | | |
| Royalty fees | 4,907 | 4,379 |
| Franchise fees | 253 | 175 |
| Total franchise revenues | 5,160 | 4,554 |
| Total franchise expense | 1,906 | 1,803 |
| Franchise profit contribution | 3,254 | 2,751 |
| Operating (loss) income | (13,163) | 497 |
| Interest expense, net | 2,378 | 873 |
| Loss before income taxes | (15,541) | (376) |
| Benefit for income taxes(a) | (2,125) | (146) |
| Net loss | \$ (13,416) | \$ (230) |
| Basic and diluted loss per share | \$ (1.08) | \$ (0.02) |
| Weighted average shares outstanding basic and diluted | 12,455 | 12,376 |
| Other information: | | |
| Depreciation and amortization | \$ 5,229 | \$ 3,634 |
| Cash flows provided by (used in): | | |
| Investing activities | \$ (7,933) | \$ (12,832) |
| Financing activities | 11,732 | 36,440 |
| Balance Sheet Data: | | |
| Working capital (deficiency) | \$ (26,694) | \$ 40,805 |

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| | | |
|--|-------------|-------------|
| Total assets | 161,319 | 119,168 |
| Bank borrowings(c) | | 40,182 |
| Stockholders equity | 35,934 | 46,103 |
| EBITDA: | | |
| EBITDA(b) | \$ (7,934) | \$ 4,131 |
| Most directly comparable GAAP measures: | | |
| Net loss | \$ (13,416) | \$ (230) |
| Cash flows provided by (used in): | | |
| Operating activities | \$ 779 | \$ (21,984) |

-
- (a) The fiscal year ended July 1, 2000 includes \$3.7 million of benefit related to the reversal of valuation reserves on deferred tax assets established in the six months ended July 3, 1999 due to the uncertainty at that time that our net operating loss carryforwards would be realized.

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

A reconciliation of EBITDA to net income follows for the periods indicated:

| | Year Ended | | | | | Six Months Ended | |
|--------------------------------------|------------------|------------------|------------------|-----------------|----------------------|------------------|------------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 | July 1, 2000 | December 31, 1998 | July 1, 1999 | June 30, 1998 |
| | (In thousands) | | | | | | |
| EBITDA | \$ 40,372 | \$ 46,461 | \$ 34,343 | \$ 15,525 | \$ 12,148 | \$ (7,934) | \$ 4,131 |
| Depreciation and amortization | (16,229) | (12,156) | (10,431) | (10,757) | (6,598) | (5,229) | (3,634) |
| Interest expense, net | (3,990) | (5,610) | (7,949) | (8,423) | (2,636) | (2,378) | (873) |
| (Provision) benefit for income taxes | (8,061) | (11,503) | (6,002) | 4,636 | (1,127) | 2,125 | 146 |
| Net income (loss) | \$ 12,092 | \$ 17,192 | \$ 9,961 | \$ 981 | \$ 1,787 | \$ (13,416) | \$ (230) |

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

| | Year Ended | | | | | Six Months Ended | |
|--|------------------|------------------|------------------|-----------------|----------------------|------------------|------------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 | July 1, 2000 | December 31, 1998 | July 1, 1999 | June 30, 1998 |
| | (In thousands) | | | | | | |
| EBITDA | \$40,372 | \$ 46,461 | \$34,343 | \$15,525 | \$ 12,148 | \$ (7,934) | \$ 4,131 |
| Interest expense, net | (3,990) | (5,610) | (7,949) | (8,423) | (2,636) | (2,378) | (873) |
| (Provision) benefit for income taxes | (8,061) | (11,503) | (6,002) | 4,636 | (1,127) | 2,125 | 146 |
| Non-cash interest | 1,624 | 1,395 | 1,815 | 1,506 | | | |
| Deferred taxes | (2,131) | 819 | 1,543 | (6,213) | (933) | (2,338) | (6) |
| Deferred rent | 556 | 765 | 1,148 | 978 | 2,459 | 1,082 | 1,024 |
| Equity based compensation | 1,663 | 463 | 264 | | | | |
| Provision for doubtful accounts | (498) | (67) | (65) | 975 | 127 | 204 | |
| Tax effect of non-qualified stock options | 556 | 37 | | | | | |
| Impairment charge | 1,505 | | 2,275 | 1,172 | | 300 | |
| Loss (gain) on dispositions and sale of stores | 162 | | (131) | 1,386 | | 234 | |
| Changes in assets and liabilities: | | | | | | | |
| Accounts payable, accrued expenses and other current liabilities | 4,036 | 7,979 | 7,301 | 777 | 5,353 | 1,392 | (8,977) |
| Merchandise inventory | (9,634) | (7,310) | (6,606) | 186 | (15,618) | 11,897 | (11,997) |

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| | | | | | | | |
|---|------------------|------------------|------------------|-----------------|-------------------|----------------|--------------------|
| Other long-term liabilities | (587) | 833 | (326) | (306) | (630) | (89) | |
| Other current assets and other assets | <u>(1,444)</u> | <u>(135)</u> | <u>2,045</u> | <u>(2,865)</u> | <u>(1,840)</u> | <u>(3,716)</u> | <u>(5,432)</u> |
| Net cash provided by (used in) operating activities | <u>\$ 24,129</u> | <u>\$ 34,127</u> | <u>\$ 29,655</u> | <u>\$ 9,334</u> | <u>\$ (2,697)</u> | <u>\$ 779</u> | <u>\$ (21,984)</u> |

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

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

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

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

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

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

EBITDA does not reflect the impact of earnings or charges resulting from matters we consider not to be indicative of our ongoing operations; and

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

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

- (c) Excludes borrowings under our previous credit agreement of \$58.6 million and \$46.8 million included in current liabilities at July 3, 1999 and December 31, 1998, respectively. Bank borrowings and other long-term liabilities at June 29, 2002, June 30, 2001 and July 1, 2000 is net of an unamortized debt discount of \$1.3 million, \$1.9 million and \$3.0 million, respectively.

Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations* **Critical Accounting Policies and Estimates**

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

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

Our accounting policies are more fully described in Note 1 to the consolidated financial statements contained herein. We have identified certain critical accounting policies that are described below.

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

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

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

Goodwill. We evaluate goodwill annually or whenever events and changes in circumstances suggest that the carrying amount may not be recoverable from its estimated future cash flows. In making this assessment, management relies on a number of factors including operating results, business plans, economic projections, anticipated future cash flows and marketplace data. A change in these underlying assumptions may cause a change in the results of the tests and, as such, could cause fair value to be less than the carrying value. In such event, we would then be required to record a charge, which would impact earnings.

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

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

General

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

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

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

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

Franchising. Franchise revenue is composed of the initial franchise fees, which are recorded as revenue when a franchise store opens, and ongoing royalty fees, generally 4.0% of the store's net sales.

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

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Results of Operations

Our revenues and earnings are generated primarily from our two business segments Retail and Franchising.

Year Ended June 28, 2003 (Fiscal 2003) Compared to Year Ended June 29, 2002 (Fiscal 2002)

Retail. Net sales from Company-owned stores increased 14.4% to \$464.3 million in Fiscal 2003 from \$405.8 million in Fiscal 2002. The Fiscal 2003 results include 209 stores that were open at the beginning of that year, plus 13 stores acquired during the year, 22 stores opened during the year and two stores closed during the year. Same store sales increased 2.2% in Fiscal 2003 and the remaining 12.2% increase in sales relates to the stores that have not been open for one year. The same store sales increase was due to a 3% increase in the dollar amount of the average sale but, offset by a decrease of 1.5% in the number of transactions.

Gross profit, which is net sales minus cost of goods sold and occupancy costs, increased 7.9% to \$153.1 million in Fiscal 2003 from \$141.8 million in Fiscal 2002. The increase in Fiscal 2003 was due to increased sales volume. Gross margin was 33.0% and 35.0% of sales for Fiscal 2003 and Fiscal 2002, respectively. The decrease in gross margin percent was related primarily to increased markdowns for seasonal and everyday merchandise and a higher occupancy cost ratio for new stores. We made the decision to mark down \$2.4 million of certain slow-selling products and also to mark down selected products for better seasonal transition.

Store operating and selling expenses increased 18.3% to \$108.3 million for Fiscal 2003 from \$91.6 million in Fiscal 2002. The increase in store operating expenses is primarily attributable to increased expenses related to new stores as well as increased advertising expenses of \$5.6 million in order to drive traffic in the stores. Store operating expenses were 23.3% of sales for Fiscal 2003 compared with 22.6% of sales in Fiscal 2002 due to the impact of new stores not having achieved mature store sales levels.

Pre-opening expenses of \$1.6 million were recorded in Fiscal 2003 for 22 new stores opened during the year and for eight stores scheduled to open in the first quarter of Fiscal 2004. Pre-opening expenses of \$753,000 were recorded in Fiscal 2002 for 13 new stores opened during the year and for eight stores scheduled to open in the first quarter of Fiscal 2003.

Company-owned store profit contribution, which is gross profit minus store operating and selling expenses, decreased to \$44.8 million in Fiscal 2003 compared with \$50.3 million in Fiscal 2002. This is further explained by the negative contributions of \$3.1 million for the stores opened in 2003 and the loss from the Seattle stores of \$3.0 million.

General and administrative expenses increased 19.9% to \$32.5 million in Fiscal 2003, compared with \$27.1 million in Fiscal 2002. The increase is primarily attributable to an increased store base, depreciation related to the investments in centralized systems, fixed asset and goodwill impairment charges of approximately \$1.5 million associated with under-performing stores, as well as the logistics initiative and professional fees of \$1.4 million related to the implementation of a new information system and the executive severance charges of \$575,000.

Retail profit contribution, which is store profit contribution minus general and administrative expenses, decreased by 46.9% to \$12.3 million in Fiscal 2003, compared with \$23.2 million in Fiscal 2002. Retail profit contribution as a percent of sales was 2.7% in Fiscal 2003 compared with 5.7% in Fiscal 2002 for the reasons set forth above.

Franchising. Royalty fees increased 5.6% to \$18.0 million in Fiscal 2003 compared with \$17.0 million in Fiscal 2002. Franchise fees, recognized on nine store openings during Fiscal 2003 decreased 44.6% to \$355,000 compared with \$641,000 during Fiscal 2002 recognized on 19 store openings. Franchise same store sales increased 3.7% in Fiscal 2003 as compared with a 4.5% increase in Fiscal 2002.

Expenses related to franchise revenue decreased 0.4% to \$6.5 million in Fiscal 2003 from \$6.6 million in Fiscal 2002. As a percentage of franchise revenue, franchise expenses were 35.6% and 37.1% for Fiscal 2003

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and Fiscal 2002, respectively. Franchise expenses include direct and indirect expenses. The direct expenses include salaries, travel and other direct expenses of the franchise operations department in addition to legal fees, bad debt expense, insurance expense and other miscellaneous charges. The indirect expenses include pro-rata allocations of corporate expenses for salaries, including bonuses, occupancy and depreciation based on time spent on franchise support.

Franchise profit contribution, which is franchise revenue minus expenses related to franchise revenue, increased 6.3% to \$11.8 million in Fiscal 2003 from \$11.1 million in Fiscal 2002. The increase in franchise profit contribution is due to the increase in royalty fees offset in part by a decrease in franchise fee income, as discussed above.

Interest Expense. Interest expense decreased 28.9% to \$4.0 million for Fiscal 2003 from \$5.6 million in Fiscal 2002. This decrease in interest expense is due to the repurchase of outstanding senior notes during the later part of the second quarter that had an effective interest rate of 29%. These notes had a cash interest rate of 18.5% as well as original issue discount accounting for the high effective interest rate. The repurchase of these notes was completed using working capital and borrowings under the credit agreement. The repurchase of the notes resulted in a pre-tax charge of \$2.2 million related to interest and a pre-payment premium.

Income Taxes. Income taxes of \$8.1 million, or 40.0% of pre-tax income, were provided in Fiscal 2003 compared to income taxes of \$11.5 million, or 40.1% of pre-tax income recorded in Fiscal 2002.

Net Income. As a result of the above factors, net income decreased to \$12.1 million or \$0.73 per basic share and \$0.62 per diluted share in Fiscal 2003, as compared to net income of \$17.2 million, or \$1.32 per basic share and \$0.89 per diluted share in Fiscal 2002. Weighted average basic shares outstanding increased from 13.1 million in Fiscal 2002 to 16.6 million in Fiscal 2003. Weighted average diluted shares increased from 19.3 million in Fiscal 2002 to 19.6 million in Fiscal 2003.

Year Ended June 29, 2002 (Fiscal 2002) Compared to Year Ended June 30, 2001 (Fiscal 2001)

Retail. Net sales from Company-owned stores increased 6.6% to \$405.8 million in Fiscal 2002 from \$380.7 million in Fiscal 2001. The Fiscal 2002 results include 193 stores that were open at the beginning of that year, plus three stores acquired during the year and 13 stores opened during the year. Same store sales increased 4.9% in Fiscal 2002.

Gross profit for Fiscal 2002 increased 10.5% to \$141.8 million compared to \$128.4 million for Fiscal 2001. The increase in Fiscal 2002 was primarily due to increased sales volume and improvements in gross margin. Gross margin was 35.0% and 33.7% of sales for Fiscal 2002 and Fiscal 2001, respectively. The increase in gross margin was related primarily to stronger controls over inventory resulting in reduced inventory loss, improved buying and leveraged occupancy costs.

Store operating and selling expenses increased 3.9% to \$91.6 million for Fiscal 2002, compared to \$88.1 million in Fiscal 2001. The increase in store operating expenses is primarily attributable to increased expenses related to new stores. Store operating expenses were 22.6% of sales for Fiscal 2002 compared to 23.2% of sales for Fiscal 2001 due to efficiencies occurring in staffing and advertising resulting from an increase in average store sales. Company-owned store profit contribution increased to \$50.3 million for Fiscal 2002, compared to \$40.2 million for Fiscal 2001.

Pre-opening expenses of \$753,000 were recorded in Fiscal 2002 for 13 new stores opened during the year and for eight stores scheduled to open in the first quarter of Fiscal 2003. Pre-opening expenses of \$78,000 were recorded in Fiscal 2001 for four stores opened in the first quarter of Fiscal 2002.

General and administrative expenses increased 1.8% to \$27.1 million in Fiscal 2002, compared to \$26.6 million in Fiscal 2001. The increase is primarily attributable to an increased store base and depreciation related to the investments in centralized systems and programs that provide efficiencies at the store level. An impairment charge of \$2.3 million related to store registers replaced in our information system initiative was recorded in Fiscal 2001. Excluding this impairment charge, general and administrative expenses increased 11.3% in Fiscal 2002 compared to Fiscal 2001. Payroll and benefits increased \$1.2 million or 10.4%, to

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\$13.2 million in Fiscal 2002 from \$12.0 million in Fiscal 2001 as a result of additional headquarters personnel and increased bonus payments. Exclusive of the impairment charge discussed above, general and administrative expenses were 6.7% and 6.4% of sales in Fiscal 2002 and Fiscal 2001, respectively.

Retail profit contribution increased by 70.2% to \$23.2 million in Fiscal 2002, compared to \$13.6 million in Fiscal 2001. Retail profit contribution as a percent of sales was 5.7% in Fiscal 2002 compared to 3.6% in Fiscal 2001 reflecting improvements and efficiencies from increased sales volume, a developing central support staff and margin improvements.

Franchising. Royalty fees increased 16.7% to \$17.0 million in Fiscal 2002 from \$14.6 million in Fiscal 2001. Franchise fees, recognized on 19 store openings during Fiscal 2002 increased 2.6% to \$641,000 compared to \$625,000 during Fiscal 2001 recognized on 51 store openings. The 51 store openings in Fiscal 2001 include 23 new Party Supermarket stores, for which the initial franchise fee was not collected and 10 new Canadian stores, for which only a reduced initial franchise fee was collected. Franchise same store sales increased 4.5% in Fiscal 2002.

Expenses directly related to franchise revenue increased 32.9% to \$6.6 million for Fiscal 2002 from \$4.9 million for Fiscal 2001. This increase is primarily attributable to additional franchise personnel required to operate this portion of our business, and the recording of a provision for bad debt related to our Canadian franchisee. As a percentage of franchise revenue, franchise expenses were 37.1% and 32.4% for Fiscal 2002 and Fiscal 2001, respectively.

Franchise profit contribution increased 8.1% to \$11.1 million for Fiscal 2002 compared to \$10.3 million for Fiscal 2001. The increase in franchise profit contribution is due to the increase in royalty and franchise fees offset in part by an increase in franchise expenses, as discussed above.

Interest Expense. Interest expense decreased to \$5.6 million for Fiscal 2002 from \$7.9 million in Fiscal 2001. This is attributable to a reduction in principal balance in Fiscal 2002 as compared to Fiscal 2001. We expensed approximately \$19,000 in the write-off of debt-issue costs, included in interest expense, related to an additional prepayment of \$7.7 million made in June 2002.

Income Taxes. Income taxes of \$11.5 million, or 40.1% of pre-tax income, were provided in Fiscal 2002 compared to income taxes of \$6.0 million, or 37.6% of pre-tax income recorded in Fiscal 2001. The effective income tax rate increased as a result of the increases in our marginal federal rate and state tax rates.

Net Income. As a result of the above factors, net income increased to \$17.2 million or \$1.32 per basic share and \$0.89 per diluted share in Fiscal 2002, as compared to net income of \$10.0 million, or \$0.78 per basic share and \$0.56 per diluted share in Fiscal 2001.

Liquidity and Capital Resources

The Company's cash requirements are primarily for working capital, the opening of new stores, the improvement and expansion of existing facilities and the improvement of information systems. Historically, these cash requirements have been met through cash flow from operations and borrowings under credit facilities. At June 28, 2003, working capital was \$12.9 million compared with \$14.7 million at June 29, 2002.

Net cash provided by operating activities was \$24.1 million in Fiscal 2003 compared with \$34.1 million in Fiscal 2002. The decrease is primarily due to a decrease in net income of \$5.1 million in Fiscal 2003 and an increase in inventories of \$9.6 million due mainly to the opening of 35 new stores offset by the closing of two stores.

Net cash used in investing activities was \$22.2 million in Fiscal 2003 as compared to \$20.0 million in Fiscal 2002. In Fiscal 2003, we made investments of \$13.8 million for 22 new store openings, \$1.8 million for acquired stores, \$2.8 million in our existing store base, and \$3.8 million for other corporate capital and systems. In Fiscal 2002, our investments were \$7.0 million for 13 new store openings, \$5.9 million for acquired stores, \$1.5 million in our existing store base, and \$5.6 million for other corporate capital and systems.

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Net cash used in financing activities was \$2.0 million primarily due to a payment in November 2002 of \$10.2 million in Senior Notes in advance of maturity, the purchase of \$4.1 million of treasury stock as part of the Company's stock buy-back plan and \$524,000 in financing costs. This is offset in part by \$11.2 million in borrowings under the Loan Agreement and \$1.6 million from proceeds of stock options and warrants.

In January 2003, the Company entered into a \$65 million revolving credit facility (the "Loan Agreement") with Wells Fargo Retail Finance, LLC, as the arranger, collateral agent and administrative agent, and Fleet Retail Finance, Inc., as the documentation agent. Under the terms of the Loan Agreement, the Company may borrow amounts based on a percentage of its eligible inventory and credit card receivables, subject to certain borrowing conditions and customary sub-limits, reserves and other limitations. Interest on advances is charged, at the Company's option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50% per annum, and is currently at 1.25% per annum, or (ii) at the prime rate less the applicable margin, which was set initially and is currently at 0.25% per annum. The term of the Loan Agreement is through April 30, 2006 and is secured by a lien on substantially all of the Company's assets. Pursuant to the Loan Agreement, we have a standby letter of credit of \$3.1 million at June 28, 2003 and September 19, 2003. At June 28, 2003 and September 19, 2003 the Company had \$11.2 million and \$20.2 million in borrowings outstanding under the Loan Agreement, respectively. The Company had \$41.7 million available to be borrowed under the Loan Agreement at September 19, 2003.

In August, 1999, we received \$30 million in financing from certain investors (the "Investors"), who purchased senior secured notes and warrants pursuant to a Securities Purchase Agreement (the "Purchase Agreement"). Under the Purchase Agreement, we issued (i) \$10 million 12.5% Secured Notes due 2003 (the "A Notes"); (ii) \$5 million 13.0% Secured Notes due 2003 (the "B Notes"); (iii) \$5 million 13.0% Secured Notes due 2002 (the "C Notes"); (iv) \$10 million 14.0% Secured Notes due 2004 (the "D Notes" and, together with the A Notes, the B Notes and the C Notes, the "Notes"); and (v) warrants (the "Warrants") to purchase 6,880,000 shares of our common stock at an initial exercise price of \$3.00 per share issued in connection with the sale and issuance of the C Notes and the D Notes. The Notes were secured by a junior lien on substantially all of our assets.

Pursuant to the First Amendment, on January 14, 2000, we received \$7 million in cash proceeds from the sale to certain of the Investors (the "Investor Group") of a new series of senior secured notes. Under the First Amendment, we issued \$7 million in aggregate principal amount of 14.0% Senior Secured Notes due 2002 (the "E Notes"). The E Notes were secured by a junior lien on substantially all of our assets. Under the terms of the First Amendment, the interest rate on the A Notes, the B Notes, the C Notes and the D Notes was increased by 4.5%. The Investor Group, together with the Investors and Congress, entered into an intercreditor agreement. In consideration for waivers and forbearances granted by the Investors to various defaults under the terms of our A Notes, B Notes, C Notes and D Notes, we also agreed to amend and restate the terms of the Warrants held by the Investors to acquire 6,880,000 shares of our common stock. The amended and restated warrants (the "Amended Warrants") provide for an exercise price of \$1.07 per share and were issued upon surrender of the Warrants, which had an exercise price of \$3.00 per share.

The Company repaid \$10.2 million, \$19.3 million and \$8.1 million of the Senior Notes in the fiscal years ended June 28, 2003, June 29, 2002 and June 30, 2001, respectively. The Notes were secured by a junior lien on substantially all of the Company's assets. The fiscal 2003 repurchase resulted in an additional payment of \$1.4 million, comprised of interest and an incentive premium, and resulted in an after-tax charge of \$1.3 million, or \$0.07 per diluted share.

In September 2001, the Board of Directors authorized us to repurchase up to \$15 million of our outstanding common stock. The stock repurchases are made at the discretion of management. During Fiscal 2002, we repurchased 284,000 shares for an aggregate amount of \$1.8 million, or 12.2% of the total amount authorized to be purchased. During Fiscal 2003, we repurchased 463,000 shares for an aggregate amount of \$4.1 million, or 27.4% of total amount authorized to be purchased. As of June 28, 2003, we have purchased a total of 747,012 shares for an aggregate amount of \$5.9 million, or 39.6% of the total amount to be purchased.

Our management currently believes that the cash generated by operations, together with the borrowing availability under the Loan Agreement, will be sufficient to meet our working capital infrastructure and new

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store growth needs for the next twelve months. We expect to be substantially free of debt by the end of the current calendar year, absent any special transactions. This permits the Company to consider a wider variety of corporate initiatives intended to improve shareholder value, although there is no assurance that any specific initiative will be pursued or consummated.

Contractual Obligations and Commercial Commitments

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

| | Payments Due By Period (in thousands) | | | | |
|--------------------------------------|---------------------------------------|-----------------|-----------------|-----------------|-----------------|
| | Total | 1 Year | 2-3 Years | 4-5 Years | After 5 years |
| Contractual Obligations | | | | | |
| Operating leases | \$266,233 | \$45,968 | \$87,607 | \$69,595 | \$63,063 |
| Advances under Loan Agreement | 11,229 | 11,229 | | | |
| Severance arrangements | 199 | 199 | | | |
| Capital lease obligations | 32 | 32 | | | |
| Total Contractual Obligations | \$277,693 | \$57,428 | \$87,607 | \$69,595 | \$63,063 |

As of June 28, 2003 and September 19, 2003, we had a contingent liability related to severance payments to 11 employees. The total contingent liability ranges from zero to approximately \$1.1 million. As of June 28, 2003 and September 19, 2003, we had a standby letter of credit of \$3.1 million pursuant to the Loan Agreement.

Off-Balance Sheet Arrangements

We have not created, and are not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating our business. We do not have any off-balance sheet arrangements or relationships with entities that are not consolidated into our financial statements that are reasonably likely to materially affect our liquidity or the availability of capital resources.

Accounting and Reporting Changes

In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS No. 146), replacing Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred instead of at the date an entity commits to an exit plan. This statement also established that fair value is the objective for the initial measurement of the liability. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS No. 146 has not had and is not expected to have a material impact on our consolidated financial statements.

In November 2002, the FASB issued FASB Interpretation (FIN) No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 requires that upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 also requires additional disclosures by a guarantor in its interim and annual financial statements about the obligations associated with guarantees issued. The recognition provisions of FIN 45 are effective for any guarantees that are issued or modified after December 31, 2002. The disclosure requirement is effective for our fiscal year ended June 28, 2003. We have evaluated the accounting provisions of the interpretations and there was no material impact on our financial condition, results of operations or cash flows for the fiscal year ended June 28, 2003. We have made the required disclosures in the consolidated financial statements as of June 28, 2003.

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In November 2002, the EITF reached a consensus on issues raised in EITF 02-16, *Accounting by a Reseller for Cash Consideration Received from a Vendor* (EITF 02-16). EITF 02-16 addresses the timing of recognition for rebates that are earned by resellers based on specified levels of purchases or over specified periods. This guidance, related to timing of recognition, is to be applied prospectively to new rebate arrangements entered into in fiscal periods beginning after January 1, 2003. EITF 02-16 also addresses the classification of cash consideration received from vendors in a reseller's statement of operations. The guidance related to income statement classification is to be applied in annual and interim financial statements for periods beginning after January 1, 2003. The adoption of EITF 02-16 has not had and is not expected to have a material impact on our consolidated financial statements, as the Company's historical policy is consistent with EITF 02-16.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation* (SFAS No. 148). SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123, *Accounting For Stock-Based Compensation* (SFAS No. 123) to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. SFAS No. 148 is effective for fiscal years ending after December 31, 2002. We will continue to account for stock-based equity compensation using the intrinsic value method of APB Opinion 25. We are required to follow the prescribed disclosure format and have provided the additional disclosures required by SFAS No. 148 for the fiscal year ended June 28, 2003.

In January 2003, the FASB issued Interpretation No. 46 *Consolidation of Variable Interest Entities* (FIN 46), with the objective of improving financial reporting by companies involved with variable interest entities. A variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights, or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Historically, entities generally were not consolidated unless the entity was controlled through voting interests. FIN 46 changes that by requiring a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. A company that consolidates a variable interest entity is called the *primary beneficiary* of that entity. FIN 46 also requires disclosures about variable interest entities that a company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements of FIN 46 apply to existing entities in the first fiscal year or interim period after January 31, 2003, regardless of when the variable interest entity was established. We have evaluated the accounting provisions of the interpretations and there was no material impact on our financial condition, results of operations or cash flows, since the Company is not the primary beneficiary of any variable interest entities.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This statement amends and clarifies financial reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. This statement is effective for contracts entered into or modified after June 30, 2003. We are currently evaluating the impact of adopting this statement on our consolidated financial position and results of operations.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. This statement establishes standards for how a company classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The statement will be implemented by reporting the cumulative effect of a change in accounting principle for financial instruments created before the issuance date of the statement and still existing at the beginning of the period of adoption. Although we are still in the process of reviewing the new statement, we believe this statement will have no material impact on our consolidated financial statements.

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Impact of Inflation

We believe that inflation did not have a material impact on our operations for the periods reported. Significant increases in cost of merchandise purchased, labor, employee benefits and other operating expenses could have a material adverse effect on our results of operations and financial condition.

Seasonality

Our business is subject to substantial seasonal variations. Historically, we have realized a significant portion of our net sales, cash flow and net income in the second fiscal quarter of the year principally due to the sales in October for the Halloween season and, to a lesser extent, due to holiday sales for end of year holidays. We expect that this general pattern will continue. Our results of operations may also fluctuate significantly as a result of a variety of other factors, including the timing of new store openings and store closings and the timing of the acquisition and disposition of stores.

Item 7A. *Quantitative and Qualitative Disclosures about Market Risk*

We, in the normal course of doing business, are exposed to interest rate change and market risk. As borrowing patterns are cyclical, we are not dependent on borrowing throughout the year. Therefore, a sudden increase in interest rates (which under the Loan Agreement is dependent on, at the Company's option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50% per annum, and is currently at 1.25% per annum, or (ii) at the prime rate less the applicable margin, which was set initially at 0.25% per annum) may, during peak borrowing, have a negative impact on short-term results.

Item 8. *Financial Statements and Supplementary Data*

The response to this item is submitted as a separate section of this Report commencing on page F-1.

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

None.

Item 9A. *Controls and Procedures*

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

As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the fourth fiscal quarter covered by this report. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in the Company's internal controls over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

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PART III

In accordance with general instruction G(3) of Form 10-K, the information called for by Items 10, 11, 12, 13 and 14 of Part III is incorporated by reference from our definitive Proxy Statement for our 2003 Annual Meeting of Stockholders.

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) List of Documents filed as part of this Annual Report on Form 10-K.

1. The following consolidated financial statements listed below are filed as a separate section of this Report commencing on page F-1.

Independent Auditors Report Deloitte & Touche LLP.

Consolidated Balance Sheets as of June 28, 2003 and June 29, 2002.

Consolidated Statements of Income for the years ended June 28, 2003, June 29, 2002 and June 30, 2001.

Consolidated Statements of Stockholders Equity for the years ended June 28, 2003, June 29, 2002 and June 30, 2001.

Consolidated Statements of Cash Flows for the years ended June 28, 2003, June 29, 2002 and June 30, 2001.

Notes to Consolidated Financial Statements for the years ended June 28, 2003, June 29, 2002 and June 30, 2001.

2. Financial Statement Schedule for the years ended June 28, 2003, June 29, 2002 and June 30, 2001.

3. List of Exhibits.

The following exhibits are included as a part of this Annual Report on Form 10-K or, where indicated, are incorporated herein by reference.

EXHIBIT INDEX

| Exhibit No. | |
|--------------------|--|
| 3.1 | Certificate of Incorporation of the Company, incorporated by reference from the Company's Registration Statement as amended on Form S-1 Number 333-00350 as filed with the Commission on January 18, 1996 (the "S-1"). |
| 3.2 | Bylaws of the Company as amended. |
| 4.1 | Specimen stock certificate evidencing the Common Stock, incorporated by reference from the S-1. |
| 4.2 | Form of Amended and Restated Warrant, incorporated by reference from the Company's Current Report on Form 8-K as filed with the Commission on January 19, 2000 (the "January 2000 8-K"). |
| 4.3 | Form of Securities Purchase Agreement, dated as of August 16, 1999, by and between the Company and each of the Investors, incorporated by reference from the Company's Current Report on Form 8-K as filed with the Commission on August 25, 1999 (the "August 1999 8-K"). |
| 4.4 | First Amendment to Securities Purchase Agreement, dated as of January 14, 2000, by and between the Company and each of the Investors, incorporated by reference from the January 2000 8-K. |

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Exhibit No.

| | |
|-------|---|
| 4.5 | Second Amendment to Securities Purchase Agreement, dated as of April 1, 2001, by and among the Company and each of the Investors, incorporated by reference from the Company's Quarterly Report on Form 10-Q as filed with the Commission on May 15, 2001 (the May 2001 10-Q). |
| 10.1 | Form of Unit Franchise Agreement entered into by the Company and franchisees, incorporated by reference from the S-1. |
| 10.2 | Option Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futterman, incorporated by reference from Amendment No. 1 to Schedule 13D as filed by Jack Futterman with the Commission on June 17, 1999 (Futterman's 13D). |
| 10.3 | Stock Pledge Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futterman, incorporated by reference from Futterman's 13D. |
| 10.4 | Amended and Restated Investor Rights Agreement, dated as of August 18, 2003, by and among the Company and the Investors. |
| 10.5 | Description of oral consulting agreement between the Company and Ralph Dillon, incorporated by reference from the Company's Quarterly Report on Form 10-Q as filed with the Commission on February 13, 2001 (the February 2001 10-Q). |
| 10.6 | General Release and Severance Agreement of James Shea, dated as of May 28, 2003, by and between the Company and James Shea. |
| 10.7 | Separation Agreement of Andrew Bailen, dated as of July 14, 2003, by and between the Company and Andrew Bailen. |
| 10.8 | Separation Agreement of Thomas Larson, dated as of August 26, 2002, by and between the Company and Thomas Larson. |
| 10.9 | Employment Agreement of Steven Skiba, dated as of November 29, 2002, by and between the Company and Steven Skiba. |
| 10.10 | Management Stock Purchase Plan of the Company, incorporated by reference from the Registration of Form S-8 as filed with the Commission on July 23, 2001. |
| 10.11 | Employee Stock Purchase Plan of the Company, incorporated by reference from the Company's Definitive Proxy Statement for the 2001 Annual Meeting of Stockholders, included within Form 14-A as filed with the Commission on October 18, 2001. |
| 10.12 | Amended and Restated 1994 Stock Option Plan, incorporated by reference from the Registration of Form S-8 as filed with the Commission on January 9, 1997. |
| 10.13 | 1999 Stock Incentive Plan (Amended and Restated as of October 25, 2000), incorporated by reference from the February 2001 10-Q. |
| 10.14 | Loan and Security Agreement (the Loan Agreement), dated January 9, 2003, by and between the Company and Wells Fargo Retail Finance, LLC (WFRF), as the arranger, collateral agent and administrative agent, and Fleet Retail Finance, Inc., as the documentation agent, incorporated by reference from the Company's Current Report on Form 8-K as filed with the Commission on January 10, 2003. |
| 10.15 | Stock Pledge Agreement, dated January 9, 2003, by and among the Company, Party City Michigan, Inc. (PCMI) and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement. |
| 10.16 | Trademark Security Agreement, dated January 9, 2003, by and between the Company and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement. |
| 10.17 | Copyright Security Agreement, dated January 9, 2003, by and between the Company and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement. |

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| Exhibit No. | |
|--------------------|--|
| 10.18 | Guaranty and Security Agreement, dated January 9, 2003, by and between PCMI and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement. |
| 21.1 | Subsidiaries. The wholly owned subsidiary of the Company is Party City Michigan, Inc. incorporated on October 23, 1997, in the State of Delaware. This subsidiary does business under the name Party City Michigan, Inc. |
| 23.1 | Consent of Deloitte & Touche LLP. |
| 31.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

(b) Reports on Form 8-K.

1. On April 11, 2003, the Company filed a Current Report on Form 8-K announcing that James Shea had resigned as Chief Executive Officer and that Nancy Pedot was replacing him, serving as Acting Chief Executive Officer. In addition, the Company announced its sales for the third fiscal quarter ended March 29, 2003.

2. On May 9, 2003, the Company filed a Current Report on Form 8-K announcing its operating results for the third fiscal quarter ended March 29, 2003.

Table of Contents**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, on September 26, 2003.

PARTY CITY CORPORATION

By: /s/ LINDA M. SILUK

Linda M. Siluk
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.

| Name | Title | Date |
|---|---|--------------------|
| By: <u> /s/ RALPH D. DILLON </u> Ralph D. Dillon | Non-Executive Chairman of the Board and Director | September 26, 2003 |
| By: <u> /s/ MICHAEL E. TENNENBAUM </u> Michael E. Tennenbaum | Vice Chairman and Director | September 26, 2003 |
| By: <u> /s/ RICHARD H. GRINER </u> Richard H. Griner | Director | September 26, 2003 |
| By: <u> /s/ L.R. JALENAK, JR. </u> L.R. Jalenak, Jr. | Director | September 26, 2003 |
| By: <u> /s/ FRANKLIN R. JOHNSON </u> Franklin R. Johnson | Director | September 26, 2003 |
| By: <u> /s/ HOWARD LEVKOWITZ </u> Howard Levkowitz | Director | September 26, 2003 |
| By: <u> /s/ WALTER SALMON </u> Walter Salmon | Director | September 26, 2003 |
| By: <u> /s/ NANCY PEDOT </u> Nancy Pedot | Acting Chief Executive Officer and Director | September 26, 2003 |
| By: <u> /s/ LINDA M. SILUK </u> | Chief Financial Officer | September 26, 2003 |

Linda M. Siluk

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Exhibit 31.1

Certification of Chief Executive Officer

Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Nancy Pedot, certify that:

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

/s/ NANCY PEDOT

Nancy Pedot
Acting Chief Executive Officer

Date: September 26, 2003

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Exhibit 31.2

Certification of Chief Financial Officer

Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Linda M. Siluk, certify that:

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

/s/ LINDA M. SILUK

Linda M. Siluk
Chief Financial Officer

Date: September 26, 2003

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Exhibit 32.1

Certification of Chief Executive Officer

Pursuant to 18 U.S.C. § 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Party City Corporation (the Company) hereby certifies, to such officer's knowledge, that:

(i) the Annual Report on Form 10-K of the Company for the annual period ended June 28, 2003 (the Report) fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ NANCY PEDOT

Nancy Pedot
Acting Chief Executive Officer

Dated: September 26, 2003

The foregoing certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. § 1350, and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

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Exhibit 32.2

Certification of Chief Financial Officer

Pursuant to 18 U.S.C. § 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Party City Corporation (the Company) hereby certifies, to such officer's knowledge, that:

(i) the Annual Report on Form 10-K of the Company for the annual period ended June 28, 2003 (the Report) fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ LINDA M. SILUK

Linda M. Siluk
Chief Financial Officer

The foregoing certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. § 1350, and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

Dated: September 26, 2003

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INDEPENDENT AUDITORS REPORT

To the Board of Directors and Stockholders of

Party City Corporation
Rockaway, New Jersey

We have audited the accompanying consolidated balance sheets of Party City Corporation and subsidiary as of June 28, 2003 and June 29, 2002 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three fiscal years ended June 28, 2003. Our audits also included the consolidated financial statement schedule listed in the Index at Item 15a. These consolidated financial statements and consolidated financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and consolidated financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Party City Corporation and subsidiary as of June 28, 2003 and June 29, 2002, and the consolidated results of their operations and their cash flows for each of the three fiscal years ended June 28, 2003 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion such consolidated financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, the Company changed its method of accounting for goodwill and other intangible assets as of July 1, 2001 to conform with Financial Accounting Standards Board Statement No. 142.

DELOITTE & TOUCHE LLP

Parsippany, New Jersey
August 21, 2003

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Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

| | June 28, 2003 | June 29, 2002 |
|--|--------------------------|--------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,372 | \$ 3,467 |
| Merchandise inventory | 65,908 | 55,867 |
| Other current assets, net | 21,900 | 17,616 |
| | <u> </u> | <u> </u> |
| Total current assets | 91,180 | 76,950 |
| Property and equipment, net | 52,819 | 49,356 |
| Goodwill | 18,614 | 18,016 |
| Other assets | 5,386 | 4,732 |
| | <u> </u> | <u> </u> |
| Total assets | \$ 167,999 | \$ 149,054 |
| | <u> </u> | <u> </u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 37,960 | \$ 32,414 |
| Book overdraft | 4,126 | 3,085 |
| Accrued expenses and other current liabilities | 24,998 | 26,744 |
| Advances under Loan Agreement | 11,229 | |
| | <u> </u> | <u> </u> |
| Total current liabilities | 78,313 | 62,243 |
| Long-term liabilities: | | |
| Deferred rent and other long-term liabilities | 10,264 | 10,297 |
| Senior Notes | | 8,915 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock, \$0.01 par value; authorized, 25,000,000 shares; issued, 17,296,807 and 16,239,081 shares, respectively | 173 | 162 |
| Additional paid-in capital | 43,178 | 39,347 |
| Retained earnings | 42,011 | 29,919 |
| Treasury shares, at cost (747,012 and 284,000 shares, respectively) | (5,940) | (1,829) |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 79,422 | 67,599 |
| | <u> </u> | <u> </u> |
| Total liabilities and stockholders' equity | \$ 167,999 | \$ 149,054 |
| | <u> </u> | <u> </u> |

See accompanying notes to consolidated financial statements.

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF INCOME**

(in thousands, except per share data)

| | Year Ended | | |
|--|----------------|----------------|----------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 |
| Revenues: | | | |
| Net sales | \$ 464,258 | \$ 405,821 | \$ 380,671 |
| Royalty fees | 18,007 | 17,048 | 14,604 |
| Franchise fees | 355 | 641 | 625 |
| | <u>482,620</u> | <u>423,510</u> | <u>395,900</u> |
| Expenses: | | | |
| Cost of goods sold and occupancy costs | 311,170 | 263,980 | 252,320 |
| Company-owned stores operating and selling expense | 108,294 | 91,576 | 88,128 |
| Franchise expense | 6,538 | 6,563 | 4,937 |
| General and administrative expense | 32,475 | 27,086 | 26,603 |
| | <u>458,477</u> | <u>389,205</u> | <u>371,988</u> |
| Operating income | 24,143 | 34,305 | 23,912 |
| Interest income | (175) | (176) | (545) |
| Interest expense | 4,165 | 5,786 | 8,494 |
| | <u>3,990</u> | <u>5,610</u> | <u>7,949</u> |
| Interest expense, net | 3,990 | 5,610 | 7,949 |
| Income before income taxes | 20,153 | 28,695 | 15,963 |
| Provision for income taxes | 8,061 | 11,503 | 6,002 |
| | <u>12,092</u> | <u>17,192</u> | <u>9,961</u> |
| Net income | \$ 12,092 | \$ 17,192 | \$ 9,961 |
| | <u>0.73</u> | <u>1.32</u> | <u>0.78</u> |
| Basic earnings per share | \$ 0.73 | \$ 1.32 | \$ 0.78 |
| | <u>16,602</u> | <u>13,068</u> | <u>12,723</u> |
| Weighted average shares outstanding basic | 16,602 | 13,068 | 12,723 |
| | <u>0.62</u> | <u>0.89</u> | <u>0.56</u> |
| Diluted earnings per share | \$ 0.62 | \$ 0.89 | \$ 0.56 |
| | <u>19,646</u> | <u>19,313</u> | <u>17,819</u> |
| Weighted average shares outstanding diluted | 19,646 | 19,313 | 17,819 |

See accompanying notes to consolidated financial statements.

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PARTY CITY CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands, except number of shares)

| | Common Stock | | Additional Paid-In- Capital | Retained Earnings | Treasury Stock at Cost | Total |
|---|--------------|---------|-----------------------------------|----------------------|------------------------------|-----------|
| | Shares | Amounts | | | | |
| Balance at July 1, 2000 | 12,722,205 | \$ 127 | \$ 37,968 | \$ 2,766 | \$ | \$ 40,861 |
| Exercise of stock options | 1,250 | | 4 | | | 4 |
| Equity compensation | | | 264 | | | 264 |
| Net income | | | | 9,961 | | 9,961 |
| | | | | | | |
| Balance at June 30, 2001 | 12,723,455 | 127 | 38,236 | 12,727 | | 51,090 |
| Warrant exercise | 3,381,624 | 34 | (34) | | | |
| Equity compensation | | | 463 | | | 463 |
| Tax effect of non-qualified options | | | 37 | | | 37 |
| Exercise of stock options | 134,002 | 1 | 645 | | | 646 |
| Repurchase of common shares (284,000 shares) | | | | | (1,829) | (1,829) |
| Net income | | | | 17,192 | | 17,192 |
| | | | | | | |
| Balance at June 29, 2002 | 16,239,081 | 162 | 39,347 | 29,919 | (1,829) | 67,599 |
| Warrant exercise | 672,459 | 7 | 484 | | | 491 |
| Equity compensation | | | 342 | | | 342 |
| Tax effect of non-qualified options | | | 556 | | | 556 |
| Exercise of stock options | 213,486 | 2 | 1,130 | | | 1,132 |
| Issuance of shares of MSPP | 95,511 | 1 | 707 | | | 708 |
| Issuance of shares of ESPP | 76,270 | 1 | 612 | | | 613 |
| Repurchase of common shares (463,012 shares) | | | | | (4,111) | (4,111) |
| Net income | | | | 12,092 | | 12,092 |
| | | | | | | |
| Balance at June 28, 2003 | 17,296,807 | \$ 173 | \$ 43,178 | \$ 42,011 | \$ (5,940) | \$ 79,422 |

See accompanying notes to consolidated financial statements.

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

| | Year Ended | | |
|---|---------------|---------------|---------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 |
| Cash flow from operating activities: | | | |
| Net income | \$ 12,092 | \$ 17,192 | \$ 9,961 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 16,229 | 12,156 | 10,431 |
| Non-cash interest and financing costs | 1,624 | 1,395 | 1,815 |
| Deferred taxes | (2,131) | 819 | 1,543 |
| Deferred rent | 556 | 765 | 1,148 |
| Equity based compensation | 342 | 463 | 264 |
| Provision for doubtful accounts | (498) | (67) | (65) |
| Tax effect of non-qualified stock options | 556 | 37 | |
| Impairment charge | 1,505 | | 2,275 |
| Loss (gain) on disposition and sale of stores | 162 | | (131) |
| Changes in assets and liabilities: | | | |
| Accounts payable, accrued expenses and other current liabilities | 4,649 | 7,979 | 7,301 |
| Merchandise inventory | (9,634) | (7,310) | (6,606) |
| Other long-term liabilities | 121 | 833 | (326) |
| Other current assets and other assets | (1,444) | (135) | 2,045 |
| Net cash provided by operating activities | 24,129 | 34,127 | 29,655 |
| Cash flow from investing activities: | | | |
| Purchases of property and equipment | (20,476) | (14,085) | (16,305) |
| Stores acquired | (1,758) | (5,923) | (516) |
| Proceeds from sales of stores | | | 1,157 |
| Net cash used in investing activities | (22,234) | (20,008) | (15,664) |
| Cash flow from financing activities: | | | |
| Payments on Senior Notes | (10,207) | (19,311) | (8,103) |
| Purchase of treasury shares | (4,111) | (1,829) | |
| Proceeds from exercise of stock options and warrants | 1,623 | 646 | 4 |
| Payment of financing costs | (524) | | |
| Net proceeds from Loan Agreement | 11,229 | | |
| Net cash used in financing activities | (1,990) | (20,494) | (8,099) |
| Net (decrease) increase in cash and cash equivalents | (95) | (6,375) | 5,892 |
| Cash and cash equivalents, beginning of year | 3,467 | 9,842 | 3,950 |
| Cash and cash equivalents, end of year | \$ 3,372 | \$ 3,467 | \$ 9,842 |
| Supplemental disclosure of cash flow information: | | | |
| Income taxes paid | \$ 9,895 | \$ 9,990 | \$ 5,315 |
| Interest paid | \$ 2,978 | \$ 5,283 | \$ 6,648 |
| Supplemental disclosure of non-cash financing activity: | | | |
| Issuance of warrants | \$ 245 | \$ 3,955 | \$ |
| Issuance of shares under management stock plan | \$ 708 | \$ | \$ |

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| | | | | |
|--|----|-----|----|----|
| Issuance of shares under employee stock plan | \$ | 613 | \$ | \$ |
|--|----|-----|----|----|

See accompanying notes to consolidated financial statements

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Consolidated Financial Statements

Party City Corporation (the Company) is incorporated in the State of Delaware and operates retail party supplies stores within the continental United States and sells franchises on an individual store and area franchise basis throughout the United States and Puerto Rico. At June 28, 2003, the Company had 242 Company-owned stores and 241 franchise stores in its network. The consolidated financial statements of the Company include the accounts of the Company and its wholly-owned subsidiary, Party City Michigan, Inc. All significant intercompany balances and transactions have been eliminated.

The Company's fiscal year ends on the Saturday nearest June 30. As used herein, the term Fiscal Year refers to the 52-week or 53-week period ending on the Saturday nearest to June 30, unless otherwise noted.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include provision for slow-moving inventory, insurance accruals, finite-lived assets, goodwill, sales returns and store closure costs.

Cash and Cash Equivalents

The Company considers its highly liquid investments purchased, with an original maturity of three months or less, as part of daily cash management activities to be cash equivalents.

Fair Value of Financial Instruments

Financial instruments consist of cash equivalents, accounts receivable, accounts payable and advances under the Loan Agreement. The carrying amounts reported in the balance sheets of such financial instruments approximate their fair market values due to their short-term maturities.

The estimated fair values of financial instruments that are presented herein have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required in interpreting market data to develop estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of amounts the Company could realize in a current market exchange.

Merchandise Inventory

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

Advertising Fund

Pursuant to its franchise agreements, the Company collects 1% of the net sales of its franchise stores for contribution into the Advertising Fund (the Ad Fund). The Company also contributes 1% of net sales of its owned stores into the Ad Fund. These amounts are restricted to be used for advertising. Receipts and disbursements are not recorded as income or expense since the Company does not have full discretion over

the use of the funds. To cover the expenses of fund administration, the Company charges the Ad Fund a

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

management fee equal to 5% of the funds contributed by franchisees. For the fiscal years ended June 28, 2003, June 29, 2002 and June 30, 2001, Ad Fund management fees of \$484,000, \$439,000 and \$401,000, respectively, were collected by the Company and credited to general and administrative expense.

Property and Equipment

Property and equipment are recorded at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives of the assets or, where applicable, the terms of the respective leases, whichever is shorter. The Company uses estimated useful lives of five to seven years for furniture, fixtures and equipment. Capitalized software costs are amortized on a straight-line basis over their estimated lives of three to five years. Depreciation begins in the year the assets are placed into service.

Maintenance and repairs are charged directly to expense as incurred. Major renewals or replacements of fixed assets are capitalized after making the necessary adjustments to the asset and accumulated depreciation of the items renewed or replaced.

Impairment of Finite-Lived Assets

The Company evaluates Finite-Lived Assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-lived Assets (SFAS No. 144). This statement supersedes SFAS No. 121, Accounting for Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed of. Finite-lived assets are evaluated for recoverability in accordance with SFAS No. 144 whenever events or changes in circumstances indicate that an asset may have been impaired. In evaluating an asset for recoverability, the Company estimates the future cash flows expected to result from the use of the asset and eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss, equal to the excess of the carrying amount over the fair market value of the asset is recognized. The Company evaluated its finite-lived assets and based on current and projected performance, determined that the fixed assets must be impaired for four stores in the Seattle market and one other store. Therefore, a pre-tax charge of \$946,000 was taken in Fiscal 2003. After adjusting for this impairment charge, management believes the carrying value and useful lives are appropriate.

Non-Compete Agreement

The Company has two non-compete agreements. One is with a franchise owner and the other is with Paper Warehouse, Inc. These agreements are included in other assets and are being amortized using the straight-line method over the life of the agreement. Amortization expense for other intangibles was \$131,000, \$33,000 and \$0 for the fiscal years ended June 28, 2003, June 29, 2002 and June 30, 2001, respectively.

Goodwill

The Company adopted SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142) effective July 1, 2001. It changes the accounting for goodwill from an amortization method to an impairment only approach. Under SFAS No. 142, goodwill is no longer amortized but reviewed for impairment annually or more frequently if certain indicators arise. The Company evaluated the goodwill associated with its acquisitions and based on current and projected performance, determined that the goodwill associated with one acquisition had little to no carrying value. Therefore, the carrying amount of goodwill was impaired and a charge for \$558,000 was taken in Fiscal 2003. After adjusting for this impairment charge, management believes the carrying value is appropriate.

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following financial information is presented as if the statement were adopted at the beginning of Fiscal 2001 (in thousands, except per share amounts):

| | Year Ended | | |
|-------------------------------------|------------------|------------------|------------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 |
| Reported net income | \$ 12,092 | \$ 17,192 | \$ 9,961 |
| Add back: | | | |
| Goodwill amortization, net of taxes | | | 725 |
| Adjusted net income | \$ 12,092 | \$ 17,192 | \$ 10,686 |
| Basic earnings per share reported | \$ 0.73 | \$ 1.32 | \$ 0.78 |
| Goodwill amortization, net of taxes | | | 0.06 |
| Adjusted basic earnings per share | \$ 0.73 | \$ 1.32 | \$ 0.84 |
| Diluted earnings per share reported | \$ 0.62 | \$ 0.89 | \$ 0.56 |
| Goodwill amortization, net of taxes | | | 0.04 |
| Adjusted diluted earnings per share | \$ 0.62 | \$ 0.89 | \$ 0.60 |

Income Taxes

The Company files a consolidated Federal income tax return. Separate state income tax returns are filed with each state in which the Company conducts business. The Company accounts for its income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date.

Stock-Based Compensation

In accordance with SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS No. 123) the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model using the following assumptions for grants in the respective periods:

| | Year Ended | | |
|---------------------|------------------|------------------|------------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 |
| Expected volatility | 55% | 50% | 97% |
| Expected lives | 5.4 years | 4.7 years | 4.0 years |

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| | | | |
|-------------------------|------|------|------|
| Risk-free interest rate | 2.3% | 3.3% | 4.3% |
| Expected dividend yield | 0.0% | 0.0% | 0.0% |

The weighted average fair value of options granted during the fiscal years 2003, 2002 and 2001 were \$7.47, \$2.53 and \$2.23 respectively.

The Company periodically grants stock options to employees. Pursuant to Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, the Company accounts for stock-based employee compensation arrangements using the intrinsic value method. Accordingly, no compensation expense has been

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Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

recorded in the Consolidated Financial Statements with respect to option grants. The Company has adopted the disclosure only provisions of SFAS No. 123, Accounting for Stock Based Compensation, as amended by SFAS No. 148, Accounting for Stock Based Compensation Transition and Disclosure, an Amendment of SFAS No. 123. If compensation cost for the Company's stock option plans had been determined in accordance with the fair value method prescribed by SFAS No. 123, the Company's net income would have been:

| | Year Ended | | |
|--|------------------|------------------|------------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 |
| (in thousands, except per share data) | | | |
| Income before extraordinary item and accounting charge: | | | |
| As reported | \$ 12,092 | \$ 17,192 | \$ 9,961 |
| Deduct: Total stock based employee compensation expense determined under fair value based method, net of taxes | (1,042) | (2,145) | (1,066) |
| Pro-forma | \$ 11,050 | \$ 15,047 | \$ 8,895 |
| Basic earnings per share: | | | |
| As reported | \$ 0.73 | \$ 1.32 | \$ 0.78 |
| Pro-forma | 0.67 | 1.16 | 0.70 |
| Diluted earnings per share: | | | |
| As reported | \$ 0.62 | \$ 0.89 | \$ 0.56 |
| Pro-forma | 0.56 | 0.78 | 0.50 |

Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share also includes the dilutive effect of potential common shares (dilutive stock options and warrants) outstanding during the period.

Revenue Recognition

The Company operates predominately as a retailer through its Company owned stores. The retail segment recognizes revenue at the point of sale. Allowances for sales returns are recorded as a component of net sales in the periods in which the related sales are recognized.

The Company's franchise segment generates revenues through one-time franchise fees and ongoing royalties. Revenue from the sale of individual franchises, recorded as franchise fees, is recognized by the Company upon completion of certain initial services, which normally coincides with the opening of the franchisee's store. Royalty fees are recorded on a monthly basis as a percentage of the franchisee's net sales. The Company is obligated in accordance with the terms of each franchisee's respective agreement to provide the following initial services: advice on site location, store design and layout, training and pre-opening assistance. On an ongoing basis, the Company provides assistance regarding sources of supply, pricing, advertising and promotion programs.

Area franchise sales represent agreements with franchisees to open a specified number of franchises within defined geographic areas and development periods. The Company's policy is to receive a deposit in advance for each of the potential stores, based on its standard initial franchise fee at the time the contract is signed. Upon receipt, the deposit is recorded as deferred revenue. When the Company satisfies its initial obligations to the franchisee and the store is opened, the Company recognizes the deposit as revenue. The Company had 241 and 242 franchise stores at June 28, 2003 and June 29, 2002, respectively.

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Store Opening and Closing Costs

New store opening costs are expensed as incurred. Closed store costs, such as future rent and real estate taxes net of expected sublease recovery, are accrued when an agreement is entered into to close a store.

Effect of New Accounting Standards

In June 2002, the Financial Accounting Standards Board (FASB) SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS No. 146), replacing Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred instead of at the date an entity commits to an exit plan. This statement also established that fair value is the objective for the initial measurement of the liability. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS 146 has not had and is not expected to have a material impact on the consolidated financial statements.

In November 2002, the FASB issued FASB Interpretation (FIN) No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 requires that upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 also requires additional disclosures by a guarantor in its interim and annual financial statements about the obligations associated with guarantees issued. The recognition provisions of FIN 45 will be effective for any guarantees that are issued or modified after December 31, 2002. The disclosure requirement is effective for the Company's Fiscal Year ended June 28, 2003. The Company has evaluated the accounting provisions of the interpretations and there was no material impact on the financial condition, results of operations or cash flows for the fiscal year ended June 28, 2003. The Company has made the required disclosures in the consolidated financial statements as of June 28, 2003.

In November 2002, the EITF reached a consensus on issues raised in EITF 02-16, Accounting by a Reseller for Cash Consideration Received from a Vendor (EITF 02-16). This EITF issue addresses the timing of recognition for rebates that are earned by resellers based on specified levels of purchases or over specified periods. This guidance, related to timing of recognition, is to be applied prospectively to new rebate arrangements entered into in fiscal periods beginning after January 1, 2003. This EITF issue also addresses the classification of cash consideration received from vendors in a reseller's statement of operations. The guidance related to income statement classification is to be applied in annual and interim financial statements for periods beginning after January 1, 2003. The adoption of EITF 02-16 has not had and is not expected to have a material impact on the consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation (SFAS No. 148). SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of FASB Statement No. 123, Accounting For Stock-Based Compensation (SFAS 123) to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. The Company will continue to account for stock-based equity compensation using the intrinsic value method of APB Opinion 25. The Company is required to follow prescribed disclosure format and has provided the additional disclosures required by SFAS 148 for the fiscal year ended June 28, 2003.

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46) with the objective of improving financial reporting by companies involved with variable interest entities. A variable interest entity is a corporation, partnership, trust, or any other legal structure used for

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

business purposes that either (a) does not have equity investors with voting rights, or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Historically, entities generally were not consolidated unless the entity was controlled through voting interests. FIN 46 changes that by requiring a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. A company that consolidates a variable interest entity is called the primary beneficiary of that entity. FIN 46 also requires disclosures about variable interest entities that a company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements of FIN 46 apply to existing entities in the first fiscal year or interim period after January 31, 2003, regardless of when the variable interest entity was established. We have evaluated the accounting provisions of the interpretations and there was no material impact on our financial condition, results of operations or cash flows, since the Company is not the primary beneficiary of any variable interest entities.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This statement amends and clarifies financial reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. This statement is effective for contracts entered into or modified after June 30, 2003. The Company is currently evaluating the impact of adopting this statement on its consolidated financial position and results of operations.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. This statement establishes standards for how a company classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The statement will be implemented by reporting the cumulative effect of a change in accounting principle for financial instruments created before the issuance date of the statement and still existing at the beginning of the period of adoption. Although the Company is still in the process of reviewing the new statement, the Company believes this statement will have no material impact on its consolidated financial statements.

Seasonality

The Company's business is subject to substantial seasonal variations. Historically, the Company has realized a significant portion of its net sales, operating income and net income in the second fiscal quarter of the year, principally due to the sales in October for the Halloween season and, to a lesser extent, due to sales for end of year holidays. The Company believes this general pattern will continue in the future. An economic downturn during this period could adversely affect the Company to a greater extent than if such downturn occurred at other times of the year. The Company's results of operations may also fluctuate significantly as a result of a variety of other factors, including the timing of new store openings, store closings and store sales.

Concentration

The Company has four suppliers who in the aggregate constituted approximately 43% of the Company's purchases for each of the three fiscal years ended June 28, 2003. The loss of any of these suppliers could adversely affect the Company's operations.

Reclassifications

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

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. Acquisitions and Disposition of Stores*****Fiscal 2001***

In Fiscal 2001, The Party Supermarket, Inc. (Party Supermarket) became a franchisee. Under the related franchise agreement, Party Supermarket purchased three stores in Florida from the Company for approximately \$1.2 million. A gain of \$131,000 was recorded by the Company on this sale.

In Fiscal 2001, the Company acquired one store from a franchisee. The aggregate consideration paid in connection with this acquisition was \$516,000.

Fiscal 2002

In Fiscal 2002, the Company acquired three stores from franchisees. One of these locations was acquired by the Company by assuming the lease of a franchise store under the default terms of the franchisee s lease agreement.

Also in Fiscal 2002, the Company acquired 13 stores in the Seattle, Washington market from Paper Warehouse, Inc. The conversion of these locations to the Party City store format was completed and all stores were opened in the first quarter of Fiscal 2003.

The aggregate consideration paid in connection with the Fiscal 2002 acquisitions was \$5.9 million. The consolidated balance sheets include allocations of the purchase prices relating to these acquisitions resulting in the recording of approximately \$4.4 million in goodwill, \$523,000 in inventory and \$1.0 million in fixed assets, of which \$558,000 of goodwill was impaired during Fiscal 2003.

Fiscal 2003

In Fiscal 2003, the Company acquired two stores from a franchisee. The aggregate consideration paid in connection with this acquisition was \$1.6 million. The consolidated balance sheet includes allocations of the purchase price relating to these acquisitions resulting in the recording of approximately \$1.0 million in goodwill, \$407,000 in inventory and \$195,000 in fixed assets.

Related to the Seattle acquisition, additional goodwill of \$154,000 was recorded during Fiscal 2003 related to the completion of the conversion of these locations.

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

Assuming the stores acquired during the Fiscal Year ended June 28, 2003 and June 29, 2002 were acquired on June 30, 2001, the pro forma results would have been as follows (in thousands, except per share amounts) (unaudited):

| | Year Ended | |
|------------|--------------------------|--------------------------|
| | June 28, 2003 | June 29, 2002 |
| Net sales | \$484,068 | \$439,989 |
| Net income | 12,168 | 17,618 |

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| | | | | |
|----------------------------|----|------|----|------|
| Basic earnings per share | \$ | 0.73 | \$ | 1.35 |
| Diluted earnings per share | | 0.62 | | 0.91 |

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Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The changes in the carrying amount of goodwill for the Fiscal Year ended June 28, 2003 and June 29, 2002 are as follows (in thousands):

| | |
|---------------------------------------|-----------|
| Balance as of June 30, 2001. | \$ 13,647 |
| Goodwill acquired during the period | 4,369 |
| | <hr/> |
| Balance as of June 29, 2002. | 18,016 |
| Goodwill acquired during the period | 1,156 |
| Goodwill impairment during the period | (558) |
| | <hr/> |
| Balance as of June 28, 2003. | \$ 18,614 |
| | <hr/> |

3. Other Current Assets

Other current assets consist of the following (in thousands):

| | June 28, 2003 | June 29, 2002 |
|---|--------------------------|--------------------------|
| | <hr/> | <hr/> |
| Deferred taxes | \$ 7,428 | \$ 5,827 |
| Prepaid expenses and other current assets | 4,764 | 4,095 |
| Prepaid rent | 4,722 | 4,127 |
| Receivables from franchisees | 2,454 | 2,562 |
| Advance merchandise payments | 1,513 | 708 |
| Restricted cash from advertising fund | 1,307 | 1,082 |
| | <hr/> | <hr/> |
| | 22,188 | 18,401 |
| Less: Allowance for doubtful accounts | (288) | (785) |
| | <hr/> | <hr/> |
| | \$ 21,900 | \$ 17,616 |
| | <hr/> | <hr/> |

4. Property and Equipment

Property and equipment consists of the following (in thousands):

| | June 28, 2003 | June 29, 2002 |
|--------------------------------|--------------------------|--------------------------|
| | <hr/> | <hr/> |
| Equipment | \$ 48,647 | \$ 43,648 |
| Furniture | 34,147 | 26,411 |
| Leasehold improvements | 25,426 | 19,469 |
| | <hr/> | <hr/> |
| | 108,220 | 89,528 |
| Less: accumulated depreciation | (55,401) | (40,172) |

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| | |
|---|---|
| <u> </u> \$ 52,819 <u> </u> | <u> </u> \$ 49,356 <u> </u> |
|---|---|

Depreciation expense of \$16.1 million, \$12.1 million and \$9.2 million was recorded in Fiscal 2003, 2002 and 2001, respectively, on equipment, furniture and leasehold improvements.

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Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. Other Assets**

Other assets consist of the following (in thousands):

| | June 28, 2003 | June 29, 2002 |
|--------------------------------|--------------------------|--------------------------|
| Deferred income taxes | \$2,779 | \$2,249 |
| Loan commitment fees and other | 2,114 | 1,866 |
| Non-compete agreement | 493 | 617 |
| | <u> </u> | <u> </u> |
| | \$5,386 | \$4,732 |
| | <u> </u> | <u> </u> |

6. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consist of the following (in thousands):

| | June 28, 2003 | June 29, 2002 |
|----------------------|--------------------------|--------------------------|
| Accrued compensation | \$ 5,649 | \$ 7,419 |
| Accrued insurance | 3,500 | 2,580 |
| Sales and use taxes | 1,749 | 1,512 |
| Other | 14,100 | 15,233 |
| | <u> </u> | <u> </u> |
| | \$24,998 | \$26,744 |
| | <u> </u> | <u> </u> |

7. Financing Agreements

In January 2003, the Company entered into a \$65 million revolving credit facility (Loan Agreement) with Wells Fargo Retail Finance, LLC, as the arranger, collateral agent and administrative agent, and Fleet Retail Finance, Inc., as the documentation agent. Under the terms of the Loan Agreement, the Company may borrow amounts based on a percentage of its eligible inventory and credit card receivables, subject to certain borrowing conditions and customary sub-limits, reserves and other limitations. Interest on advances is charged, at the Company's option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50%, currently at 1.25%, per annum or (ii) at the prime rate less the applicable margin, which was initially set at and is currently 0.25% per annum. The term of the Loan Agreement is through April 30, 2006 and is secured by a lien on substantially all of the Company's assets. The Company has a standby letter of credit of \$3.1 million outstanding at June 28, 2003 and September 19, 2003. At June 28, 2003 and September 19, 2003, the Company had \$11.2 million and \$20.3 million in borrowings outstanding under the Loan Agreement, respectively. The Company had \$41.7 million available to be borrowed under the Loan Agreement at September 19, 2003.

In August, 1999, the Company received \$30 million in financing from certain investors (the Investors), who purchased senior secured notes and warrants pursuant to the Securities Purchase Agreement. Under the Purchase Agreement, the Company issued (i) \$10 million 12.5% Secured Notes due 2003 (the A Notes); (ii) \$5 million 13.0% Secured Notes due 2003 (the B Notes); (iii) \$5 million of its 13.0% Secured Notes due 2002

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(the C Notes); (iv) \$10 million 14.0% Secured Notes due 2004 (the D Notes and, together with the A Notes, the B Notes and the C Notes, the Notes); and (v) warrants (the Warrants) to purchase 6,880,000 shares of our common stock at an initial exercise price of \$3.00 per share issued in connection with the sale and issuance of the C Notes and the D Notes. The Notes were secured by a junior lien on substantially all of the Company s assets.

Pursuant to the First Amendment, on January 14, 2000, the Company received \$7 million in cash proceeds from the sale to certain of the Investors (the Investor Group) of a new series of senior secured

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Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

notes. Under the First Amendment, the Company issued \$7 million in aggregate principal amount of 14.0% Senior Secured Notes due 2002 (the E Notes). The E Notes were secured by a lien on substantially all of the Company's assets. Under the terms of the First Amendment, the interest rate on the A Notes, the B Notes, the C Notes and the D Notes was increased by 4.5%. The Investor Group, together with the Investors and Congress, entered into an intercreditor agreement. In consideration for waivers and forbearances granted by the Investors to various defaults under the terms of our A Notes, B Notes, C Notes and D Notes, the Company also agreed to amend and restate the terms of the Warrants held by the Investors to acquire 6,880,000 shares of Company common stock. The amended and restated warrants (the Amended Warrants) provide for an exercise price of \$1.07 per share and were issued upon surrender of the Warrants, which had an exercise price of \$3.00 per share.

The Company repaid \$10.2 million, \$19.3 million and \$8.1 million of the Senior Notes in the fiscal years ended June 28, 2003, June 29, 2002 and June 30, 2001, respectively. The Notes were secured by a junior lien on substantially all of the Company's assets. The fiscal 2003 repurchase resulted in an additional payment of \$1.4 million, comprised of interest and an incentive premium, and resulted in an after-tax charge of \$1.3 million, or \$0.07 per diluted share.

8. Earnings per Share

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

| | Year Ended | | |
|--|------------------|------------------|------------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 |
| Net income | \$ 12,092 | \$ 17,192 | \$ 9,961 |
| Earnings per share - basic | \$ 0.73 | \$ 1.32 | \$ 0.78 |
| Earnings per share - diluted | \$ 0.62 | \$ 0.89 | \$ 0.56 |
| Weighted average common shares outstanding | 16,602 | 13,068 | 12,723 |
| Dilutive effect of stock options | 637 | 650 | 244 |
| Dilutive effect of warrants | 2,323 | 5,531 | 4,852 |
| Restricted stock units | 84 | 64 | |
| | <hr/> | <hr/> | <hr/> |
| Weighted average common and common equivalent shares outstanding | 19,646 | 19,313 | 17,819 |
| | <hr/> | <hr/> | <hr/> |
| Options excluded from dilutive calculation | 686,285 | 260,555 | 907,794 |
| | <hr/> | <hr/> | <hr/> |

Options to purchase common shares at prices ranging from \$11.83 to \$32.50 per share were outstanding but were not included in the computation of dilutive earnings per share because to do so would have been anti-dilutive for the periods presented.

9. Stockholders' Equity and Stock Options**Shares Outstanding**

The Company's authorized capital stock is 25,000,000 shares of its common stock, \$0.01 par value per share. Shares of common stock issued and outstanding were 17,296,807 and 16,239,081 at June 28, 2003 and June 29, 2002, respectively.

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock Repurchase

In September 2001, the Board of Directors authorized the Company to repurchase up to \$15 million of its outstanding common stock. The stock repurchases are made at the discretion of management. During Fiscal 2002, the Company repurchased 284,000 shares for an aggregate amount of \$1.8 million, or 12.2% of the total amount authorized to be purchased. During Fiscal 2003, the Company repurchased 463,012 shares for an aggregate amount of \$4.1 million or 27.4% of total amount authorized to be purchased. As of June 28, 2003, the Company had purchased 747,012 shares for an aggregate amount of \$5.9 million or 39.6% of the total amount to be purchased.

Warrants

In Fiscal 2003, 688,000 warrants to purchase the Company's common stock were exercised. This included an exercise of 458,667 warrants for which proceeds of \$490,774 were received and a cashless exercise of the remaining 229,333 warrants, in which the warrant holders received 213,792 shares of common stock. The remaining 15,541 shares were surrendered in connection with this exercise. These 15,541 shares of the Company's common stock had a market value of \$245,386 at the time of surrender.

Stock Options

On October 19, 1999, the Company's Board of Directors adopted the Company's 1999 Stock Incentive Plan (1999 Plan). This adoption was approved by the company's stockholders on November 15, 1999. A total of 500,000 shares of the Company's common stock were reserved for issuance under the 1999 Plan.

On October 5, 2000, the Board approved an amendment and restatement of the 1999 Plan, increasing the number of shares of common stock reserved for issuance thereunder from 500,000 to 2,000,000. This adoption was approved by the Company's stockholders on November 15, 2000. A total of 2,000,000 shares are reserved for issuance under the 1999 Plan. There have been 1,866,000 options issued of which 74,085 have been exercised and 1,791,915 are outstanding. There have been cancellations of 208,775 options, therefore there are 342,775 options remaining to issue.

The purpose of the 1999 Plan is to promote the long-term financial success of the Company by enhancing the ability of the Company to attract, retain and reward individuals who can and do contribute to such success and to further align the interest of the Company's key personnel with its stockholders. Key employees, directors and consultants of the Company and its subsidiary are eligible to receive options under the 1999 Plan.

The 1999 Plan provides for the grants of options and restricted stock and other stock-based awards as the compensation committee of the Board of Directors may from time to time deem appropriate. Such awards include stock appreciation rights, phantom stock awards, bargain purchase of stock and stock bonuses. Vesting and other terms of stock options awarded are set out in the agreements between the Company and the individuals receiving such awards. The exercise price of the options is determined by the compensation committee at the time of grant and will not be less than the fair market value of the Company's common stock on the date of grant. Options granted under the 1999 Plan vest over four to seven years from date of grant, and expire in ten years.

The Company also maintains the Amended and Restated 1994 Stock Option Plan (1994 Plan) pursuant to which options were granted to employees, directors and consultants for the purchase of common stock of the Company. The 1994 Plan, as amended, permitted the Company to grant incentive and non-qualified stock options to purchase a total of up to 1,800,000 shares of the Company's common stock at an exercise price not less than fair value at date of grant. As of September 4, 2000, no additional grants of options under the 1994 Plan are permitted. There were 2,330,875 options issued of which 541,701 have been exercised, 1,150,825 have been cancelled and 638,349 remain outstanding. The original terms of the agreements between

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the Company and the individuals receiving the grants under the 1994 Plan with respect to vesting, expiration and exercise price remain unchanged.

During June 2001, the Company established a Management Stock Purchase Plan (MSPP). The MSPP is designed to provide a means by which the Company may attract highly qualified persons to enter into and remain in the employment of the Company. In addition, the MSPP provides a means whereby employees of the Company can defer a portion of their compensation to be used to acquire and maintain ownership of the Company's common stock, thereby strengthening their commitment to the welfare of the Company and promoting an identity of interest among Company stockholders and these employees. The amount deferred by the individual is held in restricted stock units. These restricted stock units are purchased at a discount of 20% or 25% depending on the amount of the individual deferral from the average price of Company's common stock on the determination date. Such discounts vest at the end of three years or seven years, selected by the participant, after the determination date. The amortization of the discount is charged to compensation expense over the three-year period. The compensation expense attributable to the MSPP for Fiscal 2003, 2002 and 2001, was \$188,000, \$33,000 and \$0 respectively.

In June 2001, the Company established an Employee Stock Purchase Plan (ESPP). The ESPP provides employees of the Company with an opportunity to purchase shares of the Company's common stock at a discount of 15% through accumulated payroll deductions. This plan qualifies as an Employee Stock Purchase Plan under Section 423 of the Code. Contributions to the plan during Fiscal 2003 and 2002 were \$593,000 and \$265,000, resulting in the obligation to issue 62,234 and 41,823 shares of common stock, respectively.

The following tables summarize information about stock option transactions for the 1999 Plan and the 1994 Plan:

| | Number of Shares | Weighted Average Exercise Price |
|---------------------------|-----------------------------|--|
| | <hr/> | <hr/> |
| Balance at July 1, 2000. | 1,521,126 | \$ 7.29 |
| Granted | 398,000 | 4.14 |
| Exercised | (1,250) | 3.00 |
| Canceled | (266,500) | 8.62 |
| | <hr/> | |
| Balance at June 30, 2001. | 1,651,376 | 6.29 |
| Granted | 591,750 | 8.03 |
| Exercised | (134,002) | 4.82 |
| Canceled | (104,248) | 10.72 |
| | <hr/> | |
| Balance at June 29, 2002. | 2,004,876 | 6.59 |
| Granted | 638,000 | 14.85 |
| Exercised | (212,486) | 5.28 |
| Canceled | (208,901) | 9.71 |
| | <hr/> | |
| Balance at June 28, 2003 | 2,221,489 | \$ 8.78 |
| | <hr/> | |
| Options Exercisable at: | | |
| June 30, 2001. | 839,316 | \$ 8.49 |
| June 29, 2002. | 1,076,631 | 7.41 |
| June 28, 2003. | 1,399,241 | 7.94 |

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | |
|--------------------------|-------------------------------------|---|---------------------------------|-------------------------------------|---------------------------------|
| | Number Outstanding at June 28, 2003 | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable at June 28, 2003 | Weighted Average Exercise Price |
| \$1.71 to \$3.00. | 491,512 | 4.70 | \$ 2.19 | 455,205 | \$ 2.13 |
| \$3.15 to \$7.38. | 602,726 | 7.62 | 5.38 | 315,494 | 5.17 |
| \$7.42 to \$13.58. | 478,501 | 6.61 | 10.13 | 315,792 | 10.01 |
| \$13.63 to \$16.00. | 451,750 | 8.57 | 14.60 | 138,625 | 14.24 |
| \$16.37 to \$32.50. | 197,000 | 7.51 | 19.02 | 174,125 | 19.33 |
| | <u>2,221,489</u> | <u>6.94</u> | <u>\$ 8.78</u> | <u>1,399,241</u> | <u>\$ 7.94</u> |

10. Income Taxes

The provision for income tax expense (benefit) consists of the following (in thousands):

| | Year Ended | | |
|-----------|-----------------|------------------|----------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 |
| Current: | | | |
| Federal | \$ 8,036 | \$ 7,760 | \$3,720 |
| State | 1,925 | 2,673 | 470 |
| Foreign | 232 | 251 | 269 |
| | <u>10,193</u> | <u>10,684</u> | <u>4,459</u> |
| Deferred: | | | |
| Federal | (1,730) | 1,329 | 1,154 |
| State | (401) | (510) | 389 |
| | <u>(2,131)</u> | <u>819</u> | <u>1,543</u> |
| | <u>\$ 8,062</u> | <u>\$ 11,503</u> | <u>\$6,002</u> |

Deferred income taxes reflect the net tax effects of temporary differences between the carrying value of assets and liabilities for financial reporting purposes and amounts used for income tax purposes.

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Significant components of the net deferred tax asset at June 28, 2003 and June 29, 2002 are as follows (in thousands):

| | <u>June 28, 2003</u> | <u>June 29, 2002</u> |
|-----------------------------------|--------------------------|--------------------------|
| Current: | | |
| Inventory | \$ 6,484 | \$ 4,731 |
| Vacation pay accrual | 467 | 453 |
| Reserves not currently deductible | 1,030 | 965 |
| Bonus accrual | 94 | 209 |
| Deferred state taxes | (647) | (531) |
| | <u> </u> | <u> </u> |
| Net current deferred tax asset | \$ 7,428 | \$ 5,827 |
| | <u> </u> | <u> </u> |
| Non-current: | | |
| Deferred rent | \$ 4,188 | \$ 3,952 |
| Start-up costs | (456) | (447) |
| Property and equipment | (1,394) | (2,161) |
| Amortization of goodwill | (1,470) | (1,075) |
| Other liabilities | 1,911 | 1,980 |
| | <u> </u> | <u> </u> |
| Non-current deferred tax asset | \$ 2,779 | \$ 2,249 |
| | <u> </u> | <u> </u> |

The following table reconciles the statutory Federal income tax rate with the effective rate of the Company for the periods ended:

| | <u>Year Ended</u> | | |
|--|--------------------------|--------------------------|--------------------------|
| | <u>June 28, 2003</u> | <u>June 29, 2002</u> | <u>June 30, 2001</u> |
| Federal statutory rate | 35.0% | 35.0% | 34.0% |
| State income taxes net of Federal income tax benefit | 4.9 | 4.9 | 3.6 |
| Valuation allowance | | | (1.3) |
| Other | 0.1 | 0.2 | 1.3 |
| | <u> </u> | <u> </u> | <u> </u> |
| Effective tax rate | 40.0% | 40.1% | 37.6% |
| | <u> </u> | <u> </u> | <u> </u> |

11. Employee Benefit Plans

The Company has a defined contribution 401(k) savings plan (the "401(k) Plan") covering all eligible employees. Participants may defer between 1% and 15% of annual pre-tax compensation subject to statutory limitations. The Company contributes an amount as determined by the Board of Directors. Such amount has been established as 50% of the first 4% of the employee's contribution up to \$1,000.

For the fiscal years ended June 28, 2003, June 29, 2002 and June 30, 2001, matching contributions of \$301,000, \$309,000 and \$300,000, respectively, were made by the Company under the 401(k) Plan.

12. Related Party Transactions

In June 1999, Steven Mandell, the former president of the Company and a major stockholder granted an option to acquire 1,000,000 shares of the shareholder's common stock to Jack Futterman, then the Company's chief executive officer and a member of the Board of Directors. The option vested immediately and has an

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

exercise price of \$3.00 a share, the fair value of the common stock at date of grant. The option expires in June 2004.

On August 16, 1999, Special Value Bond Fund II, LLC, (SVBF II) purchased \$10.0 million in aggregate principal amount of the Company's 12.5% Secured Notes due 2003 (the A Notes) and \$5.0 million in aggregate principal amount of the Company's 13.0% Secured Notes due 2003 (the B Notes). Subsequently on November 20, 2000, SVBF II sold \$5.0 million in aggregate principal amount of the A Notes and \$2.5 million in aggregate principal amount of the B Notes to other Company investors. In addition, on August 16, 1999, Tennenbaum & Co., LLC (TCO) purchased \$2,250,000 in aggregate principal amount of the Company's 13.0% Secured Notes due 2002, \$4.5 million in aggregate principal amount of the Company's 14.0% Secured Notes due 2004 and Warrants to purchase 3,096,000 shares of the Company's stock. TCO then transferred all of these Secured Notes and the Warrants to Special Value Bond Fund, LLC (SVBF) effective as of September 1, 1999. Then on January 14, 2000, SVBF purchased \$3,250,000 in aggregate principal amount of the Company's 14.0% Secured Notes due 2002. The managing member of SVBF II is SVIM/MSM II, LLC (SVIM/MSM II) and the managing member of SVIM/MSM II is TCO. The managing member of SVBF is SVIM/MSM, LLC (SVIM/MSM) and the managing member of SVIM/MSM is TCO. The managing member of TCO is Michael E. Tennenbaum, the Company's Vice Chairman of the Board of Directors. During Fiscal 2003, Fiscal 2002 and Fiscal 2001, Secured Notes totaling \$3.9 million, \$9.3 million and \$5.0 million were repaid, respectively. For the fiscal years ended June 28, 2003, June 29, 2002 and June 30, 2001, the Company paid \$1.0 million, \$2.3 million and \$2.8 million of interest related to these Notes, respectively.

On November 2, 1999, Ralph Dillon, the Company's non-executive chairman of the board of directors, purchased \$167,000 in aggregate principal amount of the Company's 13.0% Secured Notes due 2002, \$333,000 in aggregate principal amount of the Company's 14.0% Secured Notes due 2004, and Warrants to purchase 229,333 shares of the Company's stock from one of the Investors for a total purchase price of \$498,000. During Fiscal 2003 and Fiscal 2002, the Secured Notes totaling \$333,000 and \$167,000 were repaid, respectively. For the years ended June 28, 2003, June 29, 2002 and June 30, 2001, the Company paid \$78,000, \$80,000 and \$93,000 of interest related to these Notes, respectively.

As of July 3, 1999, Erik Mandell, a former officer of the Company and the son of Steven Mandell, owned one franchise store. During the year ended July 1, 2000, Steven Mandell acquired this store from Erik Mandell. On July 27, 2000, the Company purchased this store from Steven Mandell. Total consideration for the purchase was \$516,000. Neither Steven Mandell nor Erik Mandell owns any other Party City franchise stores.

On June 22, 2001, the Company granted options for 90,000 shares of the Company's common stock to Ralph Dillon as compensation for his services to the Company. These options were granted at \$6.25 per share and vested upon issuance. In addition, on each of January 12, 2002, July 12, 2002 and January 12, 2003 additional grants of options for 50,000 shares of the Company's common stock were made to Mr. Dillon, which options had an exercise price of \$9.38, \$17.00 and \$17.00, respectively. An additional grant of 50,000 options for shares will be made to Mr. Dillon on July 12, 2004 with an exercise price of \$17.00 provided that Mr. Dillon remains as the non-executive chairman of the board of directors of the Company through such date and certain other requirements are met. All of these options vest upon issuance. For the fiscal years ended June 28, 2003 and June 29, 2002, \$154,000 and \$430,000 were charged to operations as compensation expense, respectively.

13. Lease Commitments and Contractual Obligations

The Company leases real estate in connection with the operation of corporate retail stores as well as its corporate office. The store leases are for properties ranging in size from 6,750 to 19,800 square feet. The terms range from five years to twenty years, and expire by 2016. The leases contain escalation clauses, renewal

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

options from five years to ten years and obligations for reimbursement of common area maintenance and real estate taxes. Certain leases contain contingent rent based upon specified sales volume. The Company paid \$26,000 for contingent rent for Fiscal 2003, and no contingent rent for Fiscal 2002 and 2001.

At June 28, 2003, the Company leased 37 motor vehicles, primarily for its district managers and regional management. The terms are for 36 months and expire through December 2005.

In 1997, the Company entered into a five-year capital lease with a present value of approximately \$1.6 million for computer hardware and software. The Company has the option to purchase the equipment for a nominal cost at the termination of the lease. The leased hardware is included in property and equipment at a net book value of approximately \$71,000 at June 28, 2003. The leased software has been fully depreciated.

Future minimum lease payments under outstanding leases, severance arrangements and advances under loan agreements at June 28, 2003, are as follows (in thousands):

| | <u>Operating Leases</u> | <u>Capital Lease</u> | <u>Severance Arrangements</u> | <u>Advances Under Loan Agreement</u> |
|------------------------------|-----------------------------|--------------------------|-----------------------------------|--|
| Fiscal year ending: | | | | |
| 2004 | \$ 45,968 | \$ 32 | \$ 199 | \$ 11,229 |
| 2005 | 44,519 | | | |
| 2006 | 43,088 | | | |
| 2007 | 38,956 | | | |
| 2008 | 30,639 | | | |
| Thereafter | 63,063 | | | |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total minimum lease payments | \$266,233 | \$ 32 | \$ 199 | \$ 11,229 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

Rent expense for all operating leases was \$43.4 million, \$35.9 million and \$35.1 million for the fiscal years ended June 28, 2003, June 29, 2002 and June 30, 2001 respectively.

The Company is obligated for guarantees, subleases or assigned lease obligations for 25 of its franchisees through 2011. The majority of the guarantees were given when the Company sold stores in 1999 as part of its restructuring. The guarantees continue until the leases expire. The maximum amount of the guarantees may vary, but is limited to the sum of the total amount due under the lease. As of June 28, 2003, the maximum amount of the guarantees was approximately \$20.6 million.

Pursuant to the Loan Agreement, the Company has a standby letter of credit of \$3,130,000 outstanding at September 19, 2003. This standby letter of credit relates to general liability and workers compensation insurance and expires on April 17, 2004.

14. Commitments and Contingencies***Securities Litigation***

The Company was named as a defendant in twelve class action complaints in the United States District Court for the District of New Jersey. A former Chief Executive Officer, a former Chief Financial Officer/Executive Vice President of Operations were also named as defendants in these complaints. The complaints were filed as class actions on behalf of persons who purchased or acquired Party City common stock during various time periods between February 26, 1998 and March 18, 1999 (the Class Period). In October 1999, plaintiffs filed an amended class action complaint and, in February 2000, plaintiffs filed a second amended complaint, which alleged, among other things, violations of

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Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder, and sought unspecified damages. The plaintiffs alleged that defendants issued a series of false and misleading statements and failed to

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

disclose material facts concerning, among other things, Party City's financial condition, adequacy of internal controls and compliance with certain loan covenants during the Class period. The plaintiffs further alleged that because of the issuance of a series of false and misleading statements and/ or the failure to disclose material facts, the price of Party City's common stock was artificially inflated.

In early 2000, defendants moved to dismiss the second amended complaint on the ground that it failed to state a cause of action. On May 29, 2001, the District Court issued an Opinion and Order dismissing the Complaint against all defendants with prejudice. On June 27, 2001, plaintiffs filed a Notice of Appeal to the United States Court of Appeals for the Third Circuit. In April 2002, the parties reached an agreement in principle to settle the action, and the Court of Appeals has remanded the case to the District Court to supervise the implementation of the settlement. The terms of the settlement were contained in the agreement in principle, and included the settlement amount, of which the Company's settlement contribution of \$380,000 was not material to the results of operations or financial condition.

On May 14, 2003, the District Court approved the terms of the definitive settlement agreement. Accordingly, in May 2003, the Company paid its contribution pursuant to the terms of the settlement agreement to close this matter.

Other

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

In addition to the foregoing, from time to time the Company is involved in routine litigation incidental to the conduct of the business. The Company is aware of no other material existing or threatened litigation to which the Company is or may be a party.

15. Segment Information

The Company owns, operates and franchises party supplies stores in North America. As of December 2002, the franchise stores in Portugal and Spain are no longer franchises and no longer operate with the Party City name or logo. The Company's management reporting system evaluates performance based on a number of factors; however, the primary measure of performance is the pre-tax operating profit of each segment. Accordingly, the Company reports two segments—retail and franchising. The retail segment generates revenue through the sale of primarily third-party branded party goods through Company-owned stores. The franchising segment generates revenue through the imposition of an initial one-time franchise fee and ongoing royalty payments based on retail sales. The accounting policies are described in the summary of significant accounting policies. The Company has no intersegment sales. No single customer accounts for 10% or more of total revenues. The revenues from the Spain and Portugal franchisee were not significant in all the periods presented. All assets of the Company are located in North America.

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

| | Year Ended | | |
|-----------------------------|---------------|---------------|---------------|
| | June 28, 2003 | June 29, 2002 | June 30, 2001 |
| Retail: | | | |
| Net revenue | \$ 464,258 | \$ 405,821 | \$ 380,671 |
| Operating income | 44,794 | 50,265 | 40,223 |
| Identifiable assets | 150,308 | 129,340 | 122,804 |
| Depreciation/amortization | 9,966 | 7,341 | 8,086 |
| Capital expenditures | 18,364 | 8,471 | 6,184 |
| Franchising: | | | |
| Net revenue | \$ 18,362 | \$ 17,689 | \$ 15,229 |
| Operating income | 11,824 | 11,126 | 10,292 |
| Identifiable assets | 2,166 | 1,777 | 1,398 |
| Depreciation/amortization | | | |
| Capital expenditures | | | |
| Corporate/ Other: | | | |
| Net revenue | \$ | \$ | \$ |
| Operating expense | (32,475) | (27,086) | (26,603) |
| Identifiable assets | 15,525 | 17,937 | 17,140 |
| Depreciation/amortization | 6,263 | 4,815 | 2,345 |
| Capital expenditures | 3,870 | 5,614 | 10,121 |
| Consolidated Totals: | | | |
| Net revenue | \$ 482,620 | \$ 423,510 | \$ 395,900 |
| Operating income | 24,143 | 34,305 | 23,912 |
| Interest expense, net | 3,990 | 5,610 | 7,949 |
| Income before income taxes | 20,153 | 28,695 | 15,963 |
| Provision for income taxes | 8,061 | 11,503 | 6,002 |
| Net income | \$ 12,092 | \$ 17,192 | \$ 9,961 |
| Identifiable assets | \$ 167,999 | \$ 149,054 | \$ 141,342 |
| Depreciation/amortization | 16,229 | 12,156 | 10,431 |
| Capital expenditures | 22,234 | 14,085 | 16,305 |

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****16. Selected Quarterly Information (Unaudited) (in thousands, except per share data)**

| | Quarter Ended | | | |
|--|---------------|------------|-----------|------------|
| | September | December | March | June |
| Year Ended June 29, 2002 | | | | |
| Total revenues | \$84,384 | \$ 148,112 | \$90,104 | \$ 100,910 |
| Cost of goods sold and occupancy costs | 57,667 | 83,928 | 60,816 | 61,569 |
| Net (loss) income | (1,786) | 14,939 | (96) | 4,135 |
| Basic (loss) earnings per share | \$ (0.14) | \$ 1.15 | \$ (0.01) | \$ 0.31 |
| Diluted (loss) earnings per share | (0.14) | 0.79 | (0.01) | 0.21 |
| Year Ended June 28, 2003 | | | | |
| Total revenues | \$95,006 | \$ 168,191 | \$99,533 | \$ 119,890 |
| Cost of goods sold and occupancy costs | 64,425 | 95,974 | 70,164 | 80,607 |
| Net (loss) income | (1,736) | 15,050 | (1,808) | 586 |
| Basic (loss) earnings per share | \$ (0.11) | \$ 0.90 | \$ (0.11) | \$ 0.04 |
| Diluted (loss) earnings per share | (0.11) | 0.76 | (0.11) | 0.03 |

The per share amounts are calculated independently for each quarter. The sum of the quarters may not equal the full year per share amounts.

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PARTY CITY CORPORATION

SCHEDULE II

VALUATION AND QUALIFYING ACCOUNTS

(in thousands)

| | Balance Beginning of Year | Amounts Charged to cost and expenses | Write-offs Against Reserve | Balance End of Year |
|---|--|---|---|------------------------------------|
| Allowance for Doubtful Accounts: | | | | |
| Year Ended June 28, 2003 | 785 | 50 | (548) | 287 |
| Year Ended June 29, 2002 | 852 | 366 | (433) | 785 |
| Year Ended June 30, 2001 | 917 | 315 | (380) | 852 |
| Reserve for Returns: | | | | |
| Year Ended June 28, 2003 | 547 | 16,249 | 16,123 | 673 |
| Year Ended June 29, 2002 | 253 | 14,204 | 13,910 | 547 |
| Year Ended June 30, 2001 | | 13,323 | 13,070 | 253 |

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