

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

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K**

(Mark One)

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

**For the fifty-three weeks ended February 3, 2007**

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

**For the transition period from** **to**

**Commission file number 0-23071**

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**THE CHILDREN S PLACE RETAIL STORES, INC.**

(Exact name of registrant as specified in its charter)

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

**31-1241495**  
(I.R.S. employer  
identification number)

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

**07094**  
(Zip Code)

**(201) 558-2400**

(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: **Common Stock, \$0.10 par value**

Name of each exchange on which registered: **Nasdaq Global Select Market**

Securities registered pursuant to Section 12(g) of the Act: **None.**

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes ☐ No ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☐ No ☒

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

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

Large accelerated filer ☒ X

Accelerated filer ☐ O

Non-accelerated filer ☐ O

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

Yes ☐ O      No ☒ X

The aggregate market value of common stock held by non-affiliates was \$1,301,495,610 at the close of business on July 29, 2006 (the last business day of the registrant's fiscal 2006 second fiscal quarter) based on the closing price of the common stock as reported on the Nasdaq Global Select Market. For purposes of this disclosure, shares of common stock held by persons who hold more than 10% of the outstanding shares of common stock and shares held by executive officers and directors of the registrant have been excluded because such persons may be deemed affiliates. This determination of executive officer or affiliate status is not necessarily a conclusive determination for other purposes.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: Common Stock, par value \$0.10 per share, outstanding at October 6, 2007: 29,083,916 shares.

Documents Incorporated by Reference: None.

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THE CHILDREN S PLACE RETAIL STORES, INC.

ANNUAL REPORT ON FORM 10-K  
FOR THE FIFTY-THREE WEEKS ENDED FEBRUARY 3, 2007  
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## EXPLANATORY NOTE

In this Annual Report on Form 10-K for the fiscal year ended February 3, 2007 ( fiscal 2006 ), The Children's Place Retail Stores, Inc. (the Company) is restating its prior period financial statements to reflect additional stock-based compensation expense relating to stock option grants made in each year from the fiscal year ended January 31, 1998 ( fiscal 1997 ) through the first quarter of fiscal 2006. The Company also is restating its financial statements for all periods beginning with the fiscal year ended February 2, 2002 ( fiscal 2001 ) through the first quarter of fiscal 2006 to reflect the correction of other errors related to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for the Company's 52- and 53-week fiscal years. Specifically, the Company is restating its: (1) consolidated balance sheet as of January 28, 2006, consolidated statements of income, cash flows and changes in stockholders' equity for the fiscal years ended January 28, 2006 ( fiscal 2005 ) and January 29, 2005 ( fiscal 2004 ); (2) selected consolidated financial data for fiscal 2005, fiscal 2004 and the fiscal years ended January 31, 2004 ( fiscal 2003 ) and February 1, 2003 ( fiscal 2002 ); and (3) unaudited quarterly financial data for the first quarter in fiscal 2006 and for all quarters in fiscal 2005. Restated financial information for fiscal years 2005 and 2004 is set forth in Note 2 Restatement of Consolidated Financial Statements in the Notes to Consolidated Financial Statements included in Item 15. Exhibits and Financial Statement Schedules of this report. The data for the Company's consolidated balance sheet for fiscal 2003 and consolidated statements of income and cash flows for fiscal 2003 and fiscal 2002 have been restated to reflect the impact of the adjustments. Unaudited consolidated quarterly financial information for the eight quarterly periods in fiscal 2006 and fiscal 2005, including disclosures regarding the impact of the restatement in each of the quarters in fiscal 2005 and the first quarter in fiscal 2006, is set forth in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Quarterly Effects of Restatement and Note 16 Quarterly Financial Data (Unaudited) in the accompanying consolidated financial statements.

The Company has not amended and does not intend to amend its previously filed Annual Reports on Form 10-K for fiscal 2005 or fiscal 2004 or any other fiscal year or its previously filed Quarterly Reports on Form 10-Q for the first quarter of fiscal 2006 or the first three quarters of fiscal 2005 or any other fiscal quarter. The financial information that has been previously filed or otherwise reported for these periods is superseded by the information in this Annual Report on Form 10-K and, as previously stated by the Company, the financial statements and related financial information contained in such previously filed reports should no longer be relied upon.

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

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

Immediately prior to filing this Annual Report on Form 10-K, the Company has filed its Quarterly Reports on Form 10-Q for the second and third quarters of fiscal 2006 and the Company intends, in the near future, to file its Quarterly Reports on Form 10-Q for the first and second quarters of fiscal 2007.



Mr. Ezra Dabah resigned from his position as the Company's CEO on September 24, 2007. Mr. Dabah remains a member of the Board. The Board has named Mr. Charles Crovitz, a current Board member, as interim CEO.

## **STOCK OPTION INVESTIGATION**

### **Overview of the Investigation**

In light of various media reports on stock option backdating at public companies and as recommended by the Audit Committee of the Company's Board, the Company undertook a preliminary review of its stock option granting practices starting in June 2006. After considering the results of this preliminary review, on August 24, 2006, the Audit Committee retained the Company's outside counsel ( Outside Counsel ) to assist it with a formal review of the Company's stock option grants. On September 6, 2006, Outside Counsel issued to the Audit Committee a preliminary report concluding that there had been errors in the grant dates of options. The report also concluded that, aside from one grant as to which the report was inconclusive, the errors in stock option dating were unintentional. The review of the Company's stock option grants continued and expanded into a full investigation. On or about September 14, 2006, the Company suspended all stock-based compensation activity, including granting stock options and other stock-based compensation and issuing shares pursuant to stock option exercises, pending completion of the review and the Company becoming current on its delinquent filings with the SEC.

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

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

### **Findings of the Stock Option Investigation**

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

There was no conclusive evidence of intentional backdating of options or other misconduct in connection with the option granting process. There was no evidence of intent to mislead about option grant dates or exercise prices.



No member of management and no director engaged in improper self-dealing in connection with the option grants made by the Company.

All Company personnel cooperated fully with the investigation.

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

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

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

The Company used available documentation and guidance set forth by the Office of the Chief Accountant of the SEC on September 19, 2006 (September 2006 OCA Guidance) to determine the revised measurement dates for option grants made during the Review Period. For a discussion of the Company's historical stock option granting process and use of available information to determine the revised measurement dates, refer to Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Restatement of Financial Statements and Note 2 Restatement of Consolidated Financial Statements in the accompanying consolidated financial statements.

After completion of the Report of Investigation, the Company in reviewing its accounting for options became aware of certain inconsistencies in its records concerning the terms of the 1997 CEO IPO Grant. Under the direction of the Special Committee, Independent Counsel investigated the Company's treatment of these options and reported thereon to the Special Committee. On April 11, 2007, the Special Committee reported to the Board on the 1997 CEO IPO Grant. Based on the evidence assembled in Independent Counsel's investigation, the Special Committee found

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that there had been confusion, resulting in inconsistencies in the Company records, in connection with the implementation of the 1997 CEO IPO Grant and over the years with regard to the terms of this grant. In considering the results of the investigation into the 1997 CEO IPO Grant, the Special Committee reconsidered the key findings it had reached in the Report of Investigation, as described above, and concluded that the evidence from the additional investigation did not lead it to different findings. The Board concurred in this conclusion.

### **Inadequate Internal Controls**

The Company is undertaking to remediate the material weakness in internal control over financial reporting related to stock option grants found by the Special Committee, as further discussed in Item 9A. Controls and Procedures of this Annual Report on Form 10-K. The Company has continued its suspension of the granting of all stock-based compensation, including the granting of stock options, as well as the exercise of any options, until these improved procedures have been instituted. Furthermore, the suspension of granting and exercise of stock options will continue until the Company becomes current with its SEC filings.

### **Resolution of Tax Consequences and Corrective Action Related to Discounted Options**

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

The Company and its directors (including Mr. Dabah, its former CEO), its President and its former Chief Administrative Officer have agreed to amend all discounted options held by them (other than those described in the next paragraph) to increase the exercise price to the average of the high and low trading price on the date determined by the Company to be the revised measurement date applicable to the option grant to be used for financial reporting purposes. In the few instances where these individuals have exercised options as to which a revised measurement date has been determined by the Company, the individuals have agreed to return to the Company the difference between the exercise price and the trading price on the revised measurement date.

In the three instances where the Report of Investigation found that non-executive directors received options shortly before the public disclosure of positive information, the Company and these directors further agreed to amend such options to increase the exercise price to the average of the high and low trading price over the balance of the calendar year following the recorded date of the grant.

With respect to all other option grants, the Company has decided to honor the options as issued, consistent with the Special Committee's finding of no intentional misconduct on the part of management in the option granting process. Nevertheless, the Company and all members of senior management holding outstanding options have agreed to have their outstanding discounted options that vested after 2004 amended either to increase the exercise price to the average of the high and low trading price on the date determined by the Company to be the revised measurement date or to limit the exercise period of their options.

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

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

**OTHER ADJUSTMENTS**

As previously mentioned in the Explanatory Note in this Annual Report on Form 10-K, in addition to the adjustments related to the stock option investigation, the restated consolidated financial statements presented herein include other adjustments related to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for the Company's 52- and 53-week fiscal years. The aggregate impact of these adjustments on the Company's consolidated statements of income, net of taxes, between fiscal 2001 and the first quarter of fiscal 2006 was an increase to net income of approximately \$1.7 million. Additionally, variable rate demand note balances as of the quarter ended April 29, 2006 have been reclassified from cash to short-term investments, and certain other balance sheet amounts have been reclassified. These reclassifications do not result in any additional charges in any period and do not affect working capital for the affected periods. For further discussion of these adjustments, refer to Note 2 Restatement of Consolidated Financial Statements and Note 16 Quarterly Financial Data (Unaudited) in the Notes to Consolidated Financial Statements included in Item 15. Exhibits and Financial Statement Schedules and Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

**CUMULATIVE ADJUSTMENTS**

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

Period Ended	Stock Option Related Adjustments			Other Adjustments(1)			Total After Tax Adjustment
	Expense (Increase)	Tax Benefit	Net Stock Option Related Adjustments	Expense (Increase) Decrease	Tax Benefit (Provision)	Net Other Adjustments	
January 30, 1999 (fiscal 1998)	\$ (59)	\$ 19	\$ (40)	\$	\$	\$	\$ (40)
January 29, 2000 (fiscal 1999)	(211)	81	(130)				(130)
February 3, 2001 (fiscal 2000)	(386)	131	(255)				(255)
February 2, 2002 (fiscal 2001)	(915)	295	(620)	240	(98)	142	(478)
February 1, 2003 (fiscal 2002)	(972)	375	(597)	772	(311)	461	(136)
January 31, 2004 (fiscal 2003)	(1,632)	486	(1,146)	1,722	(695)	1,027	(119)
January 29, 2005 (fiscal 2004)	(3,386)	772	(2,614)	589	(82)	507	(2,107)
January 28, 2006 (fiscal 2005)(2)	(8,927)	3,956	(4,971)	(853)	218	(635)	(5,606)
Cumulative effect at January 28, 2006	\$ (16,488)	\$ 6,115	\$ (10,373)	\$ 2,470	\$ (968)	\$ 1,502	\$ (8,871)
April 29, 2006 (Q1 fiscal 2006)	\$ (1,331)	\$ 544	\$ (787)	\$ 327	\$ (161)	\$ 166	\$ (621)

(1) Other adjustments relate to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for the Company's 52- and 53-week fiscal years.

(2) The Company has not previously recorded stock-based compensation expense in any fiscal year other than fiscal 2005. During fiscal 2005, the Company recorded approximately \$0.3 million related to the modification of stock options for a terminated employee, before taxes of approximately \$0.1 million. The Company also recorded approximately \$2.1 million, before taxes of approximately \$0.1 million, of stock-based compensation expense related to the acceleration of the vesting of certain options. As part of the restatement process, the stock option acceleration amounts were adjusted to approximately \$1.7 million of stock-based compensation expense, before taxes of approximately \$0.5 million. Therefore, the restated total stock-based compensation expense for fiscal 2005 is approximately \$11.3 million, before taxes of approximately \$4.1 million.

**PART I**





**ITEM 1. BUSINESS**



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*The Business section and other parts of this Annual Report on Form 10-K may contain certain forward-looking statements regarding future circumstances. Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that does not directly relate to any historical or current fact. Forward-looking statements can also be identified by words such as anticipates, believes, estimates, expects, intends, plans, predicts, and similar terms. These forward-looking statements are based upon the Company's current expectations and assumptions and are subject to various risks and uncertainties that could cause actual results to differ materially from those contemplated in such forward-looking statements including, but not limited to, those discussed in the subsection entitled "Risk Factors" under Part I, Item 1A of this Annual Report on Form 10-K. Actual results, events, and performance may differ significantly from the results discussed in the forward-looking statements. Readers of this Annual Report on Form 10-K are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to release publicly any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. The inclusion of any statement in this Annual Report on Form 10-K does not constitute an admission by the Company or any other person that the events or circumstances described in such statement are material.*

*The following discussion should be read in conjunction with the Company's audited financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K.*

### **Recent Developments**



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On September 24, 2007 during a meeting of the Board, Mr. Ezra Dabah resigned from his position as CEO of the Company and from all other officer positions with the Company and all positions as an officer or director of any of the Company's subsidiaries. Mr. Dabah continues to serve as a member of the Company's Board. Mr. Dabah is entitled to severance pursuant to section 5.01 of such agreement; the Company has not entered into any additional agreement with Mr. Dabah concerning additional severance benefits. Upon the resignation of Mr. Dabah, the Board named Mr. Charles Crovitz, a current Board member, as interim CEO. The Board has engaged a search firm to conduct an executive search for a permanent successor to Mr. Dabah. Ms. Sally Frame Kasaks, the Lead Director, will continue as Acting Chairman of the Board. The Company continues to search for two new independent board members and will designate a permanent Chairman of the Board as soon as possible after such new directors are appointed to the Board.

Consistent with its fiduciary duties, our Board has engaged an investment banking firm to act as its financial advisor in undertaking a review of strategic alternatives to improve operations and enhance shareholder value. As part of this review, our Board and management are assessing a wide variety of options to improve our business and competitive position, including, but not limited to, opportunities for organizational and operational improvement, a possible recapitalization, or other transactions. The Board has not set any specific timeline for the completion of this strategic review, and there is no assurance that as a result of this review, the Board will decide to change the Company's course of action or engage in any specific transaction.

In August 2007, in connection with the application of enhanced internal controls the Company instituted as part of the changes in its governance and internal controls resulting from the stock option remediation process, the Company identified certain violations of the Company's policies and procedures by two members of senior management. On September 26, 2007, the Board completed its consideration of these violations.

One instance involved irregularities in expense reimbursement practices on the part of the Chief Creative Officer of The Children's Place business, who is a related party to the Company's former CEO and current Board member, Ezra Dabah, and another member of the Board, Stanley Silverstein. The Board concluded that the irregularities violated the Company's Code of Business Conduct, involving gross inattention to the pertinent requirements of the Company's policies but did not involve an intentional effort to obtain an improper personal benefit. The Board imposed significant sanctions on the individual involved, including requiring the individual to refund approximately \$23,000 erroneously charged to the Company, changing the individual's position so that the individual will no longer be an officer of the Company, and requiring the reimbursement of approximately \$160,000 to cover the Company's

out-of-pocket costs incurred in connection with its investigation of the matter, but concluded that dismissal from employment was not warranted.

The other case involved two instances where the Company's former CEO, Ezra Dabah, did not comply with the Company's internal policies related to internal securities transaction reporting and approval. In one instance, Mr. Dabah did not report to the Company an immaterial increase in his wife's ownership of Company shares as a result of a trust distribution. In the second, on two occasions, he pledged shares of Company stock pursuant to a customary margin account during a black-out period when the Company's policies required prior approval of the Board for such pledges. The Board concluded that these actions violated the Company's Code of Business Conduct, but that they were not done with the intent of knowingly violating the Company's policies or in order to obtain an improper personal benefit by doing so and did not result in his obtaining an improper personal benefit or result in any liability exposure to the Company. The Audit Committee also determined that the pledges at issue would be considered valid and would be permitted. The Board imposed significant sanctions for committing the violations, including imposing new requirements on transactions involving the Company's securities by the former CEO and requiring that he reimburse the Company approximately \$36,600 for its out-of-pocket costs in investigating the violations.

The Company is instituting additional expense reimbursement procedures and additional training in the requirements of the Company's Code of Business Conduct and related policies and procedures to help ensure against future similar violations.

The Company has completed its investigation of the violations of the Company's policies and procedures and no other internal investigations are underway.

## **Overview**



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In this Report, the words the Company, we, us, our and similar terms collectively refer to The Children's Place Retail Stores, Inc. and subsidiaries. The Company was incorporated in June 1988 and is a leading specialty retailer of children's merchandise. We design, contract to manufacture and sell high-quality, value-priced merchandise under our proprietary The Children's Place and licensed Disney Store brand names. As of September 1, 2007 we owned and operated 889 The Children's Place stores and 328 Disney Stores across North America and operated Internet stores at [www.childrensplace.com](http://www.childrensplace.com) and [www.disneystore.com](http://www.disneystore.com).

In November 2004, we acquired, through two wholly-owned subsidiaries, the Disney Store retail chain in North America (the DSNA Business) from affiliates of The Walt Disney Company (Disney). (For clarification, the DSNA Business refers to the business we acquired from Disney as of November 21, 2004, whereas the Disney Store business refers to the Disney Store business we have operated since the acquisition.) As a result of the acquisition, these subsidiaries acquired a total of 313 Disney Stores, consisting of all then-existing Disney Stores in the United States and Canada, other than flagship stores and stores located at Disney theme parks and other Disney properties, along with certain other assets used in the Disney Store business. In addition, the lease obligations for all 313 stores and other legal obligations became obligations of our subsidiaries. Subsequently, our subsidiaries acquired two Disney Store flagship stores, one in Chicago, Illinois and the other in San Francisco, California, as well as certain Disney Store outlet stores. The Company's subsidiaries that operate the Disney Store business are referred to herein interchangeably and collectively as Hoop.

We are structured such that our administrative functions (e.g., finance, real estate, human resources, legal, information technology, logistics) are shared by both The Children's Place and the Disney Store brands. Functions such as design, merchandising, marketing and store operations are run independently of each other to maintain clearly defined and differentiated brands. Each brand is overseen by a President who manages day-to-day operations and who reports directly to our CEO.

The Children's Place is a specialty retailer of apparel and accessories for children from newborn to ten years of age. The brand's merchandising objective is to offer a unique, colorful, coordinated and balanced lifestyle assortment of high quality, basic and fashion merchandise, at prices that represent substantial value to our customers.

Disney originated the themed specialty retail environment when it opened the first Disney store in Glendale, California in 1987. Disney Store offers immediate access to unique Disney-branded products, such as apparel, toys, plush, and souvenirs in an emporium like setting.



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Our goal is to be the leading specialty retailer in the children's space by executing on our core purpose : making the very best accessible to all children.

During fiscal 2006, we opened 69 The Children's Place stores compared to 55 store openings in fiscal 2005. We also opened 19 Disney Stores in fiscal 2006 compared to 18 in fiscal 2005. We closed five The Children's Place stores and eight Disney Stores in fiscal 2006, compared to three The Children's Place store closures and seven Disney Store closures in fiscal 2005. Our store growth plan for fiscal 2007 includes opening approximately 60 The Children's Place stores and approximately 15 Disney Stores.

### **License Agreement with Disney**



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In connection with the acquisition of the DSNA Business in 2004, Hoop entered into a License and Conduct of Business Agreement with an affiliate of Disney (as amended to date, the License Agreement ) under which our subsidiaries use certain Disney intellectual property to operate the Disney Store retail chain in exchange for ongoing royalty payments. The agreement allows our subsidiaries to operate retail stores in the United States and Canada using the Disney Store name and to contract, manufacture, source, offer and sell merchandise featuring Disney-branded characters, past, present and future. In accordance with the License Agreement, following a two year royalty abatement, our subsidiaries began making royalty payments to Disney in November 2006 equal to 5% of net sales from physical Disney Store locations, subject to an additional royalty holiday period with respect to a limited number of stores (the Non-Core Stores ). The initial term of the License Agreement continues through January 2020, unless terminated sooner in accordance with the License Agreement, and if certain financial performance and other conditions are satisfied, the term of the License Agreement may be extended at our option for up to three additional ten-year terms.

In connection with our acquisition of the DSNA Business, we also entered into a Guaranty and Commitment (the Guaranty and Commitment ) dated as of November 21, 2004, in favor of Hoop and Disney. As required by the Guaranty and Commitment, we invested \$50 million in Hoop concurrently with the consummation of the acquisition, and we agreed to invest up to an additional \$50 million from time to time to enable Hoop to comply with their obligations under the License Agreement and otherwise fund the operations of Hoop. The Guaranty and Commitment provides that our \$50 million additional commitment is subject to increase if certain distributions are made by Hoop to The Children's Place. To date, we have not invested any portion of the additional \$50 million in Hoop. We also agreed in the Guaranty and Commitment to guarantee the payment and performance by Hoop of their royalty payment and other obligations to Disney under the License Agreement, subject to a maximum guaranty liability of \$25 million, plus expenses.

The License Agreement obligates us to maintain the quality, appearance and presentation standards of the Disney Store chain in accordance with the highest standards prevailing in the specialty retail industry. In addition, the License Agreement, as amended in April 2006, required us to:

Completely remodel each store within a specified period of time following expiration or termination of the initial term of the lease for such store, if such lease is renewed or extended on a long-term basis upon or following such expiration or termination;

Completely remodel each store at least once every 12 years; and

Completely remodel a minimum of approximately 160 of the 313 acquired stores by January 1, 2009.

During fiscal 2006, we suspended the Disney Store renovation program because of dissatisfaction with our Mickey store prototype from a brand, design and construction standpoint. As of February 3, 2007, we had remodeled a total of 45 Disney Stores since the 2004 acquisition. Pursuant to the provisions of the License Agreement, as amended in 2006, relating to required remodeling following lease renewals and required remodeling of stores at least once every 12 years, we were required to remodel a total of approximately 145 stores by February 3, 2007. As of February 3, 2007, we had remodeled 32 of these required stores, with the result that 113 of the store remodels required by that date under the terms of the License Agreement had not been completed by that date. The remaining 13 store remodels we had completed were not required pursuant to the provisions of the License Agreement.

During the fourth quarter of fiscal 2006, we received a letter and subsequent follow-up communications from Disney identifying various ways in which we had not complied with the store renovation and certain other requirements of the License Agreement. In response, during the fourth quarter of fiscal 2006, we commenced discussions with Disney regarding potential modifications to certain terms of the License Agreement to address our remodeling commitments as well as other concerns that had been raised by Disney in various communications with us. During the first quarter of fiscal 2007, Disney notified us that Disney viewed our failure to comply with these requirements of the License Agreement as constituting numerous material breaches of the License Agreement, entitling Disney to exercise its rights and remedies under the License Agreement.

Following discussions with Disney, in June 2007, we entered into a letter agreement with Disney (the "June Letter Agreement") which modified and superseded certain provisions of the License Agreement, including the remodeling requirements, through fiscal 2011 and created additional obligations for us and Hoop with respect to the remodeling of Disney Stores. The June Letter Agreement was entered into to address Disney's assertion that through the date of the June Letter Agreement we had committed 120 material breaches of the License Agreement. The June Letter Agreement stated that, if we fully comply with its terms, Disney would forbear from exercising any rights or remedies that it would have under the License Agreement based on the breaches of the License Agreement that were asserted by Disney and were the subject of the June Letter Agreement. However, if we were to violate any of its provisions, Disney would have the right to terminate its forbearance under the June Letter Agreement, in which case Disney would be free to exercise any or all of its rights and remedies under the License Agreement, including possibly terminating our license to operate the Disney Stores based on the occurrence of numerous material breaches and claiming breach fees, as if the June Letter Agreement had not been executed. The June Letter Agreement also stated that, if we were to breach any of its provisions on three or more occasions and Disney had not previously exercised its right to terminate the June Letter Agreement, a payment of \$18.0 million to Disney would become immediately due and payable with respect to the breach fees called for by the License Agreement. If we were to violate any of the provisions of the June Letter Agreement on five or more occasions, Disney would have the right to immediately terminate the License Agreement, without any right on our part to defend, counterclaim, protest or cure. The June Letter Agreement stated that its terms would take effect immediately but that the parties anticipated the June Letter Agreement would later be replaced by a formal amendment to the License Agreement incorporating the terms of the June Letter Agreement.

The June Letter Agreement, among other things, suspended the remodel obligations in the License Agreement for the approximately 4.5 year term of the June Letter Agreement and, in lieu of those provisions, imposed new obligations on the Company with respect to the renovation and maintenance of numerous stores in the Disney Store chain between fiscal 2007 and fiscal 2011 and, for stores to be remodeled in fiscal 2007, set forth a detailed timetable for submission of plans and completion dates.

Subsequent to the execution of the June Letter Agreement, we were unable to meet several deadlines set forth in the June Letter Agreement. In addition, we determined that there were upcoming deadlines during the third and fourth quarters of fiscal 2007 specified in the June Letter Agreement that we would likely not meet. Accordingly, we and Disney engaged in further discussions during August 2007 and, based on these discussions, agreed upon changes to the requirements of the June Letter Agreement that would postpone the due dates of certain of our remodel obligations, including those originally scheduled for fiscal 2007. In connection with these postponements, we agreed to remodel two additional Disney Stores during fiscal 2009 and agreed upon changes to the original License Agreement to modify restrictions on Disney's ability to relocate its flagship retail store in Manhattan and to narrow the restrictions on Disney's ability to grant direct licenses to other specialty retailers so that these restrictions would apply only with respect to specialty retail stores focusing primarily on the sale of children's merchandise.

During August 2007, we and Disney executed a formal amendment to the License Agreement (the "Refurbishment Amendment") which incorporated the terms of the June Letter Agreement, as modified by our mutual agreement during August, and the aforementioned changes to the License Agreement. The Refurbishment Amendment by its terms superseded the June Letter Agreement and took effect retroactively as of June 6, 2007, the original effective date of the June Letter Agreement. The Refurbishment Amendment provides that our compliance in full with its terms will constitute a cure of the breaches identified in the Refurbishment Amendment and that, so long as the Refurbishment Amendment is not terminated, Disney will forbear from exercising any rights or remedies that it would have under the License Agreement based on the breaches identified in the Refurbishment Amendment.



The Refurbishment Amendment suspends the remodel obligations in the License Agreement for the approximately 4.5 year term of the Refurbishment Amendment, and, in lieu of those provisions, commits us to remodel by the end of fiscal 2011 a total of 236 existing Disney Stores into a new store prototype we have developed,

of which the first seven remodels are required to be completed by December 31, 2007 (all of which we expect to complete on schedule);

an additional 49 stores are required to be remodeled by the end of fiscal 2008;

an additional 60 stores are required to be remodeled by the end of fiscal 2009;

an additional 70 stores are required to be remodeled by the end of fiscal 2010; and

an additional 50 stores are required to be remodeled by the end of fiscal 2011.

Under the Refurbishment Amendment, we also have agreed to open at least 18 new Disney Stores using the new store prototype by the end of fiscal 2008. Our prior obligations under the License Agreement did not require us to open a specified number of new stores.

In addition, the Refurbishment Amendment requires us to complete a maintenance refresh program in approximately 165 Disney Stores by June 30, 2008, including the flagship store located on Michigan Avenue in Chicago, which was completed on September 12, 2007. Some of the stores that are refreshed will subsequently be remodeled into the new store prototype. The Refurbishment Amendment obligates us to complete the remodel and refresh program described above and, as required by the Refurbishment Amendment, we have committed \$175 million, on a consolidated basis, to remodel and refresh the stores as noted above through fiscal 2011, and have committed approximately \$12 million to open new stores through fiscal 2008.

We expect that the Disney Stores will fund these commitments primarily from cash flow from operations and borrowings under its secured credit facility. We expect that The Children's Place business will need to provide additional capital to the Disney Stores to remain in compliance with the store remodel requirements under the License Agreement as modified by the Refurbishment Amendment.

In the Refurbishment Amendment, we also agreed with Disney to make certain other modifications to the provisions of the License Agreement, including:

Limiting the number of new Disney Stores to be opened per year during the remodeling period (we may open up to 25 new stores in any given year after fiscal 2007, with a rollover each year of up to five new stores from prior years);

Eliminating the extended royalty abatement for some of the Disney Stores that were identified as Non-Core Stores in the License Agreement if their leases are extended on a long-term basis and the stores are not remodeled within the timeframe that was required under the original terms of the License Agreement before giving effect to the Refurbishment Amendment;

Requiring the potential implementation of a differentiated merchandise plan for the Disney Store outlets; and

Modifying the provisions of the License Agreement that would apply to a potential wind-down of the Disney Store business following any termination of the License Agreement.

Like the June Letter Agreement, the Refurbishment Amendment states that, if we fully comply with the terms of the Refurbishment Amendment, Disney will forbear from exercising any rights or remedies that it would have under the License Agreement based on the breaches of the License Agreement that were asserted by Disney and were the subject of the Refurbishment Amendment. However, under the terms of the Refurbishment Amendment, if we violate any of the provisions of the Refurbishment Amendment, Disney will have the right to terminate its forbearance under the Refurbishment Amendment, in which case Disney would be free to exercise any or all of its rights and remedies under the License Agreement, including possibly terminating our license to operate the Disney Stores based on the occurrence of numerous material breaches and claiming breach fees, as if the Refurbishment Amendment had not been executed. The Refurbishment Amendment also states that, if we breach any of its provisions on three or more occasions and Disney has not previously exercised its right to terminate the Refurbishment Amendment, a payment of \$18.0 million would become immediately due and payable to Disney with respect to the breach fees called for by the License Agreement. If we violate any of the provisions of the Refurbishment Amendment on five or more occasions, Disney will have the right to immediately terminate the License Agreement, without any right on our part to defend, counterclaim, protest or cure. It should be noted that the Refurbishment Amendment addresses only those breaches

specifically enumerated therein. Disney continues to retain all its other rights and remedies under the License Agreement with respect to any other breaches.

We believe that we will be able to perform our obligations under the Refurbishment Amendment as and when required. However, because our ability to meet these obligations will depend on numerous factors, some of which are beyond our control, there can be no assurance that we will be able to fully comply. Like the June Letter Agreement, the Refurbishment Amendment does not excuse us from compliance with these requirements should there be events or developments that may be beyond our control, such as contractor delays, delays in landlord or regulatory approval, natural disasters or acts of war or terrorism. Our diligent efforts may not be adequate to enable us to obtain all required approvals under the Refurbishment Amendment or to comply with every requirement or meet every deadline imposed on us under the Refurbishment Amendment. In the event we are unable to comply with any of our obligations when required, we would be in breach of our agreements with Disney, entitling Disney to exercise its remedies under the Refurbishment Amendment and the License Agreement. In the event such breaches occur, there can be no assurance that we will be able to obtain waivers or other relief from Disney, if needed, to avoid the \$18.0 million payment to Disney and prevent a termination of the Refurbishment Amendment or the License Agreement. In addition, any breach by us of agreements with Disney (even if subsequently waived by Disney) would constitute a cross-default under the secured loan agreement for the Disney Store chain, entitling the lenders to exercise their contractual remedies. There can be no assurance that we will be able to obtain waivers, if needed, from our lenders in the event of any future breaches of the Refurbishment Amendment or the License Agreement.

Beginning in July 2007, our Hoop subsidiaries commenced Internet commerce operations through an alliance with a Disney affiliate in which select Disney Store merchandise is sold on the [disneyshopping.com](http://disneyshopping.com) website. Customers can find our Disney Store merchandise at [www.disneystore.com](http://www.disneystore.com) or [www.disneyshopping.com](http://www.disneyshopping.com). We anticipate entering into a formal amendment to the License Agreement relating to this Internet business. It is anticipated that this amendment to the License Agreement will supersede our obligation to launch our own Disney Store Internet store, which pursuant to the License Agreement, as modified by certain letter agreements, we are required to launch by January 31, 2008.

Refer to Item 7. Management's Discussion and Analysis for further discussion of the Refurbishment Amendment.

### **Key Capabilities to Our Long-Term Success**

We believe that the following capabilities are critical to our long-term success:

**Merchandising Strategy.** The Children's Place merchandising strategy is built on offering an appealing collection of interchangeable outfits and accessories to create a coordinated look distinctive to the brand. We offer an updated, focused assortment of styles in a variety of colors and patterns, with the aim of consistently creating a fresh, youthful look at value prices that we believe distinguishes The Children's Place brand. We divide the year into quarterly merchandising seasons: spring, summer, back-to-school and holiday. Within each season, we typically deliver two merchandise lines. Each season is built around a color palette that includes an assortment of coordinated basic and fashion apparel with matching accessories designed to encourage multiple item purchases and wardrobe building. Within the assortments we also offer a choice of good, better, and best merchandise.



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Our Disney Store merchandising strategy is to offer unique, exclusive, innovative and elevated assortments for the whole family that are high quality and showcase Disney characters. To date, the Disney Store business has been heavily concentrated in the Halloween and holiday seasons. To reduce the level of seasonality, we plan to offer more softlines merchandise during spring, summer and back-to-school. In addition, in fiscal 2006, we introduced adult apparel, offered more freshness and innovation in our hardlines business, and offered a good, better, best pricing strategy across most product categories.

***High Quality/Value Pricing Strategy.*** We believe that our high quality, value price positioning is an important component of our long-term strategy. We offer high-quality clothing and accessories under The Children's Place brand name at prices below most of our direct mall-based competitors. We employ this value pricing strategy across our entire merchandise offering. Our value price points are an important factor in the broad consumer appeal that The Children's Place brand has benefited from over the years. At Disney Store, we believe that combining the strong

appeal of Disney characters with our unique merchandise offering at value prices has contributed to the Disney Store's progress.

**Brand Image.** We continue to build a strong brand image and customer loyalty for The Children's Place by:

Offering high-quality products at value prices;

Providing a distinctive collection of coordinated and interchangeable outfits and accessories;

Maintaining a uniform merchandise presentation;

Emphasizing our fashionable, youthful image in our marketing visuals;

Utilizing our customer database to target direct mailers to customers;

Maintaining a marketing presence in targeted print publications; and

Selling our merchandise exclusively in our The Children's Place stores and on our website.

The Disney Store business benefits from one of the strongest emotional family brand names in North America. The Disney Store experience emphasizes the magic and memories of the Disney character portfolio.

**Low-Cost Sourcing.** We control the design, sourcing and presentation of our products sold at both The Children's Place and Disney Store. We believe that this control is essential in assuring the consistency and quality of our merchandise and the image of each of our brands, as well as our ability to deliver value to our customers. We have established long-standing relationships with our vendors and suppliers. Through these relationships and our extensive knowledge of low cost sourcing, we are able to offer our customers high-quality products at value prices. Furthermore, we believe that our integrated merchandise approach, from in-house design to in-store presentation, enables us to identify and respond to market trends, uphold rigorous product quality standards, manage the cost of our merchandise and strengthen our brands. Our offices in Hong Kong, Shanghai and New Delhi add to our ability to lower costs, capitalize on new sourcing opportunities, increase our control over product quality and enable us to respond to changing

merchandise trends more effectively and efficiently.

***Experienced Management Team.*** The members of our senior management team have an average of 19 years of retail or apparel industry experience. Our interim CEO, Mr. Charles Crovitz, an independent member of the Company's Board, was appointed interim CEO in September 2007. Mr. Crovitz has over 20 years experience in the retail industry, including 10 years at Gap, Inc. Mr. Crovitz was appointed interim CEO following the September 24, 2007 resignation of Ezra Dabah, who resigned as CEO. During his tenure as CEO, Mr. Dabah guided the management of the Company using his broad apparel merchandising and buying expertise, which included over 20 years in the children's segment of the market.

#### **Merchandising Process**

While we have separate design and merchandising teams for each brand, the process and planning schedules are similar. To execute our merchandising strategies, we rely on the coordinated efforts of our design, merchandising, planning and sourcing teams. These teams, in conjunction with senior management, hindsight prior season results and review fashion trends, colors and design concepts that we will offer in upcoming seasons. Merchandising selects items for production from the assortment of merchandise designs that are created by the design team. In addition, the Disney Store merchandising and design teams assess characters, are made aware of upcoming movie, DVD and television releases by the Walt Disney Company and attend toy shows and fairs to determine which merchandise to include in the assortment. Then, based upon detail design specifications, including production quantities determined by merchandising and planning, the sourcing team arranges for the issuance of purchase orders and manufacture of the selected items.

Our design and trend teams analyze and interpret current and emerging fashion trends, translating them into a broad selection of merchandise appropriate for upcoming seasons. In addition, our Disney Store design and trend teams evaluate the popularity and relevancy of existing characters, as well as the perceived customer receptivity to new characters, to create a unique and compelling merchandise assortment. Across both brands, work on each of our seasonal lines begins approximately one year before the season. However, the Company maintains, and at times

exercises, the ability to develop and deliver product on an expedited timeline. The merchandising process includes purchasing of samples and gathering market intelligence on fashion trends, which involves extensive European and domestic market research, media, trade shows, fashion magazines, the services of fashion and color forecast organizations, and analysis of prior season performance. In addition, at Disney Store, we consult with Disney as part of the normal course of operations to ensure character art and overall brand standards are properly represented. After the design teams present their ideas, the designers, with the direction of merchandising, translate those ideas into a merchandise assortment that reflects the theme of the season. These interpretations include variations in fabric and other materials, product color, decoration, character selection and age-appropriate silhouettes. Potential items are designed using computer aided design technology, which allows for a wide range of style and fashion options. Our sourcing teams and Asian offices coordinate the production of prototype samples which enable our merchandising teams to ensure that our merchandise will properly reflect our design concepts and allow us to get the most accurate understanding of an item. We have also instituted a process that involves working with prototype samples in a simulated in-store environment. This enables our design, merchandising, visual and marketing teams to create a cohesive, well balanced and fresh approach to each season.

The merchandise management teams create a detailed purchasing plan for the season covering each department, category and key item, based on historical, current and emerging category trends. The production process takes approximately five to six months from order confirmation to receipt of merchandise at our distribution facilities. Our planning teams monitor current and projected inventory levels on a weekly basis and analyze sales patterns to predict future demand for various items and categories. We regularly monitor sales and maintain some flexibility to adjust merchandise on order for future seasons or to accelerate delivery of merchandise. Our merchandise allocation teams are responsible for planning and allocating merchandise to each store based on sales levels, merchandise turns and other factors.

#### **Sourcing and Procurement**

We combine management's extensive apparel sourcing experience with a cost-based buying strategy to control merchandise costs, infuse quality features into our product and deliver value to our customers. We believe we have a thorough understanding of the economics of apparel manufacturing, including costs of materials and components. This knowledge enables us to determine the most cost-effective country and manufacturer from which to source each item and obtain high quality at low product cost. With the addition of the Disney Store business, we now source hardlines merchandise, including toys and home products, using the same sourcing strategies.

Four times a year, our U.S. sourcing team makes on-site visits to our independent agents and various manufacturers to negotiate product costs, finalize technical specifications for each product and confirm delivery of merchandise manufactured to our specifications. During fiscal 2006, approximately 400 independent manufacturers located primarily in Asia produced merchandise sold at The Children's Place and Disney Store to our specifications. To support our growing inventory needs and to control merchandise costs, we continue to pursue global sourcing opportunities and consider product quality and cost, reliability of the manufacturer, and service and product lead times, among other factors.

We have no exclusive or long-term contracts with our manufacturers and typically transact business on an item-by-item basis under purchase orders at freight on board cost in U.S. dollars. We are party to agency agreements with commissioned independent agents who oversee production, assist in sourcing and pre-production approval, provide quality inspection and ensure timely delivery of merchandise. During fiscal 2006, we purchased approximately 15% of our products through the support of a commissioned, independent agent in Taiwan, and approximately 15% of our products through an independent Hong Kong-based trading company. This trading company is responsible for procurements from wholly-owned facilities as well as contract manufacturers located throughout Asia. We have developed long-term, continuous relationships with key individual manufacturers and material suppliers, which have yielded numerous benefits, including quality control, low costs, and flexible working arrangements. In addition, we believe our offices in Hong Kong, Shanghai and New Delhi enable us to obtain more favorable material and manufacturing costs and quickly identify and act on new sourcing and supplier opportunities. Our Asian offices also facilitate our prototype sample production and enable us to foster stronger relationships with our suppliers, manufacturers, agents and trading companies. During fiscal 2006, we purchased approximately 50% of our merchandise without the aid of commissioned buying agents or trading companies. Approximately 50% of our goods

were sourced from China. Together with our agents and key suppliers, we use tracking systems that enable us to anticipate potential delivery delays in our orders and take action to mitigate the impact of any delays. Using our purchase order, advanced shipping notification and tracking systems, our independent agents and our sourcing department actively monitor the status of each purchase order from order confirmation to merchandise receipt.

To ensure quality and promote consumer confidence in our products, we augment our manufacturers' testing requirements with our own in-house quality assurance laboratory to test and evaluate fabric, trimming materials and pre-production samples against a comprehensive range of physical performance standards before production begins. The quality control personnel of our Asian offices, independent agents and trading company visit the various manufacturing facilities to monitor and improve the quality control and production process. Our Asian offices enhance our quality control by enabling us to monitor component and manufacturing quality at close range and address related problems at an early stage. With this focus on pre-production quality approval, we are generally able to detect and correct quality-related problems before bulk production begins. We do not accept finished goods until each purchase order receives formal certification of compliance from our own quality assurance associates, agents or appointed third party inspectors.

In addition to our quality control procedures, we administer a social compliance program designed to promote compliance with local legal regulations, as well as ethical and socially responsible business practices. The program involves on-site facility visits by either our social compliance auditors or third party providers, review of documentation, and interviews of facility management and workers. Additionally, our program includes education and training of our associates and our suppliers in order to ensure the sustainability of our program.

#### **Company Stores**





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**Existing Stores.** As of September 1, 2007, we operated a total of 1,217 stores: 889 The Children's Place stores and 328 Disney Stores in North America. Most of The Children's Place stores are clustered in and around major metropolitan areas in regional malls, with the exception of 136 strip center, 110 outlet and 48 street stores. All of our Disney Stores are in regional malls with the exception of 19 outlet stores, two strip stores and two street locations. The following table sets forth the number of stores in each state, Puerto Rico and Canadian province as of September 1, 2007:

State	The Children's Place	Disney Store	Total Number of Stores
Alabama	9	4	13
Arizona	14	6	20
Arkansas	5	1	6
California	79	50	129
Colorado	13	5	18
Connecticut	15	7	22
Delaware	4	3	7
Florida	45	25	70
Georgia	22	6	28
Hawaii	3	1	4
Idaho	1	1	2
Illinois	41	17	58
Indiana	18	7	25
Iowa	6	1	7
Kansas	5	2	7
Kentucky	8	3	11
Louisiana	12	3	15
Maine	4	1	5
Maryland	23	6	29
Massachusetts	25	7	32
Michigan	22	10	32
Minnesota	12	2	14

State	The Children's Place	Disney Store	Total Number of Stores
Mississippi	6	0	6
Missouri	16	8	24
Montana	1	0	1
Nebraska	3	1	4
New Hampshire	5	3	8
New Jersey	46	15	61
New Mexico	3	2	5
New York	76	20	96
Nevada	7	3	10
North Carolina	21	6	27
North Dakota	1	0	1
Ohio	30	11	41
Oklahoma	3	2	5
Oregon	9	3	12
Pennsylvania	47	20	67
Rhode Island	3	1	4
South Carolina	13	1	14
South Dakota	1	0	1
Tennessee	17	7	24
Texas	55	25	80
Utah	7	0	7
Vermont	1	0	1
Virginia	19	8	27
Washington	12	3	15
West Virginia	1	2	3
Wisconsin	13	3	16
Puerto Rico	14	0	14
<b>Total United States and Puerto Rico</b>	<b>816</b>	<b>312</b>	<b>1,128</b>

Province	The Children's Place	Disney Store	Total Number of Stores
Alberta	7	3	10
British Columbia	7	1	8
Manitoba	2	1	3
New Brunswick	3	1	4
Nova Scotia	2	1	3
Ontario	35	9	44
Quebec	15	0	15
Saskatchewan	2	0	2
<b>Total Canada</b>	<b>73</b>	<b>16</b>	<b>89</b>
<b>Total Stores</b>	<b>889</b>	<b>328</b>	<b>1,217</b>

*Store Type.*

**The Children's Place.** Our average Children's Place store is approximately 4,700 square feet. The majority of our Children's Place stores are in our Apple-Maple prototype, which features light wood floors, fixtures and trim. The store is brightly lit, featuring floor-to-ceiling glass windows that allow our colorful fashions to attract customers from the outside. A customized grid system throughout the store's upper perimeter displays featured merchandise, marketing photographs and promotions.

During fiscal 2002, we introduced our Technocolor store prototype. The unique, fun and bright stores use color to create boutique-like settings that better differentiate the various departments within the store. The stores also feature wider aisles for customers with strollers and more wall space allowing for enhanced merchandise presentation

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and ease of shopping. As of September 1, 2007, 302 stores were in this format, or approximately 34% of The Children's Place store base. In fiscal 2007, some of our new stores and remodels (except for outlets) will be in our updated Technocolor store format, and will average approximately 5,500 square feet in size to accommodate our new store-within-a-store shoe store which the Company launched during the Back-to-School season. Our street and strip center locations represent approximately 21% of The Children's Place store base and provide opportunities for further penetration in established markets.

Our typical outlet stores are approximately 6,700 square feet and represent approximately 12% of The Children's Place store base. Our outlet stores are mostly located in outlet centers and are strategically placed within each market to liquidate clearance merchandise from nearby stores. Given the brand's value orientation, we also sell an assortment of full-priced merchandise in our outlet stores. We view our outlet business as an important component of our future growth.

**Disney Store.** The average Disney Store is approximately 4,700 square feet. As of September 1, 2007, we have several Disney Store formats, as follows:

	<b>% of Store Base</b>
Pink and Green	36%
Piperaill	30%
Mickey	17%
Millennium	6%
Castle	5%
Outlet*	6%
Total	100%

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\* **Note:** Our outlets are in various formats, 13 of which are in the Mickey store format.

Our outlet stores were introduced in fiscal 2005, are approximately 5,500 square feet and have been very successful. Our Mickey stores were also introduced in fiscal 2005. They are brightly lit and feature large red Mickey ears at the entranceway. During fiscal 2006, due to dissatisfaction with the Mickey store prototype from a brand, design, and construction standpoint, we suspended our store renovation program and determined that we would need to remodel numerous Mickey stores. In fiscal 2006 we recorded a \$9.6 million charge related to the impairment of 29 such stores, or approximately 41% of the Mickey stores then in operation. We introduced a new store prototype in the third quarter of fiscal 2007 which we believe is a better reflection of the Disney brand. The new Disney Store is modern, durable and features video monitors at both the store's entrance and the middle of the store. A glittering red mirror chip stone floor is featured at the front of the store, as if to suggest a feeling of being on stage. The back of the store features brushed chrome and wood fixtures, hard wood flooring and more intimate lighting, reminiscent of being backstage in a theater.

The Refurbishment Amendment we entered into with Disney in August 2007 commits us to remodel by the end of fiscal 2011 a total of 236 existing Disney Stores into our new store prototype. The first seven remodels must be completed by December 31, 2007, with an additional 49, 60, 70 and 50 stores required to be remodeled during each of fiscal 2008, fiscal 2009, fiscal 2010, and fiscal 2011, respectively. Under the terms of the Refurbishment Amendment, we agreed to open at least 18 new Disney Stores using the new store prototype by the end of fiscal 2008, and we have the right to open up to a specified number of additional new stores using the new store prototype during each fiscal year. In addition, under the terms of the Refurbishment Amendment, we are obligated to complete a maintenance refresh program in approximately 165 Disney Stores by June 30, 2008, including the flagship store located on Michigan Avenue in Chicago, which was completed on September 12, 2007. Some of the stores that are refreshed will subsequently be remodeled into the new store prototype. Refer to Item 7. Management's Discussion and Analysis for further discussion of the Refurbishment Amendment.

**Store Operations**

Our store operations are organized into ten and six regions for The Children's Place and Disney Store, respectively. For The Children's Place brand, we have two Zone Vice Presidents who oversee our operations and to whom regional managers report. At this time, the Disney Store business does not have Zone Vice Presidents. For both

brands, a regional manager oversees each region and has several district managers reporting to him or her. Each district manager is responsible for approximately eight to ten stores, on average. Our stores are staffed by a store management team and approximately 10 part-time sales associates, with additional part-time associates hired to support seasonal needs. Across both brands, our store leadership teams spend a high percentage of their time on the store selling floors providing direction, motivation, and development to store personnel. To maximize selling productivity, our teams emphasize greeting, replenishment, presentation standards, procedures and controls. In order to motivate our store leadership, we offer a monthly incentive compensation plan that awards bonuses for exceeding goals.

#### **Store Expansion Program**

To determine the location of new stores, we conduct onsite visits and analyses of potential store sites, taking into account the performance of our stores and other retailers in the area, as well as the demographics of the surrounding area. In addition, we consider the store's location relative to consumer traffic patterns and proximity to other children's retailers.

***The Children's Place.*** During fiscal 2006, we opened 69 stores and closed five, compared to opening 55 stores and closing three in fiscal 2005. We plan to open approximately 60 stores and remodel approximately 21 Children's Place stores in fiscal 2007. Over time, we believe The Children's Place brand can grow to approximately 1,200 stores across the United States, Canada and Puerto Rico.

Our new store return on investment (defined as the return on investment for stores in which the then current fiscal year was their first full year of operation) for The Children's Place chain for fiscal 2006, 2005 and fiscal 2004 approximated 87%, 81% and 87%, respectively. We define return on investment as store level operating cash flow for new stores divided by new store investment. Store level operating cash flow for new stores is comprised of direct store contribution before the amortization of deferred rent and depreciation and amortization expense. We believe new store return on investment is a relevant measurement for assessing performance because it shows how quickly our investment in new stores becomes available for reinvestment. However, it is not a measure determined in accordance with generally accepted accounting principles in the United States ( U.S. GAAP ) and should not be considered by investors as an alternative to operating income or net income as an indicator of our performance. The new store return on investment disclosed here is not necessarily comparable to new store return on investment disclosed by other companies because new store return on investment is not uniformly defined.

Fiscal 2006 average store level operating cash flow for new stores approximated \$407,000, a 3% decrease compared to fiscal 2005. Average store investment includes store capital expenditures, initial inventory and pre-opening costs less lease incentives and an estimate for merchandise payables. Fiscal 2006 average new store investment approximated \$466,000, an 11% decrease from fiscal 2005. This decrease in average new store investment primarily reflects lower construction costs. Fiscal 2006 new stores had average net sales of approximately \$1.5 million, a 6% decrease compared to fiscal 2005, which reflects lower sales at our outlet stores as well as outlets comprising a smaller percentage of our new store base compared to the prior year.

***New Store-within-a-Store Children's Place Shoe Store.*** In fiscal 2007, we launched a new store-within-a-store shoe store during the back-to-school season. We believe there is a void in the marketplace for fashionable, high quality children's shoes at a value price. We have begun a 50 store rollout of the concept in fiscal 2007, and we will also offer our expanded shoe offering on our childrenplace.com website. Stores that carry the expanded shoe assortment will measure approximately 1,000 square feet larger than a typical store.

***Disney Store.*** In fiscal 2006 we opened 19 Disney Stores, closed eight, and remodeled 14, compared to opening 18, closing seven and remodeling 31 in fiscal 2005. Our store growth plans in fiscal 2007 include opening approximately 15 Disney Stores. Of these 15 new stores, approximately 11 will be outlet stores, a growth opportunity for the Disney Store business. In addition, we are required to remodel seven Disney Stores to a new store prototype by December 31, 2007, to open at least 18 new Disney Stores using the new store prototype by the end of fiscal 2008, and to complete a maintenance refresh program in approximately 165 Disney Stores by June 30, 2008. Over time, we believe the Disney Store chain can grow to approximately 600 stores across North America.

Our new store return on investment (defined as the return on investment for stores in which the then current fiscal year was their first full year of operation) for the ten Disney Stores for which fiscal 2006 was their first full year





of operation approximated 62%. This is the first year we are calculating return on investment for our Disney Stores since there were no new Disney Stores opened by us prior to fiscal 2005. Fiscal 2006 average store level operating cash flow for the 10 new Disney Stores approximated \$371,000. Average store investment approximated \$599,000 and included store capital expenditures, initial inventory and pre-opening costs less lease incentives and an estimate for merchandise payables. Average net sales for these 10 Disney Stores for which fiscal 2006 was their first full year of operation were approximately \$2.5 million.

#### **Seasonality**

Our business is also subject to seasonal influences, with heavier concentrations of sales during the back-to-school and holiday seasons. Our first quarter results are heavily dependent upon sales during the period leading up to the Easter holiday. Our third quarter results are heavily dependent upon back-to-school sales at The Children's Place and upon Halloween sales at Disney Store. Our fourth quarter results are heavily dependent upon sales during the holiday season. For more information regarding the seasonality of our business, refer to Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Quarterly Results and Seasonality.

#### **Internet Sales**

We believe the Internet is an effective sales, merchandising and marketing channel for our brands and is also effective in generating new customers from the portion of the U.S. population that may not have access to our store locations or who prefer to shop online. Our Internet business represented approximately 2.6% of The Children's Place sales in fiscal 2006, compared to 2.3% of sales in fiscal 2005. This profitable business continues to grow at a rapid rate and we believe it is an integral part of our customer service and brand awareness strategies.

Beginning in July 2007, our Hoop subsidiaries commenced Internet commerce operations through an alliance with a Disney affiliate in which Disney Store merchandise is sold on the [disneyshopping.com](http://disneyshopping.com) website. Customers can find our Disney Store merchandise at [www.disneystore.com](http://www.disneystore.com) or [www.disneyshopping.com](http://www.disneyshopping.com). We anticipate entering into a formal amendment to the License Agreement relating to this Internet business. It is anticipated that this amendment to the License Agreement will supersede our obligation to launch our own Disney Store Internet store, which pursuant to the License Agreement, as modified by certain letter agreements, we are required to launch by January 31, 2008.

## **Marketing**

We strive to enhance our brands' reputation and image in the marketplace and build recognition and equity by marketing our image, product and value message primarily through our store front windows, direct mail, in-store marketing, magazine advertising and The Children's Place private label credit card. Our direct mail marketing programs are designed to increase sales, promote brand loyalty and create customer excitement. In fiscal 2006, we increased the frequency and depth of our direct mail campaigns which drove sales and traffic. We also increased magazine advertising as a means to communicate The Children's Place brand message to new and existing customers. We believe our Disney Store business benefits from Disney's substantial advertising efforts.

We view The Children's Place private label credit card as an important marketing and communication tool. Pursuant to a merchant services agreement, private label credit cards are issued to our customers for use exclusively at The Children's Place stores, and credit is extended to such customers through a third-party financial institution on a non-recourse basis to us. Our private label credit card accounts for approximately 11% of The Children's Place net sales. We believe that our private label credit card promotes affinity and loyalty among those customers who use the card and facilitates communication with such customers through delivery of coupons and promotional materials.

#### **Logistics**

We currently support both The Children's Place stores and Disney Stores with a leased 525,000 square foot distribution center in South Brunswick Township, New Jersey; a leased 250,000 square foot distribution center in Ontario, California; a leased 95,000 square foot distribution center in Ontario, Canada; and an owned 700,000 square foot distribution center in Ft. Payne, Alabama, which we opened in August 2007 to support projected growth at both brands. Our distribution centers utilize automated warehouse systems, which employ radio frequency

technology and automated conveyor systems. Our approximately 150,000 square foot leased fulfillment center in Secaucus, New Jersey is used to support our Internet business. In addition, we operate other leased facilities on a seasonal basis to support warehousing needs.

#### **Competition**

The children's apparel, toy and media retail markets are highly competitive. We compete in substantially all of our markets with GapKids, babyGap and Old Navy (each of which is a division of The Gap, Inc.); The Gymboree Corporation; Too, Inc.; Babies 'R' Us and Toys 'R' Us (each of which is a division of Toys 'R' Us, Inc.); J.C. Penney Company, Inc.; Sears (a division of Sears Holdings Corporation); Kohl's and other department stores as well as discount stores such as Wal-Mart Stores, Inc.; Target Corporation; and K-Mart (a division of Sears Holdings Corporation). In addition, stores like Stride Rite and Payless, as well as smaller shoe retailers, will compete with the Company's new store-within-a-store shoe store in 2007. We also compete with a wide variety of specialty stores, other national and regional retail chains, catalog companies and Internet retailers. Our Disney Store business competes with the Disney theme parks and with third parties selling Disney-branded merchandise under license. In addition, media items such as compact discs and DVDs can be purchased in virtually every retail channel. One or more of our competitors are present in substantially all of the areas in which we have stores.

We believe we have the principal factors to compete effectively in our markets: fashionable, high quality merchandise at value prices, compelling merchandise assortments, brand name recognition, good customer service, and easy-to-shop store environments.

#### **Trademarks and Service Marks**



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The Children's Place, babyPLACE, Place, The Place, TCP, PLC and certain other marks have been registered as trademarks and/or service marks with the United States Patent and Trademark Office. The registration of the trademarks and the service marks may be renewed to extend the original registration period indefinitely, provided the marks are still in use. We intend to continue to use and protect our trademarks and service marks and maintain their registrations. We have also registered our trademarks in Canada and other countries and are continuing to take steps to register our trademarks in certain other foreign countries. We believe our trademarks and service marks have received broad recognition and are of significant value to our business.

The trademarks and copyrights used in the Disney Store business are licensed by Hoop from Disney for use by the Disney Store so long as the License Agreement remains in effect.

### **Employees**

As of September 1, 2007, we had approximately 25,400 employees, of whom approximately 1,800 are based at our corporate headquarters in Secaucus, New Jersey; our Disney Store office in Pasadena, California; our distribution centers; and international offices. We have approximately 4,200 full-time store employees and approximately 19,400 part-time store employees. None of our employees are covered by a collective bargaining agreement. We believe we have good relations with our employees. In addition, as of September 1, 2007, we employed approximately 7,400 seasonal part-time employees.

**Internet Access to Reports**

We are a public company and are subject to the informational requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act ). Accordingly, we file periodic reports, proxy statements and other information with the SEC. Such reports, proxy statements and other information may be obtained by visiting the Public Reference Room of the SEC at 100 F Street, NE, Room 1580, Washington, D.C. 20549 or by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains a website (<http://www.sec.gov>) that contains reports, proxy and information statements and other information regarding us and other issuers that file electronically.

Our website address is <http://www.childrensplace.com>. We make available, without charge, through our website, copies of our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after such reports are filed with or furnished to the SEC. References in this document to our

website are not and should not be considered part of this Report, and the information on our website is not incorporated by reference into this Report.

We also make available our corporate governance materials, including our code of business conduct, on our website. If we make any substantive amendments to our code of business conduct or grant any waiver, including any implicit waiver, from a provision of the code to our CEO, Chief Financial Officer ( CFO ) or Corporate Controller, we will disclose the nature of such amendment or waiver on that website or in a Current Report on Form 8-K.

#### **ITEM 1A. RISK FACTORS**



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Investors in the Company should consider the following risk factors as well as the other information contained herein:

*A material breach of the License Agreement and certain other events could result in termination of the License Agreement.*

Upon the occurrence of certain specified events, Disney has the right to terminate the License Agreement. These events include, but are not limited to:

An uncured breach of a royalty payment due under the License Agreement;

Three or more uncured breaches by our subsidiaries of the provisions of the License Agreement relating to use of Disney's intellectual property (or five or more breaches of these provisions, whether cured or uncured);

Any uncured material breach by our subsidiaries of certain other specific provisions of the License Agreement;

Five or more uncured material breaches of the remaining provisions of the License Agreement (or seven or more material breaches of such remaining provisions, whether cured or uncured);

A prohibited transfer of our rights under the License Agreement or a prohibited change of control (as defined in the License Agreement);

Conduct on our part that is generally viewed by the public as offensive or reprehensible and which results in a material impairment or diminution of the good name, image or brand of Disney or its properties;

A material breach by our parent company of the provisions of its guaranty and funding commitments;

Material misrepresentations by us in the License Agreement;

Bankruptcy or insolvency of Hoop or The Children's Place Retail Stores, Inc. or any affiliate engaged in the Disney Store business;

Certain defaults by Hoop with respect to any outstanding indebtedness (other than under unsecured indebtedness in an amount less than \$500,000);

The entry of a final judgment against Hoop greater than \$35 million;

Uninsured losses by Hoop exceeding a threshold amount;

Breaches of certain other contractual commitments by Hoop; and

A breach of the Refurbishment Amendment to the License Agreement.

Some of these events may be beyond our control. As noted above, if the License Agreement is terminated, Disney may, at its option, require us to sell all or a portion of the Disney Store business to Disney or one of its affiliates or to a third party at a price to be determined by appraisal and/or to rapidly wind down the remaining Disney Store business in an orderly manner, within six months.

*A breach of the Refurbishment Amendment could adversely affect us and jeopardize our ability to continue operating the Disney Store business.*

In June 2007, we entered into a June Letter Agreement with Disney to address an assertion by Disney that we had committed numerous material breaches of the License Agreement, entitling Disney to exercise its rights and remedies under the License Agreement, including termination of the License Agreement. The June Letter Agreement, among other things, set forth a detailed timetable for submission of construction plans and completion dates for store remodels.

Subsequent to the execution of the June Letter Agreement, we were unable to meet several deadlines set forth in the June Letter Agreement. In addition, we determined that there were upcoming deadlines during the third and fourth quarters of fiscal 2007 specified in the June Letter Agreement that we would likely not meet. Accordingly, we and Disney engaged in further discussions during August 2007 and, based on these discussions, agreed upon changes to the requirements of the June Letter Agreement that would postpone the due dates of certain of our remodel obligations until later in fiscal 2007 or fiscal 2008.

During August 2007, we and Disney executed the Refurbishment Amendment, which incorporated the terms of the June Letter Agreement, as modified by our mutual agreement during August. The Refurbishment Amendment by its terms superseded the June Letter Agreement and took effect retroactively as of June 6, 2007, the original effective date of the June Letter Agreement. The Refurbishment Amendment provides that our compliance in full with its terms will constitute a cure of the breaches identified in the Refurbishment Amendment and that, so long as the Refurbishment Amendment is not terminated, Disney will forbear from exercising any rights or remedies it would have under the License Agreement based on the breaches identified in the Refurbishment Amendment. The Refurbishment Amendment suspends the remodel obligations in the License Agreement for the approximately 4.5 year term of the Refurbishment Amendment. In lieu of those provisions, the Refurbishment Amendment requires us to:

Remodel by specified deadlines through the end of fiscal 2011 a total of 236 existing Disney Stores;

Complete a maintenance refresh program in approximately 165 Disney Stores by June 30, 2008; and

Open at least 18 new Disney Stores using the new store prototype by the end of fiscal 2008.

In accordance with the Refurbishment Amendment we have committed \$175 million, on a consolidated basis, to remodel and refresh the stores as noted above through fiscal 2011, and have committed approximately \$12 million to open new stores through fiscal 2008.

Like the June Letter Agreement, the Refurbishment Amendment states that, if we fully comply with the terms of the Refurbishment Amendment, Disney will forbear from exercising any rights or remedies that it would have under the License Agreement based on the breaches of the License Agreement that were asserted by Disney and were the subject of the Refurbishment Amendment. However, under the terms of the Refurbishment Amendment, if we violate any of the provisions of the Refurbishment Amendment, Disney will have the right to terminate its forbearance under the Refurbishment Amendment, in which case Disney would be free to exercise any or all of its rights and remedies under the License Agreement, including possibly terminating our license to operate the Disney Stores based on the occurrence of multiple breaches and



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claiming breach fees, as if the Refurbishment Amendment had not been executed. The Refurbishment Amendment also states that, if we breach any of the provisions of the Refurbishment Amendment on three or more occasions and Disney has not previously exercised its right to terminate the Refurbishment Amendment, we will be required to make an immediate payment of \$18.0 million to Disney with respect to the breach fees called for by the License Agreement. If we violate any of the provisions of the Refurbishment Amendment on five or more occasions, Disney will have the right to immediately terminate the License Agreement, without any right on our part to defend, counterclaim, protest or cure. It should be noted that the Refurbishment Amendment addresses only those breaches specifically enumerated therein. Disney continues to retain all its other rights and remedies under the License Agreement with respect to any other breaches.

We believe that we will be able to perform our obligations under the Refurbishment Amendment as and when required. However, because our ability to meet these obligations will depend on numerous factors, some of which are beyond our control, there can be no assurance that we will be able to fully comply. Like the June Letter Agreement,

the Refurbishment Amendment does not excuse us from compliance with these requirements should there be events or developments that may be beyond our control, such as contractor delays, delays in landlord or regulatory approval, natural disasters or acts of war or terrorism. Our diligent efforts may not be adequate to enable us to obtain all required approvals under the Refurbishment Amendment or to comply with every requirement or meet every deadline imposed on us under the Refurbishment Amendment. In the event we are unable to comply with any of our obligations when required, we would be in breach of our agreements with Disney, entitling Disney to exercise its remedies under the Refurbishment Amendment and the License Agreement. In the event such breaches occur, there can be no assurance that we will be able to obtain waivers or other relief from Disney, if needed, to avoid our being required to make the \$18.0 million payment to Disney and prevent a termination of the Refurbishment Amendment or the License Agreement. In addition, any breach by us of our agreements with Disney (even if subsequently waived by Disney) would constitute a cross-default under the secured loan agreement for the Disney Store chain, entitling the lenders to exercise their contractual remedies. There can be no assurance that we will be able to obtain waivers, if needed, from our lenders in the event of any future breaches of the Refurbishment Amendment or the License Agreement.

***A change in control of the Company resulting from an acquisition proposal or attempt may permit Disney to terminate the License Agreement, compelling the Company to promptly sell or wind down the Disney Store business, and may cause an event of default under one or more of the Company's debt instruments.***

Under the terms of our License Agreement for The Disney Store, a direct or indirect change in control of The Children's Place Retail Stores, Inc. or our subsidiaries that operate the Disney Store business (as defined in the License Agreement) would permit Disney to terminate the License Agreement if the new controlling person or entity was not a "Qualified Person" as defined in the License Agreement. Because the definition of "Qualified Person" includes both objective and subjective elements, the License Agreement affords Disney considerable discretion to determine, in its sole judgment, whether an individual or entity acquiring control of the Company, and thereby the Disney Store operator, is a Qualified Person. The uncertainty surrounding this provision may deter third parties from seeking to acquire the Company or our Disney Store business, even if such a transaction would be beneficial to our stockholders. Moreover, there can be no assurance that any particular person or entity, or group of persons and entities, that might desire to acquire a controlling interest in the Company would be considered a Qualified Person by Disney. In particular, our former Chairman and CEO, Mr. Ezra Dabah, who is also one of our major stockholders and a member of our Board, has publicly stated that he is considering the possibility of making an offer, in combination with others, to acquire the Company, but there can be no assurance that Disney would deem Mr. Dabah or any other parties with whom he may be acting to be "Qualified Persons." In the event that Disney were to determine that a new controlling person of the Company did not qualify for this purpose, Disney would have the right to terminate the License Agreement, subject to a right on the part of the Company under certain circumstances to attempt to arrange a prompt sale of the Disney Store to a party deemed to be a "Qualified Person." Following a change of control of the Company (and assuming the Company were not able to arrange a prompt sale of the Disney Store business to a Qualified Person on terms acceptable to the Company under the limited circumstances when such a sale were permitted), if Disney were to exercise its right to terminate the License Agreement, the Company would be required, as described above, at Disney's election, either to sell all or a portion of the Disney Store business at its then-appraised value to Disney or third party approved by Disney, and/or to wind down the remaining Disney Store business in an orderly manner within a six-month period.

In addition, under our credit facilities, an event of default is deemed to occur upon the occurrence of a change in control (as defined in each of our credit facilities). An acquisition of the Company by Mr. Dabah, acting alone or in combination, or by any other party could result in such an event of default. There can be no assurance that any such event of default would be waived by the Company's lenders. If such a waiver was needed but could not be obtained, we would be required to repay in full the outstanding indebtedness under these credit facilities, and there can be no assurance we would have funds available to make such repayment.

***If the License Agreement for the Disney Store were to be terminated, we could be required to sell the Disney Store to Disney or to a buyer selected by Disney and/or to wind down the remaining Disney Store business in an orderly manner within six months. Under these circumstances our subsidiaries that operate the Disney Store business would have significant financial and other obligations to Disney, lenders, landlords, vendors and other third parties and might not be able to avoid bankruptcy proceedings.***

We operate the Disney Store business in North America pursuant to the License Agreement between our subsidiaries, Hoop, and a subsidiary of The Walt Disney Company. If certain material breaches by us under the License Agreement were to occur, or if we were to experience a change of ownership of a type not permitted by the License Agreement, or if certain other events were to occur, Disney would have the right, among other things, to terminate the License Agreement. Any such material breach or any termination of the License Agreement would constitute an event of default under the secured credit facility for the Disney Store business, permitting our lenders to accelerate the amounts due. Upon any termination of the License Agreement, Disney could require us to sell all or a portion of the Disney Store business to Disney or one of its affiliates, or to a third party selected by Disney, at a price to be determined by an average of independent appraisals. While any such potential sale was pending, we would be required to continue operating the Disney Store business in the ordinary course.

In the absence of any such sale (or in the case of a partial sale), we would be obligated to wind down the remaining Disney Store business in an orderly manner over a six-month period in accordance with the wind-down provisions in the License Agreement, as amended by the Refurbishment Amendment. As part of any such wind-down, we would cancel any outstanding merchandise purchase orders that may be cancelled without a monetary penalty. In addition, the License Agreement imposes significant restrictions on the actions that we or our secured lenders (or any inventory liquidation firm that may be engaged to assist in such wind-down) may take to wind-down the Disney Store business. Among other things, the License Agreement prohibits us from promoting a going out of business or liquidation sale or from selling any Disney merchandise through distribution channels other than the Disney Stores and the Disney Store website. These restrictions may interfere with our ability to liquidate all Disney merchandise by the end of the six-month wind-down period on favorable terms, if at all. Any remaining Disney merchandise not sold by the end of the wind-down period must be destroyed and would be of no value.

In addition, if we were required to wind down the Disney Store business, Hoop would remain liable to Disney for royalties on sales of Disney merchandise through the end of the wind-down period and for any other amounts owed to Disney (such as contractual breach fees). These subsidiaries would also have substantial liabilities under Disney Store leases and for payments due to vendors, including obligations under non-cancellable purchase orders for Disney merchandise (the amount of which fluctuates based on seasonality), as well as obligations to repay outstanding amounts under the credit facility supporting the Disney Store business. By way of example, as of February 3, 2007, the total liability of Hoop under Disney Store leases through fiscal 2022 was approximately \$345.2 million and the total liability of Hoop under outstanding purchase orders for merchandise was approximately \$131.4 million.

In the case of a wind-down, Hoop might be unable to comply with all of their payment obligations to Disney, lenders, landlords, vendors and other third parties, in which case creditors of these subsidiaries might elect to commence involuntary bankruptcy proceedings or our subsidiaries might not be able to avoid voluntarily seeking bankruptcy protection. In the event of bankruptcy proceedings with respect to Hoop, creditors of Hoop may seek to have our parent company, The Children's Place Retail Stores, Inc., held liable for certain obligations of Hoop.

Our parent company has expressly committed to contribute \$175 million to Hoop as needed for store remodeling and renovation in accordance with the Refurbishment Amendment and \$50 million (subject to increase in certain circumstances), if needed for the ongoing business of Hoop. Our parent company has also guaranteed \$25 million of Hoop's payment obligations to Disney.

***Our agreements with Disney may require us to make additional investments in the Disney Store business, which could require us to seek external sources of funds or to reduce the amount of capital expenditures we make in The Children's Place business.***

The License Agreement requires the Disney Store business to maintain the stores according to the highest standards prevailing in the specialty retail industry and to otherwise fund its operations, including making royalty payments to Disney. Should the Disney Store business be unable to meet these obligations on its own, we are contractually obligated under the Guaranty and Commitment to invest up to an additional \$50 million to enable it to comply with the License Agreement. In addition, the Refurbishment Amendment with Disney, entered into in August 2007, commits us, on a consolidated basis, to a remodel and refresh program for certain Disney Stores through fiscal

2011 at a total cost which we have estimated at \$175 million, which our Board has approved. To the extent that the Disney Store business is unable to fund this remodel and maintenance refresh program, or otherwise fund its operations, The Children's Place would be required to invest additional funds, not to exceed certain annual and aggregate maximum amounts under our credit facility, in the Disney Store business, which might require us to reduce our capital expenditures in The Children's Place business or seek external sources of funds. If we are unable to generate sufficient funds to meet our Disney Store business funding obligations or are unable to obtain funds through external sources, we may be in violation of the License Agreement and the Refurbishment Amendment, in which event Disney may exercise one or more of its rights and remedies, including termination of the License Agreement. If the License Agreement is terminated, Disney may, at its option, require us to sell or wind down the Disney Store business. Upon any exercise of remedies by Disney, our financial position, results of operations and cash flows would be materially adversely impacted. For a more detailed description of the risks involved in a sale or wind down of the Disney Store business, please refer to the previous risk factor of this Form 10-K above.

We expect in the next 12 months that The Children's Place business will need to provide additional capital to the Disney Stores to remain in compliance with the store remodel requirements under the License Agreement as modified by the Refurbishment Amendment.

***If we are unable to reposition Disney Store, our results of operations and cash flows will be adversely impacted.***

A significant portion of our future success involves developing and growing the Disney Store business. The realization of any revenue growth, cost savings or synergies will depend largely upon our ability to:

Remodel and update the current store fleet and successfully operate the stores;

Execute our strategies for Disney Store without adversely impacting the existing The Children's Place business;

Source hardlines merchandise at favorable prices; and

Secure additional merchandise cost reductions from vendors and suppliers.

There can be no assurance that we can successfully operate the Disney Stores in accordance with the terms of the License Agreement, including taking the steps necessary to obtain all required consents and approvals thereunder. In addition, there can be no assurance that we can successfully execute any of the actions above or that our strategies for Disney Store will achieve the results necessary to generate profits. If we cannot successfully execute the Disney Store growth strategy, our results of operations will be adversely impacted.

***Our segregation of working capital and credit facilities could lead to a liquidity need in one business despite adequate liquidity on a consolidated basis.***

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The terms of the License Agreement and/or our credit facilities, among other things, restrict the commingling of funds between The Children's Place and the Disney Store businesses and restrict borrowings and certain distributions among The Children's Place and the Disney Store businesses. Therefore, we segregate all cash receipts and disbursements, investments, credit facility borrowings and letter of credit activity. This segregation could lead to a liquidity need in one business while there is adequate liquidity in the other business, and there is no guarantee that if such a liquidity need were to arise we would have the ability to make the appropriate intercompany distributions. In addition, there can be no guarantee that external funds would be available in a timely manner, at an appropriate cost or in a manner that would meet the requirements of the parties to the License Agreements or our credit facilities. If either of our businesses is unable to generate sufficient funds to meet its own needs and is unable to obtain funds from the other business or through external sources, our financial position, results of operations and cash flows could be materially adversely impacted.

***Restrictions on our Disney Store business to issue dividends to The Children's Place Retail Stores, Inc. could lead to our inability to re-allocate capital on a consolidated basis.***

Hoop cannot pay dividends to The Children's Place Retail Stores, Inc. unless the proposed dividend payment exceeds certain cash flow or net working capital calculations defined in the License Agreement. In addition to

meeting these requirements, any dividend payment requires approval from Hoop's independent directors or a written certification from our CFO certifying to Disney that these conditions have been satisfied. We also are restricted by our lenders from making any dividends from Hoop to The Children's Place, other than to recover the funds we invested in connection with our obligations arising from our acquisition of the DSNA Business or we will invest in connection with the Refurbishment Amendment. Accordingly, even if we satisfy the requirements to make a dividend under the License Agreement, prior to making any such dividend, we may still be required to obtain a waiver from our lenders. Based on these restrictions, we do not foresee Hoop declaring a dividend payment to The Children's Place within the next 12 months for either the recovery of our initial purchase price investment of the DSNA Business or any additional future investments we make in Hoop, including any investments made to support the capital expenditure commitments of Hoop pursuant to the License Agreement, as modified by the Refurbishment Amendment. Therefore, we cannot rely on any of Hoop's capital to fund investments in The Children's Place or in our foreign subsidiaries.

***Because we are not current in our filings with the SEC, our common stock may be delisted from the Nasdaq Global Select Market, in which event we may suffer adverse business consequences.***

As we did not timely file our Quarterly Reports on Form 10-Q for the quarters ended July 29, 2006 and October 28, 2006, our Annual Report on Form 10-K for fiscal 2006, and our Quarterly Reports on Form 10-Q for the quarters ended May 5, 2007 and August 4, 2007 (collectively, the Required Reports), we have been out of compliance with the reporting requirements of the SEC and the Nasdaq Select Market (the "Nasdaq") for more than one year. Although we have now filed this Annual Report on Form 10-K for fiscal 2006 and our Quarterly Reports on Form 10-Q for the second and third quarters of fiscal 2006, we have not yet filed our Quarterly Reports on Form 10-Q for the first and second quarters of fiscal 2007. Consequently, we continue to be in violation of the reporting requirements under the Exchange Act and the Nasdaq listing rules.

We have received various determination letters from the Staff of Nasdaq stating that, because we have not been in compliance with Nasdaq listing requirements, our common stock is subject to delisting. Since September 2006 we have been in contact with the Nasdaq Listing Qualifications Panel, Nasdaq's Listing and Hearing Review Council, and the Board of Directors of the Nasdaq Stock Market LLC (the "Nasdaq Board") regarding our inability to comply with Nasdaq's listing requirements and when we might be able to again become compliant. The last communication we received from Nasdaq on this issue was from the Nasdaq Board on November 9, 2007 stating that we had until January 9, 2008 to file all of the Required Reports in order to regain compliance with Nasdaq's listing requirements. If we have not regained compliance prior to that time, we will need to explain to the Nasdaq Staff the reasons for our inability to do so, in order for the Nasdaq Board to consider whether any further extension is warranted. We still need to file our Quarterly Reports on Form 10-Q for the quarters ended May 5, 2007 and August 4, 2007 before we will have filed all of the Required Reports. There is no assurance that we will be able to meet the January 9, 2008 deadline, and if we do not, there is no assurance that the Nasdaq Board will grant the Company additional time to become compliant. If we fail to come into compliance by January 9, 2008 or any extended deadline approved by Nasdaq, we anticipate that the Company's shares will be delisted from Nasdaq.

If Nasdaq ceases to grant us extensions to file our periodic reports, a delisting of our common stock would have a material adverse effect on us by, among other things:

Reducing the liquidity and market price of our common stock; and

Reducing the number of investors willing to hold or acquire our common stock, thereby restricting our ability to obtain equity financing.

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In addition, Nasdaq listing rules require that all issuers solicit proxies and hold an annual meeting of its shareholders within 12 months of the end of the issuer's fiscal year end. In order for us to comply with this rule, we must hold our annual meeting of shareholders for the fiscal year ended February 3, 2007, no later than February 3, 2008. In addition, we must be current in our SEC filings before we can solicit proxies for such annual meeting of our shareholders. Accordingly, if we are unable to become current in our SEC filings in sufficient time for us to solicit proxies for an annual meeting of our shareholders by February 3, 2008, or if we otherwise fail to hold such meeting by February 3, 2008, the Company's shares could be delisted from Nasdaq.



***Our failure to be current in our filings with the SEC poses other significant risks to our business, each of which could materially and adversely affect our financial condition and results of operations.***

Because of our failure to timely file our periodic reports with the SEC, we are subject to various risks in addition to the possible delisting of our common stock. These additional risks include the following:

A breach of our credit facilities would allow our lenders to declare our outstanding loans due and payable in whole or in part. So far, our lenders have waived these breaches but there can be no assurance that they will grant any additional waivers, if requested;

An inability to make offerings pursuant to existing Form S-8 registration statements covering our employee stock plans. Accordingly, we are restricted in our ability to issue new stock options or other equity awards to our employees and our employees are unable to exercise their outstanding options;

An inability to have a registration statement under the Securities Act of 1933, as amended (the Securities Act), covering a public offering of securities declared effective by the SEC. Therefore, we cannot offer and sell freely tradable securities, which prevents us from accessing the public capital markets, should we desire to do so; and

Our failure to meet our reporting obligations under the Exchange Act is a violation of Section 13(a) of the Exchange Act and could subject us to SEC investigations and enforcement actions, which could result in injunctions and monetary penalties.

Accordingly, our inability to timely file our periodic reports with the SEC could have an adverse impact on our ability to (i) access our credit facilities, (ii) attract and retain key employees, and (iii) raise funds in the public markets, and any of these events could materially and adversely affect our financial condition and results of operations.

In addition, we have lost for at least the next 12 months our status as a well known seasoned issuer, including the registration advantages associated with such status even if we become current with our delinquent filings with the SEC. As a result, we will not be able to register any new shares of our securities on certain short-form registration statements under the Securities Act, such as Forms S-3, until we have filed all reports required under the Exchange Act for a continuous period of 12 months.

***Because the trading price of our common stock has significantly declined over the last year, it is possible that one or more parties may consider seeking to acquire the Company. There is no assurance that any proposal to acquire the Company will be made or that a sale of the Company will occur, nor has our Board determined that a sale of the Company is advisable. In the event that a sale of the Company were to occur, it is likely that following such sale our public stockholders would no longer have the benefits of ownership of our common stock.***

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In light of the significant decline in our stock price over the last 12 months, it is possible that one or more parties may be interested in making an offer to acquire the Company. In particular, our former Chairman and CEO, Ezra Dabah, who is also one of our major stockholders and a member of our Board, publicly stated in a Schedule 13D he filed with the SEC on October 15, 2007 that he is considering the possibility of making an offer, in combination with others, to acquire the Company and that he intends to discuss a possible acquisition of the Company with potential private equity sponsors and strategic buyers. While the Company may be approached by other parties in addition to Mr. Dabah, there can be no assurance that any proposal to acquire the Company will be made by Mr. Dabah or any other party or as to the terms of any such proposal that may be made. At this time, our Board has not made any determination to seek offers for the sale of the Company. However, consistent with its fiduciary duties, our Board has engaged an investment banking firm to act as its financial advisor in undertaking a review of strategic alternatives to improve operations and enhance shareholder value. As part of this review, our Board and management are assessing a wide variety of options to improve our business, including, but not limited to, opportunities for organizational and operational improvement, a possible recapitalization, or other transactions. The Board has not set any specific timeline for the completion of this strategic review, and there is no assurance that, as a result of this review, the Board will decide to change the Company's course of action or engage in any specific transaction.

In the event that Mr. Dabah, either acting alone or in combination with others, or any other party were to make an offer to acquire the Company, the analysis and any negotiations relating to any such offer will likely require substantial time and attention of the Company's Board and senior management that could distract them from focusing on the Company's business, as well as result in significant expense to the Company. Mr. Dabah has stated that he may commence a proxy fight to elect one or more directors to our Board. Any actions that may be taken by Mr. Dabah could require time and attention of our management and may involve significant expense on the part of the Company.

In the event that a sale of the Company were to occur, this could constitute a going private transaction, following which we would become a private company whose common stock would no longer be publicly traded, and we would no longer be subject to the periodic reporting requirements of the Exchange Act. If this were to occur, our current public stockholders would be selling their shares and would no longer have an opportunity to benefit from any future appreciation in the value of our stock or any of the other benefits of ownership of our common stock.

***We have identified material weaknesses in our internal control over financial reporting as of February 3, 2007 that, if not remedied effectively, could result in a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis in future periods.***

Our management is responsible for establishing and maintaining adequate internal control over our financial reporting, as defined in Rules 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Our management evaluated the design and effectiveness of our internal control over financial reporting as of February 3, 2007 and identified three material weaknesses. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. As a result of the following three material weaknesses, management has concluded that our internal control over financial reporting was not effective as of February 3, 2007:

In connection with its internal investigation of option granting practices, the Company found that it did not maintain appropriate governance and other internal controls relating to its option grants. Management has determined that the lack of adequate controls over the granting of stock options and the related documentation constituted a material weakness, which resulted in the use of incorrect accounting measurement dates for certain stock option grants and related errors in recording compensation expense of \$11.2 million between fiscal 1998 and the first quarter of fiscal 2006.

Our evaluation concluded that, although policies and procedures appropriate for a strong control environment were designed and in large part instituted, the Company has not been successful in ensuring overall adherence to them to the degree necessary for maintenance of a fully effective control environment. Management specifically considered the deficiencies in the Company's stock option granting practices discussed above, violations during fiscal 2006 of the Code of Business Conduct by two members of senior management, and certain other deficiencies noted in adherence during the year to good control practices by certain members of senior management, in reaching its conclusion that collectively, the problems found in these areas reflected a material weakness in our internal control environment.

Due to lack of resources and the diversion of resources to the stock option investigation and the resulting restatement of our financial statements, the Company did not maintain effective controls over the period-end financial

close and reporting processes. As a result, the Company identified a number of adjustments to its 2006 financial statements after their normal release date. Due to the potential effect on financial statement balances and disclosures, and the importance of the financial closing and reporting processes, management has concluded that, in the aggregate, these deficiencies result in a material weakness in the Company's financial close and reporting process.

For further information about these material weaknesses, please see Item 9A. Controls and Procedures included elsewhere in this Annual Report on Form 10-K. Because of these material weaknesses, management concluded that, as of February 3, 2007, our internal control over financial reporting was not effective.

We have implemented and continue to implement a number of remedial measures designed to address the material weaknesses identified as of February 3, 2007. If these remedial initiatives are insufficient to address the identified material weaknesses, or if additional material weaknesses or significant deficiencies in our internal control are discovered in the future, we may fail to meet our future reporting obligations on a timely basis, our financial statements may contain material misstatements, our operating results may be harmed, and we may be subject to litigation. Any failure to address the identified material weaknesses or any additional material weaknesses or significant deficiencies in our internal control could also adversely affect the results of future management evaluations regarding the effectiveness of our internal control over financial reporting that are required under Section 404 of the Sarbanes-Oxley Act of 2002. Internal control deficiencies could also cause investors to lose confidence in our reported financial information.

***We have experienced deterioration in our sales and profitability. If we are unable to anticipate and respond to merchandise trends, we may continue to suffer adverse business consequences, including loss of revenue.***

We have experienced deterioration in our sales and profitability. Our continued success will depend in part on our ability to anticipate and respond to fashion trends and consumer preferences. Our design, manufacturing and distribution process generally takes up to one year, during which time fashion trends and consumer preferences may change. Failure to anticipate, identify or respond to future fashion trends may continue to adversely affect customer acceptance of our products or require substantial markdowns, which could continue to have a material adverse effect on our business.

Management and the Board are in the process of assessing the business and are re-evaluating its inventory strategy. Steps are being taken to reduce inventory levels where possible. Given the Company's merchandise buying lead times, it will likely take several quarters to make adjustments to the extent they are necessary.

***Changes in comparable store sales results from period to period could have a material adverse effect on the market price of our common stock.***

Numerous factors affect our comparable store sales results, including, among others, merchandise assortment, retail prices, fashion trends, weather conditions, macro-economic conditions, the retail sales environment and our success in executing our business strategy. During fiscal 2006, we reported a comparable store sales increase of 11%, on top of a 9% comparable store sales increase achieved during fiscal 2005. Our monthly comparable store sales results have fluctuated significantly in the past and we anticipate that our monthly comparable store sales will continue to fluctuate in the future. Moreover, comparable store sales for any particular period may decrease in the future. Further, Disney Stores comparable stores sales results may be more volatile than those of The Children's Place given one time events that occur from year to year such as major theatrical movie or DVD releases. The investment community often follows comparable store sales results closely and significant fluctuations in these results may affect the price of our common stock. Any variations in our comparable store sales results could have a material adverse effect on the market price of our common stock.

***The recent resignation of Ezra Dabah as our CEO, or the future loss of one or more of our other key personnel could have a material adverse effect on our business.***

The leadership and expertise of Ezra Dabah, our former CEO, and his unique relationships with the Company's manufacturers and independent buying agents have been instrumental in our success. His recent resignation as CEO could have a material adverse effect on our supply chain and business. Many of the Company's executives were recruited by Mr. Dabah and of them, two executive officers have employment agreements that provide that Mr. Dabah's departure constitutes a good reason for such executive officers to terminate their employment agreements with us. Accordingly, Mr. Dabah's departure may make it difficult to retain these executives.

Other members of management have substantial experience and expertise in our business and have made significant contributions to its growth and success. Most of these members of management do not have employment agreements with us. The loss of services of one or more of these individuals, or the inability to attract additional qualified managers or other personnel, could have a material adverse effect on our business. We are not protected by any key-man or similar life insurance for any of our executive officers.

*If we are unable to maintain profitable growth, our future operating results and cash flows will be adversely impacted.*

Our future operating results will depend largely upon our ability to manage a larger business profitably and open and operate new stores successfully. We anticipate opening approximately 80 stores during fiscal 2007, which will include approximately 60 The Children's Place stores and approximately 15 Disney Stores. Our ability to open and

operate new stores successfully depends on many factors, including, among others, the availability of suitable store locations, the ability to negotiate acceptable lease terms, the ability to timely complete necessary construction, the ability to successfully integrate new stores into our existing operations, the ability to hire and train store personnel and the ability to recognize and respond to regional and climate-related differences in customer preferences.

We cannot assure you that we will achieve our planned expansion on a timely and profitable basis or that we will be able to achieve results similar to those achieved in existing locations in prior periods. In fiscal 2006, our total store base grew by 7% compared to 6% during fiscal 2005, and is anticipated to grow at approximately the same rate in fiscal 2007. Operating margins may also be adversely affected during periods in which we have incurred expenses in anticipation of new store openings. We may not be able to sustain the new store return on investment we experienced in fiscal 2006 of approximately 87% for The Children's Place brand and 62% for Disney Store.

We define return on investment as store level operating cash flow for new stores divided by new store investment. Store level operating cash flow for new stores is comprised of direct store contribution before the amortization of deferred rent and depreciation and amortization expense. We believe new store return on investment is a relevant measurement for assessing performance, because it shows how quickly our investment in new stores becomes available for reinvestment. However, it is not a measure determined in accordance with U.S. GAAP and should not be considered by investors as an alternative to operating income or net income as an indicator of our performance. The new store return on investment disclosed here is not necessarily comparable to new store return on investment disclosed by other companies because new store return on investment is not uniformly defined.

Furthermore, we need to continually evaluate the adequacy of our store management and our information and distribution systems to manage our planned expansion. Any failure to successfully and profitably execute our expansion plans could have a material adverse effect on our business.

We believe that cash on hand, cash generated from operations and funds available under our credit facilities will be sufficient to fund our capital and other cash flow requirements for our business for at least the next 12 months. However, it is possible that we may be required to seek additional funds for our capital and other cash flow needs if we are not able to generate sufficient cash flows, and we cannot assure you that we will be able to obtain such funds on terms favorable to us or at all.

***The success of our Disney Store business largely depends on The Walt Disney Company character franchise and brand; and any events that negatively impact the consumers' perception of Disney could hurt our future operating results and cash flows.***

The Disney Store business is driven largely by customers' interests in apparel, toys and other products featuring Disney characters. New characters featured prominently in movies, television and DVDs and national marketing campaigns heighten consumers' interests and in-store traffic. While traditional licensed properties such as Mickey & Friends, the Pooh Family and Disney Princess may sustain store sales throughout the year, new characters enthrall young children and lead to increased customer traffic. Our ability to grow the Disney Store business is thus dependent on Disney's ability to continue to create new and likable characters.

The Disney Store business is strongly aligned with the Disney brand, the maintenance and cultivation of which is outside of our control. The Disney Store business is subject to certain risks because it relies heavily on the strong brand identification of the Disney logo, the beloved nature of the Disney characters and the Disney brand name. All of the products within the Disney Store are intrinsically tied to consumers' image of the Disney brand. While the Disney brand is among the world's most recognized and highly regarded brands, it is subject to changes in public opinion and ever changing consumer preferences. If unfavorable events occur that negatively impact the consumers' perception of Disney or the Disney brand/logo, our future results of operation and financial condition could be adversely affected.

*Our future operating results and cash flows could be adversely affected by pending litigation commenced by our shareholders.*

On January 17, 2007, a stockholder derivative action was filed against certain current members of the Board and certain current and former senior executives in the United States District Court, District of New Jersey. The Company has been named as a nominal defendant. The complaint alleges, among other things, that certain of the Company's



current and former officers and directors (i) breached their fiduciary duties to the Company and its stockholders and were unjustly enriched by improperly backdating certain grants of stock options to officers and directors of the Company, (ii) caused the Company to file false and misleading reports with the SEC, (iii) violated the Exchange Act and common law, (iv) caused the Company to issue false and misleading public statements, and (v) were negligent and abdicated their responsibilities to the Company and its stockholders. The complaint seeks money damages from the defendants, an accounting for the proceeds of sales of any allegedly backdated stock options, and the costs and disbursements of the lawsuit, as well as equitable relief. The defendants have moved to dismiss the action, and on or about June 15, 2007, the plaintiff filed an amended complaint adding, among other things, a claim for securities fraud under SEC rule 10b-5.

On September 21, 2007 a second stockholder class action was filed against the Company and certain current and former senior executives in the United States District Court, Southern District of New York. This complaint alleges, among other things, that certain of the Company's current and former officers made statements to the investing public which misrepresented material facts about the business and operations of the Company, or omitted to state material facts required in order for the statements made by them not to be misleading, causing the price of the Company's stock to be artificially inflated in violation of provisions of the Exchange Act, as amended. It alleges that more recent disclosures establish the misleading nature of these earlier disclosures. The complaint seeks money damages plus interest as well as costs and disbursements of the lawsuit. The Company intends to vigorously contest these allegations and the claims made.

On October 10, 2007, a third stockholder class action was filed in the United States District Court, Southern District of New York, against the Company and certain of its current and former senior executives. This complaint alleges, among other things, that certain of the Company's current and former officers made statements to the investing public which misrepresented material facts about the business and operations of the Company, or omitted to state material facts required in order for the statements made by them not to be misleading, thereby causing the price of the Company's stock to be artificially inflated in violation of provisions of the Exchange Act, as amended. According to this complaint, more recent disclosures establish the misleading nature of these earlier disclosures. This complaint seeks, among other relief, class certification of the lawsuit, compensatory damages plus interest, and costs and expenses of the lawsuit, including counsel and expert fees.

The outcome of the above litigations is uncertain; while we believe there are valid defenses to the claims and we will defend ourselves vigorously, no assurance can be given as to the outcome of these matters. Additionally, the above complaints and resulting litigation and other litigations could distract our management and directors from the Company's affairs, the costs and expenses of the litigation could unfavorably affect our net earnings and an unfavorable outcome could adversely affect the reputation of the Company.

***An unfavorable result from the informal investigation of the SEC and the U.S. Attorney for the District of New Jersey into our historic stock option granting practices could lead to regulatory or criminal fines and penalties, adverse publicity, and other negative consequences.***

The Division of Enforcement of the SEC is conducting an informal investigation into the Company's historic stock option practices, as is the Office of the U.S. Attorney for the District of New Jersey. We have cooperated with these investigations and have briefed both authorities on the results of the Special Committee's investigation. There have been no developments in these matters since that time. We cannot provide assurance that the Company will not be subject to adverse publicity, regulatory or criminal fines or penalties, as well as other sanctions or other contingent liabilities or adverse customer reactions in connection with this matter.

***Because we use foreign manufacturers, an unaffiliated manufacturer's failure to comply with acceptable labor practices could have an adverse effect on our business.***

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Our business is subject to the risks generally associated with purchasing from foreign countries, particularly China, from where approximately 50% of our merchandise is imported. Some of these risks are foreign governmental regulations, political instability, currency and exchange risks, quotas on the amounts and types of merchandise which may be imported into the United States and Canada from other countries, pressures from non-governmental organizations, disruptions or delays in shipments and changes in economic conditions in countries in which our manufacturing sources are located. We cannot predict the effect that such factors will have on our business

arrangements with foreign manufacturing sources. If any of these factors rendered the conduct of business in a particular country undesirable or impractical, or if our current foreign manufacturing sources ceased doing business with us for any reason, our business could be materially adversely affected. Our business is also subject to the risks associated with changes in U.S. and Canadian legislation and regulations relating to imported apparel products, including quotas, duties, taxes and other charges or restrictions on imported apparel. Such changes or other changes or restrictions with regard to China could have a material adverse impact on our business. We cannot predict whether such changes or other charges or restrictions will be imposed upon the importation of our products in the future.

We require our independent manufacturers to operate in compliance with applicable laws and our internal requirements, some of which are mandated by our License Agreement. While our purchasing guidelines promote ethical business practices, we do not control these manufacturers or their labor practices. Any violation of labor or other laws by one of the independent manufacturers we use or any divergence of an independent manufacturer's labor practices from standards mandated by our License Agreement or those generally accepted as ethical in the United States and Canada could have a material adverse effect on our business.

***Since a portion of our available cash is located in foreign jurisdictions, if we need such cash to fund domestic needs we may not be able to do so on favorable terms.***

We manage our cash and liquidity within each business according to the country and currency of operations. Because a portion of our cash balances and working capital is located in foreign jurisdictions, we could have a liquidity issue in one country while adequate liquidity exists in other countries. If such a liquidity need were to arise in our domestic operations, there is no guarantee that we would have the ability to make the appropriate intercompany transfer from our foreign subsidiaries on favorable terms and our financial position, results of operations and cash flows could be materially adversely impacted.

***Because we operate in foreign countries, some of our revenues are subject to foreign economic risks.***

We have operations in Canada and Puerto Rico. We cannot assure you that we will be able to address in a timely manner the risks of operating stores in foreign countries such as governmental requirements over merchandise importation, employment, taxation and multi-lingual requirements.

***Because we operate in foreign countries, some of our product costs and other expenses are subject to foreign currency fluctuations.***

While our business is primarily conducted in U.S. dollars, we purchase substantially all of our products overseas, and the cost of these products may be affected by changes in the values of the relevant currencies. To date, we have not significantly hedged against foreign currency fluctuations; however, we may pursue hedging alternatives in the future. Foreign currency fluctuations could have a material adverse effect on our business and results of operations.

***Disruptions in receiving and distribution could have a material adverse effect on our business.***

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Our merchandise is shipped directly from manufacturers through freight consolidators to our distribution and fulfillment centers. Our operating results depend in large part on the orderly operation of our receiving and distribution process, which depends on manufacturers' adherence to shipping schedules and our effective management of our distribution facilities and capacity. Furthermore, it is possible that events beyond our control, such as a military action, strike, natural disaster or other disruption, could result in delays in delivery of merchandise to our stores. Any such event could have a material adverse effect on our business.

*We face significant competition in the retail industry, which could impact our ability to compete successfully against existing or future competition.*

The children's apparel, toy and media retail markets are highly competitive. We compete in substantially all of our markets with GapKids, babyGap and Old Navy (each of which is a division of The Gap, Inc.); The Gymboree Corporation; Too, Inc.; Babies 'R' Us and Toys 'R' Us (each of which is a division of Toys 'R' Us, Inc.); J.C. Penney Company, Inc.; Sears (a division of Sears Holdings Corporation); Kohls and other department stores, as well as discount stores such as Wal-Mart Stores, Inc.; Target Corporation; and K-Mart (a division of Sears Holdings

Corporation). In addition, the Company's new store-within-a-store shoe store will compete with well-known national retailers such as Stride Rite and Payless as well as smaller shoe retailers. We also compete with a wide variety of specialty stores, other national and regional retail chains, catalog companies and Internet retailers. In our Disney Store business, we compete with the Disney theme parks and with third parties selling Disney-branded merchandise under license. In addition, media items such as compact discs and DVDs can be purchased in virtually every retail channel. One or more of our competitors are present in substantially all of the areas in which we have stores. Many of our competitors are larger than us and have access to significantly greater financial, marketing and other resources than we have. We cannot assure you that we will be able to continue to compete successfully against existing or future competition.

***We depend on our relationships with unaffiliated manufacturers and independent agents.***

We do not own or operate any manufacturing facilities, and therefore, are dependent upon independent third parties for the manufacture of all of our products. Our products are currently manufactured to our specifications, pursuant to purchase orders, by approximately 400 independent manufacturers located primarily in Asia. In addition, in fiscal 2006, we sourced approximately 50% of our merchandise from China. We have no exclusive or long-term contracts with our manufacturers and compete with other companies for manufacturing facilities. In addition, we have no formal written agreement with a Hong Kong-based trading company through which we purchased approximately 15% of our products in fiscal 2006. We purchase merchandise through a Hong Kong-based trading company using negotiated purchase orders. We also purchased approximately 15% of our products in fiscal 2006 through the support of a single agent in Taiwan, which has an exclusive arrangement with us, but is not obligated to sell exclusively to us. Although we believe that we have established close relationships with our trading company, independent agents and principal manufacturers, the inability to maintain such relationships or to find additional sources to support future growth could have a material adverse effect on our business.

***A material disruption in our information technology systems could adversely affect our business or results of operations and cash flows.***

We rely on various information systems to manage our operations and regularly make investments to upgrade, enhance or replace such systems. Any delays or difficulties in transitioning to these or other new systems, or in integrating these systems with our current systems, or any other disruptions affecting our information systems, could have a material adverse effect on our business.

***Our ability to discourage, delay or prevent a takeover attempt could reduce the market value of our common stock.***

Certain provisions of our Amended and Restated Certificate of Incorporation (the "Certificate of Incorporation") and Amended and Restated By-laws (the "By-laws") may have anti-takeover effects and discourage, delay or prevent a takeover attempt that a stockholder might consider in the stockholder's best interest. These provisions, among other things:

Classify our Board into three classes, each of which will serve for different three year periods;

Provide that only the Chairman of the Board may call special meetings of the stockholders;

Provide that a director may be removed by stockholders only for cause by a vote of the holders of more than two-thirds of the shares entitled to vote;

Provide that all vacancies on our Board, including any vacancies resulting from an increase in the number of directors, may be filled by a majority of the remaining directors, even if the number is less than a quorum;

Establish certain advance notice procedures for nominations of candidates for election as directors and for stockholder proposals to be considered at stockholders' meetings; and

Require a vote of the holders of more than three quarters of the shares entitled to vote in order to amend the foregoing provisions and certain other provisions of the Certificate of Incorporation and By-laws.

In addition, the Board, without further action of the stockholders, is permitted to issue and fix the terms of preferred stock, which may have rights senior to those of the common stock. Moreover, we are subject to the

provisions of Section 203 of the Delaware General Corporation Law, as amended, which would require a two-thirds vote of stockholders for any business combination (such as a merger or sales of all or substantially all of our assets) between The Children's Place Retail Stores, Inc. and an interested stockholder, unless such transaction is approved by a majority of the disinterested directors or meets certain other requirements. In certain circumstances, the existence of these provisions, which inhibit or discourage takeover attempts, could reduce the market value of our common stock.

***We are sensitive to economic, regional and other business conditions, which could adversely affect our future operating results and cash flows.***

Our business is sensitive to customers' spending patterns which are subject to prevailing regional and national economic conditions such as consumer confidence, recession, interest rates, energy prices and taxation. We are, and will continue to be, susceptible to changes in national and regional economic conditions, weather conditions, demographics, hourly wage legislation, consumer preferences and other regional factors.

***Recalls and post-manufacture repairs of our products and/or product liability claims against our products could harm our reputation, increase costs or reduce sales.***

We are subject to regulation by the Consumer Product Safety Commission and similar state and international regulatory authorities, and our products could be subject to involuntary recalls and other actions by these authorities. Concerns about product safety, including but not limited to concerns about those manufactured in developing countries, where substantially all of our merchandise is manufactured, may lead us to recall selected products, either voluntarily, or at the direction of Disney or a governmental authority. Product safety concerns, recalls, defects or errors could result in the rejection of our products by customers, damage to our reputation, lost sales, product liability litigation and increased costs, any of which could harm our business.

***A privacy breach could adversely affect our business.***

The protection of customer, employee, and company data is critical. The regulatory environment surrounding information security and privacy is demanding, with the frequent imposition of new and changing requirements. In addition, customers have a high expectation that we will adequately protect their personal information. A significant breach of customer, employee, or company data could damage our reputation and result in lost sales, fines, or lawsuits.

***Our profitability could be adversely affected if we are unable to successfully negotiate favorable lease terms.***

We generally lease our stores for an initial term of ten years. Our operating results and cash flows could be adversely affected if we are unable to continue to negotiate favorable lease and renewal terms.

***Because of conditions impacting our quarterly results of operations, including seasonality and other factors, our quarterly results fluctuate.***

As is the case with many retailers, we experience seasonal fluctuations in our net sales and net income. Our net sales and net income are generally weakest during the first two fiscal quarters, and are lower during the second fiscal quarter than during the first fiscal quarter. For example, in fiscal 2006, 21%, 20%, 27% and 32% of our consolidated net sales occurred in the first, second, third and fourth quarters, respectively. In fiscal 2006 and fiscal 2007, we experienced second quarter losses. It is likely that we will continue to experience second quarter losses in future periods. It is also possible that we could experience losses in other quarters. Our first quarter results are heavily dependent upon sales during the period leading up to the Easter holiday. Our third quarter results are heavily dependent upon back-to-school sales at The Children's Place and upon Halloween sales at Disney Store. Our fourth quarter results are heavily dependent upon sales during the holiday season. Weak sales during any of these periods could have a material adverse effect on our business.

Our quarterly results of operations may also fluctuate significantly from quarter to quarter as a result of a variety of other factors, including overall macro-economic conditions, the timing of new store openings and related pre-opening and other start-up costs, net sales contributed by new stores, increases or decreases in comparable store sales,



weather conditions, shifts in the timing of certain holidays, changes in our merchandise mix and pricing strategy. Any failure by us to meet our business plans for, in particular, the third and fourth quarter of any fiscal year would have a material adverse effect on our earnings, which in all likelihood would not be offset by satisfactory results achieved in other quarters of the same fiscal year. In addition, because our expense levels are based in part on expectations of future sales levels, a shortfall in expected sales could result in a disproportionate decrease in our net income.

*Certain stockholders have significant influence over determining the outcome of matters submitted to a stockholder vote.*

Ezra Dabah, our former CEO and a current member of our Board, and Stanley Silverstein, who is also a member of our Board, and certain members of their families beneficially own a significant percentage of our outstanding common stock. As a result, Mr. Dabah and Mr. Silverstein have, and will continue to have, significant influence on the election of our directors and on determining the outcome of any matter submitted to a vote of our stockholders for approval.

*The volatility of our stock price could adversely affect the market price of our common stock.*

Our common stock, which is quoted on the Nasdaq Global Select Market, has experienced and is likely to experience significant price and volume fluctuations, which could adversely affect the market price of the common stock without regard to our operating performance. In addition, we believe that factors such as quarterly fluctuations in our financial results, our comparable store sales results, announcements by other retailers or Disney, the overall economy, the geopolitical environment and the condition of the financial markets could cause the price of our common stock to fluctuate substantially.

*Legislative actions and new accounting pronouncements could result in us having to increase our administrative expenses to remain compliant.*

In order to comply with the Sarbanes-Oxley Act of 2002 and any subsequent guidance that may come from the Public Company Accounting Oversight Board ( PCAOB ), future changes in listing standards by Nasdaq, or future accounting guidance or disclosure requirements by the SEC, we may be required to enhance our internal controls, hire additional personnel and utilize additional outside legal, accounting and advisory services, all of which could cause our general and administrative expenses to increase. Proposed changes in the accounting rules, including legislative and other proposals could increase the expenses we report under U.S. GAAP and affect our operating results.

*Any terrorist act that impacts consumer shopping could have a material adverse effect on our business.*

We are dependent upon the continued popularity of malls as shopping destinations and the ability of mall anchor tenants and other attractions to generate customer traffic in the malls where our stores are located. Any terrorist act that decreases the level of mall traffic or other shopping traffic could have a material adverse effect on our business. In addition, military actions could negatively impact mall traffic, which would have a material adverse effect on our business.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

We currently support both The Children's Place stores and Disney Stores with a leased 525,000 square foot distribution center in South Brunswick Township, New Jersey; a leased 250,000 square foot distribution center in Ontario, California; a leased 95,000 square foot distribution center in Ontario, Canada; and an owned 700,000 square foot distribution center in Ft. Payne, Alabama, which we opened in August 2007 to support projected growth at both brands. Our distribution centers utilize automated warehouse systems, which employ radio frequency technology and automated conveyor systems. In addition, we lease our approximately 150,000 square foot fulfillment center in Secaucus, New Jersey to support our Internet business. We operate our headquarters in Secaucus, New Jersey and Pasadena, California, as well as other leased facilities to support warehousing and administrative office needs. We

also lease offices in Hong Kong, Shanghai and New Delhi to capitalize on new and existing sourcing opportunities and monitor product quality. In addition, we entered into a lease agreement for approximately 283,000 square feet of office space in Secaucus, New Jersey near our current corporate headquarters, and we plan to move our corporate headquarters into this space in fiscal 2009 after we complete its design and construction.

We lease all of our existing store locations, with the store lease terms expiring through 2023. The average unexpired store lease term for The Children's Place and Disney Store is 4.9 and 5.0 years, respectively. The leases for most of our existing stores are for initial terms of 10 years and provide for contingent rent based upon a percentage of sales in excess of specific minimums. Leases for future stores will likely include similar contingent rent provisions.

### **ITEM 3. LEGAL PROCEEDINGS**



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On September 29, 2006, the Division of Enforcement of the SEC informed us that it had initiated an informal investigation into our stock option granting practices. In addition, the Office of the U.S. Attorney for the District of New Jersey advised us that it had commenced an investigation into the same matter. We have cooperated with these investigations and have briefed both authorities on the results of the Special Committee's investigation. There have been no developments in these matters since that time.

On January 17, 2007, a stockholder derivative action was filed in the United States District Court, District of New Jersey against certain current members of our Board and certain current and former senior executives. The Company has been named as a nominal defendant. The complaint alleges, among other things, that certain of our current and former officers and directors (i) breached their fiduciary duties to the Company and its stockholders and were unjustly enriched by improperly backdating certain grants of stock options to officers and directors of the Company, (ii) caused the Company to file false and misleading reports with the SEC, (iii) violated the Exchange Act and common law, (iv) caused the Company to issue false and misleading public statements, and (v) were negligent and abdicated their responsibilities to the Company and its stockholders. The complaint seeks money damages from the defendants, an accounting for the proceeds of sales of any allegedly backdated stock options, and the costs and disbursements of the lawsuit, as well as equitable relief. The defendants have moved to dismiss the action, and on or about June 15, 2007, the plaintiff filed an amended complaint adding, among other things, a claim for securities fraud under SEC rule 10b-5.

On September 21, 2007 a second stockholder class action was filed in the United States District Court, Southern District of New York against the Company and certain current and former senior executives. The complaint alleges, among other things, that certain of the Company's current and former officers made statements to the investing public which misrepresented material facts about the business and operations of the Company, or omitted to state material facts required in order for the statements made by them not to be misleading, causing the price of the Company's stock to be artificially inflated in violation of provisions of the Exchange Act, as amended. It alleges that more recent disclosures establish the misleading nature of these earlier disclosures. The complaint seeks money damages plus interest as well as costs and disbursements of the lawsuit.

On October 10, 2007, a third stockholder class action was filed in the United States District Court, Southern District of New York, against the Company and certain of its current and former senior executives. The complaint alleges, among other things, that certain of the Company's current and former officers made statements to the investing public which misrepresented material facts about the business and operations of the Company, or omitted to state material facts required in order for the statements made by them not to be misleading, thereby causing the price of the Company's stock to be artificially inflated in violation of provisions of the Exchange Act, as amended. According to the complaint, more recent disclosures establish the misleading nature of these earlier disclosures. The complaint seeks, among other relief, class certification of the lawsuit, compensatory damages plus interest, and costs and expenses of the lawsuit, including counsel and expert fees.

The outcome of these three stockholder litigations is uncertain; while we believe there are valid defenses to the claims and we will defend ourselves vigorously, no assurance can be given as to the outcome of these matters. The litigations could distract our management and directors from the Company's affairs, the costs and expenses of the litigations could unfavorably affect our net earnings and an unfavorable outcome could adversely affect the reputation of the Company.

On or about February 15, 2005, Michael Scott Smith, a former co-sales manager for The Children's Place in the San Diego district, filed a lawsuit against the Company in the Superior Court of California, County of Los Angeles. The lawsuit alleges violations of the California Labor Code and California Business and Professions Code and seeks class action on behalf of Mr. Smith and other individuals similarly situated. On October 19, 2007, the Company entered into a class action settlement with the plaintiff's counsel and signed a memorandum of understanding providing for, among other things, a maximum total payment of \$2.1 million, inclusive of attorneys' fees, costs and expenses, service payments to the class representative and administration costs, in exchange for a full release of all claims and dismissal of the lawsuit. The court granted preliminary approval of the settlement on November 29, 2007. The settlement was recorded in the thirteen weeks ended July 29, 2006.

On or about July 12, 2006, Joy Fong, a former Disney Store manager in the San Francisco district, filed a lawsuit against the Company in the Superior Court of California, County of Los Angeles. The lawsuit alleges violations of the California Labor Code and California Business and Professions Code and seeks class action status on behalf of Ms. Fong and other individuals similarly situated. We filed our answer on August 11, 2006 denying any and all liability, and on January 14, 2007, Ms. Fong filed an amended complaint, adding a subsidiary of Disney as a defendant. We believe we have meritorious defenses to the claims. The outcome of this litigation is uncertain; while we believe there are valid defenses to the claims and will defend ourselves vigorously, we cannot reasonably estimate the amount of loss or range of loss that might be incurred as a result of this matter.

On or about September 28, 2007, Meghan Ruggiero filed a complaint against the Company and its subsidiary, Hoop Retail Stores, LLC, in the United States District Court, Northern District of Ohio on behalf of herself and other similarly situated individuals. The lawsuit alleges violations of the Fair and Accurate Credit Transactions Act ( FACTA ) and seeks class certification, an award of statutory and punitive damages, attorneys' fees and costs, and injunctive relief. The outcome of this litigation is uncertain; while we believe there are valid defenses to the claims and will defend ourselves vigorously, we cannot reasonably estimate the amount of loss or range of loss that might be incurred as a result of this matter.

In addition, we are involved in various legal proceedings arising in the normal course of our business. In the opinion of management, based on the claims asserted at this time, it is unlikely that any ultimate liability arising out of such proceedings will have a material adverse effect on our business.

#### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**





None.

**PART II**



**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**



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Our common stock is listed on the Nasdaq under the symbol PLCE. The following table sets forth the range of high and low sales prices on the Nasdaq of our common stock for the fiscal periods indicated.

	High	Low
<b>2006</b>		
First Quarter	\$ 62.98	\$ 42.33
Second Quarter	67.70	51.67
Third Quarter	71.37	53.45
Fourth Quarter	71.81	52.16
<b>2005</b>		
First Quarter	\$ 49.15	\$ 36.60
Second Quarter	52.94	37.14
Third Quarter	49.46	33.22
Fourth Quarter	54.64	41.16

On February 3, 2007, the last reported sale price of our common stock was \$58.31 per share, the number of holders of record of our common stock was approximately 105 and the number of beneficial holders of our common stock was approximately 14,000.

On November 3, 2007, the last reported sale price of common stock was \$23.87 per share.

We have never paid dividends on our common stock or purchased any of our common stock. Our Board presently intends to retain any future earnings to finance our operations and the expansion of the Company. Our credit facilities and/or License Agreement prohibit or limit significantly any payment of dividends and limit the amount of purchases of our common stock. Any determination in the future to pay dividends or purchase any of our common stock will depend upon our earnings, financial condition, cash requirements, future prospects, covenants in our credit facilities and any future debt instruments and such other factors as the Board deems appropriate at the time.

**Performance Graph**

The following graph compares the cumulative stockholder return on our common stock with the return on the Total Return Index for the Nasdaq Stock Market (U.S.) and the Nasdaq Retail Trade Stocks. The graph assumes that \$100 was invested on February 1, 2002.

DATE	THE CHILDREN S PLACE - PLCE	NASDAQ	RETAIL
2/1/2002	100.000	100.000	100.000
1/31/2003	33.417	69.754	81.321
1/30/2004	84.295	108.563	119.229
1/28/2005	115.987	107.392	142.791
1/27/2006	141.348	122.314	154.850
2/2/2007	182.790	131.843	170.138

**ITEM 6. SELECTED FINANCIAL DATA**

The following table sets forth certain historical financial and operating data for The Children's Place Retail Stores, Inc. and subsidiaries. The selected historical financial data is qualified by reference to, and should be read in conjunction with, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, and the financial statements and notes thereto included elsewhere in this report. The information presented reflects the restatement of our financial results which is more fully described in the Explanatory Note immediately preceding Part I, Item 1 and Note 2 Restatement of Consolidated Financial Statements in the Notes to Consolidated Financial Statements in this Annual Report on Form 10-K.

Statement of Operations Data (in thousands, except per share data):	Fiscal Year Ended (1)				
	February 3, 2007	January 28, 2006(2) (As restated)	January 29, 2005(2)(3) (As restated)	January 31, 2004(2) (As restated)	February 1, 2003(2) (As restated)
Net sales	\$ 2,017,713	\$ 1,668,736	\$ 1,157,548	\$ 797,938	\$ 671,409
Cost of sales (exclusive of depreciation shown separately below)	1,189,300	1,008,722	705,422	476,884	415,657
Gross profit	828,413	660,014	452,126	321,054	255,752
Selling, general and administrative expenses	626,251	513,994	336,610	238,177	201,224
Asset impairment charges(4)	17,066	244	164	448	4,539
Depreciation and amortization	65,701	52,886	49,049	46,251	41,012
Operating income	119,395	92,890	66,303	36,178	8,977
Interest income (expense), net	3,933	563	(22)	255	547
Income before income taxes and extraordinary gain	123,328	93,453	66,281	36,433	9,524
Provision for income taxes	35,938	35,149	25,905	13,851	4,025
Income before extraordinary gain	87,390	58,304	40,376	22,582	5,499
Extraordinary gain, net of taxes(5)		1,665	273		
Net income	\$ 87,390	\$ 59,969	\$ 40,649	\$ 22,582	\$ 5,499
Diluted net income per common share before extraordinary gain	\$ 2.92	\$ 2.03	\$ 1.47	\$ 0.84	\$ 0.20
Extraordinary gain, net of taxes(5)		0.06	0.01		
Diluted net income per common share	\$ 2.92	\$ 2.09	\$ 1.48	\$ 0.84	\$ 0.20
Diluted weighted average common shares and common share equivalents outstanding as restated	29,907	28,687	27,545	27,042	26,889
<b>Selected Operating Data:</b>					
Number of stores open at end of period	1,194	1,119	1,056	691	643
Comparable store sales increase (decrease)(3)(6)	11%	9%	16%	4%	(16)%
Average net sales per store (3)(7)	\$ 1,707	\$ 1,501	\$ 1,344	\$ 1,159	\$ 1,137
Average square footage per store(8)	4,590	4,562	4,591	4,472	4,398
Average net sales per gross square foot(3)(9)	\$ 372	\$ 329	\$ 300	\$ 262	\$ 263
<b>Balance Sheet Data (in thousands) (as restated):</b>					
Working capital(10)	\$ 283,749	\$ 230,038	\$ 178,956	\$ 116,589	\$ 81,064
Total assets	939,486	764,048	617,844	415,548	361,508
Long-term debt					
Stockholders' equity	521,787	395,650	303,124	248,182	219,428





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(1) All references to our fiscal years refer to the 52- or 53-week year ended on the Saturday nearest to January 31 of the following year. For example, references to fiscal 2006 mean the fiscal year ended February 3, 2007. Fiscal 2006 was a 53-week year.

(2) See Note 2 Restatement of Consolidated Financial Statements in the Notes to Consolidated Financial Statements in this Annual Report on Form 10-K for a discussion of the Company's restatement.

(3) The statement of operations data for fiscal 2004 includes ten weeks of operations for the Disney Stores from their acquisition date of November 21, 2004.

(4) Asset impairment charges represent the write down of fixed assets to fair value. In fiscal 2006, the Company recorded \$17.1 million in asset impairment charges, including \$9.6 million in impairments at 29 of our Mickey prototype stores, \$7.1 million in disposals of property and equipment resulting from our decisions not to proceed with a New York City Disney Store location and infrastructure investments that were written off in conjunction with our decision to form an e-commerce alliance with a Disney affiliate in which select Disney Store merchandise is sold on the disneyshopping.com website, and \$0.4 million of impairment at five underperforming stores. We impaired fixed assets in underperforming stores in one store each year in fiscal 2005, fiscal 2004 and fiscal 2003 and in 19 stores in fiscal 2002.

(5) The extraordinary gain represents the fair value of net assets acquired in excess of the purchase price paid for the DSNA Business, after all long-lived assets were written off.

(6) We define comparable store sales as net sales from stores that have been open for at least 14 full months and that have not been substantially remodeled during that time. The Disney Stores entered our comparable store base in fiscal 2006.

(7) Average net sales per store represents net sales from stores open throughout the full period divided by the number of such stores. The Disney Stores were not included in average net sales per store during fiscal 2004 since we did not own them for the full fiscal period.

(8) Average square footage per store represents the square footage of stores open on the last day of the period divided by the number of such stores.

(9) Average net sales per gross square foot represents net sales from stores open throughout the full period divided by the gross square footage of such stores. The Disney Stores were not included in average net sales per gross square foot during fiscal 2004 since we did not own them for the full fiscal period.

(10) Working capital is calculated by subtracting the Company's current liabilities from its current assets.

**Restatement Adjustments for Periods Not Presented in Consolidated Financial Statements**

The following tables reflect restatement adjustments for periods not presented in the accompanying audited consolidated financial statements. For periods presented in the accompanying audited financial statements, refer to Note 2 Restatement of Consolidated Financial Statements in the accompanying consolidated financial statements.

Balance Sheet Data (in thousands):	As Reported	January 29, 2005		As Restated
		Stock Option Related Adjustments	Other Adjustments(1)	
Working capital(2)	\$ 177,210	\$ (807)	\$ 2,553	\$ 178,956
Total assets	616,162	1,454	228	617,844
Stockholders' equity	300,907	647	1,570	303,124

(1) Other adjustments relate to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for our 52- and 53-week fiscal years.

(2) Working capital is calculated by subtracting the Company's current liabilities from its current assets.

Statement of Operations Data (in thousands, except per share data):	Fiscal Year Ended January 31, 2004			
	As Reported	Stock Option Related Adjustments	Other Adjustments(1)	As Restated
Net sales	\$ 797,938	\$	\$	\$ 797,938
Cost of sales (exclusive of depreciation shown separately below)	476,961	316	(393)	476,884
Gross profit	320,977	(316)	393	321,054
Selling, general and administrative expenses	238,190	1,316	(1,329)	238,177
Asset impairment charges	448			448
Depreciation and amortization	46,251			46,251
Operating income	36,088	(1,632)	1,722	36,178
Interest income (expense), net	255			255
Income before income taxes	36,343	(1,632)	1,722	36,433
Provision for income taxes	13,642	(486)	695	13,851
Net income	\$ 22,701	\$ (1,146)	\$ 1,027	\$ 22,582
Diluted net income per common share	\$ 0.84	\$ (0.04)	\$ 0.04	\$ 0.84
Diluted weighted average common shares and common share equivalents outstanding	27,099	(57)		27,042
<b>Balance Sheet Data (in thousands):</b>				
Working capital(2)	\$ 114,274	\$ (153)	\$ 2,468	\$ 116,589
Total assets	415,506	1,098	(1,056)	415,548
Stockholders' equity	245,854	945	1,383	248,182

(1) Other adjustments relate to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for our 52- and 53-week fiscal years.

(2) Working capital is calculated by subtracting the Company's current liabilities from its current assets.

Statement of Operations Data (in thousands, except per share data):	Fiscal Year Ended February 1, 2003			
	As Reported	Stock Option Related Adjustments	Other Adjustments(1)	As Restated
Net sales	\$ 671,409	\$	\$	\$ 671,409
Cost of sales (exclusive of depreciation shown separately below)	415,623	276	(242)	415,657
Gross profit	255,786	(276)	242	255,752
Selling, general and administrative expenses	201,058	696	(530)	201,224
Asset impairment charges	4,539			4,539
Depreciation and amortization	41,012			41,012
Operating income	9,177	(972)	772	8,977
Interest income (expense), net	547			547
Income before income taxes	9,724	(972)	772	9,524
Provision for income taxes	4,089	(375)	311	4,025
Net income	\$ 5,635	\$ (597)	\$ 461	\$ 5,499
Diluted net income per common share(2)	\$ 0.21	\$ (0.02)	\$ 0.02	\$ 0.20
Diluted weighted average common shares and common share equivalents outstanding	26,978	(89)		26,889
<b>Balance Sheet Data (in thousands):</b>				
Working capital(3)	\$ 79,913	\$	\$ 1,151	\$ 81,064
Total assets	361,550	712	(754)	361,508
Stockholders' equity	218,113	712	603	219,428

(1) Other adjustments relate to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for our 52- and 53-week fiscal years.

(2) Diluted earnings per share may not add due to rounding

(3) Working capital is calculated by subtracting the Company's current liabilities from its current assets.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with our audited financial statements and notes thereto included in Item 15. Exhibits and Financial Statement Schedules. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this report, particularly in Item 1A Risk Factors.*

**All of the financial information presented in this Item 7 has been adjusted to reflect the restatement of the Company's financial results, which is more fully described in the Explanatory Note immediately preceding Part I, Item 1 and in Note 2 Restatement of Consolidated Financial Statements and Note 16 Quarterly Financial Data (Unaudited) in the accompanying consolidated financial statements.**



**OVERVIEW**



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The Company is a leading specialty retailer of children's merchandise. We design, contract to manufacture and sell high-quality, value-priced merchandise under our proprietary The Children's Place and licensed Disney Store brand names. As of September 1, 2007 we owned and operated 889 The Children's Place stores and 328 Disney Stores across North America and Internet stores at [www.childrensplace.com](http://www.childrensplace.com) and [www.disneystore.com](http://www.disneystore.com).

During fiscal 2006, as a result of the execution of our strategic initiatives, we achieved strong financial results. Net sales in fiscal 2006 increased \$349 million, or 21%, to \$2.018 billion, compared to net sales of \$1.669 billion reported in fiscal 2005. During fiscal 2006, net sales from our The Children's Place business increased \$234.4 million, a 20% increase over fiscal 2005. In addition, net sales from our Disney Store business increased \$114.6 million, a 23% increase over fiscal 2005. During fiscal 2006, comparable store sales of The Children's Place brand increased 10% compared to a 9% increase in fiscal 2005. In February 2006, 260 Disney Stores entered the Disney Store comparable store base and reported a comparable store sales increase of 14%. We define comparable store sales as net sales from stores that have been open at least 14 full months and that have not been substantially remodeled during that time.

Based on information from NPD Group, a consumer and retail market research firm, we believe our market share of children's apparel for The Children's Place brand increased to 4.1% in fiscal 2006 from 3.8% in fiscal 2005. (In 2005, NPD reported The Children's Place brand's 2005 market share as 4.2%. In 2006, NPD recalibrated the size and composition of this market, adjusting The Children's Place brand's 2005 market share to 3.8% to make it comparable to 2006.)

Net income in fiscal 2006 was \$87.4 million, or \$2.92 per diluted share, compared to \$60.0 million, or \$2.09 per diluted share, in fiscal 2005.

Fiscal 2006 net income reflected:

Approximately \$16.9 million in charges associated with the stock option investigation, before income tax effects, including approximately:

\$8.1 million in legal and professional fees;

\$6.5 million related to payroll withholding taxes and related penalties and resolution of tax consequences of discounted options (approximately \$0.2 million recorded in cost of goods sold and approximately \$6.3 million recorded in selling, general and administrative expenses); and

\$2.3 million in stock-based compensation charges for recipients who have not been able to exercise options due to the suspension of option exercise activity (approximately \$0.6 million recorded in cost of goods sold and approximately \$1.7 million recorded in selling, general and administrative expenses).



Approximately \$9.6 million, before income tax effects, in asset impairment charges related to the Mickey store prototype renovation (refer to Note 6 Property and Equipment in the accompanying consolidated financial statements for more information).

Approximately \$7.9 million, before income tax effects, in asset impairments and certain other costs resulting from our decision not to proceed with a New York City Disney Store location and infrastructure investments that were written off in conjunction with our decision to form an e-commerce alliance with a Disney affiliate in which select Disney Store merchandise is sold on the disneyshopping.com website. Approximately \$7.1 million of these charges were recorded as asset impairments with the remaining \$0.8 million in costs incurred to exit these activities recorded in selling, general and administrative expenses.

Approximately \$2.0 million, before income tax effects, in charges related to: (i) the implementation of SFAS 123(R) with respect to stock options previously issued and unvested stock options, and (ii) promises to grant stock options and restricted stock. This charge was recorded in selling, general and administrative expenses.

We received a one time cash dividend from some of our Canadian subsidiaries, which brought foreign tax credits that can be utilized to reduce U.S. income taxes. Our fiscal 2006 tax provision was reduced by approximately \$9.5 million after the effect of this transaction.

Fiscal 2005 earnings included approximately \$12.0 million, before income tax effects, in stock-based compensation expense, which was comprised of:

Approximately \$8.4 million related to revised measurement dates (\$1.7 million recorded in cost of goods sold and \$6.7 million recorded in selling, general and administrative expenses),

Approximately \$1.7 million related to the accelerated vesting of 2.1 million stock options (\$0.4 million recorded in cost of goods sold and \$1.3 million recorded in selling, general and administrative expenses),

Approximately \$1.6 million primarily related to the resolution of tax consequences of discounted options (\$0.2 million recorded in cost of goods sold and \$1.4 million recorded in selling, general and administrative expenses), and

Approximately \$0.3 million related to the modification of options for a terminated associate.

During fiscal 2006, we built on our progress at The Children's Place stores by continuing to focus on increasing store productivity and elevating our brand awareness through increased marketing efforts. We opened 69 The Children's Place stores in fiscal 2006, and closed five stores. During the year, we rolled out merchandise strategies based on the climate and weather conditions of the store location and store sales volume. We also offered a greater selection of better and best merchandise (reflecting higher fashion and higher price point items) which was successful in the third quarter. However, in the fourth quarter, our better and best merchandise was not received by the customer as we had envisioned and our earnings in fiscal 2006 suffered as a result. By offering more better and best merchandise in the fourth quarter, we reduced our investment in key items which are typically offered at a value price and therefore we did not have enough of the value priced and basic merchandise our customers desired. In fiscal 2007 we are offering more key item and value priced merchandise, particularly in the fourth quarter. Other initiatives in fiscal 2007 include the launch of our store-within-a-store shoe store, and the roll out of our new store prototype.

The Disney Store business focus in fiscal 2006 was on improving gross margin through reduced product costs and better markdown control, while providing our guests with improved merchandise quality. During fiscal 2006, we opened 19 Disney Stores, remodeled 14 Disney Stores, and closed eight stores. Strategies that contributed to Disney Stores' growth included: offering more innovative and elevated merchandise, particularly in our toy category; introducing adult apparel; and offering a good, better, best merchandise offering across most product categories. In fiscal 2007, Disney Store will continue to focus on innovating and elevating its merchandise. Other strategic initiatives include increasing the number of store visitors who purchase our merchandise (i.e. customer conversion); launching e-commerce; and maximizing synergy events. In addition, in the second half of fiscal 2007 we have begun to unveil our new Disney Store prototype to our guests.

In June 2007, we amended our credit facilities with Wells Fargo and our other senior lenders for the purpose of better supporting the capital needs of our business and reducing the fees associated with our borrowings. Refer to Note 7 Credit Facilities for additional information regarding amendments to our credit facilities.

During August 2007, we entered into the Refurbishment Amendment to our License Agreement with Disney, which supersedes (through fiscal 2011) the provisions of the original License Agreement relating to required remodeling of Disney Stores with new provisions regarding store renovation and maintenance. Among other things, these new provisions obligate us, by various dates commencing in fiscal 2007 and continuing through fiscal 2011, to remodel a total of 236 existing Disney Stores into a new store prototype we have developed. We have committed \$175 million to this Disney Store renovation program.

Consistent with its fiduciary duties, our Board has engaged an investment banking firm to act as its financial advisor in undertaking a review of strategic alternatives to improve operations and enhance shareholder value. As part of this review, our Board and management are assessing a wide variety of options to improve our business and competitive position, including, but not limited to, opportunities for organizational and operational improvement, a possible recapitalization, or other transactions. The Board has not set any specific timeline for the completion of this strategic review, and there is no assurance that as a result of this review, the Board will decide to change the Company's course of action or engage in any specific transaction.

#### **RECENT OPERATING RESULTS**

Due to the seasonality of our business, our annual profitability is highly dependent on sales and gross margin during the third and fourth quarters, which is when the majority of our back-to-school and holiday sales occur. Because our sales and margins did not meet our expectations during the third quarter ended November 3, 2007, and because we anticipate that those trends will continue into the fourth quarter, we anticipate that sales will be below our previous projections during those periods, which would result in a disproportionate decrease in our net income versus last year.

#### **RESTATEMENT OF FINANCIAL STATEMENTS**

Based on the conclusions of an independent investigation into our stock option granting practices by a Special Committee of our Board, we have concluded that incorrect measurement dates for option grants were previously used for financial accounting and reporting purposes on a number of occasions. In addition, we have concluded that an action taken by management in May 2004 relating to the Company's records concerning the 1997 CEO IPO Grant, without review or approval by the Compensation Committee should be treated as a new, below market grant in 2004. As a result, we are restating our fiscal 2005 consolidated balance sheet and our consolidated statements of income, cash flows and changes in stockholders' equity for fiscal 2005 and fiscal 2004 to reflect additional stock-based compensation expense relating to stock option grants, as well as to correct other errors unrelated to stock option grants.

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

#### **Determination of Revised Measurement Dates**

During the Review Period, we used the effective date reflected in our grant approval documentation as the grant date and in accounting for option grants we also used this date as the measurement date under APB 25. In many instances that date was an as of date on a UWC of the Board or the Compensation Committee. Since we believed options were granted with exercise prices that equaled or exceeded their quoted market price at the date of grant, no compensation expense was recorded in our financial statements for options granted prior to our adoption of SFAS 123(R) as of January 29, 2006, other than in connection with the acceleration of the vesting of options in fiscal 2005.

and the acceleration of the vesting of options related to a terminated employee. The investigation revealed that the measurement dates we used often occurred prior to the time when the recipients of the grant, the number of shares subject to the options granted and the exercise price were approved and established with finality. However, in many instances, we were unable to determine with certainty when the terms were established with finality. We collected all available documentation and established a documentation hierarchy to determine the best evidence of the date when the terms of the award were final and approved, and thus, the revised measurement dates for the awards. In the following sections, we will explain our process for granting, recording and administering options and the basis for determining revised measurement dates.

### **Option Granting Process**

Under our stock option plans, our Compensation Committee was given the authority to issue options. During the Review Period, we granted stock options to our executives, employees, non-employee directors of a wholly-owned subsidiary and, as part of our director compensation program, to non-management members of our Board. Options were granted to executives and other employees upon being hired (including in one instance to a broad group of employees in connection with the acquisition of the Disney Store), and in connection with promotions, annual performance reviews, extraordinary performance and as service awards.

Option grants to executives, as recommended by our former CEO, were reviewed by the Compensation Committee on an executive-by-executive basis and were approved at a committee meeting. Usually, the committee approved the final number of shares underlying the option grant to an individual executive. However, for grants made in connection with annual performance reviews, a final determination as to the number of shares underlying the option sometimes was left to be made by our former CEO after the meeting, within an agreed upon range discussed at the meeting. The terms of executive new hire grants were generally documented either in an offer letter or formal employment agreement. It was our practice that the approval of executive option grants was formalized by means of a UWC signed by all members of our Board or Compensation Committee, even where an option grant had been approved and finalized at a meeting. As a result, for awards made in connection with annual performance reviews, the grants reflected in the UWC may have differed from the grants discussed at the committee meeting where the final determination of the amount of the grant had been left to our former CEO. In contrast, grants made in connection with new hires of executives or extraordinary performance by executives were usually finalized at a Compensation Committee meeting. Thus, all executive grants were considered and approved by the Compensation Committee, but in some instances the timing of finalization of the number of options subject to a grant occurred subsequent to the committee's meeting as a result of action by our former CEO as permitted by our Compensation Committee.

Our practice was for option grants to non-executive employees (and to non-management subsidiary board members) to be determined by our management and approved by our former CEO and subsequently formally approved by a UWC signed by all members of our Board or Compensation Committee. In the case of annual performance review awards, our Compensation Committee generally discussed in advance the aggregate number of options that would be awarded. Various individuals in our line management and our human resources function were involved in identifying employees to receive options and the number of underlying shares; however, approval by our former CEO was required with respect to all such grants. The following practices were followed with respect to new hire, promotion and service awards:

*New Hire and Promotion Grants:* Throughout the Review Period, we followed a policy, as reflected in numerous offer letters, albeit never formalized, to grant options for non-executive new hires and promotions on a monthly basis, as of the date of hire or, later in the Review Period, as of the end of the month. Each month, a list of option recipients was compiled from employee hire and promotion letters or other information establishing a new hire or promotion.

*Service Awards:* While we did not have a written policy or an established schedule for the granting of service

awards, the number of options for which service awards were granted was consistently based upon length of service and did not change during the Review Period.

In general, these grants also were subsequently formally approved by a UWC signed by all members of our Board or Compensation Committee.



The minutes of Compensation Committee meetings usually did not specifically state the grant date and rarely reflected the exercise price for an option grant and our practice was to use the meeting date as the grant date. However, in many instances there were no minutes, and the UWC, which ordinarily reflected an as of date and the exercise price (usually determined as the average of the high and low trading price on the as of date), was the only record of Board approval of a grant. Despite diligent searching, we were unable to determine the dates on which UWCs were actually signed or returned to the Company.

The investigation established that throughout the Review Period our accepted practice, understood by both our former CEO and all of our Compensation Committee members, was that our former CEO was authorized to determine the non-executive employees who would receive option grants, the number of shares subject to each such grant, and to cause the Company to make such grants, within such broad limits for the making of grants as may have been discussed with the Compensation Committee. Although formal delegation by the Compensation Committee to our former CEO of authority to make grants was never adopted, it was also understood that our former CEO was authorized to make a final determination of the number of options that would be granted to executives, where the committee, having reviewed the overall grants, did not formally make the final determination with regard to such grants. The understanding of the Compensation Committee members was that the grant date with respect to grants to executives was the date the committee approved the executive receiving a grant (either specifically or out of the pool of awards approved by the committee) and with respect to non-executive employees was the date our former CEO finalized the grants and that in these situations, the exercise price would be the trading price on the date of grant.

Our Compensation Committee members and our former CEO understood that our option granting process, including informing recipients of their grants, would be completed before all Compensation Committee or Board members signed a UWC approving the grant. They also understood that option recipients were entitled to the grants at some time prior to the UWC being signed by all Board members. The signing of the UWCs was considered an administrative formality. It was believed by all involved, including our General Counsel's office, (i) that the signing by all members of a UWC with an as of date constituted sufficient corporate action to authorize an option grant effective on the as of date, even in those instances where there had been no prior Compensation Committee action on the grant at a meeting (e.g., most grants to non-executives), and (ii) that the UWC merely confirmed an already finalized grant process. Accordingly, consistent with the findings of the Special Committee, we have concluded that, with incidental exceptions involving non-executive grants, all option grants made during the Review Period were ultimately specifically authorized by a Compensation Committee or Board UWC, although an unauthorized action (subsequently ratified in 2007) was taken regarding the 1997 CEO IPO Grant.

With respect to option grants to non-management members of our Board, the number of options was specifically determined and approved by our Compensation Committee or the full Board at a meeting or was stated in and approved by a UWC. Where the minutes did not specify the grant date and/or the exercise price, the meeting date was used as the grant date and the exercise price was the trading price (determined as the average of the high and low trading price) on that date. Where approved by a UWC, grants to non-management Board members were usually made along with grants to employees and, consequently, were usually part of a Recorded Grant also involving an employee grant.

#### **Stock Option Administration**

Throughout the Review Period, we contracted with an independent outside service provider to maintain records of our options issued and of the vested status, forfeiture or expiration of such options and any amendments to such options and to administer the exercise of options including the issuance of shares upon exercise. Our General Counsel's office and our Human Resources Department administered the grant process once decisions were made as to the options to be granted. This process included:

Creating a final list of option recipients and their respective option grants,

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Preparing UWCs, often accompanied by a memorandum to our Compensation Committee or Board transmitting the UWC for signature (a Legal Department Memo ),

Communicating stock option grants to our outside stock option plan administrator ( Stock Option Administrator ), and

Preparing and submitting Forms 3 and 4 ( Forms 4 ) to the SEC for certain executive grants.

We typically communicated stock option grants to our employees in the following manner:

New hire and employee promotion awards were typically communicated to the employee by letter or verbally by the employee's supervisor detailing terms of the grant.

Annual performance review awards were most often communicated verbally by the employee's supervisor.

Service awards were verbally communicated either at a Company town hall meeting or by the employee's supervisor.

For all types of stock option awards, we usually communicated the grants to executives and other employees prior to the time UWCs were signed by all Compensation Committee or Board members.

#### **Basis for Use of the Documentation Hierarchy**

In determining the revised measurement dates to be used in the restatement of our financial statements, we applied the guidance in APB 25, which provides that the accounting measurement date is the first date on which both of the following are known: (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. In light of our option granting practices, we have concluded that the terms of an award were approved by the authorized body or person and final prior to completion of all formal granting actions (i.e., the signing by all Compensation Committee or Board members of a UWC). Accordingly, we have used the date when, most likely, the terms of the awards included in a Recorded Grant can be identified as approved and final, as established by the best available evidence, as the revised measurement date for accounting under APB 25, even if such date preceded the completion of all formal granting actions.

Since UWCs ordinarily were distributed for signature after the option awards were established and recorded by the Company and information as to when UWCs were signed by Board members is largely unavailable, we have looked to other documentation to establish revised measurement dates. Specifically, where our records do not include signed minutes of a Board or Compensation Committee meeting that specified the recipients of an option, the number of shares subject to the award and the exercise price, we have relied on other documentation and evidence to determine the revised measurement date for option grants. If award recipients were identified by a list attached to the Compensation Committee minutes rather than in the text of the minutes, we also sought corroborating evidence, usually metadata, indicating that such list was final on the meeting date. Metadata, obtained as part of the electronic data collection process, provides information about electronic data, such as how, when and by whom a set of data was collected, recorded or changed. If such corroborating evidence was not available, we relied on other documentation and evidence to determine the revised measurement date, using the documentation hierarchy described below.

We accumulated all relevant documentation and other information pertaining to each Recorded Grant. We evaluated the documentation and information to determine the date on which the option recipients and the number of shares underlying the options granted to a recipient, as well as other material terms, were approved and established with finality. Based on the Special Committee's findings and our review of documentation and other evidence, with the assistance of the forensic accounting firm retained by Independent Counsel, we identified revised measurement dates for certain option grants made during the Review Period.

#### **The Documentation Hierarchy**

We have developed a hierarchy of documentation as our basis for determining the revised measurement date, if applicable, for each option granted during the Review Period. In each case, the document used to establish the revised measurement date is dated and evidences the point in time when we can substantiate with finality: (i) approval of the award, (ii) the recipients of the option award, and (iii) the number of shares and the exercise price pursuant to the option awarded to that recipient. This award-by-award review occasionally resulted in different measurement dates for grants made within the same Recorded Grant. Metadata was accumulated where available to corroborate the revised measurement date for an option award. When the metadata did not corroborate the revised measurement date (i.e., indicated that a document was created or revised later than it was dated), the metadata date was used as the date of the supporting document. If another source of support was available with an earlier date, that support was used to define the revised measurement date.

We have granted a total of approximately 8.1 million options. Approximately 1.4 million were granted in a private placement prior to our IPO, and approximately 6.7 million were granted in connection with and since our IPO and were reviewed during the investigation. Grant dates based on Board minutes were deemed appropriate in

determining the revised measurement dates if the minutes specified: (i) a list of stock option recipients, (ii) the number of options granted to each recipient, and (iii) the grant date and price. If the minutes were not determinative, we applied the following document hierarchy to determine the revised measurement dates:

1. *Offer Letters to New Employees/Promotion Letters* We have concluded that information set forth in accepted offer letters and promotion letters, which specified the number of options to be granted at a stated date, constituted a mutual understanding between the employee and the Company. Once the employee began to render service under the terms of the employment or promotion letter, the Company had a legal liability with respect to the option grant as promised in the letter. As such, we have concluded that these letters established with finality the number of options granted to a recipient and the date to be used as a grant date, as long as the employee had commenced employment.

2. *Documentation Sent to Third Parties and the Compensation Committee Members* If acceptable evidence was not identified in the Board minutes or offer and promotion letters, we determined that the earliest date on which a list of option recipients and number of options to each recipient was disseminated outside the Company established the finality of the grant. We have identified the following sources of documentation sent outside the Company as establishing the date on which the terms of an option became final: (i) Forms 3 and 4 filed with the SEC, (ii) archive data obtained from our Stock Option Administrator with the list of option recipients and number of options evidencing the terms of option grants that was provided by the Company and the date when our Stock Option Administrator was so advised of the grant, and (iii) Legal Department Memoranda requesting UWC approval with an attached UWC documenting with finality (either in the body of the UWC or as a referenced attachment) the option recipients, number of shares subject to each grant and the exercise price (as well as the as of grant date) which, in accordance with our option granting process, would not have been prepared if the related list of option recipients was not final and approved by our former CEO.

3. *Internal Documentation* The next level of documentation used included the last modified date included in the metadata of a Microsoft Excel file specifying the recipient and the number of shares subject to an option grant, or email dates on comparable data prepared by the Legal or Human Resources Departments, where in each case the grant information was sent to and recorded in the Stock Option Administrator's records.

4. *Unanimous Written Consents* Where we did not have any of the above documentation, we used the last modified date metadata associated with the UWC reflecting formal approval of a grant as the revised measurement date.

We have revised the measurement dates used to account for certain stock option grants since fiscal 1997 based on the hierarchy above. These changes resulted in additional stock-based compensation expense, net of forfeitures of unvested awards and before taxes, of \$11.9 million affecting our consolidated financial statements for each year from fiscal 1998 through the first quarter of fiscal 2006.

#### **Variable Accounting**

During the course of the investigation and the review of the documentation for each grant, we identified instances where changes were made in our records with respect to certain Recorded Grants. In these instances, we reviewed all documents related to the grant to determine if the change was an isolated change to an individual award or if the change indicated that the granting process was not complete for the entire Recorded Grant. If the change was an isolated change, we determined whether the change represented an administrative error or a modification of a term of the award. The investigation did not reveal a practice by the Company of retracting awards or modifying the terms of awards across a group

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of recipients after the date determined to be the revised measurement date. Instead, changes were rare and occurred only at the individual level. We found no evidence regarding any of the changes that indicated that at the time of the change the granting process remained open for an entire Recorded Grant.

Since none of the changes indicated an incomplete granting process, we used available documentation to determine whether the changes represented administrative errors or a modification to an individual award. For changes deemed to be administrative errors (e.g., adding an individual to a list of recipients for service awards where the number of options involved in the award and the criteria required to earn the award were set prior to the issuance

of the award), we did not change the revised measurement date applicable to the individual award from that determined from the Recorded Grant as determined based on the documentation hierarchy.

If we determined based on a review of supporting documentation that the change was a modification to the original award (e.g., a change in the number of shares for which the option was granted or the exercise price of the option), we considered the appropriate accounting for the individual award in accordance with FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation* (FIN 44). For any changes involving either the number of shares for which the option was granted or the exercise price of the option, we determined that variable accounting should be applied in accordance with FIN 44. With respect to options for 328,775 shares, we have applied variable accounting because of a modification to the terms of the award, resulting in additional stock-based compensation expense, before taxes, of approximately \$2.3 million from fiscal 1998 through fiscal 2005.

### **The 1997 CEO IPO Grant**

We granted options under our 1996 Plan on September 18, 1997 pursuant to a UWC of the Board in connection with our IPO, including a grant of options for 99,660 shares to our former CEO. Under the plan, options could be granted either as incentive stock options qualified under Section 422 of the Internal Revenue Code (ISOs) or as options not so qualified (NQOs). If not otherwise specified when granted, option grants were to be classified as ISOs to the extent allowed by the tax code. Under the plan, also in accordance with tax code requirements, grants to more than 10% shareholders treated as ISOs were to have an exercise price of 110% of the fair value of the related shares at the date of the grant and a five year duration. Under the plan, NQOs were to have a ten year duration and an exercise price equal to the fair value of the related shares at the date of the grant. Our former CEO was at the relevant time, and remains, a greater than 10% shareholder of the Company.

Our actions in implementing the grant of the options to our former CEO and our records regarding the grant were at the time, and subsequently, inconsistent. The Board's 1997 action approving the grant was silent as to the options' treatment as ISOs or NQOs. Among the confusing and inconsistent records regarding this grant were the following:

Option certificates were prepared contemporaneously with the Board's UWC. One certificate, evidencing options for 32,000 shares designated that portion of the grant as ISOs. The other certificate designated 67,660 options as NQOs. Both certificates provided for an exercise price of \$15.40 per share and a duration of five years. The terms for the options classified as NQOs are inconsistent with the plan.

Public reports, including periodic reports, proxy statements and a Form 4, included information as to the terms of the grant contradictory to the option certificates and other records.

As early as 1998, our Stock Option Administrator's records showed a 32,465/67,195 ISO/NQO allocation and, for both portions, an exercise price of \$15.40 per share and a duration of ten years.

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Our management recognized the inconsistencies in the Stock Option Administrator's records by April 2004. Our former General Counsel interpreted the 1997 CEO IPO Grant to have a ten year duration in its entirety and on May 6, 2004 instructed the administrator to change its records to reflect the entire grant as NQOs with a duration of ten years. The exercise price was left in the records at \$15.40. This action was taken without Board or Compensation Committee consultation, review or approval. In April 2006, our former CEO exercised a portion of the 1997 CEO IPO Grant for 84,660 shares at \$15.40 per share.

In connection with our investigation into our option grants, the Special Committee in April 2007 considered the circumstances surrounding the grant and how it had been treated by the Company over the years. Upon recommendation of the Special Committee, the Compensation Committee determined that, considering the conflicting records and actions by the Company, the options should be interpreted to have a \$15.40 exercise price and a ten year duration, as had been publicly reported by the Company. During fiscal 2007, the Board ratified the change in the Stock Option Administrator's records made in May 2004, the issuance of shares to the former CEO upon his exercise in part of the options and the validity of the remaining part of the option (covering 15,000 shares).

In determining the accounting for the 1997 CEO IPO Grant, we considered all the available evidence and records and concluded that the option certificates were the most reliable evidence of the terms of the grant from the time of the grant, consistent with our accounting for other option grants, with the result that the options granted in 1997 should be considered to have expired after five years as stated in the certificates. Accordingly, for accounting



purposes we are treating the 2004 actions by management as a new option grant on the terms, including a below-fair-market-value exercise price of \$15.40, then recorded in the Stock Option Administrator's records. We have considered the measurement date of this grant to be May 6, 2004, requiring the recognition at such time of approximately \$0.9 million in compensation expense.

We also considered the possibility that the 1997 CEO IPO Grant at the outset provided for an ISO portion with a five-year duration, consistent with the 1996 Plan's provisions pertaining to ISO grants. In that case, the ISO portion would have expired in September 2002. The remaining portion would be considered an NQO and the Company records (notably the option certificates) to the contrary would be considered administrative errors, including as to the duration of such option. In this alternative, the action taken by the former General Counsel on May 6, 2004 in changing the Stock Option Administrator's records to reflect the entire 1997 CEO IPO Grant as an NQO would be considered to have had the effect of the issuance at that time of a fully vested and exercisable option having a \$15.40 exercise price to the extent of the ISO portion. The accounting consequence of this alternative would be the recognition of compensation expense in fiscal 2004 for the ISO portion of the grant, as though a new grant, in an amount between approximately \$300,000 and \$330,000, the variation being due to discrepancies among our records as to the ISO/NQO allocation.

#### **Inadequate Internal Controls**

We are undertaking to remediate the material weakness in internal control over financial reporting related to stock option grants found by the Special Committee, as further discussed in Item 9A. Controls and Procedures of this Annual Report on Form 10-K. We have continued our suspension of the granting of stock options and other equity awards and the exercise of any outstanding options until these improved procedures have been instituted.

#### **Resolution of Tax Consequences and Corrective Action Related to Discounted Options**

Revisions to the measurement dates of stock options often resulted in discounted options. Individuals currently holding discounted options may incur an excise tax liability under Section 409A of the Internal Revenue Code. As recommended by the Special Committee, in order to avoid any benefit from the errors made in dating of options to any person involved in the stock option granting process and, also, as part of our efforts to address certain tax considerations associated with outstanding discounted options granted with an exercise price below fair market value, we have taken the following actions:

Our directors (including Mr. Dabah, our former CEO), our President and our former Chief Administrative Officer agreed to amend all discounted options held by them (other than those described in the next paragraph) to increase the exercise price to the average of the high and low trading price on the date determined by the Company to be the revised measurement date applicable to the option grant to be used for financial reporting purposes. In the few instances where these individuals have exercised options as to which a revised measurement date has been determined by the Company, the individual has returned to the Company the difference between the exercise price and the trading price on the revised measurement date.

In the three instances where the Report of Investigation found that non-executive directors received options shortly before the public disclosure of positive information, our directors further agreed to amend such options to increase the exercise price to the average of the high and low trading price over the balance of the calendar year following the recorded date of the grant.

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With respect to all other option grants, we have decided to honor the options as issued, consistent with the Special Committee's finding of no intentional misconduct on the part of management in the option grant process. Nevertheless, all members of senior management holding outstanding options have agreed to have their outstanding discounted options that vested after 2004 amended either to increase the exercise price to the average of the high and low trading price on the date determined to be the revised measurement date or to limit the exercise period of their options.

In addition, with respect to holders of discounted options that vested after 2004 who are employees at the time, other than members of senior management who have already agreed to amend their outstanding discounted options, we plan to offer as soon as practicable the opportunity to exchange their discounted options for options with the same terms except that the exercise price will be changed to the average of the high and low trading price on the revised

measurement date. Option holders who agree to such amendment will receive a cash bonus in the amount of the increase in the exercise price.

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

#### **Legal and Regulatory Matters Related to Stock Option Practices and Internal Controls**

As we did not timely file our Quarterly Reports on Form 10-Q for the quarters ended July 29, 2006 and October 28, 2006, our Annual Report on Form 10-K for fiscal 2006, and our Quarterly Reports on Form 10-Q for the quarters ended May 5, 2007 and August 4, 2007, we have been out of compliance with the reporting requirements of the SEC and Nasdaq for more than one year. Although we have now filed this Annual Report on Form 10-K for fiscal 2006 and our Quarterly Reports on Form 10-Q for the second and third quarters of fiscal 2006, we have not yet filed our Quarterly Reports on Form 10-Q for the first and second quarters of fiscal 2007. Consequently, we continue to be in violation of the reporting requirements under the Exchange Act and the Nasdaq listing rules.

We have received various determination letters from the Nasdaq stating that because we have not been in compliance with Nasdaq listing requirements, our common stock is subject to delisting. Since September 2006 we have been in contact with the Nasdaq Listing Qualifications Panel, Nasdaq's Listing and Hearing Review Council, and the Board of Directors of the Nasdaq Stock Market LLC (the "Nasdaq Board") regarding our inability to comply with Nasdaq's listing requirements and when we might be able to again become compliant. The last communication we received from Nasdaq on this issue was from the Nasdaq Board on November 9, 2007 stating that we had until January 9, 2008 to file all of the Required Reports in order to regain compliance with Nasdaq's listing requirements. If we have not regained compliance prior to that time, we will need to explain to the Nasdaq staff the reasons for our inability to do so, in order for the Nasdaq Board to consider whether any further extension is warranted. We still need to file our Quarterly Reports on Form 10-Q for the quarters ended May 5, 2007 and August 4, 2007 before we will have filed all of the Required Reports. There is no assurance that we will be able to meet the January 9, 2008 deadline, and if we do not, there is no assurance that the Nasdaq Board will grant us additional time to become compliant. If we fail to come into compliance by January 9, 2008 or any extended deadline approved by Nasdaq, we anticipate that the Company's shares will be delisted from Nasdaq.

In addition, Nasdaq listing rules require that all issuers solicit proxies and hold an annual meeting of shareholders within 12 months of the end of the issuer's fiscal year end. To comply with this rule, we must hold our annual meeting of shareholders for the fiscal year ended February 3, 2007, no later than February 3, 2008. In addition, we must be current in our SEC filings before we can solicit proxies for such annual meeting of our shareholders. Accordingly, if we are unable to become current in our SEC filings in sufficient time for us to solicit proxies for an annual meeting of our shareholders by February 3, 2008, or if we otherwise fail to hold such meeting by February 3, 2008, our shares could be delisted from Nasdaq.

On September 29, 2006, the Division of Enforcement of the SEC informed us that it had initiated an informal investigation into our stock option granting practices. In addition, the Office of the U.S. Attorney for the District of New Jersey advised us that it had commenced an investigation into the same matter. We have cooperated with these investigations and have briefed both authorities on the results of the Special Committee's investigation. There have been no developments in these matters since that time.

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On January 17, 2007, a stockholder derivative action was filed in the United States District Court, District of New Jersey against certain current members of the Board and certain current and former senior executives. The Company has been named as a nominal defendant. The complaint alleges, among other things, that certain of our current and former officers and directors (i) breached their fiduciary duties to the Company and its stockholders and were unjustly enriched by improperly backdating certain grants of stock options to officers and directors of the Company, (ii) caused the Company to file false and misleading reports with the SEC, (iii) violated the Exchange Act and common law, (iv) caused the Company to issue false and misleading public statements, and (v) were negligent

and abdicated their responsibilities to the Company and its stockholders. The complaint seeks money damages from the defendants, an accounting for the proceeds of sales of any allegedly backdated stock options, and the costs and disbursements of the lawsuit, as well as equitable relief. The defendants have moved to dismiss the action, and on or about June 15, 2007, the plaintiff filed an amended complaint adding, among other things, a claim for securities fraud under SEC rule 10b-5.

On September 21, 2007 a second stockholder class action was filed in the United States District Court, Southern District of New York against the Company and certain current and former senior executives. The complaint alleges, among other things, that certain of the Company's current and former officers made statements to the investing public which misrepresented material facts about the business and operations of the Company, or omitted to state material facts required in order for the statements made by them not to be misleading, causing the price of the Company's stock to be artificially inflated in violation of provisions of the Exchange Act, as amended. It alleges that more recent disclosures establish the misleading nature of these earlier disclosures. The complaint seeks money damages plus interest as well as costs and disbursements of the lawsuit.

On October 10, 2007, a third stockholder class action was filed in the United States District Court, Southern District of New York against the Company and certain of its current and former senior executives. The complaint alleges, among other things, that certain of the Company's current and former officers made statements to the investing public which misrepresented material facts about the business and operations of the Company, or omitted to state material facts required in order for the statements made by them not to be misleading, thereby causing the price of the Company's stock to be artificially inflated in violation of provisions of the Exchange Act, as amended. According to the complaint, more recent disclosures establish the misleading nature of these earlier disclosures. The complaint seeks, among other relief, class certification of the lawsuit, compensatory damages plus interest, and costs and expenses of the lawsuit, including counsel and expert fees.

The outcome of these litigations is uncertain. While we believe there are valid defenses to the claims and we will defend ourselves vigorously, no assurance can be given as to the outcome of these matters. The litigations could distract our management and directors from the Company's affairs, the costs and expenses of the litigations could unfavorably affect our net earnings and an unfavorable outcome could adversely affect the reputation of the Company.

#### **Other Adjustments**

**In addition to the adjustments related to the stock option investigation, our restated consolidated financial statements presented herein include other adjustments related to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for our 52- and 53-week fiscal years. The aggregate impact of these adjustments on our consolidated statements of income, net of taxes, between fiscal 2001 and first quarter of fiscal 2006 was an increase to net income of approximately \$1.7 million. Additionally, variable rate demand note balances as of the quarter ended April 29, 2006 have been reclassified from cash to short-term investments, and certain other balance sheet amounts have been reclassified. These reclassifications do not result in any additional charges in any period and do not affect working capital for the affected periods. For additional discussion of these adjustments, refer to Note 2 Restatement of Consolidated Financial Statements and Note 16 Quarterly Financial Data (Unaudited) in the accompanying consolidated financial statements.**



**Cumulative Adjustments**

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



Period Ended	Stock Option Related Adjustments			Other Adjustments(1)			Total After Tax Adjustment
	Expense (Increase)	Tax Benefit	Net Stock Option Related Adjustments	Expense (Increase) Decrease	Tax Benefit (Provision)	Net Other Adjustments	
January 30, 1999 (fiscal 1998)	\$ (59)	\$ 19	\$ (40)	\$	\$	\$	\$ (40)
January 29, 2000 (fiscal 1999)	(211)	81	(130)				(130)
February 3, 2001 (fiscal 2000)	(386)	131	(255)				(255)
February 2, 2002 (fiscal 2001)	(915)	295	(620)	240	(98)	142	(478)
February 1, 2003 (fiscal 2002)	(972)	375	(597)	772	(311)	461	(136)
January 31, 2004 (fiscal 2003)	(1,632)	486	(1,146)	1,722	(695)	1,027	(119)
January 29, 2005 (fiscal 2004)	(3,386)	772	(2,614)	589	(82)	507	(2,107)
January 28, 2006 (fiscal 2005)(2)	(8,927)	3,956	(4,971)	(853)	218	(635)	(5,606)
Cumulative effect at January 28, 2006	\$ (16,488)	\$ 6,115	\$ (10,373)	\$ 2,470	\$ (968)	\$ 1,502	\$ (8,871)
April 29, 2006 (Q1 fiscal 2006)	\$ (1,331)	\$ 544	\$ (787)	\$ 327	\$ (161)	\$ 166	\$ (621)

(1) Other adjustments relate to personal property taxes and certain accrual accounts and reserves, including those related to occupancy costs for our 52- and 53-week fiscal years.

(2) We have not previously recorded stock-based compensation expense in any fiscal year other than fiscal 2005. During fiscal 2005, we recorded approximately \$0.3 million related to the modification of stock options for a terminated employee, before taxes of approximately \$0.1 million. We also recorded approximately \$2.1 million, before taxes of approximately \$0.1 million, of stock-based compensation expense related to the acceleration of the vesting of certain options. As part of the restatement process, the stock option acceleration amounts were adjusted to approximately \$1.7 million of stock-based compensation expense, before taxes of approximately \$0.5 million. Therefore, the restated total stock-based compensation expense for fiscal 2005 is \$11.3 million, before taxes of \$4.1 million.

#### License Agreement with Disney

In connection with the acquisition of the DSNA Business in 2004, Hoop entered into a License Agreement with an affiliate of Disney under which our subsidiaries have the right to use certain Disney intellectual property to operate the Disney Store retail chain in exchange for ongoing royalty payments. The agreement allows our subsidiaries to operate retail stores in the United States and Canada using the Disney Store name and to contract, manufacture, source, offer and sell merchandise featuring Disney-branded characters, past, present and future. In accordance with the License Agreement, following a two year royalty abatement, our subsidiaries began making royalty payments to Disney in November 2006 equal to 5% of net sales from physical Disney Store locations, subject to an additional royalty holiday period with respect to the Non-Core Stores. The initial term of the License Agreement continues through January 2020, unless terminated sooner in accordance with the License Agreement, and if certain financial performance and other conditions are satisfied, the term of the License Agreement may be extended at our option for up to three additional ten-year terms.

In connection with our acquisition of the DSNA Business, we also entered into a Guaranty and Commitment dated as of November 21, 2004, in favor of Hoop and Disney. As required by the Guaranty and Commitment, we invested \$50 million in Hoop concurrently with the consummation of the acquisition, and we agreed to invest up to an additional \$50 million to enable Hoop to comply with their obligations under the License Agreement and otherwise fund the operations of Hoop. The Guaranty and Commitment provides that our \$50 million additional commitment is subject to increase if certain distributions are made by Hoop to The Children's Place. To date, we have not invested any portion of the additional \$50 million in Hoop. We also agreed in the Guaranty and Commitment to guarantee the payment and performance by Hoop of their royalty payment and other obligations to Disney under the License Agreement, subject to a maximum guaranty liability of \$25 million, plus expenses.

The License Agreement obligates us to maintain the quality, appearance and presentation standards of the Disney Store chain in accordance with the highest standards prevailing in the specialty retail industry. In addition, the License Agreement, as amended in April 2006, required us to:

Completely remodel each store within a specified period of time following expiration or termination of the initial term of the lease for such store, if such lease is renewed or extended on a long-term basis upon or following such expiration or termination;

Completely remodel each store at least once every 12 years; and

Completely remodel a minimum of approximately 160 of the 313 acquired stores by January 1, 2009.

During fiscal 2006, we suspended the store renovation program because of dissatisfaction with our Mickey store prototype from a brand, design and construction standpoint. As of February 3, 2007, we had remodeled a total of 45 Disney Stores since the 2004 acquisition. Pursuant to the provisions of the License Agreement, as amended in 2006, relating to required remodeling following lease renewals and required remodeling of stores at least once every 12 years, we were required to remodel a total of 145 stores as of February 3, 2007. As of February 3, 2007, we had remodeled 32 of these required stores, with the result that 113 of the store remodels required by that date under the terms of the License Agreement had not been completed by that date. The remaining 13 store remodels we had completed were not required pursuant to the provisions of the License Agreement.

During the fourth quarter of fiscal 2006, we received a letter and subsequent follow-up communications from Disney identifying various ways in which we had not complied with the store renovation and certain other requirements of the License Agreement. In response, during the fourth quarter of fiscal 2006, we commenced discussions with Disney regarding potential modifications to certain terms of the License Agreement to address our remodeling commitments as well as other concerns that had been raised by Disney in various communications with us. During the first quarter of fiscal 2007, Disney notified us that Disney viewed our failure to comply with these requirements of the License Agreement as constituting numerous material breaches of the License Agreement, entitling Disney to exercise its rights and remedies under the License Agreement.

Following discussions with Disney, in June 2007, we entered into a June Letter Agreement with Disney which modified and superseded certain provisions of the License Agreement, including the remodeling requirements, through fiscal 2011 and created additional obligations for us and Hoop with respect to the remodeling of Disney Stores. The June Letter Agreement was entered into to address Disney's assertion that through the date of the June Letter Agreement we had committed 120 material breaches of the License Agreement. The June Letter Agreement stated that if we fully comply with its terms, Disney would forbear from exercising any rights or remedies that it would have under the License Agreement based on the breaches of the License Agreement that were asserted by Disney and were the subject of the June Letter Agreement. However, if we were to violate any of the provisions of the June Letter Agreement, Disney would have the right to terminate its forbearance under the June Letter Agreement, in which case Disney would be free to exercise any or all of its rights and remedies under the License Agreement, including possibly terminating our license to operate the Disney Stores based on the occurrence of numerous material breaches and claiming breach fees, as if the June Letter Agreement had not been executed. The June Letter Agreement also stated that, if we were to breach any of its provisions on three or more occasions and Disney had not previously exercised its right to terminate the June Letter Agreement, a payment of \$18.0 million to Disney would become immediately due and payable with respect to the breach fees called for by the License Agreement. If we were to violate any of the provisions of the June Letter Agreement on five or more occasions, Disney would have the right to immediately terminate the License Agreement, without any right on our part to defend, counterclaim, protest or cure. The June Letter Agreement stated that its terms would take effect immediately but that the parties anticipated the June Letter Agreement would later be replaced by a formal amendment to the License Agreement incorporating the terms of the June Letter Agreement.

The June Letter Agreement, among other things, suspended the remodel obligations in the License Agreement for the approximately 4.5 year term of the June Letter Agreement and, in lieu of those provisions, imposed new obligations on the Company with respect to the renovation and maintenance of numerous stores in the Disney Store chain between fiscal 2007 and fiscal 2011 and, for the stores to be remodeled in fiscal 2007, set forth a detailed timetable for submission of plans and completion dates.

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Subsequent to the execution of the June Letter Agreement, we were unable to meet several deadlines set forth in the June Letter Agreement. In addition, we determined that there were upcoming deadlines during the third and fourth quarters of fiscal 2007 specified in the June Letter Agreement that we would likely not meet. Accordingly, we and Disney engaged in further discussions during August 2007 and, based on these discussions, agreed upon changes to the requirements of the June Letter Agreement that would postpone the due dates of certain of our remodel

obligations until later in fiscal 2007 or fiscal 2008. In connection with these postponements, we agreed to remodel two additional Disney Stores during fiscal 2009 and agreed upon changes to the original license agreement to modify restrictions on Disney's ability to relocate its flagship retail store in Manhattan and to narrow the restrictions on Disney's ability to grant direct licenses to other specialty retailers so that these restrictions would apply only with respect to specialty retail stores focusing primarily on the sale of children's merchandise.

During August 2007, we and Disney executed the Refurbishment Amendment, which incorporated the terms of the June Letter Agreement, as modified by our mutual agreement during August, and the aforementioned changes to the License Agreement. The Refurbishment Amendment by its terms superseded the June Letter Agreement and took effect retroactively as of June 6, 2007, the original effective date of the June Letter Agreement. The Refurbishment Amendment provides that our compliance in full with its terms will constitute a cure of the breaches identified in the Refurbishment Amendment and that, so long as the Refurbishment Amendment is not terminated, Disney will forbear from exercising any rights or remedies it would have under the License Agreement based on the breaches identified in the Refurbishment Amendment.

The Refurbishment Amendment suspends the remodel obligations in the License Agreement for the approximately 4.5 year term of the Refurbishment Amendment, and, in lieu of those provisions, commits us to remodel by the end of fiscal 2011 a total of 236 existing Disney Stores into a new store prototype we have developed,

of which the first seven remodels are required to be completed by specifically agreed upon dates in fiscal 2007;  
an additional 49 stores are required to be remodeled by the end of fiscal 2008;  
an additional 60 stores are required to be remodeled by the end of fiscal 2009;  
an additional 70 stores are required to be remodeled by the end of fiscal 2010; and  
an additional 50 stores are required to be remodeled by the end of fiscal 2011.

Under the Refurbishment Amendment, we also have agreed to open at least 18 new Disney Stores using the new store prototype by the end of fiscal 2008. Our prior obligations under the License Agreement did not require us to open a specified number of new stores.

In addition, the Refurbishment Amendment requires us to complete a maintenance refresh program in approximately 165 Disney Stores by June 30, 2008, including the flagship store located on Michigan Avenue in Chicago, which was completed on September 12, 2007. Some of the stores that are refreshed will subsequently be remodeled into the new store prototype. The Refurbishment Amendment obligates us to complete the remodel and refresh program described above and, in accordance with the Refurbishment Amendment, we have committed \$175 million, on a consolidated basis, to remodel and refresh the stores as noted above through fiscal 2011, and have committed approximately \$12 million to open the new stores through fiscal 2008.

We expect that the Disney Stores will fund these commitments primarily from cash flow from operations and borrowings under its secured credit facility. Over the next 12 months, we expect that The Children's Place business will need to provide additional capital to the Disney Stores to remain in compliance with the store remodel requirements under the License Agreement as modified by the Refurbishment Amendment.

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In the Refurbishment Amendment, we also agreed with Disney to make certain other modifications to the provisions of the License Agreement, including:

Limiting the number of new Disney Stores to be opened per year during the remodeling period (we may open up to 25 new stores in any given year after fiscal 2007, with a rollover each year of up to five new stores from prior years);

Eliminating the extended royalty abatement for some of the Disney Stores that were identified as Non-Core Stores in the License Agreement if their leases are extended on a long-term basis and the stores are not remodeled within the timeframe that was required under the original terms of the License Agreement before giving effect to the Refurbishment Amendment;

Requiring the potential implementation of a differentiated merchandise plan for the Disney Store outlets; and

Modifying the provisions of the License Agreement that would apply to a potential wind-down of the Disney Store business following any termination of the License Agreement.

Like the June Letter Agreement, the Refurbishment Amendment states that, if we fully comply with the terms of the Refurbishment Amendment, Disney will forbear from exercising any rights or remedies that it would have under the License Agreement based on the breaches of the License Agreement that were asserted by Disney and were the subject of the Refurbishment Amendment. However, under the terms of the Refurbishment Amendment, if we violate any of its provisions, Disney will have the right to terminate its forbearance under the Refurbishment Amendment, in which case Disney would be free to exercise any or all of its rights and remedies under the License Agreement, including possibly terminating our license to operate the Disney Stores based on the occurrence of multiple material breaches and claiming breach fees, as if the Refurbishment Amendment had not been executed. The Refurbishment Amendment also states that, if we breach any of its provisions on three or more occasions and Disney has not previously exercised its right to terminate the Refurbishment Amendment, a payment of \$18.0 million to Disney becomes immediately due and payable with respect to the breach fees called for by the License Agreement. If we violate any of the provisions of the Refurbishment Amendment on five or more occasions, Disney will have the right to immediately terminate the License Agreement, without any right on our part to defend, counterclaim, protest or cure. It should be noted that the Refurbishment Amendment addresses only those breaches specifically enumerated therein. Disney continues to retain all its other rights and remedies under the License Agreement with respect to any other breaches.

We believe that we will be able to perform our obligations under the Refurbishment Amendment as and when required. However, because our ability to meet these obligations will depend on numerous factors, some of which are beyond our control, there can be no assurance that we will be able to fully comply. Like the June Letter Agreement, the Refurbishment Amendment does not excuse us from compliance with these requirements should there be events or developments that may be beyond our control, such as contractor delays, delays in landlord or regulatory approval, natural disasters or acts of war or terrorism. Our diligent efforts may not be adequate to enable us to obtain all required approvals under the Refurbishment Amendment or to comply with every requirement or meet every deadline imposed on us under the Refurbishment Amendment. In the event we are unable to comply with any of our obligations when required, we would be in breach of our agreements with Disney, entitling Disney to exercise its remedies under the Refurbishment Amendment and the License Agreement. In the event such breaches occur, there can be no assurance that we will be able to obtain waivers or other relief from Disney, if needed, to avoid the \$18.0 million payment to Disney and prevent a termination of the Refurbishment Amendment or the License Agreement. In addition, any breach by us of our agreements with Disney (even if subsequently waived by Disney) would constitute a cross-default under the secured loan agreement for the Disney Store chain, entitling the lenders to exercise their contractual remedies. There can be no assurance that we will be able to obtain waivers, if needed, from our lenders in the event of any future breaches of the Refurbishment Amendment or the License Agreement.

Where Disney would have the right to terminate the License Agreement and compel us to rapidly wind down the Disney Store business in accordance with the wind-down provisions of the License Agreement as a result of our breach or breaches thereof, our subsidiaries that operate the Disney Store business may be unable to comply with all of their obligations to landlords and other third parties, in which case these subsidiaries might not be able to avoid seeking bankruptcy protection.

Beginning in July 2007, our Hoop subsidiaries commenced Internet commerce operations through an alliance with a Disney affiliate in which select Disney Store merchandise is sold on the [disneyshopping.com](http://disneyshopping.com) website. Customers can find Disney Store merchandise at [www.disneystore.com](http://www.disneystore.com) or [www.disneyshopping.com](http://www.disneyshopping.com). We anticipate entering into a formal amendment to the License Agreement relating to this Internet business. It is anticipated that this amendment to the License Agreement will supersede our obligation to launch our own Disney Store Internet store, which pursuant to the License Agreement, as modified by certain letter agreements, we are required to launch by January 31, 2008.

Refer to Note 5 License Agreement with Disney in the accompanying consolidated financial statements for additional information regarding the June Letter Agreement and the Refurbishment Amendment.

## **CRITICAL ACCOUNTING POLICIES**

The preparation of consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported revenues and expenses during the reported period. Actual results could differ from our estimates. The accounting policies that we believe are the most critical to aid in fully understanding and evaluating reported financial results include the following:



**Revenue Recognition** Sales are recognized upon purchase by customers at our retail stores or when received by the customer if the product was purchased via the Internet, net of coupon redemptions and anticipated sales returns. Actual sales return rates have historically been within our expectations and the allowance established. However, in the event that the actual rate of sales returns by customers increased significantly, our operational results could be adversely affected.

For the Disney Store, we act as an agent on behalf of a subsidiary of The Walt Disney Company for the sale of Walt Disney World® Resort and Disneyland® Resort tickets, and our net sales include only the 7% commission we receive from a subsidiary of The Walt Disney Company on such ticket sales.

Our policy with respect to gift cards is to record revenue as gift cards are redeemed for merchandise. Prior to their redemption, unredeemed gift cards for The Children's Place business are recorded as a liability, included within accrued expenses and other current liabilities. We recognize income from gift cards that are not expected to be redeemed based upon an extended period of dormancy where statutorily permitted. For the Disney Store, we act as an agent on behalf of a subsidiary of The Walt Disney Company for gift cards sold to customers. Therefore, we do not record a customer gift card liability for the Disney Store. However, we recognize a trade payable to Disney for the net purchase of Disney gift cards.

We offer a private label credit card to our The Children's Place customers that provides a discount on future purchases once a minimum annual purchase threshold has been exceeded. We estimate the future discounts to be provided based on history, the number of customers who have earned or are likely to earn the discount and current year sales trends on the private label credit card. We defer a proportionate amount of revenue from customers based on an estimated value of future discounts. We recognize such deferred revenue as future discounts are taken on sales above the minimum. We accomplish this by utilizing estimates based upon sales trends and the number of customers who have earned the discount privilege. Our private label customers must earn the discount privilege on an annual basis and this privilege expires at our fiscal year end. Accordingly, all deferred revenue is recognized by the end of the fiscal year.

**Inventory Valuation** Merchandise inventories are stated at the lower of average cost or market, using the retail inventory method. Under the retail inventory method, the valuation of inventories at cost and the resulting gross margins are calculated by applying a cost-to-retail ratio by merchandise department to the retail value of inventories. At any one time, inventories include items that have been marked down to our best estimate of their fair market value and an estimate of our inventory shrinkage.

We base our decision to mark down merchandise upon its current rate of sale, the season, and the age and sell-through of the item. To the extent that our markdown estimates are not adequate, additional markdowns may have to be recorded, which could reduce our gross margins and operating results. Our success is largely dependent upon our ability to gauge the fashion taste of our customers, including the popularity and relevancy of the Disney characters, and to provide a well-balanced merchandise assortment that satisfies customer demand. Any inability to provide the proper quantity of appropriate merchandise in a timely manner could increase future markdown rates.

We adjust our inventory based upon an annual physical inventory and shrinkage is estimated in interim periods based upon the historical results of physical inventories in the context of current year facts and circumstances. To the extent our shrinkage estimate is not adequate, we would be required to reduce our gross profits and operating results.

**Equity Compensation** Effective January 29, 2006, we adopted the provisions of SFAS No. 123(R) using the modified prospective transition method. In applying SFAS 123(R), we use the Black-Scholes option pricing model based on a Monte Carlo simulation, which requires extensive use of accounting judgment and financial estimates, including estimates of how long employees will hold their vested stock options before exercise, the estimated volatility of the Company's common stock over the expected term, and the number of options that will be forfeited prior to the completion of vesting requirements. Application of other assumptions could result in significantly different estimates of fair value of stock-based compensation and consequently, the related expense recognized in our financial statements. The provisions of SFAS 123(R) apply to new stock options and stock options outstanding, but not yet vested, as of the effective date. Prior to January 29, 2006, we accounted for stock option grants under the recognition and measurement provisions of APB 25 and related interpretations.

Prior to fiscal 2006, equity compensation for key management consisted only of stock option awards. Upon consideration of several factors in fiscal 2006, including the anticipated impact of SFAS 123(R), we also began

awarding key management performance share awards ( Performance Awards ) which, if earned, would be satisfied by the issuance of shares of common stock ( Performance Shares ).

**Historic Stock Option Measurement Dates** As discussed in Restatement of Financial Statements of this section and in Note 2 Restatement of Consolidated Financial Statements, we applied our documentation hierarchy to determine revised measurement dates under APB 25 for past stock option grants. This application involved judgment and careful consideration of all documentation and facts related to each grant. We believe the hierarchy provides the best evidence of approval and finality for determining revised measurement dates under APB 25. However, we also performed a sensitivity analysis to estimate potential non-cash stock based compensation expense based on minimum and maximum stock prices during the period between the Recorded Grant date and the revised measurement date.

Using the maximum stock price between Recorded Grant date and the revised measurement date would increase the cumulative non-cash stock based compensation expense relating to option issuances by \$3.1 million, before taxes, over the eight year restatement period. The most significant impact in any year would have been \$0.8 million, before taxes, in fiscal 2005, primarily due to the Company's acceleration of the vesting of approximately 2.1 million options and because more than 40% of the Company's total stock option compensation charges related to a single grant made during fiscal 2005 on April 29, 2005. Using the minimum stock price between the originally recorded grant date and the revised measurement date results in no compensation charge, as the trading price on the Recorded Grant date was the lowest price during the period.

In addition, we evaluated our documentation hierarchy to determine if different judgments in the determination of measurement dates would materially affect our restatement charge relating to option issuances. Specifically, we considered the following:

1. The application of the documentation hierarchy resulted in multiple measurement dates for awards recorded as part of a single Recorded Grant. If the measurement date for all recipients of awards made as part of a single Recorded Grant was the last date determined under our documentation hierarchy as a measurement date, the restatement charge would increase by approximately \$0.5 million, before taxes.
2. The Legal Department Memo was used to support the measurement date for approximately 13% of the options issued during the Review Period. If the Legal Department Memo were viewed as less authoritative support that an award was final than the transmission of award information to our Stock Option Administrator or the signing of a Form 4, the restatement charge would increase by approximately 4% or \$0.5 million, before taxes.
3. Of the options for 328,775 shares to which we have applied variable accounting in accordance with FIN 44, options for 75,075 shares are options as to which the number of shares were modified. Given that there is a diversity in practice with regard to the interpretation of FIN 44 as it relates to the application of variable accounting when modifications are subsequently made only to the number of shares, we determined the impact on the restatement if these options were treated as fixed option awards and we had applied our documentation hierarchy to determine revised measurement dates. We have determined that this treatment would have decreased the restatement charge by approximately \$0.2 million, before taxes.

**Accounting for Royalties** In exchange for the right to use certain Disney intellectual property, we are required to pay a Disney subsidiary royalty payments pursuant to the License Agreement. Minimum royalty commitments are recorded

on a straight-line basis over the life of the initial 15 year term of the License Agreement. During each period, amounts due in excess of the minimum royalty commitment are recorded as an expense if we expect to surpass the minimum royalty commitment on an annual basis, even if the contingency threshold has not been surpassed in that particular period. The amortization of the estimated value of the two-year royalty holiday under the License Agreement is recognized on a straight-line basis as a reduction of royalty expense over the term of the License Agreement. Royalty expense, and the associated amortization of the royalty holiday, is recorded in selling, general and administrative expenses. The royalty percentage does not increase over the term of the License Agreement.

In accordance with the License Agreement, following a two year royalty abatement, our subsidiaries began making royalty payments to Disney in November 2006 equal to 5% of net sales from physical Disney Store locations, subject to an additional royalty holiday period with respect to a limited number of stores. The initial term of the License Agreement is through January 2020, and if certain financial performance and other conditions are satisfied, it

may be extended at our option for up to three additional ten-year terms. In fiscal 2006, net royalty expense was approximately 4.1% of Disney Store net sales.

**Insurance and Self-Insurance Liabilities** Based on our assessment of risk and cost efficiency, we self-insure and purchase insurance policies to provide for workers' compensation, general liability, and property losses, as well as director's and officer's liability, vehicle liability and employee medical benefits. We estimate risks and record a liability based upon historical claim experience, insurance deductibles, severity factors and other actuarial assumptions. While we believe that our risk assessments are appropriate, to the extent that future occurrences and claims differ from our historical experience, additional charges for insurance may be recorded in future periods.

**Accounting for Acquisitions** The acquisition of the DSNA Business was accounted for under the purchase method of accounting in accordance with SFAS No. 141, Business Combinations (SFAS 141). As such, we analyzed the fair value of identified tangible and intangible assets acquired and liabilities assumed, and determined the excess of fair value of net assets acquired over cost. This excess was recorded as an extraordinary gain in fiscal 2005 and fiscal 2004.

**Impairment of Assets** We periodically evaluate each store's performance and compare the carrying value of each location's fixed assets, principally leasehold improvements and fixtures, to its projected cash flows. An impairment loss is recorded if the projected future cash flows related to the assets are insufficient to recapture the net book value of the assets. To the extent our estimates of future cash flows are incorrect, additional impairment charges may be recorded in future periods.

**Income Taxes** We compute income taxes using the liability method. This method requires recognition of deferred tax assets and liabilities, measured by enacted rates, attributable to temporary differences between financial statement and income tax basis of assets and liabilities. Temporary differences result primarily from depreciation and amortization differences between book and tax and the non-deductibility of certain reserves and accruals in the current tax period for tax purposes.



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During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. As a result, we recognize tax liabilities based on estimates of whether additional taxes and interest will be due. These tax liabilities are recognized when, despite our belief that its tax return positions are supportable, we believe that certain positions are likely to be challenged and may not be fully sustained upon review by tax authorities. We believe that our accruals for tax liabilities are adequate for all open audit years based on our assessment of many factors including past experience and interpretations of tax law. This assessment relies on estimates and assumptions and may involve a series of complex judgments about future events. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact income tax expense in the period in which such determination is made.

### **Newly Issued Accounting Pronouncements**

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement 109 ( FIN 48 ) which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48, effective for fiscal years beginning after December 15, 2006, requires that the tax benefit from an uncertain tax position may be recognized only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The amount of tax benefits recognized from such a position are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate resolution. We have substantially completed the process of evaluating the effect of FIN 48 on our consolidated financial statements as of the beginning of the period of adoption, February 4, 2007. We estimate that the cumulative effects of applying this interpretation will be recorded as a decrease of approximately \$6.6 million to beginning retained earnings. In addition, in accordance with the provisions of FIN 48, we will reclassify an estimated \$6.2 million of unrecognized tax benefits from current to non-current liabilities because payment of cash is not anticipated within one year of the balance sheet date.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ) which provides guidance for using fair value to measure assets and liabilities, defines fair value, establishes a framework for measuring fair value in U.S. GAAP, and expands disclosures about fair value measurements. SFAS 157 is effective



for fiscal years beginning after November 15, 2007 for interim periods within those years. We are currently evaluating the potential impact of adopting SFAS 157 on our consolidated balance sheets and results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides interpretive guidance on how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB 108 requires registrants to quantify misstatements using a balance sheet and income statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relative quantitative and qualitative factors. SAB 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. We have applied SAB 108 and restated our consolidated financial statements contained in this Annual Report on Form 10-K.

In June 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force in Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That is, Gross Versus Net Presentation)* (EITF 06-3). EITF 06-3 requires disclosure of an entity's accounting policy regarding the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer including sales, use, value added and some excise taxes. Since we present such taxes on a net basis (excluded from net sales) as permitted under EITF 06-3, there will be no impact on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159). This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. Most of the provisions in SFAS 159 are elective; however, the amendment to SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities with available-for-sale and trading securities. The fair value option established by SFAS 159 permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (b) is irrevocable (unless a new election date occurs); and (c) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. We are currently evaluating the effect that adoption of this statement will have on our consolidated balance sheets and results of operations.

## **RESULTS OF OPERATIONS**

The following table sets forth, for the periods indicated, selected income statement data expressed as a percentage of net sales. We primarily evaluate the results of our operations as a percentage of net sales rather than in terms of absolute dollar increases or decreases by analyzing the year over year change in our business expressed as a percentage of net sales (i.e. basis points). For example, our selling, general and administrative expenses increase