

TOYS R US INC  
Form 10-Q  
September 12, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended August 4, 2007

Commission file number 1-11609

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**TOYS R US, INC.**

(Exact name of registrant as specified in its charter)

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

**22-3260693**  
(IRS Employer

Identification Number)

**One Geoffrey Way Wayne, New Jersey**  
(Address of principal executive offices)

**07470**  
(Zip code)

**(973) 617-3500**

(Registrant's telephone number, including area code)

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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 checkmark whether the registrant is a large accelerated filer, an accelerated filer, or 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  Accelerated filer  Non-accelerated filer

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of August 31, 2007, there were outstanding 1,000 shares of common stock of Toys R Us, Inc. (all of which are owned by Toys R Us Holdings, Inc., our holding company and are not publicly traded).

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**TOYS R US, INC. AND SUBSIDIARIES**

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****TOYS R US, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)****(In millions)**

|  | August 4,<br>2007 | February 3,<br>2007 | July 29,<br>2006<br>(As restated) |
|--|-------------------|---------------------|-----------------------------------|
| <b>ASSETS</b>                                  |                   |                     |                                   |
| <i>Current Assets:</i>                         |                   |                     |                                   |
| Cash and cash equivalents                      | \$ 230            | \$ 765              | \$ 664                            |
| Accounts and other receivables                 | 173               | 230                 | 186                               |
| Merchandise inventories                        | 2,090             | 1,690               | 2,074                             |
| Income tax receivable                          | 92                |                     |                                   |
| Assets held for sale                           | 6                 | 9                   | 94                                |
| Current deferred tax assets                    | 58                | 43                  | 120                               |
| Prepaid expenses and other current assets      | 129               | 120                 | 118                               |
| <b>Total current assets</b>                    | <b>2,778</b>      | <b>2,857</b>        | <b>3,256</b>                      |
| Property and equipment, net                    | 4,321             | 4,333               | 4,310                             |
| Goodwill, net                                  | 365               | 365                 | 365                               |
| Deferred tax assets                            | 132               | 95                  | 23                                |
| Restricted cash                                | 127               | 148                 | 147                               |
| Other assets                                   | 501               | 497                 | 560                               |
|  | <b>\$ 8,224</b>   | <b>\$ 8,295</b>     | <b>\$ 8,661</b>                   |
| <b>LIABILITIES AND STOCKHOLDER S DEFICIT</b>   |                   |                     |                                   |
| <i>Current Liabilities:</i>                    |                   |                     |                                   |
| Short-term borrowings                          | \$ 235            | \$ 151              | \$ 316                            |
| Accounts payable                               | 1,202             | 1,303               | 1,021                             |
| Accrued expenses and other current liabilities | 762               | 848                 | 719                               |
| Income taxes payable                           | 14                | 142                 | 123                               |
| Current portion of long-term debt              | 94                | 66                  | 310                               |
| <b>Total current liabilities</b>               | <b>2,307</b>      | <b>2,510</b>        | <b>2,489</b>                      |
| Long-term debt                                 | 5,820             | 5,722               | 6,429                             |
| Deferred tax liabilities                       | 34                | 74                  | 22                                |
| Deferred rent liabilities                      | 254               | 248                 | 251                               |
| Other non-current liabilities                  | 389               | 282                 | 253                               |
| Minority interest in Toys R Us Japan           | 130               | 134                 | 142                               |
| Stockholder s deficit                          | (710)             | (675)               | (925)                             |
|  | <b>\$ 8,224</b>   | <b>\$ 8,295</b>     | <b>\$ 8,661</b>                   |

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See accompanying notes to the condensed consolidated financial statements.

**Table of Contents****TOYS R US, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)****(In millions)**

|  | <b>13 Weeks Ended</b>     |                          | <b>26 Weeks Ended</b>     |                          |
|--|---------------------------|--------------------------|---------------------------|--------------------------|
|  | <b>August 4,<br/>2007</b> | <b>July 29,<br/>2006</b> | <b>August 4,<br/>2007</b> | <b>July 29,<br/>2006</b> |
| Net sales                                      | <b>\$ 2,605</b>           | \$ 2,432                 | <b>\$ 5,186</b>           | \$ 4,837                 |
| Cost of sales                                  | <b>1,669</b>              | 1,584                    | <b>3,341</b>              | 3,140                    |
| <b>Gross margin</b>                            | <b>936</b>                | 848                      | <b>1,845</b>              | 1,697                    |
| Selling, general and administrative expenses   | <b>820</b>                | 738                      | <b>1,612</b>              | 1,478                    |
| Depreciation and amortization                  | <b>101</b>                | 99                       | <b>197</b>                | 213                      |
| Net gains on sales of properties               | <b>(12)</b>               |                          | <b>(16)</b>               |                          |
| Restructuring (reversals) charges and other    | <b>(1)</b>                |                          | <b>1</b>                  | 5                        |
| Total operating expenses                       | <b>908</b>                | 837                      | <b>1,794</b>              | 1,696                    |
| Operating earnings                             | <b>28</b>                 | 11                       | <b>51</b>                 | 1                        |
| Other (expense)/income:                        |                           |                          |                           |                          |
| Interest expense                               | <b>(120)</b>              | (129)                    | <b>(242)</b>              | (259)                    |
| Interest income                                | <b>4</b>                  | 5                        | <b>12</b>                 | 13                       |
| Loss before income taxes and minority interest | <b>(88)</b>               | (113)                    | <b>(179)</b>              | (245)                    |
| Income tax benefit                             | <b>45</b>                 | 2                        | <b>89</b>                 | 89                       |
| Minority interest                              | <b>1</b>                  |                          | <b>7</b>                  |                          |
| Net loss                                       | <b>\$ (42)</b>            | \$ (111)                 | <b>\$ (83)</b>            | \$ (156)                 |

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents****TOYS R US, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)****(In millions)**

|   | <b>26 Weeks Ended</b>     |                          |
|---|---------------------------|--------------------------|
|   | <b>August 4,<br/>2007</b> | <b>July 29,<br/>2006</b> |
| <b>Cash Flows from Operating Activities:</b>                                |                           |                          |
| Net loss  | \$ (83)                   | \$ (156)                 |
| Adjustments to reconcile net loss to net cash used in operating activities: |                           |                          |
| Depreciation and amortization   | 197                       | 213                      |
| Gains on sales of properties  | (16)                      |                          |
| Amortization of debt issuance costs   | 14                        | 32                       |
| Deferred income taxes   | (32)                      | (96)                     |
| Other   | 3                         | 2                        |
| Changes in operating assets and liabilities:                                |                           |                          |
| Accounts and other receivables  | 66                        | 63                       |
| Merchandise inventories   | (379)                     | (364)                    |
| Prepaid expenses and other operating assets                                 | (3)                       | (13)                     |
| Accounts payable  | (127)                     | (337)                    |
| Accrued expenses and other liabilities                                      | (178)                     | (186)                    |
| Income taxes payable and receivable   | (97)                      | (34)                     |
| Net cash used in operating activities                                       | (635)                     | (876)                    |
| <b>Cash Flows from Investing Activities:</b>                                |                           |                          |
| Capital expenditures  | (100)                     | (90)                     |
| Decrease / (increase) in restricted cash                                    | 21                        | (40)                     |
| Cash effect of the consolidation of Toys R Us-Japan                         |                           | 6                        |
| Proceeds from sale of fixed assets  | 15                        | 13                       |
| Net cash used in investing activities                                       | (64)                      | (111)                    |
| <b>Cash Flows from Financing Activities:</b>                                |                           |                          |
| Long-term debt borrowings   | 155                       | 2,733                    |
| Short-term debt borrowings  | 146                       | 149                      |
| Long-term debt repayment  | (80)                      | (2,186)                  |
| Short-term debt repayment   | (65)                      | (24)                     |
| Dividend paid to Toys R Us-Japan minority interest                          | (1)                       | (5)                      |
| Capitalized debt issuance costs   |                           | (42)                     |
| Net cash provided by financing activities                                   | 155                       | 625                      |
| Effect of exchange rate changes on cash and cash equivalents                | 9                         | 45                       |
| <b>Cash and cash equivalents:</b>   |                           |                          |
| Net decrease during period  | (535)                     | (317)                    |
| Cash and cash equivalents at beginning of period                            | 765                       | 981                      |

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|  |        |        |
|--|--------|--------|
| Cash and cash equivalents at end of period | \$ 230 | \$ 664 |
|--|--------|--------|

See accompanying notes to the condensed consolidated financial statements.



**Table of Contents****TOYS R US, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS DEFICIT****(Unaudited)****(In millions)**

| (\$ in millions)   | Common Stock<br>Issued <sup>(1)</sup> |           | Additional<br>paid-in capital | Accumulated<br>other<br>comprehensive<br>loss | Retained<br>deficit | Total<br>stockholders<br>deficit |
|--|---------------------------------------|-----------|-------------------------------|---|---------------------|----------------------------------|
|  | Shares                                | Amount    |                               |   |                     |                                  |
| Balance, February 3, 2007  |                                       | \$        | \$ 4                          | \$ (95)                                       | \$ (584)            | (675)                            |
| Cumulative effect of change in accounting principle, net of tax (Note 3) |                                       |           |                               |   | (9)                 | (9)                              |
| Cumulative effect of adoption of FIN 48 (Note 6)                         |                                       |           |                               |   | 21                  | 21                               |
| Net loss   |                                       |           |                               |   | (83)                | (83)                             |
| Foreign currency translation adjustments, net of tax                     |                                       |           |                               | 34  |                     | 34                               |
| Stock compensation expense   |                                       |           | 2                             |   |                     | 2                                |
| <b>Balance, August 4, 2007</b>   |                                       | <b>\$</b> | <b>\$ 6</b>                   | <b>\$ (61)</b>                                | <b>\$ (655)</b>     | <b>\$ (710)</b>                  |

<sup>(1)</sup> \$0.01 par value; authorized 3,000 shares, outstanding 1,000 shares.

See accompanying notes to the condensed consolidated financial statements.

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**TOYS R US, INC. AND SUBSIDIARIES**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of presentation**

As used herein, the Company, we, us, or our means Toys R Us, Inc., and its subsidiaries, except as expressly indicated or unless the context otherwise requires. The Condensed Consolidated Balance Sheets as of August 4, 2007, February 3, 2007, and July 29, 2006, the Condensed Consolidated Statements of Operations for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006, the Condensed Consolidated Statements of Cash Flows for the twenty-six weeks ended August 4, 2007 and July 29, 2006, and the Condensed Consolidated Statement of Stockholders Deficit for the twenty-six weeks ended August 4, 2007, have been prepared by us in conformity with accounting principles generally accepted in the United States of America ( GAAP ) for interim reporting, and in accordance with the requirements of this Quarterly Report on Form 10-Q. Our interim Condensed Consolidated Financial Statements are unaudited and are subject to year-end adjustments. In the opinion of management, the financial statements include all known adjustments (which consist primarily of normal, recurring accruals, estimates, and assumptions that impact the financial statements) necessary to present fairly the financial position at the balance sheet dates and the results of operations for the thirteen and twenty-six weeks then ended. The Condensed Consolidated Balance Sheet at February 3, 2007 presented herein, has been derived from our audited balance sheet included in our Annual Report on Form 10-K for the fiscal year ended February 3, 2007, but does not include all disclosures required by GAAP. These financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included within our Annual Report on Form 10-K for the fiscal year ended February 3, 2007. The results of operations for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006 are not necessarily indicative of operating results of the full year.

As of February 4, 2007, we changed our accounting method for valuing our international wholly-owned subsidiaries merchandise inventories from the retail inventory method to the weighted average cost method. We have accounted for the change in accounting principle in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS 154 ). Refer to Note 3 to the Condensed Consolidated Financial Statements entitled Change in accounting principle for the impact on our Condensed Consolidated Financial Statements and further details.

As of February 4, 2007, we adopted the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 48 (As amended) Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). Refer to Note 6 to the Condensed Consolidated Financial Statements entitled Income taxes for the impact on our Condensed Consolidated Financial Statements.

In the fourth quarter of fiscal 2006, we identified errors in the way we had previously accounted for income taxes. We did not properly record deferred tax accounts on a net basis by legal entity and taxing jurisdiction, as required by SFAS No. 109 Accounting for Income Taxes ( SFAS 109 ). As a result, we have restated the accompanying Condensed Consolidated Balance Sheet as of July 29, 2006. Refer to Note 13 to the Condensed Consolidated Financial Statements entitled Restatement of previously issued financial statements for further details.

In the fourth quarter of fiscal 2006, we adopted Securities and Exchange Commission ( SEC ) Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). As permitted under the transition provisions of SAB 108, in the prior fiscal year, we recorded a cumulative \$(24) million adjustment to opening retained deficit as of January 29, 2006 and adjusted our financial results for the first three quarters of fiscal 2006. These adjustments relate principally to tax-related errors from fiscal years 2005 and 2004 with the balance applicable to years prior to fiscal 2004.

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The impact of the adoption of SAB 108 and restatement on our interim results for the thirteen and twenty-six weeks ended July 29, 2006 is summarized below:

| (In millions)         | July 29, 2006       |                            |
|-----------------------|---------------------|----------------------------|
|                       | Previously reported | As adjusted <sup>(1)</sup> |
| Deferred tax assets   | \$ 533              | \$ 23                      |
| Income taxes payable  | 98                  | 123                        |
| Stockholder's deficit | (888)               | (925)                      |

| (In millions)      | 13 Weeks Ended<br>July 29, 2006 |                            | 26 Weeks Ended<br>July 29, 2006 |                            |
|--------------------|---------------------------------|----------------------------|---------------------------------|----------------------------|
|                    | Previously reported             | As adjusted <sup>(1)</sup> | Previously reported             | As adjusted <sup>(1)</sup> |
| Income tax benefit | \$ 3                            | \$ 2                       | \$ 102                          | \$ 89                      |
| Net loss           | (110)                           | (111)                      | (143)                           | (156)                      |

<sup>(1)</sup> As adjusted amounts include the impact of the restatement (See Note 13 entitled "Restatement of previously issued financial statements") and the adoption of SAB 108.

During the first three quarters of fiscal 2006, we presented certain immaterial other non-product revenue as a reduction in Selling, general and administrative expenses. We have restated Net sales and Selling, general and administrative expenses in the thirteen and twenty-six week periods ended July 29, 2006 to correctly present other non-product revenue in Net sales. This resulted in an increase in Net sales and an increase in Selling, general and administrative expenses. Refer to Note 13 to the Condensed Consolidated Financial Statements entitled "Restatement of previously issued financial statements" for further details.

**Table of Contents****2. Restructuring and other charges**

Our Condensed Consolidated Statements of Operations for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006 included the following pre-tax charges related to restructuring initiatives from prior years:

| (In millions)  | 13 weeks ended    |                  | 26 weeks ended    |                  |
|--|-------------------|------------------|-------------------|------------------|
|  | August 4,<br>2007 | July 29,<br>2006 | August 4,<br>2007 | July 29,<br>2006 |
| <b>2005 initiative</b>   |                   |                  |                   |                  |
| Restructuring (reversals) charges and other                      | \$ (1)            | \$               | \$ 1              | \$ 6             |
| Depreciation and amortization                                    |                   |                  |                   | 24               |
| Cost of sales  |                   |                  |                   | 3                |
| <b>Total charges related to 2005 initiative</b>                  | <b>\$ (1)</b>     | <b>\$</b>        | <b>\$ 1</b>       | <b>\$ 33</b>     |
| <b>2003 and prior years initiatives</b>                          |                   |                  |                   |                  |
| Restructuring (reversals) charges and other                      | \$                | \$               | \$                | \$ (1)           |
| <b>Total charges related to 2003 and prior years initiatives</b> | <b>\$</b>         | <b>\$</b>        | <b>\$</b>         | <b>\$ (1)</b>    |
| <b>Total</b>   | <b>\$ (1)</b>     | <b>\$</b>        | <b>\$ 1</b>       | <b>\$ 32</b>     |

During the thirteen weeks ended August 4, 2007, we reversed \$3 million of previously recorded reserves and recorded charges of \$2 million based on changes in estimated lease commitments. During the thirteen weeks ended July 29, 2006, we recorded charges of \$2 million for changes in estimated lease commitments and disposal charges, which were offset by the reversal of \$2 million of previously recorded reserves related to lease commitments and severance.

During the twenty-six weeks ended August 4, 2007, we recorded charges of \$4 million and reversed \$3 million of previously recorded reserves based on changes in estimated lease commitments. For the twenty-six weeks ended July 29, 2006, we incurred \$8 million of charges relating to lease commitments and disposal charges, which were partially offset by the reversal of \$3 million of previously recorded reserves primarily related to lease commitments and severance. For the twenty-six weeks ended July 29, 2006, we also incurred \$3 million of inventory markdowns and liquidator fees that were recorded in cost of sales, and \$24 million of accelerated depreciation related to the closed and converted stores from our 2005 initiative.

Restructuring charges and reversals related to prior years initiatives are primarily due to changes in management's estimates for events such as lease terminations, assignments and sublease income adjustments.

Our Condensed Consolidated Balance Sheets as of August 4, 2007, February 3, 2007 and July 29, 2006 included the following restructuring reserves, which we believe are adequate to cover our commitments:

| (In millions)                    | August 4,<br>2007 | February 3,<br>2007 | July 29,<br>2006 |
|----------------------------------|-------------------|---------------------|------------------|
| 2005 initiative                  | \$ 10             | \$ 11               | \$ 16            |
| 2003 and prior years initiatives | 53                | 63                  | 71               |
| <b>Total</b>                     | <b>\$ 63</b>      | <b>\$ 74</b>        | <b>\$ 87</b>     |

We currently expect to utilize our remaining reserves through January 2019. The following is a description of our individual restructuring initiatives and a roll-forward of the related charges and reserves.

***2005 initiative***

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On January 5, 2006, our Board of Directors approved the closing of 87 Toys R Us stores in the United States. As of April 2, 2006, all 87 stores had been closed. Twelve of these stores were converted into Babies R Us stores, which reopened in the fall of 2006, resulting in the permanent closure of 75 stores. As a result of the store closings, approximately 3,000 employee positions were eliminated. A reconciliation of the activity by major type of cost during the twenty-six weeks ended August 4, 2007 and July 29, 2006 is provided for this initiative below:

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| (In millions)                           | Lease commitments | Asset impairment | Severance | Inventory markdowns | Accelerated depreciation | Total        |
|---|-------------------|------------------|-----------|---------------------|--------------------------|--------------|
| Beginning balance at February 3, 2007   | \$ 11             | \$               | \$        | \$                  | \$                       | \$ 11        |
| Charges                                 | 2                 |                  |           |                     |                          | 2            |
| Reversals                               | (1)               |                  |           |                     |                          | (1)          |
| Utilized                                | (2)               |                  |           |                     |                          | (2)          |
| <b>Ending balance at August 4, 2007</b> | <b>\$ 10</b>      | <b>\$</b>        | <b>\$</b> | <b>\$</b>           | <b>\$</b>                | <b>\$ 10</b> |
| Beginning balance at January 28, 2006   | \$ 1              | \$               | \$ 8      | \$ 34               | \$                       | \$ 43        |
| Charges                                 | 5                 | 2                |           | 3                   | 24                       | 34           |
| Reversals                               |                   |                  | (1)       |                     |                          | (1)          |
| Utilized                                | (3)               | (2)              | (6)       | (37)                | (24)                     | (72)         |
| Reclassification (1)                    | 12                |                  |           |                     |                          | 12           |
| Ending balance at July 29, 2006         | \$ 15             | \$               | \$ 1      | \$                  | \$                       | \$ 16        |

(1) Reclassification of straight-line lease reserves recorded in prior periods related to the restructured properties.

**2003 and prior years initiatives**

In fiscal 2003, we decided to close all 146 freestanding Kids R Us stores and all 36 freestanding Imaginarium stores, as well as three distribution centers that supported these stores, due to deterioration in their financial performance. In fiscal 2001, we closed stores, eliminated a number of staff positions, and consolidated five store support center facilities into our Global Store Support Center facility in Wayne, New Jersey. In fiscal 1998 and fiscal 1995, we had strategic initiatives to reposition our worldwide operations.

The following is a reconciliation of the activity during the twenty-six weeks ended August 4, 2007 and July 29, 2006:

| (In millions)                           | 2003 initiative | 2001 initiative | 1998 and 1995 initiatives | Total        |
|---|-----------------|-----------------|---------------------------|--------------|
| Beginning balance at February 3, 2007   | \$ 4            | \$ 43           | \$ 16                     | \$ 63        |
| Charges                                 |                 | 2               |                           | 2            |
| Reversals                               |                 |                 | (2)                       | (2)          |
| Utilized                                | (2)             | (5)             | (3)                       | (10)         |
| <b>Ending balance at August 4, 2007</b> | <b>\$ 2</b>     | <b>\$ 40</b>    | <b>\$ 11</b>              | <b>\$ 53</b> |
| Beginning balance at January 28, 2006   | \$ 8            | \$ 51           | \$ 22                     | \$ 81        |
| Charges                                 |                 | 1               |                           | 1            |
| Reversals                               | (1)             | (1)             |                           | (2)          |
| Utilized                                | (1)             | (5)             | (3)                       | (9)          |
| Ending balance at July 29, 2006         | \$ 6            | \$ 46           | \$ 19                     | \$ 71        |

**Table of Contents*****Assets held for sale***

The following assets are classified as current assets held for sale:

| (In millions)                                   | August 4,<br>2007 | February 3,<br>2007 | July 29,<br>2006 |
|---|-------------------|---------------------|------------------|
| Land  | \$ 6              | \$ 4                | \$ 36            |
| Buildings                                       | 3                 | 5                   | 66               |
| Leasehold improvements                          | 1                 | 3                   | 21               |
|   | 10                | 12                  | 123              |
| Less: accumulated depreciation and amortization | (4)               | (3)                 | (29)             |
| Assets held for sale                            | \$ 6              | \$ 9                | \$ 94            |

**3. Change in accounting principle**

As of February 4, 2007, we changed our accounting method for valuing merchandise inventories of our international wholly-owned subsidiaries from the retail inventory method to the weighted average cost method. We recently implemented a perpetual inventory system in our international locations, excluding Toys R Us Japan, Ltd. ( Toys-Japan ), which already utilizes a similar system and follows the weighted average cost method. The weighted average cost method utilizes the newly available perpetual inventory records to value inventories. We plan to change our accounting method for valuing merchandise inventories for our U.S. divisions from the retail inventory method to the weighted average cost method in fiscal 2008 when our perpetual inventory system is implemented domestically.

Management believes the weighted average cost method is preferable over the retail inventory method because it results in greater precision in the determination of cost of sales and merchandise inventories. Our newly instituted perpetual inventory system provides management product level detail by store on both a weighted average cost and retail price basis. Management believes the weighted average cost method provides for a better matching of cost of sales with related sales. Cost of sales under the weighted average cost method will represent the weighted average cost of the individual item sold rather than the cost of an item based on an average margin realized on an entire department as under the retail method. As of August 4, 2007, February 3, 2007 and July 29, 2006, we valued approximately 42%, 10% and 12%, respectively, of merchandise inventories under the weighted average cost method, with the remainder valued under the retail inventory method.

In accordance with SFAS 154, we recorded the cumulative effect of the change in accounting principle as of February 4, 2007. We determined that retrospective application for periods prior to fiscal year 2007 is impracticable, as the period-specific information necessary to value the international merchandise inventories under the weighted average cost method is unavailable. As of February 4, 2007, the cumulative effect of this change in accounting principle was a reduction in merchandise inventory of \$13 million, an increase in deferred tax assets of \$4 million and a net increase in Stockholder's deficit of \$9 million.

For comparability purposes, the following tables set forth the effects of the change in accounting principle by comparing our Condensed Consolidated Balance Sheet and Statement of Operations (as reported under the weighted average cost method) to pro forma Condensed Consolidated Balance Sheet and Statement of Operations (as if merchandise inventories were valued under the retail inventory method) for the thirteen and twenty-six weeks ended August 4, 2007:

**Table of Contents****Condensed Consolidated Balance Sheet**

| (In millions)                               |             |           | Increase (decrease)<br>from change in |
|---|-------------|-----------|---------------------------------------|
| As of August 4, 2007                        | As reported | Pro forma | accounting <sup>(1)</sup>             |
| Merchandise inventories                     | \$ 2,090    | \$ 2,092  | \$ (2)                                |
| Total current assets                        | 2,778       | 2,780     | (2)                                   |
| Total assets                                | 8,224       | 8,226     | (2)                                   |
| Stockholder's deficit                       | (710)       | (708)     | (2)                                   |
| Total liabilities and stockholder's deficit | 8,224       | 8,226     | (2)                                   |

<sup>(1)</sup> Includes the cumulative effect of the change in accounting principle.

**Condensed Consolidated Statement of Operations**

| (In millions)                                  |             |           | Increase (decrease)<br>from change in |
|--|-------------|-----------|---------------------------------------|
| For the 13 Weeks Ended August 4, 2007          | As reported | Pro forma | accounting                            |
| Cost of sales                                  | \$ 1,669    | \$ 1,674  | \$ (5)                                |
| Gross margin                                   | 936         | 931       | 5                                     |
| Operating earnings                             | 28          | 23        | 5                                     |
| Loss before income taxes and minority interest | (88)        | (93)      | 5                                     |
| Income tax benefit                             | 45          | 47        | (2)                                   |
| Net loss                                       | (42)        | (45)      | 3                                     |

| (In millions)                                  |             |           | Increase (decrease)<br>from change in |
|--|-------------|-----------|---------------------------------------|
| For the 26 Weeks Ended August 4, 2007          | As reported | Pro forma | accounting                            |
| Cost of sales                                  | \$ 3,341    | \$ 3,352  | \$ (11)                               |
| Gross margin                                   | 1,845       | 1,834     | 11                                    |
| Operating earnings                             | 51          | 40        | 11                                    |
| Loss before income taxes and minority interest | (179)       | (190)     | 11                                    |
| Income tax benefit                             | 89          | 93        | (4)                                   |
| Net loss                                       | (83)        | (90)      | 7                                     |



**Table of Contents****4. Short-term borrowings and long-term debt**

A summary of the Company's short-term borrowings and long-term debt as of August 4, 2007, February 3, 2007 and July 29, 2006 is outlined in the table below:

| (In millions)  | August 4,<br>2007 | February 3,<br>2007 | July 29,<br>2006 |
|--|-------------------|---------------------|------------------|
| <b>Short-term borrowings</b>   |                   |                     |                  |
| Toys R Us Japan, Ltd. 0.75%-0.89% short-term bank loans due fiscal 2007                      | \$ 235            | \$ 151              | \$ 316           |
| <b>Long-term debt</b>  |                   |                     |                  |
| 6.875% notes, due August 1, 2006 <sup>(a)</sup>  | \$                | \$                  | \$ 250           |
| LIBOR plus 1.30% secured real estate loan, due August 9, 2008 <sup>(b)</sup>                 | 800               | 800                 | 800              |
| Note at an effective cost of 2.23% due in semi-annual installments through February 20, 2008 | 32                | 49                  | 64               |
| LIBOR plus 3.00%-4.00% asset sale facility, due July 19, 2008                                | 35                | 44                  | 200              |
| LIBOR plus 3.00% unsecured credit agreement, due December 9, 2008 <sup>(d)</sup>             | 1,300             | 1,300               | 1,300            |
| LIBOR plus 1.50%-2.00% multi-currency revolving credit facility, expires fiscal 2010         | 38                |                     | 157              |
| LIBOR plus 1.00%-3.75% \$2.0 billion secured revolving credit facility, expires fiscal 2010  | 65                |                     | 434              |
| 7.625% notes, due fiscal 2011 <sup>(a)</sup>   | 519               | 522                 | 524              |
| LIBOR plus 4.25% secured term loan facility, due fiscal 2012                                 | 801               | 800                 | 800              |
| LIBOR plus 5.00% unsecured credit facility, due fiscal 2012                                  | 180               | 180                 |                  |
| EURIBOR plus 1.50% French real estate credit facility, due fiscal 2012                       | 88                | 84                  | 83               |
| EURIBOR plus 1.50% Spanish real estate credit facility, due fiscal 2012                      | 183               | 173                 | 172              |
| 5.02% U.K. real estate credit facility, due fiscal 2013                                      | 724               | 700                 | 663              |
| LIBOR plus 2.25% U.K. real estate credit facility, due fiscal 2013                           | 129               | 121                 | 116              |
| 7.875% notes, due fiscal 2013 <sup>(a)</sup>   | 391               | 391                 | 390              |
| Toys R Us-Japan, Ltd. 1.20%-2.80% loans due fiscal 2007-2020                                 | 161               | 152                 | 164              |
| 7.375% notes, due fiscal 2018 <sup>(a)</sup>   | 407               | 408                 | 408              |
| 8.75% debentures, due fiscal 2021 <sup>(c)</sup>   | 22                | 22                  | 199              |
| Capital leases   | 39                | 42                  | 15               |
|  | <b>5,914</b>      | <b>5,788</b>        | <b>6,739</b>     |
| Less current portion   | <b>94</b>         | <b>66</b>           | <b>310</b>       |
| <b>Total long-term debt</b>  | <b>\$ 5,820</b>   | <b>\$ 5,722</b>     | <b>\$ 6,429</b>  |

<sup>(a)</sup> Represents obligations of the Toys R Us, Inc. legal entity.

<sup>(b)</sup> We have classified this loan as long-term debt because we have the contractual ability and intent to extend the due date to August 9, 2010.

<sup>(c)</sup> Represents obligations of Toys R Us, Inc. and our subsidiary Toys R Us-Delaware, Inc. ( Toys-Delaware ).

<sup>(d)</sup> We have classified this loan as long-term debt because we have the contractual ability and intent to extend the due date to December 7, 2010.

As of August 4, 2007, we were in compliance with all of our financial covenants related to our outstanding debt.

**Borrowing availability**

At August 4, 2007, under our \$2 billion secured revolving credit facility, we had \$65 million in borrowings outstanding, \$116 million of outstanding letters of credit, and remaining availability of \$977 million. In addition, under our multi-currency revolving credit facilities, we had \$38 million in borrowings outstanding and \$356 million of remaining availability. We have classified borrowings under these revolving credit facilities as long-term, as the revolving credit facilities expire in fiscal 2010. However, we may pay these facilities down within the next twelve months if we have the ability to do so either through additional long-term financing or through cash from operating activities.



**Table of Contents*****Secured real estate loan, due August 9, 2008 (\$800 million at August 4, 2007)***

On July 9, 2007, we notified the lenders for our \$800 million secured real estate loan that we were exercising our first maturity date extension option (the First Extension Option), which extended the maturity date of the loan from August 9, 2007 to August 9, 2008. The other key terms of the loan were not changed as a result of the extension. We have the ability and intent to exercise our two remaining maturity date extension options to August 2009 and August 2010. Pursuant to the First Extension Option, we were also required to extend our current interest rate cap through the end of the first maturity extension. Refer to Note 5 to the Condensed Consolidated Financial Statements entitled Derivative instruments and hedging activities for further details.

***Asset sale facility, due July 19, 2008 (\$35 million at August 4, 2007)***

On June 1, 2007, Toys-Delaware used the \$9 million proceeds from the properties sold on May 31, 2007 (refer to Note 10 to the Condensed Consolidated Financial Statements entitled Net gains on sales of properties) to repay a portion of the \$200 million asset sale facility.

Subsequent to quarter end, on August 23, 2007, Toys-Delaware repaid an additional \$10 million of principal in connection with a lease termination agreement during the second quarter of fiscal 2007 (refer to Note 10 to the Condensed Consolidated Financial Statements entitled Net gains on sales of properties), leaving an outstanding balance of \$25 million.

***U.K. real estate credit facility, due fiscal 2013 (\$724 million at August 4, 2007)***

As previously described in our fiscal 2006 Annual Report on Form 10-K, during fiscal 2006, we identified Vanwall Finance PLC (Vanwall) as a variable interest entity established with the limited purpose of issuing the notes under the credit agreement with Toys R Us Properties (UK) Limited (Toys Properties), our indirect wholly-owned subsidiary, and certain related transactions. Our loan agreement with Vanwall requires the Company to indemnify Vanwall against any loss or liability that Vanwall incurs as a consequence of any part of the loan being repaid or prepaid, including costs relating to terminating all or part of their interest rate swap. Management has performed an analysis of Vanwall in accordance with Financial Interpretation (FIN) No. 46 (revised December 2003), Consolidation of Variable Interest Entities (FIN 46(R)) and has concluded that the Company is not the primary beneficiary and the entity should not be consolidated.

***U.K. real estate credit facility, due fiscal 2013 (\$129 million at August 4, 2007)***

On February 8, 2007, Toys Properties borrowed an additional \$4 million (£1.9 million) from the Junior Lender of our U.K. real estate credit facility under conditions previously specified in the original loan agreement dated February 8, 2006.

***Guarantees***

Toys R Us, Inc. currently guarantees 80% of Toys-Japan's three installment loans from a third party in Japan, totaling 5.2 billion yen (\$44 million). These loans have annual interest rates of 2.6% - 2.8%, are due from 2012 to 2014, and are reported as part of the Toys R Us-Japan, Ltd. loans of \$161 million at August 4, 2007.

**5. Derivative instruments and hedging activities**

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires the recording of all derivatives as either assets or liabilities on the balance sheet measured at estimated fair value and the recognition of the unrealized gains and losses. We record the fair market value of our derivatives, based on information provided by reliable third parties, as other assets and other non-current liabilities within our Condensed Consolidated Balance Sheets. The changes in fair value of derivatives are recorded in the Condensed Consolidated Statements of Operations in interest expense, unless the derivative is designated as a hedge. In certain defined conditions, a derivative may be specifically designated as a hedge for a particular exposure. The effective portion of a cash flow hedge is recorded to other comprehensive income or loss; the ineffective portion of a cash flow hedge is recorded to interest expense. For our derivatives that are designated under SFAS 133 as cash flow hedges, no material ineffectiveness existed at August 4, 2007 and July 29, 2006. We recorded approximately a \$1 million impact to Interest expense for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006 related to these hedges.

For the thirteen and twenty-six weeks ended August 4, 2007, we recorded net charges to Interest expense of \$2 million and \$10 million, respectively, related to the change in fair value of our derivatives that do not qualify for hedge accounting. For the thirteen and twenty-six weeks ended July 29, 2006, we recorded a \$1 million reduction to Interest expense related to the change in fair value of our derivatives that did not

qualify for hedge accounting.

**Table of Contents*****Secured real estate loan, due August 9, 2008 (\$800 million at August 4, 2007)***

On July 27, 2007, we extended the interest rate caps on the \$800 million notional amount related to the secured real estate loan. The amount paid to extend the caps was less than \$1 million. The interest rate caps manage the variable cash flows associated with changes in the one month LIBOR above 7.00% and mature in August 2008. The derivative contracts do not qualify for hedge accounting under SFAS 133.

***Unsecured credit facility, due fiscal 2012 (\$180 million at August 4, 2007)***

On May 24, 2007, we entered into an interest rate cap for \$91 million notional amount related to the \$180 million unsecured credit facility due fiscal 2012, as required by the credit agreement. The amount paid to enter into the cap was less than \$1 million. The interest rate cap manages the variable cash flows associated with changes in the one month LIBOR above 7.00% and matures in May 2009. The derivative contract does not qualify for hedge accounting under SFAS 133.

***U.K. real estate credit facility, due fiscal 2013 (\$129 million at August 4, 2007)***

On April 5, 2007, we entered into an interest rate swap for \$4 million (£1.9 million) notional amount related to the additional borrowings on the U.K. real estate credit facility made in February 2007 (See Note 4 entitled "Short-term borrowings and long-term debt"). The interest rate swap hedges the variable LIBOR for a fixed rate of interest of 5.69% plus the credit spread until April 2013. The derivative contract is designated as a cash flow hedge under the long-haul method under SFAS 133.

**6. Income taxes**

The following table summarizes our income tax benefit and effective tax rates for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006:

| (In millions)                                  | 13 Weeks Ended    |                  | 26 Weeks Ended    |                  |
|--|-------------------|------------------|-------------------|------------------|
|  | August 4,<br>2007 | July 29,<br>2006 | August 4,<br>2007 | July 29,<br>2006 |
| Loss before income taxes and minority interest | \$ (88)           | \$ (113)         | \$ (179)          | \$ (245)         |
| Income tax benefit                             | 45                | 2                | 89                | 89               |
| Effective tax rate                             | (51.1)%           | (1.8)%           | (49.7)%           | (36.3)%          |

The effective tax rates for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006 were based primarily on our forecasted annualized effective tax rates, adjusted for significant and unusual items that occurred within the periods presented. Our forecasted annualized effective tax rate was 53.4% compared to 32.6% in the same period last year. The difference between our forecasted annualized effective tax rates was primarily due to improvements in our actual operating results for the twenty-six weeks ended August 4, 2007 and an increase in our forecasted pre-tax income for the remainder of fiscal 2007 as compared to the same period last year.

For the thirteen weeks ended August 4, 2007, our effective tax rate was impacted by additional income tax expense from adjustments to our current income taxes payable of \$3 million and our FIN 48 liability of \$2 million. The additional income tax expense was partially offset by income tax benefits related to settlements of certain tax audits of \$3 million and changes in foreign and state tax laws of \$1 million. For the thirteen weeks ended July 29, 2006, our effective tax rate was impacted by additional income tax expense related to adjustments in certain estimated tax reserves of \$3 million and changes in state tax laws of less than \$1 million.

For the twenty-six weeks ended August 4, 2007, our effective tax rate was impacted by additional income tax expense from settlements of certain tax audits of \$2 million, adjustments to our FIN 48 liability of \$2 million, and adjustments to our current income taxes payable of \$1 million. The additional income tax expense was partially offset by an income tax benefit related to changes in foreign and state tax laws of \$1 million. For the twenty-six weeks ended July 29, 2006, our effective tax rate was impacted by additional income tax benefits related to the reversal of certain valuation allowance of \$6 million, adjustments in certain estimated tax reserves of \$3 million, and additional foreign tax credits of \$2 million. The income tax benefits were slightly offset by income tax expense related to changes in state tax laws of less than \$1 million.

In 2006, the FASB issued FIN 48, which clarifies the accounting for uncertainty in income taxes. FIN 48 requires that we recognize in our financial statements the impact of a tax position taken or expected to be taken in a tax return, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. We adopted the provisions of FIN 48 on February 4, 2007.



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Upon adoption of FIN 48, we decreased our liability for unrecognized tax benefits by \$21 million (from \$133 million to \$112 million), which was accounted for as a cumulative effect reduction of retained deficit as of February 4, 2007. In addition, we have reflected additional unrecognized tax benefits, and corresponding tax assets, of \$148 million. As a result, the total amount of unrecognized tax benefits was \$260 million at February 4, 2007 (date of adoption).

Of the \$260 million of unrecognized tax benefits, the amount that, if recognized, would affect our effective tax rate is \$112 million. The remaining \$148 million would affect our deferred tax accounts. Included within the unrecognized tax benefits recorded on February 4, 2007 was accrued interest and penalties of \$28 million and \$4 million, respectively. We accrue interest and penalties related to unrecognized tax benefits as a component of income tax expense on the Condensed Consolidated Statement of Operations.

We believe that it is reasonably possible that the total amount of unrecognized tax benefits will decrease by as much as \$41 million during the next 12 months as a result of settling uncertain intercompany tax positions in several taxing jurisdictions.

At February 3, 2007, we reported tax reserves in the Income taxes payable line of our Consolidated Balance Sheet. As of August 4, 2007, we reported \$41 million of the reserve for unrecognized tax benefits in Accrued expenses and other current liabilities and \$115 million of the reserve for unrecognized tax benefits in Other non-current liabilities lines of our Condensed Consolidated Balance Sheet. These amounts do not include a portion of our unrecognized tax benefits, which have been recorded as a reduction of Deferred tax assets related to net operating losses. As of August 4, 2007, there have been no material changes to our unrecognized tax benefits since the date of adoption.

The Company or its subsidiaries are subject to taxation in the United States and various foreign jurisdictions. Of the major tax jurisdictions, the Company or its subsidiaries are subject to examination by the United States and Canada for the fiscal years 2003 to 2006, by France, Germany, and Spain for the fiscal years 2000 to 2006, by Japan for the fiscal years 2004 to 2006, and by the United Kingdom for fiscal years 2001 to 2006.

**7. Comprehensive loss**

Comprehensive loss, net of taxes, is comprised of:

| (In millions)  | 13 Weeks Ended    |                  | 26 Weeks Ended    |                  |
|--|-------------------|------------------|-------------------|------------------|
|  | August 4,<br>2007 | July 29,<br>2006 | August 4,<br>2007 | July 29,<br>2006 |
| Net loss   | \$ (42)           | \$ (111)         | \$ (83)           | \$ (156)         |
| Foreign currency translation adjustments, net of tax | 4                 | (11)             | 34                | (20)             |
| Unrealized loss on hedged transactions, net of tax   | 1                 | (4)              |                   | (2)              |
| Comprehensive loss                                   | \$ (37)           | \$ (126)         | \$ (49)           | \$ (178)         |

**8. Segments**

Our reportable segments are: Toys R Us-U.S. ( Toys U.S. ), which operates toy stores in 49 states and Puerto Rico and is responsible for our internet operations; Toys R Us-International ( International ), which operates and licenses or franchises toy stores in 33 foreign countries with wholly-owned operations in Australia, Austria, Canada, France, Germany, Portugal, Spain, Switzerland, and the United Kingdom, and consolidates the results of Toys-Japan; and Babies R Us ( Babies ), which operates stores in 41 states. We identify segments based on the information used by our chief operating decision maker to analyze performance and to allocate resources among each business unit of the Company. All intercompany transactions between the segments have been eliminated. Income tax information by segment has not been included as taxes are calculated at a company-wide level and are not allocated to each segment.

During the third quarter of fiscal 2006, we reorganized our operations, resulting in Toysrus.com being reflected as part of our Toys U.S. segment. Prior years information has been restated to reflect the current segment structure.

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A summary of operations by reportable segment is as follows:

| (In millions)   | 13 Weeks Ended    |                  | 26 Weeks Ended    |                  |
|---|-------------------|------------------|-------------------|------------------|
|   | August 4,<br>2007 | July 29,<br>2006 | August 4,<br>2007 | July 29,<br>2006 |
| Net sales   |                   |                  |                   |                  |
| Toys R Us U.S.  | \$ 994            | \$ 980           | \$ 2,018          | \$ 1,995         |
| Toys R Us International                               | 998               | 890              | 1,906             | 1,683            |
| Babies R Us   | 613               | 562              | 1,262             | 1,159            |
| <b>Total net sales</b>                                | <b>\$ 2,605</b>   | <b>\$ 2,432</b>  | <b>\$ 5,186</b>   | <b>\$ 4,837</b>  |
| Operating earnings (loss)                             |                   |                  |                   |                  |
| Toys R Us U.S.  | \$ (4)            | \$ 3             | \$ 4              | \$ (9)           |
| Toys R Us International                               | 17                | 11               | (6)               | (12)             |
| Babies R Us   | 78                | 65               | 182               | 156              |
| Corporate and other charges                           | (76)              | (68)             | (144)             | (129)            |
| Net gains on sales of properties                      | 12                |                  | 16                |                  |
| Restructuring and other charges                       | 1                 |                  | (1)               | (5)              |
| <b>Operating earnings</b>                             | <b>28</b>         | <b>11</b>        | <b>51</b>         | <b>1</b>         |
| Interest expense                                      | (120)             | (129)            | (242)             | (259)            |
| Interest income                                       | 4                 | 5                | 12                | 13               |
| <b>Loss before income taxes and minority interest</b> | <b>\$ (88)</b>    | <b>\$ (113)</b>  | <b>\$ (179)</b>   | <b>\$ (245)</b>  |

(1) Prior year's information has been restated to reflect the fiscal 2006 segment change and includes Toysrus.com.

| (In millions)                        | August 4,<br>2007 | February 3,<br>2007 | July 29,<br>2006 |
|--------------------------------------|-------------------|---------------------|------------------|
| Merchandise inventories              |                   |                     |                  |
| Toys R Us U.S.                       | \$ 870            | \$ 716              | \$ 939           |
| Toys R Us International              | 878               | 637                 | 822              |
| Babies R Us                          | 342               | 337                 | 313              |
| <b>Total merchandise inventories</b> | <b>\$ 2,090</b>   | <b>\$ 1,690</b>     | <b>\$ 2,074</b>  |

(1) Prior year's information has been restated to reflect the fiscal 2006 segment change and includes Toysrus.com.

(2) Refer to Note 3 to Condensed Consolidated Financial Statements entitled "Change in accounting principle" for the impact of the change in accounting methods for valuing our international subsidiaries' inventories.

**9. Litigation and legal proceedings**

During the second quarter of fiscal 2007, we established a reserve and increased selling, general and administrative expenses in the amount of \$8 million in connection with a pending legal action.

As of the end of our fiscal 2005 year, Toysrus.com operated three co-branded on-line stores under a strategic alliance agreement with Amazon.com. On May 21, 2004, we filed a lawsuit against Amazon.com and its affiliated companies in the Superior Court of New Jersey, Chancery Division, Passaic County (the New Jersey Trial Court) to terminate our strategic alliance agreement with Amazon.com. On June 25, 2004, Amazon.com filed a counterclaim against us and our affiliated companies alleging breach of contract relating to inventory and selection requirements. On March 31, 2006, the New Jersey Trial Court entered its order granting our request for termination of the agreement and



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denying Amazon.com's request for relief on its counterclaim. On or about March 2, 2007, Amazon.com filed a Notice of Appeal of the New Jersey Trial Court's March 31, 2006 order and certain other related orders. On or about March 16, 2007, we filed a Notice of Cross-Appeal on the issue of whether the New Jersey Trial Court erred in denying our claim for damages caused by Amazon.com's material breach of the parties' strategic alliance agreement.

On June 2, 2006, Amazon.com filed a lawsuit against us in the Superior Court of Washington, County of King, (the Washington Court) for money damages allegedly arising from services it was required to provide to us during the wind-down period pursuant to the final order entered in the New Jersey Trial Court. The Washington Court stayed proceedings before it in favor of the New Jersey Trial Court, and the New Jersey Trial Court has ruled that Amazon.com is not entitled to the fees it sought for services it was required to provide during the wind-down period. The Washington Court has directed that any further litigation over these issues proceed in the New Jersey courts. We believe that Amazon.com's maintenance of the Washington Court lawsuit is without merit.

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In addition to the litigation discussed above, we are involved in various other lawsuits, claims and proceedings incident to the ordinary course of business. The results of litigation are inherently unpredictable. Any claims against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in diversion of significant resources. The results of these lawsuits, claims and proceedings cannot be predicted with certainty. However, we believe that the ultimate resolution of these current matters will not have a material adverse effect on our financial statements taken as a whole.

**10. Net gains on sales of properties**

In the third quarter of fiscal 2006, Toys-Delaware and MAP 2005 Real Estate, LLC ( MAP ) (collectively referred to herein as Seller ), both wholly-owned subsidiaries, consummated the sale of its interest in 38 properties, out of a total agreed upon sale of 42 properties, to Vornado Surplus 2006 Realty LLC, a Delaware limited liability company, an affiliate of Vornado Realty Trust, an indirect equity owner of the Company and the Seller. In the first quarter of fiscal 2007, the Seller sold two additional properties for gross proceeds of approximately \$5 million and recorded a gain of \$3 million. During the second quarter of fiscal 2007, the Seller completed the sale of the two remaining properties for gross proceeds of \$9 million and recorded a gain of \$2 million.

In addition, during the second quarter of fiscal 2007, we consummated a lease termination agreement resulting in net gains of \$10 million for the thirteen and twenty-six weeks ended August 4, 2007. Upon the closing of the transaction, the \$10 million lease termination payment was assigned to a third-party exchange agent and directly deposited by the landlord in the exchange agent's account to potentially be used in a tax deferral transaction. As such, no cash receipt was reflected in our Condensed Consolidated Statement of Cash Flows.

**11. Related party transactions*****Transactions with the Sponsors***

We are indirectly owned by an investment group consisting of entities advised by or affiliated with Bain Capital Partners LLC, Kohlberg Kravis Roberts & Co., and Vornado Realty Trust (collectively, the Sponsors ). The Sponsors provide management and advisory services to us pursuant to an advisory agreement executed at the closing of the Merger Transaction on July 21, 2005. We recorded management and advisory fees of \$4 million and \$8 million for the thirteen and twenty-six weeks ended August 4, 2007, respectively. The quarterly fees for the third and fourth quarters of fiscal 2007 will be \$4 million per quarter. For the thirteen and twenty-six weeks ended July 29, 2006, we recorded management and advisory fees of \$4 million and \$11 million, respectively. Additionally, pursuant to the advisory agreement, the Company reimbursed the Sponsors for \$1 million of out-of-pocket expenses for the thirteen and twenty-six weeks ended August 4, 2007.

From time to time, the Sponsors or their affiliates may acquire debt or debt securities issued by the Company or its subsidiaries in open market transactions or through loan syndications. On December 1, 2006, Toys-Delaware entered into an unsecured credit facility with a syndicate of financial institutions and other lenders. The syndicate includes affiliates of Vornado Realty Trust and Kohlberg Kravis Roberts & Co. L.P., all indirect equity owners of the Company, which each participated in 15% of the loan amount. At August 4, 2007, we owed \$180 million under the unsecured credit facility due fiscal 2012. Refer to Note 4 to the Condensed Consolidated Financial Statements entitled Short-term borrowings and long-term debt.

During the twenty-six weeks ended August 4, 2007, we sold properties to Vornado Surplus 2006 Realty LLC. Refer to Note 10 to the Condensed Consolidated Financial Statements entitled Net gains on sales of properties .

***Equity restructuring***

Effective August 3, 2007, management amended the charter of our parent company, Toys R Us Holdings, Inc., by replacing the existing two classes of stock ( Class A Common and Class L Common Stock ) with a single class of new common stock (the New Common Stock ). The New Common Stock will not have a yield accrual, interim distribution, or liquidation preference. Each award outstanding under the previous Management Equity Plan will convert into awards of the New Common Stock. The number of shares of the New Common Stock with respect to all such awards will be based on the conversion ratios. Each option to acquire shares of the New Common Stock will have the same aggregate exercise price as the corresponding option to acquire shares of Class A and Class L Common Stock. The equity restructuring at Toys R Us Holdings, Inc. had no impact on our equity structure or our Condensed Consolidated Financial Statements.

**Table of Contents****12. Recent accounting pronouncements**

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 statement permits entities to choose to measure eligible items at fair value at specified election dates. The statement requires reporting of unrealized gains and losses on items for which the fair value option has been elected in 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 for fiscal years beginning after November 15, 2007. We are currently assessing the impact that SFAS 159 will have on our Condensed Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans ( SFAS 158 )*. This Statement requires recognition of the funded status of a single-employer defined benefit postretirement plan as an asset or liability in its statement of financial position. Funded status is determined as the difference between the fair value of plan assets and the benefit obligation. Changes in that funded status should be recognized in the year in which the changes occur, in other comprehensive income. This recognition provision and the related disclosures are effective for the Company as of the end of the fiscal year ending after June 15, 2007. The Statement also requires the measurement of plan assets and benefit obligations as of the date of the fiscal year-end statement of financial position. This measurement provision is effective for fiscal years ending after December 15, 2008. We are currently assessing the effect that SFAS 158 will have on our Condensed Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements ( SFAS 157 )*. SFAS 157, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact that SFAS 157 will have on our Condensed Consolidated Financial Statements.

**13. Restatement of previously issued financial statements**

In the fourth quarter of fiscal 2006, we identified errors in the way we had previously accounted for income taxes. We did not properly record deferred tax accounts on a net basis by legal entity and taxing jurisdiction, as required by SFAS 109. The errors resulted in an overstatement of current and non-current deferred tax assets and liabilities as of July 29, 2006. As a result we have restated the accompanying Condensed Consolidated Balance Sheet. These restatement adjustments did not impact our previously reported interim Condensed Consolidated Statements of Operations, Condensed Consolidated Statements of Cash Flows or Condensed Consolidated Statement of Stockholder's Deficit.

The following table presents the aggregate impact of the errors related to accounting for deferred income taxes on our Consolidated Balance Sheet as of July 29, 2006:

(In millions)

| As of July 29, 2006   | Previously reported | Adjustments | As restated <sup>(1)</sup> |
|---|---------------------|-------------|----------------------------|
| Prepaid expenses, derivative assets and other current assets <sup>(2)</sup> | \$ 298              | \$ (60)     | \$ 238                     |
| Total current assets  | 3,316               | (60)        | 3,256                      |
| Deferred tax assets   | 533                 | (498)       | 35                         |
| Total assets  | 9,231               | (558)       | 8,673                      |
| Accrued expenses and other current liabilities                              | 779                 | (60)        | 719                        |
| Total current liabilities   | 2,524               | (60)        | 2,464                      |
| Deferred tax liabilities  | 520                 | (498)       | 22                         |
| Total liabilities and stockholder's deficit                                 | 9,231               | (558)       | 8,673                      |

<sup>(1)</sup> As restated amounts do not include the impact of the adoption of SAB 108. Refer to Note 1 to the Condensed Consolidated Financial Statements entitled *Basis of presentation* for the combined impact of the restatement and the adoption of SAB 108.

<sup>(2)</sup> Previously reported as a single line in our Quarterly Report on Form 10-Q Condensed Consolidated Balance Sheet. However, our current Condensed Consolidated Balance Sheet presents separately \$120 million of Current deferred tax assets and \$118 million of Prepaid expenses and other current assets, as restated and adjusted for SAB 108.

During the first three quarters of fiscal 2006, we presented certain immaterial other non-product revenue as a reduction in Selling, general and administrative expenses. We have restated Net sales and Selling, general and administrative expenses by increases of \$19 million and \$35

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million for the thirteen and twenty-six weeks ended July 29, 2006, respectively, to correctly present other non-product revenue in Net sales. This resulted in an increase in Net sales and an increase in Selling, general and administrative expenses.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) is intended to help you understand our historical results of operations during the periods presented and our financial condition. This MD&A should be read in conjunction with our Condensed Consolidated Financial Statements and the accompanying notes, and contains forward-looking statements that involve risks and uncertainties. See Forward-Looking Statements below.

#### **Our Business**

We generate sales, earnings, and cash flows by retailing toys, baby-juvenile products and children's apparel worldwide. Our reportable segments are Toys R Us U.S. ( Toys U.S. ), which operates toy stores in 49 states and Puerto Rico and sells merchandise through our Internet sites; Toys R Us International ( International ), which operates and licenses or franchises stores in 33 foreign countries; and Babies R Us ( Babies ), which operates specialty baby-juvenile stores in 41 states. As of August 4, 2007, there were 1,533 R Us branded retail stores worldwide.

#### **Restatement of Previously Issued Financial Statements**

In the fourth quarter of fiscal 2006, we identified errors in the way we had previously accounted for income taxes. We did not properly record deferred tax accounts on a net basis by legal entity and taxing jurisdiction, as required by Statement of Financial Accounting Standards ( SFAS ) No. 109 Accounting for Income Taxes ( SFAS 109 ). As a result, we have restated the accompanying Condensed Consolidated Balance Sheet as of July 29, 2006. The restatement adjustments did not impact our previously reported Consolidated Statements of Operations, Consolidated Statements of Cash Flows, or Consolidated Statements of Stockholder's Deficit. Refer to Note 13 to the Condensed Consolidated Financial Statements entitled Restatement of previously issued financial statements for further details.

During the third quarter of fiscal 2006, we reorganized our operations, resulting in Toysrus.com being reflected as part of our Toys-U.S. segment. Prior year information has been restated to reflect the current segment structure.

#### **Adoption of SAB 108**

In the fourth quarter of fiscal 2006, we adopted Securities and Exchange Commission ( SEC ) Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). As permitted under the transition provisions of SAB 108, in the prior fiscal year, we recorded a cumulative \$(24) million adjustment to opening retained deficit as of January 29, 2006 and adjusted our financial results for the first three quarters of fiscal 2006. These adjustments relate principally to tax-related errors from fiscal years 2005 and 2004 with the balance applicable to years prior to fiscal 2004. We have restated our previously issued financial statement information included in this document. Refer to Note 1 of the Condensed Consolidated Financial Statements entitled Basis of presentation for further details.

#### **Financial Performance**

As discussed in more detail in this MD&A, the following financial data presents an overview of our financial performance for the thirteen and twenty-six weeks ended August 4, 2007 compared to the thirteen and twenty-six weeks ended July 29, 2006:

| (\$ in millions)  | 13 Weeks Ended |          | 26 Weeks Ended |          |
|---|----------------|----------|----------------|----------|
|   | August 4,      | July 29, | August 4,      | July 29, |
|   | 2007           | 2006     | 2007           | 2006     |
| Net sales growth (versus prior year)                                      | 7.1%           | 15.0%    | 7.2%           | 13.6%    |
| Gross margin as a percentage of net sales                                 | 35.9%          | 34.9%    | 35.6%          | 35.1%    |
| Selling, general and administrative expenses as a percentage of net sales | 31.5%          | 30.3%    | 31.1%          | 30.6%    |
| Net loss  | \$ (42)        | \$ (111) | \$ (83)        | \$ (156) |

Consolidated net sales for the thirteen and twenty-six weeks ended August 4, 2007 increased due to comparable store net sales improvements at all of our divisions, increased net sales from the opening of an additional 43 wholly-owned stores worldwide since July 29, 2006, and benefits in foreign currency translation. Prior year net sales growth for the periods presented were positively impacted by the consolidation of Toys R Us-Japan Ltd. ( Toys-Japan ) beginning in the first quarter of 2006.



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Gross margin as a percentage of net sales for the thirteen weeks ended August 4, 2007 increased due to improvements in initial markup at all of our divisions, partially offset by increased markdowns at our Babies and International divisions. Gross margin as a percentage of net sales for the twenty-six weeks ended August 4, 2007 increased due to improvements in initial markup at all of our divisions, partially offset by increases in markdowns at our Babies and Toys U.S. divisions.

Selling, general and administrative expenses ( SG&A ) as a percentage of net sales for the thirteen and twenty-six weeks ended August 4, 2007 primarily increased due to payroll-related, store occupancy, corporate-related, and advertising expenses.

Net loss for the thirteen and twenty-six weeks ended August 4, 2007 decreased primarily due to increased net sales, an improvement in gross margin, net gains on sales of properties, and a decrease in interest expense, partially offset by an increase in SG&A. Net loss for the twenty-six weeks ended August 4, 2007 was also impacted by decreased depreciation and amortization expenses.

During the second quarter of fiscal 2007, we, along with our vendors, issued recalls for certain products that may not meet or exceed our high safety and quality assurance standards. The terms and conditions of our current standard form of purchase order require vendors to reimburse us for all of the costs incurred by us in connection with a recall of such vendor's merchandise. These recalls have not had a material impact on our Condensed Consolidated Financial Statements.

**Comparable Store Net Sales**

We include, in computing comparable store net sales, stores that have been open for 56 weeks (1 year and 4 weeks) from their soft opening date. A soft opening is typically two weeks prior to the grand opening. By measuring the year-over-year sales of merchandise in the stores that have a history of being open for a full comparable 56 weeks or more, we can better gauge how the core store base is performing since it excludes store openings and closings.

Various factors affect comparable store net sales, including the number of stores we open or close, the general retail sales environment, consumer preferences and buying trends, changes in sales mix among distribution channels, our ability to efficiently source and distribute products, changes in our merchandise mix, competition, current local and global economic conditions, the timing of our releases of new merchandise and promotional events, the success of marketing programs, and the cannibalization of existing store sales by new stores. Among other things, weather conditions can affect comparable store net sales because inclement weather can require us to close certain stores temporarily and thus reduce store traffic. Even if stores are not closed, many customers may decide to avoid going to stores in bad weather. These factors have caused our comparable store net sales to fluctuate significantly in the past on an annual, quarterly and monthly basis and, as a result, we expect that comparable store net sales will continue to fluctuate in the future.

The percentages, as set forth in the table below, represent changes in comparable store net sales compared to the same period in the prior year.

|   | 13 Weeks Ended     |                            | 26 Weeks Ended     |                            |
|---|--------------------|----------------------------|--------------------|----------------------------|
|   | August 4, 2007 vs. | July 29, 2006 vs.          | August 4, 2007 vs. | July 29, 2006 vs.          |
| <b>Comparable Store Net Sales Performance</b> | <b>2006</b>        | <b>2005 <sup>(2)</sup></b> | <b>2006</b>        | <b>2005 <sup>(2)</sup></b> |
| Toys R Us U.S.                                | 1.1%               | (0.2)%                     | 3.1%               | (3.6)%                     |
| Toys R Us International                       | 5.9%               | (0.4)%                     | 4.9%               | 1.6%                       |
| Babies R Us                                   | 2.2%               | 5.8%                       | 2.5%               | 5.2%                       |

(1) Includes wholly-owned operations. Toys-Japan is considered a wholly-owned operation beginning fiscal 2006.

(2) Comparable store net sales performance for the thirteen and twenty-six weeks ended July 29, 2006, as compared to the same periods in fiscal 2005, excludes the operations of Toys-Japan, whose results we began consolidating in fiscal 2006.

**Table of Contents****Store Count by Division (Segment)**

|                         | Divisional Store Count |                  |        |
|-------------------------|------------------------|------------------|--------|
|                         | August 4,<br>2007      | July 29,<br>2006 | Change |
| Toys R Us U.S.          | 585                    | 587              | (2)    |
| Toys R Us International | 693                    | 649              | 44     |
| Babies R Us             | 255                    | 234              | 21     |
| Total                   | 1,533                  | 1,470            | 63     |

(1) Store count as of August 4, 2007 includes 494 wholly-owned (including 169 in Japan) and 199 licensed and franchised stores. Store count as of July 29, 2006 includes 472 wholly-owned (including 164 in Japan) and 177 licensed and franchised stores.

**Net Loss**

| (In millions) | 13 Weeks Ended    |                  |           | 26 Weeks Ended    |                  |           |
|---------------|-------------------|------------------|-----------|-------------------|------------------|-----------|
|               | August 4,<br>2007 | July 29,<br>2006 | \$ Change | August 4,<br>2007 | July 29,<br>2006 | \$ Change |
| Net loss      | \$ (42)           | \$ (111)         | \$ 69     | \$ (83)           | \$ (156)         | \$ 73     |

Net loss decreased by \$69 million for the thirteen weeks ended August 4, 2007, compared to the same period last year. The net loss decreased primarily due to increases in our gross margin of \$88 million as a result of increased overall net sales; an increase in income tax benefit of \$43 million; net gains on sales of properties of \$12 million primarily related to the consummation of a lease termination agreement; and decreased interest expense of \$9 million primarily due to reduced borrowings and reduced amortization of deferred financing costs. Partially offsetting the decreases to our net loss were increases in SG&A of \$82 million primarily as a result of increases in payroll-related, store occupancy, corporate-related, and advertising expenses.

Net loss decreased by \$73 million for the twenty-six weeks ended August 4, 2007, compared to the same period last year. The net loss decreased primarily due to increases in our gross margin of \$148 million as a result of increased overall net sales; decreased interest expense of \$17 million primarily due to reduced borrowings and reduced amortization of deferred financing costs in fiscal 2007; decreases in depreciation and amortization expense of \$16 million primarily due to accelerated depreciation related to the fiscal 2005 restructuring initiative recorded in the first quarter of fiscal 2006; and net gains on sales of properties of \$16 million primarily related to the consummation of a lease termination agreement. Partially offsetting the decreases to our net loss were increases in SG&A of \$134 million primarily as a result of increases in payroll-related, store occupancy, corporate-related, and advertising expenses.

**Net Sales**

During the second quarter of fiscal 2007, we, along with our vendors, issued recalls for certain products that may not meet or exceed our high safety and quality assurance standards. The terms and conditions of our current standard form of purchase order require vendors to reimburse us for all of the costs incurred by us in connection with a recall of such vendor's merchandise. These recalls have not had a material impact on our Condensed Consolidated Financial Statements.

| (In millions)           | 13 Weeks Ended    |                  |           |          | Percentage of Net Sales |                  |
|-------------------------|-------------------|------------------|-----------|----------|-------------------------|------------------|
|                         | August 4,<br>2007 | July 29,<br>2006 | \$ Change | % Change | August 4,<br>2007       | July 29,<br>2006 |
| Toys R Us U.S.          | \$ 994            | \$ 980           | \$ 14     | 1.4%     | 38.2%                   | 40.3%            |
| Toys R Us International | 998               | 890              | 108       | 12.1%    | 38.3%                   | 36.6%            |
| Babies R Us             | 613               | 562              | 51        | 9.1%     | 23.5%                   | 23.1%            |



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|                 |                 |          |        |      |               |        |
|-----------------|-----------------|----------|--------|------|---------------|--------|
| Total net sales | <b>\$ 2,605</b> | \$ 2,432 | \$ 173 | 7.1% | <b>100.0%</b> | 100.0% |
|-----------------|-----------------|----------|--------|------|---------------|--------|

For the thirteen weeks ended August 4, 2007, net sales increased by \$173 million, or 7.1%, to \$2.6 billion from \$2.4 billion for the same period last year. Net sales for the thirteen weeks ended August 4, 2007 included the impact of foreign currency translation that increased net sales by \$24 million.

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The increase in net sales for thirteen weeks ended August 4, 2007, excluding foreign currency translation, was primarily the result of increased comparable store net sales at our International, Babies, and Toys U.S. divisions of 5.9%, 2.2%, and 1.1%, respectively. In addition, net sales in our International and Babies divisions increased compared to the same period last year due to net sales related to the opening of 22 wholly-owned International stores and 21 Babies stores in the United States since July 29, 2006.

| (In millions)           | 26 Weeks Ended    |                  |           |          | Percentage of Net Sales |                  |
|-------------------------|-------------------|------------------|-----------|----------|-------------------------|------------------|
|                         | August 4,<br>2007 | July 29,<br>2006 | \$ Change | % Change | August 4,<br>2007       | July 29,<br>2006 |
| Toys R Us U.S.          | \$ 2,018          | \$ 1,995         | \$ 23     | 1.2%     | 38.9%                   | 41.2%            |
| Toys R Us International | 1,906             | 1,683            | 223       | 13.3%    | 36.8%                   | 34.8%            |
| Babies R Us             | 1,262             | 1,159            | 103       | 8.9%     | 24.3%                   | 24.0%            |
| Total net sales         | \$ 5,186          | \$ 4,837         | \$ 349    | 7.2%     | 100.0%                  | 100.0%           |

For the twenty-six weeks ended August 4, 2007, net sales increased by \$349 million, or 7.2%, to \$5.2 billion from \$4.8 billion for the same period last year. Net sales for the twenty-six weeks ended August 4, 2007 included the impact of foreign currency translation that increased net sales by \$64 million.

The increase in net sales for twenty-six weeks ended August 4, 2007, excluding foreign currency translation, was primarily the result of increased comparable store net sales at our International, Toys U.S., and Babies divisions of 4.9%, 3.1%, and 2.5%, respectively. In addition, net sales in our International and Babies divisions increased compared to the same period last year due to net sales related to the opening of 22 wholly-owned International stores and 21 Babies stores in the United States since July 29, 2006.

**Toys R Us U.S.**

Net sales for the Toys U.S. division increased by \$14 million, or 1.4%, to \$994 million for the thirteen weeks ended August 4, 2007, compared to \$980 million in the same period last year. The increase in net sales was primarily a result of increases in our internet-based net sales, as well as an increase in comparable store net sales of 1.1%.

The comparable store net sales increase was primarily the result of increases in our entertainment category, which were driven by the continued strong demand for the Nintendo Wii video game system and related accessories. These increases were partially offset by lower sales in our juvenile and apparel categories, which were primarily impacted by a change in product assortments.

Net sales for the Toys U.S. division increased by \$23 million, or 1.2%, to \$2,018 million for the twenty-six weeks ended August 4, 2007, compared to \$1,995 million in the same period last year. The increase in net sales was primarily a result of increases in our internet-based net sales, as well as an increase in comparable store net sales of 3.1%. These increases were partially offset by decreased net sales as a result of the closing of 84 stores during the first quarter of 2006.

The comparable store net sales increase was primarily a result of increases in our entertainment and seasonal categories. Increases in the entertainment category were primarily a result of the strong demand for the Nintendo Wii video game system and related accessories. Demand for gym sets drove the increases in the seasonal category. These increases were partially offset by lower sales in our juvenile and apparel categories, which were primarily impacted by a change in product assortments.

**Toys R Us International**

Net sales for the International division increased by \$108 million, or 12.1%, to \$998 million for the thirteen weeks ended August 4, 2007, compared to \$890 million in the same period last year. Excluding a \$24 million increase in net sales due to foreign currency translation, the increase in International net sales was driven by an increase in comparable store net sales of 5.9%, as well as net sales from the opening of 22 additional wholly-owned International stores since July 29, 2006.

The comparable store net sales increase was primarily a result of increases in our entertainment, core toys, infant care and learning categories. The entertainment category increased due to continued strong demand for the Nintendo Wii and Sony PlayStation 3 video game systems and related accessories. The core toys category increased primarily due to higher sales of licensed action figures. The increase in the infant care

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category was primarily due to increased sales of infant consumables, bedding and furniture. The learning category benefited from sales of children video game systems and construction toys. These increases were partially offset by decreases in our seasonal category due to decreased demand for outdoor products and bicycles.

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Net sales for the International division increased by \$223 million, or 13.3%, to \$1,906 million for the twenty-six weeks ended August 4, 2007, compared to \$1,683 million in the same period last year. Excluding a \$64 million increase in net sales due to foreign currency translation, the increase in International net sales was driven by an increase in comparable store net sales of 4.9%, as well as net sales from the opening of 22 additional wholly-owned International stores since July 29, 2006.

The comparable store net sales increase was primarily impacted by increases in our entertainment, infant care and core toys categories. The entertainment category increased due to continued strong demand for the Nintendo Wii and Sony PlayStation 3 video game systems and related accessories. The increase in the infant care category was primarily due to increased sales of infant consumables, bedding and furniture. The core toys category increased primarily due to higher sales of licensed action figures. These increases were partially offset by decreases in our seasonal category due to decreased demand for outdoor products and bicycles.

**Babies R Us**

Net sales for the Babies division increased by \$51 million, or 9.1%, to \$613 million, for the thirteen weeks ended August 4, 2007, compared to \$562 million in the same period last year. The increase was primarily a result of net sales from the 21 Babies stores opened since July 29, 2006, as well as a 2.2% increase in comparable store net sales.

The comparable store net sales increase was primarily a result of increases in our commodities, infant care, and apparel categories. The commodities category was positively impacted by continued strong demand for value packaged diapers and wipes. The infant care category increased primarily due to safety products, video monitors and infant feeding products. The apparel category benefited from seasonal products such as activity and licensed team apparel. These increases were partially offset by lower sales in the furniture and bedding categories.

Net sales for the Babies division increased by \$103 million, or 8.9%, to \$1,262 million, for the twenty-six weeks ended August 4, 2007, compared to \$1,159 million in the same period last year. The increase was primarily a result of net sales from the 21 Babies stores opened since July 29, 2006, as well as a 2.5% increase in comparable store net sales.

The comparable store net sales increase was primarily a result of increases in our commodities and infant care categories. The commodities category increased primarily due to strong demand for organic foods, value packaged diapers and wipes. The infant care category increased primarily due to strong demand for safety products, video monitors and infant feeding products. Increases in these categories were partially offset by lower sales in the furniture category.

**Cost of Sales and Gross Margin**

The following costs are included in Cost of sales and Gross margin:

The cost of acquired merchandise from vendors;

Freight in;

Markdowns;

Provision for inventory shortages; and

Credits and allowances from our merchandise vendors.

**13 Weeks Ended**  
**Percentage of Net Sales**

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| (In millions)           |                   |                  |           | Percentage of Net |                  |              |
|-------------------------|-------------------|------------------|-----------|-------------------|------------------|--------------|
|                         | August 4,<br>2007 | July 29,<br>2006 | \$ Change | August 4,<br>2007 | July 29,<br>2006 | Sales Change |
| Toys R Us U.S.          | \$ 335            | \$ 320           | \$ 15     | 33.7%             | 32.7%            | 1.0%         |
| Toys R Us International | 365               | 318              | 47        | 36.6%             | 35.7%            | 0.9%         |
| Babies R Us             | 236               | 210              | 26        | 38.5%             | 37.4%            | 1.1%         |
| Total gross margin      | \$ 936            | \$ 848           | \$ 88     | 35.9%             | 34.9%            | 1.0%         |

Gross margin increased by \$88 million to \$936 million for the thirteen weeks ended August 4, 2007, compared to \$848 million in the same period last year. Gross margin as a percentage of net sales increased by 1.0 percentage point for the thirteen weeks ended August 4, 2007, compared to the same period last year. Gross margin as a percentage of net sales was positively impacted by improvements in initial markup at all of our divisions. These increases were partially offset by increased markdowns at our Babies and International divisions.

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| (In millions)           | 26 Weeks Ended    |                  |           |                   |                  |                                   |
|-------------------------|-------------------|------------------|-----------|-------------------|------------------|-----------------------------------|
|                         | August 4,<br>2007 | July 29,<br>2006 | \$ Change | August 4,<br>2007 | July 29,<br>2006 | Percentage of Net<br>Sales Change |
| Toys R Us U.S.          | \$ 674            | \$ 662           | \$ 12     | 33.4%             | 33.2%            | 0.2%                              |
| Toys R Us International | 679               | 595              | 84        | 35.6%             | 35.4%            | 0.2%                              |
| Babies R Us             | 492               | 440              | 52        | 39.0%             | 38.0%            | 1.0%                              |
| Total gross margin      | \$ 1,845          | \$ 1,697         | \$ 148    | 35.6%             | 35.1%            | 0.5%                              |

Gross margin increased by \$148 million to \$1.8 billion for the twenty-six weeks ended August 4, 2007, compared to \$1.7 billion in the same period last year. Gross margin as a percentage of net sales increased by 0.5 percentage point for the twenty-six weeks ended August 4, 2007, compared to the same period last year. Gross margin as a percentage of net sales was positively impacted by improvements in initial markup at all of our divisions, partially offset by increases in markdowns at our Babies and Toys U.S. divisions.

**Toys R Us U.S.**

Gross margin increased by \$15 million to \$335 million for the thirteen weeks ended August 4, 2007, compared to \$320 million in the same period last year. Gross margin as a percentage of net sales for the thirteen weeks ended August 4, 2007 increased 1.0 percentage point compared to the same period last year, primarily due to improved initial markup as a result of lower product costs.

Gross margin increased by \$12 million to \$674 million for the twenty-six weeks ended August 4, 2007, compared to \$662 million in the same period last year. Gross margin as a percentage of net sales for the twenty-six weeks ended August 4, 2007 increased 0.2 percentage points compared to the same period last year. The increase in gross margin as a percentage of net sales was primarily due to improved initial markup, which contributed a 1.0 percentage point increase, partially offset by increased markdowns, which contributed a 0.8 percentage point decrease.

The improved initial markup was primarily a result of lower product costs. The increase in markdown costs was the result of planned increases in promotional events and clearance markdowns taken to keep inventory current.

**Toys R Us International**

Gross margin increased by \$47 million to \$365 million for the thirteen weeks ended August 4, 2007, compared to \$318 million in the same period last year. Gross margin as a percentage of net sales for the thirteen weeks ended August 4, 2007 increased 0.9 percentage points.

The increase in gross margin as a percentage of net sales was primarily a result of improved initial markup in certain markets due to favorable changes in our sales mix toward higher margin products such as juvenile furniture and apparel in our infant care category and licensed products in our core toy category. These increases were partially offset in other markets by additional markdowns due to increased promotional activity. Additionally, our change in accounting method for valuing merchandise inventories of our international wholly-owned subsidiaries from the retail inventory method to the weighted average cost method (see Note 3 to the Condensed Consolidated Financial Statements entitled "Change in accounting principle") contributed an approximate \$5 million increase to our gross margin for the thirteen weeks ended August 4, 2007.

Gross margin increased by \$84 million to \$679 million for the twenty-six weeks ended August 4, 2007, compared to \$595 million in the same period last year. Gross margin as a percentage of net sales for the twenty-six weeks ended August 4, 2007 increased 0.2 percentage points.

The increase in gross margin as a percentage of net sales was primarily a result of improved initial markup in certain markets due to favorable changes in our sales mix toward higher margin products such as juvenile furniture and apparel in our infant care category and licensed products in our core toy category. Additionally, our change in accounting method for valuing merchandise inventories of our international wholly-owned subsidiaries from the retail inventory method to the weighted average cost method (see Note 3 to the Condensed Consolidated Financial Statements entitled "Change in accounting principle") contributed an approximate \$11 million increase to our gross margin for the twenty-six weeks ended August 4, 2007.

**Table of Contents****Babies R Us**

Gross margin increased by \$26 million to \$236 million for the thirteen weeks ended August 4, 2007 compared to \$210 million for the same period last year. Gross margin as a percentage of net sales increased 1.1 percentage points compared to the same period last year. The increase in gross margin as a percentage of net sales was primarily due to improved initial markup, which contributed a 1.8 percentage point increase, partially offset by an increase in markdowns, which contributed a 0.7 percentage point decrease.

The improved initial markup was primarily a result of a favorable change in our sales mix toward higher margin products in apparel and infant care categories and increased supplier promotional support. This increase in gross margin percentage was partially offset by additional markdowns to keep inventory current.

Gross margin increased by \$52 million to \$492 million for the twenty-six weeks ended August 4, 2007 compared to \$440 million for the same period last year. Gross margin as a percentage of net sales increased 1.0 percentage points compared to the same period last year. The increase in gross margin as a percentage of net sales was primarily due to an increase in initial markup, which contributed a 1.9 percentage point increase, partially offset by an increase in markdowns, which contributed a 0.9 percentage point decrease.

The improved initial markup was primarily a result of a favorable change in our sales mix toward higher margin products in apparel and infant care categories and increased supplier promotional support. This increase in gross margin percentage was partially offset by additional markdowns to keep inventory current as well as an increase in cross-division promotional offers.

**Selling, General and Administrative Expenses ( SG&A )**

The following costs are included in SG&A:

Store payroll and payroll-related benefits;

Rent and other store operating expenses;

Advertising expenses;

Other income;

Costs associated with operating our distribution network that primarily relate to moving merchandise from distribution centers to stores; and

Other corporate-related expenses.

| (In millions)          | 13 Weeks Ended    |                  |           |                         |                  |                                   |  |
|------------------------|-------------------|------------------|-----------|-------------------------|------------------|-----------------------------------|--|
|                        |                   |                  |           | Percentage of Net Sales |                  |                                   |  |
|                        | August 4,<br>2007 | July 29,<br>2006 | \$ Change | August 4,<br>2007       | July 29,<br>2006 | Percentage of Net<br>Sales Change |  |
| Toys R Us Consolidated | \$ 820            | \$ 738           | \$ 82     | 31.5%                   | 30.3%            | 1.2%                              |  |

SG&A expenses increased \$82 million to \$820 million, for the thirteen weeks ended August 4, 2007, compared to \$738 million for the same period last year. As a percentage of net sales, SG&A expenses increased 1.2 percentage points.





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The increase in SG&A expenses was primarily due to increases in payroll-related, store occupancy, corporate-related, and advertising expenses. Increases in payroll-related and store occupancy expenses increased primarily due to new store openings at our International and Babies divisions, along with increased costs to improve store layouts at our Toys U.S. division. Corporate-related expenses increased primarily due to the filling of higher-level positions at the Corporate division. Advertising expenses increased primarily at our Toys U.S. division due to increases in print advertising.

| (In millions)          | 26 Weeks Ended    |                  |           | Percentage of Net Sales |                  |                                   |
|------------------------|-------------------|------------------|-----------|-------------------------|------------------|-----------------------------------|
|                        | August 4,<br>2007 | July 29,<br>2006 | \$ Change | August 4,<br>2007       | July 29,<br>2006 | Percentage of Net<br>Sales Change |
| Toys R Us Consolidated | \$ 1,612          | \$ 1,478         | \$ 134    | 31.1%                   | 30.6%            | 0.5%                              |

SG&A expenses increased \$134 million to \$1.6 billion, for the twenty-six weeks ended August 4, 2007, compared to \$1.5 billion for the same period last year. As a percentage of net sales, SG&A expenses increased 0.5 percentage points.

The increase in SG&A expenses was primarily due to increases in payroll-related, store occupancy, corporate-related, and advertising expenses. Payroll-related and store occupancy expenses increased primarily due to new store openings at our International and Babies divisions, along with increased costs to improve store layouts at our Toys U.S. division. Corporate-related expenses increased primarily due to the filling of higher-level positions at the Corporate division. Advertising expenses increased primarily at our Toys U.S. division due to increases in print advertising.

**Depreciation and Amortization**

| (In millions)          | 13 Weeks Ended    |                  |           | 26 Weeks Ended    |                  |           |
|------------------------|-------------------|------------------|-----------|-------------------|------------------|-----------|
|                        | August 4,<br>2007 | July 29,<br>2006 | \$ Change | August 4,<br>2007 | July 29,<br>2006 | \$ Change |
| Toys R Us Consolidated | \$ 101            | \$ 99            | \$ 2      | \$ 197            | \$ 213           | \$ (16)   |

Depreciation and amortization increased by \$2 million, or 2.0%, to \$101 million for the thirteen weeks ended August 4, 2007, compared to the same period last year.

Depreciation and amortization decreased by \$16 million, or 7.5%, to \$197 million for the twenty-six weeks ended August 4, 2007, compared to the same period last year. The decrease was primarily attributed to \$24 million of accelerated depreciation related to the fiscal 2005 restructuring initiative recorded in the first quarter of fiscal 2006, partially offset by higher depreciation expense at Babies and International due to stores opened since July 29, 2006.

**Table of Contents****Net gains on sales of properties**

| (In millions)          | 13 Weeks Ended |          |           | 26 Weeks Ended |          |           |
|------------------------|----------------|----------|-----------|----------------|----------|-----------|
|                        | August 4,      | July 29, | \$ Change | August 4,      | July 29, | \$ Change |
|                        | 2007           | 2006     |           | 2007           | 2006     |           |
| Toys R Us Consolidated | \$ 12          | \$       | \$ 12     | \$ 16          | \$       | \$ 16     |

Net gains on sales of properties increased by \$12 million for the thirteen weeks ended August 4, 2007, compared to the same period last year.

This increase was primarily due to gains related to the consummation of a lease termination agreement and the sale of two properties to Vornado Surplus 2006 Realty LLC.

Net gains on sales of properties increased by \$16 million for the twenty-six weeks ended August 4, 2007, compared to the same period last year.

This increase was primarily due to gains related to the consummation of a lease termination agreement and the sale of four properties to Vornado Surplus 2006 Realty LLC.

Refer to Note 10 to the Condensed Consolidated Financial Statements entitled "Net gains on sales of properties" for further details.

**Restructuring (Reversals) Charges and Other**

| (In millions)          | 13 Weeks Ended |          |           | 26 Weeks Ended |          |           |
|------------------------|----------------|----------|-----------|----------------|----------|-----------|
|                        | August 4,      | July 29, | \$ Change | August 4,      | July 29, | \$ Change |
|                        | 2007           | 2006     |           | 2007           | 2006     |           |
| Toys R Us Consolidated | \$ (1)         | \$       | \$ (1)    | \$ 1           | \$ 5     | \$ (4)    |

During the thirteen weeks ended August 4, 2007, net reversals of previously recorded reserves increased by \$1 million as compared to the same period last year. The increase in net reversals was based on changes in management's estimates primarily due to the termination and assignment of lease arrangements and sublease income adjustments.

During the twenty-six weeks ended August 4, 2007, net restructuring charges decreased by \$4 million as compared to the same period last year.

The decrease was primarily the result of a reduction in disposal charges and lease commitment charges related to our 2005 and 2001 initiatives incurred in the twenty-six weeks ended July 29, 2006.

Refer to Note 2 to the Condensed Consolidated Financial Statements entitled "Restructuring and other charges" for further details.

**Interest Expense**

| (In millions)          | 13 Weeks Ended |          |           | 26 Weeks Ended |          |           |
|------------------------|----------------|----------|-----------|----------------|----------|-----------|
|                        | August 4,      | July 29, | \$ Change | August 4,      | July 29, | \$ Change |
|                        | 2007           | 2006     |           | 2007           | 2006     |           |
| Toys R Us Consolidated | \$ (120)       | \$ (129) | \$ 9      | \$ (242)       | \$ (259) | \$ 17     |

Interest expense decreased \$9 million for the thirteen weeks ended August 4, 2007 compared to the thirteen weeks ended July 29, 2006, primarily due to reduced borrowings and reduced amortization of deferred financing costs in fiscal 2007. These decreases were partially offset by higher average interest rates.

Interest expense decreased \$17 million for the twenty-six weeks ended August 4, 2007 compared to the twenty-six weeks ended July 29, 2006, primarily due to reduced borrowings and reduced amortization of deferred financing costs in fiscal 2007. These decreases were partially offset by higher average interest rates.

**Table of Contents****Interest Income**

| (In millions)          | 13 Weeks Ended    |                  |           | 26 Weeks Ended    |                  |           |
|------------------------|-------------------|------------------|-----------|-------------------|------------------|-----------|
|                        | August 4,<br>2007 | July 29,<br>2006 | \$ Change | August 4,<br>2007 | July 29,<br>2006 | \$ Change |
| Toys R Us Consolidated | \$ 4              | \$ 5             | \$ (1)    | \$ 12             | \$ 13            | \$ (1)    |

Interest income decreased slightly by \$1 million for the thirteen and twenty-six weeks ended August 4, 2007 compared to the same periods last year.

**Income tax benefit**

The following table summarizes our income tax benefit and effective tax rates for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006:

| (In millions)                                  | 13 Weeks Ended    |                  | 26 Weeks Ended    |                  |
|--|-------------------|------------------|-------------------|------------------|
|  | August 4,<br>2007 | July 29,<br>2006 | August 4,<br>2007 | July 29,<br>2006 |
| Loss before income taxes and minority interest | \$ (88)           | \$ (113)         | \$ (179)          | \$ (245)         |
| Income tax benefit                             | 45                | 2                | 89                | 89               |
| Effective tax rate                             | (51.1)%           | (1.8)%           | (49.7)%           | (36.3)%          |

The effective tax rates for the thirteen and twenty-six weeks ended August 4, 2007 and July 29, 2006 were based primarily on our forecasted annualized effective tax rates, adjusted for significant and unusual items that occurred within the periods presented. Our forecasted annualized effective tax rate was 53.4% compared to 32.6% in the same period last year. The difference in our forecasted annualized effective tax rates was primarily due to improvements in our actual operating results for the twenty-six weeks ended August 4, 2007 and an increase in our forecasted pre-tax income for the remainder of fiscal 2007 as compared to the same period last year.

For the thirteen weeks ended August 4, 2007, our effective tax rate was impacted by additional income tax expense from adjustments to our current income taxes payable of \$3 million and our FIN 48 liability of \$2 million. The additional income tax expense was partially offset by income tax benefits related to settlements of certain tax audits of \$3 million and changes in foreign and state tax laws of \$1 million.

For the thirteen weeks ended July 29, 2006, our effective tax rate was impacted by additional income tax expense related to adjustments in certain estimated tax reserves of \$3 million and changes in state tax laws of less than \$1 million.

For the twenty-six weeks ended August 4, 2007, our effective tax rate was impacted by additional income tax expense from adjustments to settlements of certain tax audits of \$2 million, adjustments to our FIN 48 liability of \$2 million, and adjustments to our current income taxes payable of \$1 million. The additional income tax expense was partially offset by an income tax benefit related to changes in foreign and state tax laws of \$1 million.

For the twenty-six weeks ended July 29, 2006, our effective tax rate was impacted by additional income tax benefits related to the reversal of certain valuation allowance of \$6 million, adjustments in certain estimated tax reserves of \$3 million, and additional foreign tax credits of \$2 million. The income tax benefits were slightly offset by income tax expense related to changes in state tax laws of less than \$1 million.

**Liquidity and Capital Resources****Overview**

At August 4, 2007, under our \$2 billion secured revolving credit facility, we had \$65 million in borrowings outstanding, \$116 million of outstanding letters of credit, and remaining availability of \$977 million. In addition, under our multi-currency revolving credit facilities, we had \$38 million in borrowings outstanding and \$356 million of remaining availability. We have classified borrowings under these revolving credit facilities as long-term, as the revolving credit facilities expire in fiscal 2010. However, we may pay these facilities down within the next twelve months if we have the ability to do so either through additional long-term financing or through cash from operating activities. As part of our normal course of business, we are continuously evaluating opportunities that will allow us to reduce the costs related to our borrowings.

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In general, our primary uses of cash are debt servicing, financing construction of new stores and remodeling existing stores, providing for working capital, which principally represents the purchase of inventory, and paying expenses to operate our

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stores. We will consider additional sources of financing to fund our long-term growth. Our working capital needs follow a seasonal pattern, peaking in the third quarter of the year when inventory is received for the holiday selling season. Our largest source of operating cash flows is cash collections from our customers. We have been able to meet our cash needs principally by using cash on hand, cash flows from operations, our variable rate revolving credit facilities and the multi-currency revolving credit facilities.

We believe that cash generated from operations, along with our existing cash and revolving credit facilities, will be sufficient to fund our expected cash flow requirements and planned capital expenditures for at least the next twelve months.

| (In millions)  | 26 Weeks Ended    |                  |           |          |
|--|-------------------|------------------|-----------|----------|
|  | August 4,<br>2007 | July 29,<br>2006 | \$ Change | % Change |
| Net cash used in operating activities                        | \$ (635)          | \$ (876)         | \$ 241    | 27.5%    |
| Net cash used in investing activities                        | (64)              | (111)            | 47        | 42.3%    |
| Net cash provided by financing activities                    | 155               | 625              | (470)     | (75.2)%  |
| Effect of exchange rate changes on cash and cash equivalents | 9                 | 45               | (36)      | (80.0)%  |
| Net decrease during period in cash and cash equivalents      | \$ (535)          | \$ (317)         | \$ (218)  | (68.8)%  |

**Cash Flows Used in Operating Activities**

During the twenty-six weeks ended August 4, 2007, net cash used in operating activities was \$635 million compared to \$876 million used in operating activities during the twenty-six weeks ended July 29, 2006. The \$241 million decrease in net cash used in operating activities was primarily the result of changes in accounts payable due to extended payment terms from vendors, along with improved operating earnings at all of our divisions.

**Cash Flows Used in Investing Activities**

During the twenty-six weeks ended August 4, 2007, net cash used in investing activities was \$64 million compared to \$111 million for the twenty-six weeks ended July 29, 2006. The \$47 million decrease in net cash used in investing activities was primarily due to a \$61 million increase in cash flows resulting from a \$21 million release of previously restricted cash in the twenty-six weeks ended August 4, 2007 compared to a \$40 million increase in restricted cash related to property financings in the twenty-six weeks ended July 29, 2006. This decrease in net cash used in investing activities was partially offset by a \$10 million increase in capital expenditures to \$100 million in the twenty-six weeks ended August 4, 2007 from \$90 million in the twenty-six weeks ended July 29, 2006.

Our capital expenditures are primarily for financing construction of new stores and remodeling existing stores. In addition, our capital expenditures include costs to improve and enhance our information technology systems. For the remainder of the fiscal year, we plan to increase our capital spend compared to prior year as we focus on the turnaround of the Toys U.S. division, and continue our investments in our International and Babies divisions.

**Cash Flows Provided by Financing Activities**

During the twenty-six weeks ended August 4, 2007, net cash provided by financing activities was \$155 million compared to \$625 million for the twenty-six weeks ended July 29, 2006. The \$470 million decrease in net cash provided by financing activities was primarily due to a \$2,581 million reduction in borrowings, partially offset by a \$2,065 million decrease in repayments. The decrease in gross borrowings and repayments reflects a reduction in refinancing activities compared to prior year. The net decrease in borrowings is primarily due to increased borrowings in the prior year due to the timing of refinancing payments, and lower borrowings on our revolving credit facilities in the current year due to improved cash flows from operating activities.

**Debt**

During the twenty-six weeks ended August 4, 2007, we made the following changes to our debt structure:

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On February 8, 2007, Toys R Us Properties (UK) Limited borrowed an additional \$4 million (£1.9 million) from the Junior Lender of our U.K. Real Estate Credit Facility under conditions previously specified in the original loan agreement dated February 8, 2006.

On June 1, 2007, Toys R Us Delaware, Inc. ( Toys-Delaware ) used the \$9 million proceeds from the properties sold on May 31, 2007 (refer to Note 10 to the Condensed Consolidated Financial Statements entitled Net gains on sales of properties ) to repay a portion of the \$200 million asset sale facility.

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Subsequent to quarter end, on August 23, 2007, Toys-Delaware repaid an additional \$10 million of principal in connection with a lease termination agreement during the second quarter of fiscal 2007 (refer to Note 10 to the Condensed Consolidated Financial Statements entitled "Net gains on sales of properties"), leaving an outstanding balance of \$25 million.

On July 9, 2007, we notified the lenders for our \$800 million secured real estate loan that we were exercising our first maturity date extension option, which extended the maturity date of the loan from August 9, 2007 to August 9, 2008. The other key terms of the loan were not changed as a result of the extension. We have the ability and intent to exercise our two remaining maturity date extension options to August 2009 and August 2010.

### **Contractual Obligations and Commitments**

There have been no significant changes to our contractual obligations and commercial commitments table as disclosed in our Annual Report on Form 10-K for the fifty-three weeks ended February 3, 2007, except for a change related to our adoption of FIN 48. The short-term and long-term net liabilities for uncertain tax positions under FIN 48 were \$40 million and \$108 million, respectively, as of February 4, 2007. During the twenty-six weeks ended August 4, 2007, the total unrecognized tax benefits did not change materially (refer to Note 6 to the Condensed Consolidated Financial Statements entitled "Income taxes"). At this time, we are not able to reasonably estimate when cash payments of the long-term liability for uncertain tax positions will occur.

Refer to the "CONTRACTUAL OBLIGATIONS" section of the Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended February 3, 2007, for details on our contractual obligations and commitments.

### **Credit Ratings**

As of September 12, 2007, our current credit ratings, which are considered non-investment grade, were as follows:

|                | <b>Moody's</b> | <b>Standard and Poor's</b> |
|----------------|----------------|----------------------------|
| Long-term debt | B2             | B                          |
| Outlook        | Stable         | Stable                     |

On August 24, 2007, Moody's confirmed our B2 rating and upgraded the outlook to Stable after having previously changed the outlook to Review for possible downgrade, as a result of our filing an extension for our Annual Report in Form 10-K. Moody's stated that the Stable outlook is a result of the significant progress the company has made in improving its business performance and reducing financial leverage.

On June 29, 2007, Standard and Poor's upgraded our corporate credit rating from B- with a Positive outlook to B with a Stable outlook. Prior to this rating, the Company had been placed on CreditWatch with positive implications, as a result of the filing of our Annual Report in Form 10-K. The latest rating change was based on improved operating performance and credit protection metrics.

Other credit ratings for our debt are available; however, we have disclosed only the ratings of the two largest nationally recognized statistical rating organizations.

Our current credit ratings, as well as any adverse future actions taken by the rating agencies with respect to our debt ratings, could (1) negatively impact our ability to finance our operations on satisfactory terms and (2) have the effect of increasing our financing costs. Our debt instruments do not contain provisions requiring acceleration of payment upon a debt rating downgrade.

The rating agencies may, in the future, revise the ratings in respect of our outstanding debt.

### **Critical Accounting Policies**

Our condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosures of contingent assets and liabilities as of the date of the financial statements and during the applicable periods. We base these estimates on historical experience and on other factors that we believe are reasonable under the circumstances. Actual results may differ materially from these estimates under different assumptions or conditions and could have a material

impact on our condensed consolidated financial statements.



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### **Merchandise inventories**

On February 4, 2007, we changed our accounting method for valuing our international wholly-owned subsidiaries' merchandise inventories from the retail inventory method to the weighted average cost method. This change in accounting principle was a result of implementing a perpetual inventory system in our international locations that allows management to track our inventory costs at a product level. We have accounted for the change in accounting principle in accordance with SFAS No.154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS 154 ). Refer to Note 3 to the Condensed Consolidated Financial Statements entitled Change in accounting principles for the impact on our condensed consolidated financial statements and further details.

As previously described in our fiscal 2006 Annual Report on Form 10-K, merchandise inventories for the Toys U.S. division, other than apparel, are stated at the lower of LIFO (last-in, first-out) cost or market value, as determined by the retail inventory method. The excess of replacement or current cost over stated LIFO value is immaterial. All other merchandise inventories for our domestic subsidiaries are stated at the lower of FIFO (first-in, first-out) cost or market value as determined by the retail inventory method. As of August 4, 2007, February 3, 2007 and July 29, 2006, approximately 42%, 10% and 12%, respectively, of merchandise inventories were valued under the weighted average cost method.

### **Income taxes**

In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48 (As amended) Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). This interpretation clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, Accounting for Income Taxes ( SFAS 109 ) and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. FIN 48 provides that a tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, based on the technical merits. This interpretation provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of February 4, 2007, we adopted the provisions in FIN 48. Refer to Note 6 to the Condensed Consolidated Financial Statements entitled Income taxes for the impact on our Condensed Consolidated Financial Statements and further discussion related to the adoption of FIN 48.

A summary of other significant accounting policies and a description of accounting policies that we believe critical may be found in our Annual Report on Form 10-K for the fiscal year ended February 3, 2007, in the CRITICAL ACCOUNTING POLICIES section of the Management's Discussion and Analysis of Financial Condition and Results of Operations.

### **Recent Accounting Pronouncements**

Refer to Note 12 to the Condensed Consolidated Financial Statements entitled Recent accounting pronouncements for a discussion of recent accounting pronouncements and their impact on our consolidated financial statements.

### **Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains forward looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. All statements herein that are not historical facts, including statements about our beliefs or expectations, are forward-looking statements. We generally identify these statements by words or phrases, such as anticipate, estimate, plan, expect, believe, intend, foresee, will, may, and similar words. These statements discuss, among other things, our strategy, store openings and renovations, future financial or operational performance, anticipated cost savings, results of store closings and restructurings, anticipated domestic or international developments, future financings, targets and future occurrences and trends.

These statements are subject to risks, uncertainties, and other factors, including, among others, competition in the retail industry, seasonality of our business, changes in consumer preferences and consumer spending patterns, general economic conditions in the United States and other countries in which we conduct our business, our ability to implement our strategy, our substantial level of indebtedness and related debt service obligations and the covenants in our debt agreements, availability of adequate financing, our dependence on key vendors of our merchandise, international events affecting the delivery of toys and other products to our stores, economic, political and other developments associated with our international operations, and risks, uncertainties and factors set forth in our reports and documents filed with the United States Securities and Exchange Commission (which reports and documents should



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be read in conjunction with this Quarterly Report on Form 10-Q). We believe that all forward-looking statements are based on reasonable assumptions when made; however, we caution that it is impossible to predict actual results or outcomes or the effects of risks, uncertainties or other factors on anticipated results or outcomes and that, accordingly, one should not place undue reliance on these statements. Forward-looking statements speak only as of the date they were made, and we undertake no obligation to update these statements in light of subsequent events or developments. Actual results and outcomes may differ materially from anticipated results or outcomes discussed in any forward-looking statement.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There has been no significant change in our exposure to market risk during the twenty-six weeks ended August 4, 2007. For a discussion of our exposure to market risk, refer to Item 7A entitled "QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK" in our Annual Report on Form 10-K for the fiscal year ended February 3, 2007.

**Item 4. Controls and Procedures**

*Disclosure Controls and Procedures*

We maintain disclosure controls and procedures that are designed to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with U.S. Generally Accepted Accounting Principles, and to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

In connection with the preparation of this Quarterly Report on Form 10-Q and as of the end of the fiscal period covered by this Quarterly Report on Form 10-Q (August 4, 2007), we performed an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934.

Based on our evaluation as of August 4, 2007, the material weakness in internal control over financial reporting described in Item 9A entitled "CONTROLS AND PROCEDURES" of the Annual Report on Form 10-K for the fiscal year ended February 3, 2007 has not been remediated, and, therefore, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of the end of the fiscal period covered by this Quarterly Report on Form 10-Q (August 4, 2007).

We employed alternative procedures to enable management to conclude that reasonable assurance exists regarding the reliability of financial reporting and the preparation of the condensed consolidated financial statements included in this Quarterly Report on Form 10-Q filing. Accordingly, management believes that the condensed consolidated financial statements included in this Quarterly Report on Form 10-Q filing fairly present, in all material respects, our financial position, results of operations and cash flows for the periods presented.

*Changes in Internal Control over Financial Reporting*

In our ongoing effort to remediate the material weakness in our financial closing and reporting process, as disclosed in Item 9A entitled "CONTROLS AND PROCEDURES" of the Annual Report on Form 10-K for the fiscal year ended February 3, 2007, we implemented additional process and personnel improvements during the quarter. However, management concludes that the control enhancements implemented to date have not been operating effectively for a sufficient period of time in order to fully remediate the material weakness.

Other than the foregoing, there were no changes in the Company's internal control over financial reporting during the Company's second quarter of fiscal 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

Refer to Note 9 to the Condensed Consolidated Financial Statements entitled "Litigation and legal proceedings" for a discussion of material legal proceedings.

**Item 1A. Risk Factors**

At August 4, 2007, there had not been any material changes to the information related to the ITEM 1A. RISK FACTORS disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended February 3, 2007.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

Required exhibits are listed in the Index to Exhibits and are incorporated by reference.

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: September 12, 2007

**TOYS R US, INC.**  
(Registrant)

**/s/ F. CLAY CREASEY, JR.**  
**F. Clay Creasey, Jr.**  
**Executive Vice President   Chief Financial Officer**

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**INDEX TO EXHIBITS**

The following is a list of all exhibits filed or furnished as part of this report:

**Exhibit No. Description**

- |      |  |
|------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |