

TUESDAY MORNING CORP/DE
Form 10-Q
August 03, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED
June 30, 2006**

OR

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

**FOR THE TRANSITION PERIOD
FROM TO**

Commission file number 0-19658

TUESDAY MORNING CORPORATION

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(Exact Name of Registrant as Specified in its Charter)

Delaware

(State or Other Jurisdiction of
Incorporation or Organization)

75-2398532

(I.R.S. Employer
Identification Number)

**6250 LBJ Freeway
Dallas, Texas 75240**

(Address, including zip code, of principal executive offices)

(972) 387-3562

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of 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 check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class
Common Stock, par value \$0.01 per share

Outstanding at July 28, 2006
41,386,816

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws and the Private Securities Litigation Reform Act of 1995. These statements may be found throughout this Form 10-Q particularly under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations, among others. Forward-looking statements typically are identified by the use of terms such as may, will, should, expect, anticipate, believe, estimate, intend and similar words, although some forward-looking statements are expressed differently. You should consider statements that contain these words carefully because they describe our expectations, plans, strategies and goals and our beliefs concerning future business conditions, our future results of operations, our future financial position, and our business outlook or state other forward-looking information.

Readers are referred to Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, and Item 1A. Risk Factors of this Quarterly Report on Form 10Q for examples of risks, uncertainties and events that could cause our actual results to differ materially from the expectations expressed in our forward-looking statements. These risks, uncertainties and events also include, but are not limited to, the following:

- uncertainties regarding our ability to open stores in new and existing markets and operate these stores on a profitable basis;*
- conditions affecting consumer spending, such as high gasoline prices;*
- general regional and national economic conditions;*
- inclement weather, such as the pattern of hurricanes that affected the Southeast U.S. in August and September 2004 and again in September 2005;*
- changes in our merchandise mix;*
- timing and type of sales events, promotional activities and other advertising;*
- uncertainties arising out of world events;*
- increased or new competition;*
- our ability to continuously attract buying opportunities for closeout merchandise and anticipate consumer demand as closeout merchandise becomes available;*
- loss of, or disruption in, our centralized distribution center;*
- loss or departure of one or more members of our senior management;*
- our dependence on external funding sources;*
- an increase in the cost or a disruption in the flow of our products;*
- environmental regulations;*
- seasonal and quarterly fluctuations; and*
- fluctuations in our comparable store results.*

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The forward-looking statements made in this Form 10-Q relate only to events as of the date on which the statements were made. We undertake no obligation to update our forward-looking statements to reflect events and circumstances after the date on which the statements were made or to reflect the occurrence of unanticipated events.

The terms Tuesday Morning, we, us and our as used in this Quarterly Report on Form 10-Q refer to Tuesday Morning Corporation and its subsidiaries.

PART I - FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets as of June 30, 2006 and December 31, 2005

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PART I FINANCIAL INFORMATION**Item 1. Financial Statements**

Tuesday Morning Corporation
Consolidated Balance Sheets
(In thousands, except for share data)

	June 30, 2006	Dec. 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 5,766	\$ 43,547
Inventories	241,660	230,639
Prepaid expenses and other current assets	7,413	7,258
Deferred income taxes	5,071	5,071
Total current assets	259,910	286,515
Property and equipment, net	86,868	87,786
Deferred financing costs	599	685
Other assets	4,930	4,941
Total Assets	\$ 352,307	\$ 379,927
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 72,302	\$ 74,975
Accrued liabilities	29,444	42,372
Income taxes payable	4,736	16,520
Total current liabilities	106,482	133,867
Revolving credit facility	21,000	
Deferred rent	4,553	4,431
Deferred income taxes	6,267	6,267
Total Liabilities	138,302	144,565
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, par value \$.01 per share, authorized 10,000,000 shares, none issued or outstanding		
Common stock, par value \$.01 per share, authorized 100,000,000 shares; 41,386,816 shares issued and outstanding at June 30, 2006 and 41,369,922 shares at December 31, 2005	414	414
Additional paid-in capital	193,482	191,229
Retained earnings	20,100	43,763
Accumulated other comprehensive income (loss)	9	(44)
Total Stockholders' Equity	214,005	235,362
Total Liabilities and Stockholders' Equity	\$ 352,307	\$ 379,927

The accompanying notes are an integral part of these consolidated financial statements.

Tuesday Morning Corporation
Consolidated Statements of Income
(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net sales	\$ 207,669	\$ 218,756	\$ 395,428	\$ 404,350
Cost of sales	133,396	137,338	247,564	250,374
Gross profit	74,273	81,418	147,864	153,976
Selling, general and administrative expenses	69,227	64,672	132,390	126,794
Operating income	5,046	16,746	15,474	27,182
Other income (expense):				
Interest income	2	64	101	98
Interest expense	(567)	(164)	(753)	(370)
Other income, net	253	239	386	432
	(312)	139	(266)	160
Income before income taxes	4,734	16,885	15,208	27,342
Income tax expense	1,835	6,355	5,769	10,146
Net income	\$ 2,899	\$ 10,530	\$ 9,439	\$ 17,196
Earnings Per Share				
Net income per common share:				
Basic	\$ 0.07	\$ 0.26	\$ 0.23	\$ 0.42
Diluted	\$ 0.07	\$ 0.25	\$ 0.23	\$ 0.41
Weighted average number of common shares:				
Basic	41,384	41,204	41,380	41,167
Diluted	41,626	41,743	41,647	41,714
Dividends per common share	\$	0.65	\$ 0.80	0.65

The accompanying notes are an integral part of these consolidated financial statements.

Tuesday Morning Corporation
Consolidated Statements of Cash Flows
(In thousands)

	Six Months Ended June 30,	
	2006	2005
Net cash flows from operating activities:		
Net income	\$ 9,439	\$ 17,196
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	8,102	6,978
Amortization of financing fees	86	86
Stock-based compensation	1,601	
Other non-cash items	70	(62)
Change in operating assets and liabilities:		
Inventories	(10,371)	(18,610)
Prepaid and other assets	(144)	(1,138)
Accounts payable	(2,673)	(3,303)
Accrued liabilities	(12,928)	(6,188)
Deferred rent	122	4,139
Income taxes payable	(11,784)	(8,900)
Net cash used in operating activities	(18,480)	(9,802)
Net cash flows from investing activities:		
Capital expenditures	(7,184)	(8,586)
Net cash used in investing activities	(7,184)	(8,586)
Net cash flows from financing activities:		
Payment of dividends to common stockholders	(33,102)	(26,854)
Proceeds from revolving credit facility, net	21,000	3,500
Proceeds from exercise of common stock options and stock purchase plan purchases	(15)	2,161
Net cash used in financing activities	(12,117)	(21,193)
Net decrease in cash and cash equivalents	(37,781)	(39,581)
Cash and cash equivalents, beginning of period	43,547	45,067
Cash and cash equivalents, end of period	\$ 5,766	\$ 5,486

The accompanying notes are an integral part of these consolidated financial statements.

Tuesday Morning Corporation
Notes to Consolidated Financial Statements

1. **Basis of presentation** The consolidated interim financial statements included herein have been prepared by us pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These financial statements include all adjustments, consisting only of those of a normal recurring nature, which, in the opinion of management, are necessary to present fairly the results of the interim periods presented and should be read in conjunction with the consolidated financial statements and notes thereto in our Form 10-K filing for the year ended December 31, 2005. Because of the seasonal nature of our business, the results of operations for the quarter are not indicative of the results to be expected for the entire year.

2. **Stock-based compensation** On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), *Share-Based Payment* (Statement 123(R)), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the time of grant. Pro forma disclosure is no longer an alternative.

Statement 123(R) permits public companies to adopt its requirements using one of two methods: (1) a modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date; (2) a modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption. We have adopted Statement 123(R) based on the modified prospective method effective January 1, 2006.

Stock-based compensation amounts recognized in the three months and six months ended June 30, 2006 upon the adoption of Statement 123(R) is as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Total cost of stock-based compensation during the period	\$ 1,101	\$ 2,251
Amounts capitalized in ending inventory	(309)	(650)
Amounts charged against income for the period before tax	\$ 792	\$ 1,601
Amount of related income tax benefit recognized in income	\$ (233)	\$ (463)

Consistent with our inventory accounting policies, the payroll costs of buying, distribution and certain other general and administrative expenses, and with the adoption of Statement 123(R), the related stock-based compensation of these functions, are capitalized as a part of inventory and expensed as cost of sales when the related inventory is sold. The adoption of Statement 123(R) also caused a \$0.01 and \$0.02 decrease in basic and diluted earnings per share for the three and six months ended June 30, 2006, respectively. Based on non-vested stock options outstanding at June 30, 2006, we expect to incur approximately \$2.9 million, net of tax, in stock-based compensation for the year ended December 31, 2006.

Statement 123(R) includes several modifications to the way that incomes taxes are provided for in the financial statements. The expense for stock option grants is only deductible for tax purposes at the time the taxable event takes place, which will cause variability in our effective tax rates recorded throughout each year. The expected variability in our effective tax rate is caused by Statement 123(R)'s forbiddance of companies from predicting when these taxable events will take place. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in annual periods after adoption.

In the prior year, we accounted for our stock-based compensation plans utilizing the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25 (APB 25). Generally, no compensation expense was recognized for fixed stock option plans because the exercise prices of employee stock options equaled or exceeded the market prices of the underlying stock on the dates of grant. Had we applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, (as amended by Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*) the pro forma effects of stock-based compensation on net income and net income per common share for the three and six months ended June 30, 2005 were as follows (in thousands except per share amounts):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income as reported	\$ 10,530	\$ 17,196
Less: Stock-based employee compensation expense determined under the fair value method, net of related tax effects	956	1,956
Pro forma net income	\$ 9,574	\$ 15,240
Net income per common share:		
Basic as reported	\$ 0.26	\$ 0.42
Basic pro forma	\$ 0.23	\$ 0.37
Diluted as reported	\$ 0.25	\$ 0.41
Diluted pro forma	\$ 0.23	\$ 0.37

We have established the Tuesday Morning Corporation 1997 Long-Term Equity Incentive Plan, as amended (the 1997 Plan), and the Tuesday Morning Corporation 2004 Long-Term Equity Incentive Plan, as amended (the 2004 Plan), which allow our Board of Directors to grant stock options to directors, officers and key employees of, and certain other key individuals who perform services for us and our subsidiaries. The 1997 Plan and the 2004 Plan authorizes grants of options to purchase up to 4,800,000 and 2,000,000 shares, respectively, of authorized, but unissued common stock. Stock options are granted with an exercise price, terms and vesting determined by the Compensation Committee of the Board of Directors, with certain limitations.

Options granted under the 1997 Plan and the 2004 Plan vest daily over periods of four to five years and expire in ten years. The exercise prices of the options range between \$0.20 and \$35.23, which represents fair value on the grant date of the shares of common stock into which such options are exercisable. At June 30, 2006, there were 87,705 and 1,781,000 shares available for grant under the 1997 Plan and the 2004 Plan, respectively.

Consistent with prior years, the fair value of each stock option granted during the six months ended June 30, 2006 was estimated at the date of grant using a Black-Scholes option pricing model based on the assumptions of expected volatility of 35%, expected dividend yield of 2.5%, expected term of 4.5 years and a risk-free interest rate of 4.2%. The expected volatility is based on our consideration of the implied volatility of our minimally traded options on our shares and the historical volatility of our stock based on our historical stock prices. The expected term of an option is based on our historical review of employee exercise behavior based on the employee class (executive or non-executive) and based on our consideration of the remaining contractual term, if limited exercise activity existed for a certain employee class. The risk-free interest rate is the constant maturity interest rate for U.S. Treasury instruments with terms consistent with the expected lives of the awards.

A summary of stock option activity as of June 30, 2006 and changes during the six months ended June 30, 2006 is presented below (in thousands except share and per share amounts):

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Options Outstanding at January 1, 2006	2,016,293	\$ 20.07		
Granted	174,000	19.25		
Exercised	(16,894)	2.07		
Cancelled	(132,707)	29.31		
Options Outstanding at June 30, 2006	2,040,692	\$ 19.55	6.6	(13,064)
Exercisable at June 30, 2006	1,375,322	\$ 17.24	5.7	(5,618)

The weighted average grant-date fair value of share options granted during the six months ended June 30, 2006 was \$5.68. The total intrinsic value of share options exercised during the six months ended June 30, 2006 was \$308 thousand.

As of June 30, 2006, we had \$9.0 million of total unrecognized stock-based compensation expense related to stock options that is expected to be recognized over a weighted average period of 4.21 years.

3. Lease accounting adjustment - Based on certain views expressed in a letter of February 7, 2005 from the Office of the Chief Accountant of the Securities and Exchange Commission to the American Institute of Certified Public Accountants, we reviewed our accounting policies and practices associated with operating leases. Consistent with industry practices, we historically reported straight-line rental expense beginning on the lease commencement date. This had the effect of excluding the rent holiday associated with the pre-opening or build-out period of our stores from the calculation of the period over which we expensed rent. Following our review, we modified our accounting policies such that we begin recording rent expense on the date we take possession of or have the right to use the premises.

As a result of this adjustment, we recorded a non-cash, \$3.9 million (\$2.4 million, net of income tax) cumulative charge to earnings during the first quarter of fiscal 2005. The adjustment did not impact historical or future net cash flows nor the timing of the payments under related leases. Prior years' financial statements were not restated as the impact of this issue was immaterial to previously reported results for any individual previous period.

4. **Comprehensive income** - Comprehensive income is defined as net income plus the change in equity during a period from transactions and other events, excluding those resulting from investments by and distributions to stockholders. Total comprehensive income for the three month period ended June 30, 2006 and 2005 was \$2.9 million and \$10.5 million, respectively and for the six month period ended June 30, 2006 and 2005 was \$9.5 million and \$17.1 million, respectively.

5. **Legal proceedings** During 2001 and 2002, we were named as a defendant in three complaints filed in the Superior Court of California in and for the County of Los Angeles. The plaintiffs are seeking to certify a statewide class made up of some of our current and former employees, which they claim are owed compensation for overtime wages, penalties and interest. The plaintiffs are also seeking attorney's fees and costs. In October 2003, we entered into a settlement agreement with a sub-class of these plaintiffs consisting of manager-in-training and management trainees which was paid in November 2005 with no material impact to our financial statements. The remaining complaint relating to our salaried managers is still open with a scheduled trial date of January 2007. We have a similar lawsuit filed in Orange, County California in 2004 that we have filed a motion to disqualify the class representative. The motion was heard by the court in July 2006 with the outcome expected to be communicated in August 2006. The case is still in discovery. We do not expect either of these complaints to have a material impact to our financial statements.

In June 2004, we were named as a defendant in a complaint filed in the U.S. District Court, Central District of California. The plaintiff, Thomas Kinkade Company (f/k/a/ Media Arts Group Inc.), alleged copyright infringement and false advertisements on merchandise we sold in the second quarter of 2004. The case went to trial in March 2006. The jury found in favor of us on the trademark infringement claim. The jury was unable to reach a verdict on the remaining claims. The parties have agreed to mediate with the presiding judge regarding the remaining claims. A mediation date has been set for August 2006.

We intend to vigorously defend all pending actions. We do not believe these or any other legal proceedings pending or threatened against us would have a material adverse effect on our financial condition or results of operations.

6. Earnings per common share

(in thousands, except per share data)	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Basic earnings per share:				
Net income	\$ 2,899	\$ 10,530	\$ 9,439	\$ 17,196
Weighted average number of common shares outstanding	41,384	41,204	41,380	41,167
Net income per common share	\$ 0.07	\$ 0.26	\$ 0.23	\$ 0.42
Diluted earnings per share:				
Net income	\$ 2,899	\$ 10,530	\$ 9,439	\$ 17,196
Dilutive effect of employee stock options	242	539	267	547
Weighted average number of common shares outstanding	41,384	41,204	41,380	41,167
Weighted average number of common shares and diluted effect of outstanding employee stock options	41,626	41,743	41,647	41,714
Net income per common share	\$ 0.07	\$ 0.25	\$ 0.23	\$ 0.41

7. **Revolving credit facility** Our \$210 million revolving credit facility expires in December 2009. We incur commitment fees of up to 0.25% on the unused portion of the revolving credit facility. Any borrowings under the revolving credit facility incur interest at LIBOR or the prime rate, depending on the type of borrowing, plus an applicable margin. These rates are increased or reduced as our average total leverage ratio changes.

At June 30, 2006, we had \$21.0 million outstanding under the revolving credit facility and had availability of \$180.9 million.

8. In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109. This interpretation clarifies the application of Statement 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements. The interpretation would require us to review all tax positions accounted for in accordance with Statement 109 and apply a more-likely-than-not recognition threshold. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. Subsequent recognition, derecognition, and measurement is based on management's best judgment given the facts, circumstances and information available at the reporting date. The guidance is effective for fiscal years beginning after December 15, 2006, which we intend to adopt on January 1, 2007. We do not expect the adoption of this statement to have a material effect on our financial position or results of operation.

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

Introduction

We sell upscale, name brand home furnishings, gift and related items significantly below retail prices charged by department and specialty stores. We have a unique event-based selling strategy that creates a sense of urgency and excitement for our customer base. These events are held ten times a year. Each event features merchandise selections of well-known and nationally advertised manufacturers and name brands from both domestic and European closeouts that are priced 50% to 80% off regular retail prices.

We have continued to grow our store base by approximately 10% per year for the last five years. During the first six months of 2006, we expanded our store base by a net of 30 stores consisting of 35 new store openings and 5 store closures. As of June 30, 2006, we operated 762 stores in 47 states.

Business Overview

Net sales for the second quarter of 2006 were \$207.7 million, a decrease of 5.1% compared to the same period last year and a comparable store sales decrease of 10.8%. Net income for the quarter was \$2.9 million and diluted earnings per share were \$0.07.

For the six months ended June 30, 2006, net sales were \$395.4 million for a decrease of 2.2% versus the prior year and a comp store decrease of 7.9%. Net income for the year-to-date period was \$9.4 million and diluted earnings per share were \$0.23.

The second quarter of 2006 was a challenging quarter for the company due primarily to macroeconomic pressures on consumers, an overall increase in supply of home décor merchandise and a competitive promotional environment in the home furnishings sector. We have plans in place that respond to the current environment. We are adjusting the product mix in our stores by shifting product assortments to meet our customer's changing priorities. In addition, we expect to drive traffic through a reassertion of our advertising and marketing efforts. It is too early to determine the success of our plans and the impact on comparable store sales, but we will continue to closely monitor our position.

Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109. This interpretation clarifies the application of Statement 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements. The interpretation would require us to review all tax positions accounted for in accordance with Statement 109 and apply a more-likely-than-not recognition threshold. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. Subsequent recognition, derecognition, and measurement is based on management's best judgment given the facts, circumstances and information available at the reporting date. The guidance is effective for fiscal years beginning after December 15, 2006, which we intend to adopt on January 1, 2007. We do not expect the adoption of this statement to have a material effect on our financial position or results of operation.

Stock-based Compensation

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), *Share-Based Payment* (Statement 123(R)), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the time of grant. Pro forma disclosure is no longer an alternative.

Statement 123(R) permits public companies to adopt its requirements using one of two methods: (1) a modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date; (2) a modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously

recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption. We have adopted Statement 123(R) based on the modified prospective method effective January 1, 2006.

Stock-based compensation amounts recognized in the three months and six months ended June 30, 2006 upon the adoption of Statement 123(R) is as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Total cost of stock-based compensation during the period	\$ 1,101	\$ 2,251
Amounts capitalized in ending inventory	(309)	(650)
Amounts charged against income for the period before tax	\$ 792	\$ 1,601
Amount of related income tax benefit recognized in income	\$ (233)	\$ (463)

Consistent with our inventory accounting policies, the payroll costs of buying, distribution and certain other general and administrative expenses, and with the adoption of Statement 123(R), the related stock-based compensation of these functions, are capitalized as a part of inventory and expensed as cost of sales when the related inventory is sold. The adoption of Statement 123(R) also caused a \$0.01 and \$0.02 decrease in basic and diluted earnings per share for the three and six months ended June 30, 2006, respectively. Based on non-vested stock options outstanding at June 30, 2006, we expect to incur approximately \$2.9 million, net of tax, in stock-based compensation for the year ended December 31, 2006.

Statement 123(R) includes several modifications to the way that incomes taxes are provided for in the financial statements. The expense for stock option grants is only deductible for tax purposes at the time the taxable event takes place, which will cause variability in our effective tax rates recorded throughout each year. The expected variability in our effective tax rate is caused by Statement 123(R)'s forbiddance of companies from predicting when these taxable events will take place. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in annual periods after adoption.

In the prior year, we accounted for our stock-based compensation plans utilizing the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25 (APB 25). Generally, no compensation expense was recognized for fixed stock option plans because the exercise prices of employee stock options equaled or exceeded the market prices of the underlying stock on the dates of grant. Had we applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, (as amended by Statement of

Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*) the pro forma effects of stock-based compensation on net income and net income per common share for the three and six months ended June 30, 2005 were as follows (in thousands except per share amounts):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income as reported	\$ 10,530	\$ 17,196
Less: Stock-based employee compensation expense determined under the fair value method, net of related tax effects	956	1,956
Pro forma net income	\$ 9,574	\$ 15,240
Net income per common share:		
Basic as reported	\$ 0.26	\$ 0.42
Basic pro forma	\$ 0.23	\$ 0.37
Diluted as reported	\$ 0.25	\$ 0.41
Diluted pro forma	\$ 0.23	\$ 0.37

Consistent with prior years, the fair value of each stock option granted during the six months ended June 30, 2006 was estimated at the date of grant using a Black-Scholes option pricing model based on the assumptions of expected volatility of 35%, expected dividend yield of 2.5%, expected term of 4.2 years and a risk-free interest rate of 4.2%. The expected volatility is based on our consideration of the implied volatility of our minimally traded options on our shares and the historical volatility of our stock based on our historical stock prices. The expected term of an option is based on our historical review of employee exercise behavior based on the employee class (executive or non-executive) and based on our consideration of the remaining contractual term if limited exercise activity existed for a certain employee class. The risk-free interest rate is the constant maturity interest rate for U.S. Treasury instruments with terms consistent with the expected lives of the awards.

As of June 30, 2006, we had \$9.0 million of total unrecognized stock-based compensation expense related to stock options that is expected to be recognized over a weighted average period of 4.21 years.

Lease Accounting Adjustment

Based on certain views expressed in a letter of February 7, 2005 from the Office of the Chief Accountant of the Securities and Exchange Commission to the American Institute of Certified Public Accountants, we reviewed our accounting policies and practices associated with operating leases. Consistent with industry practices, we historically reported straight-line rental expense beginning on the lease commencement date. This had the effect of excluding the rent holiday associated with the pre-opening or build-out period of our stores from the calculation of the period over which we expensed rent. Following our review, we modified our accounting policies such that we begin recording rent expense on the date we take possession of or have the right to use the premises.

As a result of this adjustment, we recorded a non-cash, \$3.9 million (\$2.4 million, net of income tax) cumulative charge to earnings during the first quarter of 2005. The adjustment did not impact historical or future net cash flows nor the timing of the payments under related leases. We believe that the new lease accounting policies will not have a material effect on future diluted earnings per share. Prior years' financial statements were not restated as the impact of this issue was immaterial to previously reported results for any individual previous periods.

Results of Operations

The following table sets forth certain financial information from our consolidated statements of income expressed as a percentage of net sales. Our business is highly seasonal, with a significant portion of our net sales and most of our operating income generated in the fourth quarter, which includes the holiday season. There can be no assurance that the trends in sales growth or operating results will continue in the future.

	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2006	2005	2006	2005
Net sales	100.0 %	100.0 %	100.0 %	100.0 %
Cost of sales	64.2	62.8	62.6	61.9
Gross profit	35.8	37.2	37.4	38.1
Selling, general and administrative expense	33.3	29.6	33.5	31.4
Operating income	2.5	7.6	3.9	6.7
Net interest expense and other income (expense)	(0.2)	0.1	(0.1)	0.1
Income before income taxes	2.3	7.7	3.8	6.8
Income tax expense	0.9	2.9	1.4	2.5
Net income	1.4 %	4.8 %	2.4 %	4.3 %

**Three Months Ended June 30, 2006
Compared to the Three Months Ended June 30, 2005**

During the second quarter of 2006, net sales decreased to \$207.7 million from \$218.8 million, a decrease of \$11.1 million or 5.1% compared to the same quarter of 2005. The decrease in second quarter sales is primarily due to the decrease in comparable store sales partially offset by the \$18.7 million increase in sales from non-comparable new stores. The decrease in comparable sales for the second quarter of 2006 was comprised of a 13.8% decrease in the number of transactions offset by a 3.0% increase in the average transaction amount. Total average store sales for the second quarter of 2006 decreased 13.2% when compared to the same prior year quarter. Comparable store sales and sales per store decreased primarily due to lower traffic levels than anticipated. Management believes traffic levels are lower due to a number of factors, including a deceleration in the sales trends of home-related merchandise due to a slowdown in the housing market and reduced disposable income of our consumers given the pressure of rising gasoline and energy costs and higher interest rates on their household budget, as well as an increased supply of home décor merchandise and competitive promotional environment.

Gross profit decreased \$7.1 million, or 8.8%, to \$74.3 million for the three months ended June 30, 2006 as compared to last year's second quarter of \$81.4 million, primarily as a result of our decreased net sales. Our gross profit percentage decreased to 35.8% from 37.2% in the prior year's second quarter. This 1.4% decrease in gross profit percentage is comprised of a 0.9% decrease due to merchandise mix and markdowns and a 0.5% decrease due to an increase in damaged merchandise and freight costs.

Selling, general and administrative expenses are comprised of store labor, store occupancy costs, advertising, miscellaneous store operating expenses and corporate office costs. Increases in dollar amounts of these expenses are attributable to increases in the number of stores and changes in variable expenses. Variable expenses include payroll and related benefits, advertising expense and other expenses such as credit card fees.

Selling, general and administrative expenses increased \$4.6 million, or 7.0%, to \$69.2 million from \$64.7 million in the second quarter of 2005. The increase was attributable to a \$3.8 million increase in store occupancy costs, store personnel costs and store depreciation expense primarily due to the expansion in our store base, an increase of \$600 thousand of store maintenance and other store expenses, the \$800 thousand stock-based compensation recorded upon the adoption of Statement 123(R) and \$500 thousand of other corporate expenses. These were somewhat offset by the \$1.1 million decrease in advertising expense. As a percentage of net sales, these expenses increased 3.7% to 33.3% in the second quarter of 2006 from 29.6% in the second quarter of 2005. The increased percentage is primarily due to the reduced expense leveraging given our negative comparable store sales for the second quarter of 2006 and includes a 2.9% increase related to store occupancy costs, store personnel costs and store depreciation expense, a 0.3% increase in store maintenance and other store expenses, a 0.4% increase due to the recording of stock-based compensation upon the adoption of Statement 123(R) and a 0.4% increase in other corporate expenses but were somewhat offset by the 0.3% decrease in advertising expense.

The income tax provision for the three month periods ended June 30, 2006 and 2005 was \$1.8 million and \$6.4 million, respectively, reflecting an effective tax rate of 38.8% and 37.6%, respectively. The effective tax rate is higher in the second quarter of 2006 as compared to the second quarter of 2005 due to an adjustment to the effective tax rate to reflect projected lower pretax income for the full-year 2006 which is impacted by the permanent timing difference associated with non-deductible stock compensation expense for incentive stock options granted to employees prior to January 2006.

**Six Months Ended June 30, 2006
Compared to the Six Months Ended June 30, 2005**

During the first six months of 2006, net sales decreased to \$395.4 million from \$404.4 million, a decrease of \$8.9 million or 2.2% compared to the same period of 2005. The decrease in sales for the first six months is primarily due to the 7.9% decrease in comparable store sales, offset by the \$35.1 million increase in sales from non-comparable new stores. The decrease in comparable sales for the first six months of 2006 was comprised of a 9.8% decrease in the number of transactions offset by a 1.9% increase in the average transaction amount. Total average store sales for the first six months of 2006 decreased 10.6% when compared to the same prior year period. Comparable store sales and sales per store decreased primarily due to lower traffic levels than anticipated. Management believes traffic levels are lower due to a number of factors, including a deceleration in the sales trends of home-related merchandise due to a slowdown in the housing market and reduced disposable income of our consumers given the pressure of rising gasoline and energy costs and higher interest rates on their household budget, as well as an increased supply of home décor merchandise and competitive promotional environment.

Gross profit decreased \$6.1 million, or 4.0%, to \$147.9 million for the six months ended June 30, 2006 as compared to the six month period last year of \$154.0 million, primarily as a result of our decreased net sales. Our gross profit percentage decreased to 37.4% from 38.1% in the prior

year's six month period. This 0.7% decrease in the gross profit percentage is comprised of a 0.3% decrease due to merchandise mix and markdowns and a 0.4% decrease due to damaged merchandise and freight costs.

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Selling, general and administrative expenses increased \$5.6 million, or 4.4%, to \$132.4 million from \$126.8 million in the first six months of 2005. The increase was attributable to a \$7.5 million increase in store occupancy costs, store personnel costs and store depreciation expense primarily due to the expansion in our store base, \$1.6 million stock-based compensation recorded upon the adoption of Statement 123(R), and \$1.0 million other corporate expenses, offset by the \$3.9 million non-cash lease accounting adjustment in the same prior year period and the \$800 thousand decrease in advertising expense. As a percentage of net sales, these expenses increased 2.1% to 33.5% in the first six months of 2006 from 31.4% in the first six months of 2005. The increased percentage is primarily due to the reduced expense leveraging given our negative comparable store sales and includes a 2.4% increase related to store occupancy costs, store personnel costs and store depreciation expense, a 0.4% increase due to the recording of stock-based compensation upon the adoption of Statement 123(R) and a 0.4% increase of other corporate expenses, offset primarily by the 1.0% decrease related to the lease accounting adjustment recorded in the prior year and by the 0.1% decrease in advertising expense.

The income tax provision for the six month periods ended June 30, 2006 and 2005 was \$5.8 million and \$10.1 million, respectively, reflecting an effective tax rate of 37.9% and 37.1%, respectively. The effective tax rate is higher in the six months ended June 30, 2006 as compared to the six months ended 2005 adjustment in the effective tax rate to reflect projected lower pretax income for the full-year 2006 which is impacted by the permanent timing difference associated with non-deductible stock compensation expense for incentive stock options granted to employees prior to January 2006 somewhat offset by a favorable settlement of certain tax issues in the prior year period.

Liquidity and Capital Resources

We have financed our operations with funds generated from operating activities and borrowings under our revolving credit facility. Our cash flows will continue to be utilized for the expansion of our business and future cash dividends to our stockholders. We have no off-balance sheet arrangements or transactions with unconsolidated, limited purpose or variable interest entities, nor do we have material transactions or commitments involving related persons or entities.

Net cash used in operating activities for the six months ended June 30, 2006 and 2005 was \$18.5 million and \$9.8 million, respectively, representing a \$8.7 million increase. This increase is primarily due to the decrease in sales and related operating income.

Capital expenditures principally associated with new stores opening and warehouse equipment were \$7.2 million and \$8.6 million for the six months ended June 30, 2006 and 2005, respectively. We expect to spend approximately \$11 million for additional capital expenditures for the remainder of 2006, which will include the opening of new stores, enhancements of selected stores, and purchases of equipment for our distribution center.

We have a \$210 million revolving credit facility that expires in December 2009. Any borrowing under the revolving credit facility will incur interest at LIBOR or the prime rate, depending on the type of borrowing, plus an applicable margin. We incur commitment fees of up to 0.25% on the unused portion of the revolving credit facility. This rate is reduced or increased as our average total leverage ratio changes. Our indebtedness under the credit facility is secured by a lien on our inventory and cash accounts, as well as a pledge of our ownership interests in all of our subsidiaries.

At June 30, 2006, we had \$21 million in debt outstanding under the revolving credit facility and had availability of \$180.9 million. As of June 30, 2006, we had outstanding letters of credit of \$8.1 million, primarily for self-insurance.

The revolving credit facility contains certain restrictive covenants, which among other things, require us to comply with certain financial ratios covering maximum leverage, minimum fixed charge coverage and minimum interest coverage. Other restrictions affect our ability to incur liens or make certain other restricted payments, sell assets or merge or consolidate with any other person. As of June 30, 2006, we were in compliance with all covenants.

We anticipate that our future net cash flows from operations and unused borrowings under our revolving credit facility will be sufficient to fund our working capital needs, an annual dividend and planned capital expenditures for the next 12 months.

Store Openings/Closings

Six Months Ended June 30, 2006	Six Months Ended June 30, 2005	Twelve Months Ended December 31, 2005
---	---	--

Stores open at beginning of period	732	662	662
Stores opened during the period	35	38	81
Stores closed during the period	(5)	(8)	(11)
Stores open at end of period	762	692	732

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to various market risks, including changes in foreign currency exchange rates and interest rates. Market risk is the potential loss arising from adverse changes in market prices and rates, such as foreign currency exchange and interest rates. Based on our market risk sensitive instruments outstanding as of June 30, 2006, we have determined that there was no material market risk exposure to our consolidated financial position, results of operations or cash flows as of such date. Our market risk is discussed in more detail in our Annual Report on Form 10-K for the year ended December 31, 2005. We do not enter into derivatives or other financial instruments for trading or speculative purposes. There have been no significant changes in the foreign currency exchange rate or interest rate market risks since December 31, 2005.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Based on our management's evaluation (with participation of our principal executive officer and our principal financial officer), our principal executive officer and our principal financial officer have concluded that our disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) were effective as of June 30, 2006 to ensure that information required to be disclosed by us in this Quarterly Report on Form 10-Q was (1) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (2) accumulated and communicated to our management, including our principal executive and principal financial officers, to allow timely decisions regarding required disclosure.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met and, as set forth above, our chief executive officer and chief financial officer have concluded, based on their evaluation as of the end of the period covered by this report, that our disclosure controls and procedures were effective to provide reasonable assurance that the objectives of our disclosure control system were met.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

During 2001 and 2002, we were named as a defendant in three complaints filed in the Superior Court of California in and for the County of Los Angeles. The plaintiffs are seeking to certify a statewide class made up of some of our current and former employees, which they claim are owed compensation for overtime wages, penalties and interest. The plaintiffs are also seeking attorney's fees and costs. In October 2003, we entered into a settlement agreement with a sub-class of these plaintiffs consisting of manager-in-training and management trainees which was paid in November 2005 with no material impact to our financial statements. The remaining complaint relating to our salaried managers is still open with a scheduled trial date of January 2007. We have a similar lawsuit in Orange County, California in 2004 that we have filed a motion to disqualify the class representative. The motion was heard by the court in July 2006 with the outcome expected to be communicated in August 2006. The case is still in discovery. We do not expect either of these complaints to have a material impact to our financial statements.

In June 2004, we were named as a defendant in a complaint filed in the U.S. District Court, Central District of California. The plaintiff, Thomas Kinkade Company (f/k/a/ Media Arts Group Inc.), alleged copyright infringement and false advertisements on merchandise we sold in the second quarter of 2004. The case went to trial in March 2006. The jury found in favor of us on the trademark infringement claim. The jury was unable to reach a verdict on the remaining claims. The parties have agreed to mediate with the presiding judge regarding the remaining claims. A mediation date has been set for August 2006.

We intend to vigorously defend all pending actions. We do not believe these or any other legal proceedings pending or threatened against us would have a material adverse effect on our financial condition or results of operations.

Item 1A. Risk Factors

PART I FINANCIAL INFORMATION

There have been no material changes from our risk factors previously disclosed in Item 1A. Risk Factors of our Form 10K for the year ended December 31, 2005.

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

At the Annual Meeting of Stockholders held on May 16, 2006, the following proposals were submitted to stockholders with the following results:

1. Election of six directors to serve until their terms expire at the annual meeting of stockholders to be held in 2007, or the earlier of retirement, resignation or removal

	Number of Shares For	Withheld	Broker Non-Votes
Benjamin D. Chereskin	38,161,753	1,075,850	
Kathleen Mason	31,294,072	7,943,531	
William J. Hunckler, III	36,533,297	2,704,306	
Robin P. Selati	38,800,403	437,200	
Henry F. Frigon	36,359,027	2,878,576	
Giles H. Bateman	38,934,953	302,650	

2. Ratification of the selection of Ernst & Young as our independent registered public accounting firm for the year ending December 31, 2006

	Number of Shares
For	39,161,748
Against	58,812
Abstain	17,043

No other matters were voted upon at the meeting.

Item 5. Other Information

There have been no material changes to the procedures by which security holders may recommend nominees to our Board of Directors since April 21, 2003.

Item 6. Exhibits

Exhibit

Number	Title of Exhibit
3.1	Certificate of Incorporation of Tuesday Morning Corporation (the Company) (incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-4 (File No. 333-46017) as filed with the Securities and Exchange Commission (the Commission) on February 10, 1998)
3.1.2	Certificate of Amendment to the Certificate of Incorporation of the Company dated March 25, 1999 (incorporated by reference to Exhibit 3.3 to the Company's Registration Statement on Form S-1/A (File No. 333-74365) as filed with the Commission on March 29, 1999)
3.1.3	Certificate of Amendment to the Certificate of Incorporation of the Company dated May 7, 1999 (incorporated by reference to Exhibit 3.1.3 to the Company's Form 10-Q (File No. 000-19658) as filed with the Commission on May 2, 2005)
3.2	Amended and Restated By-laws of the Company (incorporated by reference to Exhibit 3.7 to the Company's Registration Statement on Form S-4 (File No. 333-46017) as filed with the Commission on February 10, 1998)
3.2.1	First Amendment to the Amended and Restated By-laws of the Company (incorporated by reference to Exhibit 3.1 to the Company's Form 8-K (File No. 000-19658) as filed with the Commission on May 18, 2006)
10.1	Letter Agreement dated July 18, 2006 from Kathleen Mason, on behalf of the Company, to Elizabeth Schroeder (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K (File No. 000-19658) as filed with the Commission on July 18, 2006)W
31.1	Certification by the Chief Executive Officer of the Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by the Chief Financial Officer of the Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer of the Company pursuant to 18 U.S.C §1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 *
32.2	Certification of the Chief Financial Officer of the Company pursuant to 18 U.S.C §1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 *

W Management agreement or compensatory plan or arrangement

* The certifications attached hereto as Exhibit 32.1 and Exhibit 32.2 are furnished with this Quarterly Report on Form 10-Q and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

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.

TUESDAY MORNING CORPORATION

(Registrant)

DATE: August 3, 2006

By:

/s/ Elizabeth Schroeder
Elizabeth Schroeder, Executive Vice President, Chief
Financial Officer, Treasurer and Secretary
(Principal Financial Officer and duly
authorized to sign this report on behalf of the
registrant)

EXHIBIT INDEX

Exhibit

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