

REEDS JEWELERS INC
Form 10-Q
October 15, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON DC 20549

FORM 10-Q

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

FOR THE QUARTER ENDED AUGUST 31, 2002
COMMISSION FILE NUMBER 0-15247

REEDS JEWELERS, INC.

(Exact name of registrant as specified in its charter)

North Carolina

(State or other jurisdiction of incorporation or organization)

56-1441702

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

2525 South Seventeenth Street
Wilmington, North Carolina

(Address of principal executive offices)

28401

(Zip code)

Registrant's telephone number, including area code:

(910) 350-3100

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

The number of outstanding shares of Common Stock, par value \$0.10 per share, as of October 15, 2002 was 8,476,372.

PART I

Item 1. *Financial Statements*

The consolidated financial statements included herein have been prepared by Reeds Jewelers, Inc. (the Company), without audit, 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 generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations; however, the Company believes that the disclosures are adequate to make the information presented not misleading. It is suggested that these consolidated financial statements be read in conjunction with the financial statements and the notes thereto included in the Company's latest annual report on Form 10-K for the fiscal year ended February 28, 2002.

REEDS JEWELERS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	February 28 2002	August 31 2002	August 31 2001
		(unaudited)	(unaudited)
ASSETS			
Current assets:			
Cash and cash equivalents	\$ 809,000	\$ 353,000	\$ 776,000
Accounts receivable:			
Customers, less allowance for doubtful accounts of \$1,043,000, \$581,000 and \$3,730,000, respectively (Note E)	133,000	199,000	42,902,000
Other	488,000	1,198,000	993,000
Merchandise inventories	44,337,000	48,362,000	52,066,000
Income taxes receivable	6,776,000	2,092,000	2,421,000
Deferred income taxes, net of valuation allowance of \$132,000 in 2001 (Note C)			1,939,000
Other	654,000	900,000	1,020,000
	<u>53,197,000</u>	<u>53,104,000</u>	<u>102,117,000</u>
Property, furniture and equipment:			
Land and building	83,000	83,000	83,000
Furniture and equipment	20,650,000	20,148,000	27,362,000
Leasehold improvements	9,186,000	9,206,000	12,303,000
	<u>29,919,000</u>	<u>29,437,000</u>	<u>39,748,000</u>
Less accumulated depreciation and amortization	17,765,000	18,316,000	20,654,000
	<u>12,154,000</u>	<u>11,121,000</u>	<u>19,094,000</u>
Other assets:			
Goodwill, net of accumulated amortization of \$3,216,000 in 2001			5,180,000
Deferred income taxes, net of valuation allowance of \$19,000 in 2001 (Note C)			284,000
Restricted investments (Note D)			2,367,000
Other Receivable, less allowance of \$906,000, \$906,000, and \$0, respectively	5,474,000	5,474,000	
Miscellaneous	1,123,000	1,051,000	975,000
	<u>6,597,000</u>	<u>6,525,000</u>	<u>8,806,000</u>
TOTAL ASSETS	\$ 71,948,000	\$ 70,750,000	\$ 130,017,000
LIABILITIES AND SHAREHOLDERS			
EQUITY			
Current liabilities:			
Accounts payable	\$ 17,233,000	\$ 12,558,000	\$ 21,944,000
Accrued compensation	2,011,000	1,267,000	1,287,000
Accrued expenses	3,805,000	2,383,000	1,951,000
Current portion of long-term debt			60,100,000
	<u>23,049,000</u>	<u>16,208,000</u>	<u>85,282,000</u>
Total current liabilities	23,049,000	16,208,000	85,282,000
Revolving credit note	15,809,000	23,880,000	
Subordinated notes payable to shareholders	2,579,000	2,579,000	845,000
Deferred income taxes (Note C)			2,095,000
Other long-term liabilities	855,000	855,000	874,000

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Total liabilities	42,292,000	43,522,000	89,096,000
Shareholders' equity:			
Common stock, par value \$0.10 per share; 25,000,000 shares authorized; 8,476,372 shares issued and outstanding in 2002 and 2001	847,000	847,000	847,000
Additional paid-in capital	10,560,000	10,560,000	10,560,000
Retained earnings	18,249,000	15,821,000	29,514,000
Total shareholders' equity	29,656,000	27,228,000	40,921,000
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 71,948,000	\$ 70,750,000	\$ 130,017,000

REEDS JEWELERS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three months ended August 31		Six months ended August 31	
	2002	2001	2002	2001
Net sales	\$ 19,212,000	\$ 22,306,000	\$ 40,319,000	\$ 43,599,000
Cost of sales	9,708,000	12,146,000	20,278,000	23,029,000
Gross profit	9,504,000	10,160,000	20,041,000	20,570,000
Selling, general and administrative expenses	10,689,000	12,707,000	21,663,000	25,048,000
Depreciation and amortization	599,000	1,029,000	1,207,000	2,009,000
Restructuring charge (Note F)	270,000		270,000	
Operating loss	(2,054,000)	(3,576,000)	(3,099,000)	(6,487,000)
Interest expense	372,000	557,000	755,000	1,045,000
Loss from continuing operations before income taxes	(2,426,000)	(4,133,000)	(3,854,000)	(7,532,000)
Income tax benefit	(898,000)	(1,311,000)	(1,426,000)	(2,384,000)
Loss from continuing operations	(1,528,000)	(2,822,000)	(2,428,000)	(5,148,000)
Income from discontinued credit operations, net of income tax expense of \$200,000 and \$449,000 in 2001		462,000		1,037,000
Net loss	\$ (1,528,000)	\$ (2,360,000)	\$ (2,428,000)	\$ (4,111,000)
Basic and diluted net loss from continuing operations per share	\$ (0.18)	\$ (0.33)	\$ (0.29)	\$ (0.61)
Basic and diluted net income from discontinued credit operations per share		0.05		0.12
Basic and diluted net loss per share	\$ (0.18)	\$ (0.28)	\$ (0.29)	\$ (0.49)
Weighted average shares outstanding-diluted	8,476,372	8,476,372	8,476,372	8,476,372

REEDS JEWELERS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Six months ended August 31, 2002	Six months ended August 31, 2001
Operating activities		
Net loss	\$(2,428,000)	\$(4,111,000)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities of continuing operations:		
Income from discontinued credit operations		(1,486,000)
Depreciation	1,148,000	1,728,000
Amortization	59,000	281,000
Loss on sale of property, furniture and equipment	24,000	18,000
Changes in operating assets and liabilities:		
Accounts receivable	(776,000)	7,858,000
Merchandise inventories	(4,025,000)	(3,514,000)
Other current assets and other assets	(233,000)	(206,000)
Accounts payable	(4,675,000)	8,526,000
Accrued compensation and expenses	(2,166,000)	(1,415,000)
Income taxes	4,684,000	(2,073,000)
Other long-term liabilities		663,000
Net cash (used in) provided by operating activities of continuing operations	(8,388,000)	6,269,000
Investing activities		
Proceeds from sale of property, furniture and equipment	285,000	
Purchases of property, furniture and equipment	(424,000)	(2,730,000)
Proceeds from sale of restricted investments		2,517,000
Purchase of restricted investments		(2,304,000)
Net cash used in investing activities	(139,000)	(2,517,000)
Financing activities		
Net proceeds from (payments on) revolving credit note	8,071,000	(3,661,000)
Net cash provided by (used in) financing activities	8,071,000	(3,661,000)
Net (decrease) increase in cash and cash equivalents	(456,000)	91,000
Cash and cash equivalents at beginning of period	809,000	685,000
Cash and cash equivalents at end of period	\$ 353,000	\$ 776,000
Supplemental disclosures of cash flow information:		
Cash paid (received) during the period for:		
Interest	\$ 1,016,000	\$ 2,170,000
Income taxes	\$(6,422,000)	\$ 53,000

REEDS JEWELERS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A. MANAGEMENT'S OPINION

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Form 10-K for the fiscal year ended February 28, 2002.

Management of Reeds Jewelers, Inc. believes that the consolidated financial statements contained herein contain all adjustments necessary to present fairly the financial position, consolidated results of operations, and cash flows for the interim period. Management also believes that all adjustments so made are of a normal and recurring nature.

B. RECLASSIFICATIONS

Certain reclassifications were made to the 2001 financial statements to conform to the classifications used in 2002. The reclassifications had no effect on net loss or shareholders' equity as previously reported.

C. INCOME TAXES

Deferred tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities and are measured using the enacted tax rates and laws anticipated to be in effect when those differences are expected to reverse. For the six months ended August 31, 2002 and 2001 the Company generated net losses. The Company has established a valuation allowance for these net operating loss carryforwards and certain other deferred tax assets. The Company will reduce the valuation allowance when, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will be realized.

D. RESTRICTED INVESTMENTS

	08/31/02	08/31/01
Cash	\$	\$2,307,000
Equity investment		60,000
	_____	_____
Total restricted investments	\$	\$2,367,000
	_____	_____

Restricted investments in the accompanying balance sheet represent cash and stock held by the Company's subsidiary, First Retail Bank N.A., to comply with the Federal Banking Regulations.

The Company's equity investment, carried at cost, consisted of 1,200 shares of Federal Reserve Bank stock with a \$50 par value at August 31, 2001.

In October 2001, the company dissolved the First Retail Bank, N. A. and as a result, the restricted investments became available for general use.

E. OPERATING SEGMENT INFORMATION

On February 28, 2002, Reeds Jewelers discontinued its credit segment. The Company sold substantially all of the outstanding accounts receivable owned by its subsidiary Reeds Financial Services, Inc. (RFSI). In connection with the sale of the accounts receivable portfolio the Company signed a seven-year agreement with the purchaser whereby the purchaser will provide a full-service private label credit card program to Reeds Jewelers, Inc. Upon outsourcing its credit operations, the Company closed its credit facilities in Wilmington, NC and Flowery Branch, GA. In accordance with SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, the Company reported two segments, retail operations and credit operations. Separate financial information was produced internally and was regularly reviewed by the chief operating decision-maker (CODM). The retail operations segment consists of all store locations and corporate headquarters. The stores have all been combined into one segment because they have similar basic characteristics, such as the nature of products, and the class of customers for their products. Corporate headquarters is included in this same segment due to the fact that its revenues earned are incidental to the Company s activities and it serves as a support system to the stores. The credit operations segment was primarily engaged in providing and maintaining financing for the Company s customers. This operation was segregated since the CODM evaluated it separately. It also met one of the three quantitative thresholds, the asset test, since it represented 10.0% or more of the combined assets of all operating segments.

The following table summarizes the net sales, revenues, operating earnings, interest expense, assets, depreciation, and capital expenditures for each reportable segment for the quarters and six-months ended August 31, 2002 and 2001. In the financial statements, other revenues are reflected as a reduction of selling, general, and administrative expenses and inter-segment revenue eliminates in consolidation.

	Retail Operations	Credit Operations	Total
<i>For the quarter ended August 31, 2002</i>			
Net Sales	\$ 19,212,000	\$	\$ 19,212,000
Other revenues	310,000		310,000
Inter-segment revenue			
Operating loss excluding inter-segment revenue	(2,054,000)		(2,054,000)
Interest expense	372,000		372,000
Identifiable assets	70,750,000		70,750,000
Depreciation and amortization	599,000		599,000
Capital expenditures	277,000		277,000

	Retail Operations	Credit Operations	Total
<i>For the quarter ended August 31, 2001</i>			
Net Sales	\$ 22,306,000	\$	\$ 22,306,000
Other revenues	367,000	3,233,000	3,600,000
Inter-segment revenue		242,000	242,000
Operating (loss) earnings excluding inter-segment revenue	(3,576,000)	1,141,000	(2,435,000)
Interest expense	557,000	479,000	1,036,000
Identifiable assets	84,419,000	45,598,000	130,017,000
Depreciation and amortization	1,029,000	34,000	1,063,000
Capital expenditures	1,183,000		1,183,000

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	Retail Operations	Credit Operations	Total
<i>For the six month ended August 31, 2002</i>			
Net Sales	\$ 40,319,000	\$	\$ 40,319,000
Other revenues	661,000		661,000
Inter-segment revenue			
Operating loss excluding inter-segment revenue	(3,099,000)		(3,099,000)
Interest expense	755,000		755,000
Identifiable assets	70,750,000		70,750,000
Depreciation and amortization	1,207,000		1,207,000
Capital expenditures	424,000		424,000

	Retail Operations	Credit Operations	Total
<i>For the six months ended August 31, 2001</i>			
Net Sales	\$43,599,000	\$	\$ 43,599,000
Other revenues	761,000	6,662,000	7,423,000
Inter-segment revenue		411,000	411,000
Operating (loss) earnings excluding inter-segment revenue	(6,487,000)	2,585,000	(3,902,000)
Interest expense	1,045,000	1,099,000	2,144,000
Identifiable assets	84,419,000	45,598,000	130,017,000
Depreciation and amortization	2,009,000	68,000	2,077,000
Capital expenditures	2,730,000		2,730,000

F. RESTRUCTURING CHARGE

In the fiscal year ended February 28, 2002, \$6,020,000 was recorded for restructuring and related costs associated with the Company's exit from under-performing markets. In the quarter ended August 31, 2002, the Company recorded the final expenses of its restructuring plan in the amount of \$270,000. These costs, in accordance with EITF 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring), represent the costs of closing 24 under-performing stores and costs of not opening 3 new stores in new or under-performing markets. The amounts recorded consist of the costs associated with buying out store leases, store closing costs, and the loss on the sale or abandonment of leasehold improvements and furniture and fixtures. The restructuring charge also includes the severance costs associated with reducing its corporate office personnel by approximately 20% and its store personnel by approximately 17%. The remaining liability as of August 31, 2002 was \$103,000, which is included in accrued expenses on the balance sheet. As of August 31, 2002, the following amounts were recorded:

Activity For the Period Ended August 31, 2002

	Balance at February 28, 2002	Accruals	Write-offs/ Payments	Balance at August 31, 2002
Lease exit costs	\$ 307,000	\$ 132,000	\$ 339,000	\$ 100,000
Sale/disposal of fixed assets	33,000	93,000	126,000	
Severance costs	38,000	39,000	77,000	
Professional fees	15,000	6,000	18,000	3,000
Totals	\$ 393,000	\$ 270,000	\$ 560,000	\$ 103,000

G. ACCOUNTING CHANGES

As of March 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 144, Accounting for the Impairment of Disposal of Long-Lived Assets, which addresses financial accounting and reporting for the impairment of disposal of long-lived assets. This standard harmonizes the accounting for impaired assets and resolves some of the implementation issues as originally described in SFAS No. 121. The adoption of SFAS 144 did not affect the Company's operations or financial position.

H. DERIVATIVE FINANCIAL INSTRUMENTS

Financial Accounting Standards Board Statement (SFAS) No. 133/138, Accounting for Derivative Instruments and Hedging Activities, as amended, requires the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through earnings. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of the derivative will either be offset against the change in fair value of the hedged assets, liabilities or firm commitments through earnings, or recognized in comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value is recognized in earnings.

Our interest rate risk management objective is to limit the impact of interest rate changes on earnings and cashflows and to lower overall borrowing costs. To achieve these objectives, from time to time the Company enters into interest rate hedge contracts such as swaps and caps in order to mitigate our interest rate risk with respect to various debt instruments. We do not hold these derivatives for trading or speculative purposes.

Throughout the year ended February 28, 2002, the Company did not hold any derivative instruments. During the first quarter of fiscal 2003, the Company purchased an interest rate cap for \$152,000 with a notional amount of \$20 million. The fair value of the interest rate cap agreement was \$10,000 at August 31, 2002 and is recorded in other long-term assets in the Consolidated Balance Sheet at August 31, 2002. The decrease in the fair market value of the hedge was \$142,000 for the six months ending August 31, 2002 and is reflected in selling, general and administrative expenses. To determine the fair values of derivative and financial instruments, we use a variety of methods and assumptions that are based on market conditions and risks existing at the balance sheet date. For the majority of financial instruments including derivatives and long-term debt, standard market conventions and techniques such as discounted cash flow analysis, option pricing models, replacement cost and termination cost are used to determine fair value. All methods of assessing fair value result in a general approximation of value, and such value may never actually be realized.

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

Results of Operations

Net Sales

Total net sales were down 13.9% to \$19,212,000 for the second quarter ended August 31, 2002, compared to \$22,306,000 for the second quarter last year. Net sales decreased 7.5% to \$40,319,000 for the six months ended August 31, 2002 from \$43,599,000 for the same period a year earlier while operating an average of 17.0% fewer stores. Same store sales, or stores open in comparable periods, declined 3.7% in the second quarter this year compared to the second quarter last year, but increased 1.7% for the six-month period this year compared with the same six-month period last year. At August 31, 2002, the Company operated 96 stores in 20 states compared to 119 stores in 21 states at August 31, 2001. In the second quarter of fiscal 2003, the Company closed two under-performing stores in Wichita KS and one under-performing store in Macon GA. The Company has no commitments to open additional stores in the remainder of this fiscal year.

The sales of a retail jeweler depend upon having the right mixture of merchandise available in its stores. Core merchandise items are those that are the most profitable and have the highest turnover. The Company averaged 95.7% in-stock on its core items during the second quarter of fiscal 2003 and fiscal 2002. The Company averaged 91.8% in-stock on its entire basic merchandise mix compared to 93.4% during the same quarter a year ago. For the quarter ended August 31, 2002, core merchandise accounted for 50.9% of net sales, 51.0% of the items offered in

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the Company's basic merchandise mix, and 32.7% of its inventory investment. During the same quarter last year, core merchandise accounted for 54.3% of net sales, 59.9% of the items offered in the Company's basic merchandise mix, and 35.2% of its inventory investment. The average price of each piece of merchandise sold in the second quarter of fiscal 2003 was \$241, down 2.0% from \$246 a year earlier.

Gross Profit

Gross margins were 49.5% during the quarter, up from 45.5% in the second quarter last year. Year-to-date, gross margins were 49.7%, up from 47.2% for the first six months last year. The increase in gross margins is a result of a higher recovery value on discontinued merchandise and management's efforts to control excess discounting.

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

Selling, general, and administrative expenses as a percentage of net sales were 55.6% and 57.0% for the quarters ended August 31, 2002 and 2001, respectively. Significant expense categories are reflected as a percentage of net sales for the second quarters and six months of the last two fiscal years in the following table:

	Quarter Ended		Six Months Ended	
	08/31/02	08/31/01	08/31/02	08/31/01
Compensation salaries & hourly wages	22.0%	22.7%	21.4%	23.3%
Compensation bonuses & commissions	3.5%	3.3%	3.8%	3.1%
Compensation benefits & other personnel costs	4.8%	4.7%	4.6%	5.0%
Rents for space	13.4%	13.8%	13.0%	13.8%
Advertising	1.9%	2.7%	2.4%	3.3%

Selling, general, and administrative expenses decreased as a percentage of net sales primarily due to the combination of the 1.7% increase in comparable store sales and the closing of 24 under-performing stores. Fixed costs, on a per store basis, including occupancy, base compensation, and benefits decreased 1.6% from the second quarter of the prior year and year-to-date fixed costs per store decreased 2.0% from the prior year.

In the second half of the prior fiscal year, store closings reduced the staffing in the stores by 17% and management implemented corporate office personnel reductions of approximately 20%. These two factors account for the decrease in salaries & hourly wages and benefits & other personnel costs. Bonuses & commissions are higher in the quarter and six months ended August 31, 2002 versus the same periods in the prior year as a result of the improved sales and operating performance at the store level and an incentive plan introduced to increase sales of discontinued merchandise. Management negotiated additional cooperative advertising agreements from its vendors resulting in lower net advertising expenses.

Depreciation and Amortization

Depreciation and amortization expenses were \$599,000 and \$1,207,000 for the three and six-month periods ended August 31, 2002, respectively, compared to \$1,029,000 and \$2,009,000 for the three and six-month periods ended August 31, 2001. The decrease in depreciation and amortization expenses for the three and six-months ended August 31, 2002 is a result of the goodwill impairment write-down at the end of fiscal 2002, the fixed asset impairment write-down in fiscal 2002, the disposal of fixed assets from the 24 stores closed since August 31, 2001, and the disposal of assets from its credit segment closed February 28, 2002.

Interest Expense

Interest expense from continuing operations decreased \$185,000 or 33.2% over the prior year to \$372,000 for the quarter. The Company's effective pre-tax interest rate during the quarter dropped to 5.9% from 6.5% for the same period in the previous year. The Company negotiated a new revolving credit agreement with a different lender in February 2002, which changed the base rate charged on its borrowings from LIBOR to Prime. The Prime Rate also dropped from 6.50% at August 31, 2001 to 4.75% at August 31, 2002. The decrease in interest expense from continuing operations results from the reduced interest rate and a decrease in average borrowings. Interest expense

related to the financing of the accounts receivable portfolio is included in the income from discontinued credit operations, net of taxes.

Income Taxes

The benefit from income taxes (including income tax expense reflected in income from discontinued credit operations of \$200,000 in 2001) was \$898,000 and \$1,111,000 during the quarters ended August 31, 2002 and 2001, respectively. The Company's estimated net effective tax rate was 37.0% during the second quarter ended August 31, 2002 and 32.0% in the second quarter of the previous year.

Liquidity and Capital Resources

Reeds Jewelers requires cash for purchasing inventory, updating technology and equipment, opening new stores, and remodeling existing locations. The Company's primary sources of liquidity are cash flows generated from operations and its revolving credit facility with the Bank of America, N.A. Cash used in operations for the six months ending August 31, 2002 was \$8,388,000 compared to cash provided by operations of \$6,269,000 for the six months ending August 31, 2001. The main factors that contributed to the change in cash flows from operations were the sale of the accounts receivable portfolio in February 2002, the increase of payments to the Company's suppliers, and the receipt of \$6.3 million tax refund related to net operating losses incurred in fiscal 2002. During the quarter ended August 31, 2001 the Company's accounts receivable balance decreased as customers paid for their Mother's Day purchases thereby increasing cash flows provided by operations. Since the accounts receivable portfolio was sold in February 2002, the Company realized the cash benefit in the fourth quarter of fiscal 2002 instead of the first and second quarters of fiscal 2003. The sale of the accounts receivable in February 2002 also increased the availability on the Company's revolving credit agreement. The Company was therefore able to take advantage of cash payment discounts with its vendors. Working capital (current assets less current liabilities) and the corresponding current ratio (current assets divided by current liabilities) were \$36,896,000 and 3.3 to 1 at August 31, 2002 compared with \$30,148,000 and 2.3 to 1 at February 28, 2002 and \$16,835,000 and 1.2 to 1 at August 31, 2001. Working capital needs normally peak in the third quarter as the Company increases inventories to meet anticipated demand during the Christmas selling season. The fourth quarter has historically produced the majority of the Company's cash flows from operations.

The asset-based revolving credit agreement with Bank of America, N.A. is collateralized by substantially all of the Company's assets and permits borrowings of up to \$30 million, subject to advance rates applied to levels of eligible inventory. The Company could have borrowed \$26.0 million at August 31, 2002 based on its eligible inventory and a 55% advance rate. At that time, \$23.9 million was outstanding. The loan agreement requires Reeds Jewelers to satisfy certain financial and other covenants including maintaining a minimum amount of earnings before interest, taxes, depreciation and amortization (EBITDA) and limiting capital expenditures to \$1,000,000 per fiscal year. Because Reeds places significant reliance on its annual operations to provide cash flow, any reduction in sales would increase the Company's need to borrow additional funds and could adversely affect Reeds' ability to meet certain of the financial covenants.

The Company borrowed \$1,734,000 from three related parties in February 2002 in conjunction with the pay-off of its previous revolving credit facility. Interest is payable monthly at the prime rate (4.75% at August 31, 2002) plus 6.0%. The note is secured and is subordinate to the Bank of America, N.A. revolving credit facility. The loan matures on February 28, 2005, but principal payments may be made earlier based on the Company achieving certain financial targets in its audited financial results for the fiscal year ending February 28, 2003.

The Company also has subordinated notes totaling \$845,000 with three related parties, with interest payable monthly at the prime rate (4.75% at August 31, 2002) quoted in *The Wall Street Journal*. The notes are unsecured and are subordinate to the revolving credit facility.

Reeds Jewelers has incurred \$424,000 in capital expenditures as of August 31, 2002 and expects to incur additional capital expenditures of almost \$576,000 in the remaining months of the fiscal year ending February 28, 2003 for equipment upgrades and store remodels. The Company does not plan to open additional locations in the current fiscal year.

Disclosure Regarding Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements to encourage companies to provide prospective information about their companies without fear of litigation so long as those statements are identified as forward-looking and are accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. Various forward-looking statements have been made throughout this discussion, including comments about:

- (i) planned store openings and closings;
- (ii) anticipated capital expenditures
- (iii) anticipated outcome of legal proceedings

Accordingly, Reeds Jewelers, Inc. hereby identifies the following important factors that could cause its actual financial results to differ materially from those projected by the Company in forward-looking statements:

- (i) availability of favorable locations on terms acceptable to the Company;
- (ii) unexpected changes in the marketing and pricing strategies of competitors;
- (iii) adverse changes in the political environments of countries providing raw materials for the jewelry industry;
- (iv) potential future terrorist attacks and a decline in the domestic economy;
- (v) adverse changes in consumer spending;
- (vi) significant changes in interest rates; or
- (vii) the loss of key executives.

Impact of Inflation

In management's opinion, changes in net sales and net earnings that have resulted from inflation and changing prices have not been material during the periods presented. There is no assurance, however, that inflation will not materially affect Reeds Jewelers, Inc. in the future.

ITEM 3. *Quantitative and Qualitative Disclosures About Market Risks*

The Company believes that the market risk related to interest rate changes as of August 31, 2002 has not materially changed since February 28, 2002. The market risk disclosure in the Company's Annual Report on Form 10-K for the year ended February 28, 2002 is incorporated by reference herein.

ITEM 4. *Internal Controls*

As of October 11, 2002, an evaluation was performed under the supervision and with the participation of the Company's management, including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of October 11, 2002. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to October 11, 2002.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

The Company is involved in certain legal actions and claims incidental to the conduct of its business. Management believes that such litigation and claims will be resolved without material effect on the Company's financial position or results of operations.

Item 2. Changes in Securities.

Not applicable.

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

Not applicable.

Item 5. Other Information.

Not applicable.

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits.

Not applicable.

(b) Reports on Form 8-K.

Not applicable.

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SIGNATURES

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.

REEDS JEWELERS, INC.

October 15, 2002

/s/ James R. Rouse

James R. Rouse
Treasurer and
Chief Financial Officer

CERTIFICATIONS

I, Alan M. Zimmer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Reeds Jewelers, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

October 15, 2002

/s/ Alan M. Zimmer

Alan M. Zimmer
President and
Chief Executive Officer

CERTIFICATIONS

I, James R. Rouse, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Reeds Jewelers, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

October 15, 2002

/s/ James R. Rouse

James R. Rouse
Treasurer and
Chief Financial Officer