VALASSIS COMMUNICATIONS INC
Form 10-Q
May 08, 2006

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

**x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the Quarterly Period Ended March 31, 2006**

**¨ Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**Commission File Number: 1-10991**

# VALASSIS COMMUNICATIONS, INC.

**(Exact Name of Registrant as Specified in its Charter)**

| **Delaware** | **38-2760940** |
|---|---|
| **(State or Other Jurisdiction of Incorporation or Organization)** | **(IRS Employer Identification Number)** |

**19975 Victor Parkway**

**Livonia, Michigan 48152**

**(address of principal executive offices)**

**Registrant s Telephone Number: (734) 591-3000**

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 x 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 126-2 of the Exchange Act:

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 126-2 of the Exchange Act): Yes ¨ No x

As of May 2, 2006, there were 47,784,568 shares of the Registrant s Common Stock outstanding.

**Part I - Financial Information**

Item 1. Financial Statements

**VALASSIS COMMUNICATIONS, INC.**

**Condensed Consolidated Balance Sheets**

**(U.S. dollars in thousands)**

| | March 31, 2006 (unaudited) | Dec. 31, 2005 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 52,979 | $ 64,320 |
| Auction-rate securities | 82,394 | 72,031 |
| Accounts receivable (less allowance for doubtful accounts of $5,042 at March 31, 2006 and $5,101 at December 31, 2005) | 244,921 | 273,863 |
| Inventories: | | |
| Raw materials | 14,698 | 13,352 |
| Work in progress | 13,801 | 11,883 |
| Prepaid expenses and other | 17,022 | 12,894 |
| Deferred income taxes | 2,571 | 2,573 |
| Total current assets | 428,386 | 450,916 |
| Property, plant and equipment, at cost: | | |
| Land and buildings | 54,286 | 54,247 |
| Machinery and equipment | 137,985 | 136,771 |
| Office furniture and equipment | 59,223 | 61,449 |
| Automobiles | 221 | 221 |
| Leasehold improvements | 2,888 | 2,784 |
| | 254,603 | 255,472 |
| Less accumulated depreciation and amortization | (148,098) | (147,325) |
| Net property, plant and equipment | 106,505 | 108,147 |
| Intangible assets: | | |
| Goodwill | 173,134 | 173,134 |
| Other intangibles | 35,555 | 35,555 |
| | 208,689 | 208,689 |
| Less accumulated amortization | (74,862) | (74,724) |
| Net intangible assets | 133,827 | 133,965 |
| Equity investment | 580 | 614 |
| Other assets | 10,858 | 4,041 |
| Total assets | $ 680,156 | $ 697,683 |

See accompanying notes to condensed consolidated financial statements.

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**VALASSIS COMMUNICATIONS, INC.**

**Condensed Consolidated Balance Sheets, Continued**

**(U.S. dollars in thousands)**

| | March 31, 2006 (unaudited) | Dec. 31, 2005 |
|---|---|---|
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Current portion, long-term debt | $ 14,365 | $ 14,260 |
| Accounts payable | 182,088 | 215,696 |
| Accrued expenses | 47,525 | 49,181 |
| Progress billings | 43,591 | 44,314 |
| Total current liabilities | 287,569 | 323,451 |
| Long-term debt | 259,906 | 259,896 |
| Other non-current liabilities | 7,856 | 8,090 |
| Deferred income taxes | 2,721 | 2,721 |
| Stockholders equity: | | |
| Preferred stock of $.01 par value. Authorized 25,000,000 shares; no shares issued or outstanding at March 31, 2006 and December 31, 2005 | | |
| Common stock of $.01 par value. Authorized 100,000,000 shares; issued 63,280,644 at March 31, 2006 and 63,217,176 at December 31, 2005; outstanding 47,660,014 at March 31, 2006 and 47,629,580 at December 31, 2005 | 632 | 632 |
| Additional paid-in capital | 39,124 | 39,102 |
| Unearned compensation | | (925) |
| Retained earnings | 604,985 | 586,927 |
| Accumulated other comprehensive income | 1,761 | 1,389 |
| Treasury stock, at cost (15,620,630 shares at March 31, 2006 and 15,587,596 shares at December 31, 2005) | (524,398) | (523,600) |
| Total stockholders equity | 122,104 | 103,525 |
| Total liabilities and stockholders equity | $ 680,156 | $ 697,683 |

See accompanying notes to condensed consolidated financial statements.

**VALASSIS COMMUNICATIONS, INC.**

**Condensed Consolidated Statements of Income**

**(U.S. dollars in thousands, except per share data)**

**(unaudited)**

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 |
|---|---|---|
| Revenues | $ 247,646 | $ 279,284 |
| Costs and expenses: | | |
| Cost of products sold | 185,269 | 199,656 |
| Selling, general and administrative | 32,880 | 34,067 |
| Total costs and expenses | 218,149 | 233,723 |
| Earnings from operations | 29,497 | 45,561 |
| Other expenses (income): | | |
| Interest expense | 2,855 | 2,677 |
| Other income, net | (1,354) | (1,074) |
| Total other expenses (income) | 1,501 | 1,603 |
| Earnings before income taxes | 27,996 | 43,958 |
| Income taxes | 9,938 | 15,716 |
| Net earnings | $ 18,058 | $ 28,242 |
| Net earnings per common share, basic | $ 0.38 | $ 0.56 |
| Net earnings per common share, diluted | $ 0.38 | $ 0.55 |
| Shares used in computing net earnings per share, basic | 47,652,165 | 50,687,098 |
| Shares used in computing net earnings per share, diluted | 47,769,495 | 51,430,015 |

See accompanying notes to condensed consolidated financial statements.

**VALASSIS COMMUNICATIONS, INC.**

**Condensed Consolidated Statements of Cash Flows**

**(U.S. dollars in thousands)**

**(unaudited)**

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net earnings | $ 18,058 | $ 28,242 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization of intangibles | 3,678 | 3,792 |
| Amortization of bond discount | 114 | 111 |
| Provision for losses on accounts receivable | 450 | 496 |
| Loss on sale of property, plant and equipment | 13 | 271 |
| Gain on equity investments | (89) | (40) |
| Stock-based compensation charge | 1,418 | 414 |
| Changes in assets and liabilities which (decrease) increase cash flow: | | |
| Accounts receivable | 28,492 | 4,037 |
| Inventories | (3,264) | 728 |
| Prepaid expenses and other | 831 | 4,626 |
| Other liabilities | (234) | (64) |
| Other assets | (1,177) | 1,459 |
| Accounts payable | (33,608) | (25,083) |
| Accrued expenses and interest | (10,083) | (11,534) |
| Income taxes | (1,693) | 14,898 |
| Progress billings | (723) | 14,473 |
| Total adjustments | (15,875) | 8,584 |
| Net cash provided by operating activities | 2,183 | 36,826 |
| **Cash flows from investing activities:** | | |
| Additions to property, plant and equipment | (1,834) | (9,054) |
| Replacement equipment reimbursed by insurance companies from damage claims | | (4,757) |
| Purchases of auction-rate securities | (105,081) | (61,584) |
| Proceeds from sales of auction-rate securities | 94,718 | 71,913 |
| Other | (38) | (33) |
| Net cash used in investing activities | (12,235) | (3,515) |
| **Cash flows from financing activities:** | | |
| Repurchase of common stock | (3,913) | (29,900) |
| Proceeds from the issuance of common stock | 2,292 | 15,016 |
| Net cash used in financing activities | (1,621) | (14,884) |
| Effect of exchange rate changes on cash | 332 | 67 |
| Net (decrease) increase in cash | (11,341) | 18,494 |
| Cash at beginning of period | 64,320 | 85,214 |
| Cash at end of period | $ 52,979 | $ 103,708 |
| **Supplemental disclosure of cash flow information:** | | |
| Cash paid during the period for interest | $ 3,815 | $ 2,694 |
| Cash paid during the period for income taxes | $ 14,373 | $ 224 |

| | | | | |
|---|---|---|---|---|
| Non-cash financing activities: | | | | |
| Stock issued under stock-based compensation plan | $ | 1,845 | $ | 2,346 |

See accompanying notes to condensed consolidated financial statements.

**VALASSIS COMMUNICATIONS, INC.**

**Notes to Condensed Consolidated Financial Statements**

1. **BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( generally accepted accounting principles ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the information contained herein reflects all adjustments necessary for a fair presentation of the information presented. All such adjustments are of a normal recurring nature. The results of operations for the interim periods are not necessarily indicative of results to be expected for the fiscal year. For further information, refer to the consolidated financial statements and footnotes thereto included in the Valassis Communications, Inc. ( Valassis , the Company, we or our ) Annual Report on Form 10-K for the year ended December 31, 2005.

2. **STOCK-BASED COMPENSATION**

Effective January 1, 2006, we adopted Statement of Financial Accounting Standard 123R, Share-Based Payment (FAS 123R). For the interim period ended March 31, 2006, the effect of the adoption of FAS 123R was a decrease to pre-tax earnings of $1.0 million and a decrease to net earnings of $0.6 million. The effect on both basic earnings per share and diluted earnings per share was a reduction of $.01. Compensation expense related to stock options for the three months ended March 31, 2006 of $1.0 million is included in selling, general and administrative expenses. Total compensation expense related to non-vested options not yet recognized at March 31, 2006 is $9.2 million, which we expect to recognize as compensation expense over the next 5 years.

We use a Black-Scholes valuation model to determine the fair value of stock option grants and the straight-line attribution method for recognizing stock-based compensation expense under FAS 123R, which is consistent with the method we used in recognizing stock-based compensation expense for disclosure purposes under FAS 123 prior to the adoption of FAS 123R.

The following table reconciles reported net income to pro forma net income for the quarter ended March 31, 2005 as if Valassis accounted for its stock options under the fair value method of Statement of Financial Accounting Standards (SFAS) No. 123R prior to its adoption on January 1, 2006.

| (in thousands of U.S. dollars, except per share data) | | Three Months Ended March 31, 2005 |
|---|---|---|
| Net earnings, as reported | $ | 28,242 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | | 266 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards granted since January 1, 1995, net of related tax effects | | (2,077) |
| Pro forma net earnings | $ | 26,431 |
| Earnings per share: | | |
| Basic - as reported | $ | 0.56 |
| Basic - pro forma | $ | 0.52 |
| Diluted - as reported | $ | 0.55 |
| Diluted - pro forma | $ | 0.51 |

3. **FOREIGN CURRENCY AND DERIVATIVE FINANCIAL INSTRUMENTS**

The functional currencies for our foreign operations are the applicable local currencies. Accounts of foreign operations are translated into U.S. dollars using the spot rate of the local currency on the balance sheet date for assets and liabilities and average monthly exchange rates for revenues and expenses. Translation adjustments are reflected as an adjustment to equity on a cumulative basis.

Currencies to which Valassis has exposure are the Mexican peso, Canadian dollar, British pound and euro. Currency restrictions are not expected to have a significant effect on our cash flows, liquidity, or capital resources. Valassis typically purchases the Mexican peso under three to twelve-month forward foreign exchange contracts to stabilize the cost of production in Mexico. Under SFAS No. 133, our Mexican peso forward exchange contracts meet the definition of a cash flow hedge. Accordingly, changes in the fair value of the hedge are recorded as a component of other comprehensive income. For the quarter ended March 31, 2006, the recorded unrealized market value gains and losses included in other comprehensive income were immaterial. Actual exchange losses or gains are recorded against production expense when the contracts are executed. As of March 31, 2006, Valassis had a commitment to purchase $3.6 million in Mexican pesos over the next 6 months.

As of March 31, 2006, our accumulated other comprehensive income was $1.8 million. Changes in other comprehensive income for the quarter were immaterial. Foreign currency translation is the majority component of accumulated other comprehensive income. The remainder relates to cumulative gains from hedging contracts and accrued interest from auction-rate securities.

4. **GOODWILL AND OTHER INTANGIBLES**

Intangible assets as of March 31, 2006 are comprised of:

| (in thousands of U.S. dollars) | Intangible Assets, at Cost | Accumulated Amortization at March 31, 2006 | Unamortized Balance at March 31, 2006 | Weighted Average Useful Life (in years) |
|---|---|---|---|---|
| **Amortizable intangible assets** | $ 3,455 | $ (2,057) | $ 1,398 | 5.4 |
| **Non-amortizable intangible assets:** | | | | |
| *Goodwill:* | | | | |
| Free-standing Inserts | 65,401 | (47,144) | 18,257 | |
| Run of Press | 3,599 | (2,260) | 1,339 | |
| Neighborhood Targeted | 4,195 | (209) | 3,986 | |
| Household Targeted | 86,375 | (53,733)[1] | 32,642 | |
| International & Services | 64,864 | | 64,864 | |
| *The Valassis name and other* | 32,100 | (20,759) | 11,341 | |
| **Total non-amortizable intangible assets** | **256,534** | **(124,105)** | **132,429** | |
| **Total** | **$259,989** | **$ (126,162)** | **$133,827** | |

(1) Includes impairment charge of $51.3 million taken in the fourth quarter of 2002.

5. **CONTINGENCIES**

On April 28, 2006, the Federal Trade Commission announced that it had approved issuance of the final consent order concerning Valassis, settling a claim alleging that remarks made during Valassis second quarter earnings call, held on July 22, 2004, violated Section 5 of the Federal Trade Commission Act.

Under the terms of the settlement, we did not admit any wrongdoing and are not required to pay any fines or penalties. The allegations were limited to the remarks made on our second quarter earnings conference call held on July 22, 2004 and there were no allegations regarding any conduct or effect beyond the remarks themselves. The settlement relieved us of the substantial expense, time and resources of continuing this proceeding.

The FTC announced the approval of the consent agreement on March 14, 2006, subject to a 30-day public comment period, during which time there were no public comments. The consent agreement prohibits us from communicating certain statements about competitive intentions (and standard prohibitions related to allocating markets and fixing prices).

Valassis is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on our financial position, results of operations or liquidity.

6. **LONG-TERM DEBT**

Long-term debt is summarized as follows:

| (in thousands of U.S. dollars) | March 31, 2006 | Dec. 31, 2005 |
|---|---|---|
| Revolving Credit Facility | $ | $ |
| 6 5/8% Senior Notes due 2009, net of discount | 99,906 | 99,896 |
| Zero Coupon Senior Convertible Notes due 2021, net of discount | 14,365 | 14,260 |
| Senior Convertible Notes due 2033, net of discount | 160,000 | 160,000 |
| | $ 274,271 | $ 274,156 |
| Less current portion | 14,365 | 14,260 |
| | $ 259,906 | $ 259,896 |

7. **SEGMENT REPORTING**

Valassis has five reportable segments: Free-standing Inserts (FSI), Run of Press (ROP), Neighborhood Targeted, Household Targeted and International & Services. These segments are strategic business units that offer different products and services and are subject to regular review by our chief operating decision-makers. They are managed separately because each business requires different executional strategies and caters to different customer marketing needs.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. We evaluate performance based on earnings from operations. Assets are not allocated in all cases to reportable segments and are not used to assess the performance of a segment.

| | Three Months Ended March 31, | | | | | |
|---|---|---|---|---|---|---|
| (in millions of U.S. dollars) | FSI | ROP | Neighborhood Targeted | Household Targeted | International & Services | Total |
| **2006** | | | | | | |
| Revenues from external customers | $ 115.3 | $ 20.3 | $ 66.9 | $ 18.2 | $ 26.9 | $ 247.6 |
| Intersegment revenues | $ | $ | $ | $ | $ | $ |
| Depreciation/amortization | $ 1.9 | $ | $ 0.5 | $ 0.1 | $ 1.0 | $ 3.5 |
| Segment profit | $ 17.6 | $ 1.5 | $ 5.9 | $ 2.4 | $ 2.1 | $ 29.5 |
| **2005** | | | | | | |
| Revenues from external customers | $ 131.7 | $ 30.1 | $ 74.3 | $ 19.0 | $ 24.2 | $ 279.3 |
| Intersegment revenues | $ | $ | $ | $ | $ | $ |
| Depreciation/amortization | $ 2.2 | $ | $ 0.5 | $ 0.2 | $ 0.8 | $ 3.7 |
| Segment profit (loss) | $ 29.6 | $ 3.1 | $ 9.6 | $ 0.9 | $ 2.4 | $ 45.6 |

Reconciliations to consolidated financial statement totals are as follows:

| (in millions of U.S. dollars) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Profit for reportable segments | $ 29.5 | $ 45.6 |
| Unallocated amounts: | | |
| Interest expense | (2.9) | (2.7) |
| Other income | 1.4 | 1.1 |
| Earnings before income taxes | $ 28.0 | $ 44.0 |

Domestic and foreign revenues were as follows:

| (in millions of U.S. dollars) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| United States | $ 233.0 | $ 266.6 |
| Foreign | 14.6 | 12.7 |
| Total | $ 247.6 | $ 279.3 |

8. **EARNINGS PER SHARE**

Earnings per common share (EPS) data were computed as follows:

| (in thousands of U.S. dollars) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Net Earnings | $ 18,058 | $ 28,242 |
| Basic EPS: | | |
| Weighted average common shares outstanding | 47,652 | 50,687 |
| Earnings per common share - basic | $ 0.38 | $ 0.56 |
| Diluted EPS: | | |
| Weighted average common shares outstanding | 47,652 | 50,687 |
| Weighted average shares purchased on exercise of dilutive options | 2,171 | 5,444 |
| Shares purchased with proceeds of options | (2,087) | (4,753) |
| Shares contingently issuable | 33 | 52 |
| Shares applicable to diluted earnings | 47,769 | 51,430 |
| Earnings per common share - diluted | $ 0.38 | $ 0.55 |

Unexercised employee stock options to purchase 4,294,651 shares and 1,606,523 shares, of Valassis common stock were not included in the computations of diluted EPS for the three months ended March 31, 2006 and March 31, 2005, respectively, because the options exercise prices were greater than the average market price of our common stock during the applicable periods.

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

Certain statements under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations, including specifically statements made in Business Outlook, Overview and elsewhere in this report on Form 10-Q, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks and uncertainties and other factors which may cause the actual results, performance or achievements of Valassis to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements and to cause future results to differ from our operating results in the past. Such factors include, among others, the following: price competition from our existing competitors; new competitors in any of Valassis businesses; a shift in customer preference for different promotional materials, promotional strategies or coupon delivery methods; an unforeseen increase in Valassis paper costs; economic disruptions caused by terrorist activity, armed conflict or changes in general economic conditions; or changes which affect the businesses of our customers and lead to reduced sales promotion spending. Valassis disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**Overview**

Valassis achieved quarterly revenues of $247.6 million for the quarter ended March 31, 2006, down 11.3% from the first quarter of 2005. First-quarter net earnings were $18.1 million, down 36.1% from the comparable period last year. We delivered diluted earnings per share (EPS) of $0.38, which fell within our previously published EPS range for the quarter of $0.38 to $0.44.

We believe the first quarter 2006 was difficult for the promotional media industry. Pre-Easter promotions moved out of the first quarter due to the fact that the Easter holiday fell in mid-April this year and there were fewer strong promotion Sundays in the quarter. Competition for marketing dollars from the Winter Olympics and telecommunications industry consolidation also contributed to a reduction in available promotional media spending. We also experienced price and margin pressure in almost every segment as many competitors vied for fewer promotional marketing opportunities during the quarter.

As expected, the Free-standing Insert (FSI) segment was negatively affected in the first quarter. In addition to a decline in industry units, we experienced a mid- to high-single digit percentage decline in FSI pricing in comparison to the first quarter of 2005, as a result of an aggressive competitive environment during 2004 and 2005 and the renegotiation of a contract with a major client effective January 1, 2006. Due to the multi-year nature of FSI customer contracts, the economic impact of a competitive pricing environment will likely continue into future periods even if pricing improves for new contracts.

**Segment Results**

*FSI*

In the quarter ended March 31, 2006, FSI revenues were $115.3 million, down 12.5% compared to the quarter ended March 31, 2005. Decreased revenues are attributable to a mid- to high-single digit percentage decline in average FSI pricing as the result of an aggressive competitive environment and the renegotiation of a contract with a major customer effective January 1, 2006 which has affected pricing on business in 2006. We also experienced a mid-single digit percentage decline in industry units coupled with a slight decline in market share as compared to the first quarter of 2005. We expect market share to improve in the second half of 2006 based on the timing of customer contracts. FSI cost of goods sold was relatively flat for the quarter ended March 31, 2006 versus the comparable period a year-ago on a cost-per-thousand (CPM) basis. Paper cost decreases were offset by an increase in media unit costs, caused by a decrease in pages produced coupled with an increase in publishing dates resulting in lower average pages per book.

*ROP*

Revenues for ROP decreased 32.6% in the first quarter of 2006 to $20.3 million from the year-ago quarter. This decline was primarily the result of the loss of business due to consolidation in the telecommunications industry and a large customer s shift in budget dollars to later quarters in 2006.

*Neighborhood Targeted*

Our Neighborhood Targeted product revenues decreased 10.0% in the quarter ended March 31, 2006 to $66.9 million versus the quarter ended March 31, 2005. This decrease was primarily the result of the weak environment in the promotional print media industry and the movement of pre-Easter holiday advertising from the first quarter in 2005 to the second quarter in 2006. We lost a significant amount of business in the telecommunications area due to industry consolidation; however, we have re-secured some of this business and expect it to deliver revenue beginning in the third quarter of 2006. Segment profit declined due to the reduced revenue during the quarter as well as the effect of the competitive environment on margins.

*Household Targeted*

The Household Targeted segment had revenues of $18.2 million in the quarter ended March 31, 2006, a decrease of 4.2% over the quarter ended March 31, 2005. The decrease in revenues for this segment is due to a decline in direct mail pieces distributed and the discontinuance of PreVision s agency business. We have secured a major grocery retailer s frequent-shopper card data to replace our previous data source and have observed increased interest in frequent-shopper direct mail programs. The restructuring in this segment, which took place at the end of 2005, resulted in a significant increase in segment profit despite the reduced revenue.

*International & Services*

The International & Services segment reported revenues of $26.9 million in the first quarter of 2006, an increase of 11.2% over the first quarter of 2005. The majority of this increase is derived from coupon clearing services in the U.S., new media products in Germany and France, and increased revenue in Canada. Segment profit is down slightly due primarily to lower coupon clearing volumes in Europe.

**Selling, General and Administrative Costs**

Selling, general and administrative costs decreased in the first quarter of 2006 to $32.9 million versus $34.1 million in the first quarter of 2005 despite the fact that the first quarter of 2006 includes $1.0 million of stock option expense as the result of the adoption of FAS 123R on January 1, 2006. The decrease resulted from our headcount reductions and other cost cutting measures undertaken in the fourth quarter of 2005.

**Non-operating Items**

Interest expense was $2.9 million in the first quarter of 2006, compared to $2.7 million in the first quarter of 2005.

**Net Earnings**

Net earnings were $18.1 million in the first quarter of 2006, a decrease of $10.1 million, or 36.1% from the first quarter of 2005. The decrease in earnings was due to a weak environment in the promotional media industry, the movement of the pre-Easter advertising period into the second quarter of 2006 versus the first quarter of 2005 and the expensing of stock options. Diluted earnings per share were $0.38 in the first quarter of 2006, compared to $0.55 in the first quarter of 2005. Had stock options been expensed in 2005, earnings would have been $26.4 million and EPS would have been $0.51 for the first quarter of 2005.

**Financial Condition, Liquidity and Sources of Capital**

Valassis liquidity requirements arise mainly from its working capital needs, primarily accounts receivable, inventory and debt service requirements. Generally, FSI customers (except remnant space customers) are billed for 75% of each order eight weeks in advance of the publication date and are billed for the balance immediately prior to the publication date. FSI revenue accounted for 46.6% of Valassis total revenue in the three months ended March 31, 2006. Valassis records work in progress at cost while it accrues progress billings as a current liability at full sales value. Although Valassis receives considerable payments from its customers prior to the publication of promotions, revenue is recognized only upon publication dates. Therefore, the progress billings on the balance sheet include the future profits in the related receivables.

The majority of the revenue generated by NCH, a 100% owned subsidiary of Valassis, is from its coupon clearing business. NCH invoices the face value of the coupon, a retailer handling fee (if applicable) as well as NCH s processing fee. The face value and the retailer handling fee are ultimately remitted by NCH to retailers and their agents. NCH records a gross receivable and payable for the coupon face value as well as the retailer handling fees and recognizes revenue only on the NCH processing fee.

*Sources and Uses of Cash and Cash Equivalents*

Cash and cash equivalents totaled $53.0 million at March 31, 2006 versus $64.3 million at December 31, 2005. This decrease was the result of cash provided by operations of $2.2 million offset by cash used for investing activities and financing activities of $12.2 million and $1.6 million, respectively, during the three-month period ended March 31, 2006.

Cash flow from operating activities was $2.2 million during the three months ended March 31, 2006 compared to $36.8 million during the year-ago quarter. This decrease was the result of $10.1 million in decreased earnings, approximately $11.0 million in estimated tax payments made in the first quarter of 2006 and the timing of ROP media payments in comparable periods.

Net cash used in investing activities was $12.2 million, consisting of $1.8 million in capital expenditures and $10.3 million in net sales of auction-rate securities to fund operating activities.

Net cash used in financing activities was $1.6 million, as the result of $3.9 million used to repurchase Valassis common stock under our share repurchase programs, partially offset by proceeds from stock option exercises. Although share repurchases were significantly lower than recent quarters, as of March 31, 2006, we had Board of Directors authorization to repurchase up to 6.1 million shares.

Cash and cash equivalents do not include investments in auction-rate securities of $82.4 million and $72.0 million at March 31, 2006 and December 31, 2005, respectively. Auction-rate securities are considered highly liquid due to the short duration of their reset periods.

*Current and Long-term Debt*

As of March 31, 2006, Valassis debt was $274.3 million, which consists of $100.0 million ($99.9 million, net of discount) of its 6 5/8% Senior Notes due 2009, $14.4 million of Zero Coupon Senior Convertible Notes due 2021, and $160.0 million of Senior Convertible Notes due 2033. In addition, we have a revolving line of credit of $125 million with a variable rate of interest calculated on either a euro currency-based rate or a prime rate. During the quarter ended March 31, 2006, there was no outstanding balance under this line of credit. Valassis was in compliance with all debt covenants at March 31, 2006. All of our long-term debt contains cross-default provisions which become applicable if we default under any mortgage, indebtedness or instrument for money borrowed by Valassis and the default results in the acceleration of such indebtedness in excess of $25 million. Additionally, each of the Senior Convertible Notes contains conversion triggers based upon credit rating downgrades by either Moody s Investor Service, Inc. or Standard & Poor s Rating Group.

The holders of Valassis Zero Coupon Senior Convertible Notes due 2021 (the 2021 Notes) may require us to purchase all or a portion of their notes on June 6, 2006, June 6, 2011 and June 6, 2016, at a price of $639.76, $742.47 and $861.67 per note, respectively, payable in cash. Therefore, the $14.4 million outstanding balance of this debt has been classified as current as of March 31, 2006. Also, each holder may require us to repurchase all or a portion of such holder s notes if a change of control of Valassis occurs on or before June 6, 2006. Valassis, at its option, may redeem all or a portion of the 2021 Notes at their accreted value at any time on or after June 6, 2006, for cash.

The holders of the Senior Convertible Notes due 2033 (the 2033 Notes) receive cash interest payments of 1.625% per year on the original discounted amount, payable semiannually from 2003 through 2008. The holders of the 2033 Notes may require us to purchase all or a portion of their notes on May 22, 2008, May 22, 2013, May 22, 2018, May 22, 2023 and May 22, 2028 at a price of $667.24, $723.48, $784.46, $850.58 and $922.27 per Note, respectively, payable in cash. Also, each holder may require us to repurchase all or a portion of such holder s 2033 Notes if a change of control of Valassis occurs. Valassis, at its option, may redeem all or a portion of the 2033 Notes at their accreted value at any time on or after May 22, 2008, for cash.

*Future Commitments and Contractual Obligations*

Valassis intends to use cash generated by operations to meet interest and principal repayment obligations, for general corporate purposes, to reduce its indebtedness, to make acquisitions and, from time to time, to repurchase common stock through our stock repurchase program.

As of March 31, 2006, Valassis had Board of Directors authorization to repurchase up to 6.1 million shares of its common stock under its existing share repurchase programs.

Management believes we will generate sufficient funds from operations and will have sufficient lines of credit available to meet currently anticipated liquidity needs, including interest and required payments of indebtedness.

*Off-balance Sheet Arrangements*

As of March 31, 2006, Valassis did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

*Capital Expenditures*

Capital expenditures were $1.8 million for the three months ended March 31, 2006, although we still anticipate capital spending of $20 million during 2006. Management expects future capital expenditure requirements of approximately $20 to $25 million for each of the next three to five years to meet the business needs of enhancing technology and replacing equipment as required. It is expected that these expenditures will be made using funds provided by operations.

**Business Outlook**

The following statements are based on current expectations for 2006. These statements are forward looking and actual results may differ materially.

Valassis expects earnings per share for 2006 to be between $1.95 and $2.15, including the effect of stock option expensing as required under FAS 123R. FSI pricing is expected to be down by a percentage in the mid- to high-single digits compared to 2005. Capital expenditures are expected to be approximately $20 million in 2006.

**RECENT ACCOUNTING PRONOUNCEMENTS**

We adopted SFAS 123R on January 1, 2006. The standard requires that all equity-based compensation be recorded in the financial statements at the grant date fair value. Valassis applied this Statement to all unvested awards outstanding as of December 31, 2005 and all awards granted on or after January 1, 2006. Compensation cost is being recognized on and after January 1, 2006 for the unvested portion of outstanding awards at that date based on the grant-date fair value of these awards previously calculated under SFAS 123 for pro-forma disclosures. Prior period financial statements are not restated to reflect the effect of SFAS 123R.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs. This Statement amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). SFAS 151 requires that those items be recognized as current-period charges. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS 151 are effective for inventory costs incurred in fiscal years beginning after June 15, 2005. As such, Valassis adopted these provisions at January 1, 2006. The adoption did not have a material impact on our financial condition, results of operations and liquidity.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that in certain circumstances affect amounts reported in the accompanying consolidated financial statements. The SEC has defined a company s most critical accounting policies as the ones that are most important to the portrayal of the Company s financial condition and results of operations, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Our critical accounting policies have not changed materially from those disclosed in our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005, except as follows:

***Stock Compensation*** Valassis grants stock options to its employees under various incentive plans. Options are granted with exercise prices at least equal to the fair value on the date of grant. Effective January 1, 2006, Valassis accounts for all options under SFAS No. 123R, Share-Based Payment, and utilizes the Black-Scholes valuation model, which requires us to make various estimates in calculating expense as required by SFAS No. 123R.

***Customer Contract Bonuses*** Valassis occasionally provides cash bonuses to key customers to secure the value of a long-term contract. The cost of such bonuses are capitalized and amortized as a reduction to revenue over the life of the customer contract to match the associated value of the contract.

**Item 3. Quantitative and Qualitative Disclosure about Market Risk**

Valassis principal market risks are interest rates on various debt instruments and foreign exchange rates at its international subsidiaries.

Interest Rates

Valassis has a revolving line of credit of $125 million with a variable rate of interest calculated on either a Euro currency-based rate or a prime rate. During the three months ended March 31, 2006, there was no outstanding balance under this line of credit. As of March 31, 2006, we have no borrowings on a variable-rate basis.

Foreign Currency

Currencies to which Valassis has exposure are the Mexican peso, Canadian dollar, British pound, and euro. Currency restrictions are not expected to have a significant effect on our cash flows, liquidity, or capital resources. We typically purchase the Mexican peso under three to twelve-month forward foreign exchange contracts to stabilize the cost of production in Mexico. Under SFAS No. 133, Valassis Mexican peso forward exchange contracts meet the definition of a cash flow hedge. Accordingly, changes in the fair value of the hedge are recorded as a component of other comprehensive income. For the quarter ended March 31, 2006, the recorded unrealized market value losses included in other comprehensive income were immaterial. Actual exchange losses or gains are recorded against production expense when the contracts are executed. As of March 31, 2006, Valassis had a commitment to purchase $3.6 million in Mexican pesos over the next six months.

**Item 4. Controls and Procedures**

As of the end of the period covered by this Quarterly Report, the Company carried out an evaluation, under the supervision and with the participation of the Company s Disclosure Committee, including the Chief Executive Officer and Chief Financial Officer, of disclosure controls and procedures pursuant to the Securities Exchange Act of 1934 Rule 13a-15. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that the information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms.

There has been no change in our internal control over financial reporting during the three months ended March 31, 2006 that has materially affected, or is likely to materially affect, internal control over financial reporting.

**Part II Other Information**

**Item 1. Legal Proceedings**

On January 18, 2006, Valassis filed a lawsuit in Michigan Federal Court against News America Incorporated, a/k/a News America Marketing Group, News America Marketing FSI, Inc. a/k/a News America Marketing FSI, LLC and News America Marketing In-Store Services, Inc. a/k/a News America Marketing In-Store Services, LLC (collectively, News ). The complaint alleges the violation of the Sherman Act, various state competitive statutes and the commission of torts by News in connection with the marketing and sale of FSI space and in-store promotion and advertising services. Specifically, the complaint alleges that News has tied the purchase of its in-store promotion and advertising services to the purchase of space in its FSI and that News has attempted to monopolize the FSI market. The complaint alleges damages in excess of $1.5 billion, injunctive relief and costs for violation of the Sherman Act.

On April 28, 2006, the Federal Trade Commission announced that it had approved issuance of the final consent order concerning Valassis, settling a claim that alleged that remarks made during Valassis second quarter earnings call, held on July 22, 2004, violated Section 5 of the Federal Trade Commission Act.

Under the terms of the settlement, we did not admit any wrongdoing and are not required to pay any fines or penalties. The allegations were limited to the remarks made on our second quarter earnings conference call held on July 22, 2004 and there were no allegations regarding any conduct or effect beyond the remarks themselves. The settlement relieved us of the substantial expense, time and resources of continuing this proceeding.

The FTC announced the approval of the consent agreement on March 14, 2006, subject to a 30-day public comment period, during which time there were no public comments. The consent agreement prohibits us from communicating certain statements about competitive intentions (and standard prohibitions related to allocating markets and fixing prices).

Valassis is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on our financial position, results of operations or liquidity.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

The following table provides certain information with respect to our purchase of shares of Valassis common stock during the quarter ended March 31, 2006.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| Jan. 1 through Jan. 31, 2006 | 104,500 | $ 28.60 | 104,500 | 6,124,625 |
| Feb. 1 through Feb. 28, 2006 | 32,800 | $ 28.21 | 32,800 | 6,091,825 |
| March 1 through March 31, 2006 | | | | 6,091,825 |
| Total | 137,300 | $ 28.51 | 137,300 | 6,091,825 |

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

Exhibits

| | |
|---|---|
| 31.1 | Section 302 Certification from Alan F. Schultz |
| 31.2 | Section 302 Certification from Robert L. Recchia |
| 32.1 | Section 906 Certification from Alan F. Schultz |
| 32.2 | Section 906 Certification from Robert L. Recchia |

**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.

Dated: May 8, 2006

Valassis Communications, Inc.

(Registrant)

By: /s/ Robert L. Recchia
Robert L. Recchia
Executive Vice President and Chief Financial Officer

Signing on behalf of the Registrant and as principal financial and accounting officer.