ADVO INC
Form 10-Q
August 13, 2002

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

(Mark One)

(X) Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended JUNE 29, 2002

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 1-11720

ADVO, INC.
(Exact name of registrant as specified in its charter)

Delaware	06-0885252
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One Univac Lane, P.O. Box 755, Windsor, CT	06095-0755
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number including area code: (860) 285-6100

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 [ ]

As of July 27, 2002 there were 19,978,750 shares of common stock outstanding.

ADVO, INC.
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ON FORM 10-Q

QUARTER ENDED JUNE 29, 2002

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ADVO, INC.
CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(In thousands, except share data)

ASSETS	June 29, 2002	September 29, 2001
Current assets:		
Cash and cash equivalents	$ 19,744	$ 17,728
Accounts receivable, net	107,197	119,388
Inventories	3,068	2,840
Prepaid expenses and other current assets	7,998	7,282
Investment in deferred compensation plan	11,731	11,493
Deferred income taxes	12,716	11,319
Total current assets	162,454	170,050
Property, plant and equipment	263,019	246,936

Less accumulated depreciation and amortization	(142,381)	(126,455)
Net property, plant and equipment	120,638	120,481
Goodwill	22,174	21,525
Other assets	12,523	10,264
TOTAL ASSETS	$ 317,789	$ 322,320
LIABILITIES		
Current liabilities:		
Current portion of long-term debt	$ 20,000	$ 11,250
Notes payable - short term	1,715	2,390
Accounts payable	30,923	37,759
Accrued compensation and benefits	25,928	21,531
Deferred compensation plan	11,731	11,493
Other current liabilities	37,845	44,678
Total current liabilities	128,142	129,101
Long-term debt	145,000	173,750
Notes payable - long term	--	1,715
Deferred income taxes	10,789	9,852
Other liabilities	5,014	4,949
STOCKHOLDERS' EQUITY		
Series A Convertible preferred stock, $.01 par value (Authorized 5,000,000 shares, none issued)	--	--
Common stock, $.01 par value (Authorized 40,000,000 shares, issued 30,549,002 and 30,317,994 shares, respectively)	305	303
Additional paid-in capital	203,043	197,222
Accumulated earnings	49,974	19,321
	253,322	216,846
Less common stock held in treasury, at cost	(222,090)	(208,620)
Accumulated other comprehensive loss	(2,388)	(5,273)
Total stockholders' equity	28,844	2,953
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	$ 317,789	$ 322,320

See Accompanying Notes.

ADVO, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share data)

	Nine months ended		Three months ended	
	June 29, 2002	June 30, 2001	June 29, 2002	June 30, 2001

REVENUES	$842,308	$851,083	$280,939	$281,759
Costs and expenses:				
Cost of sales	615,892	615,918	206,675	202,572
Selling, general and administrative	161,436	158,824	53,602	53,660
Provision for bad debts	5,467	4,471	1,355	1,454
OPERATING INCOME	59,513	71,870	19,307	24,073
Interest expense	10,035	13,426	3,170	4,249
Other expense, net	823	406	36	185
Income before income taxes	48,655	58,038	16,101	19,639
Provision for income taxes	18,002	21,474	5,957	7,266
NET INCOME	$ 30,653	$ 36,564	$ 10,144	$ 12,373
BASIC EARNINGS PER SHARE	$ 1.54	$ 1.81	$ .51	$ .61
DILUTED EARNINGS PER SHARE	$ 1.51	$ 1.77	$ .50	$ .60
Weighted average basic shares	19,963	20,151	20,010	20,242
Weighted average diluted shares	20,305	20,629	20,353	20,585

See Accompanying Notes.

ADVO, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

	Nine months ended	
	June 29, 2002	June 30, 2001
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 58,138	$ 42,901
Cash flows from investing activities:		
Acquisition of property, plant and equipment	(21,932)	(22,958)
Proceeds from disposals of property, plant and equipment	331	118
Distributions from equity affiliates	71	--
Acquisitions/joint ventures, net of cash acquired	(1,429)	(14,303)

NET CASH USED BY INVESTING ACTIVITIES	(22,959)	(37,143)
Cash flows from financing activities:		
Revolving line of credit - net	(12,500)	1,000
Payments on long-term debt	(7,500)	--
(Decrease) increase in note payable - net	(2,391)	4,105
Proceeds from exercise of stock options	2,692	4,733
Purchase of common stock for treasury	(13,469)	(4,954)
NET CASH (USED) PROVIDED BY FINANCING ACTIVITIES	(33,168)	4,884
Effect of exchange rate changes on cash and cash equivalents	5	--
Increase in cash and cash equivalents	2,016	10,642
Cash and cash equivalents at beginning of period	17,728	6,003
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 19,744	$ 16,645

Noncash activities:		
Change in fair value of interest rate swap liabilities	2,876	(2,849)
Change in noncash portion of deferred compensation plan	341	(1,184)
Note receivable in sale of business	--	415

See Accompanying Notes.

ADVO, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with 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, all adjustments considered necessary for a fair presentation have been included.

Operating results for the nine month period ended June 29, 2002 are not necessarily indicative of the results that may be expected for the fiscal year ending September 28, 2002. For further information, refer to the consolidated financial statements and footnotes thereto included in ADVO's annual report on Form 10-K for the fiscal year ended September 29, 2001. Certain reclassifications have been made in the fiscal 2001 financial statements to conform with the fiscal 2002 presentation.

2. SUMMARY OF ACCOUNTING POLICIES

Long-lived assets

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("Statement") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and for the disposal of a segment of a business. The Company expects to adopt Statement No. 144 in fiscal 2003 and does not expect such adoption to have a material effect on the Company's financial position or results of operations.

Foreign Currency Translation

The functional currency for the Company's Canadian operation is the Canadian dollar. As such, assets and liabilities are translated into United States dollars at month-end exchange rates. Income and expenses are translated into United States dollars at average rates of exchange for the reporting period. The resulting translation adjustments, as well as, gains and losses from certain intercompany transactions are reported in a separate component of stockholders' equity.

3. ACQUISITIONS

During the third quarter of the current fiscal year, the Company acquired two businesses for a total of $0.9 million, all paid in cash. On June 5, 2002, the Company acquired FACC Corporation ("FACC") based in Toronto, Canada which includes both FACC and Breezeway Communications, Inc. FACC, which has been renamed ADVO Canada, Inc., is an innovator in both targeting and distribution of in-home print advertising in Canada. On May 29, 2002, the Company acquired a franchise operation directly from the franchisee of the Company's MailCoups subsidiary.

The purchase price for both companies was allocated to the fair value of assets acquired totaling $1.5 million and liabilities assumed of $1.2 million and resulted in goodwill of $0.6 million which is expected to be deductible for tax purposes. Under the terms of the purchase agreement with FACC, the Company may be required to pay certain contingencies if certain future earnings objectives are achieved.

The results of operations for the acquired companies have been included in the consolidated statement of operations from the acquisition dates. The acquired assets have been recorded at their estimated fair values. The acquisitions did not have a material pro-forma effect on operations for the periods prior to the acquisition.

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ADVO, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

4. GOODWILL AND OTHER INTANGIBLE ASSETS

Effective October 1, 2001, the Company adopted Statement No. 142, "Goodwill and Other Intangible Assets". Under Statement No. 142, goodwill and intangible assets that have indefinite useful lives are no longer subject to amortization. Accordingly, the Company ceased amortization of all goodwill upon adoption. Intangible assets that have a finite life continue to be amortized over their useful lives.

Statement No. 142 also requires that goodwill be tested for impairment at least annually. Impairment exists when the carrying amount of goodwill exceeds its

fair market value. The Company performed the impairment tests upon the adoption of Statement No. 142 on October 1, 2001. Fair value was determined using the discounted cash flow methodology. The Company has determined that no impairment of goodwill exists.

The increase in the carrying amount of goodwill from the beginning of the fiscal year to June 29, 2002 is the result of the Company's acquisitions during the third quarter of fiscal 2002.

The following table reflects actual results of operations for the nine-month and three-month periods ended June 29, 2002 and pro-forma results of operations for the nine-month and three-month periods ended June 30, 2001 had the Company applied the non-amortization provisions of Statement No. 142 in those periods:

	Nine months ended		Three months end	
	June 29, 2002	June 30, 2001	June 29, 2002	Jun 2
(In thousands, except per share data)				
Reported net income	$ 30,653	$ 36,564	$ 10,144	$
Add: Goodwill amortization, net of tax	--	724	--	
Adjusted net income	$ 30,653	$ 37,288	$ 10,144	$
Reported basic earnings per share	$ 1.54	$ 1.81	$ .51	$
Add: Goodwill amortization, net of tax	--	.04	--	
Adjusted basic earnings per share	$ 1.54	$ 1.85	$ .51	$
Reported diluted earnings per share	$ 1.51	$ 1.77	$ .50	$
Add: Goodwill amortization, net of tax	--	.04	--	
Adjusted diluted earnings per share	$ 1.51	$ 1.81	$ .50	$

Intangible assets that continue to be subject to amortization are included in other assets and consist primarily of customer based intangibles with a gross carrying value of $4.0 million and accumulated amortization of $3.5 million at June 29, 2002.

Amortization expense for the quarter and nine months ended June 29, 2002 was $0.1 million and $0.3 million, respectively. Amortization expense is estimated to be $0.1 million for the remainder of fiscal 2002 and $0.4 million for fiscal 2003. Subsequent to fiscal 2003, all intangible assets are expected to be fully amortized.

5. COMPREHENSIVE INCOME

Comprehensive income for a period encompasses net income and all other changes in a company's equity other than from transactions with the company's owners. The Company's comprehensive income was as follows:

	Nine months ended		Three months ende	
	June 29, 2002	June 30, 2001	June 29, 2002	June 200
(In thousands)				
Net income	$ 30,653	$ 36,564	$ 10,144	$ 12,
Other comprehensive income (loss):				
Unrealized gain (loss) on derivative instruments	2,876	(2,849)	848	
Foreign currency translation adjustments	9	--	9	
Total comprehensive income	$ 33,538	$ 33,715	$ 11,001	$ 12,

6. EARNINGS PER SHARE

Basic earnings per share excludes the effect of common stock equivalents, such as stock options, and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution that could occur if common stock equivalents, such as stock options, were exercised.

	Nine months ended		Three months ended	
	June 29, 2002	June 30, 2001	June 29, 2002	June 30, 2001
(In thousands, except per share data)				
Net income	$ 30,653	$ 36,564	$ 10,144	$ 12,373
Weighted average basic shares	19,963	20,151	20,010	20,242
Effect of dilutive securities:				
Stock options	315	443	324	310
Restricted stock	27	35	19	33
Dilutive potential common shares	342	478	343	343
Weighted average diluted shares	20,305	20,629	20,353	20,585
Basic earnings per share	$ 1.54	$ 1.81	$ .51	$ .61
Diluted earnings per share	$ 1.51	$ 1.77	$ .50	$ .60

========	========	========	========

ADVO, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

7. NON-RECURRING CHARGES

In the third quarter of the current fiscal year, the Company recorded a pre-tax charge of approximately $4.2 million, or $0.13 per share, in selling, general and administrative costs for structural changes to the organization. The changes resulting from this charge will strengthen the focus of the Company's sales and marketing efforts.

During the third quarter of fiscal 2001, the Company recorded a pre-tax charge of approximately $1.9 million, or $0.06 per share, in selling, general and administrative costs as a result of a pre-existing contractual agreement upon the resignation of the former President and Chief Operating Officer.

ADVO, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This section should be read in conjunction with the consolidated financial statements of the Company and the notes thereto.

RESULTS OF OPERATIONS

REVENUES For the third quarter and nine months ended June 29, 2002 revenues were $280.9 million and $842.3 million, respectively, decreasing 0.3% and 1.0% from the comparable periods in fiscal 2001. The decline in revenues was attributable to decreases in volumes and shifts in product mix and weights, offset by pricing gains due in part to the postal rate increases in the prior year. Revenue results included decreases in shared mail products and declines in revenues associated with the Company's MailCoups subsidiary. These decreases were offset by increases in the Company's A.N.N.E. (ADVO National Network Extension) brokered distribution program and revenues associated with the Company's second in-home date mailings, as well as, revenue associated with the acquisition of ADVO Canada. In June 2002, the Company acquired FACC Corporation based in Toronto, Canada, which has been renamed ADVO Canada. In addition, offsetting the year-to-date revenue decline were incremental revenues associated with the Company's acquisition of the New Jersey Shoppers Guide in the third quarter of fiscal 2001 of approximately $4.0 million.

Revenue per thousand pieces for the three months ended June 29, 2002 was $39.81, representing a 0.5% decrease over the comparable period in the prior year. Revenue per thousand pieces remained relatively constant for the nine months ended June 29, 2002 at $39.59 versus $39.54 for the same period in fiscal 2001. Average pieces per package were 7.55 for the third quarter and 7.74 for the nine months ended June 29, 2002, decreasing 5.6% and 5.0%, respectively, from the prior year due to the dilutive effect of the second in-home date mailings. Conversely, these additional mailings contributed to the increase in shared mail packages delivered to 853.6 million packages and 2,509.5 million packages for the three and nine months ended June 29, 2002, representing a 6.4% and 4.5% increase, respectively, over the prior year period. Also, total shared mail

pieces distributed increased 0.4% and decreased 0.7% for the third quarter and nine months of fiscal 2002, respectively, compared to the same periods in fiscal 2001.

OPERATING EXPENSES Cost of sales as a percentage of revenue increased 1.7 and 0.7 percentage points, respectively, for the three and nine months ended June 29, 2002 when compared to the same periods last year. The increase for both periods primarily resulted from underweight postage costs incurred as a result of the decline in average pieces per package due to the expected dilutive effect of the second in-home date initiatives, as well as fewer pieces in the Company's core packages. This increase was offset to a degree by continued improvements and efficiencies in the branch operations of the Company and favorable print and paper costs.

In absolute terms, cost of sales increased $4.1 million to $206.7 million for the third quarter of fiscal 2002 and remained essentially flat at $615.9 million for the nine months ended June 29, 2002 when compared to the same periods in the prior year. The increase was due to higher distribution and security costs, offset to a degree by lower print and paper costs and branch operational efficiencies. Distribution costs, consisting primarily of postage costs, increased for the three months ended June 29, 2002 due to higher postage costs resulting from the 6.4% increase in shared mail packages delivered in the current quarter. Security costs related to operations increased quarter over quarter as the Company continues to strengthen its security and safety, as announced at the beginning of the fiscal year. Print costs decreased for the third quarter due to volume declines and lower paper prices. Cost of sales for the nine months ended June 29, 2002 was affected by the same factors detailed above in the analysis for the quarter, however, higher distribution and security costs were offset entirely by lower print and paper costs and branch operating efficiencies.

Subsequent to the end of the third quarter, on June 30, 2002, new postage rates became effective. The new rates represent approximately a 3.0% increase to the Company's shared mail clients. The Company expects its preplanning activities in the past months will result in a full pass-through of the new postal rate increase.

Selling, general and administrative costs ("SG&A costs"), including the provision for bad debt, decreased $0.2 million and increased $3.6 million, respectively, for the three and nine months ended June 29, 2002 when compared to the same periods in the prior year. As a percentage of revenues, SG&A costs remained flat at 19.6% for the third quarter of fiscal 2002 and increased 0.6 percentage points for the nine months ended June 29, 2002 versus the comparable periods in fiscal 2001.

For the third quarter and nine months ended June 29, 2002, SG&A costs included a $4.2 million charge, recorded in the current quarter, relating to structural changes in the Company. The changes resulting from this charge will strengthen the focus of the Company's sales and marketing efforts. Third quarter costs also included incremental security costs related to the Company's newly established Office of Safety and Security. These increases were offset by lower incentive wages and lower commission expense in the current period versus the prior period, and reductions in spending due to strict fixed cost controls implemented throughout the organization. In the third quarter of fiscal 2001, SG&A costs included a $1.9 million charge as a result of a pre-existing contractual

agreement with the Company's former President and Chief Operating Officer ("COO"). In addition, SG&A costs for the nine months ended June 29, 2002, also included organizational realignment costs incurred during the first quarter of fiscal 2002.

OPERATING INCOME For the third quarter of fiscal 2002, the Company reported operating income of $19.3 million compared to $24.1 million for the third quarter of fiscal 2001. Operating income was $59.5 million for the year to date period ended June 29, 2002 versus $71.9 million for the same period in the prior year.

Excluding the $4.2 million structural charge in the third quarter of fiscal 2002 and the $1.9 million charge related to the former COO in the third quarter of fiscal 2001, operating income would have been $23.5 million and $26.0 million, respectively, for the current and prior year third quarter.

INTEREST EXPENSE Interest expense decreased $1.1 million and $3.4 million for the three and nine month periods ended June 29, 2002, respectively. The decreases were due to lower market rates of interest and a decrease in the average outstanding debt balance.

INCOME TAXES The effective income tax rate was 37% for both the three and nine months ended June 29, 2002 and June 30, 2001.

EARNINGS PER SHARE For the three months ended June 29, 2002, the Company reported diluted earnings per share of $0.50 versus $0.60 for the same period of the prior year. Excluding the $4.2 million structural charge, diluted earnings per share would have increased $0.13 per share in the third quarter of fiscal 2002. Excluding the $1.9 million charge related to the former COO, diluted earnings per share would have increased $0.06 per share in the third quarter of fiscal 2001. Diluted earnings per share was $1.51 for the nine months ended June 29, 2002 and $1.77 in the comparable prior year period.

ADVO, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FINANCIAL CONDITION

Working capital was $34.3 million at June 29, 2002, decreasing $6.6 million from September 29, 2001. The decrease in working capital from the end of the prior fiscal year was primarily related to the $7.6 million decrease in current assets offset by $1.0 million decrease in current liabilities. The decrease in current assets was primarily attributed to a decrease in accounts receivable due to improved and focused collection efforts and lower revenues in fiscal 2002 versus fiscal 2001. This decrease was offset by an increase in cash and cash equivalents and deferred income taxes. The overall decrease in current liabilities was the result of the following: decreases in accounts payable due to the timing of vendor payments, decreases in other current liabilities relating to the timing of customer advance payments and the change in the fair value of interest rate swap liabilities. Offsetting these decreases were increases in accrued compensation and benefits due to the third quarter structural charge and an increase in the current portion of long-term debt due to scheduled debt payments.

Stockholders' equity increased $25.9 million to $28.8 million at June 29, 2002. The increase in stockholders' equity was primarily the result of the Company's net income of $30.7 million. Also contributing to the increase was $5.8 million

of stock/option related transactions by associates and a positive $2.9 million change in the fair value of derivative instruments since the beginning of the fiscal year. These increases were offset by treasury stock purchases of $13.5 million, which consisted of $11.2 million made on the open market associated with the Company's buyback program and $2.3 million pursuant to elections by employees to satisfy withholding requirements under the Company's restricted stock and stock option plans.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment investments were $21.9 million for the nine-month period ended June 29, 2002. These capital investments consisted mainly of software development for several new systems being developed, as well as, upgrades to the human resource/payroll systems, deployment of computer hardware and renovations at certain of the Company's facilities. The Company expects its capital expenditures for the entire year to be between $35.0 million and $37.0 million.

LIQUIDITY

The Company's main source of liquidity continues to be funds generated from operating activities. In addition, the Company has available unused credit commitments of $120.0 million that may be used to fund operating activities.

The Company experienced a $15.2 million increase in net cash provided by operating activities for the nine months ended June 29, 2002. The year over year increase resulted primarily from the change in accounts receivable due to improved collections and the change in accrued compensation and benefits as a result of two items: the fiscal 2000 incentive payment which was made in fiscal 2001 for which no comparable payment was made in fiscal year 2002 and the structural charge in the current quarter. The favorable change in accounts payable year over year also contributed to the increase in cash provided by operating activities.

Cash and cash equivalents for the first nine months of fiscal 2002 increased $2.0 million to $19.7 million. The increase was comprised of net cash outlays for investing activities of $23.0 million and financing activities of $33.2 million partially offset by net cash provided by operating activities of $58.1 million.

Investing activities of $23.0 million during the first nine months of fiscal 2002 primarily consisted of $21.9 million for the capital expenditures detailed previously, and acquisitions and joint ventures totaling $1.4 million, primarily related to the acquisition of ADVO Canada and a MailCoups franchisee in the current quarter. Investing activities for the first nine months of the prior fiscal year included $23.0 million of capital expenditures and $14.3 million for acquisitions and joint ventures, most notably for the $8.3 million acquisition of MMSI, net of cash acquired and the New Jersey Shoppers Guide for $4.9 million.

Net cash used for financing activities was $33.2 million for the nine months ended June 29, 2002 versus net cash provided by financing activities of $4.9 million in the same prior year period. In the current year, financing activities consisted of debt payments of $20.0 million which included net payments on the

revolver and scheduled principal payments on the term loan, payment of a $2.4 million note resulting from the acquisition of MMSI in the prior year, and $13.5 million of treasury stock purchases. These uses of cash were offset by $2.7 million of proceeds from option exercises under the Company's stock option plans. In the prior year, financing activities included net borrowings of $1.0 million, a $4.1 million note payable related to the acquisition of MMSI and proceeds of $4.7 million relating to stock option exercises offset by treasury stock purchases of $5.0 million.

Contractual and commercial commitments

The Company's contractual obligations are as follows:

(In millions)	Long-term debt	Operating leases
Less than one year	$ 20.0	$ 13.2
One to three years	145.0	23.4
Four to five years	--	11.1
After five years	--	16.2
Total	$165.0	$ 63.9

The Company's long-term debt obligations are discussed below in the "Financing Arrangements" section. The Company leases property in its normal business operations under noncancellable operating leases. Certain of these leases contain renewal options and certain leases also provide for cost escalation payments.

The Company has various agreements with International Business Machines Corporation ("IBM") Global Services to provide systems development, technical support, a customer support center and server farm management services to the Company. The noncancellable portions of these contracts have lapsed, allowing the Company the option to cancel these contracts subject to termination charges ranging from $9.6 million in fiscal 2002 to $1.7 million in fiscal 2006 depending on the year in which the cancellation becomes effective.

The Company has outstanding letters of credit of approximately $7.5 million under separate agreements expiring in April 2003, primarily relating to its worker's compensation program.

The Company anticipates it will be able to meet its commitments detailed above through funds generated from operations or from unused credit under its revolving line of credit.

FINANCING ARRANGEMENTS

The Company maintains a credit agreement which provides for total credit facilities of $300 million, consisting of a $135 million term loan and a $165 million revolving line of credit. At June 29, 2002, there was $165.0 million of

debt outstanding, with $20.0 million classified as current due to scheduled principal payments. The Company anticipates it will be able to meet its debt obligations through funds generated from operations. During July 2002, the Company borrowed an additional $10.0 million under the revolving line of credit.

Under the terms of the credit agreement, the Company is required to maintain certain financial ratios. In addition, the credit agreement also places restrictions on disposals of assets, mergers and acquisitions, dividend payments, investments and additional debt.

NEW ACCOUNTING PRONOUNCEMENTS

Effective October 1, 2001, the Company adopted Statement of Financial Accounting Standards ("Statement") No. 142, "Goodwill and Other Intangible Assets". Under Statement No. 142, goodwill and intangible assets that have indefinite useful lives are no longer subject to amortization. Accordingly, the Company ceased amortization of all goodwill upon adoption. Additionally, intangible assets that have a finite life continue to be amortized over their useful lives. Operating income was $19.3 million and $24.1 million for the third quarter of fiscal 2002 and 2001, respectively, and $59.5 million and $71.9 million for the first nine months of fiscal 2002 and 2001, respectively. Had the Company applied the non-amortization provisions of Statement No. 142 in fiscal 2001, operating income would have been $24.5 million and $73.0 million for the three and nine months ended June 30, 2001. See the discussion in Note 3 of the "Notes to Consolidated Financial Statements" of this report for a further discussion of the impact of Statement No. 142 to the Company.

Statement No. 142 also requires that goodwill be tested for impairment at least annually. Impairment exists when the carrying amount of goodwill exceeds its fair market value. The Company performed the impairment tests upon the adoption of Statement No. 142 on October 1, 2001. Fair value was determined using the discounted cash flow methodology. The Company has determined that no impairment of goodwill exists. Additional evaluations of goodwill may be performed in future periods should any circumstances arise that would indicate that the carrying value of goodwill might be impaired. Impairment adjustments recognized after adoption, if any, are required to be recognized as operating expenses.

CRITICAL ACCOUNTING POLICIES

Critical accounting polices are defined as those that are most important to the portrayal of a company's financial condition and results and which require complex or subjective judgements or estimates. The preparation of financial statements in conformity with general accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Actual results could differ from those estimates under different assumptions and conditions. The Company had determined its critical accounting polices to include the allowance for doubtful accounts and the valuation of goodwill and intangible assets.

Allowance for doubtful accounts

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company reviews the collectibility of its receivables on an ongoing basis taking

into account a combination of factors. On a monthly basis, the Company conducts meetings to identify and review potential problems, such as a bankruptcy filing or deterioration in the customer's financial condition, to ensure the Company is adequately accrued for potential loss. The Company also calculates a trended write-off of bad debts over a rolling twelve-month period and takes into account aging category and historical trends. If a customer's situation changes, such as bankruptcy or creditworthiness, or there is a change in the current economic climate, the Company may modify its estimate of the allowance for doubtful accounts.

Valuation of goodwill and intangible assets

Goodwill represents the excess purchase price over fair value of net assets acquired in connection with purchase business combinations. With the adoption of Statement No. 142, the Company ceased amortization of goodwill, but is now subject to an annual impairment test as discussed under "New Accounting Pronouncements". The Company's goodwill impairment test was performed by comparing the net present value of projected cash flows to the carrying value of goodwill. The Company utilized discount rates determined by management to be similar with the level of risk in the current business model. The Company has determined that no impairment of goodwill exists. If the assumptions the Company made regarding estimated cash flows, such as future operating performance and other factors to determine the fair value, is less favorable than expected, the Company may be required to record an impairment charge.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's interest expense is sensitive to changes in interest rates. In this regard, changes in interest rates affect the interest paid on its debt. To mitigate the impact of interest rate fluctuations, the Company has historically maintained interest rate swap agreements on notional amounts totaling $100 million which is currently over 50% of its outstanding debt balance.

The Company believes that the interest rate swap agreements limit substantial risk if interest rates should fluctuate. If interest rates should change by 2 percentage points for the remainder of the 2002 fiscal year from those rates in effect at June 29, 2002, assuming no change in the outstanding debt balance and considering the effects of the Company's interest rate swap agreements, interest expense would increase/decrease by approximately $0.3 million.

FORWARD LOOKING STATEMENTS

Except for the historical information stated herein, the matters discussed in this Management's Discussion and Analysis of Financial Condition and Results of Operations contain forward looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Such forward looking statements are based on current information and expectations and are subject to risks and uncertainties which could cause the Company's actual results to differ materially from those in the forward looking statements. Such risks and uncertainties include but are not limited to: changes in customer demand and pricing; the possibility of consolidation throughout the retail sector; the impact of economic and political conditions on retail advertising spending and our distribution system; postal and paper prices; possible governmental regulation or legislation affecting aspects of the Company's business; the

efficiencies achieved with technology upgrades and other general economic factors.

PART II - OTHER INFORMATION

ITEM 5. OTHER INFORMATION

Beginning in July 2002, the Company's internal audit function will be performed by PricewaterhouseCoopers.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibit Index

Exhibit No.	Exhibits
99a	Certification of Periodic Report - CEO.
99b	Certification of Periodic Report - CFO.

(b) Reports on Form 8-K

No report on Form 8-K was filed by the Company with respect to the quarter ended June 29, 2002.

Omitted from this Part II are items which are inapplicable or to which the answer is negative for the period covered.

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.

ADVO, Inc.

Date: August 13, 2002

By: /s/ JOHN SPERIDAKOS

John Speridakos
Vice President and Controller
(Principal Accounting Officer)