

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Our fiscal year ends on the Sunday closest to January 31 of the following year, typically resulting in a 52 week year, but occasionally giving rise to an additional week, resulting in a 53 week year.

Fiscal 2016, fiscal 2015, and fiscal 2014 were 52 week years. The following discussion and analysis should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K.

This discussion and analysis contains forward-looking statements based on current expectations that involve risks, uncertainties and assumptions, such as our plans, objectives, expectations, and intentions set forth in the "Special Note Regarding Forward-Looking Statements." Our actual results and the timing of events may differ materially from those anticipated in these forward looking statements as a result of various factors, including those set forth in the "Item 1A. Risk Factors" section and elsewhere in this Annual Report on Form 10-K.

### **Overview**

Fiscal 2016 was a year in which successful execution against our long-term strategies returned the Company to positive operating income growth for the first time in three years.

We have renewed our design-led focus, blending function and fashion with a solid innovation pipeline in place to fuel our long term growth.

We continued to optimize and strategically grow our square footage in North America, exploring new concepts such as our co-located stores and Locals that are tailored and unique to each community.

We made meaningful progress towards building a robust digital ecosystem with key investments in customer relationship management, analytics, and omni-channel capabilities which will be essential in continuing to elevate our guest experience across all touch points.

We continued to expand our collective globally through our international expansion, opening 11 stores in Asia and Europe, which included our first stores in China, South Korea, and Switzerland. As of January 29, 2017, we operated a total of 54 stores across nine countries outside of North America.

Lastly, we made significant improvements to our product and supply chain infrastructure which resulted in 280 basis points of gross margin expansion from fiscal 2015.

Looking forward in fiscal 2017, we will continue to focus our growth efforts across our four key strategic pillars:

1. Within product innovation, our design-led vision will be concentrated on driving innovation in both our women's and men's categories.
2. Our digital strategy will center on pursuing our channel agnostic model, improving our web and mobile experience, and leveraging our guest database to amplify how we connect with our collective both online and in-store.
3. In North America, our priorities are to continue to optimize our square footage through tailored and curated formats that fit with each community, while expanding our omni-channel capabilities.
4. Finally, in our international markets, our focus is on accelerating our expansion through store densification in key strategic cities while driving brand awareness and guest acquisition in new and existing markets.

These priorities and investments will continue to position us well for sustainable long term profitable growth.

### **Financial Highlights**

- Net revenue increased 14% to \$2.3 billion in fiscal 2016, from \$2.1 billion in fiscal 2015. On a constant dollar basis, net revenue increased 14%. Net revenue increased across all segments, and the increase in net revenue was primarily due to the addition of 43 net new company-operated stores during fiscal 2016, as well as increased comparable store sales and the growth of our direct to consumer segment.
- Total comparable sales, which includes comparable store sales and direct to consumer, increased 6% in fiscal 2016 compared to fiscal 2015, or by 7% on a constant dollar basis.
- Comparable store sales increased 4% in fiscal 2016 compared to fiscal 2015, or by 5% on a constant dollar basis, primarily as a result of increased dollar value per transaction and improved conversion rates.

- Direct to consumer net revenue increased 13% in fiscal 2016 compared to fiscal 2015, or by 13% on a constant dollar basis, primarily as a result of increased traffic on our e-commerce websites, increased dollar value per transaction, and improved conversion rates.
- Gross profit for fiscal 2016 increased 20% to \$1.2 billion, from \$1.0 billion in fiscal 2015. Gross profit as a percentage of net revenue, or gross margin, increased to 51.2% compared to 48.4% in fiscal 2015. The increase in gross margin was primarily due to lower product costs and improved average retail prices, partially offset by increased expenses related to our product and supply chain departments and increased occupancy and depreciation costs.
- Income from operations for fiscal 2016 increased 14% to \$421.2 million, from \$369.1 million in fiscal 2015. As a percentage of net revenue, income from operations increased to 18.0% compared to 17.9% of net revenue in fiscal 2015.
- Income tax expense for fiscal 2016 increased 16% to \$119.3 million, from \$102.4 million in fiscal 2015. Our effective tax rate for fiscal 2016 was 28.2% compared to 27.8% for fiscal 2015. Fiscal 2016 and fiscal 2015 included net income tax recoveries and related net interest expenses as a result of the finalization of an Advance Pricing Arrangement with the Internal Revenue Service and the Canada Revenue Agency. Our effective tax rate excluding these adjustments was 30.7% for fiscal 2016 compared to 29.5% for fiscal 2015.
- Diluted earnings per share for fiscal 2016 were \$2.21 compared to \$1.89 in fiscal 2015. Excluding the above tax and related interest adjustments, diluted earnings per share were \$2.14 for fiscal 2016 and \$1.86 for fiscal 2015.

Refer to the non-GAAP reconciliation tables contained in the "Non-GAAP Financial Measures" section of this "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" for reconciliations between constant dollar changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue, and the effective tax rate and diluted earnings per share excluding certain tax and related interest adjustments, and the most directly comparable measures calculated in accordance with GAAP.

## General

*Net revenue* is comprised of company-operated store sales, direct to consumer sales through [www.lululemon.com](http://www.lululemon.com), [www.ivivva.com](http://www.ivivva.com), and other country and region specific websites, and other net revenue, which includes outlet sales, showroom sales, sales from temporary locations, sales to wholesale accounts, warehouse sales, and license and supply arrangement net revenue, which consists of royalties as well as sales of our products to licensees.

*Cost of goods sold* includes the cost of purchased merchandise, including freight, duty, and nonrefundable taxes incurred in delivering the goods to our distribution centers. It also includes occupancy costs and depreciation expense for our company-operated store locations, all costs incurred in operating our distribution centers and production, design, distribution, and merchandise departments, hemming, shrink, and inventory provision expense. The primary drivers of the costs of individual products are the costs of raw materials and labor in the countries where we source our merchandise.

*Selling, general and administrative expenses* consist of all operating costs not otherwise included in cost of goods sold. We expect selling, general and administrative expenses to increase in fiscal 2017 as we incur additional operating expenses to support our store and direct to consumer growth, while also making strategic investments to support the long term growth of the business.

*Income tax expense* depends on the statutory tax rates in the countries where we sell our products and the proportion of taxable income earned in those jurisdictions. To the extent the relative proportion of taxable income in the jurisdictions fluctuates, or the tax legislation in the respective jurisdictions changes, so will our effective tax rate. We also anticipate that, in the future, we may start to sell our products through retail locations in countries in which we have not yet operated, in which case, we would become subject to taxation based on the foreign statutory rates in the countries where these sales take place and our effective tax rate could fluctuate accordingly.

## Results of Operations

The following tables summarize key components of our results of operations for the periods indicated, both in dollars and as a percentage of net revenue:

	Fiscal Year Ended		
	January 29, 2017	January 31, 2016	February 1, 2015
	<i>(In thousands)</i>		
Net revenue	\$ 2,344,392	\$ 2,060,523	\$ 1,797,213
Cost of goods sold	1,144,775	1,063,357	883,033
Gross profit	1,199,617	997,166	914,180
Selling, general and administrative expenses	778,465	628,090	538,147
Income from operations	421,152	369,076	376,033
Other income (expense), net	1,577	(581)	7,102
Income before income tax expense	422,729	368,495	383,135
Income tax expense	119,348	102,448	144,102
Net income	\$ 303,381	\$ 266,047	\$ 239,033

  

	Fiscal Year Ended		
	January 29, 2017	January 31, 2016	February 1, 2015
	<i>(Percentages)</i>		
Net revenue	100.0%	100.0%	100.0%
Cost of goods sold	48.8	51.6	49.1
Gross profit	51.2	48.4	50.9
Selling, general and administrative expenses	33.2	30.5	30.0
Income from operations	18.0	17.9	20.9
Other income (expense), net	—	—	0.4
Income before income tax expense	18.0	17.9	21.3
Income tax expense	5.1	5.0	8.0
Net income	12.9%	12.9%	13.3%

## Comparison of Fiscal 2016 to Fiscal 2015

### Net Revenue

Net revenue increased \$283.9 million, or 14%, to \$2.344 billion in fiscal 2016 from \$2.061 billion in fiscal 2015. On a constant dollar basis, assuming the average exchange rates in fiscal 2016 remained constant with the average exchange rates in fiscal 2015, net revenue increased \$292.9 million, or 14%.

Net revenue increased across all segments. The increase in net revenue was primarily due to the addition of 43 net new company-operated stores during fiscal 2016, as well as increased comparable store sales and the growth of our direct to consumer segment. Total comparable sales, which includes comparable store sales and direct to consumer, increased 6% in fiscal 2016 compared to fiscal 2015. Total comparable sales increased 7% on a constant dollar basis.

Our net revenue on a segment basis for fiscal 2016 and fiscal 2015 is summarized below. Net revenue is expressed in dollar amounts. The percentages are presented as a percentage of total net revenue.

	Fiscal Years Ended January 29, 2017 and January 31, 2016			
	2016	2015	2016	2015
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 1,704,357	\$ 1,516,323	72.7%	73.6%
Direct to consumer	453,287	401,525	19.3	19.5
Other	186,748	142,675	8.0	6.9
Net revenue	\$ 2,344,392	\$ 2,060,523	100.0%	100.0%

*Company-Operated Stores.* Net revenue from our company-operated stores segment increased \$188.0 million, or 12%, to \$1.704 billion in fiscal 2016 from \$1.516 billion in fiscal 2015. The following contributed to the increase in net revenue from our company-operated stores segment:

- Net revenue from company-operated stores we opened or significantly expanded subsequent to January 31, 2016, and therefore not included in comparable store sales, contributed \$126.7 million to the increase. During fiscal 2016 we opened 43 net new company-operated stores, which included 27 stores in the United States, four stores in Canada, three stores in each of China and the United Kingdom, two stores in South Korea, and one store in each of Australia, Hong Kong, Singapore, and Switzerland.
- A comparable store sales increase of 4% in fiscal 2016 compared to fiscal 2015 resulted in a \$61.3 million increase to net revenue. Comparable store sales increased 5%, or \$66.4 million on a constant dollar basis. The increase in comparable store sales was primarily as a result of increased dollar value per transaction and improved conversion rates.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$51.8 million, or 13%, to \$453.3 million in fiscal 2016 from \$401.5 million in fiscal 2015. Direct to consumer net revenue increased 13% on a constant dollar basis. The increase in net revenue from our direct to consumer segment was primarily the result of increased traffic on our e-commerce websites, increased dollar value per transaction and improved conversion rates.

*Other.* Net revenue from our other segment increased \$44.1 million, or 31%, to \$186.7 million in fiscal 2016 from \$142.7 million in fiscal 2015. This increase was primarily the result of an increased number of outlets which were open for the full year in fiscal 2016, increased net revenue at other existing outlets, and an increase in the number of temporary locations.

### **Gross Profit**

Gross profit increased \$202.5 million, or 20%, to \$1.200 billion in fiscal 2016 from \$997.2 million in fiscal 2015.

Gross profit as a percentage of net revenue, or gross margin, increased 280 basis points, to 51.2% in fiscal 2016 from 48.4% in fiscal 2015. The increase in gross margin was primarily the result of an increase in product margin of 330 basis points, primarily due to lower product costs, improved average retail prices, and lower costs related to our raw material commitments.

The increase in gross margin was partially offset by an increase in expenses related to our product and supply chain departments of 20 basis points, an increase in occupancy costs and depreciation of 20 basis points, and an unfavorable impact of foreign exchange rates of 10 basis points.

### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses increased \$150.4 million, or 24%, to \$778.5 million in fiscal 2016 from \$628.1 million in fiscal 2015. The increase in selling, general and administrative expenses was principally comprised of:

- an increase in employee costs for our operating locations of \$47.0 million, primarily from a growth in labor hours and bonuses, mainly associated with new company-operated stores;
- an increase in head office employee costs of \$35.4 million to support the growth in our business;
- an increase in head office costs other than employee costs of \$21.2 million primarily as a result of increased brand and community costs, increased depreciation, and increased information technology costs;
- an increase in net foreign exchange revaluation losses of \$20.3 million, primarily related to the revaluation of U.S. dollar cash and receivables held in Canadian subsidiaries. There were net foreign exchange losses of \$8.3 million in fiscal 2016 compared to net foreign exchange gains of \$12.0 million in fiscal 2015.
- an increase in other costs of \$18.5 million for our operating channels such as digital marketing expenses, repairs and maintenance costs, and increased depreciation; and
- an increase in variable costs such as credit card fees and distribution costs of \$8.1 million primarily as a result of increased sales.

As a percentage of net revenue, selling, general and administrative expenses increased 270 basis points, to 33.2% in fiscal 2016 from 30.5% in fiscal 2015.

**Income from Operations**

Income from operations increased \$52.1 million, or 14%, to \$421.2 million in fiscal 2016 from \$369.1 million in fiscal 2015. The increase was a result of increased gross profit of \$202.5 million, partially offset by increased selling, general and administrative costs of \$150.4 million.

On a segment basis, we determine income from operations without taking into account our general corporate expenses.

Income from operations before general corporate expenses for fiscal 2016 and fiscal 2015 is summarized below and is expressed in dollar amounts. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Fiscal Years Ended January 29, 2017 and January 31, 2016			
	2016		2015	
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores . . . . .	\$ 415,635	\$ 346,802	24.4%	22.9%
Direct to consumer . . . . .	186,178	166,418	41.1	41.4
Other . . . . .	22,312	5,826	11.9	4.1
Income from operations before general corporate expenses . . .	624,125	519,046		
General corporate expenses . . . . .	202,973	149,970		
Income from operations . . . . .	<u>\$ 421,152</u>	<u>\$ 369,076</u>		

*Company-Operated Stores.* Income from operations from our company-operated stores segment increased \$68.8 million, or 20%, to \$415.6 million for fiscal 2016 from \$346.8 million for fiscal 2015. The increase was primarily the result of an increase in gross profit of \$132.8 million, which was primarily due to increased net revenue and higher gross margin. Net revenue increased as a result of new stores as well as increased comparable store sales, which was primarily a result of increased dollar value per transaction and improved conversion rates. This was partially offset by an increase in selling, general and administrative expenses, including increased store employee costs and increased operating expenses associated with new stores and increased net revenue at existing stores. Income from operations as a percentage of company-operated stores net revenue increased by 150 basis points primarily due to increased gross margin, partially offset by deleverage of selling, general and administrative expenses.

*Direct to Consumer.* Income from operations from our direct to consumer segment increased \$19.8 million, or 12%, to \$186.2 million in fiscal 2016 from \$166.4 million in fiscal 2015. The increase was primarily the result of increased gross profit of \$43.2 million primarily due to increased net revenue resulting from an increase in traffic on our e-commerce websites, increased dollar value per transaction, and improved conversion rates. This was partially offset by an increase in selling, general and administrative expenses including higher digital marketing expenses and higher variable costs such as distribution costs and credit card fees as a result of increased net revenue. Income from operations as a percentage of direct to consumer net revenue has decreased by 30 basis points primarily due to deleverage of selling, general and administrative expenses, partially offset by an increase in gross margin.

*Other.* Income from operations from our other segment increased \$16.5 million, or 283%, to \$22.3 million in fiscal 2016 from \$5.8 million in fiscal 2015. The increase was primarily the result of increased gross profit of \$26.4 million, partially offset by increased selling, general and administrative expenses primarily due to increased employee costs. Income from operations as a percentage of other net revenue increased by 780 basis points primarily due to an increase in gross margin and decreased selling, general and administrative expenses as a percentage of other net revenue.

*General Corporate Expenses.* General corporate expenses increased \$53.0 million, or 35%, to \$203.0 million in fiscal 2016 from \$150.0 million in fiscal 2015. This increase was primarily due to increased head office employee costs, brand and community costs, depreciation, and information technology costs. There was also a \$20.3 million increase in foreign exchange revaluation losses. We expect general corporate expenses to continue to increase in future years as we grow our overall business and require increased efforts at our head office to support our company-operated stores, direct to consumer and other segments.

**Other Income (Expense), Net**

There was net other income of \$1.6 million in fiscal 2016 compared to net other expense of \$0.6 million in fiscal 2015. This was primarily the result of a \$1.8 million reduction in net interest expense related to certain tax adjustments that are outlined in Note 15 to the consolidated financial statements included in Item 8 of Part II of this report, as well as interest earned on our increased cash and cash equivalents in fiscal 2016 compared to fiscal 2015.

**Income Tax Expense**

Income tax expense increased \$16.9 million, or 16%, to \$119.3 million in fiscal 2016 from \$102.4 million in fiscal 2015. Fiscal 2016 and fiscal 2015 included certain tax adjustments which resulted in net income tax recoveries of \$10.7 million and \$7.4 million, respectively, as outlined in Note 15 to the consolidated financial statements included in Item 8 of Part II of this report.

Our effective tax rate for fiscal 2016 was 28.2% compared to 27.8% for fiscal 2015. Our effective tax rate excluding the above tax and related interest adjustments was 30.7% for fiscal 2016 compared to 29.5% for fiscal 2015.

**Net Income**

Net income increased \$37.4 million, or 14%, to \$303.4 million in fiscal 2016 from \$266.0 million in fiscal 2015. The increase in net income in fiscal 2016 was primarily due to a \$202.5 million increase in gross profit and an increase in other income (expense), net of \$2.2 million, partially offset by an increase of \$150.4 million in selling, general and administrative expenses and an increase of \$16.9 million in income tax expense.

**Comparison of Fiscal 2015 to Fiscal 2014****Net Revenue**

Net revenue increased \$263.3 million, or 15%, to \$2.061 billion in fiscal 2015 from \$1.797 billion in fiscal 2014. On a constant dollar basis, assuming the average exchange rates in fiscal 2015 remained constant with the average exchange rates in fiscal 2014, net revenue increased \$352.2 million, or 20%.

The net revenue increase was primarily driven by sales from new stores and the growth of our direct to consumer segment. Total comparable sales, which includes comparable store sales and direct to consumer, increased 5% in fiscal 2015 compared to fiscal 2014. Total comparable sales increased 10% on a constant dollar basis.

Our net revenue on a segment basis for fiscal 2015 and fiscal 2014 is summarized below. Net revenue is expressed in dollar amounts. The percentages are presented as a percentage of total net revenue.

	Fiscal Years Ended January 31, 2016 and February 1, 2015			
	2015	2014	2015	2014
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores . . . . .	\$ 1,516,323	\$ 1,348,225	73.6%	75.0%
Direct to consumer . . . . .	401,525	321,180	19.5	17.9
Other . . . . .	142,675	127,808	6.9	7.1
Net revenue . . . . .	<u>\$ 2,060,523</u>	<u>\$ 1,797,213</u>	<u>100.0%</u>	<u>100.0%</u>

*Company-Operated Stores.* Net revenue from our company-operated stores segment increased \$168.1 million, or 12%, to \$1.516 billion in fiscal 2015 from \$1.348 billion in fiscal 2014.

During fiscal 2015 we opened 61 net new stores, which included 49 stores in the United States, three stores in Canada, four stores in the United Kingdom, two stores in Hong Kong, and one store in each of Germany, Puerto Rico, and Singapore.

The increase in net revenue from our company-operated stores segment resulted from an increase of \$175.4 million from non-comparable stores, which includes sales from new stores that have not been open for 12 months and sales from stores which have been significantly expanded. The increase in net revenue was partially offset by a decrease of \$7.3 million from comparable store sales.

Comparable store sales decreased by less than 1% in fiscal 2015 compared to fiscal 2014. Comparable store sales increased 4%, or \$48.8 million on a constant dollar basis. Comparable store sales on a constant dollar basis increased primarily as the result of increased traffic which resulted in an increase in the number of transactions, and due to higher average unit retail prices.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$80.3 million, or 25%, to \$401.5 million in fiscal 2015 from \$321.2 million in fiscal 2014. Direct to consumer net revenue increased 30% on a constant dollar basis. The increase in net revenue from our direct to consumer segment was primarily the result of an increase in the number of transactions which was driven by increased traffic and higher conversion rates on our e-commerce websites.

*Other.* Net revenue from our other segment increased \$14.9 million, or 12%, to \$142.7 million in fiscal 2015 from \$127.8 million in fiscal 2014. This increase was primarily the result of an increased number of outlets and an increased number of warehouse sales held during fiscal 2015 compared to fiscal 2014. This was partially offset by fewer temporary locations open during fiscal 2015 compared to fiscal 2014.

### ***Gross Profit***

Gross profit increased \$83.0 million, or 9%, to \$997.2 million in fiscal 2015 from \$914.2 million in fiscal 2014.

Gross profit as a percentage of net revenue, or gross margin, decreased 250 basis points, to 48.4% in fiscal 2015 from 50.9% in fiscal 2014. The decrease in gross margin was primarily the result of:

- an increase in fixed costs, such as occupancy costs and depreciation, relative to the increase in net revenue, of 90 basis points;
- an unfavorable impact of foreign exchange rates on product costs which contributed to a decrease in gross margin of 90 basis points; and
- a decrease in product margin of 70 basis points, primarily due to an increase in markdowns and discounts, as well as other product related costs.

### ***Selling, General and Administrative Expenses***

Selling, general and administrative expenses increased \$89.9 million, or 17%, to \$628.1 million in fiscal 2015 from \$538.1 million in fiscal 2014. The increase in selling, general and administrative expenses was principally comprised of:

- an increase in employee costs for our operating locations of \$36.8 million, primarily from a growth in labor hours and bonuses, mainly associated with new company-operated stores;
- an increase in head office costs other than employee costs of \$18.7 million primarily as a result of increased professional fees, including supply chain consulting costs, increased brand and community costs, and increased depreciation;
- an increase in variable costs such as distribution costs, credit card fees, and packaging of \$14.6 million primarily as a result of new company-operated stores as well as increased sales volume from our direct to consumer segment;
- an increase in head office employee costs of \$14.5 million to support the growth in our business; and
- an increase in other costs of \$10.9 million for our operating channels such as repairs and maintenance costs, digital marketing expenses, and store community costs.
- The increase in selling, general and administrative expenses was partially offset by an increase in net foreign exchange revaluation gains of \$5.6 million.

As a percentage of net revenue, selling, general and administrative expenses increased 50 basis points, to 30.5% in fiscal 2015 from 30.0% in fiscal 2014.

### ***Income from Operations***

Income from operations decreased \$7.0 million, or 2%, to \$369.1 million in fiscal 2015 from \$376.0 million in fiscal 2014. The decrease was a result of increased selling, general and administrative costs of \$89.9 million, partially offset by increased gross profit of \$83.0 million.

On a segment basis, we determine income from operations without taking into account our general corporate expenses.

Income from operations before general corporate expenses for fiscal 2015 and fiscal 2014 is summarized below and is expressed in dollar amounts. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Fiscal Years Ended January 31, 2016 and February 1, 2015			
	2015		2014	
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores . . . . .	\$ 346,802	\$ 356,589	22.9%	26.4%
Direct to consumer . . . . .	166,418	132,877	41.4	41.4
Other . . . . .	5,826	9,499	4.1	7.4
Income from operations before general corporate expenses . . .	519,046	498,965		
General corporate expenses . . . . .	149,970	122,932		
Income from operations . . . . .	\$ 369,076	\$ 376,033		

*Company-Operated Stores.* Income from operations from our company-operated stores segment decreased \$9.8 million, or 3%, to \$346.8 million for fiscal 2015 from \$356.6 million for fiscal 2014 primarily due to an increase in selling, general and administrative expenses related to employee costs as well as operating expenses associated with new stores, partially offset by an increase of \$41.0 million in gross profit from increased sales. Income from operations as a percentage of company-operated stores net revenue decreased by 350 basis points primarily due to lower gross margin resulting from an increase in fixed costs relative to the increase in net revenue, unfavorable foreign exchange rates, and an increase in markdowns and discounts, as well as increased selling, general and administrative expenses as a percentage of net revenue.

*Direct to Consumer.* Income from operations from our direct to consumer segment increased \$33.5 million, or 25%, to \$166.4 million in fiscal 2015 from \$132.9 million in fiscal 2014. The increase was primarily the result of increased gross profit of \$39.8 million primarily due to increased net revenue resulting from an increase in the number of transactions which was driven by increased traffic and higher conversion rates, partially offset by increased selling, general and administrative expenses. Income from operations as a percentage of direct to consumer net revenue was 41.4% in each of fiscal 2015 and fiscal 2014.

*Other.* Income from operations from our other segment decreased \$3.7 million, or 39%, to \$5.8 million in fiscal 2015 from \$9.5 million in fiscal 2014. Income from operations as a percentage of other net revenue decreased by 330 basis points primarily due to an increased proportion of outlet and warehouse sales within our other segment net revenue in fiscal 2015 compared to fiscal 2014 that carry a lower gross margin.

*General Corporate Expenses.* General corporate expenses increased \$27.0 million, or 22%, to \$150.0 million in fiscal 2015 from \$122.9 million in fiscal 2014. This increase was primarily due to increased head office employee costs, professional fees, including increased professional fees related to supply chain consulting costs, and brand and community costs to support the growth of our business. The increase in general corporate expenses was partially offset by an increase in net foreign exchange revaluation gains of \$5.6 million.

#### ***Other Income (Expense), Net***

There was net other expense of \$0.6 million in fiscal 2015 compared to net other income of \$7.1 million in fiscal 2014. This was primarily the result of less interest earned on our decreased cash and cash equivalents in fiscal 2015 compared to fiscal 2014 as well as a net interest expense of \$3.5 million related to certain tax adjustments that are outlined in Note 15 to the audited consolidated financial statements included in Item 8 of Part II of this report.

#### ***Income Tax Expense***

Income tax expense decreased \$41.7 million, or 29%, to \$102.4 million in fiscal 2015 from \$144.1 million in fiscal 2014. Our effective tax rate for fiscal 2015 was 27.8% compared to 37.6% for fiscal 2014. Fiscal 2015 included certain tax adjustments which resulted in a net recovery of \$7.4 million as outlined in Note 15 to the audited consolidated financial statements included in Item 8 of Part II of this report. Fiscal 2014 included a tax expense of \$33.7 million to provide for U.S. income and applicable foreign withholding taxes on dividends of \$473.7 million which were distributed during fiscal 2014 from foreign subsidiaries to the U.S. parent entity to fund our share repurchase program. Our effective tax rate excluding these adjustments was 29.5% for fiscal 2015 compared to 28.8% for fiscal 2014.

### ***Net Income***

Net income increased \$27.0 million, or 11%, to \$266.0 million in fiscal 2015 from \$239.0 million in fiscal 2014. The increase in net income in fiscal 2015 was primarily due to a \$83.0 million increase in gross profit resulting from new stores and the growth of our direct to consumer segment and a decrease of \$41.7 million in income tax expense, partially offset by an increase of \$89.9 million in selling, general and administrative expenses and a \$7.7 million increase in other income (expense), net.

### **Comparable Sales**

We separately track comparable store sales, which reflect net revenue from company-operated stores that have been open for at least 12 months, or open for at least 12 months after being significantly expanded. Net revenue from a store is included in comparable store sales beginning with the first month for which the store has a full month of sales in the prior year. Comparable store sales exclude sales from new stores that have not been open for at least 12 months, from stores which have not been in their significantly expanded space for at least 12 months, and from stores which have been temporarily relocated for renovations. Comparable store sales also exclude sales from direct to consumer, outlets, showrooms, temporary locations, wholesale accounts, warehouse sales, license and supply arrangements, and sales from company-operated stores that we have closed.

Total comparable sales combines comparable store sales and direct to consumer sales. We are evolving towards an omni-channel approach to support the shopping behavior of our guests. This involves country and region specific websites, mobile/tablet devices in stores, social networks, product notification emails, and online order fulfillment through stores. We therefore believe that reporting total comparable sales with comparable store sales and direct to consumer sales combined provides a relevant performance metric.

Various factors affect comparable sales, including:

- the location of new stores relative to existing stores;
- consumer preferences, buying trends, and overall economic trends;
- our ability to anticipate and respond effectively to customer preferences for technical athletic apparel;
- competition;
- changes in our merchandise mix;
- pricing;
- the timing of our releases of new merchandise and promotional events;
- the effectiveness of our grassroots marketing efforts;
- the design and ease of use of our websites;
- the level of customer service that we provide in our stores and on our websites;
- our ability to source and distribute products efficiently; and
- the number of stores we open, close (including for temporary renovations), and expand in any period.

Opening new stores is an important part of our growth strategy. Accordingly, total comparable sales has limited utility for assessing the success of our growth strategy insofar as comparable sales do not reflect the performance of stores open less than 12 months. The comparable sales measures we report may not be equivalent to similarly titled measures reported by other companies.

### **Non-GAAP Financial Measures**

Constant dollar changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue, and the effective tax rate and diluted earnings per share excluding certain tax and related interest adjustments, are non-GAAP financial measures.

A constant dollar basis assumes the average foreign exchange rates for the period remained constant with the average foreign exchange rates for the same period of the prior year. We provide constant dollar changes in net revenue, total comparable sales, comparable store sales, and changes in direct to consumer net revenue because we use these measures to understand the underlying growth rate of net revenue excluding the impact of changes in foreign exchange rates. We believe

that disclosing these measures on a constant dollar basis is useful to investors because it enables them to better understand the level of growth of our business.

We disclose the effective tax rate and diluted earnings per share excluding certain tax and related interest adjustments because of their comparability to our historical information, which we believe is useful to investors.

The presentation of this financial information is not intended to be considered in isolation or as a substitute for, or with greater prominence to, the financial information prepared and presented in accordance with GAAP. A reconciliation of the non-GAAP financial measures follows, which includes more detail on the GAAP financial measure that is most directly comparable to each non-GAAP financial measure, and the related reconciliations between these financial measures.

The below changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue show the change compared to the corresponding period in the prior year.

**Constant dollar changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue**

	Fiscal Year Ended January 29, 2017		Fiscal Year Ended January 31, 2016	
	(In thousands)	(Percentages)	(In thousands)	(Percentages)
Change in net revenue . . . . .	\$ 283,869	14%	\$ 263,310	15%
Adjustments due to foreign exchange rate changes . . . . .	8,983	—	88,877	5
Change in net revenue in constant dollars . . . . .	<u>\$ 292,852</u>	<u>14%</u>	<u>\$ 352,187</u>	<u>20%</u>

	Fiscal Year Ended	
	January 29, 2017	January 31, 2016
Change in total comparable sales <sup>1,2</sup> . . . . .	6%	5%
Adjustments due to foreign exchange rate changes . . . . .	1	5
Change in total comparable sales in constant dollars <sup>1,2</sup> . . . . .	<u>7%</u>	<u>10%</u>

	Fiscal Year Ended January 29, 2017		Fiscal Year Ended January 31, 2016	
	(In thousands)	(Percentages)	(In thousands)	(Percentages)
Change in comparable store sales <sup>2</sup> . . . . .	\$ 61,341	4%	\$ (7,335)	—%
Adjustments due to foreign exchange rate changes . . . . .	5,036	1	56,106	4
Change in comparable store sales in constant dollars <sup>2</sup> . . . . .	<u>\$ 66,377</u>	<u>5%</u>	<u>\$ 48,771</u>	<u>4%</u>

	Fiscal Year Ended	
	January 29, 2017	January 31, 2016
Change in direct to consumer net revenue . . . . .	13%	25%
Adjustments due to foreign exchange rate changes . . . . .	—	5
Change in direct to consumer net revenue in constant dollars . . . . .	<u>13%</u>	<u>30%</u>

<sup>1</sup>Total comparable sales includes comparable store sales and direct to consumer sales.

<sup>2</sup>Comparable store sales reflects net revenue from company-operated stores that have been open for at least 12 months, or open for at least 12 months after being significantly expanded.

**Effective tax rate and diluted earnings per share, excluding tax and related interest adjustments**

	Fiscal Year Ended		
	January 29, 2017	January 31, 2016	February 1, 2015
Effective tax rate .....	28.2%	27.8%	37.6%
Tax and related interest adjustments <sup>1</sup> .....	2.5	1.7	(8.8)
Effective tax rate, excluding tax and related interest adjustments .....	<u>30.7%</u>	<u>29.5%</u>	<u>28.8%</u>

	Fiscal Year Ended		
	January 29, 2017	January 31, 2016	February 1, 2015
Diluted earnings per share .....	\$ 2.21	\$ 1.89	\$ 1.66
Tax and related interest adjustments <sup>1</sup> .....	(0.07)	(0.03)	0.23
Diluted earnings per share, excluding tax and related interest adjustments .....	<u>\$ 2.14</u>	<u>\$ 1.86</u>	<u>\$ 1.89</u>

<sup>1</sup>Please refer to Note 15 to the audited consolidated financial statements included in Item 8 of Part II of this report for an explanation as to the nature of these items.

**Liquidity and Capital Resources**

Our primary sources of liquidity are our current balances of cash and cash equivalents, cash flows from operations, and capacity under our revolving credit facility. Our primary cash needs are capital expenditures for opening new stores and remodeling or relocating existing stores, making information technology system enhancements, funding working capital requirements, and making other strategic capital investments both in North America and internationally. We may also use cash to repurchase shares of our common stock. Cash and cash equivalents in excess of our needs are held in interest bearing accounts with financial institutions.

As of January 29, 2017, our working capital (excluding cash and cash equivalents) was \$186.4 million, our cash and cash equivalents were \$734.8 million and our capacity under our revolving credit facility was \$149.2 million.

The following table summarizes our net cash flows provided by and used in operating, investing and financing activities for the periods indicated:

	Fiscal Year Ended		
	January 29, 2017	January 31, 2016	February 1, 2015
	<i>(In thousands)</i>		
Total cash provided by (used in):			
Operating activities .....	\$ 385,119	\$ 298,740	\$ 314,449
Investing activities .....	(149,511)	(143,487)	(119,733)
Financing activities .....	(25,338)	(273,693)	(149,077)
Effect of exchange rate changes .....	23,094	(44,557)	(79,809)
Increase (decrease) in cash and cash equivalents .....	<u>\$ 233,364</u>	<u>\$ (162,997)</u>	<u>\$ (34,170)</u>

**Operating Activities**

Cash flows provided by operating activities consist primarily of net income adjusted for certain items not affecting cash and the effect of changes in operating assets and liabilities.

In fiscal 2016, cash provided by operating activities increased \$86.4 million, to \$385.1 million compared to cash provided by operating activities of \$298.7 million in fiscal 2015. The increase was primarily a result of a decrease in inventory purchases, a decrease in the change in prepaid and receivable income taxes, and an increase in net income. This was partially offset by a decrease in the change in income taxes payable, deferred income taxes, and accrued inventory liabilities.

Inventory purchases decreased during fiscal 2016 primarily as a result of actions taken to align inventory levels with forward sales trends.

In fiscal 2015, cash provided by operating activities decreased \$15.7 million, to \$298.7 million compared to cash provided by operating activities of \$314.4 million in fiscal 2014. The decrease was primarily a result of an increase in inventory purchases and an increase in prepaid and receivable income taxes. This was partially offset by an increase in net income, changes in other operating assets and liabilities, and the change in items not affecting cash. The change in items not affecting cash was primarily due to an increase in depreciation related to our increased number of stores and a reduction in net deferred income tax assets.

Inventory increased during fiscal 2015 primarily due to the opening of new stores, increased inventory levels to support the sales growth in our company-operated stores and direct to consumer segments, and the timing of product deliveries.

Prepaid and receivable income taxes increased during fiscal 2015 primarily as a result of certain tax adjustments as outlined in Note 15 to the consolidated financial statements included in Item 8 of Part II of this report. These adjustments resulted in an income tax receivable in the United States and an increase in income taxes payable in Canada.

### ***Investing Activities***

Cash flows used in investing activities relate entirely to capital expenditures. Cash used in investing activities increased \$6.0 million, to \$149.5 million in fiscal 2016 from \$143.5 million in fiscal 2015. Cash used in investing activities increased \$23.8 million, to \$143.5 million in fiscal 2015 from \$119.7 million in fiscal 2014.

Capital expenditures for our company-operated stores segment were \$75.3 million in fiscal 2016 which included \$30.6 million to open 46 company-operated stores, \$85.8 million in fiscal 2015 which included \$49.2 million to open 62 company-operated stores, and \$76.9 million in fiscal 2014 which included \$38.1 million to open 49 new company-operated stores. The remaining capital expenditures for our company-operated stores segment in each period were primarily for the remodeling or relocation of certain stores, and ongoing store refurbishment.

Capital expenditures for our direct to consumer segment were \$11.5 million, \$8.3 million, and \$10.0 million in fiscal 2016, fiscal 2015, and fiscal 2014, respectively. The capital expenditures for our direct to consumer segment in fiscal 2016 were primarily related to our global website redesign as well as mobile website enhancements, and in fiscal 2015 and 2014 were primarily related to website enhancements and country and region specific website launches.

Capital expenditures related to corporate activities and other were \$62.7 million, \$49.4 million, and \$32.9 million in fiscal 2016, fiscal 2015, and fiscal 2014, respectively. During the second quarter of fiscal 2016, we purchased a land parcel in Vancouver, BC for general corporate purposes for \$19.7 million. The capital expenditures in each period for corporate activities and other were for investments in information technology and business systems, improvements at our head office and other corporate buildings, and for capital expenditures related to opening retail locations other than company-operated stores.

Capital expenditures are expected to range between \$170 million and \$175 million in fiscal 2017.

### ***Financing Activities***

Cash flows used in or provided by financing activities consist primarily of cash used to repurchase shares of our common stock and certain cash flows related to stock-based compensation.

Cash used in financing activities decreased \$248.4 million, to \$25.3 million in fiscal 2016 from \$273.7 million in fiscal 2015. Cash used in financing activities increased \$124.6 million, to \$273.7 million in fiscal 2015 from \$149.1 million in fiscal 2014. The primary cause of these changes in cash used in financing activities was our stock repurchase program.

On June 11, 2014, our board of directors approved a program to repurchase shares of our common stock up to an aggregate value of \$450.0 million. This stock repurchase program was completed during the second quarter of fiscal 2016. On December 1, 2016, our board of directors approved a program to repurchase shares of our common stock up to an aggregate value of \$100.0 million.

During the fiscal years ended January 29, 2017, January 31, 2016, and February 1, 2015, 0.5 million, 5.0 million, and 3.7 million shares, respectively, were repurchased under the programs at a total cost of \$29.3 million, \$274.2 million, and \$147.4 million, respectively.

We believe that our cash and cash equivalent balances, cash generated from operations, and borrowings available to us under our revolving credit facility will be adequate to meet our liquidity needs and capital expenditure requirements for at least the next 12 months. Our cash from operations may be negatively impacted by a decrease in demand for our products as well as the other factors described in "Item 1A. Risk Factors". In addition, we may make discretionary capital improvements with respect to our stores, distribution facilities, headquarters, or systems, which we would expect to fund through the use of cash, issuance of debt or equity securities or other external financing sources to the extent we were unable to fund such capital expenditures out of our cash and cash equivalents and cash generated from operations.

## Revolving Credit Facility

On December 15, 2016, we entered into a credit agreement for \$150.0 million under an unsecured five-year revolving credit facility. Bank of America, N.A., is administrative agent and HSBC Bank Canada is the syndication agent and letter of credit issuer, and the lenders party thereto. Borrowings under the revolving credit facility may be made, in U.S. Dollars, Euros, Canadian Dollars, and in other currencies, subject to the approval of the administrative agent and the lenders. Up to \$35.0 million of the revolving credit facility is available for the issuance of letters of credit and up to \$25.0 million is available for the issuance of swing line loans. Commitments under the revolving credit facility may be increased by up to \$200.0 million, subject to certain conditions, including the approval of the lenders. Borrowings under the agreement may be prepaid and commitments may be reduced or terminated without premium or penalty (other than customary breakage costs). The principal amount outstanding under the credit agreement will be due and payable in full on December 15, 2021, subject to provisions that permit us to request a limited number of one year extensions annually.

Borrowings made under the revolving credit facility bear interest at a rate per annum equal to, at our option, either (a) a rate based on the rates applicable for deposits on the interbank market for U.S. Dollars or the applicable currency in which the borrowings are made ("LIBOR") or (b) an alternate base rate, plus, in each case, an applicable margin. The applicable margin is determined by reference to a pricing grid, based on the ratio of indebtedness to earnings before interest, tax depreciation, amortization and rent ("EBITDAR") and ranges between 1.00%-1.75% for LIBOR loans and 0.00%-0.75% for alternate base rate loans. Additionally, a commitment fee of between 0.125%-0.200%, also determined by reference to the pricing grid, is payable on the average daily unused amounts under the revolving credit facility.

The credit agreement contains negative covenants that, among other things and subject to certain exceptions, limit the ability of our subsidiaries to incur indebtedness, incur liens, undergo fundamental changes, make dispositions of all or substantially all of their assets, alter their businesses and enter into agreements limiting subsidiary dividends and distributions.

We are also required to maintain a consolidated rent-adjusted leverage ratio of not greater than 3.50:1.00 and we are not permitted to allow the ratio of consolidated EBITDAR to consolidated interest charges (plus rent) to be less than 2.00:1.00. The credit agreement also contains certain customary representations, warranties, affirmative covenants, and events of default (including, among others, an event of default upon the occurrence of a change of control). If an event of default occurs, the credit agreement may be terminated and the maturity of any outstanding amounts may be accelerated.

As of January 29, 2017, aside from letters of credit of \$0.8 million, we had no other borrowings outstanding under this credit facility.

## Contractual Obligations and Commitments

*Leases.* We lease certain store and other retail locations, distribution centers, offices, and equipment under non-cancelable operating leases. Our leases generally have initial terms of between five and 10 years, and generally can be extended only in five-year increments, if at all. Our leases expire at various dates between one and 15 years, excluding extensions at our option. A substantial number of our leases include renewal options and certain of our leases include rent escalation clauses, rent holidays and leasehold rental incentives, none of which are reflected in the table below. The majority of our leases for store premises also include contingent rental payments based on sales, the impact of which also are not reflected in the table below.

*Product Purchase Obligations.* The amounts listed for product purchase obligations in the table below represent agreements (including open purchase orders) to purchase products in the ordinary course of business that are enforceable and legally binding and that specify all significant terms. In some cases, prices are subject to change throughout the production process. The reported amounts exclude product purchase liabilities included in accounts payable and accrued inventory liabilities as of January 29, 2017.

The following table summarizes our contractual arrangements as of January 29, 2017, and the timing and effect that such commitments are expected to have on our liquidity and cash flows in future periods:

	Payments Due by Fiscal Year						
	Total	2017	2018	2019	2020	2021	Thereafter
				<i>(In thousands)</i>			
Operating leases (minimum rent) . . .	\$ 518,613	\$ 118,897	\$ 106,496	\$ 94,085	\$ 71,973	\$ 45,019	\$ 82,143
Product purchase obligations . . . . .	\$ 176,312	\$ 176,312	\$ —	\$ —	\$ —	\$ —	\$ —

## Off-Balance Sheet Arrangements

We enter into standby letters of credit to secure certain of our obligations, including leases, taxes and duties. As of January 29, 2017, letters of credit totaling \$0.8 million had been issued.

We have not entered into any transactions, agreements or other contractual arrangements to which an entity unconsolidated with us is a party and under which we have (i) any obligation under a guarantee, (ii) any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity, (iii) any obligation under derivative instruments that are indexed to our shares and classified as equity in our consolidated balance sheets, or (iv) any obligation arising out of a variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

### **Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions. Predicting future events is inherently an imprecise activity and, as such, requires the use of judgment. Actual results may vary from our estimates in amounts that may be material to the financial statements. An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact our consolidated financial statements.

We believe that the following critical accounting policies affect our more significant estimates and judgments used in the preparation of our consolidated financial statements:

*Revenue Recognition.* Net revenue is recognized net of sales taxes, discounts, and an estimated allowance for sales returns. Sales to customers through company-operated stores and other physical locations are recognized at the point of sale, net of an estimated allowance for sales returns. Direct to consumer sales are recognized once delivery has occurred and collection is reasonably assured, net of an estimated allowance for sales returns. Other net revenue includes outlet sales, showroom sales, sales from temporary locations, sales to wholesale accounts, warehouse sales, and license and supply arrangement net revenue, which consists of royalties as well as sales of our product to licensees. Revenue is recognized when these sales occur. Employee discounts are classified as a reduction of net revenue.

Our estimated allowance for sales returns is a subjective critical estimate that has a direct impact on reported net revenue. This allowance is calculated based on a history of actual returns, estimated future returns and any significant future known or anticipated events. Consideration of these factors results in an estimated allowance for sales returns. Our standard terms for retail sales limit returns to approximately 14 days after the sale of the merchandise, however we accept returns after 14 days where the product fails to meet our guests' quality expectations.

Revenue from our gift cards is recognized when tendered for payment, or upon redemption. Outstanding customer balances are included in "Unredeemed gift card liability" on the consolidated balance sheets. There are no expiration dates on our gift cards, and we do not charge any service fees that cause a decrement to customer balances.

While we will continue to honor all gift cards presented for payment, we may determine the likelihood of redemption to be remote for certain card balances due to, among other things, long periods of inactivity. In these circumstances, to the extent we determine there is no requirement for remitting card balances to government agencies under unclaimed property laws, card balances may be recognized in the consolidated statements of operations in net revenue. The amount recognized is an estimate, based on historical customer redemption rates.

*Inventory.* Inventory is valued at the lower of cost and market. We periodically review our inventories and make provisions as necessary to appropriately value goods that are obsolete, have quality issues, or are damaged. The amount of the provision is equal to the difference between the cost of the inventory and its net realizable value based upon assumptions about future demand, selling prices, and market conditions. If changes in market conditions result in reductions in the estimated net realizable value of our inventory below our previous estimate, we would increase our reserve in the period in which we made such a determination. In addition, we provide for inventory shrinkage as a percentage of sales, based on historical trends from actual physical inventories. Inventory shrinkage estimates are made to reduce the inventory value for lost or stolen items. We perform physical inventory counts throughout the year and adjust the shrink provision accordingly.

*Property and Equipment.* Property and equipment are recorded at cost less accumulated depreciation. Buildings are depreciated on a straight-line basis over the expected useful life of the asset, which we estimate to be 20 years. Leasehold improvements are depreciated on a straight-line basis over the lesser of the length of the lease and the estimated useful life of the assets, up to a maximum of five years. All other property and equipment is depreciated using the declining balance method as follows:

Furniture and fixtures .....	20%
Computer hardware and software .....	20% - 30%
Equipment and vehicles .....	30%

Changes in circumstances (such as technological advances) can result in differences between the actual and estimated useful lives. In those cases where we determine that the useful life of a long-lived asset should be shortened, we increase depreciation expense over the remaining useful life to depreciate the asset's net book value to its estimated salvage value.

*Long-Lived Assets.* Long-lived assets, including intangible assets with finite useful lives are evaluated for impairment when the occurrence of events or changes in circumstances indicates that the carrying value of the assets may not be recoverable as measured by comparing their net book value to the undiscounted estimated future cash flows generated by their use and eventual disposition. Impaired assets are recorded at fair value, determined principally by the present value of the estimated future cash flows expected from their use and eventual disposition.

*Income Taxes.* Deferred income tax assets and liabilities are determined based on the temporary differences between the carrying amounts and the tax basis of assets and liabilities, and for tax losses, tax credit carry forwards, and other tax attributes, using the enacted tax rates that are to be in effect when these differences are expected to reverse.

Deferred income tax liabilities are provided for U.S. income taxes on the undistributed earnings of foreign subsidiaries, unless those earnings can be distributed on a tax-free basis or if the earnings are indefinitely reinvested. We determine on a regular basis the amount of undistributed earnings that will be indefinitely reinvested in our non-U.S. operations. This assessment is based on the cash flow projections and operational and fiscal objectives of each of our U.S. and foreign subsidiaries. Such estimates are inherently imprecise since many assumptions used in the projections are subject to revision. The possibility exists that amounts determined to be indefinitely reinvested outside of the U.S. may ultimately be repatriated.

U.S. income and foreign withholding taxes have not been provided on approximately \$852.3 million of cumulative undistributed earnings of a Canadian subsidiary as of January 29, 2017. These earnings are indefinitely reinvested outside of the United States. Income taxes of approximately \$38.4 million would be incurred if these earnings were repatriated to the United States.

As of January 29, 2017, we had cash and cash equivalents of \$559.5 million outside of the United States. We do not intend to repatriate these funds to the United States.

We evaluate our tax filing positions and recognize the largest amount of tax benefit that is considered more likely than not to be sustained upon examination by the relevant taxing authorities based on the technical merits of the position. This determination requires the use of significant judgment. Income tax expense is adjusted in the period in which an uncertain tax position is effectively settled, the statute of limitations expires, facts or circumstances change, tax laws change, or new information becomes available.

Our tax positions include intercompany transfer pricing policies and the associated taxable income and deductions arising from intercompany charges between subsidiaries within the consolidated group. Although we believe that our intercompany transfer pricing policies and tax positions are reasonable, the final outcomes of tax audits or potential tax disputes may be materially different from that which is reflected in our income tax provisions and accruals.

*Goodwill and Intangible Assets.* Intangible assets are recorded at cost. Reacquired franchise rights are amortized on a straight-line basis over their estimated useful lives of 10 years. Goodwill represents the excess of the purchase price over the fair market value of identifiable net assets acquired and is not amortized. Goodwill is tested for impairment annually or more frequently when an event or circumstance indicates that goodwill might be impaired. Goodwill impairment testing requires us to estimate the fair value of our reporting units. We generally base our measurement of the fair value on the present value of future cash flows. Our significant estimates in the discounted cash flows model include the discount rate and long-term rates of growth. We use our best estimates and judgment based on available evidence in conducting the impairment testing.

*Stock-Based Compensation.* We account for stock-based compensation using the fair value method. The fair value of awards granted is estimated at the date of grant and is recognized as employee compensation expense on a straight-line basis over the requisite service period. For awards with service and/or performance conditions, the amount of compensation expense recognized is based on the number of awards that are expected to vest.

The estimation of the number of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We consider several factors when estimating the number of awards which are expected to vest, including, future profit forecasts, types of awards, size of option holder group, and anticipated employee retention. Actual results may differ substantially from these estimates.

The calculation of the grant-date fair value of stock options requires us to make certain estimates and assumptions, including, stock price volatility, and the expected life of the options. We evaluate and revise these estimates and assumptions as necessary, to reflect market conditions and our historical experience. The expected term of the options is based upon historical experience of similar awards, giving consideration to expectations of future employee behavior. Expected volatility is based upon the historical volatility of our common stock for the period corresponding with the expected term of the options. In the future, the expected volatility and expected term may change which could substantially change the grant-date fair value of future awards of stock options and, ultimately, the expense we record.

*Contingencies.* In the ordinary course of business, we are involved in legal proceedings regarding contractual and employment relationships and a variety of other matters. We record contingent liabilities resulting from claims against us, when a loss is assessed to be probable and the amount of the loss is reasonably estimable. Assessing probability of loss and estimating probable losses requires analysis of multiple factors, including in some cases judgments about the potential actions of third-party claimants and courts.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. Our market risk exposure is primarily a result of fluctuations in interest rates and foreign currency exchange rates. We do not hold or issue financial instruments for trading purposes.

*Foreign Currency Exchange Risk.* The functional currency of our foreign subsidiaries is generally the applicable local currency. Our consolidated financial statements are presented in U.S. dollars. Therefore, the net revenue, expenses, assets, and liabilities of our foreign subsidiaries are translated from their functional currencies into U.S. dollars. Fluctuations in the value of the U.S. dollar affect the reported amounts of net revenue, expenses, assets, and liabilities. Foreign exchange differences which arise on translation of our foreign subsidiaries' balance sheets into U.S. dollars are recorded as a foreign currency translation adjustment in accumulated other comprehensive income or loss within stockholders' equity.

We also have exposure to changes in foreign exchange rates associated with transactions which are undertaken by our subsidiaries in currencies other than their functional currency. Such transactions include intercompany transactions and inventory purchases denominated in currencies other than the functional currency of the purchasing entity. As a result, we have been impacted by changes in exchange rates and may be impacted for the foreseeable future. The potential impact of currency fluctuation increases as our international expansion increases.

We currently generate a significant portion of our net revenue and incur a significant portion of our expenses in Canada. We also hold a significant portion of our net assets in Canada. The reporting currency for our consolidated financial statements is the U.S. dollar. A weakening of the U.S. dollar against the Canadian dollar results in:

- an increase in our net revenue upon translation of the sales made by our Canadian operations into U.S. dollars for the purposes of consolidation;
- an increase in our selling, general and administrative expenses incurred by our Canadian operations upon translation into U.S. dollars for the purposes of consolidation; and
- foreign exchange revaluation losses by our Canadian subsidiaries on U.S. dollar cash and receivables denominated in U.S. dollars.

During fiscal 2016, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$41.7 million reduction in accumulated other comprehensive loss within stockholders' equity. During fiscal 2015, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$63.2 million increase in accumulated other comprehensive loss within stockholders' equity.

A 10% appreciation in the relative value of the U.S. dollar against the Canadian dollar compared to the exchange rates in effect for fiscal 2016 would have resulted in additional income from operations of approximately \$0.2 million in fiscal 2016. This assumes a consistent 10% appreciation in the U.S. dollar against the Canadian dollar throughout the fiscal year. The timing of changes in the relative value of the U.S. dollar combined with the seasonal nature of our business, can affect the magnitude of the impact that fluctuations in foreign exchange rates have on our income from operations.

We have not historically hedged foreign currency fluctuations. However, in the future, in an effort to mitigate these risks, we may at times enter into derivative financial instruments, although we have not historically done so. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

*Interest Rate Risk.* Our revolving credit facility, which is described in Note 8 to the consolidated financial statements included in Item 8 of Part II of this report, provide us with available borrowings in an amount up to \$150.0 million in the aggregate. Because our revolving credit facility bears interest at a variable rate, we will be exposed to market risks relating to changes in interest rates, if we have a meaningful outstanding balance. As of January 29, 2017, aside from letters of credit of \$0.8 million, we had no other borrowings outstanding under this credit facility. We currently do not engage in any interest rate hedging activity and currently have no intention to do so. However, in the future, if we have a meaningful outstanding balance under our revolving facility, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. These may take the form of forward contracts, option contracts, or interest rate swaps. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

### **Inflation**

Inflationary factors such as increases in the cost of our product and overhead costs may adversely affect our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of gross margin and selling, general and administrative expenses as a percentage of net revenue if the selling prices of our products do not increase with these increased costs.