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chapter **1** Page 2

# Financial Statements and Business Decisions

**L**e-Nature's Inc. designed its business strategy to ride the growing wave of interest in non-carbonated beverages. And its financial statements reported growth in sales from \$156 to \$275 million in just three years. How did this small family-run business compete with the likes of Coke and Pepsi in this growing market? The business press suggested the first key to its success was manufacturing a broad range of products that fit into the fastest growing “healthy” segments: flavored waters, teas, and fruit drinks. Founder and CEO Gregory Podlucky said that an obsessive drive for quality and efficiency was just as critical. Matching customers’ concerns for the environment and healthy living, Le-Nature's was praised as one of the first companies to switch to environmentally friendlier PET plastic bottles and to employ safe in-bottle pasteurization. Its 21st-century manufacturing operation in Latrobe, Pennsylvania, produced everything that goes into its products, from the injection-molded PET bottles to the final packaging. Complete control over the whole process assures quality and provides the flexibility to respond quickly to changes in customers’ demands. When convenience stores moved to larger-sized drinks or school cafeterias switched from carbonated beverages to healthier drinks, Le-Nature's could change its production to meet the customers’ needs. In August, the company opened a second new state-of-the-art manufacturing facility in Arizona to meet the apparent growing demand.

But here is the twist: Just three short months later, investigators discovered that Le-Nature's phenomenal sales growth was more fiction than fact. How could this seeming success story portrayed in the financial statements really be one of the most remarkable frauds in history?

Chapter 1 concentrates on the key financial statements that businesspeople rely upon when they evaluate a company's performance, and the importance of the accuracy of financial statements in making our economic system work. We will discuss these issues in the context of Le-Nature's rise and fall.

Accounting knowledge will be valuable to you only if you can apply it in the real world. Learning is also easier when it takes place in real contexts. So at the beginning of each chapter we always provide some background about the business that will provide the context for the chapter discussion.

## Learning Objectives

**After studying this chapter, you should be able to:**

- 1-1** Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers). p. 4
- 1-2** Identify the role of generally accepted accounting principles (GAAP) in determining financial statement content and how companies ensure the accuracy of their financial statements. p. 16

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FOCUS COMPANY:

**Le-Nature's Inc.**

USING FINANCIAL STATEMENT  
INFORMATION TO MANAGE  
GROWTH

## UNDERSTANDING THE BUSINESS

Le-Nature's Inc., our focus company for this chapter, was founded by Gregory Podlucky and his brother Jonathan, who initially were the sole owners or **stockholders** of the company. They were also the managers of the company. Using expertise gained working at their parents' brewery (Stoney's Beer), the brothers were early believers in the trend toward healthier noncarbonated beverages. Like most entrepreneurs, their growth ambitions quickly outpaced their own financial resources. So they

turned to banks, including Wells Fargo Bank and other lenders, to finance additional manufacturing facilities and equipment. Different units of Wells Fargo continued to arrange lending to Le-Nature's as the need arose, becoming its largest lender or **creditor**. Creditors make money on the loans by charging **interest**. The Podlucky's also convinced others to buy stock in Le-Nature's. These individuals became part owners or stockholders along with the Podlucky's. They hoped to receive a portion of what the company earned in the form of cash payments called **dividends** and to eventually sell their share of the company at a higher price than they paid. Creditors are more willing to lend and stock prices usually rise when creditors and investors expect the company to do well in the future. Both groups often judge future performance based on information in the company's financial statements.

## The Accounting System

Managers (often called **internal decision makers**) need information about the company's business activities to manage the operating, investing, and financing activities of the firm. Stockholders and creditors (often called **external decision makers**) need information about these same business activities to assess whether the company will be able to pay back its debts with interest and pay dividends. All businesses must have an **accounting system** that collects and processes financial information about an organization's business activities and reports that information to decision makers. Le-Nature's **business activities** included:

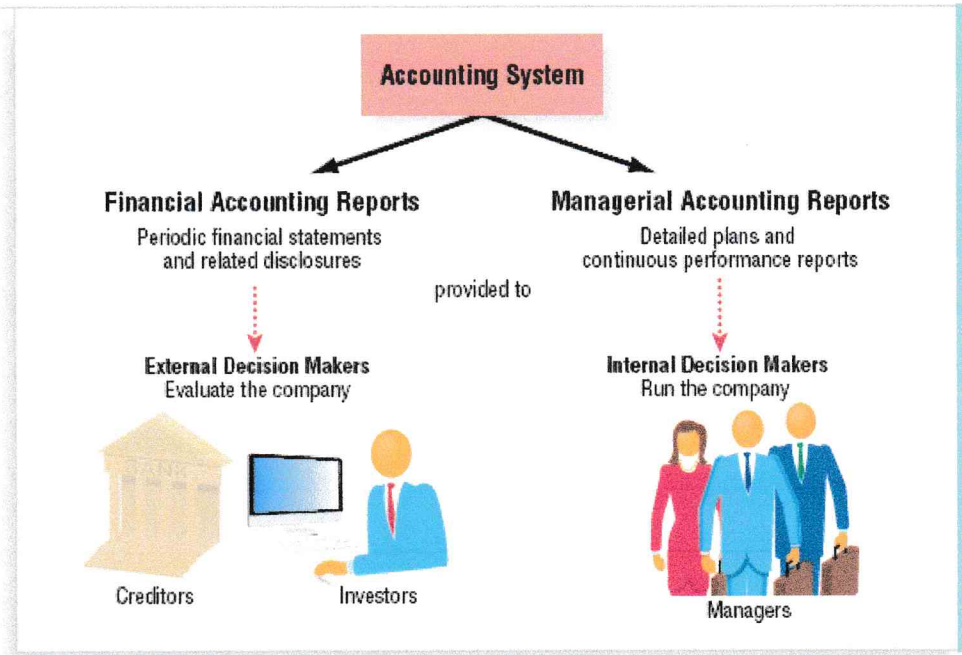
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### EXHIBIT 1.1

The Accounting System and Decision Makers



**ACCOUNTING** is a system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.

#### LEARNING OBJECTIVE 1-1

Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).

- **Financing Activities:** borrowing or paying back money to lenders and receiving additional funds from stockholders or paying them dividends.
- **Investing Activities:** buying or selling items such as plant and equipment used in the production of beverages.
- **Operating Activities:** the day-to-day process of purchasing raw tea and other ingredients from suppliers, manufacturing beverages, delivering them to customers, collecting cash from customers, and paying suppliers.

Exhibit 1.1 outlines the two parts of the accounting system. Internal managers typically require continuous, detailed information because they must plan and manage the day-to-day operations of the organization. Developing accounting information for internal decision makers, called managerial or **management accounting**, is the subject of a separate accounting course. The focus of this text is accounting for external decision makers, called **financial accounting**, and the four basic financial statements and related disclosures that are periodically produced by that system.

## Why Study Financial Accounting?

No matter what your business career goals, you can't get away from financial accounting. You may want to work for an investment firm, a bank, or an accounting firm that would be involved in the financing of companies like Le-Nature's. We will focus much of our discussion on the perspectives of **investors, creditors, and preparers** of financial statements. However, you might not be aware that managers within the firm also make direct use of financial statements. For example, **marketing managers** and **credit managers** use customers' financial statements to decide whether to extend credit to their customers. **Supply chain managers**

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analyze suppliers' financial statements to see whether the suppliers have the resources to meet demand and invest in future development. Both the employees' unions and company **human resource managers** use financial statements as a basis for contract negotiations over pay rates. Financial statement figures even serve as a basis for calculating employee bonuses. Regardless of the functional area of management in which you are employed, you will use financial statement data.

**Page 5**

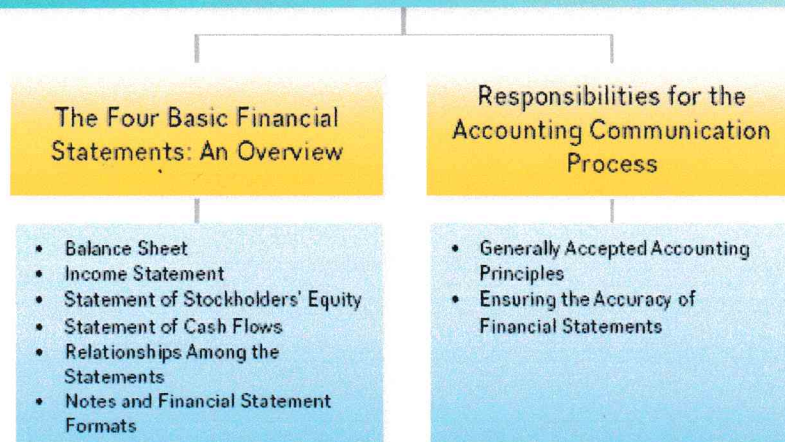
We begin with a brief but comprehensive overview of the information reported in the four basic financial statements and the people and organizations involved in their preparation and use. This overview provides a context in which you can learn the more detailed material presented in the chapters that follow. Then we will discuss the parties that are responsible for the accuracy of financial statements as well as the consequences of misstated financial statements. Le-Nature's stockholders and creditors used its financial statements to learn more about the company before making their investment and lending decisions. In doing so, they assumed that the statements accurately represented Le-Nature's financial condition.

## Your Goals for Chapter 1

To understand the way in which creditors and stockholders used Le-Nature's financial statements, we must first understand what specific information is presented in the four basic financial statements for a company such as Le-Nature's. **PLEASE NOTE: Rather than trying to memorize the definitions of every term used in this chapter, try to focus your attention on learning the general content, structure, and use of the statements. Specifically:**

- **Content:** the categories of items (often called **elements**) reported on each of the four statements.
- **Structure:** the equation that shows how the elements within the statement are organized and related.
- **Use:** how the information is used in stockholders' or creditors' decisions.

The Pause for Feedback–Self-Study Quizzes at key points in the chapter will help you assess whether you have reached these goals. Remember that since this chapter is an overview, each concept discussed here will be discussed again in Chapters 2 through 5.

**ORGANIZATION** of the Chapter

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## THE FOUR BASIC FINANCIAL STATEMENTS: AN OVERVIEW

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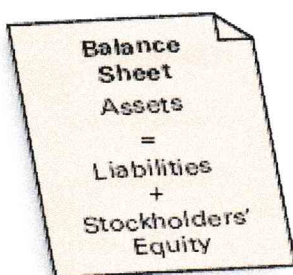
Four financial statements are normally prepared by profit-making organizations for use by investors, creditors, and other external decision makers.

1. On its **balance sheet**, Le-Nature's reports the economic resources it owns and the sources of financing for those resources.
2. On its **income statement**, Le-Nature's reports its ability to sell goods for more than their cost to produce and sell.
3. On its **statement of stockholders' equity**, Le-Nature's reports additional contributions or payments to investors and the amount of income the company reinvested for future growth.
4. On its **statement of cash flows**, Le-Nature's reports its ability to generate cash and how it was used.

The four basic statements can be prepared at any point in time (such as the end of the year, quarter, or month) and can apply to any time span (such as one year, one quarter, or one month). Like most companies, Le-Nature's prepared financial statements for external users (investors and creditors) at the end of each quarter (known as **quarterly reports**) and at the end of the year (known as **annual reports**).

## The Balance Sheet

A **BALANCE SHEET** (Statement of Financial Position) reports the amount of assets, liabilities, and stockholders' equity of an accounting entity at a point in time.



The purpose of the **balance sheet** is to report the financial position (amount of assets, liabilities, and stockholders' equity) of an accounting entity at a particular point in time. We can learn a great deal about what the balance sheet reports just by reading the statement from the top. The balance sheet Le-Nature's Inc. presented to creditors and stockholders is shown in Exhibit 1.2.

### Structure

Notice that the **heading** specifically identifies four significant items related to the statement:

1. **Name of the entity**, Le-Nature's Inc.

2. **Title of the statement**, Balance Sheet.
3. **Specific date of the statement**, At December 31, 2012.
4. **Unit of measure** (in millions of dollars).

An **ACCOUNTING ENTITY** is the organization for which financial data are to be collected.

The organization for which financial data are to be collected, called an **accounting entity**, must be precisely defined. On the balance sheet, the business entity itself, not the business owners, is viewed as owning the resources it uses and as owing its debts. The heading of each statement indicates the time dimension of the report. The balance sheet is like a financial snapshot indicating the entity's financial position at a specific point in time—in this case, December 31, 2012—which is stated clearly on the balance sheet. Financial reports are normally denominated in the currency of the country in which they are located. U.S. companies report in U.S. dollars, Canadian companies in Canadian dollars, and Mexican companies in Mexican pesos. Le-Nature's statements report in millions of dollars. That is, they round the last six digits to the nearest **million** dollars. The listing of Cash \$10.6 on Le-Nature's balance sheet actually means \$10,600,000.

**BASIC ACCOUNTING EQUATION** (Balance Sheet Equation): Assets = Liabilities + Stockholders' Equity

Notice that Le-Nature's balance sheet has three major captions: assets, liabilities, and stockholders' equity. The **basic accounting equation**, often called the balance sheet equation, explains their relationship:

<b>Assets</b>	<b>=</b>	<b>Liabilities</b>	<b>+</b>	<b>Stockholders' Equity</b>
Economic resources (e.g., cash, inventory, buildings)		Financing from creditors (e.g., amounts owed to suppliers, employees, banks)		Financing from stockholders (e.g., common stock, retained earnings)

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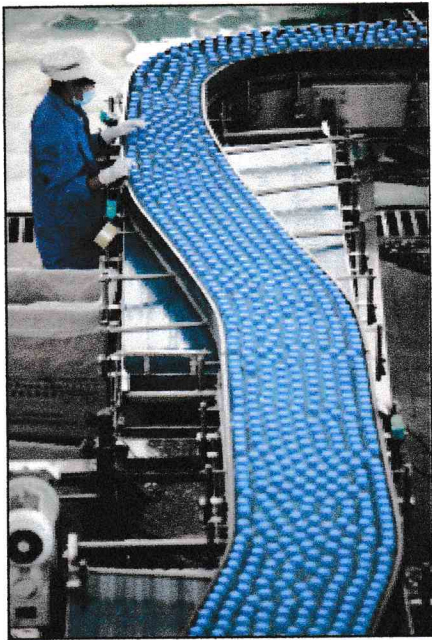
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LE-NATURE'S INC. Balance Sheet At December 31, 2012 (in millions of dollars)	EXPLANATION	EXHIBIT 1.2
	<i>Name of the entity</i>	
	<i>Title of the statement</i>	
	<i>Specific date of the statement</i>	
	<i>Unit of measure</i>	Balance Sheet*
<b>Assets:</b>	<b>Resources controlled by the company</b>	<b>LE-NATURE'S</b>
Cash	<i>Amount of cash in the company's bank accounts</i>	
Accounts receivable	<i>Amounts owed by customers from prior sales</i>	
Inventories	<i>Ingredients and beverages ready for sale</i>	
Property, plant, and equipment	<i>Factories, production equipment, and land</i>	
<b>Total assets</b>	<b>Total amount of company's resources</b>	
	<b>Sources of financing for company's resources</b>	
<b>Liabilities and stockholders' equity:</b>	<b>Sources of financing for company's resources</b>	
<b>Liabilities</b>	<i>Financing supplied by creditors</i>	
Accounts payable	<i>Amounts owed to suppliers for prior purchases</i>	
Notes payable to banks	<i>Amounts owed to banks on written debt contracts</i>	
<b>Total liabilities</b>		
<b>Stockholders' equity</b>	<i>Financing provided by stockholders</i>	
Common stock	<i>Amounts invested in the business by stockholders</i>	
Retained earnings	<i>Past earnings not distributed to stockholders</i>	
<b>Total stockholders' equity</b>		
<b>Total liabilities and stockholders' equity</b>	<b>Total sources of financing for company's resources</b>	
<i>The notes are an integral part of these financial statements.</i>		

The basic accounting equation shows what we mean when we refer to a company's **financial position**: the economic resources that the company owns and the sources of financing for those resources.

## Elements



**Assets** are the economic resources owned by the entity. Le-Nature's lists four items under the category Assets. The exact items listed as assets on a company's balance sheet depend on the nature of its operations. But these are common names used by many companies. The four items listed by Le-Nature's are the economic resources needed to manufacture and sell beverages to retailers and vending companies. Each of these economic resources is expected to provide future benefits to the firm. To prepare to manufacture the beverages, Le-Nature's first needed cash to purchase land on which to build factories and install production machinery (property, plant, and equipment). Le-Nature's then began purchasing ingredients and producing beverages, which led to the balance assigned to inventories. When Le-Nature's sells its beverages to grocery stores and others, it sells them on credit and receives promises to pay called accounts receivable, which are collected in cash later.

Every asset on the balance sheet is initially measured at the total cost incurred to acquire it. Balance sheets do not generally show the amounts for which the assets could currently be sold.

Liabilities and stockholders' equity are the sources of financing for the company's economic resources. **Liabilities** indicate the amount of financing provided by creditors. They are the company's debts or obligations. Under the category Liabilities, Le-Nature's lists two items. The accounts payable arise from the purchase of goods

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**E1-13**

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**Focus on Cash Flows: Matching Cash Flow Statement Items to Categories**

**LO1-1**

The following items were taken from a recent cash flow statement. Note that different companies use slightly different titles for the same item. Without referring to Exhibit 1.5, mark each item in the list as a cash flow from operating activities (O), investing activities (I), or financing activities (F). Also place parentheses around the letter only if it is a cash outflow.

- \_\_\_ (1) Purchases of property, plant, and equipment
- \_\_\_ (2) Cash received from customers
- \_\_\_ (3) Cash paid for dividends to stockholders
- \_\_\_ (4) Cash paid to suppliers
- \_\_\_ (5) Income taxes paid
- \_\_\_ (6) Cash paid to employees
- \_\_\_ (7) Cash proceeds received from sale of investment in another company
- \_\_\_ (8) Repayment of borrowings

To practice with more exercises, go to the text website at [www.mhhe.com/libby8e](http://www.mhhe.com/libby8e).

PROBLEMS



**P1-1**

**Preparing an Income Statement, Statement of Stockholders' Equity, and Balance Sheet (AP1-1)**

**LO1-1** → Appendix ~~A~~ A-1



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Assume that you are the president of Highlight Construction Company. At the end of the first year (December 31, 2014) of operations, the following financial data for the company are available:

Cash	\$ 25,600
Receivables from customers (all considered collectible)	10,800
Inventory of merchandise (based on physical count and priced at cost)	81,000
Equipment owned, at cost less used portion	42,000
Accounts payable owed to suppliers	46,140
Salary payable for 2014 (on December 31, 2014, this was owed to an employee who was away because of an emergency; will return around January 10, 2015, at which time the payment will be made)	2,520
Total sales revenue	128,400
Expenses, including the cost of the merchandise sold (excluding income taxes)	80,200
Income taxes expense at 30% $\times$ pretax income; all paid during 2014	?
Common stock (December 31, 2014)	87,000
Dividends declared and paid during 2014	10,000
(Note: The beginning balances in Common stock and Retained earnings are zero because it is the first year of operations.)	

**Required:**

Using the financial statement exhibits in the chapter as models and showing computations:

1. Prepare a summarized income statement for the year 2014.
2. Prepare a statement of stockholders' equity for the year 2014.
3. Prepare a balance sheet at December 31, 2014.

**P1-2****Analyzing a Student's Business and Preparing an Income Statement (AP1-2)****LO1-1**

During the summer between his junior and senior years, James Cook needed to earn sufficient money for the coming academic year. Unable to obtain a job with a reasonable salary, he decided to try the lawn care business for three months. After a survey of the market potential, James bought a used pickup truck on June 1 for \$1,800. On each door he painted "James Cook Lawn Service, Phone 471-4487." He also spent \$900 for mowers, trimmers, and tools. To acquire these items, he borrowed \$3,000 cash by signing a note payable promising to pay the \$3,000 plus interest of \$78 at the end of the three months (ending August 31).

At the end of the summer, James realized that he had done a lot of work, and his bank account looked good. This fact prompted him to become concerned about how much profit the business had earned.

A review of the check stubs showed the following: Bank deposits of collections from customers totaled \$15,000. The following checks had been written: gas, oil, and lubrication, \$1,050; pickup repairs, \$250; mower repair, \$110; miscellaneous supplies used, \$80; helpers, \$5,400; payroll taxes, \$190; payment for assistance in preparing payroll tax forms, \$25; insurance, \$125; telephone, \$110; and \$3,078 to pay off the note including interest (on August 31). A notebook kept in the pickup, plus some unpaid

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## APPENDIX A Page A-1

**TABLE A.1** Present Value of \$1

Periods	2%	3%	3.75%	4%	4.25%	5%	6%	7%	8%
1	0.9804	0.9709	0.9639	0.9615	0.9592	0.9524	0.9434	0.9346	0.9259
2	0.9612	0.9426	0.9290	0.9246	0.9201	0.9070	0.8900	0.8734	0.8573
3	0.9423	0.9151	0.8954	0.8890	0.8826	0.8638	0.8396	0.8163	0.7938
4	0.9238	0.8885	0.8631	0.8548	0.8466	0.8227	0.7921	0.7629	0.7350
5	0.9057	0.8626	0.8319	0.8219	0.8121	0.7835	0.7473	0.7130	0.6806
6	0.8880	0.8375	0.8018	0.7903	0.7790	0.7462	0.7050	0.6663	0.6302
7	0.8706	0.8131	0.7728	0.7599	0.7473	0.7107	0.6651	0.6227	0.5835
8	0.8535	0.7894	0.7449	0.7307	0.7168	0.6768	0.6274	0.5820	0.5403
9	0.8368	0.7664	0.7180	0.7026	0.6876	0.6446	0.5919	0.5439	0.5002
10	0.8203	0.7441	0.6920	0.6756	0.6595	0.6139	0.5584	0.5083	0.4632
20	0.6730	0.5537	0.4789	0.4564	0.4350	0.3769	0.3118	0.2584	0.2145
Periods	9%	10%	11%	12%	13%	14%	15%	20%	25%
1	0.9174	0.9091	0.9009	0.8929	0.8850	0.8772	0.8696	0.8333	0.8000
2	0.8417	0.8264	0.8116	0.7972	0.7831	0.7695	0.7561	0.6944	0.6400
3	0.7722	0.7513	0.7312	0.7118	0.6931	0.6750	0.6575	0.5787	0.5120
4	0.7084	0.6830	0.6587	0.6355	0.6133	0.5921	0.5718	0.4823	0.4096
5	0.6499	0.6209	0.5935	0.5674	0.5428	0.5194	0.4972	0.4019	0.3277
6	0.5963	0.5645	0.5346	0.5066	0.4803	0.4556	0.4323	0.3349	0.2621
7	0.5470	0.5132	0.4817	0.4523	0.4251	0.3996	0.3759	0.2791	0.2097
8	0.5019	0.4665	0.4339	0.4039	0.3762	0.3506	0.3269	0.2326	0.1678
9	0.4604	0.4241	0.3909	0.3606	0.3329	0.3075	0.2843	0.1938	0.1342
10	0.4224	0.3855	0.3522	0.3220	0.2946	0.2697	0.2472	0.1615	0.1074
20	0.1784	0.1486	0.1240	0.1037	0.0868	0.0728	0.0611	0.0261	0.0115

**TABLE A.2** Present Value of Annuity of \$1

Periods*	2%	3%	3.75%	4%	4.25%	5%	6%	7%	8%
1	0.9804	0.9709	0.9639	0.9615	0.9592	0.9524	0.9434	0.9346	0.9259
2	1.9416	1.9135	1.8929	1.8861	1.8794	1.8594	1.8334	1.8080	1.7833
3	2.8839	2.8286	2.7883	2.7751	2.7620	2.7232	2.6790	2.6243	2.5771
4	3.8077	3.7171	3.6514	3.6299	3.6086	3.5460	3.4651	3.3872	3.3121
5	4.7135	4.5797	4.4833	4.4518	4.4207	4.3295	4.2124	4.1002	3.9927
6	5.6014	5.4172	5.2851	5.2421	5.1997	5.0757	4.9173	4.7665	4.6229
7	6.4720	6.2303	6.0579	6.0021	5.9470	5.7864	5.5824	5.3893	5.2064
8	7.3255	7.0197	6.8028	6.7327	6.6638	6.4632	6.2098	5.9713	5.7466
9	8.1622	7.7861	7.5208	7.4353	7.3513	7.1078	6.8017	6.5152	6.2469
10	8.9826	8.5302	8.2128	8.1109	8.0109	7.7217	7.3601	7.0236	6.7101
20	16.3514	14.8775	13.8962	13.5903	13.2944	12.4622	11.4699	10.5940	9.8181

\*There is one payment each period.

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Periods*	9%	10%	11%	12%	13%	14%	15%	20%	25%
1	0.9174	0.9091	0.9009	0.8929	0.8550	0.8772	0.8696	0.8333	0.8000
2	1.7591	1.7355	1.7125	1.6901	1.6681	1.6467	1.6257	1.5278	1.4400
3	2.5313	2.4869	2.4437	2.4018	2.3612	2.3216	2.2832	2.1065	1.9520
4	3.2397	3.1699	3.1024	3.0373	2.9745	2.9137	2.8550	2.5887	2.3616
5	3.8897	3.7908	3.6959	3.6048	3.5172	3.4331	3.3522	2.9906	2.6893
6	4.4859	4.3553	4.2305	4.1114	3.9975	3.8887	3.7845	3.3255	2.9514
7	5.0330	4.8684	4.7122	4.5638	4.4226	4.2883	4.1604	3.6046	3.1611
8	5.5348	5.3349	5.1461	4.9676	4.7988	4.6389	4.4873	3.8372	3.3289
9	5.9952	5.7590	5.5370	5.3282	5.1317	4.9464	4.7716	4.0310	3.4631
10	6.4177	6.1446	5.8892	5.6502	5.4262	5.2161	5.0188	4.1925	3.5705
20	9.1285	8.5136	7.9633	7.4694	7.0248	6.6231	6.2593	4.8696	3.9539

\*There is one payment each period.

TABLE A.3 Future Value of \$1

Periods	2%	3%	3.75%	4%	4.25%	5%	6%	7%	8%
0	1.	1.	1.	1.	1.	1.	1.	1.	1.
1	1.02	1.03	1.0375	1.04	1.0425	1.05	1.06	1.07	1.08
2	1.0404	1.0609	1.0764	1.0816	1.0868	1.1025	1.1236	1.1449	1.1664
3	1.0612	1.0927	1.1168	1.1249	1.1330	1.1576	1.1910	1.2250	1.2597
4	1.0824	1.1255	1.1587	1.1699	1.1811	1.2155	1.2625	1.3108	1.3605
5	1.1041	1.1593	1.2021	1.2167	1.2313	1.2763	1.3382	1.4026	1.4693
6	1.1262	1.1941	1.2472	1.2653	1.2837	1.3401	1.4185	1.5007	1.5869
7	1.1487	1.2299	1.2939	1.3159	1.3382	1.4071	1.5036	1.6058	1.7138
8	1.1717	1.2668	1.3425	1.3686	1.3951	1.4775	1.5938	1.7182	1.8509
9	1.1951	1.3048	1.3928	1.4233	1.4544	1.5513	1.6895	1.8385	1.9990
10	1.2190	1.3439	1.4450	1.4802	1.5162	1.6289	1.7908	1.9672	2.1589
20	1.4859	1.8061	2.0882	2.1911	2.2989	2.6533	3.2071	3.8697	4.6610

Periods	9%	10%	11%	12%	13%	14%	15%	20%	25%
0	1.	1.	1.	1.	1.	1.	1.	1.	1.
1	1.09	1.10	1.11	1.12	1.13	1.14	1.15	1.20	1.25
2	1.1881	1.2100	1.2321	1.2544	1.2769	1.2996	1.3225	1.4400	1.5625
3	1.2950	1.3310	1.3676	1.4049	1.4429	1.4815	1.5209	1.7280	1.9531
4	1.4116	1.4641	1.5181	1.5735	1.6305	1.6890	1.7490	2.0736	2.4414
5	1.5386	1.6105	1.6851	1.7623	1.8424	1.9254	2.0114	2.4883	3.0518
6	1.6771	1.7716	1.8704	1.9738	2.0820	2.1950	2.3131	2.9660	3.8147
7	1.8280	1.9487	2.0762	2.2107	2.3526	2.5023	2.6600	3.5832	4.7684
8	1.9926	2.1436	2.3045	2.4760	2.6584	2.8526	3.0590	4.2998	5.9605
9	2.1719	2.3579	2.5580	2.7731	3.0040	3.2519	3.5179	5.1598	7.4506
10	2.3674	2.5937	2.8394	3.1058	3.3946	3.7072	4.0456	6.1917	9.3132
20	5.6044	6.7275	8.0623	9.6463	11.5231	13.7435	16.3665	38.3376	86.7362

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**TABLE A.4** Future Value of Annuity of \$1

**Page A-3**

Periods*	2%	3%	3.75%	4%	4.25%	5%	6%	7%	8%
1	1.	1.	1.	1.	1.	1.	1.	1.	1.
2	2.02	2.03	2.0375	2.04	2.0425	2.05	2.06	2.07	2.08
3	3.0604	3.0909	3.1139	3.1216	3.1293	3.1525	3.1836	3.2149	3.2464
4	4.1216	4.1836	4.2307	4.2465	4.2623	4.3101	4.3746	4.4399	4.5061
5	5.2040	5.3091	5.3893	5.4163	5.4434	5.5256	5.6371	5.7507	5.8666
6	6.3081	6.4684	6.5914	6.6330	6.6748	6.8019	6.9753	7.1533	7.3359
7	7.4343	7.6625	7.8386	7.8983	7.9585	8.1420	8.3938	8.6540	8.9228
8	8.5830	8.8923	9.1326	9.2142	9.2967	9.5491	9.8975	10.2598	10.6366
9	9.7546	10.1591	10.4750	10.5828	10.6918	11.0266	11.4913	11.9780	12.4876
10	10.9497	11.4639	11.8678	12.0061	12.1462	12.5779	13.1908	13.8164	14.4866
20	24.2974	26.8704	29.0174	29.7781	30.5625	33.0660	36.7856	40.9955	45.7620
Periods*	9%	10%	11%	12%	13%	14%	15%	20%	25%
1	1.	1.	1.	1.	1.	1.	1.	1.	1.
2	2.09	2.10	2.11	2.12	2.13	2.14	2.15	2.20	2.25
3	3.2781	3.3100	3.3421	3.3744	3.4069	3.4396	3.4725	3.6400	3.8125
4	4.5731	4.6410	4.7097	4.7793	4.8498	4.9211	4.9934	5.3680	5.7656
5	5.9847	6.1051	6.2278	6.3528	6.4803	6.6101	6.7424	7.4416	8.2070
6	7.5233	7.7156	7.9129	8.1152	8.3227	8.5355	8.7537	9.9299	11.2588
7	9.2004	9.4872	9.7833	10.0890	10.4047	10.7305	11.0668	12.9159	15.0735
8	11.0285	11.4359	11.8594	12.2997	12.7573	13.2328	13.7268	16.4991	19.8419
9	13.0210	13.5975	14.1640	14.7757	15.4157	16.0853	16.7858	20.7989	25.8023
10	15.1929	15.9374	16.7220	17.5487	18.4197	19.3373	20.3037	25.9587	33.2529
20	51.1601	57.2750	64.2028	72.0524	80.9468	91.0249	102.4436	186.6880	342.9447

\*There is one payment each period.

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Are its financial statements audited by independent CPAs? How do you know?

- Did its total assets increase or decrease over the last year?
- How much inventory (in dollars) did the company have as of January 28, 2012 (accountants would call this the ending balance)?

• Write out the basic accounting (balance sheet) equation and provide the values in dollars reported by the company as of January 28, 2012.

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## CP1-2

### Finding Financial Information

#### LO1-1

Refer to the financial statements of Urban Outfitters in Appendix C at the end of this book.



Appendix C next page

*Required:*

1. What is the amount of net income for the most recent year?
2. What amount of revenue was earned in the most recent year?
3. How much inventory (in dollars) does the company have as of January 31, 2012?
4. By what amount did cash and cash equivalents\* change during the most recent year?
5. Who is the auditor for the company?

## CP1-3

### Comparing Companies within an Industry

#### LO1-1

Refer to the financial statements of American Eagle Outfitters in Appendix B and Urban Outfitters in Appendix C.



*Required:*

1. Total assets is a common measure of the size of a company. Which company had the higher total assets at the end of the most recent year? (**Note: Some companies will label a year that has a January year-end as having a fiscal year-end dated one year earlier. For example, a January 2012 year-end may be labeled as Fiscal 2011 since the year actually has more months that fall in the 2011 calendar year than in the 2012 calendar year.**)



2. Net sales is also a common measure of the size of a company. Which company had the higher net sales for the most recent year?



3. Growth during a period is calculated as:

$$\frac{\text{Ending amount} - \text{Beginning amount}}{\text{Beginning amount}} \times 100 = \text{Growth rate}$$

Which company had the highest growth in total assets during the most recent year? Which company had the highest growth in net sales during the most recent year?

### Financial Reporting and Analysis Cases

#### CP1-4

#### Using Financial Reports: Identifying and Correcting Deficiencies in an Income Statement and Balance Sheet

#### LO1-1

Performance Corporation was organized on January 1, 2012. At the end of 2012, the company had not yet employed an accountant; however, an employee who was “good with numbers” prepared the following statements at that date:

<b>PERFORMANCE CORPORATION</b>	
<b>December 31, 2012</b>	
Income from sales of merchandise	\$180,000
Total amount paid for goods sold during 2012	(90,000)
Selling costs	(25,000)
Depreciation (on service vehicles used)	(12,000)
Income from services rendered	52,000
Salaries and wages paid	(62,000)

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## APPENDIX C

Page C-1

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, DC 20549

**FORM 10-K**

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended January 31, 2012
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File No. 000-22754

**URBAN OUTFITTERS, INC.**

(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania  
(State or Other Jurisdiction of  
Incorporation or Organization)

5000 South Broad Street, Philadelphia, PA  
(Address of Principal Executive Offices)

23-2003332  
(I.R.S. Employer  
Identification No.)

19112-1495  
(Zip Code)

Registrant's telephone number, including area code: (215) 454-5500  
Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Exchange on Which Registered
Common Shares, \$.0001 par value	The NASDAQ Global Select Market LLC
Securities registered pursuant to Section 12(g) of the Act: None	

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by a check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter, was \$3,956,641,654.

The number of shares outstanding of the registrant's common stock on March 27, 2012, was 144,706,907.

**DOCUMENTS INCORPORATED BY REFERENCE**

Certain information required by Items 10, 11, 12, 13 and 14 is incorporated by reference into Part III hereof from portions of the Proxy Statement for the registrant's 2012 Annual Meeting of Shareholders.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM****Page C-2**

To the Board of Directors and Shareholders of  
Urban Outfitters, Inc.  
Philadelphia, Pennsylvania

We have audited the accompanying consolidated balance sheets of Urban Outfitters, Inc., and subsidiaries (the "Company") as of January 31, 2012, and 2011, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended January 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Urban Outfitters, Inc., and subsidiaries as of January 31, 2012, and 2011, and the results of their operations and their cash flows for each of the three years in the period ended January 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of January 31, 2012, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 2, 2012, expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Philadelphia, Pennsylvania  
April 2, 2012

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**Page C-3**

**URBAN OUTFITTERS, INC.**  
**Consolidated Balance Sheets**  
(in thousands, except share and per share data)

	<u>January 31,</u>	
	<u>2012</u>	<u>2011</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 145,273	\$ 340,257
Marketable securities	89,854	116,420
Accounts receivable, net of allowance for doubtful accounts of \$1,614 and \$1,015, respectively	36,673	36,502
Inventories	250,073	229,561
Prepaid expenses and other current assets	69,876	66,886
Deferred taxes	5,243	14,351
Total current assets	<u>596,992</u>	<u>803,977</u>
Property and equipment, net	684,979	586,346
Marketable securities	126,913	351,988
Deferred income taxes and other assets	74,824	52,010
Total Assets	<u>\$1,483,708</u>	<u>\$1,794,321</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 95,754	\$ 82,904
Accrued compensation	15,630	20,212
Accrued expenses and other current liabilities	122,082	107,908
Total current liabilities	<u>233,466</u>	<u>211,024</u>
Deferred rent and other liabilities	183,974	171,749
Total Liabilities	<u>417,440</u>	<u>382,773</u>
Commitments and contingencies (see Note 12)		
Shareholders' equity:		
Preferred shares; \$.0001 par value, 10,000,000 shares authorized, none issued	—	—
Common shares; \$.0001 par value, 200,000,000 shares authorized, 144,633,007 and 164,413,427 issued and outstanding, respectively	15	17
Additional paid-in capital	—	27,603
Retained earnings	1,077,765	1,394,190
Accumulated other comprehensive loss	(11,512)	(10,262)
Total Shareholders' Equity	<u>1,066,268</u>	<u>1,411,548</u>
Total Liabilities and Shareholders' Equity	<u>\$1,483,708</u>	<u>\$1,794,321</u>

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

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**URBAN OUTFITTERS, INC.**  
**Consolidated Statements of Income**  
**(in thousands, except share and per share data)**

	Fiscal Year Ended January 31,		
	2012	2011	2010
Net sales	\$ 2,473,801	\$ 2,274,102	\$ 1,937,815
Cost of sales, including certain buying, distribution and occupancy costs	1,613,265	1,337,482	1,151,670
Gross profit	860,536	936,620	786,145
Selling, general and administrative expenses	575,811	522,417	447,161
Income from operations	284,725	414,203	338,984
Interest income	5,120	4,669	6,290
Other income	553	486	463
Other expenses	(1,567)	(2,150)	(1,331)
Income before income taxes	288,831	417,208	344,406
Income tax expense	103,580	144,250	124,513
Net income	<u>\$ 185,251</u>	<u>\$ 272,958</u>	<u>\$ 219,893</u>
Net income per common share:			
Basic	<u>\$ 1.20</u>	<u>\$ 1.64</u>	<u>\$ 1.31</u>
Diluted	<u>\$ 1.19</u>	<u>\$ 1.60</u>	<u>\$ 1.28</u>
Weighted average common shares outstanding:			
Basic	<u>154,025,589</u>	<u>166,896,322</u>	<u>168,053,502</u>
Diluted	<u>156,191,289</u>	<u>170,333,550</u>	<u>171,230,245</u>

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

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**Page C-5**

## URBAN OUTFITTERS, INC.

**Consolidated Statements of Shareholders' Equity**  
(in thousands, except share data)

	Compre- hensive Income	Common Shares			Retained Earnings	Accumulated Other Compre- hensive Loss	Total
		Number of Shares	Par Value	Additional Paid-in Capital			
Balances as of January 31, 2009		167,712,088	\$ 17	\$ 170,166	\$ 901,339	\$ (17,747)	\$1,053,775
Net income	\$219,893	—	—	—	219,893	—	219,893
Foreign currency translation	7,173	—	—	—	—	7,173	7,173
Unrealized gains on marketable securities, net of tax	1,480	—	—	—	—	1,480	1,480
Comprehensive income	<u>\$228,546</u>						
Share-based compensation		—	—	4,766	—	—	4,766
Stock options and awards		846,283	—	3,250	—	—	3,250
Tax effect of share exercises		—	—	6,438	—	—	6,438
Balances as of January 31, 2010		168,558,371	\$ 17	\$ 184,620	\$1,121,232	\$ (9,094)	\$1,296,775
Net income	\$272,958	—	—	—	272,958	—	272,958
Foreign currency translation	(429)	—	—	—	—	(429)	(429)
Unrealized losses on marketable securities, net of tax	(739)	—	—	—	—	(739)	(739)
Comprehensive income	<u>\$271,790</u>						
Share-based compensation		—	—	10,725	—	—	10,725
Stock options and awards		2,256,273	—	24,129	—	—	24,129
Tax effect of share exercises		—	—	12,847	—	—	12,847
Share repurchases		(6,401,217)	—	(204,718)	—	—	(204,718)
Balances as of January 31, 2011		164,413,427	\$ 17	\$ 27,603	\$1,394,190	\$ (10,262)	\$1,411,548
Net income	\$185,251	—	—	—	185,251	—	185,251
Foreign currency translation	(2,285)	—	—	—	—	(2,285)	(2,285)
Unrealized gains on marketable securities, net of tax	1,035	—	—	—	—	1,035	1,035
Comprehensive income	<u>\$184,001</u>						
Share-based compensation		—	—	3,068	—	—	3,068
Stock options and awards		993,923	—	4,134	—	—	4,134
Tax effect of share exercises		—	—	8,995	—	—	8,995
Share repurchases		(20,774,343)	(2)	(43,800)	(501,676)	—	(545,478)
Balances as of January 31, 2012		<u>144,633,007</u>	<u>\$ 15</u>	<u>\$ —</u>	<u>\$1,077,765</u>	<u>\$ (11,512)</u>	<u>\$1,066,268</u>

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

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**URBAN OUTFITTERS, INC.**  
**Consolidated Statements of Cash Flows**  
(in thousands)

	Fiscal Year Ended January 31,		
	2012	2011	2010
Cash flows from operating activities:			
Net income	\$ 185,251	\$ 272,958	\$ 219,893
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	108,112	101,105	92,350
Provision for deferred income taxes	(12,150)	(8,727)	2,161
Excess tax benefit on share-based compensation	(8,995)	(12,847)	(6,438)
Share-based compensation expense	3,068	10,725	4,766
Loss on disposition of property and equipment, net	857	119	339
Changes in assets and liabilities:			
Receivables	(251)	1,835	(1,825)
Inventories	(20,817)	(43,372)	(15,544)
Prepaid expenses and other assets	6,317	14,825	(25,619)
Accounts payable, accrued expenses and other liabilities	21,310	48,492	55,311
Net cash provided by operating activities	<u>282,702</u>	<u>385,113</u>	<u>325,394</u>
Cash flows from investing activities:			
Cash paid for property and equipment	(190,010)	(143,642)	(109,260)
Cash paid for marketable securities	(169,467)	(463,129)	(806,546)
Sales and maturities of marketable securities	414,769	571,236	421,040
Net cash provided by (used in) investing activities	<u>55,292</u>	<u>(35,535)</u>	<u>(494,766)</u>
Cash flows from financing activities:			
Exercise of stock options	4,136	24,129	3,250
Excess tax benefit from stock option exercises	8,995	12,847	6,438
Share repurchases	(545,478)	(204,718)	—
Net cash (used in) provided by financing activities	<u>(532,347)</u>	<u>(167,742)</u>	<u>9,688</u>
Effect of exchange rate changes on cash and cash equivalents	(631)	(603)	2,673
(Decrease) increase in cash and cash equivalents	(194,984)	181,233	(157,011)
Cash and cash equivalents at beginning of period	340,257	159,024	316,035
Cash and cash equivalents at end of period	<u>\$ 145,273</u>	<u>\$ 340,257</u>	<u>\$ 159,024</u>
Supplemental cash flow information:			
Cash paid during the year for:			
Income taxes	<u>\$ 120,847</u>	<u>\$ 121,341</u>	<u>\$ 137,490</u>
Non-cash investing activities—Accrued capital expenditures	<u>\$ 21,955</u>	<u>\$ 8,077</u>	<u>\$ 12,960</u>

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

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## URBAN OUTFITTERS, INC.

**Page C-7**

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in thousands, except share and per share data)

#### 1. Nature of Business

Urban Outfitters, Inc. (the "Company" or "Urban Outfitters"), which was founded in 1970 and originally operated by a predecessor partnership, was incorporated in the Commonwealth of Pennsylvania in 1976. The principal business activity of the Company is the operation of a general consumer product retail and wholesale business selling to customers through various channels including retail stores, nine websites and five catalogs. As of January 31, 2012, and 2011, the Company operated 429 and 372 stores, respectively. Stores located in the United States totaled 381 as of January 31, 2012, and 334 as of January 31, 2011. Operations in Europe and Canada included 33 stores and 15 stores as of January 31, 2012, respectively and 24 stores and 14 stores as of January 31, 2011, respectively. In addition, the Company's wholesale segment sold and distributed apparel to approximately 1,400 better department and specialty retailers worldwide.

#### 2. Summary of Significant Accounting Policies

##### *Fiscal Year-End*

The Company operates on a fiscal year ending January 31 of each year. All references to fiscal years of the Company refer to the fiscal years ended on January 31 in those years. For example, the Company's fiscal 2012 ended on January 31, 2012.

##### *Principles of Consolidation*

The Consolidated Financial Statements include the accounts of Urban Outfitters, Inc., and all of its subsidiaries. All inter-company transactions and accounts have been eliminated in consolidation.

##### *Use of Estimates*

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of net sales and expenses during the reporting period. Actual results could differ from those estimates.

##### *Cash and Cash Equivalents*

Cash and cash equivalents are defined as cash and short-term highly liquid investments with maturities of less than three months at the time of purchase. These short-term highly liquid investments are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. As of January 31, 2012, and 2011, cash and cash equivalents included cash on hand, cash in banks and money market accounts.

##### *Marketable Securities*

All of the Company's marketable securities as of January 31, 2012, and 2011, are classified as available-for-sale and are carried at fair value, which approximates amortized cost. Interest on these securities, as well as the amortization of discounts and premiums, is included in interest income in the Consolidated Statements of Income. Unrealized gains and losses on these securities are considered temporary and therefore are excluded from earnings and are reported in accumulated other comprehensive loss in shareholders' equity until realized. Other than temporary impairment losses related to credit losses are considered to be realized losses. When available-for-sale securities are sold, the cost of the securities is specifically identified and is used to determine the realized gain or loss. Securities classified as current have maturity dates of less than one year from the

balance sheet date. Securities classified as non-current have maturity dates greater than one year from the balance sheet date. Available-for-sale securities, such as Auction Rate Securities ("ARS") that fail at auction and do not liquidate in the normal course, are classified as non-current assets.

The Company's ARS represent interests in municipal and student loan related collateralized debt obligations, all of which are rated "A" or better and are guaranteed by either government agencies and/or insured by private insurance agencies up to 97% or greater of par value. The Company's ARS had a fair value of \$20.2 million as of January 31, 2012, and \$29.5 million as of January 31, 2011. As of and subsequent to the end of the current fiscal year, all of the ARS held by the Company failed to liquidate at auction due to a lack of market demand. Liquidity for these ARS was historically provided by an auction process that resets the applicable interest rate at pre-determined intervals, usually 7, 28, 35 or 90 days. The principal associated with these failed auctions will not be available until a successful auction occurs, the bond is called by the issuer, a buyer is

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found from outside the auction process, or the debt obligation reaches its maturity. Based on review of credit quality, collateralization, final stated maturity, estimates of the probability of being called or becoming illiquid prior to final maturity, redemptions of similar ARS, previous market activity for same investment security, impact due to extended periods of maximum auction rates and valuation models, the Company has recorded \$2.8 million and \$3.8 million of temporary impairment on its ARS as of January 31, 2012, and January 31, 2011, respectively. To date the Company has collected all interest receivable on outstanding ARS when due and has not been informed by the issuers that accrued interest payments are currently at risk. The Company does not have the intent to sell the underlying securities prior to their recovery and the Company believes it is not likely that it will be required to sell the underlying securities prior to their anticipated recovery of full amortized cost. As a result of the current illiquidity, the Company has classified all ARS as non-current assets under marketable securities. The Company continues to monitor the market for ARS and consider the impact, if any, on the fair value of its investments.

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### *Accounts Receivable*

Accounts receivable primarily consists of amounts due from our wholesale customers as well as credit card receivables outstanding with third-party credit card vendors. The activity of the allowance for doubtful accounts for the years ended January 31, 2012, 2011, and 2010 was as follows:

	<u>Balance at beginning of year</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at end of year</u>
Year ended January 31, 2012	\$1,015	3,920	(3,321)	\$1,614
Year ended January 31, 2011	\$1,284	2,397	(2,666)	\$1,015
Year ended January 31, 2010	\$1,229	1,791	(1,736)	\$1,284

### *Inventories*

Inventories, which consist primarily of general consumer merchandise held for sale, are valued at the lower of cost or market. Cost is determined on the first-in, first-out method and includes the cost of merchandise and import related costs, including freight, import taxes and agent commissions. A periodic review of inventory is performed in order to determine if inventory is properly stated at the lower of cost or market. Factors related to current inventories such as future expected consumer demand and fashion trends, current aging, current and anticipated retail markdowns or wholesale discounts, and class or type of inventory are analyzed to determine estimated net realizable value. Criteria utilized by the Company to quantify aging trends include factors such as average selling cycle and seasonality of merchandise, the historical rate at which merchandise has sold below cost during the average selling cycle, and the value and nature of merchandise currently priced below original cost. A provision is recorded to reduce the cost of inventories to the estimated net realizable values, if appropriate. The majority of inventory at January 31, 2012, and 2011 consisted of finished goods. Unfinished goods and work-in-process were not material to the overall net inventory value.

Adjustments to reserves related to the net realizable value of inventories are primarily based on the market value of the Company's physical inventories, cycle counts and recent historical trends. The Company's physical inventories for fiscal 2012 were performed as of June 2011 and January 2012. The Company's estimates generally have been accurate and its reserve methods have been applied on a consistent basis. The Company expects the amount of its reserves and related inventories to increase over time as it expands its store base and increases direct-to-consumer sales.

### *Property and Equipment*

Property and equipment are stated at cost and primarily consist of store-related leasehold improvements, buildings and furniture and fixtures. Depreciation is typically computed using the straight-line method over five years for furniture and fixtures, the lesser of the lease term or useful life for leasehold improvements, three to ten years for other operating equipment and 39 years for buildings. Major renovations or improvements that extend the service lives of our assets are capitalized over the extension period or life of the improvement, whichever is less.

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The Company reviews long-lived assets for possible impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable. This determination includes evaluation of factors such as future asset utilization and future net undiscounted cash flows expected to result from the use of the assets. Management believes there has been no material impairment of the Company's long-lived assets as of January 31, 2012.

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### *Deferred Rent*

Rent expense from leases is recorded on a straight-line basis over the lease period. The net excess of rent expense over the actual cash paid is recorded as deferred rent. In addition, certain store leases provide for contingent rentals when sales exceed specified break-point levels that are weighted based upon historical cyclicity. For leases where achievement of these levels is considered probable based on cumulative lease year revenue versus the established breakpoint at any given point in time, the Company accrues a contingent rent liability and a corresponding rent expense.

### *Operating Leases*

The Company leases its retail stores under operating leases. Many of the lease agreements contain rent holidays, rent escalation clauses and contingent rent provisions or some combination of these items.

The Company recognizes rent expense on a straight-line basis over the lease period commencing on the date that the premise is available from the landlord. The lease period includes the construction period required to make the leased space suitable for operating during which time the Company is not permitted to occupy the space. For purposes of calculating straight-line rent expense, the commencement date of the lease term reflects the date the Company takes possession of the building for initial construction and setup.

The Company classifies tenant improvement allowances in its consolidated financial statements under deferred rent and amortizes them on a straight-line basis over the related lease period. Tenant improvement allowance activity is presented as part of cash flows from operating activities in the accompanying Consolidated Statements of Cash Flows.

### *Revenue Recognition*

Revenue is recognized at the point-of-sale for retail store sales or when merchandise is shipped to customers for wholesale and direct-to-consumer sales, net of estimated customer returns. Revenue is recognized at the completion of a job or service for landscape sales. Revenue is presented on a net basis and does not include any tax assessed by a governmental or municipal authority. Payment for merchandise at stores and through the Company's direct-to-consumer channel is tendered by cash, check, credit card, debit card or gift card. Therefore, the Company's need to collect outstanding accounts receivable for its retail and direct-to-consumer channel is negligible and mainly results from returned checks or unauthorized credit card transactions. The Company maintains an allowance for doubtful accounts for its wholesale and landscape service accounts receivable, which management reviews on a regular basis and believes is sufficient to cover potential credit losses and billing adjustments. Deposits for custom orders are recorded as a liability and recognized as a sale upon delivery of the merchandise to the customer. These custom orders, typically for upholstered furniture, are not material. Deposits for landscape services are recorded as a liability and recognized as a sale upon completion of service. Landscape services and related deposits are not material.

The Company accounts for a gift card transaction by recording a liability at the time the gift card is issued to the customer in exchange for consideration from the customer. A liability is established and remains on the Company's books until the card is redeemed by the customer, at which time the Company records the redemption of the card for merchandise as a sale or when it is determined the likelihood of redemption is remote, based on historical redemption patterns. Revenues attributable to gift card liabilities relieved after the likelihood of redemption becomes remote are included in sales and are not material. The Company's gift cards do not expire.

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## Sales Return Reserve

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The Company records a reserve for estimated product returns where the sale has occurred during the period reported, but the return is likely to occur subsequent to the period reported and may otherwise be considered in-transit. The reserve for estimated in-transit product returns is based on the Company's most recent historical return trends. If the actual return rate or experience is materially higher than the Company's estimate, additional sales returns would be recorded in the future. The activity of the sales returns reserve for the years ended January 31, 2012, 2011, and 2010 was as follows:

	Balance at beginning of year	Additions	Deductions	Balance at end of year
Year ended January 31, 2012	\$11,367	41,034	(41,434)	\$ 10,967
Year ended January 31, 2011	\$ 9,912	41,692	(40,237)	\$11,367
Year ended January 31, 2010	\$ 7,547	33,889	(31,524)	\$ 9,912

*Cost of Sales, Including Certain Buying, Distribution and Occupancy Costs*

Cost of sales, including certain buying, distribution and occupancy costs includes the following: the cost of merchandise; merchandise markdowns; obsolescence and shrink provisions; store occupancy costs including rent and depreciation; customer shipping costs for direct-to-consumer orders; in-bound and outbound freight; U.S. Customs related taxes and duties; inventory acquisition and purchasing costs; warehousing and handling costs and other inventory acquisition related costs.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses includes expenses such as: direct selling and selling supervisory expenses; marketing expenses; various corporate expenses such as information systems, finance, loss prevention, talent acquisition, and executive management expenses; and other associated general expenses.

*Shipping and Handling Fees and Costs*

The Company includes shipping and handling revenues in net sales and shipping and handling costs in cost of sales. The Company's shipping and handling revenues consist of amounts billed to customers for shipping and handling merchandise. Shipping and handling costs include shipping supplies, related labor costs and third-party shipping costs.

*Advertising*

The Company expenses the costs of advertising when the advertising occurs, except for direct-to-consumer advertising, which is capitalized and amortized over its expected period of future benefit. Advertising costs primarily relate to our direct-to-consumer marketing expenses which are comprised of web marketing, catalog printing, paper, postage and other costs related to production of photographic images used in our catalogs and on our websites. The catalog printing, paper, postage and other costs are amortized over the period in which the customer responds to the marketing material determined based on historical customer response trends to a similar season's advertisement. Amortization rates are reviewed on a regular basis during the fiscal year and may be adjusted if the predicted customer response appears materially different than the historical response rate. The Company has the ability to measure the response rate to direct marketing early in the course of the advertisement based on its customers' reference to a specific catalog or by product placed and sold. The average amortization period for a catalog and related items are typically three months. If there is no expected future benefit, the cost of advertising is expensed when incurred. Advertising costs reported as prepaid expenses were \$3,586 and \$3,323 as of January 31, 2012, and 2011, respectively. Advertising expenses were \$71,684, \$58,336 and \$46,827 for fiscal 2012, 2011 and 2010, respectively.

*Start-up Costs*

The Company expenses all start-up and organization costs as incurred, including travel, training, recruiting, salaries and other operating costs.

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## Website Development Costs

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The Company capitalizes applicable costs incurred during the application and infrastructure development stage and expenses costs incurred during the planning and operating stage. During fiscal 2012, 2011 and 2010, the Company did not capitalize any internal-use software development costs because substantially all costs were incurred during the planning and operating stages, and costs incurred during the application and infrastructure development stage were not material.

### *Income Taxes*

The Company utilizes a balance sheet approach to provide for income taxes. Under this method, deferred tax assets and liabilities are recognized for the expected future tax consequences of net operating loss carryforwards and temporary differences between the carrying amounts and the tax bases of assets and liabilities. The Company files a consolidated United States federal income tax return (see Note 8 for a further discussion of income taxes).

### *Net Income Per Common Share*

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares and common share equivalents outstanding. Common share equivalents include the effect of stock options, stock appreciation rights ("SARs"), restricted stock units ("RSUs") and performance share units ("PSUs").

### *Accumulated Other Comprehensive Loss*

Comprehensive income is comprised of two subsets—net income and accumulated other comprehensive loss. Amounts included in accumulated other comprehensive loss relate to foreign currency translation adjustments and unrealized gains or losses on marketable securities. The foreign currency translation adjustments are not adjusted for income taxes because these adjustments relate to non—U.S. subsidiaries for which foreign earnings have been designated as permanently reinvested. Accumulated other comprehensive loss consisted of foreign currency translation losses of \$10,037 and \$7,752 as of January 31, 2012, and January 31, 2011, respectively, and unrealized losses, net of tax, on marketable securities of \$1,475 and \$2,510 as of January 31, 2012, and January 31, 2011, respectively. Gross realized gains and losses are included in other income in the Consolidated Statements of Income and were not material to the Company's Consolidated Financial Statements for all three years presented.

### *Foreign Currency Translation*

The financial statements of the Company's foreign operations are translated into U.S. dollars. Assets and liabilities are translated at current exchange rates as of the balance sheet date, equity accounts at historical exchange rates, while revenue and expense accounts are translated at the average rates in effect during the year. Translation adjustments are not included in determining net income, but are included in accumulated other comprehensive loss within shareholders' equity. As of January 31, 2012, 2011 and 2010, foreign currency translation adjustments resulted in accumulated losses of \$10,037 and \$7,752, respectively.

### *Concentration of Credit Risk*

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash, cash equivalents, marketable securities and accounts receivable. The Company manages the credit risk associated with cash, cash equivalents and marketable securities by investing in high-quality securities held with reputable trustees and, by policy, limiting the amount of credit exposure to any one issuer or issue, as well as providing limitations on investment maturities. The Company's investment policy requires that the majority of its cash, cash equivalents and marketable securities are invested in corporate and municipal bonds rated "A" or better and federally insured or guaranteed investment vehicles such as federal government agencies, irrevocable

pre-refunded municipal bonds and United States treasury bills. Receivables from third-party credit cards are processed by financial institutions, which are monitored for financial stability. The Company periodically evaluates the financial condition of its wholesale segment customers. The Company's allowance for doubtful accounts reflects current market conditions and management's assessment regarding the collectability of its accounts receivable. The Company maintains cash accounts that, at times, may exceed federally insured limits. The Company has not experienced any losses from maintaining cash accounts in excess of such limits. Management believes that it is not exposed to any significant risks related to its cash accounts.

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## Recently Issued Accounting Pronouncements

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In January 2010, the Financial Accounting Standards Board (“FASB”) issued an accounting standards update that amended fair value measurements and disclosures and aimed to improve the transparency of financial reporting of assets and liabilities measured at fair value. The update required new disclosures for transfers in and out of Level 1 and Level 2 and the basis for such transfers. Also required are disclosures for activity in Level 3, including purchase, sale, issuance and settlement information. Lastly, it clarified guidance regarding disaggregation and disclosure of information about valuation techniques and inputs used to measure fair value for both recurring and non-recurring fair value measurements in Level 2 and Level 3 categories. The Company adopted the provisions of this accounting standards update effective February 1, 2010, except for the requirement to disclose purchases, sales, issuances, and settlements related to Level 3 measurements, which we adopted February 1, 2011. This adoption had no impact on the Company's financial condition, results of operations or cash flows.

In May 2011, the FASB issued an additional update that amended fair value measurements and disclosures. This amendment provides that the inputs and measures used to value assets that fall within Level 3 of the valuation hierarchy be quantitatively presented. Application is required prospectively for interim and annual periods beginning after December 15, 2011. The Company is required to adopt the provisions of this update in the first quarter of fiscal 2013. Other than the change in presentation, this accounting standards update will not have an impact on the Company's financial position and results of operations.

In June 2011, the FASB issued an accounting standards update that requires an increase in the prominence of other comprehensive income and its components within the financial statements. The update provides entities the option to present the components of net income and other comprehensive income in either one or two consecutive financial statements. It also eliminates the option to present other comprehensive income in the statements of shareholders' equity. Application is to be applied retrospectively and is effective for interim and annual periods beginning after December 15, 2011. The Company is required to adopt the provisions of this update in the first quarter of fiscal 2013. Other than the change in presentation, this accounting standards update will not have an impact on the Company's financial position and results of operations.

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### 3. Marketable Securities

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During all periods shown, marketable securities are classified as available-for-sale. The amortized cost, gross unrealized gains (losses) and fair values of available-for-sale securities by major security type and class of security as of January 31, 2012, and 2011 are as follows:

	Amortized Cost	Unrealized Gains	Unrealized (Losses)	Fair Value
<b>As of January 31, 2012</b>				
Short-term Investments:				
Corporate bonds	\$ 34,899	\$ 7	\$ (28)	\$ 34,878
Municipal and pre-refunded municipal bonds	41,519	135	(10)	41,644
Certificate of deposit	5,225	—	—	5,225
Federal government agencies	4,513	2	—	4,515
Commercial paper	3,580	12	—	3,592
	<u>89,736</u>	<u>156</u>	<u>(38)</u>	<u>89,854</u>
Long-term Investments:				
Corporate bonds	60,852	277	(72)	61,057
Municipal and pre-refunded municipal bonds	18,410	186	(6)	18,590
Auction rate securities	22,975	—	(2,778)	20,197
Treasury bills	14,982	6	—	14,988
Certificate of deposit	6,970	—	(1)	6,969
Federal government agencies	5,111	2	(1)	5,112
	<u>129,300</u>	<u>471</u>	<u>(2,858)</u>	<u>126,913</u>
	<u>\$219,036</u>	<u>\$ 627</u>	<u>\$ (2,896)</u>	<u>\$216,767</u>
<b>As of January 31, 2011</b>				
Short-term Investments:				
Municipal and pre-refunded municipal bonds	\$ 42,996	\$ 48	\$ (9)	\$ 43,035
Treasury bills	7,004	4	—	7,008
Federal government agencies	40,842	80	—	40,922
FDIC insured corporate bonds	23,489	66	—	23,555
Variable rate demand notes	1,900	—	—	1,900
	<u>116,231</u>	<u>198</u>	<u>(9)</u>	<u>116,420</u>
Long-term Investments:				
Corporate bonds	137,540	173	(154)	137,559
Municipal and pre-refunded municipal bonds	143,711	216	(558)	143,369
Auction rate securities	33,250	—	(3,788)	29,462
Treasury bills	23,311	34	—	23,345
Federal government agencies	18,225	30	(2)	18,253
	<u>356,037</u>	<u>453</u>	<u>(4,502)</u>	<u>351,988</u>
	<u>\$472,268</u>	<u>\$ 651</u>	<u>\$ (4,511)</u>	<u>\$468,408</u>

Proceeds from the sale and maturities of available-for-sale securities were \$414,769, \$571,236 and \$421,040 in fiscal 2012, 2011 and 2010, respectively. The Company included in interest income, in the Consolidated Statements of Income, a net realized gain of \$1,171 during fiscal 2012, a net realized loss of \$30 during fiscal 2011 and a net realized gain of \$1,075 during fiscal 2010. Amortization of discounts and premiums, net, resulted in a reduction to interest income of \$7,373, \$8,702 and \$6,204 for fiscal years 2012, 2011, and 2010, respectively.

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The following tables show the gross unrealized losses and fair value of the Company's marketable securities with unrealized losses that are not deemed to be other-than-temporarily impaired aggregated by the length of time that individual securities have been in a continuous unrealized loss position, at January 31, 2012, and January 31, 2011, respectively.

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Description of Securities	January 31, 2012					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	45,089	(100)	—	—	45,089	(100)
Municipal and pre-refunded municipal bonds	9,985	(9)	2,954	(7)	12,939	(16)
Auction rate securities	—	—	20,197	(2,778)	20,197	(2,778)
Treasury bills	1,039	—	—	—	1,039	—
Certificates of deposit	1,489	(1)	—	—	1,489	(1)
Federal government agencies	1,099	(1)	—	—	1,099	(1)
Total	58,701	(111)	23,151	(2,785)	81,852	(2,896)

Description of Securities	January 31, 2011					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
FDIC-insured corporate bonds	67,359	(154)	—	—	67,359	(154)
Municipal and pre-refunded municipal bonds	103,090	(567)	—	—	103,090	(567)
Auction rate securities	—	—	29,462	(3,788)	29,462	(3,788)
Federal government agencies	1,397	(2)	—	—	1,397	(2)
Total	171,846	(723)	29,462	(3,788)	201,308	(4,511)

As of January 31, 2012, and 2011, there were a total of 76 and 128 issued securities with unrealized loss positions within the Company's portfolio, respectively. The total unrealized loss position due to the impairment of ARS held by the Company that have experienced auction failures as of January 31, 2012, and 2011 was \$2,778 and \$3,788, respectively. The Company deemed all of these securities as temporarily impaired. The unrealized loss positions were primarily due to auction failures of the ARS held and fluctuations in the market interest rates for remaining securities. The Company believes it has the ability to realize the full value of all of these investments upon maturity or redemption.

As of January 31, 2012, the par value of our ARS was \$22,975 and the estimated fair value was \$20,197. Our ARS portfolio consists of "A" or better rated ARS that represent interests in municipal and student loan related collateralized debt obligations, all of which are guaranteed by either government agencies and/or insured by private insurance agencies at 97% or greater of par value. To date, we have collected all interest payable on outstanding ARS when due and have not been informed by the issuers that accrued interest payments are currently at risk. The Company does not have the intent to sell the underlying securities prior to their recovery and the Company believes it is not likely that it will be required to sell the underlying securities prior to their anticipated recovery of full amortized cost.

#### 4. Fair Value

The Company utilizes a hierarchy that prioritizes fair value measurements based on the types of inputs used for the various valuation techniques (market approach, income approach and cost approach that relate to its financial assets and financial liabilities). The levels of the hierarchy are described as follows:

- Level 1: Observable inputs such as quoted prices in active markets for identical assets or liabilities.

- Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly; these include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.
- Level 3: Unobservable inputs that reflect the Company's own assumptions.

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Amounts noted above include commitments for 36 executed leases for stores not opened as of January 31, 2012. The majority of our leases allow for renewal options between five and ten years upon expiration of the initial lease term. The store leases generally provide for payment of direct operating costs including real estate taxes. Certain store leases provide for contingent rentals when sales exceed specified levels. Additionally, the Company has entered into store leases that require a percentage of total sales to be paid to landlords in lieu of minimum rent.

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Rent expense consisted of the following:

	Fiscal Year Ended January 31,		
	2012	2011	2010
Minimum and percentage rentals	\$165,901	\$143,919	\$125,651
Contingent rentals	5,403	5,836	3,327
Total	<u>\$171,304</u>	<u>\$149,755</u>	<u>\$128,978</u>

The Company also has commitments for unfulfilled purchase orders for merchandise ordered from our vendors in the normal course of business, which are liquidated within 12 months, of \$315,890. The majority of the Company's merchandise commitments are cancellable with no or limited recourse available to the vendor until merchandise shipping date. The Company also has commitments related to contracts with construction contractors, fully liquidated upon the completion of construction, which is typically within 12 months, of \$16,292.

### *Benefit Plan*

Full and part-time U.S.—based employees who are at least 18 years of age are eligible after three months of employment to participate in the Urban Outfitters 401(k) Savings Plan (the “Plan”). Under the Plan, employees can defer 1% to 25% of compensation as defined. The Company makes matching contributions in cash of \$0.25 per employee contribution dollar on the first 6% of the employee contribution. The employees' contribution is 100% vested while the Company's matching contribution vests at 20% per year of employee service. The Company's contributions were \$1,365, \$1,308 and \$1,171 for fiscal years 2012, 2011 and 2010, respectively.

### *Contingencies*

The Company is party to various legal proceedings arising from normal business activities. Management believes that the ultimate resolution of these matters will not have a material adverse effect on the Company's financial position, results of operations or cash flows.

## **13. Related Party Transactions**

Drinker Biddle & Reath LLP (“DBR”), a law firm, provided general legal services to the Company. Fees paid to DBR during fiscal 2012, 2011 and 2010 were \$2,509, \$2,707 and \$1,732, respectively. Harry S. Cherken, Jr., a director of the Company, is a partner at DBR. Fees due to DBR for the fiscal years ended January 31, 2012, 2011 and 2010 were approximately \$273, \$251 and \$251, respectively.

The McDevitt Company, a real estate company, acted as a broker in substantially all of the Company's new real estate transactions during fiscal 2012, 2011 and 2010. The Company has not paid any compensation to The McDevitt Company for such services, but the Company has been advised that The McDevitt Company has received commissions from other parties to such transactions. Wade L. McDevitt is the president and the sole shareholder of The McDevitt Company and brother-in-law of Scott A. Belair, one of the Company's directors. There were no amounts due to The McDevitt Company as of January 31, 2012, and January 31, 2011. Mr. McDevitt's wife, Wendy B. McDevitt, is an executive officer of the Company, serving as President of the Terrain Brand.

The Addis Group (“Addis”), an insurance brokerage and risk management consulting company, acted as the Company's commercial insurance broker and risk management consultant for the years ended January 31, 2012, 2011 and 2010. The Company has not paid any compensation to Addis for such services, but has been advised that Addis has received commissions from other parties to such transactions. Scott Addis, the brother-in-law of Richard A. Hayne, Chief Executive Officer, President and Chairman of the Board of the Company, is the President of The Addis Group. There were no amounts due to or from Addis as of January 31, 2012, and January 31, 2011.

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The accounting policies of the operating segments are the same as the policies described in Note 2, "Summary of Significant Accounting Policies." Both the retail and wholesale segments are highly diversified. No customer comprises more than 10% of sales. A summary of the information about the Company's operations by segment is as follows:

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	Fiscal Year		
	2012	2011	2010
<b>Net sales</b>			
Retail operations	\$2,340,794	\$2,153,792	\$1,833,733
Wholesale operations	140,657	124,768	109,269
Intersegment elimination	(7,650)	(4,458)	(5,187)
Total net sales	<u>\$2,473,801</u>	<u>\$2,274,102</u>	<u>\$1,937,815</u>
<b>Income from operations</b>			
Retail operations	\$ 276,581	\$ 418,403	\$ 338,114
Wholesale operations	26,919	23,372	22,164
Intersegment elimination	(709)	(389)	(202)
Total segment operating income	302,791	441,386	360,076
General corporate expenses	(18,066)	(27,183)	(21,092)
Total income from operations	<u>\$ 284,725</u>	<u>\$ 414,203</u>	<u>\$ 338,984</u>
<b>Depreciation expense for property and equipment</b>			
Retail operations	\$ 99,645	\$ 91,267	\$ 85,077
Wholesale operations	1,094	1,136	1,069
Total depreciation expense for property and equipment	<u>\$ 100,739</u>	<u>\$ 92,403</u>	<u>\$ 86,146</u>
<b>Inventories</b>			
Retail operations	\$ 237,825	\$ 213,420	
Wholesale operations	12,248	16,141	
Total inventories	<u>\$ 250,073</u>	<u>\$ 229,561</u>	
<b>Property and equipment, net</b>			
Retail operations	\$ 681,501	\$ 582,241	
Wholesale operations	3,478	4,105	
Total property and equipment, net	<u>\$ 684,979</u>	<u>\$ 586,346</u>	
<b>Cash paid for property and equipment</b>			
Retail operations	\$ 189,311	\$ 142,791	\$ 107,941
Wholesale operations	699	851	1,319
Total cash paid for property and equipment	<u>\$ 190,010</u>	<u>\$ 143,642</u>	<u>\$ 109,260</u>

The Company has foreign operations in Europe and Canada. Revenues and long-lived assets, based upon the Company's domestic and foreign operations, are as follows:

	Fiscal Year		
	2012	2011	2010
<b>Net sales</b>			
Domestic operations	\$2,169,976	\$2,027,074	\$1,752,787
Foreign operations	303,825	247,028	185,028
Total net sales	<u>\$2,473,801</u>	<u>\$2,274,102</u>	<u>\$1,937,815</u>
<b>Property and equipment, net</b>			
Domestic operations	\$ 557,512	\$ 497,521	
Foreign operations	127,467	88,825	
Total property and equipment, net	<u>\$ 684,979</u>	<u>\$ 586,346</u>	