# UNITED STATES SECURITIES AND EXCHANGE COMMISSION 

WASHINGTON, D.C. 20549

## FORM 10-Q

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

For the quarterly period ended August 3, 2013
OR

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

# American Eagle Outfitters, Inc. 

(Exact name of registrant as specified in its charter)

Delaware<br>No. 13-2721761<br>(State or other jurisdiction of<br>(I.R.S. Employer<br>incorporation or organization)<br>Identification No.)<br>77 Hot Metal Street, Pittsburgh, PA<br>15203-2329<br>(Address of principal executive offices)<br>(Zip Code)<br>Registrant $s$ telephone number, including area code: (412) 432-3300<br>Former name, former address and former fiscal year, if changed since last report:

## N/A

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T ( $\$ 232.405$ of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO *

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.


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## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS.

## AMERICAN EAGLE OUTFITTERS, INC.

## CONSOLIDATED BALANCE SHEETS

| (In thousands, except per share amount) | August 3, <br> 2013 <br> (Unaudited) | February 2, <br> 2013 | July 28, <br> (Unaudited) |
| :--- | ---: | ---: | ---: |
| Assets |  |  |  |
| Current assets: | 345,188 | $\$ 509,119$ | $\$$ |
| Cash and cash equivalents | 59,678 | 121,873 | 5,077 |
| Short-term investments | 461,080 | 332,452 | 462,013 |
| Merchandise inventory | 4,669 | 9,499 | 19,850 |
| Assets held for sale | 45,965 | 46,321 | 40,202 |
| Accounts receivable | 115,595 | 73,805 | 76,584 |
| Prepaid expenses and other | 41,807 | 58,230 | 55,607 |
| Deferred income taxes | $1,073,982$ | $1,151,299$ | $1,356,328$ |
|  | 593,879 | 500,134 | 534,886 |
| Total current assets | 44,658 | 38,136 | 38,682 |
| Property and equipment, at cost, net of accumulated depreciation | 13,814 | 11,484 | 11,445 |
| Intangible assets, at cost, net of accumulated amortization | 25,441 | 31,282 | 22,477 |
| Goodwill | 28,311 | 23,718 | 15,064 |
| Non-current deferred income taxes |  |  |  |
| Other assets | $1,780,085$ | $\$ 1,756,053$ | $\$ 1,978,882$ |



| Contributed capital | 587,905 | 627,065 | 574,671 |
| :--- | ---: | ---: | ---: |
| Accumulated other comprehensive income | 24,397 | 29,297 | 28,073 |
| Retained earnings | $1,588,094$ | $1,553,058$ | $1,770,546$ |
| Treasury stock, $56,866,56,962$ and 53,302 shares, respectively | $(999,219)$ | $(990,729)$ | $(897,372)$ |
| Total stockholders equity | $1,203,673$ | $1,221,187$ | $1,478,414$ |
| Total liabilities and stockholders equity | $\$ 1,780,085$ | $\$ 1,756,053$ | $\$ 1,978,882$ |

## Refer to Notes to Consolidated Financial Statements

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## AMERICAN EAGLE OUTFITTERS, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS

(Unaudited)

| (In thousands, except per share amounts) | 13 Weeks Ended |  |  |  | 26 Weeks Ended |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | August 3 , 2013 |  | $\begin{gathered} \text { July } 28, \\ 2012 \end{gathered}$ | August 3, $2013$ | $\text { July } 28,$ $2012$ |
| Total net revenue | \$ | 727,313 | \$ | 739,680 | \$ 1,406,790 | \$ 1,448,375 |
| Cost of sales, including certain buying, occupancy and warehousing expenses |  | 481,818 |  | 463,116 | 897,686 | 896,898 |
| Gross profit |  | 245,495 |  | 276,564 | 509,104 | 551,477 |
| Selling, general and administrative expenses |  | 186,336 |  | 182,125 | 368,589 | 360,664 |
| Depreciation and amortization expense |  | 29,734 |  | 32,643 | 65,273 | 64,709 |
| Operating income |  | 29,425 |  | 61,796 | 75,242 | 126,104 |
| Other income (expense), net |  | 1,149 |  | (343) | 467 | 3,164 |
| Income before income taxes |  | 30,574 |  | 61,453 | 75,709 | 129,268 |
| Provision for income taxes |  | 10,980 |  | 18,607 | 28,139 | 42,387 |
| Income from continuing operations |  | 19,594 |  | 42,846 | 47,570 | 86,881 |
| Loss from discontinued operations, net of tax |  |  |  | $(23,819)$ |  | $(28,157)$ |
| Net income | \$ | 19,594 | \$ | 19,027 | \$ 47,570 | \$ 58,724 |
| Basic income per common share: |  |  |  |  |  |  |
| Income from continuing operations | \$ | 0.10 | \$ | 0.22 | 0.25 | \$ 0.44 |
| Loss from discontinued operations |  |  |  | (0.12) |  | (0.14) |
| Net income per basic share | \$ | 0.10 | \$ | 0.10 | \$ 0.25 | \$ 0.30 |
| Diluted income per common share: |  |  |  |  |  |  |
| Income from continuing operations | \$ | 0.10 | \$ | 0.21 | \$ 0.24 | \$ 0.44 |
| Loss from discontinued operations |  |  |  | (0.12) |  | (0.14) |
| Net income per diluted share | \$ | 0.10 | \$ | 0.09 | \$ 0.24 | \$ 0.30 |
| Cash dividends per common share | \$ | 0.125 | \$ | 0.11 | 0.125 | \$ 0.22 |
| Weighted average common shares outstanding - basic |  | 192,731 |  | 196,160 | 192,720 | 195,525 |
| Weighted average common shares outstanding - diluted |  | 195,951 |  | 199,807 | 196,451 | 198,329 |
| Retained earnings, beginning |  | 1,592,706 |  | 1,774,205 | \$ 1,553,058 | \$ 1,771,464 |
| Net income |  | 19,594 |  | 19,027 | 47,570 | 58,724 |
| Cash dividends and dividend equivalents |  | $(24,574)$ |  | $(22,117)$ | $(24,574)$ | $(44,062)$ |
| Reissuance of treasury stock |  | 368 |  | (569) | 12,040 | $(15,580)$ |
| Retained earnings, ending |  | 1,588,094 |  | 1,770,546 | \$ 1,588,094 | \$ 1,770,546 |

Refer to Notes to Consolidated Financial Statements

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## AMERICAN EAGLE OUTFITTERS, INC. <br> CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

## (Unaudited)

|  | 13 Weeks Ended |  | 26 Weeks Ended |  |
| :---: | :---: | :---: | :---: | :---: |
| (In thousands) | August 3, 2013 | July 28, 2012 | August 3, 2013 | $\begin{gathered} \text { July } 28, \\ 2012 \end{gathered}$ |
| Net income | \$ 19,594 | \$ 19,027 | \$ 47,570 | \$ 58,724 |
| Other comprehensive loss: |  |  |  |  |
| Foreign currency translation loss | $(4,398)$ | $(2,459)$ | $(4,900)$ | (586) |
| Other comprehensive loss | $(4,398)$ | $(2,459)$ | $(4,900)$ | (586) |
| Comprehensive income | \$ 15,196 | \$ 16,568 | \$ 42,670 | \$ 58,138 |

Refer to Notes to Consolidated Financial Statements

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## AMERICAN EAGLE OUTFITTERS, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

## (Unaudited)

| (In thousands) | 26 Weeks Ended |  |
| :---: | :---: | :---: |
|  | August 3, <br> 2013 | $\text { July } 28 \text {, }$ |
| Operating activities: |  |  |
| Net income | \$ 47,570 | \$ 58,724 |
| Loss from discontinued operations, net of tax |  | 28,157 |
| Income from continuing operations | \$ 47,570 | 86,881 |
| Adjustments to reconcile net income to net cash from operating activities: |  |  |
| Depreciation and amortization | 66,343 | 65,761 |
| Share-based compensation | 9,661 | 28,029 |
| Provision for deferred income taxes | 23,683 | $(16,556)$ |
| Tax benefit from share-based payments | 8,067 | 4,396 |
| Excess tax benefit from share-based payments | $(8,179)$ | $(2,894)$ |
| Foreign currency transaction loss | 936 | 472 |
| Loss on impairment of assets |  | 514 |
| Changes in assets and liabilities: |  |  |
| Merchandise inventory | $(127,459)$ | $(94,762)$ |
| Accounts receivable | 296 | (532) |
| Prepaid expenses and other | $(40,627)$ | (739) |
| Other assets | $(8,654)$ | 808 |
| Accounts payable | 96,578 | $(5,519)$ |
| Unredeemed gift cards and gift certificates | $(19,916)$ | $(20,620)$ |
| Deferred lease credits | 8,871 | $(2,592)$ |
| Accrued compensation and payroll taxes | $(45,155)$ | 10,871 |
| Accrued income and other taxes | $(20,328)$ | $(15,028)$ |
| Accrued liabilities | $(1,173)$ | 9,256 |
| Total adjustments | $(61,852)$ | $(39,135)$ |
| Net cash (used for) provided by operating activities | $(9,486)$ | 47,746 |
| Investing activities: |  |  |
| Capital expenditures for property and equipment | $(123,865)$ | $(48,240)$ |
| Purchase of assets in acquisition | $(20,751)$ |  |
| Acquisition of intangible assets | (700) | (674) |
| Purchase of available-for-sale securities | $(7,571)$ | (570) |
| Sale of available-for-sale securities | 69,173 | 20,592 |
| Net cash used for investing activities | $(83,714)$ | $(28,892)$ |
| Financing activities: |  |  |
| Payments on capital leases | (260) | $(1,666)$ |
| Repurchase of common stock as part of publicly announced programs | $(33,051)$ |  |
| Repurchase of common stock from employees | $(23,343)$ | $(4,108)$ |
| Net proceeds from stock options exercised | 2,632 | 18,495 |
| Excess tax benefit from share-based payments | 8,179 | 2,894 |
| Cash dividends paid | $(24,085)$ | $(43,108)$ |
| Net cash used for financing activities | $(69,928)$ | $(27,493)$ |


| Effect of exchange rates changes on cash |  | (803) | (517) |
| :---: | :---: | :---: | :---: |
| Cash flows of discontinued operations |  |  |  |
| Net cash used for operating activities |  |  | $(13,544)$ |
| Net cash used for investing activities |  |  | (768) |
| Net cash used for financing activities |  |  |  |
| Effect of exchange rates changes on cash |  |  |  |
| Net cash used for discontinued operations |  |  | $(14,312)$ |
| Net decrease in cash and cash equivalents |  | $(163,931)$ | $(23,468)$ |
| Cash and cash equivalents - beginning of period |  | 509,119 | 719,545 |
| Cash and cash equivalents - end of period |  | 345,188 | \$ 696,077 |
| Supplemental disclosure of cash flow information: |  |  |  |
| Cash paid during the period for income taxes |  | 58,555 | \$ 61,606 |
| Cash paid during the period for interest |  | 209 | \$ 132 |

Refer to Notes to Consolidated Financial Statements

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## AMERICAN EAGLE OUTFITTERS, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## 1. Interim Financial Statements

The accompanying Consolidated Financial Statements of American Eagle Outfitters, Inc. (the Company ) at August 3, 2013 and July 28, 2012 and for the 13 and 26 week periods ended August 3, 2013 and July 28, 2012 have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Certain notes and other information have been condensed or omitted from the interim Consolidated Financial Statements presented in this Quarterly Report on Form 10-Q. Therefore, these Consolidated Financial Statements should be read in conjunction with the Company s Fiscal 2012 Annual Report. In the opinion of the Company s management, all adjustments (consisting of normal recurring adjustments and those described in the footnotes that follow) considered necessary for a fair presentation have been included. The existence of subsequent events has been evaluated through the filing date of this Quarterly Report on Form 10-Q.

As used in this report, all references to we, our and the Company refer to American Eagle Outfitters, Inc. and its wholly owned subsidiaries. American Eagle Outfitters, American Eagle, AEO and the AE Brand refer to our American Eagle Outfitters stores. aerie referbyo our aerie American Eagle ${ }^{\circledR}$ stores. AEO Direct refers to our e-commerce operations, ae.com and aerie.com. 77kids refers to the 77kids by american ${ }^{\text {eagle }}$ stores and related e-commerce operations which the Company exited in Fiscal 2012.

The Company s business is affected by the pattern of seasonality common to most retail apparel businesses. The results for the current and prior periods are not necessarily indicative of future financial results.

## 2. Summary of Significant Accounting Policies

## Principles of Consolidation

The Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation. At August 3, 2013, the Company operated in one reportable segment.

In Fiscal 2012, the Company announced plans to exit the 77kids business, which included all 22 stores and related e-commerce operations. These Consolidated Financial Statements reflect the results of 77 kids as a discontinued operation for all periods presented. Refer to Note 13 to the Consolidated Financial Statements for additional information regarding the discontinued operations of 77kids.

## Fiscal Year

The Company s financial year is a $52 / 53$ week year that ends on the Saturday nearest to January 31. As used herein, Fiscal 2013 refers to the 52 week period ending February 1, 2014. Fiscal 2012 refers to the 53 week period ended February 2, 2013. Fiscal 2011 and Fiscal 2010 refer to the 52 week periods ended January 28, 2012 and January 29, 2011, respectively.

## Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of our contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, our management reviews its estimates based on currently available information. Changes in facts and circumstances may result in revised estimates.

## Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income ( ASU

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2013-02 ). ASU 2013-02 requires an entity to provide additional information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income. The amendments are effective prospectively for reporting periods beginning after December 15, 2012. ASU 2013-02 does not change the current requirements for reporting net income or other comprehensive income. Because the standard only affects the presentation of comprehensive income and does not impact what is included in comprehensive income, ASU 2013-02 did not have an impact on the Company s Consolidated Financial Statements.

## Foreign Currency Translation

In accordance with Accounting Standards Codification (ASC ) 830, Foreign Currency Matters, assets and liabilities denominated in foreign currencies were translated into United States dollars ( USD ) (the reporting currency) at the exchange rate prevailing at the balance sheet date. Revenues and expenses denominated in foreign currencies were translated into USD at the monthly average exchange rate for the period. Gains or losses resulting from foreign currency transactions are included in the results of operations, whereas, related translation adjustments are reported as an element of other comprehensive income in accordance with ASC 220, Comprehensive Income.

## Revenue Recognition

Revenue is recorded for store sales upon the purchase of merchandise by customers. The Company s e-commerce operation records revenue upon the estimated customer receipt date of the merchandise. Shipping and handling revenues are included in total net revenue. Sales tax collected from customers is excluded from revenue and is included as part of accrued income and other taxes on the Company s Consolidated Balance Sheets.

Revenue is recorded net of estimated and actual sales returns and deductions for coupon redemptions and other promotions. The Company records the impact of adjustments to its sales return reserve quarterly within total net revenue and cost of sales. The sales return reserve reflects an estimate of sales returns based on projected merchandise returns determined through the use of historical average return percentages.

Revenue is not recorded on the purchase of gift cards. A current liability is recorded upon purchase, and revenue is recognized when the gift card is redeemed for merchandise. Additionally, the Company recognizes revenue on unredeemed gift cards based on an estimate of the amounts that will not be redeemed ( gift card breakage ), determined through historical redemption trends. Gift card breakage revenue is recognized in proportion to actual gift card redemptions as a component of total net revenue. For further information on the Company s gift card program, refer to the Gift Cards caption below.

The Company recognizes royalty revenue generated from its franchise agreements based on a percentage of merchandise sales by the franchisee. This revenue is recorded as a component of total net revenue when earned.

## Cost of Sales, Including Certain Buying, Occupancy and Warehousing Expenses

Cost of sales consists of merchandise costs, including design, sourcing, importing and inbound freight costs, as well as markdowns, shrinkage and certain promotional costs (collectively merchandise costs ) and buying, occupancy and warehousing costs. Buying, occupancy and warehousing costs consist of compensation, employee benefit expenses and travel for our buyers and certain senior merchandising executives; rent and utilities related to our stores, corporate headquarters, distribution centers and other office space; freight from our distribution centers to the stores; compensation and supplies for our distribution centers, including purchasing, receiving and inspection costs; and shipping and handling costs related to our e-commerce operation. Gross profit is the difference between total net revenue and cost of sales.

## Selling, General and Administrative Expenses

Selling, general and administrative expenses consist of compensation and employee benefit expenses, including salaries, incentives and related benefits associated with our stores and corporate headquarters. Selling, general and administrative expenses also include advertising costs, supplies for our stores and home office, communication costs, travel and entertainment, leasing costs and services purchased. Selling, general and administrative expenses do not include compensation, employee benefit expenses and travel for our design, sourcing and importing teams, our buyers and our distribution centers as these amounts are recorded in cost of sales.

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## Other Income (Expense), Net

Other income (expense), net consists primarily of interest income/expense, foreign currency transaction gain/loss and realized investment gains/losses.

## Other-than-Temporary Impairment

The Company evaluates its investments for impairment in accordance with ASC 320, Investments Debt and Equity Securities ( ASC 320 ). ASC 320 provides guidance for determining when an investment is considered impaired, whether impairment is other-than-temporary, and measurement of an impairment loss. An investment is considered impaired if the fair value of the investment is less than its cost. If, after consideration of all available evidence to evaluate the realizable value of its investment, impairment is determined to be other-than-temporary, then an impairment loss is recognized in the Consolidated Statement of Operations equal to the difference between the investment s cost and its fair value. Additionally, ASC 320 requires additional disclosures relating to debt and equity securities both in the interim and annual periods as well as requires the Company to present total other-than-temporary impairment ( OTTI ) with an offsetting reduction for any non-credit loss impairment amount recognized in other comprehensive income ( OCI ). There was no net impairment loss for investment securities recognized in earnings during the 13 and 26 weeks ended August 3, 2013 or July 28, 2012.

## Cash and Cash Equivalents and Short-term Investments

The Company considers all highly liquid investments purchased with a maturity of three months or less to be cash equivalents.

As of August 3, 2013, short-term investments include treasury bills and term-deposits with a maturity of greater than three months, but less than one year.

Unrealized gains and losses on the Company s available-for-sale securities are excluded from earnings and are reported as a separate component of stockholders equity, within accumulated other comprehensive income, until realized. When available-for-sale securities are sold, the cost of the securities is specifically identified and is used to determine any realized gain or loss.

Refer to Note 3 to the Consolidated Financial Statements for information regarding cash and cash equivalents and short-term investments.

## Merchandise Inventory

Merchandise inventory is valued at the lower of average cost or market, utilizing the retail method. Average cost includes merchandise design and sourcing costs and related expenses. The Company records merchandise receipts at the time at which title and risk of loss for the merchandise transfers to the Company.

The Company reviews its inventory levels to identify slow-moving merchandise and generally uses markdowns to clear merchandise. Additionally, the Company estimates a markdown reserve for future planned permanent markdowns related to current inventory. Markdowns may occur when inventory exceeds customer demand for reasons of style, seasonal adaptation, changes in customer preference, lack of consumer acceptance of fashion items, competition, or if it is determined that the inventory in stock will not sell at its currently ticketed price. Such markdowns may have a material adverse impact on earnings, depending on the extent and amount of inventory affected. The Company also estimates a shrinkage reserve for the period between the last physical count and the balance sheet date. The estimate for the shrinkage reserve, based on historical results, can be affected by changes in merchandise mix and changes in actual shrinkage trends.

## Income Taxes

The Company calculates income taxes in accordance with ASC 740, Income Taxes (ASC 740 ), which requires the use of the asset and liability method. Under this method, deferred tax assets and liabilities are recognized based on the difference between the Consolidated Financial Statement carrying amounts of existing assets and liabilities and their respective tax bases as computed pursuant to ASC 740. Deferred tax assets and liabilities are measured using the tax rates, based on certain judgments regarding enacted tax laws and published guidance, in effect in the years when those temporary differences are expected to reverse. A valuation allowance is established against the deferred tax assets when it is more likely than not that some portion or all of the deferred taxes may not be realized. Changes in the Company s level and composition of earnings, tax laws or the deferred tax valuation allowance, as well as the results of tax audits may materially impact the Company seffective income tax rate.

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The Company evaluates its income tax positions in accordance with ASC 740, which prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including a decision whether to file or not to file in a particular jurisdiction. Under ASC 740, a tax benefit from an uncertain position may be recognized only if it is more likely than not that the position is sustainable based on its technical merits.

The calculation of the deferred tax assets and liabilities, as well as the decision to recognize a tax benefit from an uncertain position and to establish a valuation allowance require management to make estimates and assumptions. The Company believes that its assumptions and estimates are reasonable, although actual results may have a positive or negative material impact on the balances of deferred tax assets and liabilities, valuation allowances or net income.

Refer to Note 10 to the Consolidated Financial Statements for additional information regarding income taxes.

## Property and Equipment

Property and equipment is recorded on the basis of cost, including costs to prepare the asset for use, with depreciation computed utilizing the straight-line method over the assets estimated useful lives. The useful lives of our major classes of assets are as follows:

| Buildings | 25 years |
| :--- | :--- |
| Leasehold improvements | Lesser of 10 years or the term of the lease |
| Fixtures and equipment | 5 years |

In accordance with ASC 360, Property, Plant, and Equipment ( ASC 360 ), the Company evaluates long-lived assets for impairment at the individual store level, which is the lowest level at which individual cash flows can be identified, for stores that have been open for a period of time sufficient to reach maturity. Impairment losses are recorded on long-lived assets used in operations when events and circumstances indicate that the assets are impaired and the undiscounted cash flows estimated to be generated by those assets are less than their carrying amounts. When events such as these occur, the impaired assets are adjusted to their estimated fair value and an impairment loss is recorded.

The Company had $\$ 4.7$ million, $\$ 9.5$ million and $\$ 19.9$ million of long-lived assets held-for-sale as of August 3, 2013, February 2, 2013 and July 28, 2012, respectively. The $\$ 19.9$ million of long-lived assets held for sale as of July 28, 2012 include merchandise inventory related to 77 kids in addition to other corporate assets. These long-lived corporate assets held-for-sale, which the Company believes will be sold within one year, are recorded at their estimated net realizable value, less disposal costs. Refer to Note 13 for additional information regarding 77kids as a discontinued operation.

Refer to Note 6 to the Consolidated Financial Statements for additional information regarding property, plant and equipment.

## Goodwill

The Company s goodwill is primarily related to the acquisition of its importing operations, Canadian business and recently acquired operations in Hong Kong and China. In accordance with ASC 350, Intangibles Goodwill and Other ( ASC 350 ), the Company evaluates goodwill for possible impairment on at least an annual basis and last performed an annual impairment test as of February 2, 2013. As a result of the Company sannual goodwill impairment test, the Company concluded that its goodwill was not impaired.

Refer to Note 12 to the Consolidated Financial Statements for additional information on the Company sacquisition of its Hong Kong and China operations.

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## Intangible Assets

Intangible assets are recorded on the basis of cost with amortization computed utilizing the straight-line method over the assets estimated useful lives. The Company s intangible assets, which primarily include trademark assets, are generally amortized over 15 to 25 years.


#### Abstract

The Company evaluates intangible assets for impairment in accordance with ASC 350 when events or circumstances indicate that the carrying value of the asset may not be recoverable. Such an evaluation includes the estimation of undiscounted future cash flows to be generated by those assets. If the sum of the estimated future undiscounted cash flows are less than the carrying amounts of the assets, then the assets are impaired and are adjusted to their estimated fair value. No intangible asset impairment charges were recorded in the 13 and 26 weeks ended August 3, 2013 or July 28, 2012.


Refer to Note 7 to the Consolidated Financial Statements for additional information regarding intangible assets.

## Gift Cards

The value of a gift card is recorded as a current liability upon purchase, and revenue is recognized when the gift card is redeemed for merchandise. The Company estimates gift card breakage and recognizes revenue in proportion to actual gift card redemptions as a component of total net revenue. The Company determines an estimated gift card breakage rate by continuously evaluating historical redemption data and the time when there is a remote likelihood that a gift card will be redeemed. The Company recorded $\$ 1.3$ million and $\$ 1.4$ million of revenue related to gift card breakage during the 13 weeks ended August 3, 2013 and July 28, 2012, respectively. During the 26 weeks ended August 3, 2013 and July 28, 2012, the Company recorded $\$ 3.2$ million and $\$ 3.3$ million, respectively, of revenue related to gift card breakage.

## Deferred Lease Credits

Deferred lease credits represent the unamortized portion of construction allowances received from landlords related to the Company s retail stores. Construction allowances are generally comprised of cash amounts received by the Company from its landlords as part of the negotiated lease terms. The Company records a receivable and a deferred lease credit liability at the lease commencement date (date of initial possession of the store). The deferred lease credit is amortized on a straight-line basis as a reduction of rent expense over the term of the original lease (including the pre-opening build-out period) and any subsequent renewal terms. The receivable is reduced as amounts are received from the landlord.

## Co-branded Credit Card and Customer Loyalty Program

The Company offers a co-branded credit card (the AEO Visa Card ) and a private label credit card (the AEO Credit Card ). These credit cards are issued by a third-party bank (the Bank ), and the Company has no liability to the Bank for bad debt expense, provided that purchases are made in accordance with the Bank s procedures. Once a customer is approved to receive the AEO Visa Card or the AEO Credit Card and the card is activated, the customer is eligible to participate in the credit card rewards program. Customers who make purchases earn discounts in the form of savings certificates when certain purchase levels are reached. Also, AEO Visa Card customers who make purchases at other retailers where the card is accepted earn additional discounts. Savings certificates are valid for 90 days from issuance.

Points earned under the credit card rewards program on purchases are accounted for by analogy to ASC 605-25, Revenue Recognition, Multiple Element Arrangements ( ASC 605-25 ). The Company believes that points earned under its point and loyalty programs represent deliverables in a multiple element arrangement rather than a rebate or refund of cash. Accordingly, the portion of the sales revenue attributed to the award points is deferred and recognized when the award is redeemed or when the points expire. Additionally, credit card reward points earned on non-AE or aerie purchases are accounted for in accordance with ASC 605-25. As the points are earned, a current liability is recorded for the estimated cost of the award, and the impact of adjustments is recorded in cost of sales.

The Company offers its customers the AEREWARD $\$^{\text {sm }}$ loyalty program (the Program ). Under the Program, customers accumulate points based on purchase activity and earn rewards by reaching certain point thresholds during three-month earning periods. Rewards earned during these periods are valid through the stated expiration date, which is approximately one month from the mailing date of the reward. These rewards can be redeemed for a discount on a purchase of merchandise. Rewards not redeemed during the one-month redemption period are forfeited. The Company determined that rewards earned using the Program should be accounted for in accordance with ASC 605-25. Accordingly, the portion of the sales revenue attributed to the award credits is deferred and recognized when the awards are redeemed or expire.

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## Segment Information

In accordance with ASC 280, Segment Reporting ( ASC 280 ), the Company has identified three operating segments (American Eagle Brand retail stores, aerie retail stores and AEO Direct) that reflect the basis used internally to review performance and allocate resources. All of the operating segments have been aggregated and are presented as one reportable segment, as permitted by ASC 280 .

## Reclassification

Certain reclassifications have been made to the Consolidated Financial Statements for prior periods in order to conform to the current period presentation.

## 3. Cash and Cash Equivalents and Short-term Investments

The following table summarizes the fair market values for the Company s cash and marketable securities, which are recorded on the Consolidated Balance Sheets:

| (In thousands) | August 3, <br> 2013 | February 2, 2013 | July 28, $2012$ |
| :---: | :---: | :---: | :---: |
| Cash and cash equivalents: |  |  |  |
| Cash | \$ 289,444 | \$ 257,191 | \$ 623,277 |
| Money-market | 46,912 | 221,929 | 44,789 |
| Treasury bills | 8,832 |  | 23,011 |
| Commercial paper |  | 29,999 | 5,000 |
| Total cash and cash equivalents | \$ 345,188 | \$ 509,119 | \$ 696,077 |
| Short-term investments: |  |  |  |
| Treasury bills | \$ 50,035 | \$ 109,305 | \$ 5,995 |
| Term-deposits | 9,643 | 12,568 |  |
| Total short-term investments | \$ 59,678 | \$ 121,873 | \$ 5,995 |
| Total | \$ 404,866 | \$ 630,992 | \$ 702,072 |

Proceeds from the sale of investments were $\$ 69.2$ million and $\$ 20.6$ million for the 26 weeks ended August 3, 2013 and July 28, 2012, respectively. The purchase of investments was $\$ 7.6$ million and $\$ 0.6$ million for the 26 weeks ended August 3, 2013 and July 28, 2012, respectively.

## 4. Fair Value Measurements

ASC 820, Fair Value Measurement Disclosures ( ASC 820 ), defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. Fair value is defined under ASC 820 as the exit price associated with the sale of an asset or transfer of a liability in an orderly transaction between market participants at the measurement date.

## Financial Instruments

Valuation techniques used to measure fair value under ASC 820 must maximize the use of observable inputs and minimize the use of unobservable inputs. In addition, ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs (i.e., projections, estimates, interpretations, etc.) that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

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As of August 3, 2013 and July 28, 2012, the Company held certain assets that are required to be measured at fair value on a recurring basis. These include cash equivalents and short-term investments.

In accordance with ASC 820, the following table represents the Company s fair value hierarchy for its financial assets (cash equivalents and investments) measured at fair value on a recurring basis as of August 3, 2013 and July 28, 2012:

| (In thousands) | Carrying Amount | $\begin{array}{cc}\text { Fair Value Measurements at August 3, } 2013 \\ \text { Quoted Market } & \\ \text { Prices in Active } & \\ \text { Markets for } & \text { Significant Other } \\ \text { Identical } & \text { Observable } \\ \text { Assets } & \text { Inputs } \\ \text { (Level 1) } & \text { (Level 2) }\end{array}$ |  |  | Significant Unobservable Inputs (Level 3) |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Cash and cash equivalents: |  |  |  |  |  |
| Cash | \$ 289,444 | \$ | 289,444 | \$ | \$ |
| Money-market | 46,912 |  | 46,912 |  |  |
| Treasury bills | 8,832 |  | 8,832 |  |  |
| Total cash and cash equivalents | \$ 345,188 | \$ | 345,188 | \$ | \$ |
| Short-term investments: |  |  |  |  |  |
| Treasury bills | \$ 50,035 | \$ | 50,035 | \$ | \$ |
| Term-deposits | 9,643 |  | 9,643 |  |  |
| Total short-term investments | \$ 59,678 | \$ | 59,678 | \$ | \$ |
| Total | \$ 404,866 | \$ | 404,866 | \$ | \$ |


| (In thousands) | Carrying <br> Amount | $\begin{gathered} \text { Fair } \\ \text { Qu } \\ \text { Pric } \end{gathered}$ | alue Measu ted Market es in Active arkets for Identical Assets Level 1) | ts at J <br> Sign <br> O | Significant Unobservable <br> Inputs <br> (Level 3) |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Cash and cash equivalents: |  |  |  |  |  |
| Cash | \$ 623,277 | \$ | 623,277 | \$ | \$ |
| Money-market | 44,789 |  | 44,789 |  |  |
| Treasury bills | 23,011 |  | 23,011 |  |  |
| Commercial paper | 5,000 |  | 5,000 |  |  |
| Total cash and cash equivalents | \$ 696,077 | \$ | 696,077 | \$ | \$ |
| Short-term investments: |  |  |  |  |  |
| Treasury bills | \$ 5,995 | \$ | 5,995 | \$ | \$ |
| Total short-term investments | \$ 5,995 | \$ | 5,995 | \$ | \$ |
| Total | \$ 702,072 | \$ | 702,072 | \$ | \$ |

In the event the Company holds Level 3 investments, a discounted cash flow model is used to value those investments. There were no Level 3 investments at August 3, 2013 or July 28, 2012.

Non-Financial Assets

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The Company s non-financial assets, which include goodwill, intangible assets and property and equipment, are not required to be measured at fair value on a recurring basis. However, if certain triggering events occur, or if an annual impairment test is required and the Company is required to evaluate the non-financial instrument for impairment, a resulting asset impairment would require that the non-financial asset be recorded at the estimated fair value. As a result of the Company s annual goodwill impairment test performed as of February 2, 2013, the Company concluded that its goodwill was not impaired.

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## 5. Earnings per Share

The following is a reconciliation between basic and diluted weighted average shares outstanding:

|  | 13 Wee | Ended | 26 We | Ended |
| :---: | :---: | :---: | :---: | :---: |
| (In thousands) | August 3, 2013 | July 28, 2012 | August 3, 2013 | July 28, <br> 2012 |
| Weighted average common shares outstanding: |  |  |  |  |
| Basic number of common shares outstanding | 192,731 | 196,160 | 192,720 | 195,525 |
| Dilutive effect of stock options and non-vested restricted stock | 3,220 | 3,647 | 3,731 | 2,804 |
| Diluted number of common shares outstanding | 195,951 | 199,807 | 196,451 | 198,329 |

Equity awards to purchase approximately 1.8 million and 1.0 million shares of common stock during the 13 and 26 weeks ended August 3, 2013 and approximately 2.9 million and 3.4 million shares of common stock during the 13 and 26 weeks ended July 28, 2012, respectively, were outstanding, but were not included in the computation of weighted average diluted common share amounts as the effect of doing so would be anti-dilutive.

There were no shares and 0.8 million shares for the 13 and 26 weeks ended August 3, 2013, respectively, and approximately 30,000 shares for both the 13 and 26 weeks ended July 28, 2012 of restricted stock units that were outstanding but not included in the computation of weighted average diluted common share amounts as the effect of doing so would be anti-dilutive. Additionally, approximately 0.6 million shares of restricted stock units for both the 13 and 26 weeks ended August 3, 2013 were not included in the computation of weighted average diluted common share amounts because the number of shares ultimately issued is contingent on the Company s performance compared to pre-established annual performance goals.

Refer to Note 9 to the Consolidated Financial Statements for additional information regarding share-based compensation.

## 6. Property and Equipment

Property and equipment consists of the following:

|  | August 3, | February 2, | July 28, |
| :--- | :---: | :---: | :---: |
| (In thousands) | 2013 | 2013 | 2012 |
| Property and equipment, at cost | $\$ 1,544,477$ | $\$ 1,417,933$ | $\$ 1,432,517$ |
| Less: Accumulated depreciation | $(950,598)$ | $(917,799)$ | $(897,631)$ |
|  |  |  |  |
| Property and equipment, net | $\$ 593,879$ | $\$ 500,134$ | $\$ 534,886$ |

## 7. Intangible Assets

Intangible assets consist of the following:

|  | August 3, | February 2, | July 28, |
| :--- | :---: | :---: | :---: |
| (In thousands) | 2013 | 2013 | 2012 |
| Trademarks and other intangibles, at cost | $\$ 51,956$ | $\$ 44,272$ | $\$ 43,844$ |
| Less: Accumulated amortization | $(7,298)$ | $(6,136)$ | $(5,162)$ |
|  |  |  |  |
| Intangible assets, net | $\$ 44,658$ | $\$ 38,136$ | $\$ 38,682$ |

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## 8. Other Credit Arrangements

In Fiscal 2012, the Company entered into a five-year, $\$ 150.0$ million syndicated, unsecured, revolving credit agreement (the Credit Agreement ). The primary purpose of the Credit Agreement is to provide additional access to capital for general corporate purposes, growth initiatives and the issuance of letters of credit.

The Credit Agreement contains financial covenants that require the Company to maintain certain coverage and leverage ratios, and various customary affirmative and negative covenants such as the ability to incur additional debt not otherwise permitted under the Credit Agreement.

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The Credit Agreement has various borrowing options, including rates of interest that are based on (i) an Adjusted London Interbank Offered Rate ( LIBOR as defined in the Credit Agreement) plus a margin ranging from $1.00 \%$ to $1.75 \%$ based on a defined leverage ratio, payable at the end of the applicable interest period; and (ii) a Base Rate (as defined in the Credit Agreement), plus a margin ranging from $0.00 \%$ to $0.75 \%$ based on a defined leverage ratio, payable quarterly.

Under the Credit Agreement, the Company is also required to pay a commitment fee ranging from $0.175 \%$ to $0.30 \%$, based on the defined leverage ratio, on the unused portion of the total lender commitments.

As of August 3, 2013, the Company was in compliance with the terms of the Credit Agreement and had $\$ 8.3$ million outstanding in letters of credit and no borrowings.

Additionally, the Company has borrowing agreements with two separate financial institutions under which it may borrow an aggregate of $\$ 135.0$ million USD for the purposes of trade letter of credit issuances. The availability of any future borrowings under the trade letter of credit facilities is subject to acceptance by the respective financial institutions.

As of August 3, 2013, the Company had outstanding trade letters of credit of $\$ 88.8$ million.

## 9. Share-Based Compensation

The Company accounts for share-based compensation under the provisions of ASC 718, Compensation - Stock Compensation ( ASC 718 ), which requires companies to measure and recognize compensation expense for all share-based payments at fair value. Total share-based compensation expense included in the Consolidated Statements of Operations for the 13 and 26 weeks ended August 3, 2013 was $\$ 4.4$ million ( $\$ 2.7$ million, net of tax) and $\$ 9.7$ million ( $\$ 6.0$ million, net of tax), respectively and for the 13 and 26 weeks ended July 28, 2012 was $\$ 7.1$ million ( $\$ 4.4$ million, net of tax) and $\$ 28.0$ million ( $\$ 17.3$ million, net of tax), respectively.

## Stock Option Grants

The Company grants both time-based and performance-based stock options under its 2005 Stock Award and Incentive Plan. Time-based stock option awards vest over the requisite service period of the award or to an employee s eligible retirement date, if earlier. Performance-based stock option awards vest over one year and are earned if the Company meets pre-established performance goals.

A summary of the Company s stock option activity for the 26 weeks ended August 3, 2013 follows:

|  | Options (In thousands) | Weighted- <br> Average <br> Exercise Price |  | Weighted- <br> Average <br> Remaining <br> Contractual <br> Term <br> (In years) | Aggregate Intrinsic Value (In thousands) |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Outstanding - February 2, 2013 | 4,629 | \$ | 15.31 |  |  |  |
| Granted | 376 | \$ | 22.55 |  |  |  |
| Exercised (1) | (180) | \$ | 14.84 |  |  |  |
| Cancelled | (42) | \$ | 23.09 |  |  |  |
| Outstanding - August 3, 2013 | 4,783 | \$ | 16.78 | 3.2 | \$ | 20,777 |
| Vested and expected to vest - August 3, 2013 | 4,708 | \$ | 16.77 | 3.1 | \$ | 20,472 |
| Exercisable - August 3, 2013 (2) | 3,294 | \$ | 14.80 | 2.9 | \$ | 17,306 |

(1) Options exercised during the 26 weeks ended August 3, 2013 had exercise prices ranging from $\$ 4.24$ to $\$ 19.28$.
(2)

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Options exercisable represent in-the-money vested options based upon the weighted-average exercise price of vested options compared to the Company s stock price at August 3, 2013.
The weighted-average grant date fair value of stock options granted during the 26 weeks ended August 3, 2013 and July 28, 2012 was $\$ 4.17$ and $\$ 3.69$, respectively. The aggregate intrinsic value of options exercised during the 26 weeks ended August 3, 2013 and July 28, 2012 was $\$ 0.9$ million and $\$ 15.0$ million, respectively.

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Cash received from the exercise of stock options was $\$ 2.6$ million for the 26 weeks ended August 3, 2013 and $\$ 18.5$ million for the 26 weeks ended July 28, 2012. The actual tax benefit realized from stock option exercises totaled $\$ 8.1$ million for the 26 weeks ended August 3, 2013 and $\$ 4.4$ million for the 26 weeks ended July 28, 2012.

The fair value of stock options was estimated based on the closing market price of the Company s common stock on the date of the grant using a Black-Scholes option pricing model with the following weighted-average assumptions:

|  | 26 Weeks Ended |  |  |
| :--- | :---: | :---: | :---: |
|  | August 3, | July 28, |  |
| Black-Scholes Option Valuation Assumptions | 2013 | 2012 |  |
| Risk-free interest rate (1) | $0.3 \%$ | $0.6 \%$ |  |
| Dividend yield | $2.0 \%$ | $2.8 \%$ |  |
| Volatility factor (2) | $34.4 \%$ | $41.2 \%$ |  |
| Weighted-average expected term (3) | 2.5 years | 4.0 years |  |
| Expected forfeiture rate (4) | $8.0 \%$ | $8.0 \%$ |  |

(1) Based on the U.S. Treasury yield curve in effect at the time of grant with a term consistent with the expected life of our stock options.
(2) Based on a combination of historical volatility of the Company s common stock and implied volatility.
(3) Represents the period of time options are expected to be outstanding, based on historical experience.
(4) Based upon historical experience.

As of August 3, 2013, there was $\$ 1.8$ million of unrecognized compensation expense related to non-vested time-based stock option awards that is expected to be recognized over a weighted average period of 1.4 years.

## Restricted Stock Grants

Time-based restricted stock awards are comprised of time-based restricted stock units. These awards vest over three years; however, they may be accelerated to vest over one year if the Company meets pre-established performance goals in the year of grant. Time-based restricted stock units receive dividend equivalents in the form of additional time-based restricted stock units, which are subject to the same restrictions and forfeiture provisions as the original award.

Performance-based restricted stock awards include performance-based restricted stock units. These awards cliff vest at the end of a three year period based upon the Company s achievement of pre-established goals throughout the term of the award. Performance-based restricted stock units receive dividend equivalents in the form of additional performance-based restricted stock units, which are subject to the same restrictions and forfeiture provisions as the original award.

The grant date fair value of all restricted stock awards is based on the closing market price of the Company s common stock on the date of grant.
A summary of the Company s restricted stock activity is presented in the following tables:

|  | Time-Based Restricted Stock Units |  |  | Performance-Based Restricted StockUnits |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |  |
|  | 26 Weeks Ended |  |  | 26 Weeks Ended |  |  |
|  | August 3, 2013 |  |  | August 3, 2013 |  |  |
|  | Weighted-Average Grant |  |  | Weighted-Average Grant |  |  |
| Nonvested - February 2, 2013 | 1,386 | \$ | 13.91 | 2,086 | \$ | 14.91 |
| Granted | 871 | \$ | 22.36 | 857 | \$ | 21.80 |
| Vested | (972) | \$ | 13.55 | (566) | \$ | 17.39 |
| Cancelled | (51) | \$ | 18.50 | (4) | \$ | 14.65 |
| Nonvested - August 3, 2013 | 1,234 | \$ | 19.97 | 2,373 | \$ | 16.81 |

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As of August 3, 2013, there was $\$ 20.3$ million of unrecognized compensation expense related to non-vested time-based restricted stock unit awards that is expected to be recognized over a weighted-average period of 2.3 years. Additionally, there was $\$ 20.7$ million of unrecognized compensation expense related to performance-based restricted stock unit awards which will be recognized as achievement of performance goals is probable over a one to three year period.

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As of August 3, 2013, the Company had 17.8 million shares available for all equity grants.

## 10. Income Taxes

The provision for income taxes from continuing operations is based on the current estimate of the annual effective income tax rate and is adjusted as necessary for discrete quarterly events. The effective income tax rate from continuing operations based on actual operating results for the 13 weeks ended August 3, 2013 was $35.9 \%$ compared to $30.3 \%$ for the 13 weeks ended July 28, 2012. The effective income tax rate from continuing operations based on actual operating results for the 26 weeks ended August 3, 2013 was $37.2 \%$ compared to $32.8 \%$ for the 26 weeks ended July 28, 2012. The lower effective income tax rate for the 13 and 26 weeks ended July 28, 2012 was primarily due to income tax settlements and other changes in income tax reserves.

The Company records accrued interest and penalties related to unrecognized tax benefits in income tax expense.
The Company recognizes income tax liabilities related to unrecognized tax benefits in accordance with ASC 740 and adjusts these liabilities when its judgment changes as the result of the evaluation of new information not previously available. Unrecognized tax benefits did not change significantly during the 13 weeks ended August 3, 2013. Unrecognized tax benefits decreased by $\$ 7.3$ million during the 13 weeks ended July 28,2012 primarily due to income tax settlements and other changes in income tax reserves. Over the next twelve months the Company does not anticipate any significant changes to unrecognized tax benefits.

## 11. Legal Proceedings

The Company is subject to certain legal proceedings and claims arising out of the conduct of its business. In accordance with ASC 450, Contingencies ( ASC 450 ), management records a reserve for estimated losses when the loss is probable and the amount can be reasonably estimated. If a range of possible loss exists and no anticipated loss within the range is more likely than any other anticipated loss, the Company records the accrual at the low end of the range, in accordance with ASC 450. As the Company believes that it has provided adequate reserves, it anticipates that the ultimate outcome of any matter currently pending against the Company will not materially affect the consolidated financial position or results of operations of the Company.

## 12. Acquisitions and Dispositions

On May 31, 2013, the Company completed a transaction with Dickson Concepts (International) Limited ( Dickson ) to acquire six existing American Eagle Outfitters franchised stores in Hong Kong and China, as well as and the related assets operated by Dickson, for total consideration of $\$ 20.8$ million USD. Included in the total consideration for the transaction was a $\$ 10.0$ million USD payment to Dickson terminate their right to open additional stores in Hong Kong, Macau, China and other designated territories in Asia.

The total purchase price was allocated to the net tangible and intangible assets acquired based on their preliminary estimated fair values as of May 31, 2013. Such estimated fair values require management to make estimates and judgments, especially with respect to intangible assets. The Company s valuation of intangible assets, including deferred income taxes, is subject to finalization during Fiscal 2013.

The preliminary allocation of the purchase price to the fair value of assets acquired is as follows:

| (In thousands) | $\$ 2,456$ |
| :--- | ---: |
| Merchandise inventory | 2,351 |
| Other assets | 6,460 |
| Property and equipment | 9,484 |
| Intangible assets and goodwill | $\$ 20,751$ |

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Results of operations of the six acquired stores have been included in our Consolidated Statements of Operations since the May 31, 2013 acquisition date. Pro forma results of the acquired business have not been presented as the results were not material to our Consolidated Financial Statements for all years presented and would not have been material had the acquisition occurred at the beginning of Fiscal 2013.

## 13. Discontinued Operations

During Fiscal 2012, the Company exited the 77kids business which included all 22 stores and related e-commerce operations. These Consolidated Financial Statements reflect the results of 77 kids as a discontinued operation for all periods presented.

Additionally, the third party purchaser assumed certain liabilities associated with the 77 kids business and paid the Company an amount equal to $65 \%$ of the cost of the acquired inventory. A $\$ 10.0$ million inventory balance for 77 kids has been recorded as a component of assets held-for-sale on the Company s Consolidated Balance Sheets as of July 28, 2012. There were no balances for 77kids as of August 3, 2013 or February 2, 2013.

In connection with the exit of the 77 kids business, the Company is secondarily liable for obligations under the lease agreements for 21 store leases assumed by the third party purchaser. These obligations will remain in effect until the leases expire through 2022, unless the Company otherwise is released by the applicable landlord. In the event that the third party purchaser does not fulfill its obligations under any of the leases and the Company is required to make any such payments, the Company would seek full reimbursement from the third party purchaser in accordance with the asset purchase agreement. The third party purchaser has provided a stand-by letter of credit to the Company in order to secure payment of obligations under the leases.

In accordance with ASC 460, Guarantees ( ASC 460 ), as we became secondarily liable under the leases at the time that we transferred them to the third party, no amounts have been accrued in our Consolidated Financial Statements related to these guarantees.

The table below presents the significant components of 77kids results included in Loss from Discontinued Operations on the Consolidated Statement of Operations for the 13 and 26 weeks ended July 28, 2012. There were no losses from Discontinued Operations within the Consolidated Statement of Operations for both the 13 and 26 weeks ended August 3, 2013.

|  | 13 Weeks <br> Ended <br> July 28, <br> 2012 | 26 Weeks <br> Ended <br> July 28, <br> 2012 |  |
| :--- | :---: | :---: | :---: |
| (In thousands) | $\$ 9,719$ | $\$ 20,117$ |  |
| Total net revenue | $\$(38,600)$ | $\$(45,648)$ |  |
| Loss from discontinued operations, before income taxes | 14,781 | 17,491 |  |
| Income tax benefit | $\$(23,819)$ | $\$(28,157)$ |  |
| Loss from discontinued operations, net of tax |  |  |  |
| Loss per common share from discontinued operations: $\$$ $(0.12)$ $\$$ <br> Basic $\$$ $(0.12)$ $\$$ <br> Diluted  $(0.14)$  |  |  |  |

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There were no assets or liabilities included in the Consolidated Balance Sheets for 77kids as of August 3, 2013 or February 2, 2013. The major classes of assets and liabilities included in the Consolidated Balance Sheet for 77kids as of July 28, 2012 are as follows:

| (In thousands) | July 28, <br> 2012 |
| :--- | :---: |
| Current assets | $\$ 10,189$ |
| Non-current assets | $\$ 10,189$ |
| Total assets (1) | $\$ 9,034$ |
| Total current liabilities | 2,597 |
| Total non-current liabilities | $\$ 11,631$ |

(1) Current assets primarily relate to merchandise inventory classified as an asset held-for-sale on the Company s Consolidated Balance Sheets.

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## Review by Independent Registered Public Accounting Firm

Ernst \& Young LLP, our independent registered public accounting firm, has performed a limited review of the unaudited Consolidated Financial Statements as of and for the twenty-six week periods ended August 3, 2013 and July 28, 2012, as indicated in their report on the limited review included below. Since they did not perform an audit, they express no opinion on the unaudited Consolidated Financial Statements referred to above.

## Review Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

American Eagle Outfitters, Inc.
We have reviewed the consolidated balance sheets of American Eagle Outfitters, Inc. (the Company) as of August 3, 2013 and July 28, 2012, and the related consolidated statements of operations and retained earnings, and comprehensive income for the thirteen and twenty-six week periods ended August 3, 2013 and July 28, 2012 and the consolidated statements of cash flows for the twenty-six week periods ended August 3, 2013 and July 28, 2012. These financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of American Eagle Outfitters, Inc. as of February 2, 2013, and the related consolidated statements of operations, comprehensive income, stockholders equity, and cash flows for the year then ended (not presented herein), and we expressed an unqualified audit opinion on those consolidated financial statements in our report dated March 12, 2013. In our opinion, the accompanying consolidated balance sheet of American Eagle Outfitters, Inc. as of February 2, 2013, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.
/s/ Ernst \& Young LLP
August 29, 2013

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.
The following discussion and analysis of financial condition and results of operations should be read in conjunction with our Fiscal 2012
Management s Discussion and Analysis of Financial Condition and Results of Operations which can be found in our Fiscal 2012 Annual Report on Form 10-K.

In addition, the following discussion and analysis of financial condition and results of operations are based upon our Consolidated Financial Statements and should be read in conjunction with these statements and notes thereto.

This report contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which represent our expectations or beliefs concerning future events, including the following:
the planned opening of approximately 55 to 60 new American Eagle Outfitters stores in North America and internationally during Fiscal 2013;
the planned opening of approximately 20 new franchised American Eagle Outfitters stores during Fiscal 2013;
the selection of approximately 50 to 65 American Eagle Outfitters stores in the United States and Canada for remodeling and refurbishing during Fiscal 2013;
the potential closure of approximately 20 to 30 American Eagle Outfitters and 15 to 20 aerie stores in the United States and Canada during Fiscal 2013;
the success of our efforts to expand internationally, engage in future franchise/license agreements, and/or grow through acquisitions or joint ventures;
the success of our core American Eagle Outfitters and aerie brands through our omni-channel outlets within North America and internationally;
the possibility that economic pressures and other business factors will have a significant negative impact on our continued growth and results of operations;
the expected payment of a dividend in future periods;
the possibility that our credit facilities may not be available for future borrowings;
the possibility that rising prices of raw materials, labor, energy and other inputs to our manufacturing process, if unmitigated, will have a significant impact to our profitability; and
the possibility that we may be required to take additional store impairment charges related to underperforming stores.

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We caution that these forward-looking statements, and those described elsewhere in this report, involve material risks and uncertainties and are subject to change based on factors beyond our control as discussed within Item 1A of this Quarterly Report on Form 10-Q and Item 1A of our Fiscal 2012 Annual Report on Form 10-K. Accordingly, our future performance and financial results may differ materially from those expressed or implied in any such forward-looking statements.

## Key Performance Indicators

Our management evaluates the following items, which are considered key performance indicators, in assessing our performance:
Comparable sales Comparable sales provide a measure of sales growth for stores and channels open at least one year over the comparable prior year period. In fiscal years following those with 53 weeks, including Fiscal 2013, the prior year period is shifted by one week to compare similar calendar weeks. A store is included in comparable sales in the thirteenth month of operation. However, stores that have a gross square footage increase of $25 \%$ or greater due to a remodel are removed from the comparable sales base, but are included in total sales. These stores are returned to the comparable sales base in the thirteenth month following the remodel. Sales from American Eagle Outfitters and aerie stores, as well as sales from AEO Direct, are included in total comparable sales. Sales from franchise stores are not included in comparable sales. Individual American Eagle Outfitters and aerie brand comparable sales disclosures represent sales from stores and AEO Direct.

We began to include AEO Direct sales in the individual American Eagle Outfitters and aerie brand comparable sales metric in Fiscal 2013 for the following reasons:
our approach to customer engagement continues to evolve as omni-channel, which provides a seamless customer experience through both traditional and non-traditional channels, including four wall store locations, web, mobile/tablet devices, social networks, email, in-store displays and kiosks;
shopping behavior has continued to evolve across multiple channels that work in tandem to meet all customer needs. Management believes that presenting a brand level performance metric that includes all channels (i.e., stores and AEO Direct) to be the most appropriate, given customer behavior.

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Our management considers comparable sales to be an important indicator of our current performance. Comparable sales results are important to achieve leveraging of our costs, including store payroll, store supplies, rent, etc. Comparable sales also have a direct impact on our total net revenue, cash and working capital.

Gross profit - Gross profit measures whether we are optimizing the price and inventory levels of our merchandise and achieving an optimal level of sales. Gross profit is the difference between total net revenue and cost of sales. Cost of sales consists of: merchandise costs, including design, sourcing, importing and inbound freight costs, as well as markdowns, shrinkage, certain promotional costs and buying, occupancy and warehousing costs. Buying, occupancy and warehousing costs consist of compensation, employee benefit expenses and travel for our buyers and certain senior merchandising executives; rent and utilities related to our stores, corporate headquarters, distribution centers and other office space; freight from our distribution centers to the stores; compensation and supplies for our distribution centers, including purchasing, receiving and inspection costs; and shipping and handling costs related to our e-commerce operation. The inability to obtain acceptable levels of sales, initial markups or any significant increase in our use of markdowns could have an adverse effect on our gross profit and results of operations.

Operating income - Our management views operating income as a key indicator of our success. The key drivers of operating income are comparable sales, gross profit, our ability to control selling, general and administrative expenses, and our level of capital expenditures. Management also uses earnings before interest and taxes ( EBIT ) as an indicator of successful operating results.

Return on invested capital - Our management uses return on invested capital ( ROIC ) as a key measure to assess our efficiency at allocating capital to profitable investments. This measure is critical in determining which strategic alternatives to pursue.

Store productivity - Store productivity, including total net revenue per average square foot, sales per productive hour, average unit retail price ( AUR ), conversion rate, the number of transactions per store, the number of units sold per store, the number of units per transaction and four wall profit, is evaluated by our management in assessing our operational performance.

Inventory turnover - Our management evaluates inventory turnover as a measure of how productively inventory is bought and sold. Inventory turnover is important as it can signal slow moving inventory. This can be critical in determining the need to take markdowns on merchandise.

Cash flow and liquidity - Our management evaluates cash flow from operations, investing and financing in determining the sufficiency of our liquidity. Cash flow from operations has historically been sufficient to cover our uses of cash. Our management believes that cash flow from operations will be sufficient to fund anticipated capital expenditures and working capital requirements.

Our management s goals are to drive improvements to our gross profit performance, bring greater consistency to our results and to deliver profitable growth over the long term. Specifically, our targets are to deliver a total net revenue compounded annual growth rate ( CAGR ) of $7 \%$ to $9 \%$, an EBIT CAGR of $12 \%$ to $15 \%$ and a ROIC in the range of $14 \%$ to $17 \%$.

## Results of Operations

## Overview

Our performance in the second quarter of Fiscal 2013 was negatively impacted by a disappointing women sassortment, primarily within the core and core fashion businesses, and a highly competitive and promotional retail environment. Store traffic in North America was uneven throughout the quarter and further decelerated in July. These factors led to deeper and broader promotions, directly resulting in increased markdowns, which pressured second quarter earnings.

Our second quarter total net revenue decreased $2 \%$ to $\$ 727.3$ million and comparable sales, including AEO Direct, decreased $7 \%$, compared to an $8 \%$ increase last year. By brand, American Eagle Outfitters brand comparable sales decreased $8 \%$ and aerie brand decreased $2 \%$. Comparable sales for AEO Direct, which is included in the consolidated brand comparable sales, increased $11 \%$.

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Gross profit decreased $11 \%$ to $\$ 245.5$ million compared to $\$ 276.6$ million last year and declined 360 basis points to $33.8 \%$ as a rate to total net revenue. The decline is the result of higher markdowns, increased delivery costs and the deleverage of rent on negative comparable sales.

Operating income for the second quarter was $\$ 29.4$ million compared to $\$ 61.8$ million a year ago, which includes $\$ 5.1$ million of pre-tax restructuring costs and asset impairments. Net income this year was $\$ 19.6$ million, or $\$ 0.10$ per diluted share. This compares to adjusted income from continuing operations last year of $\$ 0.21$ per diluted share, which excludes $\$ 0.02$ per diluted share of tax benefits from audit settlements, fully offset by $\$ 0.02$ of pre-tax restructuring costs and asset impairments.

The preceding paragraph contains non-GAAP financial measures ( non-GAAP or adjusted ), comprised of earnings per share information excluding non-GAAP items. This financial measure is not based on any standardized methodology prescribed by U.S. generally accepted accounting principles (GAAP ) and is not necessarily comparable to similar measures presented by other companies. We believe that this non-GAAP information is useful as an additional means for investors to evaluate our operating performance, when reviewed in conjunction with our GAAP financial statements. These amounts are not determined in accordance with GAAP and therefore, should not be used exclusively in evaluating our business and operations. The table below reconciles the GAAP financial measure to the non-GAAP financial measure discussed above.

|  | 26 Weeks <br> Ended <br> July 28, <br> 2012 |
| :--- | :---: |
| Income from continuing operations per diluted share - GAAP Basis | $\$ 0.21$ |
| Add back: Corporate charges and asset write-offs ${ }^{(1)}$ | 0.02 |
| Less: Tax Benefits ${ }^{(1)}$ | $(0.02)$ |

Income from continuing operations per diluted share - Non-GAAP Basis
\$ 0.21
(1) Non-GAAP Items consist of $\$ 4.4$ million of tax benefits from audit settlements, offset by $\$ 3.9$ million of pre-tax restructuring costs and $\$ 1.2$ million of pre-tax asset impairments and asset write offs.
We had $\$ 404.9$ million in cash and cash equivalents and short-term investments as of August 3, 2013. Merchandise inventory at the end of the second quarter was $\$ 461.1$ million, compared to $\$ 462.0$ million last year, a decrease of $1 \%$ on a cost per foot basis. The decrease is due to a $7 \%$ decrease in ending units per foot, partially offset by a $6 \%$ increase in ending average cost per unit as a result of product mix.

Our business is affected by the pattern of seasonality common to most retail apparel businesses. The results for the current and prior periods are not necessarily indicative of future financial results.

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The following table shows the percentage relationship to total net revenue of the listed line items included in our Consolidated Statements of Operations.

|  | 13 Weeks Ended |  | 26 Weeks Ended |  |
| :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { August } 3 \text {, } \\ 2013 \end{gathered}$ | July 28, $2012$ | $\begin{gathered} \text { August } 3 \text {, } \\ 2013 \end{gathered}$ | $\begin{gathered} \text { July } 28, \\ 2012 \end{gathered}$ |
| Total net revenue | 100.0\% | 100.0\% | 100.0\% | 100.0\% |
| Cost of sales, including certain buying, occupancy and warehousing expenses | 66.2 | 62.6 | 63.8 | 61.9 |
| Gross profit | 33.8 | 37.4 | 36.2 | 38.1 |
| Selling, general and administrative expenses | 25.6 | 24.6 | 26.2 | 24.9 |
| Depreciation and amortization expense | 4.1 | 4.4 | 4.6 | 4.5 |
| Operating income | 4.1 | 8.4 | 5.4 | 8.7 |
| Other (expense) income, net | 0.1 | (0.1) |  | 0.2 |
| Income before income taxes | 4.2 | 8.3 | 5.4 | 8.9 |
| Provision for income taxes | 1.5 | 2.5 | 2.0 | 2.9 |
| Income from continuing operations | 2.7 | 5.8 | 3.4 | 6.0 |
| Loss from discontinued operations, net of tax |  | (3.2) |  | (1.9) |
| Net income | 2.7\% | 2.6\% | $3.4 \%$ | 4.1\% |

The following table shows our adjusted consolidated store data, which excludes 77kids stores:

|  | 13 Weeks Ended |  | 26 Weeks Ended |  |
| :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { August 3, } \\ 2013 \end{gathered}$ | $\begin{gathered} \text { July } 28, \\ 2012 \end{gathered}$ | $\begin{gathered} \text { August } 3 \text {, } \\ 2013 \end{gathered}$ | $\begin{gathered} \text { July } 28, \\ 2012 \end{gathered}$ |
| Number of stores: |  |  |  |  |
| Beginning of period | 1,037 | 1,068 | 1,044 | 1,069 |
| Opened | 26 | 3 | 33 | 9 |
| Closed | (7) | (8) | (21) | (15) |
| End of period | 1,056 | 1,063 | 1,056 | 1,063 |
| Total gross square feet at end of period | 6,373,055 | 6,283,028 | 6,373,055 | 6,283,028 |
| International franchise stores at end of period (1) | 57 | 39 | 57 | 39 |

(1) International franchise stores are not included in the consolidated store data or the total gross square feet calculation. International franchise stores at July 28, 2012 include the six stores in Hong Kong and China which were acquired in 2013. Refer to Note 12 to the Consolidated Financial Statements for additional information on the Company s acquisition of its Hong Kong and China operations.
Our operations are conducted in one reportable segment, which includes 921 American Eagle Outfitters retail stores, 135 aerie stand-alone retail stores and AEO Direct.

Comparison of the 13 weeks ended August 3, 2013 to the 13 weeks ended July 28, 2012

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## Total net revenue

Total net revenue decreased $2 \%$ to $\$ 727.3$ million compared to $\$ 739.7$ million last year. The change in total net revenue resulted primarily from a comparable sales decrease of $7 \%$ for the period. By brand, including the respective AEO Direct sales, American Eagle Outfitters brand comparable sales decreased $8 \%$, or $\$ 51.2$ million, and aerie brand comparable sales decreased $2 \%$, or $\$ 1.2$ million. Second quarter 2013 comparable sales are compared to the 13 weeks ended August 4, 2012.

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AE women s and men s comparable sales decreased $9 \%$ and $4 \%$, respectively. For the second quarter, weak traffic led to a $3 \%$ decrease in transactions per store on flat conversion. The average transaction value was down $4 \%$ on a $1 \%$ decline in AUR.

## Gross Profit

Gross profit decreased $11 \%$ to $\$ 245.5$ million compared to $\$ 276.6$ million last year. As a rate to total net revenue, gross profit was $33.8 \%$ compared to $37.4 \%$ in the same quarter last year. The 360 basis point decline in gross margin was due to increased markdowns, partially offset by product cost improvement, which led to 250 basis points of the decline. Buying, occupancy and warehousing costs increased 110 basis points from the deleverage of rent on negative comparable sales and higher delivery costs.

There was $\$ 1.7$ million and $\$ 3.6$ million of share-based payment expense included in gross profit for the periods ended August 3, 2013 and July 28, 2012, respectively, comprised of both time and performance-based awards.

Our gross profit may not be comparable to that of other retailers, as some retailers include all costs related to their distribution network as well as design costs in cost of sales and others may exclude a portion of these costs from cost of sales, including them in a line item such as selling, general and administrative expenses. Refer to Note 2 to the Consolidated Financial Statements for a description of our accounting policy regarding cost of sales, including certain buying, occupancy and warehousing expenses.

## Selling, General and Administrative Expenses

Selling, general and administrative expenses increased to $\$ 186.3$ million from $\$ 182.1$ million last year and increased 100 basis points, as a rate to total net revenue, to $25.6 \%$ from $24.6 \%$ last year. The dollar increase this year was driven primarily by hiring of open positions at the corporate office and incremental expense relating to the opening of factory stores, international expansion and omni-channel initiatives. Additionally, restructuring costs and asset impairments of $\$ 4.4$ million, or 60 basis points, were included last year.

There was $\$ 2.7$ million and $\$ 3.6$ million of share-based payment expense included in selling, general and administrative expenses for the periods ended August 3, 2013 and July 28, 2012, respectively, comprised of both time and performance-based awards.

## Depreciation and Amortization Expense

Depreciation and amortization expense decreased to $\$ 29.7$ million, compared to $\$ 32.6$ million last year due to the impact of prior year store impairment and the maturing of assets. Additionally, depreciation and amortization expense includes $\$ 0.7$ million of restructuring asset write-offs in the second quarter of 2012.

## Other (Expense) Income, Net

Other income was $\$ 1.1$ million, which primarily consisted of interest income and foreign currency translation, compared to expense of $\$ 0.3$ million last year.

## Provision for Income Taxes

The provision for income taxes from continuing operations is based on the current estimate of the annual effective income tax rate and is adjusted as necessary for discrete quarterly events. The effective income tax rate from continuing operations based on actual operating results for the 13 weeks ended August 3, 2013 was $35.9 \%$ compared to $30.3 \%$ for the 13 weeks ended July 28, 2012. The lower effective income tax rate for the 13 weeks ended July 28, 2012 was primarily due to income tax settlements and other changes in income tax reserves.

## Income from Continuing Operations

Income from continuing operations for the second quarter was $\$ 19.6$ million, or $\$ 0.10$ per diluted share, compared to $\$ 42.8$ million, or $\$ 0.21$ per diluted share, last year. The decline is attributable to the factors noted above.

## Loss from Discontinued Operations

Due to the completion of the sale of the 77kids business to a third party in Fiscal 2012, the results of 77kids are presented as a discontinued operation. Loss from discontinued operations, net of tax, was $\$ 23.8$ million, or a $\$ 0.12$ loss per diluted share, for the period ended July 28, 2012.

There were no losses from discontinued operations this year.

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Refer to Note 13 to the Consolidated Financial Statements for additional information regarding the discontinued operations of 77kids.

## Net Income

Net income increased to $\$ 19.6$ million, or $2.7 \%$ as a percent to total net revenue, from $\$ 19.0$ million, or $2.6 \%$ as a percent to total net revenue last year. Net income per diluted share increased to $\$ 0.10$ per diluted share from $\$ 0.09$ per diluted share in the prior year. The change in net income is attributable to the factors noted above, including the impact of the discontinued operations of 77 kids last year.

Comparison of the 26 weeks ended August 3, 2013 to the 26 weeks ended July 28, 2012

## Total net revenue

Total net revenue decreased $3 \%$ to $\$ 1.407$ billion compared to $\$ 1.448$ billion last year. The change in total net revenue resulted primarily from a comparable sales decrease of $6 \%$ for the period. By brand, including the respective AEO Direct sales, American Eagle Outfitters brand comparable sales decreased $7 \%$, or $\$ 88.7$ million, and aerie brand comparable sales increased $1 \%$, or $\$ 0.7$ million. Year-to-date 2013 comparable sales are compared to the 26 weeks ended August 4, 2012.

AE women s and men s comparable sales decreased $8 \%$ and $3 \%$, respectively. For the 26 week period, traffic, transactions and average transaction value decreased. AUR decreased in the low single-digits, primarily due to greater promotional activity.

## Gross Profit

Gross profit decreased $8 \%$ to $\$ 509.1$ million compared to $\$ 551.5$ million last year. As a rate to total net revenue, gross profit was $36.2 \%$, compared to $38.1 \%$ last year. Included in gross profit were $\$ 2.4$ million of corporate charges this year. Favorable product costs provided 150 basis points of improvement, offset by 200 basis points of decline due to higher markdowns. Buying, occupancy and warehousing costs deleveraged 140 basis points from higher delivery costs and deleverage of rent on negative comparable sales.

There was $\$ 4.0$ million and $\$ 14.4$ million of share-based payment expense included in gross profit for the periods ended August 3, 2013 and July 28, 2012, respectively, comprised of both time and performance-based awards.

Our gross profit may not be comparable to that of other retailers, as some retailers include all costs related to their distribution network as well as design costs in cost of sales and others may exclude a portion of these costs from cost of sales, including them in a line item such as selling, general and administrative expenses. Refer to Note 2 to the Consolidated Financial Statements for a description of our accounting policy regarding cost of sales, including certain buying, occupancy and warehousing expenses.

## Selling, General and Administrative Expenses

Selling, general and administrative expenses increased to $\$ 368.6$ million from $\$ 360.7$ million last year and increased 130 basis points, as a rate to total net revenue, to $26.2 \%$ from $24.9 \%$ last year. Corporate charges of $\$ 1.5$ million this year and $\$ 4.4$ million last year, were included in selling, general and administrative expense. The dollar increase this year was driven primarily by fortifying our corporate team and incremental expense relating to the opening of factory stores, international expansion and omni-channel initiatives, offset by lower incentive compensation costs.

There was $\$ 5.7$ million and $\$ 13.6$ million of share-based payment expense included in selling, general and administrative expenses for the periods ended August 3, 2013 and July 28, 2012, respectively, comprised of both time and performance-based awards.

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## Depreciation and Amortization Expense

Depreciation and amortization expense increased to $\$ 65.3$ million, compared to $\$ 64.7$ million last year. Depreciation and amortization expense includes $\$ 7.6$ million of restructuring asset write-offs this year and $\$ 0.7$ million last year.

## Other Income, Net

Other income was $\$ 0.5$ million this year, compared to $\$ 3.2$ million last year, primarily as a result of proceeds received from the ARS Call Option last year.

## Provision for Income Taxes

The provision for income taxes from continuing operations is based on the current estimate of the annual effective income tax rate and is adjusted as necessary for discrete quarterly events. The effective income tax rate from continuing operations based on actual operating results for the 26 weeks ended August 3, 2013 was $37.2 \%$ compared to $32.8 \%$ for the 26 weeks ended July 28, 2012. The lower effective income tax rate for the 26 weeks ended July 28, 2012 was primarily due to income tax settlements and other changes in income tax reserves.

## Income from Continuing Operations

Income from continuing operations for the 26 week period ended August 3, 2013 was $\$ 47.6$ million, or $\$ 0.24$ per diluted share, compared to $\$ 86.9$ million, or $\$ 0.44$ per diluted share, last year. The change in income from continuing operations is attributable to the factors noted above.

## Loss from Discontinued Operations

Due to the completion of the sale of the 77kids business to a third party in Fiscal 2012, the results of 77 kids are presented as a discontinued operation. Loss from discontinued operations, net of tax, was $\$ 28.2$ million, or a $\$ 0.14$ loss per diluted share, for the period ended July 28, 2012. There were no losses from discontinued operations this year.

Refer to Note 13 to the Consolidated Financial Statements for additional information regarding the discontinued operations of 77kids.

## Net Income

Net income decreased to $\$ 47.6$ million, or $3.4 \%$ as a percent to total net revenue, from $\$ 58.7$ million, or $4.1 \%$ as a percent to total net revenue last year. Net income per diluted share decreased to $\$ 0.24$ per diluted share from $\$ 0.30$ per diluted share in the prior year. The change in net income is attributable to the factors noted above, including the impact of the discontinued operations of 77kids last year.

## International Operations

We have entered into franchise agreements with multiple partners to expand our brands internationally. Through these franchise agreements, we plan to open a series of American Eagle Outfitters stores in Eastern Europe, Northern Africa and various parts of Asia. As of August 3, 2013, we had 57 franchised stores operated by our franchise partners in 12 countries. These franchise agreements do not involve a significant capital investment or operational involvement from AEO and require minimal operational involvement. International franchise stores are not included in the consolidated store data or the total gross square feet calculation.

As of August 3, 2013, we operated 93 wholly owned stores in Canada, three in Hong Kong, three in China, three in Mexico and six in Puerto Rico. We acquired the stores in Hong Kong and China from our franchise partner, Dickson Concepts (International) Limited, in the second quarter of this year. We plan to open several additional wholly owned stores in Mexico throughout 2013. We continue to evaluate further opportunities to expand internationally, which may include additional franchise agreements or wholly owned stores, as well as joint ventures.

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## Fair Value Measurements

ASC 820 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. Fair value is defined under ASC 820 as the exit price associated with the sale of an asset or transfer of a liability in an orderly transaction between market participants at the measurement date.

## Financial Instruments

Valuation techniques used to measure fair value under ASC 820 must maximize the use of observable inputs and minimize the use of unobservable inputs. In addition, ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs (i.e., projections, estimates, interpretations, etc.) that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.
As of August 3, 2013, we held certain assets that are required to be measured at fair value on a recurring basis. These include cash equivalents and short-term investments.

In accordance with ASC 820, the following table represents the fair value hierarchy of our financial assets (cash equivalents and investments) measured at fair value on a recurring basis as of August 3, 2013:

| (In thousands) | Carrying <br> Amount | Fair Value Measurements at August 3, 2013  <br> Quoted Market  <br> Prices in Active  <br> Markets for Significant Other <br> Identical Observable <br> Assets Inputs <br> (Level 1) (Level 2) |  |  |  | Significant Unobservable Inputs (Level 3) |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Cash and cash equivalents: |  |  |  |  |  |  |
| Cash | \$ 289,444 | \$ | 289,444 | \$ |  | \$ |
| Money-market | 46,912 |  | 46,912 |  |  |  |
| Treasury bills | 8,832 |  | 8,832 |  |  |  |
| Total cash and cash equivalents | \$ 345,188 | \$ | 345,188 | \$ |  | \$ |
| Short-term investments: |  |  |  |  |  |  |
| Treasury bills | \$ 50,035 | \$ | 50,035 | \$ |  | \$ |
| Term-deposits | 9,643 |  | 9,643 |  |  |  |
| Total short-term investments | \$ 59,678 | \$ | 59,678 | \$ |  | \$ |
| Total | \$ 404,866 | \$ | 404,866 | \$ |  | \$ |
| Percent to Total | 100.0\% |  | 100.0\% |  | 0.0\% | 0.0\% |

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Refer to Notes 3 and 4 to the Consolidated Financial Statements for additional information on our investment securities, including a description of the securities and a discussion of the uncertainties relating to their liquidity.

## Liquidity and Capital Resources

Our uses of cash are generally for working capital, the construction of new stores and remodeling of existing stores, information technology upgrades, distribution center improvements and expansion, the purchase of both short and long-term investments, the repurchase of common stock and the payment of dividends. Historically, these uses of cash have been funded with cash flow from operations and existing cash on hand. We expect to be able to fund our future cash requirements through current cash holdings as well as cash generated from operations.

Our growth strategy includes internally developing our brands and the possibility of further international expansion or acquisitions. We periodically consider and evaluate these options to support future growth. In the event we do pursue such options, we could require additional debt financing. There can be no assurance that we would be successful in any endeavor we may undertake to increase our profitability.

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The following sets forth certain measures of our liquidity:

|  | August 3, | February 2, | July 28, |
| :--- | ---: | ---: | ---: |
|  | 2013 | 2013 | 2012 |
| Working Capital (in thousands) | $\$ 609,183$ | $\$ 715,397$ | $\$ 970,454$ |
| Current Ratio | 2.31 | 2.64 | 3.51 |

The $\$ 106.2$ million decrease in working capital compared to February 2, 2013 and the $\$ 361.3$ million decrease compared to last year, is primarily related to use of cash for financing and investing activities including capital expenditures and the distribution of cash to shareholders through the payment of dividends and share repurchases, which is partially offset from positive cash flow from operations.

## Cash Flows from Operating Activities of Continuing Operations

Net cash (used for) provided by operating activities totaled (\$9.5) million and $\$ 47.7$ million for the 26 weeks ended August 3, 2013 and July 28, 2012, respectively. For both periods, our major source of cash from operations was merchandise sales and our primary outflow of cash for operations was for the payment of operational costs. Cash flows from operations last year were positive, driven in part by an increase in income from continuing operations, net of non-cash adjustments, as a result of improved margin rates resulting from favorable product costs and lower overall inventory balances. Net cash used for operations this year is due to the decrease in profitability and the payment of accrued bonuses and other operating items subsequent to Fiscal 2012 end.

## Cash Flows from Investing Activities of Continuing Operations

Investing activities for the 26 weeks ended August 3, 2013 included $\$ 123.9$ million of capital expenditures for property and equipment, $\$ 20.8$ million for the purchase of assets in acquisition, $\$ 7.6$ million of investment security purchases and $\$ 0.7$ million for the acquisition of intangibles partially offset by $\$ 69.2$ million of proceeds from the sale of investments classified as available-for-sale. Purchase of assets in acquisition relate to the franchise stores and related assets we acquired from Dickson Concepts (International) Limited. Investing activities for the 26 weeks ended July 28, 2012 primarily included $\$ 48.2$ million of capital expenditures for property and equipment and $\$ 0.6$ million of investment security purchases partially offset by $\$ 20.6$ million of proceeds from the sale of investments classified as available-for-sale.

## Cash Flows from Financing Activities of Continuing Operations

Cash used for financing activities for the 26 weeks ended August 3, 2013 consisted primarily of $\$ 33.1$ million for the repurchase of common stock as part of publicly announced programs, $\$ 24.1$ million for the cash dividends paid, $\$ 23.3$ million for the repurchase of common stock from employees for the payment of taxes in connection with the vesting of share-based payment and $\$ 0.3$ million for the payments on capital leases, partially offset by $\$ 8.2$ million related to excess tax benefit from share-based payments. Cash used for financing activities for the 26 weeks ended July 28, 2012 consisted primarily of $\$ 43.1$ million for the payment of dividends, offset by $\$ 18.5$ million related to proceeds from stock option exercises.

## Credit Facilities

In Fiscal 2012, we entered into a five-year, $\$ 150$ million syndicated, unsecured, revolving credit agreement (the Credit Agreement ). The primary purpose of the Credit Agreement is to provide additional access to capital for general corporate purposes, growth initiatives and the issuance of letters of credit.

The Credit Agreement contains financial covenants that require us to maintain certain coverage and leverage ratios, and various customary affirmative and negative covenants such as the ability to incur additional debt not otherwise permitted under the Credit Agreement.

The Credit Agreement has various borrowing options, including rates of interest that are based on (i) an Adjusted London Interbank Offered Rate ( LIBOR as defined in the Credit Agreement) plus a margin ranging from $1.00 \%$ to $1.75 \%$ based on a defined leverage ratio, payable at the end of the applicable interest period; and (ii) a Base Rate (as defined in the Credit Agreement), plus a margin ranging from 0.00\% to 0.75\% based on a defined leverage ratio, payable quarterly.

Under the Credit Agreement, the Company is also required to pay a commitment fee ranging from $0.175 \%$ to $0.30 \%$, based on the defined leverage ratio, on the unused portion of the total lender commitments.

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As of August 3, 2013, the Company was in compliance with the terms of the Credit Agreement and had $\$ 8.3$ million outstanding in letters of credit and no borrowings.

Additionally, we have borrowing agreements with two separate financial institutions under which we may borrow an aggregate of $\$ 135.0$ million USD for the purposes of trade letter of credit issuances. The availability of any future borrowings under the trade letter of credit facilities is subject to acceptance by the respective financial institutions.

As of August 3, 2013, the Company had outstanding trade letters of credit of $\$ 88.8$ million.

## Capital Expenditures for Property and Equipment

Capital expenditures for the 26 weeks ended August 3, 2013 were $\$ 123.9$ million and included $\$ 46.9$ million related to investments in our stores, including 27 new AE stores and 30 remodels. Additionally, we continued to support our infrastructure growth by investing in information technology initiatives ( $\$ 33.0$ million), other home office projects ( $\$ 14.6$ million), the improvement and expansion of our distribution centers ( $\$ 22.6$ million) and investments in e-commerce ( $\$ 6.8$ million).

For Fiscal 2013, we expect capital expenditures to be approximately $\$ 230$ million to $\$ 250$ million related to stores, the construction of a new distribution center to support our expansion efforts, information technology upgrades to support growth and investments in e-commerce. New store growth is primarily related to AEO Factory stores, which are among our most productive format. Additionally, we plan to remodel and refurbish approximately 50 to 65 AEO stores. During the 26 weeks ended August 3, 2013, we completed 30 remodels and refurbishes.

## Stock Repurchases

During the 26 weeks ended August 3, 2013, as part of our publicly announced share repurchase program, we repurchased 1.6 million shares for approximately $\$ 33.1$ million, at a weighted average price of $\$ 20.66$ per share. As of August 3, 2013, we had 18.4 million shares remaining authorized for repurchase. These shares may be repurchased at our discretion through January 28, 2017. There were no share repurchases as a part of our publicly announced repurchase programs during the 26 weeks ended July 28, 2012

During the 26 weeks ended August 3, 2013, we repurchased approximately 1.1 million shares from certain employees at market prices totaling $\$ 23.3$ million. These shares were repurchased for the payment of taxes, not in excess of the minimum statutory withholding requirements, in connection with the vesting of share-based payments, as permitted under the 2005 Stock Award and Incentive Plan. The aforementioned shares repurchased have been recorded as treasury stock.

## Dividends

During the 13 weeks ended August 3, 2013, our Board declared a quarterly cash dividend of $\$ 0.125$ per share, which was paid on July 12, 2013. The payment of future dividends is at the discretion of our Board and is based on future earnings, cash flow, financial condition, capital requirements, changes in U.S. taxation and other relevant factors. It is anticipated that any future dividends paid will be declared on a quarterly basis.

## Critical Accounting Policies

Our critical accounting policies are described in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, and in the notes to our Consolidated Financial Statements for the year ended February 2, 2013 contained in our Fiscal 2012 Annual Report on Form 10-K. Any new accounting policies or updates to existing accounting policies as a result of new accounting pronouncements have been discussed in the notes to our Consolidated Financial Statements in this Quarterly Report on Form 10-Q. The application of our critical accounting policies may require management to make judgments and estimates about the amounts reflected in the Consolidated Financial Statements. Management uses historical experience and all available information to make these estimates and judgments, and different amounts could be reported using different assumptions and estimates.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

There were no material changes in our exposure to market risk from February 2, 2013. Our market risk profile as of February 2, 2013 is disclosed in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, of our Fiscal 2012 Annual Report on Form 10-K.

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## ITEM 4. CONTROLS AND PROCEDURES.

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to provide reasonable assurance that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended (the Exchange Act ), is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management including our Principal Executive Officer and our Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

In connection with the preparation of this Quarterly Report on Form 10-Q, as of August 3, 2013, an evaluation was performed under the supervision and with the participation of our management, including the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon that evaluation, our Principal Executive Officer and our Principal Financial Officer have concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of the end of the period covered by this Quarterly Report on Form 10-Q.

## Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the 26 weeks ended August 3, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II OTHER INFORMATION

## ITEM 1A. RISK FACTORS.

Risk factors that affect our business and financial results are discussed within Item 1A of our Fiscal 2012 Annual Report on Form 10-K. There have been no material changes to the disclosures relating to this item from those set forth in our Fiscal 2012 Annual Report on Form 10-K.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS. Issuer Purchases of Equity Securities

The following table provides information regarding our repurchases of our common stock during the 26 weeks ended August 3, 2013.

|  |  |  | Shares Purchased as <br> Part of |
| :--- | :---: | :---: | :---: | :---: |
| Publicly |  |  |  |$\quad$| Total |
| :---: |
| Maximum Number of |
| Shares that May |

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There were no shares repurchased as part of our publicly announced share repurchase program during the 13 weeks ended August 3, 2013, and there were 2,637 shares repurchased for the payment of taxes in connection with the vesting of share- based payments.
(2) Average price paid per share excludes any broker commissions paid.
(3) In January 2013, our Board authorized the repurchase of 20.0 million shares of our common stock. The authorization of the remaining 18.4 million shares that may yet be purchased expires on January 28, 2017.

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ITEM 6. EXHIBITS.

* Exhibit 15 Acknowledgement of Independent Registered Public Accounting Firm
* Exhibit $31.1 \quad$ Certification by Robert L. Hanson pursuant to Rule 13a-14(a) or Rule 15d-14(a)
* Exhibit $31.2 \quad$ Certification by Mary M. Boland pursuant to Rule 13a-14(a) or Rule 15d-14(a)
**Exhibit 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
**Exhibit 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
* Exhibit 101 Interactive Data File
* Filed with this report.
** Furnished with this report.


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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: August 29, 2013

American Eagle Outfitters, Inc.
(Registrant)

By: /s/ Robert L. Hanson
Robert L. Hanson
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Mary M. Boland
Mary M. Boland
Chief Financial Officer and Chief Administrative Officer
(Principal Financial Officer)

