FOSSIL INC
Form 10-Q
August 16, 2007

## UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION 

Washington, D.C. 20549

## FORM 10-Q

## (Mark One)

x

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

For the quarterly period ended: July 7, 2007
OR

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

Commission file number: 0-19848

## FOSSIL, INC.

(Exact name of registrant as specified in its charter)

## Delaware

(State or other jurisdiction of incorporation or organization)

75-2018505
(I.R.S. Employer

Identification No.)

2280 N. Greenville Avenue, Richardson, Texas 75082
(Address of principal executive offices)
(Zip Code)
(972) 234-2525
(Registrant s telephone number, including area code)

Indicate by check mark whether 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 o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x
Accelerated filer o
Non-accelerated filer o

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

## Yes o No x

The number of shares of registrant s common stock outstanding as of August 13, 2007: 68,140,234

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## FOSSIL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

## UNAUDITED

## AMOUNTS IN THOUSANDS

| July 7, | January 6, |
| :--- | :--- |
| 2007 | 2007 |



See notes to condensed consolidated financial statements.

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FOSSIL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

## AND COMPREHENSIVE INCOME

## UNAUDITED

## AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA

|  | For the 13 Weeks Ended July 7, 2007 |  | For the 13 Weeks Ended July 8, 2006 |  | For the 26 Weeks Ended July 7, 2007 |  |  | For the 27 Weeks Ended July 8, 2006 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net sales | \$ | 306,464 | \$ | 259,238 | \$ | 611,289 |  | \$ | 523,463 |  |
| Cost of sales |  |  |  |  |  |  |  |  |  |  |
| Gross profit |  |  |  |  |  |  |  |  |  |  |
| Operating expenses: |  |  |  |  |  |  |  |  |  |  |
| Selling and distribution |  |  |  |  |  |  |  |  |  |  |
| General and administrative |  |  |  |  |  |  |  |  |  |  |
| Total operating expenses |  |  |  |  |  |  |  |  |  |  |
| Operating income |  |  |  |  |  |  |  |  |  |  |
| Interest expense | 21 |  | 951 |  | 43 |  |  | 1,5 |  |  |
| Other income (expense) net | 34 |  | 365 |  | 1,8 |  |  | (538 |  | ) |
| Income before income taxes |  |  |  |  |  |  |  |  |  |  |
| Provision for income taxes | 8,5 |  | 4,3 |  |  |  |  |  |  |  |
| Net income | \$ | 14,672 | \$ | 11,238 | \$ | 39,704 |  | \$ | 20,954 |  |
| Other comprehensive income, net of taxes: |  |  |  |  |  |  |  |  |  |  |
| Currency translation adjustment | 3,1 |  | 9,0 |  | 7,7 |  |  |  |  |  |
| Unrealized loss on securities available for sale | (44) |  | (37 |  | (63 |  | ) | (36 |  | ) |
| Forward contracts hedging intercompany foreign currency payments change in fair values | 55 |  | (1,3 |  |  |  | ) |  |  | ) |
| Total comprehensive income | \$ | 17,463 | \$ | 18,533 | \$ | 46,088 |  | \$ | 29,612 |  |
| Earnings per share: |  |  |  |  |  |  |  |  |  |  |
| Basic | \$ | 0.22 | \$ | 0.17 | \$ | 0.59 |  | \$ | 0.31 |  |
| Diluted | \$ | 0.21 | \$ | 0.16 | \$ | 0.57 |  | \$ | 0.31 |  |
| Weighted average common shares outstanding: |  |  |  |  |  |  |  |  |  |  |
| Basic |  |  |  |  |  |  |  |  |  |  |
| Diluted |  |  |  |  |  |  |  |  |  |  |

See notes to condensed consolidated financial statements.
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## FOSSIL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

## UNAUDITED

## AMOUNTS IN THOUSANDS

|  | For the 26 Weeks Ended July 7, 2007 |  | For the 27 Weeks Ended July 8, 2006 |  |
| :---: | :---: | :---: | :---: | :---: |
| Operating activities: |  |  |  |  |
| Net income | \$ 39,704 |  | \$ 20,954 |  |
| Noncash items affecting net income: |  |  |  |  |
| Minority interest in subsidiaries | 2,413 |  | 1,982 |  |
| Equity in earnings of joint venture | (719 |  | (688 | ) |
| Depreciation and amortization | 15,709 |  | 15,720 |  |
| Stock-based compensation | 2,184 |  | 1,821 |  |
| Excess tax benefits from stock-based compensation | (1,266 |  | (540 | ) |
| Loss on disposal of assets | 207 |  | 189 |  |
| Decrease in allowance for doubtful accounts | (622 |  | (513 | ) |
| Increase in allowance for returns - net of related inventory | (977 |  | (990 | ) |
| Deferred income taxes | 1,362 |  | (697 | ) |
| Changes in operating assets and liabilities, net of effects of acquisitions: |  |  |  |  |
| Accounts receivable | 7,007 |  | 15,396 |  |
| Inventories | (11,103 | ) | (21,737 | ) |
| Prepaid expenses and other current assets | (13,227 |  | (4,513 | ) |
| Accounts payable | 1,161 |  | (8,595 | ) |
| Accrued expenses | 3,453 |  | 792 |  |
| Income taxes payable | 2,497 |  | 2,549 |  |
| Net cash from operating activities | 47,783 |  | 21,130 |  |
| Investing activities: |  |  |  |  |
| Business acquisitions, net of cash acquired | (1,326 |  | (7,227 | ) |
| Additions to property, plant and equipment | (11,597 |  | $(25,165$ | ) |
| Purchase of securities available for sale | (1,339 |  | (409 | ) |
| Increase in intangible and other assets | (3,756 |  | (680 | ) |
| Net cash used in investing activities | (18,018 | ) | (33,481 | ) |
| Financing activities: |  |  |  |  |
| Proceeds from exercise of stock options | 5,194 |  | 2,210 |  |
| Acquisition and retirement of common stock | (287 |  | (25,930 | ) |
| Excess tax benefits from stock-based compensation | 1,266 |  | 540 |  |
| Distribution of minority interest earnings | (2,065 |  | (186 | ) |
| Net (payments on)/borrowings of short-term debt | (2,110 |  | 43,260 |  |
| Net cash from financing activities | 1,998 |  | 19,894 |  |
| Effect of exchange rate changes on cash and cash equivalents | 4,624 |  | 6,473 |  |
| Net increase in cash and cash equivalents | 36,387 |  | 14,016 |  |
| Cash and cash equivalents: |  |  |  |  |
| Beginning of period | 133,304 |  | 57,457 |  |
| End of period | \$ 169,691 |  | \$ 71,473 |  |

See notes to condensed consolidated financial statements.

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## FOSSIL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## UNAUDITED

## 1. <br> FINANCIAL STATEMENT POLICIES

Basis of Presentation. The condensed consolidated financial statements include the accounts of Fossil, Inc., a Delaware corporation, and its wholly and majority-owned subsidiaries (the Company ). The condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary to present a fair statement of the Company s financial position as of July 7, 2007, and the results of operations for the thirteen-week periods ended July 7, 2007 ( Second Quarter ) and July 8, 2006, ( Prior Year Quarter ), respectively and the twenty-six week period ended July 7, 2007 ( Year To Date Period ) and the twenty-seven week period ended July 8, 2006 ( Prior Year YTD Period ), respectively. All adjustments are of a normal, recurring nature. The Company noted that fiscal 2007 is a 52 -week year as compared to a 53 -week year in fiscal 2006. For financial reporting purposes, this extra week was included in the first quarter of fiscal year 2006.


#### Abstract

These interim financial statements should be read in conjunction with the audited financial statements and the notes thereto included in the annual report on Form 10-K filed by the Company pursuant to the Securities Exchange Act of 1934 (the Exchange Act ) for the year ended January 6, 2007. Operating results for the twenty-six week period ended July 7, 2007, are not necessarily indicative of the results to be achieved for the full year.

The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America which require the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and revenues and expenses during the periods reported. Actual results could differ from those estimates. The Company has not made any changes in its significant accounting policies from those disclosed in its most recent annual report.


Business. The Company is a global design, marketing and distribution company that specializes in consumer fashion accessories. Its principal offerings include an extensive line of men $s$ and women $s$ fashion watches and jewelry, handbags, small leather goods, belts, sunglasses, and apparel. In the watch and jewelry product category, the Company has a diverse portfolio of globally recognized owned and licensed brand names under which its products are marketed. The Company s products are distributed globally through various distribution channels including wholesale, export and direct to the consumer at varying price points to service the needs of its customers, whether they are value conscious or luxury oriented. Based on its extensive range of accessory products, brands, distribution channels and price points, the Company is able to target style-conscious consumers across a wide age spectrum on a global basis.

Foreign Currency Hedging Instruments. The Company s foreign subsidiaries periodically enter into forward contracts principally to hedge the future payment of intercompany inventory transactions with the U.S. company. At July 7, 2007, the Company s foreign subsidiaries had forward contracts to sell (i) 64.9 million Euro for approximately $\$ 86.5$ million, expiring through December 2008 and (ii) approximately 6.0 million British Pounds for $\$ 12.0$ million, expiring through February 2008. If the Company s foreign subsidiaries were to settle their Euro and British Pound based contracts at the reporting date, the net result would be a net loss of approximately $\$ 1.6$ million, net of taxes, as of July 7 , 2007. The net decrease in fair value for the Year To Date Period and the Prior Year YTD Period of approximately $\$ 1.3$ million and $\$ 2.2$ million, respectively, is included in other comprehensive income. The net decrease for the Year To Date Period consisted of net losses from these hedges of $\$ 1.4$ million and approximately $\$ 200,000$ of net losses reclassified into earnings.

Earnings Per Share. The following table reconciles the numerators and denominators used in the computations of both basic and diluted EPS:

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|  | For the 13 <br> Weeks Ended <br> July 7, 2007 <br> IN THOUSAN | For the 13 Weeks Ended July 8, 2006 <br> PT PER SHAR | For the 26 Weeks Ended July 7, 2007 | For the 27 Weeks Ended July 8, 2006 |
| :---: | :---: | :---: | :---: | :---: |
| Numerator: |  |  |  |  |
| Net income | \$ 14,672 | \$ 11,238 | \$ 39,704 | \$ 20,954 |
| Denominator: |  |  |  |  |
| Basic EPS computation: |  |  |  |  |
| Weighted average common shares outstanding | 67,814 | 66,884 | 67,695 | 67,122 |
| Basic EPS | \$ 0.22 | \$ 0.17 | \$ 0.59 | \$ 0.31 |
| Diluted EPS computation: |  |  |  |  |
| Denominator: |  |  |  |  |
| Basic weighted average common shares outstanding | 67,814 | 66,884 | 67,695 | 67,122 |
| Dilutive effect of stock-based compensation | 1,928 | 1,415 | 1,861 | 1,578 |
|  | 69,742 | 68,299 | 69,556 | 68,700 |
| Diluted EPS | \$ 0.21 | \$ 0.16 | \$ 0.57 | \$ 0.31 |

Approximately $78,000,2.0$ million, 134,000 and 1.8 million weighted average shares issuable under stock-based awards were not included in the diluted earnings per share calculation at the end of the Second Quarter, Prior Year Quarter, Year To Date Period and Prior Year YTD Period, respectively, because they were antidilutive. These common share equivalents may be dilutive in future earnings per share calculations.

Goodwill. The changes in the carrying amount of goodwill, which is not subject to amortization, are as follows:

|  | Domestic <br> Wholesale | Europe <br> Wholesale | Other <br> International <br> Wholesale | Direct to <br> Consumer | Total |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

New Accounting Standards. In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ( SFAS 157 ). This Standard provides guidance for using fair value to measure assets and liabilities. Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. SFAS 157 is effective beginning in the Company s fiscal year 2008. The Company is currently evaluating the effect of adopting SFAS 157, but does not expect it to have a material impact on its consolidated results of operations or financial condition.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 ( SFAS 159 ). The fair value option permits entities to choose to measure eligible financial instruments at fair value at specified election dates. The entity will report unrealized gains and losses on the items on which it has elected the fair value option in earnings. SFAS 159 is effective beginning in the Company s fiscal year 2008. The Company is currently evaluating the effect of adopting SFAS 159, but does not expect it to have a material impact on its consolidated results of operations or financial condition.

There are no other recently issued accounting standards effective after July 7, 2007, that are expected to materially impact the Company.

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## 2. INVENTORIES

Inventories - net consist of the following:


## 3. INCOME TAXES

The provision for income taxes reflects the Company s estimate of the effective tax rate expected to be applicable for the full fiscal year, adjusted for any discrete events, which are reported in the period that they occur. This estimate is re-evaluated each quarter based upon the Company s estimated tax expense for the full fiscal year. The Company s income tax expense for the Second Quarter and Prior Year Quarter was $\$ 8.6$ million and $\$ 4.4$ million, respectively, resulting in an effective income tax rate of $36.9 \%$ and $28.0 \%$, respectively. The lower effective rate for the Prior Year Quarter is the result of a release of certain income tax contingency reserves and the interest expense thereon. Income tax expense was $\$ 17.4$ million for the Year To Date Period, with an effective rate of $30.4 \%$. For the comparable Prior Year YTD Period, income tax expense was $\$ 10.1$ million, resulting in an effective rate of $32.6 \%$. The lower effective tax rate for the Year to Date period is the result of the release of certain income tax contingency reserves related to our federal income tax return for 2003 that were effectively settled during the First Quarter when the Internal Revenue Service ( IRS ) completed the examination phase of its audit of our 2003 and 2004 federal income tax returns.

Effective January 7, 2007, the Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes- an Interpretation of FASB Statement No. 109 ( FIN 48 ). Under FIN 48, the Company must recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate resolution. This interpretation also provides guidance on de-recognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods and income tax disclosures. The cumulative effects of applying this interpretation have been recorded as a decrease of $\$ 6.1$ million to retained earnings, an increase of $\$ 1.3$ million to net deferred income tax liabilities, and an increase of $\$ 4.8$ million in the liability for uncertain tax benefits as of January 7, 2007.

The Company has classified uncertain tax positions as long-term income taxes payable unless such amounts are expected to be paid in twelve months. Consistent with its past practice, the Company recognizes interest and/or penalties related to income tax overpayments and underpayments in income tax expense and income taxes payable. The total amount of accrued income tax-related interest and penalties included in the condensed consolidated balance sheet at adoption was $\$ 9.4$ million (net). For the six months ended July 7, 2007, the Company accrued interest expense of $\$ 1.1$ million.

As of April 7, 2007 and January 7, 2007, the total amount of unrecognized tax benefits, excluding interest and penalties, was $\$ 44.3$ million and $\$ 46.6$ million, respectively, of which $\$ 29.7$ million and $\$ 32.0$ million would favorably impact the effective tax rate in future periods, if recognized. As of January 7, 2007, the Company was subject to an IRS examination for the 2003 and 2004 tax years. The Company is also subject to examinations in various state and foreign jurisdictions for the 2001-2006 tax years, none of which are individually significant. During the first quarter, the examination phase of the IRS audit for tax years 2003 and 2004 was completed. The IRS has proposed certain adjustments and the Company has filed a protest at this time. This protest is under review by the IRS Office of Appeals and it is possible that it may be resolved within the next 12 months. As of April 7, 2007, and January 7, 2007, the Company has recorded $\$ 14.2$ million and $\$ 18.0$ million, respectively of unrecognized tax benefits, excluding interest and

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penalties for positions that could be settled within the next twelve months. At this time, an estimate of the range of the reasonably possible outcomes cannot be made. Audit outcomes and the timing of audit settlements are subject to significant uncertainty.

## 4. STOCK-BASED COMPENSATION PLANS

The Company accounts for stock-based compensation in accordance with the provisions of Statement of Financial Accounting Standards No. 123(R), Share-Based Payment ( SFAS 123R ) using the Black-Scholes option pricing model to determine the fair value of stock options at the date of grant. The Company s current stock-based compensation plans include: a) stock options and restricted stock for its international employees, b) stock options for its non-employee directors, and c) stock appreciation rights, restricted stock and restricted stock units for its U.S.-based employees. Prior to 2006, the Company s stock based-compensation plans included stock options for its non-employee directors and stock options and restricted stock for its employees, including its executive officers.

Long-Term Incentive Plan. Designated employees of the Company, including officers, are eligible to receive a) stock options, b) stock appreciation rights, c) restricted or non-restricted stock awards, d) restricted stock units, e) cash awards or f) any combination of the foregoing. As of July 7, 2007, approximately 15,000 shares issued to employees in prior years were forfeited and are held in the Company treasury to be issued as future awards are granted. The current stock options, stock appreciation rights, restricted stock and restricted stock units outstanding include an original vesting term ranging from three to five years. All stock options, stock appreciation rights, restricted stock and restricted stock units are accounted for at fair value at the date of grant. All stock appreciation rights and restricted stock units are settled in shares of Company stock.

Restricted Stock Plan. Shares awarded under the 2002 Restricted Stock Plan have been funded with shares contributed to the Company from a significant stockholder. As of July 7, 2007, approximately 105,000 shares issued to employees in prior years were forfeited and are held in the Company treasury to be issued as future awards are granted. The current restricted shares outstanding include an original vesting term ranging from one to nine years. These shares are accounted for at fair value at the date of grant.

Non-employee Director Stock Option Plan. During the first year individuals are elected as non-employee directors of the Company, they receive a grant of 5,000 non-qualified stock options. In addition, on the first day of each subsequent calendar year, each non-employee director automatically receives a grant of an additional 4,000 non-qualified stock options as long as the individual is serving as a non-employee director. Pursuant to this plan, $50 \%$ of the options granted will become exercisable on the first anniversary of the date of grant and in two additional installments of $25 \%$ on the second and third anniversaries. All stock options granted under this plan are accounted for at fair value at the date of grant.

The following table summarizes stock option and stock appreciation right activity during the Second Quarter:

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The aggregate intrinsic value in the table above is before income taxes and is based on the exercise price for outstanding and exercisable options and rights at July 7, 2007 and based on the fair market value on the exercise date for options and rights that have been exercised during the Second Quarter.

Stock Options and Stock Appreciation Rights Outstanding and Exercisable. The following table summarizes information with respect to stock options and stock appreciation rights outstanding and exercisable at July 7, 2007 (number of shares in thousands):

|  |  | Stock Opti | nding |  |  | Stock Opti |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Range of Exercise Prices |  | Number of Shares | Weig <br> Aver <br> Exer <br> Price |  | Weighted- <br> Average <br> Remaining <br> Contractual <br> Life (Yrs.) | Number of Shares |  |  |
|  | \$3.14-\$6.28 | 442.1 | \$ | 4.71 | 1.4 | 442.1 | \$ | 4.71 |
|  | 6.28 - 9.42 | 1,409.4 | 8.31 |  | 3.2 | 1,409.4 |  |  |
|  | 9.42-12.56 | 634.7 | 11.57 |  | 5.1 | 528.7 |  |  |
|  | 12.56-15.70 | 97.8 | 13.31 |  | 5.2 | 84.8 |  |  |
|  | 15.70-18.83 | 333.4 | 18.38 |  | 7.6 | 107.8 |  |  |
|  | 18.83-21.97 | 764.4 | 19.24 |  | 6.4 | 678.6 |  |  |
|  | 21.97-25.11 | 141.4 | 22.99 |  | 8.0 | 31.7 |  |  |
|  | 25.11-28.25 | 669.2 | 25.85 |  | 7.3 | 619.1 |  |  |
|  | \$28.25-\$31.39 | 350.5 | 30.81 |  | 9.3 | 86.5 |  |  |
| Total |  | 4,842.9 | \$ | 15.41 | 5.3 | 3,988.7 | \$ | 13.87 |

The Company has elected to apply the long-form method to determine the hypothetical additional paid-in capital ( APIC ) pool provided by FASB Staff Position FAS 123R-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards. The Company had determined that a hypothetical pool of excess tax benefits existed in APIC as of January 1, 2006, the date of adoption of SFAS No. 123R, related to historical stock option exercises. In future periods, excess tax benefits resulting from option and stock appreciation right exercises will be recognized as additions to APIC in the period the benefit is realized. In the event of a shortfall (that is, the tax benefit realized is less than the amount previously recognized through periodic stock-based compensation expense recognition and related deferred tax accounting), the shortfall would be charged against APIC to the extent of previous excess
benefits, if any, including the amounts included in the hypothetical APIC pool, and then to tax expense.

Restricted Stock and Restricted Stock Units. The following table summarizes restricted stock and restricted stock unit activity during the Second Quarter:
$\left.\begin{array}{lllll} & & \begin{array}{l}\text { Weighted- } \\ \text { Average } \\ \text { Exercise } \\ \text { Price }\end{array} \\ \hline & \begin{array}{l}\text { Number of } \\ \text { Shares } \\ \text { IN }\end{array} & & & \\ \text { THOUSANDS }\end{array}\right)$

The total fair value of shares/units vested during the Second Quarter was \$199,000.

## 5. SEGMENT AND GEOGRAPHIC INFORMATION

The Company manages its business primarily on a geographic basis. The Company s reportable operating segments are comprised of the United States Wholesale, Europe Wholesale, Other International Wholesale and Direct to Consumer. The United States Wholesale, Europe Wholesale, and Other International Wholesale reportable segments do not include activities related to the Direct to Consumer segment. The Europe Wholesale segment primarily includes sales to wholesale or distributor customers based in European countries as well as the Middle East and Africa. The Other International Wholesale segment primarily includes sales to wholesale or distributor customers based in Australia, Canada, China (including the Company s assembly and procurement operations), Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Singapore, South America and Taiwan. The Direct to Consumer segment includes company-owned retail stores and sales generated from e-commerce activities. Each reportable operating segment provides similar products and services.

The Company evaluates the performance of its operating segments based on net sales and operating income. Net sales for geographic segments are generally based on the location of the customers. Operating income for each segment includes net sales to third parties, related cost of sales and operating expenses directly attributable to the segment. Operating income for each segment includes the impact of intercompany profits associated with the sale of products by one segment to another. Costs associated with various corporate expenses and amounts related to intercompany eliminations are not allocated to the various segments but are included in the United States wholesale segment. Intercompany sales of products between segments are referred to as intersegment items. Summary information by operating segment follows:

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|  | For the 13 Weeks Ended July 7, 2007 |  | For the 13 Weeks Ended July 8, 2006 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Net Sales <br> IN THOUSANDS | Operating Income (Loss) | Net Sales |  | Operating Income (Loss) |
| United States wholesale: |  |  |  |  |  |
| External customers | \$ 96,917 | \$ (14,335 | \$ 96,111 |  | \$ (5,100 |
| Intersegment | 33,513 |  | 27,197 |  |  |
| Direct to consumer | 55,284 | 2,445 | 46,792 |  | 2,335 |
| Europe wholesale: |  |  |  |  |  |
| External customers | 99,685 | 11,923 | 77,354 |  | 7,506 |
| Intersegment | 10,503 |  | 7,705 |  |  |
| Other international wholesale: |  |  |  |  |  |
| External customers | 54,578 | 23,083 | 38,981 |  | 11,455 |
| Intersegment | 87,897 |  | 80,999 |  |  |
| Intersegment items | (131,913 |  | (115,901 | ) |  |
| Consolidated | \$ 306,464 | \$ 23,116 | \$ 259,238 |  | \$ 16,196 |



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

The following is a discussion of the financial condition and results of operations of Fossil, Inc. and its wholly and majority-owned subsidiaries for the thirteen and twenty-six week periods ended July 7, 2007 (the Second Quarter and Year To Date Period, respectively), as compared to the thirteen and twenty-seven week periods ended July 8, 2006 (the Prior Year Quarter and Prior Year YTD Period, respectively). Fiscal 2007 is a 52 -week year as compared to a 53 -week year for fiscal 2006. This extra week was included in the first quarter of fiscal year 2006. This discussion should be read in conjunction with the Condensed Consolidated Financial Statements and the related Notes attached hereto.

## General

We are a global design, marketing and distribution company that specializes in consumer fashion accessories. Our principal offerings include an extensive line of men s and women s fashion watches and jewelry and handbags, small leather goods, belts, sunglasses, and apparel. In the watch and jewelry product category, we have a diverse portfolio of globally recognized owned and licensed brand names under which our products are marketed. Our products are distributed globally through various distribution channels including wholesale, export and direct to the consumer at varying price points to service the needs of our customers, whether they are value conscious or luxury oriented. Based on our extensive range of accessory products, brands, distribution channels and price points, we are able to target style-conscious consumers across a wide age spectrum on a global basis.

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Domestically, we sell our products through a diversified distribution network that includes department stores, specialty retail locations, specialty watch and jewelry stores, owned retail and factory outlet stores, mass market stores, owned and affiliated internet sites and through our FOSSIL catalog. Our wholesale customer base includes Neiman Marcus, Nordstrom, Macy s, Dillard s, JCPenney, Kohl s, Sears, Wal-Mart and Target. We also sell our products in the United States through a network of company-owned stores, which included 81 retail stores located in premier retail sites and 72 outlet stores located in major outlet malls as of July 7, 2007. In addition, we offer an extensive collection of our FOSSIL brand products through our catalog and on our website, www.fossil.com, as well as proprietary and licensed watch and jewelry brands through other managed and affiliated websites.

Internationally, our products are sold to department stores, specialty retail stores and specialty watch and jewelry stores in over 90 countries worldwide through 21 company-owned foreign sales subsidiaries and through a network of approximately 56 independent distributors. Our products are distributed in Africa, Asia, Australia, Europe, Central and South America, Canada, the Caribbean, Mexico, and the Middle East. Our products are offered on airlines, cruise ships and in international company-owned retail stores, which included 45 accessory retail stores and 4 outlet stores in select international markets as of July 7, 2007. Additionally, our products are sold through independently-owned FOSSIL retail stores and kiosks in certain international markets.

## Significant Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates and judgments, including those related to product returns, bad debts, inventories, long-lived asset impairment, impairment of goodwill and income taxes. We base these estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe there have been no changes to the significant accounting policies disclosed in Management s Discussion and Analysis of Financial Condition and Results of Operations included in the Company s Annual Report on Form 10-K filed for the year ended January 6, 2007.

## Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ( SFAS 157 ). This Standard provides guidance for using fair value to measure assets and liabilities. Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. SFAS 157 is effective beginning in our fiscal year 2008. We are currently evaluating the effect of adopting SFAS 157, but do not expect it to have a material impact on our consolidated results of operations or financial condition.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 ( SFAS 159 ). The fair value option permits entities to choose to measure eligible financial instruments at fair value at specified election dates. The entity will report unrealized gains and losses on the items on which it has elected the fair value option in earnings. SFAS 159 is effective beginning in our fiscal year 2008. We are currently evaluating the effect of adopting SFAS 159, but do not expect it to have a material impact on our consolidated results of operations or financial condition.

There are no other recently issued accounting standards effective after July 7, 2007, that are expected to materially impact the Company.

## Results of Operations

The following table sets forth, for the periods indicated, (i) the percentages of our net sales represented by certain line items from our condensed consolidated statements of income and comprehensive income and (ii) the percentage changes in these line items. Fiscal 2007 is a 52 -week year as compared to a 53 -week year in fiscal 2006. This extra week was included in our first quarter of fiscal year 2006. We estimate the extra week increased net sales and operating expenses by approximately $\$ 16.0$ million and $\$ 5.0$ million, respectively, during the first quarter of fiscal 2006 and the prior year YTD period.
\(\left.$$
\begin{array}{llllll} & \begin{array}{l}\text { Percentage of } \\
\text { Net Sales } \\
\text { For the 13 } \\
\text { Weeks Ended } \\
\text { July 7, 2007 }\end{array} & & \begin{array}{l}\text { For the 13 } \\
\text { Weeks Ended } \\
\text { July 8, 2006 }\end{array} & \begin{array}{l}\text { Percentage } \\
\text { Change }\end{array}
$$ <br>

Net sales \& 100.0 \& \% \& 100.0 \& \% \& 18.2\end{array}\right]\)| \% |
| :--- |


|  | Perce <br> Net $\mathbf{S}$ <br> For th <br> Weeks <br> July 7 |  | For the Weeks July 8, |  | Percen Chang |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net sales | 100.0 | \% | 100.0 | \% | 16.8 | \% |
| Cost of sales | 49.8 |  | 50.3 |  | 15.7 |  |
| Gross profit | 50.2 |  | 49.7 |  | 17.9 |  |
| Selling and distribution expenses | 28.6 |  | 31.5 |  | 6.0 |  |
| General and administrative expenses | 12.5 |  | 11.9 |  | 23.0 |  |
| Operating income | 9.1 |  | 6.3 |  | 67.7 |  |
| Interest expense | (0.1 | ) | (0.3 | ) | (71.6 | ) |
| Other income (expense) - net | 0.3 |  | (0.1 | ) | * |  |
| Income before income taxes | 9.3 |  | 5.9 |  | 83.5 |  |
| Income taxes | 2.8 |  | 1.9 |  | 71.1 |  |
| Net income | 6.5 | \% | 4.0 | \% | 89.5 | \% |

[^0]Net Sales. The following table sets forth certain components of our consolidated net sales and the percentage relationship of the components to consolidated net sales for the periods indicated (in millions, except percentage data):



The following tables are intended to illustrate by factor the total of the percentage change in sales by segment and on a consolidated basis:

|  | Analysis of Percentage Change in Sales Versus Prior Year Quarter Attributable to Changes in the Following Factors |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Exchange Rates |  | Acquisitions |  | Organic Growth |  | Total Change |  |
| Europe wholesale | 8.1 | \% | 0.0 | \% | 20.8 | \% | 28.9 | \% |
| Other international wholesale | 0.5 | \% | 1.8 | \% | 37.7 | \% | 40.0 | \% |
| United States wholesale | 0.0 | \% | 0.0 | \% | 0.8 | \% | 0.8 | \% |
| Direct to consumer | 1.4 | \% | 0.0 | \% | 16.8 | \% | 18.2 | \% |
| Total | 2.8 | \% | 0.3 | \% | 15.1 | \% | 18.2 | \% |


|  | Analysis of Percentage Change in Sales Versus Prior Year YTD Attributable to Changes in the Following Factors |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Exchange Rates |  | Acquisitions |  | Organic Growth |  | Total Change |  |
| Europe wholesale | 8.6 | \% | 0.0 | \% | 17.7 | \% | 26.3 | \% |
| Other international wholesale | 5.2 | \% | 1.6 | \% | 30.5 | \% | 37.3 | \% |
| United States wholesale | 0.0 | \% | 0.0 | \% | 0.5 | \% | 0.5 | \% |
| Direct to consumer | 1.1 | \% | 0.0 | \% | 18.4 | \% | 19.5 | \% |
| Total | 3.6 | \% | 0.2 | \% | 13.0 | \% | 16.8 | \% |

Europe Wholesale Net Sales (excluding the impact of sales growth attributable to foreign currency rate change as noted in the above table). For the Second Quarter, European wholesale net sales increased as a result of sales volume growth in FOSSIL and licensed watch brands as well as from FOSSIL and EMPORIO ARMANI jewelry businesses. Each of our major watch and jewelry businesses in Europe reported sales growth and all of our major subsidiaries in Europe achieved double-digit net sales increases during the Second Quarter. Consumers responded favorably to our new watch and jewelry styles delivered into the market during the end of fiscal 2006 and early fiscal 2007. Our branding efforts in Europe, including the expansion of our company-owned retail stores, are also benefiting our net sales growth in this segment. Additionally, Germany, the location of our largest subsidiary in Europe, is experiencing a stronger economy in comparison to last year and reports are that consumer confidence in Germany is at the highest level in 27 years.

Other International Wholesale Net Sales (excluding the impact of sales growth attributable to foreign currency rate changes and acquisitions as noted in the above table). Our other international wholesale segment experienced strong double-digit growth across all of our major owned and licensed watch and jewelry brands during the Second Quarter. Overall sales increases for the Second Quarter were positively impacted by a $68.7 \%$ increase in net sales from our Mexico subsidiary that we acquired in February 2006 and a $34.5 \%$ increase in net sales from our Asia Pacific subsidiaries in comparison to the Prior Year Quarter. Our shop-in-shop concepts in the Asia Pacific region continue to build awareness, resulting in increased sales and market share within the department store environment. Export sales from the U.S. grew $58.7 \%$ as a result of increased shipments to our distributors in South America and increases in our wholesale shipments to the Caribbean. Although net sales from our Asia Pacific businesses represent only slightly more than $10 \%$ of the consolidated Company s net sales, we believe this region will continue to provide a solid growth platform for our product portfolio.

We believe we maintain a competitive advantage as a result of our long-term relationships and strength of our business with retailers throughout the international marketplace. We believe the global recognition of our branded portfolio of watches and jewelry positions us as a significant resource to retailers throughout the international marketplace. Our strategy is not to force any one brand into a specific market, but rather allow the market to dictate which brands are important based upon consumer preference. We further believe our global distribution network and design and marketing capabilities will allow us to acquire additional brands that will position us for further penetration internationally as we continue to take shelf space from lesser known local and regional brands.

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United States Wholesale Net Sales. Net sales from our U.S. watch business increased $11.9 \%$ primarily due to sales volume growth in our mass market and licensed watch businesses. Our mass market business posted a $69 \%$ increase in sales during the Second Quarter reflecting a shift in Wal-Mart s buying pattern, which moved certain deliveries from first quarter into the Second Quarter this yearSales of licensed watches rose by $42 \%$ driven by sales volume growth from DKNY and EMPORIO ARMANI watches as a result of new and innovative styles performing well at retail. Additionally, BURBERRY and MICHAEL KORS brand watch sales more than doubled during the Second Quarter. U.S. sales of FOSSIL watches, excluding discontinued product sales from both the Second Quarter and the Prior Year Quarter, increased by 4.7\%. Second Quarter net sales from our U.S. accessories business declined $11.0 \%$ compared to the prior year quarter with sales volume growth from FOSSIL men s leather goods and RELIC eyewear more than offset by sales volume declines in FOSSIL women s leather products. While our women s handbag, small leather goods and belt businesses experienced sales volume declines, primarily due to our spring/summer styles not meeting consumer preferences in these categories, our men s business grew $5.9 \%$ during the Second Quarter. We believe we have identified and corrected the fashion miss in our women s business and are working to have newer assortments into the stores for the holiday season. Nevertheless, we are not expecting this category to demonstrate growth during the second half of fiscal 2007. U.S. watch net sales for the Year To Date Period increased by $\$ 3.8$ million, to $\$ 102.0$ million, in comparison to $\$ 98.2$ million in the Prior Year YTD Period, primarily due to sales volume growth from license watches. U.S. accessory net sales for the Year To Date Period decreased by $\$ 2.8$ million, to $\$ 101.6$ million, in comparison to $\$ 104.4$ million in the Prior Year YTD Period, primarily due to sales volume declines in FOSSIL women s leather categories.

## Direct to Consumer Net Sales (Excluding the impact on sales growth attributable to foreign currency rate changes as noted in the above

table). Net sales from our direct to consumer segment increased $18.2 \%$ during the Second Quarter as a result of a $12 \%$ increase in the average number of company-owned retail stores opened during the period and comparable store sales increases of $4.9 \%$. Second Quarter net sales from our e-commerce businesses increased by $23.3 \%$ in comparison to the Prior Year Quarter. For the Year To Date Period, net sales from our direct to consumer segment increased $19.5 \%$ as a result of a $25.6 \%$ increase in the average number of stores opened and comparable store sales increases of $5.2 \%$. Net sales from our e-commerce businesses increased by $14.9 \%$ during the Year To Date Period. We ended the Second Quarter with 202 stores, including 126 full price stores, 45 of which were outside the U.S., and 76 outlet locations, including four outside the U.S. This compares to 181 stores at the end of the Prior Year Quarter that included 109 full-price stores, 36 outside the U.S. and 72 outlet locations, including one outside the U.S. During the quarter we opened five new stores and closed two.

Gross Profit. Second Quarter gross profit increased by $\$ 23.5$ million to $\$ 150.5$ million, compared to $\$ 127.0$ million in the Prior Year Quarter. Gross profit margin increased to $49.1 \%$ in the Second Quarter compared to $49.0 \%$ in the Prior Year Quarter. A higher percentage of sales derived from our international wholesale business segments, as experienced during the Second Quarter, would have normally increased our reported gross profit margin. However, we were unable to reflect this positive mix shift in our reported gross profit margin due to weaker gross profit margins related to certain new watch styles sold during the Second Quarter. In the development of these new watch styles, we experienced slightly higher manufacturing costs that we did not pass on to our customers. We have implemented certain initiatives to address this issue and are confident that our consolidated gross profit margin will show improvement, in comparison to the prior year periods and the Second Quarter, during the second half of fiscal year 2007. Additionally, our Second Quarter gross profit margin reflects an approximate 30 basis point increase in comparison to the Prior Year Quarter as a result of the continued weakening of the U.S. dollar. We also experienced a benefit in consolidated gross profit margin from increased outlet store margins as a result of reduced sales of deeply discounted watches sold through this channel during the Second Quarter in comparison to the Prior Year Quarter. These increases in gross profit margin were partially offset by increased markdowns and lower margin off-price liquidation sales related to our U.S. accessory business and a higher sales mix of lower margin mass market sales. For the Year To Date Period, gross profit margin increased by 50 basis points to $50.2 \%$ compared to $49.7 \%$ in the Prior Year YTD Period. This increase was primarily related to factors similar to those experienced during the Second Quarter, and included a 40 basis point increase in gross profit margin related to a weaker U.S. dollar in the Year To Date Period in relation to the Prior Year YTD period.

Operating Expenses. Second Quarter operating expenses increased $\$ 16.6$ million to $\$ 127.4$ million compared to $\$ 110.8$ million in the Prior Year Quarter, and as a percentage of net sales, decreased to $41.6 \%$ in the Second Quarter compared to $42.8 \%$ in the Prior Year Quarter. Second Quarter operating expenses included an unfavorable \$1.5 million shift in expenses related to the Basel Watch Fair, which occurred during the first quarter of fiscal year 2006, and $\$ 4.4$ million in expenses related to our equity granting practices review (the Grant Review ). Expenses unrelated to the Basel Watch Fair and the Grant Review increased $\$ 10.7$ million, or $9.7 \%$, in comparison to the Prior Year Quarter and, as a percent of net sales, decreased to $39.6 \%$. This $\$ 10.7$ million increase is primarily related to increased payroll costs and $\$ 2.7$ million related to the translation impact of international expenses due to the weakening U.S. dollar. The increase in payroll cost is primarily related to Company-owned retail store growth, increased commissions due to increased net sales and additional payroll cost associated with our expansion of our shop-in-shop program internationally. For the Year To Date Period, operating expenses increased $\$ 24.1$ million and included $\$ 10.0$ million of expenses relating to the Review and $\$ 6.5$ million related to the translation impact of international expenses due to the weakening U.S. dollar. As a percentage of net sales, operating expenses for the Year To Date Period decreased to $41.1 \%$ compared to $43.3 \%$ in the Prior Year YTD Period.

The following table sets forth operating expenses on a segment basis and the relative percentage of operating expenses to net sales for each segment for the periods indicated (in millions, except for percentage data):

|  | Amounts <br> For the 13 <br> Weeks <br> Ended <br> July 7, 2007 | For the 13 <br> Weeks <br> Ended <br> July 8, 2006 | Fet Sales <br> For the 13 <br> Weeks <br> Ended <br> July 7, 2007 |  | For the 13 <br> Weeks <br> Ended <br> July 8, 2006 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Segment |  |  |  |  |  |


|  | Amounts |  |  |  | \% of Net Sales |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | For the 26 |  | For the 27 |  | For the 26 |  | For the 27 |  |
|  | Weeks |  | Weeks |  | Weeks |  | Weeks |  |
|  | Ended |  | Ended |  | Ended |  | Ended <br> July 8, 2006 |  |
| Segment | July | 2007 | July | 006 | July 7 |  |  |  |
| Europe wholesale | \$ | 70.4 | \$ | 63.0 | 35.1 | \% | 39.7 | \% |
| Other international wholesale | 29.6 |  | 26.2 |  | 28.2 |  | 34.3 |  |
| United States wholesale (1) | 97.9 |  | 93.9 |  | 48.1 |  | 46.3 |  |
| Direct to consumer | 53.1 |  | 43.8 |  | 51.8 |  | 51.0 |  |
| Total | \$ | 251.0 | \$ | 226.9 | 41.1 | \% | 43.3 | \% |

(1) Certain corporate costs not allocated to individual operating segments for management reporting purposes and intercompany eliminations for specific income statement items are reflected in the United States wholesale segment. Additionally, for the Second Quarter and Year To Date Period, the United States wholesale segment includes approximately $\$ 4.4$ million and $\$ 10.0$ million, respectively, related to legal and accounting costs incurred in connection with the Grant Review by a Special Committee of the Board of Directors.

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Interest Expense. Interest expense of $\$ 219,000$ during the Second Quarter decreased from $\$ 951,000$ during the Prior Year Quarter. Interest expense of $\$ 439,000$ during the Year To Date Period decreased from $\$ 1.5$ million during the comparable Prior Year YTD Period. These decreases are primarily the result of the reduction of all previously outstanding borrowings under our U.S.-based revolving line of credit at the end of fiscal year 2006.

Other Income (Expense) - Net. Second Quarter other income - net of \$342,000 remained relatively unchanged from the Prior Year Quarter amount of $\$ 365,000$. Second Quarter other income net included increased interest income from increased levels of invested cash balances partially offset by foreign currency losses and approximately $\$ 590,000$ in tax penalties recorded as a result of the Company s historical equity granting practices review. For the Year To Date Period, other income (expense) - net increased favorably by approximately $\$ 2.4$ million, with this increase primarily attributable to the impact of currency gains in the current year versus currency losses in the Prior Year YTD Period and increased interest income as a result of higher levels of invested cash balances in the Year To Date Period as compared to the Prior Year YTD Period.

Provision For Income Taxes. Income tax expense for the Second Quarter and Prior Year Quarter was $\$ 8.6$ million and $\$ 4.4$ million, respectively, resulting in an effective income tax rate of $36.9 \%$ and $28.0 \%$, respectively. The lower effective rate for the Prior Year Quarter is the result of the release of certain income tax contingency reserves and the interest expense thereon. Income tax expense was $\$ 17.4$ million for the Year To Date Period, with an effective rate of $30.4 \%$. For the Prior Year YTD Period, income tax expense was $\$ 10.1$ million, resulting in an effective rate of $32.6 \%$. The lower effective tax rate for the Year to Date period is the result of the release of certain income tax contingency reserves related to our federal income tax return for 2003 that were effectively settled during the First Quarter when the Internal Revenue Service ( IRS ) completed the examination phase of its audit of our 2003 and 2004 federal income tax returns. For the second half of fiscal year 2007, we estimate our effective tax rate will approximate $38 \%$.

2007 Net Sales and Earnings Estimates. We currently estimate third quarter and full year 2007 diluted earnings per share will approximate $\$ 0.33$ and $\$ 1.58$, which includes the impact of expenses related to our Grant Review. Excluding these expenses, we estimate third quarter and full year 2007 diluted earnings per share will approximate $\$ 0.37$ and $\$ 1.72$. We reported 2006 third quarter fully diluted earnings per share of $\$ 0.31$, which included an effective tax rate of $32 \%$. Normalizing the tax rate to $37 \%$ in the prior year third quarter would have resulted in a reduction in fully diluted earnings per share of $\$ 0.02$. We are estimating net sales growth in the low to mid double-digit range for both the third and fourth quarters of fiscal year 2007. This guidance is based upon the current spot rate of the U.S. dollar compared to other foreign currencies, primarily the Euro and British Pound.

## Liquidity and Capital Resources

Our general business operations historically have not required substantial cash needs during the first several months of our fiscal year. Generally, starting in the Second Quarter, our cash needs begin to increase, typically reaching their peak in the September-November time frame. Our cash and cash equivalents as of the end of the Second Quarter amounted to $\$ 169.7$ million in comparison to $\$ 71.5$ million at the end of the Prior Year Quarter and $\$ 133.3$ million at the end of fiscal year 2006. The $\$ 36.4$ million increase in cash and cash equivalents since the end of fiscal year 2006 is primarily the result of net cash from operating activities and financing activities of $\$ 47.8$ million and $\$ 2.0$ million, respectively, partially offset by cash used in investing activities of $\$ 18.0$ million. The effect of exchange rate changes had a $\$ 4.6$ million favorable impact on cash balances. Net cash from operating activities was primarily related to net income of $\$ 39.7$ million and favorable non-cash activities of $\$ 18.3$ million partially offset by $\$ 10.2$ million in unfavorable changes in operating assets and liabilities. Cash from financing activities was principally comprised of proceeds from exercise of stock options and excess tax benefits from stock-based compensation of $\$ 6.5$ million partially offset by distribution of minority interest earnings and net payments on borrowings of $\$ 2.1$ million each. Cash used in investing activities consisted mainly of $\$ 11.6$ million of capital additions and $\$ 1.3$ million related to a contingent purchase price payment related to the acquisition of our former Mexico Distributor in the first quarter of fiscal year 2006.

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Accounts receivable increased to $\$ 151.3$ million at the end of the Second Quarter compared to $\$ 128.5$ million at the end of the Prior Year Quarter primarily driven by increased sales in the Second Quarter compared to the Prior Year Quarter. Day s sales outstanding remained unchanged at 45 days for the Second Quarter compared to the Prior Year Quarter. Inventory at quarter-end was $\$ 237.8$ million, a decrease of $10.1 \%$ compared to Prior Year Quarter inventory of $\$ 264.6$ million. We continued to make progress in our efforts to reduce our inventory balances in comparison to the Prior Year Quarter, even though we experienced an $18.2 \%$ net sales increase during the Second Quarter. We expect that our inventory balances will remain below the levels in the comparable prior year periods throughout the remainder of fiscal year 2007.

At the end of the Second Quarter, we had working capital of $\$ 431.9$ million compared to working capital of $\$ 314.4$ million at the end of the Prior Year Quarter and approximately $\$ 9.5$ million of outstanding short-term borrowings, primarily related to our U.K. and Japanese revolving lines of credit. Borrowings under our U.S. credit facility bear interest, at our option, at (i) the lesser of (a) the prime rate ( $8.25 \%$ at the end of the Second Quarter) less $1 \%$ or $3 \%$ or (b) the maximum rate allowed by law or (ii) London Interbank Offer Rate ( LIBOR ) base rate ( $5.33 \%$ at the end of the Second Quarter) plus one-half percent. The U.S. credit facility is secured by $65 \%$ of the issued and outstanding shares of certain of our subsidiaries pursuant to a Stock Pledge Agreement. The U.S. credit facility requires the maintenance of net worth, quarterly income, working capital and certain financial ratios. Available borrowings under our U.S. credit facility are reduced by amounts outstanding related to open letters of credit. We intend to use the proceeds available under our U.S. credit facility for working capital needs, potential acquisitions and general corporate purposes, which may include additional common stock repurchases. We also maintain a 400 million Yen short-term credit facility in Japan, bearing interest based upon the Euroyen rate (approximately $1.60 \%$ at the end of the Second Quarter), and a 3 million British Pound credit facility in the U.K., bearing interest at the aggregate of the Margin, LIBOR and Mandatory Lending Agreement ( MLA ) costs ( $6.63 \%$ on a combined basis at the end of the Second Quarter). Our revolving short-term credit facilities in the United States, Japan and the U.K. renew each year in September, November and May, respectively. At the end of the Second Quarter, we had combined available borrowings of approximately $\$ 73.6$ million relating to these facilities.

## Forward-Looking Statements

The statements contained in this Quarterly Report on Form 10-Q and incorporated by reference that are not historical facts, including, but not limited to, statements regarding our expected financial position, results of operations, business and financing plans found in this Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 3. Quantitative and Qualitative Disclosures About Market Risk, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and involve a number of risks and uncertainties. The words may, believes, expects, plans, intends, estimates, anticipates and similar expre identify forward-looking statements. The actual results of the future events described in such forward-looking statements could differ materially from those stated in such forward-looking statements. Among the factors that could cause actual results to differ materially are: the effect of worldwide economic conditions; significant changes in consumer spending patterns or preferences; acts of war or acts of terrorism; changes in foreign currency valuations in relation to the U.S. dollar, principally the Euro, British Pound and Swiss Franc; lowered levels of consumer spending resulting from a general economic downturn or generally reduced shopping activity caused by public safety or consumer confidence concerns; the performance of our products within the prevailing retail environment; customer acceptance of both new designs and newly-introduced product lines; financial difficulties encountered by customers; the effects of vigorous competition in the markets in which we operate; the integration of the organizations and operations of any acquired businesses into our existing organization and operations; the termination or non-renewal of material licenses, foreign operations and manufacturing; changes in the costs of materials, labor and advertising; government regulation; our ability to secure and protect trademarks and other intellectual property rights; the costs associated with the Company s voluntary review of historical equity granting practices; the recent restatement of our consolidated financial statements; and the outcome of current and possible future litigation.

In addition to the factors listed above, our actual results may differ materially due to the other risks and uncertainties discussed in this Quarterly Report and the risks and uncertainties set forth in our Annual Report on Form 10-K for the year ended January 6, 2007. Accordingly, readers of this Quarterly Report should consider these facts in evaluating the information and are cautioned not to place undue reliance on the forward-looking statements contained herein. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

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## Item 3. Quantitative and Qualitative Disclosures About Market Risk

As a multinational enterprise, we are exposed to changes in foreign currency exchange rates. Our most significant foreign currency risks relate to the Euro, British Pound and, to a lesser extent the Swiss Franc, as compared to the U.S. dollar. Due to our vertical nature whereby a significant portion of goods are sourced from our owned facilities, the foreign currency risks relate primarily to the necessary current settlement of intercompany inventory transactions. We employ a variety of practices to manage this market risk, including our operating and financing activities and, where deemed appropriate, the use of foreign currency forward contracts. The use of these instruments allows us to offset exposure to rate fluctuations because the gains or losses incurred on the derivative instruments will offset, in whole or in part, losses or gains on the underlying foreign currency exposure. We use derivative instruments only for risk management purposes and do not use them for speculation or for trading. There were no significant changes in how we managed foreign currency transactional exposure in the Second Quarter and we do not anticipate any significant changes in such exposures or in the strategies we employ to manage such exposure in the near future.

At the end of the Second Quarter, we had outstanding foreign exchange contracts to sell 64.9 million Euro for approximately $\$ 86.5$ million, expiring through December 2008 and approximately 6.0 million British Pounds for $\$ 12.0$ million, expiring through February 2008. If we were to settle our Euro and British Pound based contracts at the reporting date, the net result would be a net loss of approximately $\$ 1.6$ million, net of taxes. Exclusive of these outstanding foreign exchange contracts or other operating or financing activities that may be employed by us, a measurement of the unfavorable impact of a 10 percent change in the Euro, British Pound and Swiss Franc as compared to the U.S. dollar on our operating profits and stockholders equity is presented in the following paragraph.

At the end of the Second Quarter, a 10 percent unfavorable change in the U.S. dollar strengthening against the Euro, British Pound, and Swiss Franc involving balance sheet transactional exposures would have reduced net pre-tax income by $\$ 4.1$ million. The translation of the balance sheets of our European, United Kingdom and Switzerland-based operations from their local currencies into U.S. dollars is also sensitive to changes in foreign currency exchange rates. At the end of the Second Quarter, a 10 percent unfavorable change in the exchange rate of the U.S. dollar strengthening against the Euro, British Pound and Swiss Franc would have reduced consolidated stockholders equity by approximately $\$ 15.3$ million. In our view, the risks associated with exchange rate changes in other currencies we have exposure to are not material, and these hypothetical losses resulting from these assumed changes in foreign currency exchange rates are not material to our consolidated financial position, results of operations or cash flows.

## Item 4. Controls and Procedures

## Background of Equity Granting Practices Review

Following an internal investigation by a special committee of our Board of Directors into our equity granting practices during the period from 1993 through 2006, we and our Audit Committee concluded that our consolidated financial statements for the thirteen and thirty-nine week periods ended October 1, 2005, and our fiscal years ended December 31, 2005, January 1, 2005, January 3, 2004 and January 4, 2003 should be restated to record additional stock-based compensation expense and the related tax effects resulting from equity grants awarded from 1993 through 2005 that were incorrectly accounted for under generally accepted accounting principles. The decision was based on the determination that the actual measurement dates for determining the accounting treatment of certain equity grants differed from the measurement dates we used in preparing our consolidated financial statements.

We previously reported a material weakness in our internal control over financial reporting in our Form 10-Q for the quarter ended April 7, 2007 and our Annual Report on Form 10-K for the fiscal year ended January 6, 2007 ( 2006 Form 10-K ), filed on August 8, 2007, regarding this restatement. Specifically, we did not design and implement controls necessary to provide reasonable assurance that the measurement date for stock option grants was appropriately determined. As a result, the measurement date used for certain option grants was not appropriate and such grants were not accounted for in accordance with accounting principles generally accepted in the United States.

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## Evaluation of Disclosure Controls and Procedures

We have established and maintained disclosure controls and procedures that are designed to ensure that material information relating to the Company required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s ( SEC ) rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, we recognized that any controls and procedures, no matter how well designed and operated, can provide only a reasonable assurance of achieving the desired control objectives, and management was necessarily required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Our management, with the participation of our CEO and CFO, evaluated the effectiveness of the design and operation of our disclosure controls and procedures and concluded that, because of the material weakness in our internal controls over financial reporting relating to our equity award plan administration and accounting for and disclosure of equity grants, our disclosure controls and procedures were not effective as of July 7, 2007.

The Public Company Accounting Oversight Board s Auditing Standard No. 2 defines a material weakness as a significant deficiency, or a combination of significant deficiencies, that results in there being a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Specifically, we did not design and implement controls necessary to provide reasonable assurance that the grant dates we used for equity awards was in conformity with the measurement date as defined in APB No. 25. As a result, the measurement date used for certain equity grants was not appropriate and such grants were not accounted for in conformity with generally accepted accounting principles in the United States of America.

## Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three months ended July 7, 2007 that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

As previously discussed in our 2006 Form 10-K, we are in the process of adopting and testing certain actions concerning corporate governance to enhance the process for granting equity-based compensation awards in the future, and we have implemented and are in the process of implementing, remedial actions to address the material weakness described above. These actions include:

- We will institute internal audit procedures relating to the equity-based compensation awards approval and documentation process; engage an independent compensation consultant and/or independent counsel (at least for a transitional period) and focus on improving the Compensation Committee approval and oversight process; designate specific members of in-house legal, accounting, and human resources staffs to oversee documentation, accounting and disclosure of all equity-based compensation awards; widely distribute and explain enhanced equity grant processes and documentation requirements; increase automation of the equity grant record keeping process; improve process and controls regarding delegated grant authority; and improve training and education designed to ensure that all relevant personnel involved in the administration of equity-based compensation awards understand relevant policies and requirements.
- Annual grants will be determined in connection with annual performance reviews of employees, including executives. Generally, one annual grant date will apply to all annual grants to U.S. employees, and another annual grant date will apply to all annual grants to employees outside of the U.S.

We are continuing to implement the recommendations of the Special Committee of our Board of Directors and intend to take additional actions at a later date.

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## PART II - OTHER INFORMATION

## Item 1. Legal Proceedings.

Three shareholder derivative lawsuits have been filed in the United States District Court for the Northern District of Texas, Dallas Division, naming us as a nominal defendant and naming all of our then current directors and certain of our current and former officers and directors as defendants. The first suit, captioned City of Pontiac Policeman s and Fireman s Retirement System, derivatively on behalf of Fossil, Inc. v. Tom Kartsotis, Kosta N. Kartsotis, Michael L. Kovar, Michael W. Barnes, Mark D. Quick, Randy S. Kercho, Jal S. Shroff, Randy S. Hyne, Thomas R. Tunnel, Richard H. Gundy, Kenneth W. Anderson, Andrea Camerana, Alan J. Gold, Michael Steinberg, Donald J. Stone and Cadence Wang (Cause No. 3-06CV1672-P), was filed on September 13, 2006. The second suit, captioned Robert B. Minich, derivatively on behalf of Fossil, Inc. v. Tom Karstotis, Kosta N. Kartsotis, Michael L. Kovar, Michael W. Barnes, Mark D. Quick, Randy S. Kercho, Jal S. Shroff, Randy S. Hyne, Thomas R. Tunnel, Richard H. Gundy, Kenneth W. Anderson, Andrea Camerana, Alan J. Gold, Michael Steinberg, Donald J. Stone and Cadence Wang (Cause No. 3-06CV1977-M), was filed on October 26, 2006. The third suit, captioned Robert Neel, derivatively on behalf of Fossil, Inc. v. Michael W. Barnes, Richard H. Gundy, Randy S. Kercho, Mark D. Quick, Tom Kartsotis, Kosta N. Kartsotis, Jal S. Shroff, T.R. Tunnell, Michael L. Kovar, Donald J. Stone, Kenneth W. Anderson, Alan J. Gold, Michael Steinberg, and Fossil, Inc. (Cause No. 3-06CV2264-G), was filed on December 8, 2006. The complaints allege purported violations of federal securities laws and state law claims for breach of fiduciary duty, abuse of control, constructive fraud, corporate waste, unjust enrichment and gross mismanagement in connection with certain stock option grants made by us. We believe that we have meritorious defenses to these claims, and we intend to assert a vigorous defense to the litigation. The ultimate liability with respect to these claims cannot be determined at this time; however, we do not expect this matter to have a material impact on our financial position, operations or liquidity.

On November 14, 2006, we self-reported to the staff of the SEC that a Special Committee, consisting of certain independent members of our Board of Directors, was voluntarily reviewing our historical equity granting practices. In a letter dated November 28, 2006, the SEC staff advised us that it had commenced an informal inquiry regarding our stock option grants and related accounting. We cooperated fully with this inquiry. In a letter dated July 20, 2007, the SEC staff has informed us that their investigation has been completed and they do not intend to recommend any enforcement action by the SEC.

As a result of the review of our historical equity granting practices, we were delinquent in filing certain of our periodic reports with the SEC, and consequently we were not in compliance with Nasdaq s Marketplace Rules. As a result, we received a total of three delisting notices from the Nasdaq, and we underwent a review and hearing process with the Nasdaq to determine our listing status. On August 15, 2007, we received a letter from the Nasdaq Listing and Hearing Review Council (the Council ) that we have demonstrated compliance with all Nasdaq Marketplace Rules. The pending review of our listing status by the Council has been closed and our securities will continue to be listed on The Nasdaq Global Select Market.

There are no other legal proceedings to which we are a party or to which our properties are subject to, other than routine litigation incident to our business, which is not material to our consolidated financial condition, results of operations or cash flows.

## Item 1A. Risk Factors.

During the Second Quarter, there were no material changes to the Risk Factors disclosed in Part I, Item 1A of our 2006 Annual Report on Form 10-K.

## Item 6. Exhibits.

## (a) Exhibits

3.1 Second Amended and Restated Certificate of Incorporation of Fossil, Inc. (incorporated by reference to Exhibit 3.1 of the Company s Report on Form 10-K for the year ended January 1, 2005).
3.2 Certificate of Amendment of the Second Amended and Restated Certificate of Incorporation of Fossil, Inc. (incorporated by reference to Exhibit 3.2 of the Company s Report on Form 10-K for the year ended January 1, 2005).
3.3 Amended and Restated Bylaws of Fossil, Inc. (incorporated by reference to Exhibit 3.3 of the Company s Report on Form $10-\mathrm{K}$ for the year ended January 1, 2005).
3.4 Amendment to Bylaws, effective as of March 15, 2006 (incorporated by reference to Exhibit 3.1 of the Company s Report on Form 8-K filed on March 20, 2006).
31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
32.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

## 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.

FOSSIL, INC.

Date: August 16, 2007
/s/ Mike L. Kovar
Mike L. Kovar
Senior Vice President and Chief Financial Officer (Principal financial and accounting officer duly authorized to sign on behalf of Registrant)

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## EXHIBIT INDEX

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[^0]:    * not meaningful

[^1]:    Operating Income. The increase in gross profit margin and leverage in operating expenses resulted in operating profit increasing $42.7 \%$ and $67.7 \%$ during the Second Quarter and the Year To Date Period, respectively, as compared to the respective prior year periods. Our Second Quarter and Year To Date Period operating income included approximately $\$ 1.8$ million and $\$ 5.4$ million of net currency gains related to the translation of foreign sales and expenses into U.S. dollars.

