



RECREATIONAL EQUIPMENT, INC.

Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(With Independent Auditors' Report Thereon)

RECREATIONAL EQUIPMENT, INC.

Table of Contents

	Page
Independent Auditors' Report	1
Consolidated Balance Sheets	3
Consolidated Statements of Comprehensive Income	4
Consolidated Statements of Members' Equity	5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7



KPMG LLP
Suite 2900
1918 Eighth Avenue
Seattle, WA 98101

Independent Auditors' Report

The Board of Directors
Recreational Equipment, Inc.:

We have audited the accompanying consolidated financial statements of Recreational Equipment, Inc. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2016 and January 2, 2016, and the related consolidated statements of comprehensive income, members' equity, and cash flows for the 52-week periods ended December 31, 2016 and January 2, 2016, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.



Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Recreational Equipment, Inc. and its subsidiaries as of December 31, 2016 and January 2, 2016, and the results of their operations and their cash flows for the 52-week periods ended December 31, 2016 and January 2, 2016, in accordance with U.S. generally accepted accounting principles.

KPMG LLP

Seattle, Washington
March 9, 2017

RECREATIONAL EQUIPMENT, INC.

Consolidated Balance Sheets

December 31, 2016 and January 2, 2016

(In thousands)

Assets	December 31, 2016	January 2, 2016
Current assets:		
Cash and cash equivalents	\$ 191,163	227,175
Short-term investments	285,144	271,868
Accounts receivable, less allowance for doubtful accounts of \$23 and \$30, respectively	27,289	29,202
Inventories	463,841	476,404
Prepaid expenses and other	18,093	18,530
Total current assets	985,530	1,023,179
Property and equipment, net of accumulated depreciation of \$738,007 and \$651,428, respectively	497,021	443,768
Goodwill, net of accumulated amortization of \$1,731 and \$632, respectively	6,301	6,951
Deferred income taxes, net	57,021	59,805
Other	13,640	11,479
Total assets	\$ 1,559,513	1,545,182
Liabilities and Members' Equity		
Current liabilities:		
Accounts payable	\$ 161,290	193,553
Customer-related obligations	207,722	204,719
Patronage dividends payable	137,882	132,903
Accrued payroll and benefits	100,630	113,117
Business taxes and other accrued liabilities	37,695	36,925
Income taxes payable	6,538	14,671
Total current liabilities	651,757	695,888
Deferred rent and other long-term liabilities	70,317	67,983
Commitments and contingencies (note 9)		
Members' equity:		
Memberships	251,240	233,177
Accumulated other comprehensive loss	(332)	(122)
Retained earnings	586,531	548,256
Total members' equity	837,439	781,311
Total liabilities and members' equity	\$ 1,559,513	1,545,182

See accompanying notes to consolidated financial statements.

RECREATIONAL EQUIPMENT, INC.

Consolidated Statements of Comprehensive Income

Periods ended December 31, 2016 and January 2, 2016

(In thousands)

	January 3, 2016 – December 31, 2016	January 4, 2015 – January 2, 2016
Net sales	\$ 2,557,543	2,423,221
Cost of sales	<u>1,460,433</u>	<u>1,388,125</u>
Gross profit	<u>1,097,110</u>	<u>1,035,096</u>
Operating expenses:		
Payroll-related expenses	494,820	478,474
Occupancy, general and administrative	<u>420,898</u>	<u>381,147</u>
Operating expenses	<u>915,718</u>	<u>859,621</u>
Operating income	181,392	175,475
Other expense, net	<u>(4,464)</u>	<u>(5,035)</u>
Income before patronage dividends and income taxes	176,928	170,440
Patronage dividends, net	<u>116,937</u>	<u>116,818</u>
Income before income taxes	59,991	53,622
Provision for income taxes	<u>21,716</u>	<u>18,250</u>
Net income	<u>38,275</u>	<u>35,372</u>
Other comprehensive loss:		
Unrealized loss on available-for-sale securities, net of tax of \$199 and \$68, respectively	<u>(210)</u>	<u>(122)</u>
Comprehensive income	\$ <u>38,065</u>	<u>35,250</u>

See accompanying notes to consolidated financial statements.

RECREATIONAL EQUIPMENT, INC.

Consolidated Statements of Members' Equity

Periods ended December 31, 2016 and January 2, 2016

(In thousands)

	<u>Memberships</u>	<u>Retained earnings</u>	<u>Accumulated other comprehensive loss</u>	<u>Total members' equity</u>
Balance at January 3, 2015	\$ 213,045	512,884	—	725,929
Unrealized loss on available-for-sale securities, net of tax	—	—	(122)	(122)
Memberships issued	20,132	—	—	20,132
Net income	<u>—</u>	<u>35,372</u>	<u>—</u>	<u>35,372</u>
Balance at January 2, 2016	233,177	548,256	(122)	781,311
Unrealized loss on available-for-sale securities, net of tax	—	—	(210)	(210)
Memberships issued	18,063	—	—	18,063
Net income	<u>—</u>	<u>38,275</u>	<u>—</u>	<u>38,275</u>
Balance at December 31, 2016	<u>\$ 251,240</u>	<u>586,531</u>	<u>(332)</u>	<u>837,439</u>

See accompanying notes to consolidated financial statements.

RECREATIONAL EQUIPMENT, INC.

Consolidated Statements of Cash Flows

Periods ended December 31, 2016 and January 2, 2016

(In thousands)

	January 3, 2016 – December 31, 2016	January 4, 2015 – January 2, 2016
Operating activities:		
Net income	\$ 38,275	35,372
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of goodwill	94,324	85,157
Amortization of investment premium/discount	1,567	2,518
Change in provision for sales returns	(2,680)	(4,348)
Deferred income taxes, net	2,784	(7,999)
Deferred rent	476	77
(Gain) loss on sale of equipment and asset impairment	565	(650)
Changes in operating assets and liabilities:		
Accounts receivable	1,912	(9,622)
Inventories	10,139	(68,841)
Prepays and other current assets	(1,725)	(4,326)
Accounts payable and other accrued expenses	(32,911)	60,320
Net cash provided by operating activities	<u>112,726</u>	<u>87,658</u>
Investing activities:		
Acquisition of business, net of cash received	(1,503)	(6,263)
Purchases of short-term investments	(478,740)	(217,455)
Proceeds from sale of short-term investments	463,555	266,811
Purchases of property and equipment	(150,112)	(136,030)
Proceeds from sale of property and equipment	(1)	4,077
Net cash used in investing activities	<u>(166,801)</u>	<u>(88,860)</u>
Financing activities:		
Proceeds from sale of memberships	<u>18,063</u>	<u>20,132</u>
Net cash provided by financing activities	<u>18,063</u>	<u>20,132</u>
Net increase (decrease) in cash and cash equivalents	(36,012)	18,930
Cash and cash equivalents at beginning of year	<u>227,175</u>	<u>208,245</u>
Cash and cash equivalents at end of year	\$ <u><u>191,163</u></u>	<u><u>227,175</u></u>
Supplemental disclosures of cash flow information:		
Cash paid for:		
Income taxes	\$ 26,736	21,069
Noncash investing activity:		
Property and equipment additions in accounts payable	\$ 4,189	7,259

See accompanying notes to consolidated financial statements.

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

(1) Basis of Presentation and Summary of Significant Accounting Policies

(a) Business Overview

Recreational Equipment, Inc. and its subsidiaries (collectively, REI or the Company) operate as a national outdoor retail cooperative dedicated to inspiring, educating, and outfitting its members and the community for a lifetime of outdoor adventure and stewardship. REI was founded in 1938 by a group of Pacific Northwest mountaineers seeking quality equipment and is committed to promoting environmental stewardship and creating access to inspirational places throughout the country. REI sells goods and services through more than 140 retail stores located throughout the United States, online through rei.com, and through mail order.

(b) Principles of Consolidation

The consolidated financial statements present the results of operations, financial position, and cash flows of the Company in U.S. dollars, in accordance with U.S. generally accepted accounting principles (GAAP). The consolidated financial statements include the accounts of Recreational Equipment, Inc. and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated upon consolidation.

(c) Fiscal Year

REI reports results on a 52/53-week fiscal year ending on the Saturday closest to December 31. Reported results relate to the 52-week fiscal years ended December 31, 2016, and January 2, 2016.

(d) Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses and disclosure of contingent assets and liabilities. Uncertainties regarding such estimates and assumptions are inherent and, as a result, actual results could differ. Such estimates include, but are not limited to, the following: useful lives and recoverability of fixed assets, inventory obsolescence, income taxes, sales returns reserves, unredeemed gift cards, unredeemed patronage dividends, and goodwill.

(e) Cash and Cash Equivalents

Cash equivalents are highly liquid short-term investments with original maturities of three months or less. Cash and cash equivalents include payments due from financial institutions for third-party credit card and debit card deposits, which are typically received within 24 to 72 hours of the sales transaction, except for transactions occurring on a Friday, which are generally processed the following Monday. The Company maintains cash and cash equivalent balances with financial institutions that exceed federally insured limits. The Company has not experienced any losses related to these balances and management believes its credit risk to be minimal.

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

(f) *Short-Term Investments*

The Company invests cash in accordance with its investment policy. The Company's short-term investments are classified as available-for-sale securities and consist primarily of tax-exempt municipal bonds, commercial paper, corporate bonds, a municipal income bond mutual fund, certificates of deposit, including those insured by the Federal Deposit Insurance Corporation (FDIC), asset-backed securities (primarily credit card and auto receivables), taxable and tax-exempt variable rate demand notes (VRDNs), U.S. Treasury securities, and U.S. Agency securities. The Company is exposed to credit risk in the event of default by issuers and counterparties of the short-term investments. The Company's available-for-sale securities consist primarily of investments that regularly trade in active markets; as such, the Company has classified the entire available-for-sale portfolio as a current asset on the consolidated balance sheets. The Company's investments are stated at fair value, with any unrealized gains and losses, net of deferred income taxes, reported as a component of accumulated other comprehensive income. Realized gains and losses on these securities are included in other expense, net in the consolidated statements of comprehensive income. The cost of securities sold is determined using the specific identification method. The Company periodically evaluates unrealized losses in its investment securities for other-than-temporary impairment, using both qualitative and quantitative criteria. In the event a security is deemed to be other-than-temporarily impaired, the Company records a charge against net income. No such charges were recorded for the periods ended December 31, 2016 or January 2, 2016.

The cost and fair value of the Company's available-for-sale securities that are carried at fair value at December 31, 2016, by contractual maturity, are as follows (in thousands):

	<u>Cost</u>	<u>Fair value</u>
Due in one year or less	\$ 195,008	194,752
Due in more than one year	90,668	90,392
Total	<u>\$ 285,676</u>	<u>285,144</u>

(g) *Accounts Receivable*

Accounts receivable are primarily due from vendors and landlords. The Company estimates its allowance for doubtful accounts based on length of time past due and ability to collect the receivable.

(h) *Inventories*

Inventories are carried at the lower of cost or market on an average-cost basis. The Company records a write-down of inventories, which are obsolete or slow-moving based upon historical experience.

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

(i) Property and Equipment

Property and equipment are recorded at historical cost less accumulated depreciation and impairments. Depreciation is computed primarily by using the straight-line method based on the assets' estimated useful lives, which are ten to thirty years for buildings and improvements, and two to ten years for software, equipment, furniture, and fixtures. Renewals and betterments that add to the productive capacity or extend the useful life of the asset are capitalized. Capitalized software includes the costs of developing or obtaining internal-use software, including external direct costs of materials and services and internal payroll costs related to each software project.

Leasehold improvements made at the inception of the lease are amortized over the shorter of the initial lease term or the asset life. Leasehold improvements made during the lease term are amortized over the shorter of the asset life or the remaining lease term.

Maintenance and repairs are charged to expense as incurred.

(j) Goodwill

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

In 2015, the Company elected to adopt Accounting Standards Update (ASU) 2014-02, *Accounting for Goodwill*, which allows a private company to elect an accounting alternative to amortize goodwill on a straight-line basis over ten years or less than ten years if the entity demonstrates another useful life is appropriate. For goodwill acquired during 2016 and 2015 an amortization period of 7 years was applied as this period corresponds to the assets acquired. The Company has elected to follow the authoritative guidance available to private companies to assess goodwill impairment at the entity-wide level. The Company will assess goodwill for impairment whenever events or changes in circumstances indicate that the carrying amount of goodwill may not be fully recoverable. There was no impairment recognized for the periods ended December 31, 2016 and January 2, 2016.

(k) Long-Lived Assets

When facts or circumstances indicate that the carrying values of long-lived assets, including buildings, equipment, and internal-use software may not be recoverable, an evaluation for impairment is performed. An asset is considered impaired when estimated undiscounted future cash flows are less than the carrying amount of the asset. In the event that the carrying amount of such asset is not deemed recoverable, the asset is adjusted to its estimated fair value. Fair value is generally determined based upon a discounted future cash flow model. Property and equipment assets are grouped at the lowest level in which there are identifiable cash flows when assessing impairment. Cash flows for retail assets are identified at the individual store level. There was no impairment recognized for the periods ended December 31, 2016 and January 2, 2016.

(l) Customer-Related Obligations

Sales returns reserves, deferred revenue for unredeemed gift cards, and the REI co-branded credit card rebate program are reflected within customer-related obligations.

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

(m) Patronage Dividends

The Company declares a patronage dividend to members based on the level of qualifying member purchases during each calendar year. As required by the Company's bylaws, the dividend is limited to the distribution of operating income (as defined). The Company records the patronage dividends payable liability based upon its estimate of dividends that will be redeemed by co-op members prior to the dividend expiration date. The Company has historical experience demonstrating that less than 100% of members redeem their entire patronage dividends within the time period these dividends are available to them. At December 31, 2016, the balance of patronage dividends payable was \$137.9 million, net of estimated dividends of \$37.1 million that will not be redeemed, and \$132.9 million at January 2, 2016, net of estimated dividends of \$33.2 million that will not be redeemed.

(n) Sabbatical Leave

The Company provides paid leave to employees with service of 15 or more years. The Company records the compensation cost associated with sabbatical leaves over the requisite service periods.

(o) Rent

The Company recognizes minimum rent expense, net of landlord reimbursements, on a straight-line basis over the lease term from the time that the Company controls the leased property. For leases that contain predetermined, fixed escalations of the minimum rent, the Company recognizes the rent expense on a straight-line basis and records the difference between the rent expense and the rent payable as a deferred credit.

As part of entering into certain retail store leases, the lessor may provide the Company with a tenant improvement allowance. Typically, such allowances are in the form of cash and represent reimbursements to the Company for tenant improvements made to the leased space. These improvements are capitalized as fixed assets and the allowances are classified as a component of deferred rent. This incentive is considered a reduction of rent expense by the Company over the term of the lease on a straight-line basis.

(p) Memberships

As a cooperative, the Company is owned by its members. Each eligible member is entitled to vote in the election of the Company's Board of Directors. To be considered eligible to vote, a member must have purchased at least \$10 worth of merchandise, had a shipping charge of at least \$10, or become a new member in the previous calendar year. Since January 1, 2008, the one-time fee for a nonrefundable, nontransferable membership has been \$20. As of December 31, 2016, there were 6.3 million voting eligible members.

(q) Net Sales

The Company recognizes revenue from product sales when products are purchased by customers at the Company's stores or when products are shipped for online sales. Revenue is recorded net of sales taxes and estimated allowances for returns. The allowance for sales returns is based on historical information and reduces both sales and cost of sales. Shipping revenue is included in net sales and the related costs of shipping are included in cost of sales.

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

The Company recognizes revenue associated with gift cards when the gift cards are redeemed for merchandise or services. The determination of the likelihood of redemption is based on an analysis of the Company's historical redemption trends. Unredeemed gift cards are recognized in the consolidated statements of comprehensive income as a reduction to occupancy, general, and administrative expenses when redemption becomes remote.

(r) Cost of Sales

Cost of sales includes the cost to purchase and transport merchandise to the Company. The Company receives rebates, allowances, and cooperative advertising funds from vendors. Amounts received related to the reimbursement of costs incurred, such as advertising, are recognized as a reduction in the related expense when the vendor receives a specific incremental, identifiable benefit. Other consideration received from vendors in the form of cash and credits are recorded as a reduction of cost of sales as the related merchandise is sold.

(s) Occupancy, General, and Administrative Expenses

Occupancy, general, and administrative expenses consist primarily of depreciation, advertising, rent, bankcard fees, and other miscellaneous expenses.

(t) Advertising Costs

Advertising production costs for internet, photo, video, direct mail, and other media are expensed the first time the advertisement is delivered. Other advertising costs are expensed as incurred. Advertising expense for 2016 and 2015 was \$71.6 million and \$72.6 million, respectively, and is included in occupancy, general, and administrative expenses.

(u) New Store Opening Costs

Noncapital expenditures associated with opening or relocating stores are charged to expense as incurred and included in occupancy, general, and administrative expenses.

(v) Income Taxes

The Company operates as a cooperative subject to taxes on all income not distributed to members. The Company computes income taxes using the asset and liability method, under which deferred income taxes are provided for the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the tax basis. The deferred tax assets and liabilities are calculated using the enacted tax rates that are expected to be in effect when the differences are expected to reverse. The Company establishes a valuation allowance for deferred tax assets if it is more likely than not that these items will expire before the Company is able to realize the benefit or future deductibility is uncertain.

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

In November 2015, the Financial Accounting Standards Board (FASB) issued ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*. This ASU requires all deferred tax assets and liabilities be presented in the balance sheet as noncurrent. The amendments in the Update are effective for financial statements issued for annual periods beginning after December 15, 2017. Earlier application is permitted for all entities as of the beginning of an annual reporting period. The Company elected to early adopt this new guidance in 2015 and has applied the changes to all years presented.

(w) Recent Accounting Pronouncements Not Yet Adopted

(i) Lease Accounting

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which requires lessees to recognize leases on-balance sheet and disclose key information about leasing arrangements. The new standard establishes a right-of-use (ROU) model that requires a lessee to record an ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. For nonpublic entities, the new standard is effective for interim and annual periods beginning after December 15, 2019, with early adoption permitted. The guidance is required to be adopted at the earliest period presented using a modified retrospective approach. The Company is currently evaluating the impact of ASU 2016-02 on the consolidated financial statements.

(ii) Updated Revenue Accounting

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The core principle of the new standard is for companies to recognize revenue in a manner that depicts the transfer of goods or services to customers in amounts that reflect the consideration, or payment, to which the company expects to be entitled in exchange for those goods or services. In July 2015, the FASB deferred the effective date for nonpublic entities, to annual reporting periods beginning after December 15, 2018. The amendments may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. The Company is currently evaluating the impact of ASU 2014-09 on the consolidated financial statements.

(2) Fair Value

The Company applies fair value accounting for all financial assets and liabilities that are recognized at fair value in the financial statements. The Company defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities, which are required to be recorded at fair value, the Company considers the principal or most advantageous market in which the Company would transact and the market-based risk measurements or assumptions that market participants would use in pricing the asset or liability, such as risks inherent in valuation techniques, transfer restrictions, and credit risk. Fair value is estimated by applying the following hierarchy, which prioritizes the inputs used to measure fair value into three levels and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement.

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

The hierarchy is broken down into three levels based on the reliability of inputs as follows:

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

Level 2 – Other inputs that are directly or indirectly observable in the marketplace

Level 3 – Inputs that are generally unobservable and typically reflect management's estimate of assumptions that market participants would use in pricing the asset or liability

As of December 31, 2016 and January 2, 2016, there were no financial instruments within Level 3 of the hierarchy. Nonfinancial assets, which include long-lived assets, including Property and equipment and Goodwill are reported at carrying value and are not required to be measured at fair value on a recurring basis. However, on a periodic basis, or whenever events or changes in circumstances indicate their carrying value may not be recoverable, the Company assesses long-lived assets for impairment. Nonrecurring assessments use significant unobservable inputs and, therefore, fall under Level 3 of the fair value hierarchy.

In accordance with the fair value accounting requirements, companies may choose to measure eligible financial instruments and certain other items at fair value. The Company has not elected the fair value option for any eligible financial instruments. The carrying amount of the Company's accounts receivable and accounts payable on the consolidated balance sheets approximate fair value due to their short-term nature.

Assets and liabilities measured at fair value consist of the following as of December 31, 2016 (in thousands):

	<u>Cost basis</u>	<u>Unrealized gains (losses)</u>	<u>Fair value</u>	<u>Cash and cash equivalents</u>	<u>Short-term investments</u>
Cash	\$ 41,482	—	41,482	41,482	—
Level 1:					
Money market	149,681	—	149,681	149,681	—
U.S. Treasury securities	4,992	—	4,992	—	4,992
Mutual funds	25,896	(189)	25,707	—	25,707
Subtotal	<u>222,051</u>	<u>(189)</u>	<u>221,862</u>	<u>191,163</u>	<u>30,699</u>

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

	<u>Cost basis</u>	<u>Unrealized gains (losses)</u>	<u>Fair value</u>	<u>Cash and cash equivalents</u>	<u>Short-term investments</u>
Level 2:					
Asset-backed securities	\$ 14,691	(11)	14,680	—	14,680
U.S. agency securities	2,497	1	2,498	—	2,498
Commercial paper	78,132	—	78,132	—	78,132
Corporate bonds	54,167	(101)	54,066	—	54,066
Certificates of deposits	19,624	1	19,625	—	19,625
Municipal bonds	79,462	(233)	79,229	—	79,229
VRDNs	6,215	—	6,215	—	6,215
Subtotal	<u>254,788</u>	<u>(343)</u>	<u>254,445</u>	<u>—</u>	<u>254,445</u>
Total	<u>\$ 476,839</u>	<u>(532)</u>	<u>476,307</u>	<u>191,163</u>	<u>285,144</u>

Assets and liabilities measured at fair value consist of the following as of January 2, 2016 (in thousands):

	<u>Cost basis</u>	<u>Unrealized gains (losses)</u>	<u>Fair value</u>	<u>Cash and cash equivalents</u>	<u>Short-term investments</u>
Cash	\$ 53,346	—	53,346	53,346	—
Level 1:					
Money market	173,829	—	173,829	173,829	—
U.S. Treasury securities	23,181	1	23,182	—	23,182
Mutual funds	25,685	(1)	25,684	—	25,684
Subtotal	<u>276,041</u>	<u>—</u>	<u>276,041</u>	<u>227,175</u>	<u>48,866</u>
Level 2:					
Asset-backed securities	13,861	(27)	13,834	—	13,834
U.S. agency securities	5,595	3	5,598	—	5,598
Commercial paper	21,088	—	21,088	—	21,088
Corporate bonds	71,736	(136)	71,600	—	71,600
Certificates of deposits	29,371	1	29,372	—	29,372
Municipal bonds	71,591	(31)	71,560	—	71,560
VRDNs	9,950	—	9,950	—	9,950
Subtotal	<u>223,192</u>	<u>(190)</u>	<u>223,002</u>	<u>—</u>	<u>223,002</u>
Total	<u>\$ 499,233</u>	<u>(190)</u>	<u>499,043</u>	<u>227,175</u>	<u>271,868</u>

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

(3) Property and Equipment

Property and equipment consist of the following as of December 31, 2016 and January 2, 2016 (in thousands):

	<u>2016</u>	<u>2015</u>
Land, buildings, and improvements	\$ 369,790	333,233
Equipment, furniture, and fixtures	353,360	266,450
Leasehold improvements	249,726	227,245
Software	235,407	194,362
Construction-in-progress	<u>26,745</u>	<u>73,906</u>
	1,235,028	1,095,196
Less accumulated depreciation	<u>738,007</u>	<u>651,428</u>
Total	<u>\$ 497,021</u>	<u>443,768</u>

The Company's depreciation expense was \$93.2 million for 2016 and \$84.5 million for 2015.

(4) Goodwill

In 2016 and 2015, the Company completed business acquisitions for \$0.5 million and \$7.6 million, respectively. Revenue and total assets of the acquired companies are not material to the Company's overall revenue and total assets. Operating results of the acquired businesses subsequent to acquisition dates are included in the Company's operating results. For each acquisition, the Company estimated the allocation of the purchase price to the assets acquired and liabilities assumed, of which \$0.5 million in 2016 and \$7.6 million in 2015 were allocated to goodwill, to be amortized over the respective useful lives of seven years. For the periods ended December 31, 2016 and January 2, 2016, goodwill amortization expense was \$1.1 million and \$0.6 million, respectively.

	<u>2016</u>	<u>2015</u>
Goodwill, beginning balance	\$ 6,951	—
Goodwill acquired during the period	450	7,583
Goodwill amortization during the period	<u>(1,100)</u>	<u>(632)</u>
	<u>\$ 6,301</u>	<u>6,951</u>

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

(5) Line of Credit

The Company has a line of credit available with a bank that permits borrowings of up to \$5 million, which expires in June 2018. Interest on outstanding borrowings accrues at the prime rate or London Interbank Offered Rate (LIBOR) plus one and a half percent. No amounts were outstanding under this line of credit at December 31, 2016 or January 2, 2016. At December 31, 2016, approximately \$2.9 million of the amount available under the line of credit was reserved for outstanding letters of credit. The Company was in compliance with all covenants imposed by the line of credit agreement as of December 31, 2016 and January 2, 2016.

(6) Income Taxes

The provision for income taxes is as follows for the periods ended December 31, 2016 and January 2, 2016 (in thousands):

	<u>2016</u>	<u>2015</u>
Current:		
Federal	\$ 14,319	22,528
State	4,613	3,721
	<u>18,932</u>	<u>26,249</u>
Deferred	2,784	(7,999)
Total provision for income taxes	<u>\$ 21,716</u>	<u>18,250</u>

A reconciliation from the U.S. statutory rate to the effective tax rate is as follows for the periods ended December 31, 2016 and January 2, 2016 (in thousands):

	<u>2016</u>		<u>2015</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Tax at federal statutory rate	\$ 20,997	35.00%	\$ 18,768	35.00%
State income taxes, net of federal tax benefit	2,786	4.64	1,809	3.37
Tax credits	(2,318)	(3.86)	(3,470)	(6.47)
Other	251	0.42	1,143	2.13
	<u>\$ 21,716</u>	<u>36.20%</u>	<u>\$ 18,250</u>	<u>34.03%</u>

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

Significant components of the Company's deferred income taxes are as follows for December 31, 2016 and January 2, 2016 (in thousands):

	<u>2016</u>	<u>2015</u>
Deferred tax assets:		
Noncurrent:		
Patronage dividends	\$ 13,395	13,421
Inventory basis differences	10,057	5,402
Gift cards	9,550	8,381
Fixed asset depreciation and basis differences	(18,265)	(5,879)
Deferred rent	18,997	18,922
Deferred income	3,183	3,690
Nonqualified retirement plan accrual	3,757	2,951
Employee benefits and compensation	9,096	8,852
Other	7,251	4,065
Valuation allowance	—	—
Net deferred tax assets	<u>\$ 57,021</u>	<u>59,805</u>

Significant judgment is required in evaluating the Company's tax positions and determining the Company's provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate determination is uncertain. The Company establishes reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes will be due. These reserves are established when Company management believes that certain positions might be challenged despite the Company's belief that their tax return positions are fully supportable. These reserves are adjusted in light of changing facts and circumstances, such as the outcome of tax audits. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate. The Company recognizes interest and penalties accrued related to unrecognized tax benefits in tax expense and tax liabilities. As of December 31, 2016, the liability for uncertain tax positions includes an immaterial amount related to interest and penalties. Tax years 2012 through 2016 remain open to examination by the major taxing jurisdictions to which the Company is subject. Management does not anticipate any potential settlement or examination to result in a material change to the Company's financial position.

(7) Employee Benefits Plan

The Company has a defined contribution retirement and profit-sharing plan covering employees meeting certain eligibility requirements (generally, one year of employment and 1,000 hours of service). Company contributions are based on a percentage of eligible participant compensation ranging from 5% to 15%, depending on the Company's profitability. The retirement and profit-sharing plan Company contributions were approximately \$24.0 million and \$26.0 million for 2016 and 2015, respectively.

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

The Company also has a nonqualified deferred compensation plan, which provides a voluntary pay deferral option enabling eligible participants to contribute a portion of their respective annual base salary and bonus plan payments. Compensation is charged to expense in the period earned. In order to fund the nonqualified deferred compensation plan's future obligations, the Company has purchased investments held in irrevocable trusts commonly referred to as "Rabbi Trusts." As the Company is the owner of the investments and in order to reflect the Company's policy to pay benefits equal to the accumulations, the assets and liabilities are reflected in the consolidated balance sheets. At December 31, 2016 and January 2, 2016, assets and liabilities recorded in connection with deferred compensation plan benefits totaled \$13.0 million and \$10.9 million, respectively.

The nonqualified deferred compensation plan also provides the Company's highly compensated employees with a contribution equal to that which would have been allocated to them under the qualified retirement plan were it not for the limitations imposed by Internal Revenue Code Section 401(a)(17) and Section 415 and one-time eligibility limitations due to hire date. The Company's contributions to the nonqualified deferred compensation plan are based on a percentage of eligible participant compensation ranging from 5% to 15%, depending on the Company's profitability. Total Company contributions were approximately \$0.2 million and \$0.2 million for 2016 and 2015, respectively.

(8) Leases

The Company leases 127 retail store locations and office spaces. All leases are classified as operating leases and expire within the next 20 years but contain various renewal options. Certain leases contain provisions for contingent rent expense based on a percentage of sales revenue. Rent expense under operating leases, net of tenant improvement allowances, was approximately \$62.8 million and \$56.1 million for 2016 and 2015, respectively, and does not include common area charges, real estate taxes, and other executory costs.

Future minimum lease payments under noncancelable operating leases as of December 31, 2016 are as follows (in thousands):

2017	\$	74,511
2018		70,941
2019		62,467
2020		52,362
2021		45,510
Thereafter		184,934
	\$	<u>490,725</u>

RECREATIONAL EQUIPMENT, INC.

Notes to Consolidated Financial Statements

December 31, 2016 and January 2, 2016

(In thousands)

(9) Commitments and Contingencies

The Company is subject from time to time to various claims and lawsuits arising in the ordinary course of business, including lawsuits alleging infringement of technology patents, violations of state and/or federal wage and hour and other employment laws, and other consumer-based claims. Some of these lawsuits purport or may be determined to be class or collective actions and seek substantial damages or injunctive relief, or both, and some may remain unresolved for several years. In management's opinion, the recorded reserves in the Company's consolidated financial statements are adequate in light of the probable and estimable liabilities. As of the date of this report, management does not believe any currently identified claim, proceeding, or litigation, either alone or in the aggregate with other claims, will have a material impact on the Company's results of operations, financial position, or cash flows. Because these matters are subject to inherent uncertainties, management's view of them may change in the future.

(10) Subsequent Events

The Company evaluated subsequent events through March 9, 2017, the date the consolidated financial statements were available to be issued. There were no material subsequent events or transactions that required recognition or disclosure in these consolidated financial statements.