

AMERICAN EAGLE OUTFITTERS INC

Form 10-Q

August 25, 2011

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended July 30, 2011

OR

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

Commission File Number: 1-33338

**American Eagle Outfitters, Inc.**

(Exact name of registrant as specified in its charter)

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<b>Delaware</b> (State or other jurisdiction of incorporation or organization)	<b>No. 13-2721761</b> (I.R.S. Employer Identification No.)
<b>77 Hot Metal Street, Pittsburgh, PA</b> (Address of principal executive offices)	<b>15203-2329</b> (Zip Code)
<b>Registrant's telephone number, including area code: (412) 432-3300</b>	

Former name, former address and former fiscal year, if changed since last report:

N/A

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

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

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

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 194,901,192 Common Shares were outstanding at August 22, 2011.

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**Table of Contents****PART I- FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS.****AMERICAN EAGLE OUTFITTERS, INC.****CONSOLIDATED BALANCE SHEETS**

*(In thousands, except per share amounts)*

	July 30, 2011 (Unaudited)	January 29, 2011	July 31, 2010 (Unaudited)
<b>Assets</b>			
Current assets:			
Cash and cash equivalents	\$ 389,299	\$ 667,593	\$ 425,523
Short-term investments	124,697	67,102	5,800
Merchandise inventory	470,242	301,208	349,091
Accounts receivable	31,530	36,721	41,793
Prepaid expenses and other	90,788	53,727	99,475
Deferred income taxes	48,585	48,059	41,129
<b>Total current assets</b>	<b>1,155,141</b>	<b>1,174,410</b>	<b>962,811</b>
Property and equipment, at cost, net of accumulated depreciation	635,540	643,120	657,131
Intangible assets, at cost, net of accumulated amortization	40,295	7,485	6,520
Goodwill	11,668	11,472	11,364
Long-term investments	648	5,915	166,717
Non-current deferred income taxes	2,460	19,616	28,724
Other assets	20,750	17,980	16,436
<b>Total assets</b>	<b>\$ 1,866,502</b>	<b>\$ 1,879,998</b>	<b>\$ 1,849,703</b>
<b>Liabilities and Stockholders Equity</b>			
Current liabilities:			
Accounts payable	\$ 187,572	\$ 167,723	\$ 144,929
Accrued compensation and payroll taxes	24,928	34,954	31,356
Accrued rent	72,477	70,390	83,617
Accrued income and other taxes	13,998	32,468	13,801
Unredeemed gift cards and gift certificates	26,542	41,001	21,201
Current portion of deferred lease credits	15,938	16,203	16,909
Other liabilities and accrued expenses	21,037	25,098	19,413
<b>Total current liabilities</b>	<b>362,492</b>	<b>387,837</b>	<b>331,226</b>
Non-current liabilities:			
Deferred lease credits	77,925	78,606	83,709
Non-current accrued income taxes	38,256	38,671	35,748
Other non-current liabilities	20,842	23,813	21,030
<b>Total non-current liabilities</b>	<b>137,023</b>	<b>141,090</b>	<b>140,487</b>
Commitments and contingencies			
Stockholders equity:			
Preferred stock, \$0.01 par value; 5,000 shares authorized; none issued and outstanding			

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Common stock, \$0.01 par value; 600,000 shares authorized; 249,566, 249,566 and 249,559 shares issued; 194,901, 194,366 and 195,539 shares outstanding, respectively	2,496	2,496	2,496
Contributed capital	546,677	546,597	540,326
Accumulated other comprehensive income	32,692	28,072	19,250
Retained earnings	1,713,778	1,711,929	1,735,503
Treasury stock, 54,665, 55,200 and 54,020 shares, respectively	(928,656)	(938,023)	(919,585)
 Total stockholders' equity	 1,366,987	 1,351,071	 1,377,990
 Total liabilities and stockholders' equity	 \$ 1,866,502	 \$ 1,879,998	 \$ 1,849,703

Refer to Notes to Consolidated Financial Statements

**Table of Contents****AMERICAN EAGLE OUTFITTERS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS****(Unaudited)**

<i>(In thousands, except per share amounts)</i>	13 Weeks Ended		26 Weeks Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
Net sales	\$ 675,703	\$ 651,502	\$ 1,285,265	\$ 1,299,964
Cost of sales, including certain buying, occupancy and warehousing expenses	443,642	411,794	821,443	802,560
Gross profit	232,061	239,708	463,822	497,404
Selling, general and administrative expenses	167,099	165,493	325,590	334,138
Depreciation and amortization expense	35,675	36,049	70,555	71,574
Operating income	29,287	38,166	67,677	91,692
Other income (expense), net	1,431	(1,110)	5,943	(989)
Income before income taxes	30,718	37,056	73,620	90,703
Provision for income taxes	11,049	11,213	25,626	28,998
Income from continuing operations	19,669	25,843	47,994	61,705
Loss from discontinued operations, net of tax		(16,180)		(41,120)
Net income	\$ 19,669	\$ 9,663	\$ 47,994	\$ 20,585
<b>Basic income per common share:</b>				
Income from continuing operations	\$ 0.10	\$ 0.13	\$ 0.25	\$ 0.30
Loss from discontinued operations	\$ 0.00	(\$ 0.08)	\$ 0.00	(\$ 0.20)
Basic income per common share	\$ 0.10	\$ 0.05	\$ 0.25	\$ 0.10
<b>Diluted income per common share:</b>				
Income from continuing operations	\$ 0.10	\$ 0.13	\$ 0.24	\$ 0.30
Loss from discontinued operations	\$ 0.00	(\$ 0.08)	\$ 0.00	(\$ 0.20)
Diluted income per common share	\$ 0.10	\$ 0.05	\$ 0.24	\$ 0.10
Cash dividends per common share	\$ 0.11	\$ 0.11	\$ 0.22	\$ 0.21
Weighted average common shares outstanding - basic	194,909	201,764	194,800	204,238
Weighted average common shares outstanding - diluted	196,578	203,153	196,626	206,430
Retained earnings, beginning	\$ 1,716,173	\$ 1,749,513	\$ 1,711,929	\$ 1,764,049
Net income	19,669	9,663	47,994	20,585
Cash dividends and dividend equivalents	(21,850)	(22,434)	(43,602)	(43,517)
Reissuance of treasury stock	(214)	(1,239)	(2,543)	(5,614)
Retained earnings, ending	\$ 1,713,778	\$ 1,735,503	\$ 1,713,778	\$ 1,735,503

Refer to Notes to Consolidated Financial Statements



**Table of Contents****AMERICAN EAGLE OUTFITTERS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

<i>(In thousands)</i>	26 Weeks Ended	
	July 30, 2011	July 31, 2010
<b>Operating activities:</b>		
Net income	\$ 47,994	\$ 20,585
Loss from discontinued operations		41,120
Income from continuing operations	47,994	61,705
Adjustments to reconcile income from continuing operations to net cash from operating activities:		
Depreciation and amortization	71,864	73,660
Share-based compensation	5,838	18,380
Provision for deferred income taxes	16,389	17,933
Tax benefit from share-based payments	290	13,039
Excess tax benefit from share-based payments	(152)	(4,100)
Foreign currency transaction loss	219	1,159
Net impairment loss recognized in earnings		1,248
Realized loss on sale of investment securities		225
Changes in assets and liabilities:		
Merchandise inventory	(167,590)	(29,870)
Accounts receivable	5,271	(8,690)
Prepaid expenses and other	(36,797)	(53,574)
Other assets	(2,767)	180
Accounts payable	23,526	(11,134)
Unredeemed gift cards and gift certificates	(14,632)	(17,964)
Deferred lease credits	(1,272)	(2,805)
Accrued compensation and payroll taxes	(10,112)	(26,183)
Accrued income and other taxes	(18,490)	(10,117)
Accrued liabilities	(4,558)	(1,187)
<b>Total adjustments</b>	<b>(132,973)</b>	<b>(39,800)</b>
<b>Net cash (used for) provided by operating activities from continuing operations</b>	<b>(84,979)</b>	<b>21,905</b>
<b>Investing activities:</b>		
Capital expenditures for property and equipment	(65,601)	(39,344)
Acquisition of intangible assets	(33,545)	(1,530)
Purchase of available-for-sale securities	(166,443)	
Sale of available-for-sale securities	115,229	27,875
<b>Net cash used for investing activities from continuing operations</b>	<b>(150,360)</b>	<b>(12,999)</b>
<b>Financing activities:</b>		
Payments on capital leases	(1,556)	(1,145)
Repayment of note payable		(30,000)
Repurchase of common stock as part of publicly announced programs		(192,268)
Repurchase of common stock from employees	(2,189)	(17,986)
Net proceeds from stock options exercised	2,659	4,475
Excess tax benefit from share-based payments	152	4,100
Cash used to net settle equity awards		(6,434)



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Cash dividends paid	(42,869)	(43,148)
<b>Net cash used for financing activities from continuing operations</b>	<b>(43,803)</b>	<b>(282,406)</b>
Effect of exchange rates changes on cash	848	88
Cash flows of discontinued operations		
Net cash provided by operating activities		4,981
Net cash used for investing activities		(6)
Net cash used for financing activities		
Effect of exchange rates changes on cash		
<b>Net cash provided by discontinued operations</b>		<b>4,975</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(278,294)</b>	<b>(268,437)</b>
Cash and cash equivalents - beginning of period	667,593	693,960
Cash and cash equivalents - end of period	<b>\$ 389,299</b>	<b>\$ 425,523</b>
Supplemental disclosure of cash flow information:		
Cash paid during the period for income taxes	\$ 59,533	\$ 32,168
Cash paid during the period for interest	\$ 0	\$ 191

Refer to Notes to Consolidated Financial Statements

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**AMERICAN EAGLE OUTFITTERS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Interim Financial Statements**

The accompanying Consolidated Financial Statements of American Eagle Outfitters, Inc. (the Company) at July 30, 2011 and July 31, 2010 and for the 13 and 26 week periods ended July 30, 2011 and July 31, 2010 have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Certain notes and other information have been condensed or omitted from the interim Consolidated Financial Statements presented in this Quarterly Report on Form 10-Q. Therefore, these Consolidated Financial Statements should be read in conjunction with the Company's Fiscal 2010 Annual Report. In the opinion of the Company's management, all adjustments (consisting of normal recurring adjustments and those described in the footnotes that follow) considered necessary for a fair presentation have been included. The existence of subsequent events has been evaluated through the filing date of this Quarterly Report on Form 10-Q.

As used in this report, all references to we, our and the Company refer to American Eagle Outfitters, Inc. and its wholly owned subsidiaries.

American Eagle Outfitters, American Eagle, AE and the AE Brand refer to our U.S. and Canadian American Eagle Outfitters stores. aerie refers to our U.S. and Canadian aerie® by American Eagle® stores. 77kids refers to our 77kids by american eagle stores. AEO Direct refers to our e-commerce operations, ae.com, aerie.com and 77kids.com. MARTIN+OSA or M+O refers to the MARTIN+OSA stores and e-commerce operation which we operated until its closure during the second quarter of Fiscal 2010.

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

**2. Summary of Significant Accounting Policies**

***Principles of Consolidation***

The Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation. At July 30, 2011, the Company operated in one reportable segment.

On March 5, 2010, the Company's Board of Directors (the Board) approved management's recommendation to proceed with the closure of the M+O brand. The Company completed the closure of the M+O stores and e-commerce operation during the second quarter of Fiscal 2010. These Consolidated Financial Statements reflect the results of M+O as a discontinued operation for all periods presented.

***Fiscal Year***

The Company's financial year is a 52/53 week year that ends on the Saturday nearest to January 31. As used herein, Fiscal 2011 refers to the 52 week period ending January 28, 2012. Fiscal 2010 and Fiscal 2009 refer to the 52 week periods ended January 29, 2011 and January 30, 2010, respectively.

***Estimates***

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

***Recent Accounting Pronouncements***

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In June 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2011-05, *Presentation of Comprehensive Income* ( ASU 2011-05 ). ASU 2011-05 requires that all non-owner

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changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income and the total of comprehensive income. For public entities, the amendments in ASU 2011-05 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and are to be applied retrospectively, with early adoption permitted. The Company is currently evaluating the impact of ASU 2011-05 on its financial statement presentation of comprehensive income.

***Foreign Currency Translation***

The Canadian dollar is the functional currency for the Canadian business. In accordance with Accounting Standards Codification (ASC) 830, *Foreign Currency Matters*, assets and liabilities denominated in foreign currencies were translated into U.S. dollars (the reporting currency) at the exchange rate prevailing at the balance sheet date. Revenues and expenses denominated in foreign currencies were translated into U.S. dollars at the monthly average exchange rate for the period. Gains or losses resulting from foreign currency transactions are included in the results of operations, whereas, related translation adjustments are reported as an element of other comprehensive income in accordance with ASC 220, *Comprehensive Income* (refer to Note 9 to the Consolidated Financial Statements).

***Revenue Recognition***

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

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

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

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

The Company sells off end-of-season, overstock and irregular merchandise to a third-party. The proceeds from these sales are presented on a gross basis, with proceeds and cost of sell-offs recorded in net sales and cost of sales, respectively.

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

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

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

Selling, general and administrative expenses consist of compensation and employee benefit expenses, including salaries, incentives and related benefits associated with our stores and corporate headquarters. Selling, general and administrative expenses also include advertising costs, supplies for our stores and home office, communication



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costs, travel and entertainment, leasing costs and services purchased. Selling, general and administrative expenses do not include compensation, employee benefit expenses and travel for our design, sourcing and importing teams, our buyers and our distribution centers as these amounts are recorded in cost of sales.

**Other Income (Expense), Net**

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

**Other-than-Temporary Impairment**

The Company evaluates its investments for impairment in accordance with ASC 320, *Investments – Debt and Equity Securities* ( ASC 320 ). ASC 320 provides guidance for determining when an investment is considered impaired, whether impairment is other-than-temporary, and measurement of an impairment loss. An investment is considered impaired if the fair value of the investment is less than its cost. If, after consideration of all available evidence to evaluate the realizable value of its investment, impairment is determined to be other-than-temporary, then an impairment loss is recognized in the Consolidated Statement of Operations equal to the difference between the investment's cost and its fair value. Additionally, ASC 320 requires additional disclosures relating to debt and equity securities both in the interim and annual periods as well as requires the Company to present total other-than-temporary impairment ( OTTI ) with an offsetting reduction for any non-credit loss impairment amount recognized in other comprehensive income ( OCI ).

There was no net impairment loss recognized in earnings during the 13 and 26 weeks ended July 30, 2011. The following table presents the components of net impairment loss recognized in earnings within other income (expense), net on the Consolidated Statement of Operations for the 13 and 26 weeks ended July 31, 2010:

<i>(In thousands)</i>	13 Weeks Ended July 31, 2010	26 Weeks Ended July 31, 2010
Total other-than-temporary impairment losses	(\$ 4,575)	(\$ 5,089)
Portion of loss recognized in other comprehensive income, before tax	3,327	3,841
<b>Net impairment loss recognized in earnings</b>	<b>(\$ 1,248)</b>	<b>(\$ 1,248)</b>

Refer to Note 4 to the Consolidated Financial Statements for additional information regarding net impairment losses recognized in earnings.

**Cash and Cash Equivalents, Short-term Investments and Long-term Investments**

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

As of July 30, 2011, short-term investments included commercial paper, corporate bonds, treasury bills and term deposits purchased with a maturity of greater than three months, but less than one year. It also includes auction rate securities ( ARS ) classified as available for sale that the Company expects to be redeemed at par within 12 months.

As of July 30, 2011, long-term investments include the Company's ARS Call Option related to investment sales during Fiscal 2010. The ARS Call Option expires on October 29, 2013.

Unrealized gains and losses on the Company's available-for-sale securities are excluded from earnings and are reported as a separate component of stockholders' equity, within accumulated other comprehensive income, until realized. The components of OTTI losses related to credit losses, as defined by ASC 320, are considered by the Company to be realized and are recorded in earnings. When available-for-sale securities are sold, the cost of the securities is specifically identified and is used to determine any realized gain or loss.

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

***Merchandise Inventory***

Merchandise inventory is valued at the lower of average cost or market, utilizing the retail method. Average cost includes merchandise design and sourcing costs and related expenses. The Company records merchandise receipts at

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the time merchandise is delivered to the foreign shipping port by the manufacturer (FOB port). This is the point at which title and risk of loss transfer to the Company.

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

***Income Taxes***

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

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

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

***Property and Equipment***

Property and equipment is recorded on the basis of cost with depreciation computed utilizing the straight-line method over the assets' estimated useful lives. The useful lives of our major classes of assets are as follows:

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

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

No asset impairment charges were recorded during the 26 weeks ended July 30, 2011. During the 26 weeks ended July 31, 2010, the Company recorded asset impairment charges of \$18.0 million related to the impairment of M+O stores. Based on the Company's decision to close all M+O stores in Fiscal 2010, the Company determined that the stores not previously impaired would not be able to generate sufficient cash flow over the life of the related leases to





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recover the Company's initial investment in them. The asset impairment charges for the 26 weeks ended July 31, 2010 are recorded within Loss from Discontinued Operations on the Consolidated Statements of Operations.

Refer to Note 13 to the Consolidated Financial Statements for additional information regarding the discontinued operations of M+O.

### ***Goodwill***

As of July 30, 2011, the Company had approximately \$11.7 million of goodwill compared to \$11.5 million as of January 29, 2011. The Company's goodwill is primarily related to the acquisition of its importing operations and Canadian business. The increase in goodwill is due to the fluctuation in the foreign exchange spot rate at which the Canadian goodwill is translated. In accordance with ASC 350, the Company evaluates goodwill for possible impairment on at least an annual basis and last performed an annual impairment test as of January 29, 2011. As a result of the Company's annual goodwill impairment test, the Company concluded that its goodwill was not impaired.

### ***Intangible Assets***

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

The Company evaluates intangible assets for impairment in accordance with ASC 350 when events or circumstances indicate that the carrying value of the asset may not be recoverable. Such an evaluation includes the estimation of undiscounted future cash flows to be generated by those assets. If the sum of the estimated future undiscounted cash flows are less than the carrying amounts of the assets, then the assets are impaired and are adjusted to their estimated fair value. No intangible asset impairment charges were recorded in both the 13 and 26 weeks ended July 30, 2011 and July 31, 2010.

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

### ***Gift Cards***

The value of a gift card is recorded as a current liability upon purchase, and revenue is recognized when the gift card is redeemed for merchandise. The Company estimates gift card breakage and recognizes revenue in proportion to actual gift card redemptions as a component of net sales. The Company determines an estimated gift card breakage rate by continuously evaluating historical redemption data and the time when there is a remote likelihood that a gift card will be redeemed. During the 13 weeks ended July 30, 2011 and July 31, 2010, the Company recorded \$0.9 million and \$0.7 million, respectively, of revenue related to gift card breakage. During the 26 weeks ended July 30, 2011 and July 31, 2010, the Company recorded \$2.0 million and \$1.7 million, respectively, of revenue related to gift card breakage.

### ***Deferred Lease Credits***

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

### ***Co-branded Credit Card and Customer Loyalty Program***

The Company offers a co-branded credit card (the AEO Visa Card) and a private label credit card (the AEO Credit Card) under the American Eagle, aerie and 77kids brands. These credit cards are issued by a third-party bank (the Bank), and the Company has no liability to the Bank for bad debt expense, provided that purchases are made in accordance with the Bank's procedures. Once a customer is approved to receive the AEO Visa Card or the AEO Credit Card and the card is activated, the customer is eligible to participate in the credit card rewards program. Customers who make purchases at AE, aerie and 77kids earn discounts in the form of savings certificates when

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certain purchase levels are reached. Also, AEO Visa Card customers who make purchases at other retailers where the card is accepted earn additional discounts. Savings certificates are valid for 90 days from issuance.

Points earned under the credit card rewards program on purchases at AE, aerie and 77kids are accounted for by analogy to ASC 605-25, *Revenue Recognition, Multiple Element Arrangements* ( ASC 605-25 ). The Company believes that points earned under its point and loyalty programs represent deliverables in a multiple element arrangement rather than a rebate or refund of cash. Accordingly, the portion of the sales revenue attributed to the award points is deferred and recognized when the award is redeemed or when the points expire. Additionally, credit card reward points earned on non-AE, aerie or 77kids purchases are accounted for in accordance with ASC 605-25. As the points are earned, a current liability is recorded for the estimated cost of the award, and the impact of adjustments is recorded in cost of sales.

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

## ***Segment Information***

In accordance with ASC 280, *Segment Reporting* ( ASC 280 ), the Company has identified four operating segments (American Eagle Brand US and Canadian stores, aerie retail stores, 77kids retail stores and AEO Direct) that reflect the basis used internally to review performance and allocate resources. All of the operating segments have been aggregated and are presented as one reportable segment, as permitted by ASC 280.

## ***Reclassification***

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

**Table of Contents****3. Cash and Cash Equivalents, Short-term Investments and Long-term Investments**

The following table summarizes the fair market values for the Company's cash and marketable securities, which are recorded as cash and cash equivalents, short-term investments and long-term investments on the Consolidated Balance Sheets:

<i>(In thousands)</i>	July 30, 2011	January 29, 2011	July 31, 2010
<b>Cash and cash equivalents:</b>			
Cash	\$ 287,753	\$ 122,578	\$ 186,888
Money-market	74,387	397,440	88,411
Commercial paper	23,996	40,884	31,499
Treasury bills	3,163	102,996	118,725
Corporate bonds		3,695	
<b>Total cash and cash equivalents</b>	<b>\$ 389,299</b>	<b>\$ 667,593</b>	<b>\$ 425,523</b>
<b>Short-term investments:</b>			
Treasury bills	\$ 76,262	\$	\$
Corporate bonds	16,111		
Term-deposits	15,427	63,402	
Commercial paper	9,997		
State and local government ARS	6,900	3,700	5,800
<b>Total short-term investments</b>	<b>\$ 124,697</b>	<b>\$ 67,102</b>	<b>\$ 5,800</b>
<b>Long-term investments:</b>			
ARS Call Option	\$ 648	\$ 415	\$
State and local government ARS		5,500	22,200
Student-loan backed ARS			131,163
Auction rate preferred securities			13,354
<b>Total long-term investments</b>	<b>\$ 648</b>	<b>\$ 5,915</b>	<b>\$ 166,717</b>
<b>Total</b>	<b>\$ 514,644</b>	<b>\$ 740,610</b>	<b>\$ 598,040</b>

Proceeds from the sale of investments were \$115.2 million and \$27.9 million for the 26 weeks ended July 30, 2011 and July 31, 2010, respectively. The purchase of investments for the 26 weeks ended July 30, 2011 was \$166.4 million. There were no purchases of investments during the 26 weeks ended July 31, 2010.

The following table presents the length of time available-for-sale securities were in continuous unrealized loss positions but were not deemed to be other-than-temporarily impaired. As of July 30, 2011, the fair value of all ARS investments approximated par, with no gross unrealized holding losses.

<i>(In thousands)</i>	Less Than 12 Months		Greater Than or Equal to 12 Months	
	Gross Unrealized Holding Losses	Fair Value	Gross Unrealized Holding Losses	Fair Value
<b>July 31, 2010</b>				
Student-loan backed ARS	\$ (805)	\$ 54,959	\$ (9,384)	\$ 47,453
Auction rate preferred securities			(706)	14,294

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Total (1)	\$ (805)	\$ 54,959	\$ (10,090)	\$ 61,747
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(1) Fair value excludes \$58.0 million as of July 31, 2010 of securities whose fair value approximated par. Additionally, as of July 31, 2010, fair value shown above excludes (\$2.2) million of OTTI that has been previously recognized in earnings.

During Fiscal 2010, the Company liquidated \$191.4 million carrying value of ARS investments for proceeds of \$177.5 million and a realized loss of \$24.4 million (of which \$10.9 million was previously included in OCI on the Company's Consolidated Balance Sheets). The ARS securities sold during Fiscal 2010 included \$119.7 million of par value ARS securities whereby the Company entered into a settlement agreement under which a financial

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institution (the purchaser) purchased the ARS at a discount to par, plus accrued interest. Additionally, under this agreement, the Company retained a right (the ARS Call Option), for a period ending October 29, 2013 to: (a) repurchase any or all of the ARS securities sold at the agreed upon purchase prices received from the purchaser plus accrued interest; and/or (b) receive additional proceeds from the purchaser upon certain redemptions of the ARS securities sold. The ARS Call Option is cancelable by the purchaser for additional cash consideration.

The Company is required to assess the value of the ARS Call Option at the end of each reporting period, with any changes in fair value recorded within the Consolidated Statement of Operations. Upon origination, the Company determined that the fair value was \$0.4 million. The fair value of the ARS Call Option was included as an offsetting amount within the net loss on liquidation of \$24.4 million referenced above. As of July 30, 2011, the Company determined that the remaining value of the ARS Call Option, which is classified as a long-term investment on the Consolidated Balance Sheets, was \$0.6 million.

The Company continues to monitor the market for ARS and consider the impact, if any, on the fair value of its investments. If current market conditions deteriorate further, or the anticipated recovery in market values does not occur, the Company may be required to record impairment charges on its remaining ARS investments.

### **4. Fair Value Measurements**

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

#### ***Financial Instruments***

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

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

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

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

As of July 30, 2011 and July 31, 2010, the Company held certain assets that are required to be measured at fair value on a recurring basis. These include cash equivalents and short and long-term investments, including ARS and auction rate preferred securities.

In accordance with ASC 820, the following table represents the Company's fair value hierarchy for its financial assets (cash equivalents and investments) measured at fair value on a recurring basis as of July 30, 2011 and July 31, 2010:

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<i>(In thousands)</i>	Carrying Amount	Fair Value Measurements at July 30, 2011		
		Quoted Market Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Cash and cash equivalents:</b>				
Cash	\$ 287,753	\$ 287,753	\$	\$
Money-market	74,387	74,387		
Commercial paper	23,996	23,996		
Treasury bills	3,163	3,163		
<b>Total cash and cash equivalents</b>	<b>\$ 389,299</b>	<b>\$ 389,299</b>	<b>\$</b>	<b>\$</b>
<b>Short-term investments:</b>				
Treasury bills	\$ 76,262	\$ 76,262	\$	\$
Corporate bonds	16,111	16,111		
Term-deposits	15,427	15,427		
Commercial paper	9,997	9,997		
State and local government ARS	6,900			6,900
<b>Total short-term investments</b>	<b>\$ 124,697</b>	<b>\$ 117,797</b>	<b>\$</b>	<b>\$ 6,900</b>
<b>Long-term investments:</b>				
ARS Call Option	\$ 648	\$	\$	\$ 648
<b>Total long-term investments</b>	<b>\$ 648</b>	<b>\$</b>	<b>\$</b>	<b>\$ 648</b>
<b>Total</b>	<b>\$ 514,644</b>	<b>\$ 507,096</b>	<b>\$</b>	<b>\$ 7,548</b>

<i>(In thousands)</i>	Carrying Amount	Fair Value Measurements at July 31, 2010		
		Quoted Market Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Cash and cash equivalents:</b>				
Cash	\$ 186,888	\$ 186,888	\$	\$
Treasury bills	118,725	118,725		
Money-market	88,411	88,411		
Commercial paper	31,499	31,499		
<b>Total cash and cash equivalents</b>	<b>\$ 425,523</b>	<b>\$ 425,523</b>	<b>\$</b>	<b>\$</b>
<b>Short-term investments:</b>				
State and local government ARS	\$ 5,800	\$	\$	\$ 5,800
<b>Total short-term investments</b>	<b>\$ 5,800</b>	<b>\$</b>	<b>\$</b>	<b>\$ 5,800</b>
<b>Long-term investments:</b>				
Student-loan backed ARS	\$ 131,163	\$	\$	\$ 131,163
State and local government ARS	22,200			22,200
Auction rate preferred securities	13,354			13,354
<b>Total long-term investments</b>	<b>\$ 166,717</b>	<b>\$</b>	<b>\$</b>	<b>\$ 166,717</b>
<b>Total</b>	<b>\$ 598,040</b>	<b>\$ 425,523</b>	<b>\$</b>	<b>\$ 172,517</b>

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The Company uses a discounted cash flow model to value its Level 3 investments. For July 30, 2011, the assumptions in the Company's model for Level 3 investments, excluding the ARS Call Option, included different recovery periods, ranging from two to 11 months depending on the type of security, a discount factor for yield of 0.16% and illiquidity of 0.50%. For July 31, 2010, the assumptions in the Company's model included different recovery periods, ranging from 11 months to 11 years depending on the type of security, varying discount factors for yield, ranging from 0.1% to 4.4%, and illiquidity, ranging from 0.3% to 4.0%. These assumptions are subjective. They are based on the Company's current judgment and its view of current market conditions. The use of different assumptions would result in a different valuation and related charge.



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As a result of the discounted cash flow analysis, no net impairment loss was recorded for the 13 or 26 weeks ended July 30, 2011. For the 26 weeks ended July 31, 2010, the Company recognized a net impairment of \$0.6 million (\$0.4 million, net of tax), which increased the total cumulative impairment recognized in OCI as of July 31, 2010 to \$10.9 million (\$6.8 million, net of tax) from \$10.3 million (\$6.4 million, net of tax) at the end of Fiscal 2009. The increase in temporary impairment was primarily driven by unfavorable changes in the discount rate. These amounts were recorded in OCI and resulted in a decrease in the investments' estimated fair values. As a result of a credit rating downgrade on a student-loan backed ARS, the Company also recorded an impairment loss in earnings of \$1.2 million during the 13 weeks ended July 31, 2010.

The reconciliation of the Company's assets measured at fair value on a recurring basis using unobservable inputs (Level 3) is as follows:

(In thousands)	Total	Level 3 (Unobservable inputs)		
		State and Local Government ARS	Student Loan-Backed Auction-Rate Securities	Auction-Rate Preferred Securities
Carrying value at January 30, 2010	\$ 202,448	\$ 40,244	\$ 149,431	\$ 12,773
Settlements	(28,100)	(12,700)	(15,400)	
<b>Gains and (losses):</b>				
Reported in earnings	(1,248)		(1,248)	
Reported in OCI	(583)	456	(1,620)	581
Balance at July 31, 2010	\$ 172,517	\$ 28,000	\$ 131,163	\$ 13,354

As of July 30, 2011, the Company's Level 3 (unobservable inputs) included \$6.9 million and \$0.6 million in state and local government ARS and the ARS Call Option, respectively. The \$6.9 million of state and local government ARS are presented net of \$2.3 million of settlements during the 26 weeks ended July 30, 2011. Additionally, there was a \$0.2 million increase in the carrying value of ARS Call Option reported in earnings during the 26 weeks ended July 30, 2011.

**Non-Financial Assets**

The Company's non-financial assets, which include goodwill, intangible assets and property and equipment, are not required to be measured at fair value on a recurring basis. However, if certain triggering events occur, or if an annual impairment test is required and the Company is required to evaluate the non-financial instrument for impairment, a resulting asset impairment would require that the non-financial asset be recorded at the estimated fair value. As a result of the Company's annual goodwill impairment test performed as of January 29, 2011, the Company concluded that its goodwill was not impaired. During the 13 and 26 weeks ended July 30, 2011, there were no triggering events that prompted an asset impairment test of the Company's goodwill.

Certain long-lived assets were measured at fair value on a nonrecurring basis using Level 3 inputs as defined in ASC 820. Based on the decision to close all M+O stores in Fiscal 2010, the Company determined that the M+O stores not previously impaired would not be able to generate sufficient cash flow over the life of the related leases to recover the Company's initial investment in them. Therefore, during the 26 weeks ended July 31, 2010, the M+O stores not previously impaired were written down to their fair value, resulting in a loss on impairment of assets of \$18.0 million. The fair value of those stores were determined by estimating the amount and timing of net future cash flows and discounting them using a risk-adjusted rate of interest. The Company estimates future cash flows based on its experience and knowledge of the market in which the store is located.

Refer to Note 13 to the Consolidated Financial Statements for additional information regarding the discontinued operations of M+O.

**5. Earnings per Share**

ASC 260-10-45, *Participating Securities and the Two-Class Method* (ASC 260-10-45), addresses whether awards granted in invested share-based payment transactions that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and therefore are included in computing earnings



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per share under the two-class method, as described in ASC 260, *Earnings Per Share* ( ASC 260 ). Participating securities are securities that may participate in dividends with common stock and the two-class method is an earnings allocation formula that treats a participating security as having rights to earnings that would otherwise have been available to common shareholders. Under the two-class method, earnings for the period are allocated between common shareholders and other shareholders, based on their respective rights to receive dividends. Restricted stock awards granted to certain employees under the Company's 2005 Stock Award and Incentive Plan ( 2005 Plan ) are considered participating securities as these employees receive non-forfeitable dividends at the same rate as common stock. There were no participating securities outstanding during the 13 and 26 weeks ending July 30, 2011. During the 13 and 26 weeks ended July 31, 2010, the allocation of earnings to participating securities was not significant. The application of ASC 260-10-45 resulted in no change to basic or diluted income from continuing operations per common share for both the 13 and 26 weeks ended July 30, 2011 and July 31, 2010.

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

<i>(In thousands)</i>	13 Weeks Ended		26 Weeks Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
<b>Weighted average common shares outstanding:</b>				
Basic number of common shares outstanding	194,909	201,764	194,800	204,238
Dilutive effect of stock options and non-vested restricted stock	1,669	1,389	1,826	2,192
Diluted number of common shares outstanding	196,578	203,153	196,626	206,430

Equity awards to purchase approximately 7.5 million and 7.2 million shares of common stock during the 13 and 26 weeks ended July 30, 2011, respectively, and approximately 8.4 million and 8.3 million shares of common stock during the 13 and 26 weeks ended July 31, 2010, respectively, were outstanding, but were not included in the computation of weighted average diluted common share amounts as the effect of doing so would be anti-dilutive.

Approximately 1.9 million shares of restricted stock units for both the 13 and 26 weeks ended July 30, 2011 and approximately 0.9 million shares of restricted stock units for both the 13 and 26 weeks ended July 31, 2010 were not included in the computation of weighted average diluted common share amounts because the number of shares ultimately issued is contingent on the Company's performance compared to pre-established annual performance goals. Additionally, there were approximately 25,000 shares for the 13 weeks ended July 30, 2011 and 1.0 million and 33,000 shares for the 13 and 26 weeks ended July 31, 2010, respectively, of time-based restricted stock units that were outstanding, but not included in the computation of weighted average diluted common share amounts as the effect of doing so would have been anti-dilutive.

**6. Property and Equipment**

Property and equipment consists of the following:

<i>(In thousands)</i>	July 30, 2011	January 29, 2011	July 31, 2010
Property and equipment, at cost	\$ 1,478,208	\$ 1,432,802	\$ 1,393,899
Less: Accumulated depreciation	(842,668)	(789,682)	(736,768)
Property and equipment, net	\$ 635,540	\$ 643,120	\$ 657,131

**7. Intangible Assets**

Intangible assets include costs to acquire and register the Company's trademark assets. During the 26 weeks ended July 30, 2011, the Company purchased \$33.5 million of trademark assets primarily to support its international expansion strategy. The following table represents intangible assets as of July 30, 2011, January 29, 2011 and July 31, 2010.

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<i>(In thousands)</i>	July 30, 2011	January 29, 2011	July 31, 2010
Trademarks, at cost	\$ 43,506	\$ 9,967	\$ 8,676
Less: Accumulated amortization	(3,211)	(2,482)	(2,156)
<b>Intangible assets, net</b>	<b>\$ 40,295</b>	<b>\$ 7,485</b>	<b>\$ 6,520</b>

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Intangible assets are recorded on the basis of cost with amortization computed utilizing the straight-line method over the assets estimated useful life of 15 to 25 years. Amortization expense was \$0.7 million and \$1.0 million for the 13 and 26 weeks ended July 30, 2011, respectively, and \$0.3 million and \$0.6 million for the 13 and 26 weeks ended July 31, 2010, respectively.

The table below summarizes the estimated future amortization expense for the next five fiscal years:

<i>(In thousands)</i>	Future Amortization
Remainder of 2011	\$ 976
2012	1,912
2013	1,912
2014	1,912
2015	1,909

**8. Other Credit Arrangements**

The Company has borrowing agreements with four separate financial institutions under which it may borrow an aggregate of \$295.0 million United States Dollars ( USD ) and \$25.0 million Canadian Dollars ( CAD ). Of this amount, \$185.0 million USD can be used for demand letter of credit issuances, \$50.0 million USD and \$25.0 million CAD can be used for demand line borrowings and the remaining \$60.0 million USD can be used for either letters of credit or demand line borrowings at the Company's discretion.

The letter of credit facilities of \$150.0 million USD and \$35.0 million USD expire November 1, 2011 and May 31, 2012, respectively. The \$50.0 million USD and \$25.0 million CAD demand lines expire on April 19, 2012 and December 13, 2011, respectively. The remaining \$60.0 million USD facility expires on May 22, 2012.

As of July 30, 2011, the Company had outstanding demand letters of credit of \$56.0 million USD and no demand line borrowings. The availability of any future borrowings is subject to acceptance by the respective financial institutions.

**9. Comprehensive Income**

Comprehensive income is comprised of the following:

<i>(In thousands)</i>	13 Weeks Ended		26 Weeks Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
Net income	\$ 19,669	\$ 9,663	\$ 47,994	\$ 20,585
Other comprehensive (loss) income:				
Temporary impairment reversal related to ARS, net of tax (1)		(1,057)		(361)
Foreign currency translation adjustment	(881)	(749)	4,620	2,773
Other comprehensive (loss) income:	(881)	(1,806)	4,620	2,412
Total comprehensive income	\$ 18,788	\$ 7,857	\$ 52,614	\$ 22,997

(1) Amounts are shown net of tax of \$1.4 million and \$1.0 million for the 13 and 26 weeks ended July 31, 2010, respectively.

**10. Share-Based Compensation**

The Company accounts for share-based compensation under the provisions of ASC 718, *Compensation - Stock Compensation* ( ASC 718 ), which requires companies to measure and recognize compensation expense for all share-based payments at fair value. Total share-based compensation expense included in the Consolidated Statements of Operations for the 13 and 26 weeks ended July 30, 2011 was \$3.3 million (\$2.1 million, net

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of tax) and \$5.8 million (\$3.6 million net of tax) and for the 13 and 26 weeks ended July 31, 2010 was \$6.3 million (\$3.9 million, net of tax) and \$18.4 million (\$11.3 million, net of tax), respectively.

**Table of Contents****Stock Option Grants**

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

A summary of the Company's stock option activity for the 26 weeks ended July 30, 2011 follows:

	Options (In thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding - January 29, 2011	12,124	\$ 15.25		
Granted	47	\$ 15.02		
Exercised (1)	(257)	\$ 10.32		
Cancelled	(115)	\$ 21.65		
Outstanding - July 30, 2011	11,799	\$ 15.29	3.1	\$ 27,178
Vested and expected to vest - July 30, 2011	11,673	\$ 15.32	3.1	\$ 26,956
Exercisable - July 30, 2011	3,918	\$ 6.91	2.0	\$ 24,406

(1) Options exercised during the 26 weeks ended July 30, 2011 had exercise prices ranging from \$4.54 to \$11.66. The weighted-average grant date fair value of stock options granted during the 26 weeks ended July 30, 2011 and July 31, 2010 was \$4.73 and \$5.31, respectively. The aggregate intrinsic value of options exercised during the 26 weeks ended July 30, 2011 and July 31, 2010 was \$1.3 million and \$9.8 million, respectively.

Cash received from the exercise of stock options was \$2.7 million for the 26 weeks ended July 30, 2011 and \$4.5 million for the 26 weeks ended July 31, 2010. The actual tax benefit realized from stock option exercises totaled \$0.3 million for the 26 weeks ended July 30, 2011 and \$13.0 million for the 26 weeks ended July 31, 2010.

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

Black-Scholes Option Valuation Assumptions	26 Weeks Ended	
	July 30, 2011	July 31, 2010
Risk-free interest rate (1)	2.1%	2.3%
Dividend yield	2.6%	2.1%
Volatility factor (2)	42.7%	40.2%
Weighted-average expected term (3)	5.0 years	4.5 years
Expected forfeiture rate (4)	8.0%	8.0%

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

(4) Based upon historical experience.

As of July 30, 2011, there was \$2.3 million of unrecognized compensation expense related to non-vested stock option awards that is expected to be recognized over a weighted average period of 1.3 years.

***Restricted Stock Grants***

Time-based restricted stock awards are comprised of time-based restricted stock units. These awards vest over three years; however, they may be accelerated to vest over one year if the Company meets pre-established performance



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goals in the year of grant. Time-based restricted stock units receive dividend equivalents in the form of additional time-based restricted stock units, which are subject to the same restrictions and forfeiture provisions as the original award.

Performance-based restricted stock awards include performance-based restricted stock units. These awards cliff vest at the end of a three year period based upon the Company's achievement of pre-established goals throughout the term of the award. Performance-based restricted stock units receive dividend equivalents in the form of additional performance-based restricted stock units, which are subject to the same restrictions and forfeiture provisions as the original award. The grant date fair value of all restricted stock awards is based on the closing market price of the Company's common stock on the date of grant.

A summary of the Company's restricted stock activity is presented in the following tables:

<i>(Shares in thousands)</i>	Time-Based Restricted Stock Units		Performance-Based Restricted Stock Units	
	26 Weeks Ended		26 Weeks Ended	
	July 30, 2011		July 30, 2011	
	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Nonvested - January 29, 2011	877	\$ 17.45	630	\$ 12.59
Granted	1,406	15.03	1,240	15.03
Vested	(372)	17.45		
Cancelled	(72)	17.47	(97)	15.53
<b>Nonvested - July 30, 2011</b>	<b>1,839</b>	<b>\$ 15.66</b>	<b>1,773</b>	<b>\$ 14.05</b>

As of July 30, 2011, there was \$25.7 million of unrecognized compensation expense related to non-vested time-based restricted stock unit awards that is expected to be recognized over a weighted average period of 2.3 years.

As of July 30, 2011, the Company had 25.0 million shares available for all equity grants.

**11. Income Taxes**

The provision for income taxes from continuing operations is based on the current estimate of the annual effective income tax rate and is adjusted as necessary for quarterly events. The effective income tax rate from continuing operations based on actual operating results for the 13 weeks ended July 30, 2011 was 36.0% compared to 30.3% for the 13 weeks ended July 31, 2010. The effective income tax rate from continuing operations based on actual operating results for the 26 weeks ended July 30, 2011 was 34.8% compared to 32.0% for the 26 weeks ended July 31, 2010. The lower effective income tax rate for the 13 and 26 weeks ended July 31, 2010 was primarily due to a release of the valuation allowance associated with state income tax credit carryforwards. This valuation allowance was released as a result of a favorable incentive program agreed to with the Kansas Department of Commerce during the 13 weeks ended July 31, 2010 related to the Company's distribution center in Ottawa, Kansas.

The Company records accrued interest and penalties related to unrecognized tax benefits in income tax expense.

The Company recognizes income tax liabilities related to unrecognized tax benefits in accordance with ASC 740 and adjusts these liabilities when its judgment changes as the result of the evaluation of new information not previously available. Unrecognized tax benefits decreased by \$1.5 million and \$2.6 million during the 13 weeks ended July 30, 2011 and July 31, 2010, respectively. The decreases were primarily due to federal and state income tax settlements and other changes in income tax reserves. The Company does not anticipate any significant changes to the unrecognized tax benefits recorded at the balance sheet date within the next 12 months.

**12. Legal Proceedings**

The Company is subject to certain legal proceedings and claims arising out of the conduct of its business. In accordance with ASC 450, *Contingencies* (ASC 450), management records a reserve for estimated losses when the loss is probable and the amount can be reasonably estimated. If a range of possible loss exists and no anticipated loss within the range is more likely than any other anticipated loss, the Company records the accrual at the low end of the range, in accordance with ASC 450. As the Company believes that it has provided adequate reserves, it



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anticipates that the ultimate outcome of any matter currently pending against the Company will not materially affect the consolidated financial position or results of operations of the Company.

**13. Discontinued Operations**

On March 5, 2010, the Company's Board approved management's recommendation to proceed with the closure of the M+O brand. The Company completed the closure of the M+O stores and e-commerce operation during the second quarter of Fiscal 2010. These Consolidated Financial Statements reflect the results of M+O as a discontinued operation for all periods presented.

Costs associated with exit or disposal activities are recorded when incurred. A summary of the exit and disposal costs recognized within Loss from Discontinued Operations on the Consolidated Income Statement for the 13 and 26 weeks ended July 31, 2010 are as follows:

<i>(In thousands)</i>	13 Weeks Ended July 31, 2010	26 Weeks Ended July 31, 2010
<b>Non-cash charges:</b>		
Asset impairments	\$	\$ 17,980
<b>Cash charges:</b>		
Lease-related charges (1)	15,481	15,481
Inventory charges		2,422
Severance charges	2,429	7,790
<b>Total Charges</b>	<b>\$ 17,910</b>	<b>\$ 43,673</b>

(1) Presented net of the reversal of non-cash lease credits.

The table below presents the significant components of M+O's results included in Loss from Discontinued Operations on the Consolidated Statement of Operations for the 13 and 26 weeks ended July 31, 2010.

<i>(In thousands)</i>	13 Weeks Ended July 31, 2010	26 Weeks Ended July 31, 2010
Net sales	\$ 10,890	\$ 21,881
Loss from discontinued operations, before income taxes	\$ (26,223)	\$ (66,688)
Income tax benefit	10,043	25,568
Loss from discontinued operations, net of tax	\$ (16,180)	\$ (41,120)
<b>Loss per common share from discontinued operations:</b>		
Basic	\$ (0.08)	\$ (0.20)
Diluted	\$ (0.08)	\$ (0.20)

There were no assets or liabilities included in the Consolidated Balance Sheets for M+O as of July 30, 2011 or January 29, 2011. The major classes of assets and liabilities included in the Consolidated Balance Sheets for M+O as of July 31, 2010 are as follows:

<i>(In thousands)</i>	July 31, 2010
Current assets	\$ 2,357
Non-current assets	

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Total assets	\$ 2,357
Total current liabilities	\$ 21,767
Total non-current liabilities	
Total liabilities	\$ 21,767

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### **Review by Independent Registered Public Accounting Firm**

Ernst & Young LLP, our independent registered public accounting firm, has performed a limited review of the unaudited Consolidated Financial Statements as of and for the thirteen and twenty-six week periods ended July 30, 2011 and July 31, 2010, as indicated in their report on the limited review included below. Since they did not perform an audit, they express no opinion on the unaudited Consolidated Financial Statements referred to above.

### **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

American Eagle Outfitters, Inc.

We have reviewed the consolidated balance sheets of American Eagle Outfitters, Inc. (the Company) as of July 30, 2011 and July 31, 2010, and the related consolidated statements of operations and retained earnings for the thirteen and twenty-six week periods ended July 30, 2011 and July 31, 2010 and the consolidated statements of cash flows for the twenty-six week periods ended July 30, 2011 and July 31, 2010. These financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of American Eagle Outfitters, Inc. as of January 29, 2011, and the related consolidated statements of operations, comprehensive income, stockholder's equity, and cash flows for the year then ended not presented herein, and in our report dated March 11, 2011, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of January 29, 2011, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP

Pittsburgh, Pennsylvania  
August 25, 2011

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

The following discussion and analysis of financial condition and results of operations should be read in conjunction with our Fiscal 2010 Management's Discussion and Analysis of Financial Condition and Results of Operations which can be found in our Fiscal 2010 Annual Report on Form 10-K.

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

This report contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which represent our expectations or beliefs concerning future events, including the following:

the planned opening of 11 new American Eagle stores, 12 new 77kids stores and 10 new aerie stores in the United States and Canada during Fiscal 2011;

the selection of approximately 60 to 65 American Eagle stores in the United States and Canada for remodeling during Fiscal 2011;

the planned closure of 15 to 25 American Eagle stores in the United States and Canada during Fiscal 2011;

the planned opening of 18 new franchised American Eagle stores during Fiscal 2011;

the success of aerie by American Eagle and aerie.com;

the success of 77kids by American Eagle and 77kids.com;

the expected payment of a dividend in future periods;

the possibility to engage in future franchise agreements, growth through acquisitions and/or internally developing additional new brands;

the possibility that our credit facilities may not be available for future borrowings;

the possibility that rising prices of raw materials, labor, energy and other inputs to our manufacturing process, if unmitigated, will have a significant impact to our profitability; and

the possibility that we may be required to take additional store impairment charges related to underperforming stores.

We caution that these forward-looking statements, and those described elsewhere in this report, involve material risks and uncertainties and are subject to change based on factors beyond our control as discussed within Item 1A of this Quarterly Report on Form 10-Q and Item 1A of our Fiscal 2010 Annual Report on Form 10-K. Accordingly, our future performance and financial results may differ materially from those expressed or implied in any such forward-looking statements.

## Key Performance Indicators

Our management evaluates the following items, which are considered key performance indicators, in assessing our performance:

*Comparable store sales* - Comparable store sales provide a measure of sales growth for stores open at least one year over the comparable prior year period. In fiscal years following those with 53 weeks, the prior year period is shifted by one week to compare similar calendar weeks. A store is included in comparable store sales in the thirteenth month of operation. However, stores that have a gross square footage increase of 25% or greater due to a remodel are removed from the comparable store sales base, but are included in total sales. These stores are returned to the comparable store sales base in the thirteenth month following the remodel. Sales from American Eagle and aerie stores are included in comparable stores sales. Sales from AEO Direct are not included in comparable store sales. 77kids stores will be included in comparable store sales upon achieving 13 months of operations.

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

*Gross profit* - Gross profit measures whether we are optimizing the price and inventory levels of our merchandise and achieving an optimal level of sales. Gross profit is the difference between net sales and cost of sales. Cost of sales consists of: merchandise costs, including design, sourcing, importing and inbound freight costs, as well as markdowns, shrinkage, certain promotional costs and buying, occupancy and warehousing costs. Buying, occupancy

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and warehousing costs consist of: compensation, employee benefit expenses and travel for our buyers; rent and utilities related to our stores, corporate headquarters, distribution centers and other office space; freight from our distribution centers to the stores; compensation and supplies for our distribution centers, including purchasing, receiving and inspection costs; and shipping and handling costs related to our e-commerce operation. The inability to obtain acceptable levels of sales, initial markups or any significant increase in our use of markdowns could have an adverse effect on our gross profit and results of operations.

*Operating income* - Our management views operating income as a key indicator of our success. The key drivers of operating income are comparable store sales, gross profit, our ability to control selling, general and administrative expenses, and our level of capital expenditures.

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

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

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

## **Results of Operations**

### **Overview**

The second quarter continued to be a challenging and highly promotional retail environment. However, we are managing our business prudently, strengthening assortments and making strides on our longer-term initiatives. We are maximizing key item categories with stronger and more impactful promotions. Second quarter sales demonstrated an improvement from the first quarter and promotional activity was well controlled. The second quarter operating margin decline reflected higher product costs and increases in rent expense, partially offset by expense improvement.

Net sales for the second quarter ended July 30, 2011 increased 4% to \$675.7 million and comparable store sales were flat, against a 1% decrease last year. By brand, AE brand comparable store sales were flat to last year, aerie decreased 1% and sales for AEO Direct increased 16% in the second quarter.

The gross margin decreased 250 basis points. Merchandise profit dollars improved over last year as a result of higher net sales and lower markdowns. However, as a rate to sales, merchandise margin decreased by 150 basis points reflecting increased product costs. Buying, occupancy and warehousing costs increased by 100 basis points due to rent related to new store openings, lease renewals and flat comparable store sales. The 70 basis point improvement in selling, general and administrative expenses resulted primarily from expense reduction efforts.

Operating income for the second quarter was \$29.3 million compared to \$38.2 million last year. Operating income as a percent to net sales was 4.3% this year compared to 5.9% last year. Income from continuing operations decreased 24% to \$19.7 million compared to \$25.8 million a year ago. Income from continuing operations per diluted share decreased \$0.03 to \$0.10 per diluted share.

We had \$514.6 million in cash and cash equivalents, short-term and long-term investments as of July 30, 2011. Merchandise inventory at July 30, 2011 was \$470.2 million, compared to \$349.1 million last year, reflecting increased cotton costs related to fall product receipts, strategic investments in year-round key item categories and our planned accessory business expansion.

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



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

	13 Weeks Ended		26 Weeks Ended	
	July 30, 2011	July 31, 2010	July 30, 2011	July 31, 2010
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales, including certain buying, occupancy and warehousing expenses	65.7	63.2	63.9	61.7
Gross profit	34.3	36.8	36.1	38.3
Selling, general and administrative expenses	24.7	25.4	25.3	25.7
Depreciation and amortization expense	5.3	5.5	5.5	5.5
Operating income	4.3	5.9	5.3	7.1
Other income (expense), net	0.2	(0.2)	0.4	(0.1)
Income before income taxes	4.5	5.7	5.7	7.0
Provision for income taxes	1.6	1.7	2.0	2.2
Income from continuing operations	2.9	4.0	3.7	4.8
Loss from discontinued operations	0.0	(2.5)	0.0	(3.2)
Net income	2.9%	1.5%	3.7%	1.6%

The following table shows our adjusted consolidated store data for the 13 and 26 weeks ended July 30, 2011 and July 31, 2010.

	13 Weeks Ended		26 Weeks Ended	
	July 30, 2011	July 31, 2010 (1)	July 30, 2011	July 31, 2010 (1)
Number of stores:				
Beginning of period	1,096	1,077	1,086	1,075
Opened	9	11	20	18
Closed	(2)	(5)	(3)	(10)
End of period	1,103	1,083	1,103	1,083
Total gross square feet at end of period	6,458,784	6,279,510	6,458,784	6,279,510
International franchise stores at end of period (2)	9	2	9	2

(1) The number of stores and gross square feet for the 13 and 26 weeks ended July 31, 2010 excludes all 28 M+O stores that were closed during the second quarter of Fiscal 2010.

(2) The international franchise stores are not included in the consolidated store data or the total gross square feet calculation as of July 30, 2011 or July 31, 2010.

Our operations are conducted in one reportable segment, which includes 931 U.S. and Canadian AE retail stores, 151 aerie stand-alone retail stores, 21 77kids retail stores and AEO Direct.



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### **Comparison of the 13 weeks ended July 30, 2011 to the 13 weeks ended July 31, 2010**

#### *Net Sales*

Net sales for the 13 weeks ended July 30, 2011 increased 4% to \$675.7 million compared to \$651.5 million for the 13 weeks ended July 31, 2010. The change in net sales resulted primarily from the flat comparable store sales for the period, combined with a 16% increase in AEO Direct sales.

AE men's and women's comparable store sales were both flat to last year. For the second quarter, transactions declined in the mid single-digits, driven by decreased traffic and a flat customer conversion rate. The impact of lower transactions on our net sales was fully offset by the increase in average transaction value.

#### *Gross Profit*

Gross profit for the 13 weeks ended July 30, 2011 was \$232.1 million, or 34.3% as a percent to net sales, compared to \$239.7 million, or 36.8% as a rate to net sales last year. Merchandise profit dollars improved over last year as a result of higher net sales and improved markdowns. As a rate to sales, merchandise margin decreased by 150 basis points reflecting rising product costs. Buying, occupancy and warehousing costs increased by 100 basis points as a result of rent related to new store openings, lease renewals and flat comparable store sales.

There was \$1.5 million of share-based payment expense for the 13 weeks ended July 30, 2011, consisting of time-based awards, included in gross profit for the period compared to \$1.3 million for the 13 weeks ended July 31, 2010.

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

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

Selling, general and administrative expenses increased to \$167.1 million from \$165.5 million last year due to investments in new stores and higher sales levels, offset by continued expense savings. As a rate to net sales, selling, general and administrative expenses were 24.7% or 70 basis points lower than last year.

There was \$1.8 million of share-based payment expense, consisting of time-based awards, included in selling, general and administrative expenses compared to \$5.0 million last year.

#### *Depreciation and Amortization Expense*

Depreciation and amortization expense as a percent to net sales decreased to 5.3% for the 13 weeks ended July 30, 2011 compared to 5.5% for the corresponding period last year as a result of the higher net sales for the period. Depreciation and amortization expense decreased to \$35.7 million, compared to \$36.0 million last year.

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

Other income was \$1.4 million for the 13 weeks ended July 30, 2011 compared to expense of \$1.1 million for the 13 weeks ended July 31, 2010 primarily as a result of additional proceeds received from the ARS Call Option this year and a \$1.2 million net impairment loss recognized in earnings related to ARS securities last year.

#### *Provision for Income Taxes*

The provision for income taxes from continuing operations is based on the current estimate of the annual effective income tax rate and is adjusted as necessary for quarterly events. The effective income tax rate from continuing operations based on actual operating results for the 13 weeks ended July 30, 2011 was 36.0% compared to 30.3% for the 13 weeks ended July 31, 2010. The lower effective income tax rate for the 13 weeks ended July 31, 2010 was primarily due to a release of the valuation allowance associated with state income tax credit carryforwards. This valuation allowance was released as a result of a favorable incentive program agreed to with the Kansas Department of Commerce during the 13

weeks ended July 31, 2010 related to our distribution center in Ottawa, Kansas.

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### *Income from Continuing Operations*

Income from continuing operations for the 13 weeks ended July 30, 2011 was \$19.7 million, or \$0.10 per diluted share, compared to income from continuing operations for the 13 weeks ended July 31, 2010 of \$25.8 million, or \$0.13 per diluted share. The change in income from continuing operations is attributable to the factors noted above.

### *Loss from Discontinued Operations*

We completed the closure of M+O stores and related e-commerce operation during the second quarter of Fiscal 2010. Accordingly, the after-tax operating results appear in Loss from Discontinued Operations on the Consolidated Statements of Operations for all periods presented. Loss from Discontinued Operations, net of tax, was \$16.2 million for the 13 weeks ended July 31, 2010 and includes pre-tax closure charges of \$15.5 million for lease related items and \$2.4 million for severance and other employee-related charges.

Refer to Note 13 to the Consolidated Financial Statements for additional information regarding the discontinued operations of M+O.

### *Net Income*

Net income increased to \$19.7 million, or 2.9% as a percent to net sales, from \$9.7 million, or 1.5% as a percent to net sales last year. Net income per diluted share increased to \$0.10 from \$0.05 in the prior year. The change in net income is attributable to the factors noted above including the impact of the closure of M+O during the 13 weeks ended July 31, 2010.

## **Comparison of the 26 weeks ended July 30, 2011 to the 26 weeks ended July 31, 2010**

### *Net Sales*

Net sales for the 26 weeks ended July 30, 2011 decreased 1% to \$1.285 billion compared to \$1.300 billion for the 26 weeks ended July 31, 2010. The decrease in net sales resulted primarily from a 4% decrease in comparable store sales for the period, offset by a 9% increase in AEO Direct sales.

For the 26 week period, AE men's comparable store sales declined in the low single-digits and women's comparable store sales declined in the mid single-digits. Transactions declined in the high single-digits, driven by decreased traffic and customer conversion rate. Consistent with the 13 weeks ended July 30, 2011, the impact to our net sales caused by the decrease in transactions was offset by the increase in average transaction value.

### *Gross Profit*

Gross profit for the 26 weeks ended July 30, 2011 decreased 7% to \$463.8 million, or 36.1% as a rate to net sales, compared to \$497.4 million, or 38.3% as a rate to net sales last year. Merchandise margin decreased by 60 basis points primarily due to product cost increases offset by improved markdowns in the period. Buying, occupancy and warehousing costs increased by 160 basis points as a result of an increase in rent related to new store openings as well as the impact of negative comparable store sales for the 26 weeks ended July 30, 2011.

There was \$2.6 million of share-based payment expense for the 26 weeks ended July 30, 2011, consisting of time-based rewards, included in gross profit for the period compared to \$5.3 million for the 26 weeks ended July 31, 2010.

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

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### *Selling, General and Administrative Expenses*

Selling, general and administrative expenses decreased to \$325.6 million from \$334.1 million last year and decreased 40 basis points, as a rate to net sales, to 25.3% from 25.7% last year. The improvement in the rate reflects our expense saving efforts, offset by planned investments in advertising and costs associated with new store growth.

There was \$3.2 million of share-based payment expense, consisting of time-based rewards, included in selling, general and administrative expenses compared to \$13.2 million last year.

### *Depreciation and Amortization Expense*

Depreciation and amortization expense decreased to \$70.6 million compared to \$71.6 million last year. As a rate to net sales, depreciation and amortization was 5.5% for both the 26 weeks ended July 30, 2011 and July 31, 2010 due to the lower level of expense offset by negative comparable store sales for the period.

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

Other income was \$5.9 million for the 26 weeks ended July 30, 2011 compared to expense of \$1.0 million for the 26 weeks ended July 31, 2010, primarily as a result of additional proceeds received from the ARS Call Option this year and a \$1.2 million net impairment loss recognized in earnings related to ARS securities last year.

### *Provision for Income Taxes*

The provision for income taxes from continuing operations is based on the current estimate of the annual effective income tax rate and is adjusted as necessary for quarterly events. The effective income tax rate from continuing operations based on actual operating results for the 26 weeks ended July 30, 2011 was 34.8% compared to 32.0% for the 26 weeks ended July 31, 2010. The lower effective income tax rate for the 26 weeks ended July 31, 2010 was primarily due to a release of the valuation allowance associated with state income tax credit carryforwards. This valuation allowance was released as a result of a favorable incentive program agreed to with the Kansas Department of Commerce during the 13 weeks ended July 31, 2010 related to the our distribution center in Ottawa, Kansas.

### *Income from Continuing Operations*

Income from continuing operations for the 26 weeks ended July 30, 2011 was \$48.0 million, or \$0.24 per diluted share, compared to income from continuing operations for the 26 weeks ended July 31, 2010 of \$61.7 million, or \$0.30 per diluted share. The change in income from continuing operations is attributable to the factors noted above.

### *Loss from Discontinued Operations*

We completed the closure of M+O stores and related e-commerce operation during the second quarter of Fiscal 2010. Accordingly, the after-tax operating results appear in Loss from Discontinued Operations on the Consolidated Statements of Operations for all periods presented. Loss from Discontinued Operations, net of tax, was \$41.1 million for the 26 weeks ended July 31, 2010 and includes pre-tax closure charges of \$43.7 million. Included in the pre-tax charges were \$15.5 million of lease-related items, \$7.8 million for severance and other employee-related charges, \$2.4 million in inventory charges and a non-cash asset impairment charge of \$18.0 million.

Refer to Note 13 to the Consolidated Financial Statements for additional information regarding the discontinued operations of M+O.

### *Net Income*

Net income increased to \$48.0 million, or 3.7% as a percent to net sales, from \$20.6 million, or 1.6% as a percent to net sales last year. Net income per diluted share increased to \$0.24 from \$0.10 in the prior year. The increases are attributable to the factors noted above, including the impact of the closure of M+O during the 26 weeks ended July 31, 2010.

### **International Expansion**

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We have entered into franchise agreements with multiple partners to expand our brands internationally. Through these franchise agreements, we plan to open a series of American Eagle and aerie stores in the Middle East,

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Northern Africa, Eastern Europe, Japan and Israel. As of the July 30, 2011, we had nine franchised stores operated by our franchise partners in Dubai, Kuwait City, Hong Kong, China and Russia. These franchise agreements do not involve a capital investment from AEO and require minimal operational involvement.

### **Fair Value Measurements**

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

### **Financial Instruments**

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

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

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

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

As of July 30, 2011, we held certain assets that are required to be measured at fair value on a recurring basis. These include cash equivalents and short and long-term investments, including auction rate securities ( ARS ).



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In accordance with ASC 820, the following table represents the fair value hierarchy of our financial assets (cash equivalents and investments) measured at fair value on a recurring basis as of July 30, 2011:

<i>(In thousands)</i>	Carrying Amount	Fair Value Measurements at July 30, 2011		
		Quoted Market Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Cash and cash equivalents:</b>				
Cash	\$ 287,753	\$ 287,753	\$	\$
Money-market	74,387	74,387		
Commercial paper	23,996	23,996		
Treasury bills	3,163	3,163		
<b>Total cash and cash equivalents</b>	<b>\$ 389,299</b>	<b>\$ 389,299</b>	<b>\$</b>	<b>\$</b>
<b>Short-term investments:</b>				
Treasury bills	\$ 76,262	\$ 76,262	\$	\$
Corporate bonds	16,111	16,111		
Term-deposits	15,427	15,427		
Commercial paper	9,997	9,997		
State and local government ARS	6,900			6,900
<b>Total short-term investments</b>	<b>\$ 124,697</b>	<b>\$ 117,797</b>	<b>\$</b>	<b>\$ 6,900</b>
<b>Long-term investments:</b>				
ARS Call Option	\$ 648	\$	\$	\$ 648
<b>Total long-term investments</b>	<b>\$ 648</b>	<b>\$</b>	<b>\$</b>	<b>\$ 648</b>
<b>Total</b>	<b>\$ 514,644</b>	<b>\$ 507,096</b>	<b>\$</b>	<b>\$ 7,548</b>
Percent to Total	100.0%	98.5%	0.0%	1.5%

We use a discounted cash flow model to value our Level 3 investments. The assumptions in our model for Level 3 investments, excluding the ARS Call Option, included different recovery periods, ranging from two months to 11 months depending on the type of security, varying discount factors for yield of 0.16% and illiquidity of 0.50%. These assumptions are subjective. They are based on our current judgment and our view of current market conditions. The use of different assumptions (i.e., an increase in the recovery period by one year or an increase to the discount rate and illiquidity premium of 100 basis points) would not result in a material change to the valuation.

The fair value of the ARS Call Option described in Note 3 to the Consolidated Financial Statements was also estimated using a discounted cash flow model. The model considers potential changes in yields for securities with similar characteristics to the underlying ARS and evaluates possible future refinancing opportunities of the issuers of the ARS. The analysis then assesses the likelihood that the options would be exercisable as a result of the underlying ARS being redeemed or traded in a secondary market at an amount greater than the exercise price prior to the end of the option term. Future changes in the fair values of the ARS Call Option will be recorded within the Consolidated Statements of Operations.

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

**Liquidity and Capital Resources**

Our uses of cash are generally for working capital, the construction of new stores and remodeling of existing stores, information technology upgrades, distribution center improvements and expansion, the purchase of both short and long-term investments, the repurchase of common stock and the payment of dividends. Historically, these uses of cash have been funded with cash flow from operations and existing cash on hand. Additionally, our current and future uses of cash include the development of aerie and 77kids. We expect to be able to fund our future cash

requirements through current cash holdings as well as cash generated from operations.

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

The following sets forth certain measures of our liquidity:

	July 30, 2011	January 29, 2011	July 31, 2010
Working Capital (in 000 s)	\$ 792,649	\$ 786,573	\$ 631,585
Current Ratio	3.19	3.03	2.91

The \$6.1 million increase in working capital as of July 30, 2011 compared to January 29, 2011, resulted primarily from net income, net of non-cash adjustments, offset by the use of cash for capital expenditures, purchase of intangible assets and the payment of dividends. The \$161.1 million increase in working capital as of July 30, 2011, compared to July 31, 2010, is primarily related to an increase in cash and short-term investments as a result of business performance and the liquidation of our ARS investments.

*Cash Flows from Operating Activities of Continuing Operations*

Net cash (used for) provided by operating activities totaled (\$85.0) million and \$21.9 million for the 26 weeks ended July 30, 2011 and July 31, 2010, respectively. For both periods, our major source of cash from operations was merchandise sales and our primary outflows of cash for operations were for the acquisition of merchandise inventory and the payment of operational costs. For the 26 weeks ended July 30, 2011, increases in cotton costs related to fall product receipts, strategic investments in year-round key item categories and our planned accessory business expansion.

*Cash Flows from Investing Activities of Continuing Operations*

Investing activities for the 26 weeks ended July 30, 2011 included \$65.6 million of capital expenditures for property and equipment, \$33.5 million for the acquisition of intangible assets related to our international expansion strategy and \$166.4 million of investment purchases, partially offset by \$115.2 million of proceeds from the sale of investments classified as available-for-sale. Investing activities for the 26 weeks ended July 31, 2010 primarily included \$39.3 million used for capital expenditures, partially offset by \$27.9 million of proceeds from the sale of investments classified as available-for-sale.

*Cash Flows from Financing Activities of Continuing Operations*

Cash used for financing activities for the 26 weeks ended July 30, 2011 consisted primarily of \$42.9 million for the payment of dividends. Cash used for financing activities for the 26 weeks ended July 31, 2010 included \$192.3 million for the repurchase of 14.0 million shares as part of our publicly announced share repurchase program, \$43.1 million for the payment of dividends, \$30.0 million for the full repayment of our demand line borrowing and \$18.0 million for the repurchase of common stock from employees for the payment of taxes in connection with the vesting of share-based payments.

*Credit Facilities*

We have borrowing agreements with four separate financial institutions under which we may borrow an aggregate of \$295.0 million United States Dollars ( USD ) and \$25.0 million Canadian Dollars ( CAD ). Of this amount, \$185.0 million USD can be used for demand letter of credit issuances, \$50.0 million USD and \$25.0 million CAD can be used for demand line borrowings and the remaining \$60.0 million USD can be used for either letters of credit or demand line borrowings at our discretion.

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The letter of credit facilities of \$150.0 million USD and \$35.0 million USD expire November 1, 2011 and May 31, 2012, respectively. The \$50.0 million USD and \$25.0 million CAD demand lines expire on April 19, 2012 and December 13, 2011, respectively. The remaining \$60.0 million USD facility expires on May 22, 2012.

As of July 30, 2011, we had outstanding demand letters of credit of \$56.0 million USD and no demand line borrowings. The availability of any future borrowings is subject to acceptance by the respective financial institutions.

### *Capital Expenditures for Property and Equipment*

Capital expenditures for the 26 weeks ended July 30, 2011 were \$65.6 million and included \$47.4 million related to investments in our stores, including 20 new AE, aerie and 77kids stores, and 54 remodels. Additionally, we continued to support our infrastructure growth by investing in the improvement and expansion of our distribution centers (\$7.8 million), information technology initiatives (\$7.6 million) and other home office projects (\$2.8 million).

For Fiscal 2011, we continue to expect capital expenditures to be in the range of \$90 million to \$100 million with approximately half of the amount relating to store growth and renovation.

### *Stock Repurchases*

During Fiscal 2007, our Board of Directors (the Board) authorized a total of 60.0 million shares of our common stock for repurchase under our share repurchase program with expiration dates extending into Fiscal 2010. At the beginning of Fiscal 2010, we had 30.0 million shares remaining authorized for repurchase.

During Fiscal 2010, we repurchased 15.5 million shares as part of our publicly announced repurchase programs for approximately \$216.1 million, at a weighted average price of \$13.94 per share. Of the total Fiscal 2010 share repurchases, 14.0 million shares were repurchased in the 26 weeks ended July 31, 2010 for approximately \$192.3 million, at a weighted average price of \$13.73 per share.

There were no share repurchases as a part of our publicly announced repurchase programs during the 13 and 26 weeks ended July 30, 2011. As of July 30, 2011, we had 14.5 million shares remaining authorized for repurchase. These shares may be repurchased at our discretion. During Fiscal 2010, our Board extended the current remaining share repurchase authorization of 14.5 million shares through February 2, 2013.

During the 26 weeks ended July 30, 2011 and July 31, 2010, we repurchased approximately 0.1 million and 1.0 million shares, respectively, from certain employees at market prices totaling \$2.2 million and \$18.0 million, respectively. These shares were repurchased for the payment of taxes, not in excess of the minimum statutory withholding requirements, in connection with the vesting of share-based payments, as permitted under the 2005 Award and Incentive Plan. The aforementioned share repurchases have been recorded as treasury stock.

### *Dividends*

During the 13 weeks ended July 30, 2011, our Board declared a quarterly cash dividend of \$0.11 per share, which was paid on July 22, 2011.

## **Critical Accounting Policies**

Our critical accounting policies are described in Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, and in the notes to our Consolidated Financial Statements for the year ended January 29, 2011 contained in our Fiscal 2010 Annual Report on Form 10-K. Any new accounting policies or updates to existing accounting policies as a result of new accounting pronouncements have been discussed in the notes to our Consolidated Financial Statements in this Quarterly Report on Form 10-Q. The application of our critical accounting policies may require management to make judgments and estimates about the amounts reflected in the Consolidated Financial Statements. Management uses historical experience and all available information to make these estimates and judgments, and different amounts could be reported using different assumptions and estimates.

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

There were no material changes in our exposure to market risk from January 29, 2011. Our market risk profile as of January 29, 2011 is disclosed in Item 7A, *Quantitative and Qualitative Disclosures About Market Risk*, of our Fiscal 2010 Annual Report on Form 10-K.

### **ITEM 4. CONTROLS AND PROCEDURES.**

#### *Disclosure Controls and Procedures*

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

In connection with the preparation of this Quarterly Report on Form 10-Q, as of July 30, 2011, an evaluation was performed under the supervision and with the participation of our management, including the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon that evaluation, our Principal Executive Officer and our Principal Financial Officer have concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of the end of the period covered by this Quarterly Report on Form 10-Q.

#### *Changes in Internal Control over Financial Reporting*

There were no changes in our internal control over financial reporting that occurred during the 13 weeks ended July 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1A. RISK FACTORS.**

Risk factors that affect our business and financial results are discussed within Item 1A of our Fiscal 2010 Annual Report on Form 10-K. There have been no material changes to the disclosures relating to this item from those set forth in our Fiscal 2010 Annual Report on Form 10-K.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

#### **Issuer Purchases of Equity Securities**

The following table provides information regarding our repurchases of our common stock during the 13 weeks ended July 30, 2011.

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Period	Total Number of Shares Purchased (1)	Average Price Paid Per Share (2)	Total Number of Shares Purchased as Part of Publicly Announced Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Program (1) (3)
Month #1 (May 1, 2011 through May 28, 2011)	82	\$ 15.02	0.00	14,500,000
Month #2 (May 29, 2011 through July 2, 2011)	0	\$ 0.00	0.00	14,500,000
Month #3 (July 3, 2011 through July 30, 2011)	0	\$ 0.00	0.00	14,500,000
Total	82	\$ 15.02	0.00	14,500,000

- (1) Shares purchased during Month #1 were all repurchased from employees for the payment of taxes in connection with the vesting of share-based payments.
- (2) Average price paid per share excludes any broker commissions paid.
- (3) In January 2008, our Board authorized the repurchase of 60.0 million shares of our common stock. The authorization of the remaining 14.5 million shares that may yet be purchased has been extended through the end of Fiscal 2012.

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**ITEM 6. EXHIBITS.**

* Exhibit 15	Acknowledgement of Independent Registered Public Accounting Firm
* Exhibit 31.1	Certification by James V. O Donnell pursuant to Rule 13a-14(a) or Rule 15d-14(a)
* Exhibit 31.2	Certification by Joan Holstein Hilson pursuant to Rule 13a-14(a) or Rule 15d-14(a)
**Exhibit 32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
**Exhibit 32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
**Exhibit 101	Interactive Data File

\* Filed with this report.

\*\* Furnished with this report.

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**SIGNATURES**

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

Dated: August 25, 2011

American Eagle Outfitters, Inc.

(Registrant)

By: /s/ James V. O' Donnell  
James V. O' Donnell  
Chief Executive Officer  
(Principal Executive Officer)

By: /s/ Joan Holstein Hilson  
Joan Holstein Hilson  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer and Principal Accounting Officer)