FOOT LOCKER INC
Form 10-Q
December 09, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended: October 31, 2015

OR

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

For the transition period from __________ to __________

Commission File Number: 1-10299

(Exact name of registrant as specified in its charter)

New York	**13-3513936**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

112 West 34th Street, New York, New York 10120

(Address of principal executive offices, Zip Code)

(212-720-3700)

(Registrant's telephone number, including area code)

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 þ No o

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 þ No o

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 þ Accelerated filer o Non-accelerated filer o Smaller reporting company o

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

Number of shares of Common Stock outstanding as of November 27, 2015: 137,261,732

FOOT LOCKER, INC.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FOOT LOCKER, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

($ in millions, except shares)

	October 31, 2015 (Unaudited)	November 1, 2014 (Unaudited)	January 31, 2015 *
ASSETS			
Current assets			
Cash and cash equivalents	$ 878	$ 916	$ 967
Merchandise inventories	1,336	1,324	1,250
Other current assets	277	244	239
	2,491	2,484	2,456
Property and equipment, net	664	613	620
Deferred taxes	256	237	221
Goodwill	156	160	157
Other intangible assets, net	46	56	49
Other assets	82	68	74
	$ 3,695	$ 3,618	$ 3,577
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Accounts payable	$ 258	$ 287	$ 301
Accrued and other liabilities	401	358	393
Current portion of capital lease obligations	1	3	2
	660	648	696
Long-term debt and obligations under capital leases	130	132	132
Other liabilities	358	236	253
Total liabilities	1,148	1,016	1,081
Shareholders' equity			
Common stock and paid-in capital: 173,333,777; 170,469,434 and 170,529,401 shares, respectively	1,099	971	979
Retained earnings	3,058	2,665	2,780

Accumulated other comprehensive loss	(343)	(221)	(319)
Less: Treasury stock at cost: 34,772,045; 27,323,176 and 29,665,213 shares, respectively	(1,267)	(813)	(944)
Total shareholders' equity	2,547	2,602	2,496
	$ 3,695	$ 3,618	$ 3,577

See Accompanying Notes to Condensed Consolidated Financial Statements.

* The balance sheet at January 31, 2015 has been derived from the previously reported audited financial statements at that date, but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in Foot Locker, Inc.'s Annual Report on Form 10-K for the year ended January 31, 2015.

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FOOT LOCKER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

($ in millions, except per share amounts)

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Sales	$ 1,794	$ 1,731	$ 5,405	$ 5,240
Cost of sales	1,187	1,157	3,575	3,495
Selling, general and administrative expenses	352	353	1,028	1,051
Depreciation and amortization	38	34	109	106
Litigation and impairment charges	100	—	100	3
Interest expense, net	1	1	3	3
Other income, net	(1)	(1)	(2)	(3)
	1,677	1,544	4,813	4,655
Income before income taxes	117	187	592	585
Income tax expense	37	67	209	211
Net income	$ 80	$ 120	$ 383	$ 374
Basic earnings per share:				
Net income	$ 0.57	$ 0.84	$ 2.74	2.59
Weighted-average common shares outstanding	139.3	143.6	139.6	144.5
Diluted earnings per share:				
Net income	$ 0.57	$ 0.82	$ 2.71	$ 2.55
Weighted-average common shares assuming dilution	140.9	145.7	141.4	146.6

See Accompanying Notes to Condensed Consolidated Financial Statements.

FOOT LOCKER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

($ in millions)

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Net income	$ 80	$ 120	$ 383	$ 374
Other comprehensive income (loss), net of income tax				
Foreign currency translation adjustment:				
Translation adjustment arising during the period, net of income tax	(10)	(42)	(32)	(42)
Cash flow hedges:				
Change in fair value of derivatives, net of income tax	2	1	1	1
Pension and postretirement adjustments:				
Amortization of net actuarial gain/loss included in net periodic benefit costs, net of income tax expense of $1, $2, $3, and $4 million, respectively	3	2	7	6
Comprehensive income	$ 75	$ 81	$ 359	$ 339

See Accompanying Notes to Condensed Consolidated Financial Statements.

FOOT LOCKER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

($ in millions)

	Thirty-nine weeks ended October 31, 2015	November 1, 2014
From Operating Activities:		
Net income	$ 383	$ 374
Adjustments to reconcile net income to net cash provided by operating activities:		
Non-cash impairment charge	—	3
Depreciation and amortization	109	106
Share-based compensation expense	17	18
Qualified pension plan contributions	(4)	(2)
Excess tax benefits on share-based compensation	(33)	(11)
Change in assets and liabilities:		
Merchandise inventories	(96)	(124)
Accounts payable	(39)	28
Accrued and other liabilities	(12)	(7)
Other, net	89	54
Net cash provided by operating activities	414	439
From Investing Activities:		

Capital expenditures		(173	)		(138	)
Acquisition, net of cash acquired		(1	)		—	
Sales and maturities of short-term investments		—			9	
Net cash used in investing activities		(174	)		(129	)
From Financing Activities:						
Purchase of treasury shares		(316	)		(174	)
Dividends paid on common stock		(105	)		(96	)
Issuance of common stock		63			17	
Treasury stock issued under employee stock purchase plan		5			5	
Excess tax benefits on share-based compensation		33			11	
Repayments of obligations under capital leases		(2	)		(3	)
Net cash used in financing activities		(322	)		(240	)
Effect of exchange rate fluctuations on Cash and Cash Equivalents		(7	)		(12	)
Net change in Cash and Cash Equivalents		(89	)		58	
Cash and Cash Equivalents at beginning of year		967			858	
Cash and Cash Equivalents at end of interim period	$	878		$	916	
Cash paid during the period:						
Interest	$	5		$	5	
Income taxes	$	240		$	200	

See Accompanying Notes to Condensed Consolidated Financial Statements.

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FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements contained in this report are unaudited. In the opinion of management, the condensed consolidated financial statements include all adjustments, which are of a normal recurring nature, necessary for a fair presentation of the results for the interim periods of the fiscal year ending January 30, 2016 and of the fiscal year ended January 31, 2015. Certain items included in these statements are based on management's estimates. Actual results may differ from those estimates. The results of operations for any interim period are not necessarily indicative of the results expected for the year. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Notes to Consolidated Financial Statements contained in Foot Locker, Inc.'s (the "Company") Form 10-K for the year ended January 31, 2015, as filed with the U.S. Securities and Exchange Commission (the "SEC") on March 30, 2015.

Recent Accounting Pronouncements

In November 2015, the Financial Accounting Standards Board issued Accounting Standards Update ("ASU") 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes.* This amendment changes how deferred taxes are recognized by eliminating the requirement of presenting deferred tax liabilities and assets as current and noncurrent on the balance sheet. Instead, the requirement will be to classify all deferred tax liabilities and assets as noncurrent. ASU 2015-17 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, with earlier adoption permitted. ASU 2015-17 can be adopted either prospectively or retrospectively to all periods presented. The Company plans on early adopting ASU 2015-17 prospectively during fiscal year 2016. The adoption of this guidance is not expected to have an effect on our results of operations or cash flows, as this represents only a change in balance sheet classification.

Other recently issued accounting pronouncements did not, or are not believed by management to, have a material effect on the Company's present or future consolidated financial statements.

2. Acquisitions

On August 3, 2015, the Company completed an insignificant asset acquisition from Futura Sport AG for total consideration of $2 million, of which $1 million was paid during the third quarter of 2015. The Company expects to make the remaining payment of $1 million during the fourth quarter for the remainder of the purchase price. The assets acquired include store fixtures, lease agreements, and inventory for 10 Runners Point and Sidestep franchise stores in Switzerland. The purchase price allocation has been completed as of October 31, 2015.

3. Segment Information

The Company has determined that its reportable segments are those that are based on its method of internal reporting. The Company has two reportable segments, Athletic Stores and Direct-to-Customers. The Company evaluates performance based on several factors, of which the primary financial measure is division results. Division profit reflects income before income taxes, pension litigation charge, corporate expense, non-operating income, and net interest expense.

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
	($ in millions)			
Sales				
Athletic Stores	$1,571	$ 1,521	$ 4,755	$ 4,646
Direct-to-Customers	223	210	650	594
Total sales	$1,794	$ 1,731	$ 5,405	$ 5,240

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FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

3. Segment Information – (continued)

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
	($ in millions)			
Operating Results				
Athletic Stores [1]	$206	$ 181	$ 649	$ 577
Direct-to-Customers [2]	31	25	98	67
Division profit	237	206	747	644
Less: Litigation charge [3]	100	—	100	—
Corporate expense, net	20	19	54	59
Operating profit	117	187	593	585
Other income [4]	1	1	2	3
Interest expense, net	1	1	3	3
Income before income taxes	$117	$ 187	$ 592	$ 585

(1) Included in the thirty-nine weeks ended November 1, 2014 is a non-cash impairment charge of $1 million to fully write down the remaining value of the tradename related to the Company's stores in the Republic of Ireland.

(2) Included in the thirty-nine weeks ended November 1, 2014 is a $2 million non-cash impairment charge related to the CCS tradename.

(3) Included in the thirteen and thirty-nine weeks ended October 31, 2015 is a pre-tax litigation charge of $100 million relating to a pension litigation matter described further in Note 12, *Legal Proceedings*.

(4) Other income includes non-operating items, such as lease termination gains, royalty income, and the changes in fair value, premiums paid, and realized gains associated with foreign currency option contracts.

4. Goodwill

Annually during the first quarter, or more frequently if impairment indicators arise, the Company reviews goodwill and intangible assets with indefinite lives for impairment. The annual review of goodwill and intangible assets with indefinite lives performed during the first quarter of 2015 did not result in the recognition of impairment.

The following table provides a summary of goodwill by reportable segment. The change in the balance primarily represents foreign currency exchange fluctuations.

	October 31, 2015	November 1, 2014	January 31, 2015
	($ in millions)		
Athletic Stores	$17	$ 19	$ 17
Direct-to-Customers	139	141	140
	$156	$ 160	$ 157

5. Other Intangible Assets, net

The components of finite-lived intangible assets and intangible assets not subject to amortization are as follows:

	October 31, 2015			November 1, 2014			January 31, 2015		
($ in millions)	**Gross value**	**Accum. amort.**	**Net Value**	**Gross value**	**Accum. amort.**	**Net Value**	**Gross value**	**Accum. amort.**	**Net Value**
Amortized intangible assets: [(1), (2)]									
Lease acquisition costs	$119	$ (109)	$ 10	$143	$ (129)	$ 14	$128	$ (116)	$ 12
Trademarks	21	(12)	9	21	(11)	10	21	(12)	9
Favorable leases	7	(4)	3	7	(4)	3	7	(4)	3
	$147	$ (125)	$ 22	$171	$ (144)	$ 27	$156	$ (132)	$ 24

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

5. Other Intangible Assets, net – (continued)

($ in millions)	October 31, 2015 Gross value	Accum. amort.	Net Value	November 1, 2014 Gross value	Accum. amort.	Net Value	January 31, 2015 Gross value	Accum. amort.	Net Value
Indefinite life intangible assets: [1]									
Runners Point Group trademarks			24			28			25
Other trademarks			—			1			—
			$ 24			$ 29			$ 25
Other intangible assets, net			$ 46			$ 56			$ 49

(1) The change in the ending balances also reflects the effect of foreign currency fluctuations due primarily to the movements of the euro in relation to the U.S. dollar.

(2) During 2014, the Company exited the CCS e-commerce business; as such, the fully amortized customer relationship intangible of $21 million was removed from the amounts presented above for all periods.

For the thirty-nine week period ended October 31, 2015, activity included amortization of $3 million and a $1 million decrease related to foreign currency exchange fluctuations. This was partially offset by $1 million of lease acquisition additions primarily related to our European businesses, which are being amortized over a weighted-average life of 8 years.

($ in millions)	Thirteen weeks ended October 31, 2015	Thirteen weeks ended November 1, 2014	Thirty-nine weeks ended October 31, 2015	Thirty-nine weeks ended November 1, 2014
Amortization expense	$ 1	$ 2	$ 3	$ 5

Estimated future amortization expense for finite life intangible assets is as follows:

	($ in millions)
Remainder of 2015	$ 1
2016	4
2017	3
2018	3
2019	3
2020	3

6. Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss (“AOCL”), net of tax, is comprised the following:

	October 31, 2015	November 1, 2014	January 31, 2015
	($ in millions)		
Foreign currency translation adjustments	$(107)	$ 15	$ (75)
Cash flow hedges	(2)	(1)	(3)
Unrecognized pension cost and postretirement benefit	(233)	(234)	(240)
Unrealized loss on available-for-sale security	(1)	(1)	(1)
	$(343)	$ (221)	$ (319)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

6. Accumulated Other Comprehensive Loss – (continued)

The changes in AOCL for the thirty-nine weeks ended October 31, 2015 were as follows:

($ in millions)	**Foreign currency translation adjustments**	**Cash flow hedges**	**Items related to pension and postretirement benefits**	**Unrealized loss on available-for-sale security**	Total
Balance as of January 31, 2015	$ (75)	(3)	(240)	(1)	$(319)
OCI before reclassification	(32)	1	1	—	(30)
Reclassified from AOCL	—	—	6	—	6
Other comprehensive income/(loss)	(32)	1	7	—	(24)
Balance as of October 31, 2015	$ (107)	(2)	(233)	(1)	$(343)

Reclassifications from AOCL for the thirty-nine weeks ended October 31, 2015 were as follows:

	($ in millions)
Amortization of actuarial (gain) loss:	
Pension benefits - amortization of actuarial loss	$ 10
Postretirement benefits - amortization of actuarial gain	(1)
Net periodic benefit cost (see *Note 10*)	9
Income tax benefit	(3)
Net of tax	$ 6

7. Financial Instruments

The Company operates internationally and utilizes certain derivative financial instruments to mitigate its foreign currency exposures, primarily related to third-party and intercompany forecasted transactions. As a result of the use of derivative instruments, the Company is exposed to the risk that counterparties will fail to meet their contractual obligations. To mitigate this counterparty credit risk, the Company has a practice of entering into contracts only with major financial institutions selected based upon their credit ratings and other financial factors. The Company monitors the creditworthiness of counterparties throughout the duration of the derivative instrument. Additional information is contained within Note 8, *Fair Value Measurements*.

Derivative Holdings Designated as Hedges

For a derivative to qualify as a hedge at inception and throughout the hedged period, the Company formally documents the nature of the hedged items and the relationships between the hedging instruments and the hedged items, as well as its risk-management objectives, strategies for undertaking the various hedge transactions, and the methods of assessing hedge effectiveness and ineffectiveness. In addition, for hedges of forecasted transactions, the significant characteristics and expected terms of a forecasted transaction must be specifically identified, and it must be probable that each forecasted transaction would occur. If it were deemed probable that the forecasted transaction would not occur, the gain or loss on the derivative instrument would be recognized in earnings immediately. No such gains or losses were recognized in earnings for any of the periods presented. Derivative financial instruments qualifying for hedge accounting must maintain a specified level of effectiveness between the hedging instrument and the item being hedged, both at inception and throughout the hedged period, which management evaluates periodically.

The primary currencies to which the Company is exposed are the euro, British pound, Canadian dollar, and Australian dollar. For the most part, merchandise inventories are purchased by each geographic area in their respective local currency. The exception to this is the United Kingdom, whose merchandise inventory purchases are denominated in euros. For option and foreign exchange forward contracts designated as cash flow hedges of the purchase of inventory, the effective portion of gains and losses is deferred as a component of AOCL and is recognized as a component of cost of sales when the related inventory is sold. The amount reclassified to cost of sales related to such contracts was not significant for any of the periods presented.

FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

7. Financial Instruments – (continued)

The effective portion of gains or losses associated with other forward contracts is deferred as a component of AOCL until the underlying transaction is reported in earnings. The ineffective portion of gains and losses related to cash flow hedges recorded to earnings was also not significant for any of the periods presented. When using a forward contract as a hedging instrument, the Company excludes the time value of the contract from the assessment of effectiveness. At each quarter-end, substantially all of the Company's hedged forecasted transactions are less than twelve months, and the Company expects substantially all derivative-related amounts reported in AOCL to be reclassified to earnings within twelve months.

The net change in the fair value of the foreign exchange derivative financial instruments designated as cash flow hedges of the purchase of inventory was a gain of $2 million and $1 million for the thirteen and thirty-nine weeks ended October 31, 2015, respectively, and therefore decreased AOCL. At October 31, 2015, there was a $2 million loss included in AOCL. For both the thirteen and thirty-nine weeks ended November 1, 2014, the net change resulted in a loss of $1 million. The notional value of the foreign exchange contracts designed as hedges outstanding at October 31, 2015 was $93 million, and these contracts mature at various dates through January 2017.

Derivative Holdings Not Designated as Hedges

The Company enters into foreign exchange forward contracts that are not designated as hedges in order to manage the costs of foreign-currency denominated merchandise purchases and intercompany transactions. Changes in the fair value of these foreign exchange forward contracts are recorded in earnings immediately within selling, general and administrative expenses. The net change in fair value resulted in expense of $3 million and $1 million for the thirteen and thirty-nine weeks ended October 31, 2015, respectively. The net change in fair value was not significant for the thirteen weeks ended November 1, 2014 and resulted in $1 million of income for the thirty-nine weeks ended November 1, 2014. The notional value of the foreign exchange contracts not designed as hedges outstanding at October 31, 2015 was $15 million, and these contracts mature at various dates through December 2015.

The Company mitigates the effect of fluctuating foreign exchange rates on the reporting of foreign-currency denominated earnings by entering into currency option contracts. Changes in the fair value of these foreign currency option contracts, which are not designated as hedges, are recorded in earnings immediately within other income. The realized gains, premiums paid, and changes in the fair market value recorded were not significant for the thirteen and thirty-nine weeks ended October 31, 2015. The realized gain was $1 million for the thirteen weeks and thirty-nine weeks ended November 1, 2014. No such contracts were outstanding at October 31, 2015.

Additionally, the Company enters into diesel fuel forward and option contracts to mitigate a portion of the Company's freight expense due to the variability caused by fuel surcharges imposed by our third-party freight carriers. Changes in the fair value of these contracts are recorded in earnings immediately. The effect was not significant for any of the periods presented. The notional value of the diesel fuel forward contracts outstanding at October 31, 2015 was $1 million and these contracts mature at various dates through May 2016.

Fair Value of Derivative Contracts

The following represents the fair value of the Company's derivative contracts. Many of the Company's agreements allow for a netting arrangement. The following is presented on a gross basis, by type of contract:

($ in millions)	Balance Sheet Caption	October 31, 2015		November 1, 2014		January 31, 2015	
Hedging Instruments:							
Foreign exchange forward contracts	Current liabilities	$	3	$	2	$	4
Non-Hedging Instruments:							
Foreign exchange forward contracts	Current assets	$	2	$	—	$	—
Foreign exchange forward contracts	Current liabilities	$	3	$	—	$	1

FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

8. Fair Value Measurements

The Company's financial assets recorded at fair value are categorized as follows:

Level 1 – Quoted prices for identical instruments in active markets.

Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs or significant value-drivers are observable in active markets.

Level 3 – Model-derived valuations in which one or more significant inputs or significant value-drivers are unobservable.

The following tables provide a summary of the Company's recognized assets and liabilities that are measured at fair value on a recurring basis:

	At October 31, 2015			At November 1, 2014			At January 31, 2015		
($ in millions)									
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Assets									
Auction rate security	—	6	—	—	6	—	—	6	—
Total Assets	$—	$ 6	$ —	$ —	$ 6	$ —	$ —	$ 6	$ —
Liabilities									
Foreign exchange forward contracts	—	4	—	—	2	—	—	5	—
Total Liabilities	$—	$ 4	$ —	$ —	$ 2	$ —	$ —	$ 5	$ —

Securities classified as available-for-sale are recorded at fair value with unrealized gains and losses reported, net of tax, in other comprehensive income, unless unrealized losses are determined to be other than temporary. The fair value of the auction rate security is determined by using quoted prices for similar instruments in active markets and accordingly is classified as a Level 2 instrument.

The Company's derivative financial instruments are valued using market-based inputs to valuation models. These valuation models require a variety of inputs, including contractual terms, market prices, yield curves, and measures of volatility and, therefore, are classified as Level 2 instruments.

There were no transfers into or out of Level 1, Level 2, or Level 3 assets and liabilities for any of the periods presented.

The carrying value and estimated fair value of long-term debt and obligations under capital leases were as follows:

	October 31, 2015	November 1, 2014	January 31, 2015
	($ in millions)		
Carrying value	$131	$ 135	$ 134
Fair value	$157	$ 161	$ 163

The fair value of long-term debt is determined by using model-derived valuations in which all significant inputs or significant value drivers are observable in active markets and, therefore, are classified as Level 2. The carrying values of cash and cash equivalents and other current receivables and payables approximate their fair value.

FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

9. Earnings Per Share

The Company accounts for and discloses earnings per share using the treasury stock method. Basic earnings per share is computed by dividing reported net income for the period by the weighted-average number of common shares outstanding at the end of the period. Restricted stock awards, which contain non-forfeitable rights to dividends, are considered participating securities and are included in the calculation of basic earnings per share. Diluted earnings per share reflects the weighted-average number of common shares outstanding during the period used in the basic earnings per share computation plus dilutive common stock equivalents.

The computation of basic and diluted earnings per share is as follows:

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
	($ in millions)			
Weighted-average common shares outstanding	**139.3**	143.6	**139.6**	144.5
Effect of Dilution:				
Stock options and awards	1.6	2.1	**1.8**	2.1
Weighted-average common shares assuming dilution	140.9	145.7	**141.4**	146.6

The number of options excluded from the computation was not significant for the thirteen weeks ended October 31, 2015, and was 0.6 million for the thirty-nine weeks ended October 31, 2015. The number of options excluded from the computation was not significant for the thirteen and thirty-nine weeks ended November 1, 2014. These options were not included because the effect would have been antidilutive. Contingently issuable shares of 0.3 million and 0.4 million have not been included as the vesting conditions have not been satisfied as of October 31, 2015 and November 1, 2014, respectively.

10. Pension and Postretirement Plans

The Company has defined benefit pension plans covering certain of its North American employees, which are funded in accordance with the provisions of the laws where the plans are in effect. In addition, the Company has a defined benefit pension plan covering certain individuals of the Runners Point Group.

In addition to providing pension benefits, the Company sponsors postretirement medical and life insurance plans, which are available to most of its retired U.S. employees. These medical and life insurance plans are contributory and are not funded.

The following are the components of net periodic pension benefit cost and net periodic postretirement benefit income, which is recognized as part of SG&A expense:

	Pension Benefits				Postretirement Benefits			
	Thirteen weeks ended		**Thirty-nine weeks ended**		**Thirteen weeks ended**		**Thirty-nine weeks ended**	
($ in millions)	**October 31, 2015**	**November 1, 2014**	**October 31, 2015**	**November 1, 2014**	**October 31, 2015**	**November 1, 2014**	**October 31, 2015**	**November 1, 2014**
Service cost	**$5**	$ 3	**$ 13**	$ 11	**$ —**	$ —	**$ —**	$ —
Interest cost	**6**	7	**18**	21	**—**	—	**1**	—
Expected return on plan assets	**(10)**	(9)	**(29)**	(28)	**—**	—	**—**	—
Amortization of net loss (gain)	**3**	5	**10**	12	**—**	(1)	**(1)**	(2)
Net benefit expense (income)	**$4**	$ 6	**$ 12**	$ 16	**$ —**	$ (1)	**$ —**	$ (2)

On August 14, 2015, the Company made a contribution of $4 million to the U.S. qualified plan. The Company continually evaluates the amount and timing of any future contributions. The Company currently does not expect any further pension plan contributions during the current year. Actual contributions are dependent on several factors, including the outcome of the ongoing pension litigation. See Note 12, *Legal Proceedings,* for further information.

FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

11. Share-Based Compensation

Total compensation expense included in SG&A, and the associated tax benefits recognized related to the Company's share-based compensation plans were as follows:

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
	($ in millions)			
Options and shares purchased under the employee stock purchase plan	$ 3	$ 3	$ 9	$ 9
Restricted stock and restricted stock units	3	3	8	9
Total share-based compensation expense	$ 6	$ 6	$ 17	$ 18
Tax benefit recognized	$ 3	$ 1	$ 6	$ 5
Excess income tax benefit from settled equity-classified share-based awards reported as a cash flow from financing activities			$ 33	$ 11

Valuation Model and Assumptions

The Company uses a Black-Scholes option-pricing model to estimate the fair value of share-based awards. The Black-Scholes option-pricing model incorporates various and highly subjective assumptions, including expected term and expected volatility. The following table shows the Company's assumptions used to compute the share-based compensation expense:

	Stock Option Plans		Stock Purchase Plan	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Weighted-average risk free rate of interest	1.52 %	2.12 %	0.22 %	0.14 %
Expected volatility	30 %	39 %	24 %	24 %

Weighted-average expected award life	**6.0 years**	6.1 years	**1.0 year**	1.0 year
Dividend yield	1.61 %	2.0 %	1.7 %	2.0 %
Weighted-average fair value	$16.07	$ 14.91	$10.20	$ 7.11

The information in the following table covers options granted under the Company's stock option plans for the thirty-nine weeks ended October 31, 2015:

	Shares	Weighted-Average Term	**Weighted-Average Exercise Price**
	(in thousands, except price per share and weighted-average term)		
Options outstanding at the beginning of the year	5,569		$ 25.89
Granted	694		62.29
Exercised	(2,447)		25.64
Expired or cancelled	(55)		48.68
Options outstanding at October 31, 2015	3,761	6.3	$ 32.44
Options exercisable at October 31, 2015	2,531	5.1	$ 22.13
Options vested and expected to vest at October 31, 2015	3,720	6.3	$ 32.17
Options available for future grant at October 31, 2015	13,037		

FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

11. Share-Based Compensation – (continued)

The total intrinsic value of options exercised (the difference between the market price of the Company's common stock on the exercise date and the price paid by the optionee to exercise the option) is presented below:

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
	($ in millions)			
Exercised	$ 31	$ 6	$ 96	$ 21

The aggregate intrinsic value for stock options outstanding and for stock options exercisable (the difference between the Company's closing stock price on the last trading day of the period and the exercise price of the options, multiplied by the number of in-the-money stock options) is presented below:

	Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014
	($ in millions)	
Outstanding	$ 133	$ 170
Outstanding and exercisable	$ 116	$ 138
Vested and expected to vest	$ 133	$ 169

As of October 31, 2015 there was $9 million of total unrecognized compensation cost related to nonvested stock options, which is expected to be recognized over a weighted-average period of 1.5 years.

The cash received from option exercises for the thirteen and thirty-nine weeks ended October 31, 2015 was $25 million and $63 million, respectively. The cash received from option exercises for the thirteen and thirty-nine weeks ended November 1, 2014 was $4 million and $17 million, respectively. The total tax benefit realized from option exercises was $12 million and $37 million for the thirteen and thirty-nine weeks ended October 31, 2015, respectively, and was $2 million and $7 million for the corresponding prior-year periods.

The following table summarizes information about stock options outstanding and exercisable at October 31, 2015:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
	(in thousands, except prices per share and contractual life)				
$9.85 to $18.80	870	3.9	$ 13.28	870	$ 13.28
$18.84 to $24.75	899	4.8	$ 19.81	899	$ 19.81
$30.92 to $36.59	790	6.7	$ 32.84	616	$ 32.44
$45.08 to $73.21	1,202	8.9	$ 55.47	146	$ 45.70
	3,761	6.3	$ 32.44	2,531	$ 22.13

Restricted Stock and Restricted Stock Units

Restricted shares of the Company's common stock and restricted stock units ("RSU") may be awarded to certain officers and key employees of the Company. RSU awards generally are made to executives outside of the United States and to nonemployee directors. Additionally, RSU awards are made in connection with the Company's long-term incentive program. Each RSU represents the right to receive one share of the Company's common stock provided that the vesting conditions are satisfied. There were 588,308 and 734,295 RSU awards outstanding as of October 31, 2015 and November 1, 2014, respectively.

FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

11. Share-Based Compensation – (continued)

Generally, awards fully vest after the passage of time, typically three years. However, RSU awards made in connection with the Company’s long-term incentive program vest after the attainment of both certain performance metrics and the passage of time. Restricted stock is considered outstanding at the time of grant and the holders have voting rights. Dividends are paid to holders of restricted stock that vest with the passage of time. With regard to performance-based restricted stock, dividends will be accumulated and paid after the performance criteria are met. No dividends are paid or accumulated on RSU awards.

Compensation expense is recognized using the fair market value at the date of grant and is amortized over the vesting period, provided the recipient continues to be employed by the Company.

Restricted stock and RSU activity for the thirty-nine weeks ended October 31, 2015 is summarized as follows:

	Number of Shares	**Weighted-Average Grant Date Fair Value per Share**
	(in thousands, except price per share)	
Nonvested at the beginning of the year	1,038	$ 37.96
Granted	154	63.72
Vested	(312)	32.33
Expired or cancelled	(68)	37.97
Nonvested at October 31, 2015	812	$ 45.02
Aggregate value ($ in millions)	$ 37	
Weighted-average remaining contractual life (in years)	1.1 years	

The weighted grant-date fair value per share was $63.72 and $45.24 for the thirty-nine weeks ended October 31, 2015 and November 1, 2014, respectively . The total value of awards for which restrictions lapsed for the thirty-nine weeks ended October 31, 2015 and November 1, 2014 was $10 million and $14 million, respectively. As of October 31, 2015, there was $12 million of total unrecognized compensation cost net of forfeitures related to nonvested restricted awards.

12. Legal Proceedings

Legal proceedings pending against the Company or its consolidated subsidiaries consist of ordinary, routine litigation, including administrative proceedings, incidental to the business of the Company or businesses that have been sold or disposed of by the Company in past years. These legal proceedings include commercial, intellectual property, customer, environmental, and employment-related claims.

The Company and the Company’s U.S. retirement plan are defendants in a class action (*Osberg v. Foot Locker Inc.* et ano., filed in the U.S. District Court for the Southern District of New York) in which the plaintiff alleges that, in connection with the 1996 conversion of the retirement plan to a defined benefit plan with a cash balance formula, the Company and the retirement plan failed to properly advise plan participants of the “wear-away” effect of the conversion. Plaintiff’s claims were for breach of fiduciary duty under the Employee Retirement Income Security Act of 1974, as amended, and violation of the statutory provisions governing the content of the Summary Plan Description. The trial was held in July 2015 and the court issued a decision in September 2015 in favor of the class on the foregoing claims. The court ordered that the Plan be reformed. The Company is appealing the court’s decision, and the judgment has been stayed pending the outcome of the appeal. As a result of this development, the Company has determined that it is probable a liability exists. The Company’s reasonable estimate of this liability is a range between $100 million and $200 million, with no amount within that range more probable than any other amount. Therefore, in accordance with U.S. GAAP, the Company recorded a charge of $100 million pre-tax ($61 million after-tax) in the third quarter of 2015. This amount has been classified as a long-term liability. The Company will continue to vigorously defend itself in this case. In light of the uncertainties involved in this matter, there is no assurance that the ultimate resolution will not differ from the amount currently accrued by the Company.

FOOT LOCKER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

12. Legal Proceedings – (continued)

Certain of the Company's subsidiaries were defendants in a number of lawsuits filed in state and federal courts containing various class action allegations under federal or state wage and hour laws, including allegations concerning unpaid overtime, meal and rest breaks, and uniforms. In *Pereira v. Foot Locker*, filed in the U.S. District Court for the Eastern District of Pennsylvania, the plaintiff alleged that the Company permitted unpaid off-the-clock hours in violation of the Fair Labor Standards Act and state labor laws and sought compensatory and punitive damages, injunctive relief, and attorneys' fees and costs. Additional purported wage and hour class actions were filed against the Company that asserted claims similar to those asserted in *Pereira* and sought similar remedies. With the exception of *Hill v. Foot Locker* filed in state court in Illinois, *Kissinger v. Foot Locker* filed in state court in California, and *Cortes v. Foot Locker* filed in federal court in New York, all of these actions were consolidated by the United States Judicial Panel on Multidistrict Litigation with *Pereira* under the caption *In re Foot Locker, Inc. Fair Labor Standards Act and Wage and Hour Litigation*. The Company and plaintiffs entered into a settlement agreement resolving *Hill* and the consolidated cases that was approved by the court during the second quarter of 2015. Additionally, during the third quarter of 2015, the Company and plaintiffs in *Cortes* and *Kissinger* entered into settlement agreements that have also been approved by the respective courts.

Management does not believe that the outcome of any such legal proceedings pending against the Company or its consolidated subsidiaries, including *Osberg*, as described above, would have a material adverse effect on the Company's consolidated financial position, liquidity, or results of operations, taken as a whole, based upon current knowledge and taking into consideration current accruals. Litigation is inherently unpredictable, and judgments could be rendered or settlements entered into that could adversely affect the Company's operating results or cash flows in a particular period.

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

Business Overview

Foot Locker, Inc., through its subsidiaries, operates in two reportable segments – Athletic Stores and Direct-to-Customers.

The Athletic Stores segment is one of the largest athletic footwear and apparel retailers in the world, with formats that include Foot Locker, Lady Foot Locker, SIX:02, Kids Foot Locker, Champs Sports, Footaction, Runners Point, and Sidestep.

The Direct-to-Customers segment is multi-branded and multi-channeled. This segment sells, through its affiliates, directly to customers through its Internet and mobile sites and catalogs. Eastbay, one of the affiliates, is among the largest direct marketers in the United States. The Direct-to-Customers segment operates the websites for eastbay.com, final-score.com, eastbayteamsales.com, as well as websites aligned with the brand names of its store banners (footlocker.com, footlocker.ca, footlocker.eu, ladyfootlocker.com, six02.com, kidsfootlocker.com, champssports.com, footaction.com, runnerspoint.com, and sidestep-shoes.com). Additionally, this segment includes sp24.com, a clearance website for our European e-commerce business.

Store Count

At October 31, 2015, the Company operated 3,432 stores as compared with 3,423 and 3,474 stores at January 31, 2015 and November 1, 2014, respectively.

A total of 64 franchised stores were operating at October 31, 2015, as compared with 78 and 73 stores at January 31, 2015 and November 1, 2014, respectively. During the third quarter of 2015, the Company completed an acquisition from Futura Sport AG of 10 Runners Point and Sidestep stores, which were previously franchise stores.

Revenue from the franchised stores was not significant for any of the periods presented. These stores are not included in the Company’s operating store count above.

Sales

All references to comparable-store sales for a given period relate to sales of stores that were open at the period-end and had been open for more than one year. The computation of comparable-store sales also includes the sales of the Direct-to-Customers segment. Stores opened or closed during the period are not included in the comparable-store base; however, stores closed temporarily for relocation or remodeling are included. Computations exclude the effect of foreign currency fluctuations.

Sales increased by $63 million, or 3.6 percent, to $1,794 million for the thirteen weeks ended October 31, 2015, from $1,731 million for the thirteen weeks ended November 1, 2014. For the thirty-nine weeks ended October 31, 2015, sales of $5,405 million increased 3.1 percent from sales of $5,240 million for the corresponding prior-year period. Excluding the effect of foreign currency fluctuations, total sales for both the thirteen and thirty-nine week periods increased 8.9 percent as compared with the corresponding prior-year periods. Comparable-store sales increased by 8.7 percent for both the thirteen and thirty-nine weeks ended October 31, 2015.

Gross Margin

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Gross margin rate	33.8 %	33.2 %	33.9 %	33.3 %
Basis point increase in the gross margin rate	60		60	
Components of the increase-				
Merchandise margin rate improvement	50		30	
Lower occupancy and buyers’ compensation expense rate	10		30	

The gross margin rate improved by 60 basis points for both the thirteen and thirty-nine weeks ended October 31, 2015. Excluding the effect of foreign currency fluctuations, the gross margin rate improved by 80 and 70 basis points for the thirteen and thirty-nine weeks ended October 31, 2015, respectively. The improvement in the gross margin rate for both the thirteen and thirty-nine weeks ended October 31, 2015 was primarily the result of a higher merchandise margin rate, which primarily reflected a lower markdown rate. In addition, the prior year merchandise margin rate was negatively affected by the liquidation of CCS merchandise. Further, the occupancy and buyers compensation expense rate decreased 10 and 30 basis points for the thirteen and thirty-nine weeks ended October 31, 2015, respectively, which was the result of leveraging the fixed rent and salary elements within our cost of sales.

Selling, General and Administrative Expenses (SG&A)

	Thirteen weeks ended		Thirty-nine weeks ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
	($ in millions)			
SG&A	$352	$ 353	$ 1,028	$ 1,051
$ Change	$(1)			