

ACE HARDWARE CORPORATION  
2014 Annual Report



**ACE HARDWARE CORPORATION**  
**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND**  
**SUPPLEMENTARY DATA**

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## Report of Independent Auditors

The Board of Directors  
Ace Hardware Corporation

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Ace Hardware Corporation, which comprise the consolidated balance sheets as of January 3, 2015 and December 28, 2013, and the related consolidated statements of income, comprehensive income, equity, and cash flows for each of the three fiscal years in the period ended January 3, 2015, and the related notes to the consolidated financial statements.

### Management's Responsibility for the Financial Statements

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

### Auditor's Responsibility

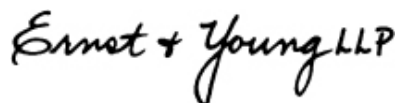
Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether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

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

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

### Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Ace Hardware Corporation at January 3, 2015 and December 28, 2013, and the consolidated results of its operations and its cash flows for each of the three fiscal years in the period ended January 3, 2015, in conformity with U.S. generally accepted accounting principles.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style font.

Chicago, Illinois  
February 24, 2015

**ACE HARDWARE CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(In millions, except share data)

	<b>January 3, 2015</b>	<b>December 28, 2013</b>
<b>Assets</b>		
Cash and cash equivalents	\$ 29.8	\$ 17.9
Marketable securities	42.2	53.8
Receivables, net of allowance for doubtful accounts of \$6.5 and \$9.3, respectively	381.8	335.9
Inventories	692.9	505.5
Prepaid expenses and other current assets	54.7	41.8
Total current assets	1,201.4	954.9
Property and equipment, net	323.0	324.7
Notes receivable, net of allowance for doubtful accounts of \$10.9 and \$11.4, respectively	12.2	21.2
Goodwill and other intangible assets	35.0	24.1
Other assets	85.6	63.6
Total assets	<u>\$ 1,657.2</u>	<u>\$ 1,388.5</u>
<b>Liabilities and Equity</b>		
Current maturities of long-term debt	\$ 41.5	\$ 23.4
Accounts payable	601.6	491.7
Patronage distributions payable in cash	53.7	39.9
Patronage refund certificates payable	6.6	-
Accrued expenses	162.5	165.9
Total current liabilities	865.9	720.9
Long-term debt	242.2	178.6
Patronage refund certificates payable	32.3	28.4
Other long-term liabilities	67.0	66.3
Total liabilities	1,207.4	994.2
<b>Member Retailers' Equity:</b>		
Class A voting common stock, \$1,000 par value, 10,000 shares authorized, 2,751 and 2,764 issued and outstanding, respectively	2.8	2.8
Class C nonvoting common stock, \$100 par value, 6,000,000 shares authorized, 3,425,232 and 3,156,908 issued and outstanding, respectively	342.5	315.7
Class C nonvoting common stock, \$100 par value, issuable to retailers for patronage distributions, 565,068 and 408,684 shares issuable, respectively	56.5	40.9
Contributed capital	20.6	20.0
Retained earnings	15.5	6.3
Accumulated other comprehensive income	1.7	0.3
Equity attributable to Ace member retailers	439.6	386.0
Equity attributable to noncontrolling interests	10.2	8.3
Total equity	449.8	394.3
Total liabilities and equity	<u>\$ 1,657.2</u>	<u>\$ 1,388.5</u>

See accompanying notes to the consolidated financial statements.

**ACE HARDWARE CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(In millions)

	<b>Years Ended</b>		
	<b>January 3, 2015 (53 Weeks)</b>	<b>December 28, 2013 (52 Weeks)</b>	<b>December 29, 2012 (52 Weeks)</b>
Revenues:			
Wholesale revenues	\$ 4,466.7	\$ 3,928.6	\$ 3,832.9
Retail revenues	233.8	225.6	8.0
Total revenues	<u>4,700.5</u>	<u>4,154.2</u>	<u>3,840.9</u>
Cost of revenues:			
Wholesale cost of revenues	3,920.3	3,450.2	3,367.0
Retail cost of revenues	128.0	127.1	4.8
Total cost of revenues	<u>4,048.3</u>	<u>3,577.3</u>	<u>3,371.8</u>
Gross profit:			
Wholesale gross profit	546.4	478.4	465.9
Retail gross profit	105.8	98.5	3.2
Total gross profit	<u>652.2</u>	<u>576.9</u>	<u>469.1</u>
Distribution operations expenses	119.2	100.0	98.1
Selling, general and administrative expenses	154.1	142.3	138.1
Retailer success and development expenses	135.1	124.3	117.6
Retail operating expenses	91.5	90.6	3.3
Warehouse facility closure costs	0.7	6.2	-
Gain on sale of paint assets, net of acquisition and disposition costs	-	-	(7.0)
Total operating expenses	<u>500.6</u>	<u>463.4</u>	<u>350.1</u>
Operating income	151.6	113.5	119.0
Interest expense	(13.1)	(14.1)	(23.9)
Loss on early extinguishment of debt	-	-	(19.9)
Interest income	3.0	3.9	4.2
Other income, net	6.1	6.3	6.3
Income tax expense	(6.3)	(4.5)	(3.5)
Net income	141.3	105.1	82.2
Less: net income attributable to noncontrolling interests	0.4	0.6	0.4
Net income attributable to Ace Hardware Corporation	<u>\$ 140.9</u>	<u>\$ 104.5</u>	<u>\$ 81.8</u>
Accrued patronage distributions	<u>\$ 135.3</u>	<u>\$ 100.7</u>	<u>\$ 75.5</u>
Accrued patronage distributions to third party retailers	<u>\$ 131.7</u>	<u>\$ 98.2</u>	<u>\$ 75.5</u>

See accompanying notes to the consolidated financial statements.

**ACE HARDWARE CORPORATION**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(In millions)

	<b>Years Ended</b>		
	<b>January 3, 2015 (53 Weeks)</b>	<b>December 28, 2013 (52 Weeks)</b>	<b>December 29, 2012 (52 Weeks)</b>
Net income	\$ 141.3	\$ 105.1	\$ 82.2
Other comprehensive income (loss), net of tax:			
Foreign currency translation	0.2	(0.1)	(0.1)
Unrecognized postretirement cost	(0.1)	0.1	-
Unrealized gain on investments	0.9	-	1.5
Unrealized gain (loss) on derivative financial instrument	0.4	1.5	(2.6)
Total other comprehensive income (loss), net	1.4	1.5	(1.2)
Comprehensive income	142.7	106.6	81.0
Less: Comprehensive income attributable to noncontrolling interest	0.4	0.6	0.4
Comprehensive income attributable to Ace Hardware Corporation	\$ 142.3	\$ 106.0	\$ 80.6

See accompanying notes to the consolidated financial statements.

**ACE HARDWARE CORPORATION**  
**CONSOLIDATED STATEMENTS OF EQUITY**  
(In millions)

**Shareholders of Ace Hardware Corporation**

	Capital Stock		Class C Stock Issuable to Retailers for Patronage Dividends	Additional Stock Subscribed	Contributed Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests	Total Equity
	Class A	Class C							
Balances at December 31, 2011	\$ 2.8	\$ 298.3	\$ 24.7	\$ -	\$ 20.9	\$ (6.7)	\$ -	\$ 7.8	\$ 347.8
Net income	-	-	-	-	-	81.8	-	0.4	82.2
Other comprehensive loss	-	-	-	-	-	-	(1.2)	-	(1.2)
Net payments on subscriptions	-	-	-	0.9	-	-	-	-	0.9
Stock issued	0.1	24.2	(24.7)	(0.9)	-	-	-	-	(1.3)
Sale of noncontrolling interests	-	-	-	-	0.3	-	-	-	0.3
Stock repurchased	(0.2)	(21.6)	-	-	(1.6)	-	-	(0.8)	(24.2)
Patronage distributions issuable	-	-	25.7	-	-	-	-	-	25.7
Patronage distributions payable	-	-	-	-	-	(75.3)	-	-	(75.3)
Other	-	-	-	-	0.1	0.1	-	-	0.2
Balances at December 29, 2012	\$ 2.7	\$ 300.9	\$ 25.7	\$ -	\$ 19.7	\$ (0.1)	\$ (1.2)	\$ 7.4	\$ 355.1
Net income	-	-	-	-	-	104.5	-	0.6	105.1
Other comprehensive income	-	-	-	-	-	-	1.5	-	1.5
Net payments on subscriptions	-	-	-	0.9	-	-	-	-	0.9
Stock issued	0.1	26.0	(25.7)	(0.9)	0.1	-	-	-	(0.4)
Sale of noncontrolling interests	-	-	-	-	(0.3)	-	-	0.3	-
Stock repurchased	-	(11.2)	-	-	-	-	-	-	(11.2)
Patronage distributions issuable	-	-	40.9	-	-	-	-	-	40.9
Patronage distributions payable	-	-	-	-	-	(98.1)	-	-	(98.1)
Other	-	-	-	-	0.5	-	-	-	0.5
Balances at December 28, 2013	\$ 2.8	\$ 315.7	\$ 40.9	\$ -	\$ 20.0	\$ 6.3	\$ 0.3	\$ 8.3	\$ 394.3
Net income	-	-	-	-	-	140.9	-	0.4	141.3
Other comprehensive income	-	-	-	-	-	-	1.4	-	1.4
Net payments on subscriptions	-	-	-	1.2	-	-	-	-	1.2
Stock issued	0.1	41.8	(40.9)	(1.2)	-	-	-	-	(0.2)
Sale of noncontrolling interests	-	-	-	-	0.5	-	-	1.5	2.0
Stock repurchased	(0.1)	(15.0)	-	-	-	-	-	-	(15.1)
Patronage distributions issuable	-	-	56.5	-	-	-	-	-	56.5
Patronage distributions payable	-	-	-	-	-	(131.7)	-	-	(131.7)
Other	-	-	-	-	0.1	-	-	-	0.1
Balances at January 3, 2015	\$ 2.8	\$ 342.5	\$ 56.5	\$ -	\$ 20.6	\$ 15.5	\$ 1.7	\$ 10.2	\$ 449.8

See accompanying notes to the consolidated financial statements.

**ACE HARDWARE CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In millions)

	<b>Years Ended</b>		
	<b>January 3, 2015 (53 Weeks)</b>	<b>December 28, 2013 (52 Weeks)</b>	<b>December 29, 2012 (52 Weeks)</b>
<b>Operating Activities</b>			
Net income	\$ 141.3	\$ 105.1	\$ 82.2
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	50.3	45.6	40.1
Amortization of deferred gain on sale leaseback	(1.1)	(1.1)	(1.2)
Amortization of deferred financing costs	1.1	1.2	1.9
Loss on disposal of assets, net	1.5	-	0.4
Provision for doubtful accounts	1.1	3.4	2.6
Loss on early extinguishment of debt	-	-	19.9
Gain on sale of paint assets, net of acquisition and disposition costs	-	-	(7.0)
Warehouse facility closure costs	0.7	6.2	-
Other, net	0.2	0.5	0.2
Changes in operating assets and liabilities, exclusive of effect of acquisitions and dispositions:			
Receivables	(34.8)	(53.6)	(7.8)
Inventories	(133.1)	52.2	24.9
Other current assets	(15.0)	6.2	(4.4)
Other long-term assets	(20.9)	(1.1)	(9.9)
Accounts payable and accrued expenses	66.5	2.0	30.7
Other long-term liabilities	1.9	(0.5)	1.2
Deferred taxes	(0.8)	1.9	2.9
Net cash provided by operating activities	<u>58.9</u>	<u>168.0</u>	<u>176.7</u>
<b>Investing Activities</b>			
Purchases of marketable securities	(15.9)	(27.1)	(12.0)
Proceeds from sale of marketable securities	28.5	27.6	11.0
Purchases of property and equipment	(41.1)	(45.0)	(46.4)
Cash paid for acquired businesses, net of cash acquired	(63.2)	-	(52.0)
Proceeds from sale of paint manufacturing assets	-	-	34.8
Decrease in notes receivable, net	2.0	2.9	1.8
Other	0.5	0.2	0.2
Net cash used in investing activities	<u>(89.2)</u>	<u>(41.4)</u>	<u>(62.6)</u>
<b>Financing Activities</b>			
Net borrowings (payments) under revolving lines of credit	99.9	(78.6)	43.6
Proceeds from issuance of long-term debt	-	-	200.0
Redemption of senior notes	-	-	(301.3)
Principal payments on long-term debt	(24.1)	(16.3)	(9.5)
Payments of deferred financing costs	-	(0.7)	(5.2)
Payments of cash portion of patronage distribution	(36.6)	(27.1)	(27.7)
Payments of patronage refund certificates	(0.2)	(0.1)	(17.4)
Proceeds from sale of noncontrolling interests	2.0	0.1	0.3
Other	1.2	0.9	0.4
Net cash provided by (used in) financing activities	<u>42.2</u>	<u>(121.8)</u>	<u>(116.8)</u>
Increase (decrease) in cash and cash equivalents	11.9	4.8	(2.7)
Cash and cash equivalents at beginning of period	17.9	13.1	15.8
Cash and cash equivalents at end of period	<u>\$ 29.8</u>	<u>\$ 17.9</u>	<u>\$ 13.1</u>
Supplemental disclosure of cash flow information:			
Interest paid	<u>\$ 12.3</u>	<u>\$ 11.3</u>	<u>\$ 22.5</u>
Income taxes paid	<u>\$ 6.2</u>	<u>\$ 1.4</u>	<u>\$ 1.0</u>

See accompanying notes to the consolidated financial statements.



**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(In millions)**

**1) Summary of Significant Accounting Policies**

***The Company and Its Business***

Ace Hardware Corporation (“the Company”) is a wholesaler of hardware, paint and other related products. The Company also provides to its retail members value-added services such as advertising, marketing, merchandising and store location and design services. The Company’s goods and services are sold predominately within the United States, primarily to retailers that operate hardware stores and with whom the Company has a retail membership agreement. As a retailer-owned cooperative, the Company distributes substantially all of its patronage sourced income in the form of patronage distributions to member retailers based on their volume of merchandise purchases. See Note 8, Patronage Distributions and Refund Certificates Payable, for further discussion regarding patronage distributions.

On December 31, 2014, Ace Wholesale Holdings LLC (“AWH,” a newly-formed subsidiary of the Company) acquired all of the outstanding member units of Jensen-Byrd Co., LLC (“Jensen”), a wholesale hardlines distributor. See Note 2 for additional information.

On February 19, 2014, AWH acquired all of the outstanding shares of capital stock of Emery-Waterhouse (“Emery”), a distributor of hardlines products for independent lumber, paint, industrial and hardware outlets. Immediately following the acquisition, AWH sold a 5 percent noncontrolling interest in Emery to Emery’s current Chief Executive Officer. See Note 2 for additional information.

Effective December 16, 2012, Ace Retail Holdings LLC (“ARH”) acquired all of the outstanding shares of capital stock of WHI Holding Corp. (“WHI”), the indirect owner of the 85 store Westlake Ace Hardware retail chain. As a result of the acquisition of its largest Ace-branded customer, the Company has become a retailer of hardware, paint and other related products.

The Company’s international operations are a stand-alone legal entity with its own management team and board of directors. The entity Ace Hardware International Holdings, Ltd. (“AIH”) is a majority-owned and controlled subsidiary of the Company with a noncontrolling interest owned by its international retailers. International retailers do not own shares of stock in the Company nor receive patronage dividends.

***Basis of Presentation***

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). The Company’s fiscal year ends on the Saturday nearest December 31. Accordingly, fiscal years 2014, 2013 and 2012 ended on January 3, 2015, December 28, 2013 and December 29, 2012, respectively. Unless otherwise noted, all references herein for the years 2014, 2013 and 2012 represent fiscal years ended January 3, 2015, December 28, 2013 and December 29, 2012, respectively. Fiscal year 2014 consisted of 53 weeks while fiscal years 2013 and 2012 consisted of 52 weeks each.

Subsequent events have been evaluated through February 24, 2015, the date these statements were available to be issued.

***Principles of Consolidation***

The accompanying consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All intercompany transactions have been eliminated.

***Use of 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 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.

***Cash, Cash Equivalents and Marketable Securities***

The Company classifies all highly liquid investments with original maturities of three months or less as cash equivalents.

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(In millions)**

The Company determines the appropriate classification of its investments in marketable securities, which are predominately held by the Company's New Age Insurance, Ltd. ("NAIL") subsidiary, at the time of purchase and evaluates such designation at each balance sheet date. All marketable securities have been classified and accounted for as available for sale. The Company may hold debt securities until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, securities are occasionally sold prior to their stated maturities. Debt securities with maturities beyond twelve months are viewed by the Company as available to support current operations and are thereby classified as current assets in the accompanying Consolidated Balance Sheets. Marketable securities are carried at fair value based on quoted market prices, with unrealized gains and losses, net of taxes, reported as a component of Accumulated other comprehensive income ("AOCI"). Realized gains and losses on securities are determined using the specific identification method.

In the normal course of NAIL's operations, letters of credit of \$27.6 million and \$31.2 million at January 3, 2015 and December 28, 2013, respectively, were issued in favor of the insurance companies that reinsure a portion of NAIL's loss exposure. At January 3, 2015, NAIL has pledged substantially all of its cash and cash equivalents and marketable securities as collateral for these letters of credit.

***Revenue Recognition***

The Company recognizes wholesale revenue when products are shipped and the retailer takes ownership and assumes risk of loss and when services are rendered, provided collection of the resultant receivable is probable, persuasive evidence of an arrangement exists and the sales price is fixed and determinable. The Company records shipping and handling amounts billed to retailers as wholesale revenues, with the related costs recorded in cost of revenues. Direct expenses related to retail services are included in cost of revenues and indirect expenses from these activities are included in operating expenses. The Company also records amounts billed to the retailers for advertising activities, brand building initiatives and fees generated for various retail services as wholesale revenues. Revenues at retail locations operated by the Company are recognized when the customer takes ownership of the products sold and assumes ownership and the risk of loss. Provisions for sales returns are provided at the time the related sales are recorded.

***Receivables***

Receivables from retailers include amounts invoiced for the sale of merchandise, services and equipment used in the operation of retailers' businesses.

***Notes Receivable***

The Company makes available to its retailers various lending programs whose terms exceed one year. The notes bear interest at various rates based on market rates, the loan program or the retailer's credit quality and are recorded at face value. Interest is recognized over the life of the note on the effective interest method. Loan origination fees were not material for any period presented.

***Allowance for Doubtful Accounts***

Management records an allowance for doubtful accounts based on judgments considering a number of factors, primarily historical collection statistics, current member retailer credit information, the current economic environment, the aging of receivables, the evaluation of compliance with lending covenants and the offsetting amounts due to members for stock, notes, interest and anticipated but unpaid patronage distributions. The Company considers accounts and notes receivable past due if invoices remain unpaid past their due date and provides for the write-off of uncollectible receivables after exhausting all commercially reasonable collection efforts.

***Inventories***

Wholesale inventories are valued at the lower of cost or net realizable value. Cost is determined primarily using the last-in, first-out ("LIFO") method for all inventories.

Inventories at retail locations operated by the Company are valued at the lower of cost or net realizable value. Inventory cost is determined using the moving average method, which approximates the first-in, first-out ("FIFO") method.

***Vendor Funds***

The Company receives funds from vendors in the normal course of business principally as a result of purchase volumes, sales, early payments or promotions of vendors' products. Based on the provisions of the vendor agreements in place, management develops accrual rates by estimating the point at which the Company will have completed its performance under the agreement and the

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(In millions)**

amount agreed upon will be earned. Due to the complexity and diversity of the individual vendor agreements, the Company performs analyses and reviews of historical trends throughout the year to ensure the amounts earned are appropriately recorded. As part of these analyses, the Company validates its accrual rates based on actual purchase trends and applies those rates to actual purchase volumes to determine the amount of funds that should be accrued by the Company and receivable from the vendor. Amounts accrued throughout the year could be impacted if actual purchase volumes differ from projected annual purchase volumes, especially in the case of programs that provide for increased funding when graduated purchase volumes are met. At year end, the accrual reflects actual purchases made throughout the year.

Vendor funds are treated as a reduction of inventory cost, unless they represent a reimbursement of specific, incremental and identifiable costs incurred by the Company to sell the vendor's product, in which case the costs would be netted. Substantially all of the vendor funds that the Company receives do not meet the specific, incremental and identifiable criteria. Therefore, the Company treats a majority of these funds as a reduction of inventory as the amounts are accrued and recognizes these funds as a reduction of cost of revenues when the inventory is sold.

***Property and Equipment***

Property and equipment are stated at cost less accumulated depreciation and amortization. Expenditures for maintenance, repairs and renewals of relatively minor items are generally charged to expense. Significant improvements or renewals are capitalized. Depreciation expense is computed on the straight-line method based on estimated useful lives of 6 to 40 years for buildings and improvements and 3 to 20 years for equipment. Leasehold improvements are generally amortized on a straight-line basis over the lesser of the lease term or the estimated useful life of the asset.

The Company evaluates long-lived assets, such as property and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds its fair value.

***Goodwill and Other Intangible Assets***

Goodwill represents the excess of the cost of an acquired business over the amounts assigned to net assets. Goodwill is not amortized but is tested for impairment at a reporting unit level on an annual basis or more frequently, if circumstances change or an event occurs that would more likely than not reduce the fair value of a reporting unit below its carrying amount. No impairment charges were recorded for any periods presented.

The Company's other intangible assets primarily relate to the Westlake Ace Hardware trade name acquired in the WHI acquisition and a customer relationship intangible acquired in the Emery acquisition. The intangibles are amortized over their estimated useful lives. For additional information, see Note 7.

***Internal-Use Software***

Included in fixed assets is the capitalized cost of internal-use software. The Company capitalizes costs incurred during the application development stage of internal-use software and amortizes these costs over its estimated useful life. Costs incurred related to design or maintenance of internal-use software are expensed as incurred. For fiscal year 2014, 2013 and 2012, the Company capitalized \$3.5 million, \$3.7 million and \$1.6 million, respectively, of software development costs related to internal programming time. Amortization of these previously capitalized amounts was \$2.0 million, \$1.5 million and \$1.4 million for fiscal 2014, 2013 and 2012, respectively. As of January 3, 2015 and December 28, 2013, the Company had \$1.4 million and \$3.0 million, respectively, of capitalized costs for internal-use software that had not been placed into service.

***Leases***

The Company leases certain warehouse and distribution space, office space, retail locations, equipment and vehicles. All of the Company's leases are operating leases. As leases expire, management expects that in the normal course of business, certain leases will be renewed or replaced.

Certain lease agreements include escalating rent over the lease terms and rent holidays and concessions. The Company expenses rent on a straight-line basis over the life of the lease, which commences on the date the Company has the right to control the property. The cumulative expense recognized on a straight-line basis in excess of the cumulative payments is included in Other long-term liabilities in the Consolidated Balance Sheets.

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(In millions)**

***Advertising Expense***

The Company expenses advertising costs when incurred. Gross advertising expenses amounted to \$129.5 million, \$108.6 million, and \$103.8 million in fiscal 2014, 2013 and 2012, respectively.

***Retirement Plans***

The Company participates in a multi-employer defined benefit retirement plan covering a limited number of former union employees. Costs with respect to the noncontributory pension plan are determined actuarially and consist of current costs and amounts to amortize unrecognized prior service costs and unrecognized gains and losses. See Note 16 for detail on the Company's intention to withdraw from this plan.

The Company also sponsors health benefit plans for its retired officers and a limited number of non-officer employees. The Company and its subsidiaries also sponsor defined contribution profit sharing plans for substantially all employees. The Company's contribution under these plans is determined annually by the Board of Directors and charged to expense in the period in which it is earned by employees.

***Income Taxes***

The Company accounts for income taxes under the asset and liability method. Under this approach, deferred taxes are recognized for the future tax consequences of differences between the financial statement and income tax bases of existing assets and liabilities, and measured based upon enacted tax laws and rates.

***Self-Insurance***

The Company has a wholly-owned subsidiary, NAIL, which operates as a captive insurance company. This entity provides the reinsurance of property and casualty insurance policies for some retailer members and is the direct insurer for certain property and casualty insurance policies of the Company. These insurance programs are subject to varying retention levels of self-insurance. Such self-insurance relates to losses and liabilities primarily associated with property, general liability, workers' compensation and auto liability insurance programs. Losses are accrued based upon the Company's estimates of the aggregate liability for claims incurred using certain actuarial assumptions based on Company experience and insurance industry metrics.

***Concentration of Credit Risk***

Credit risk pertains primarily to the Company's trade and notes receivables. The Company extends credit to its members as part of its day-to-day operations. Management believes that as no specific receivable or group of receivables comprises a significant percentage of total trade accounts, its concentration of credit risk with respect to trade receivables is limited. Additionally, management believes that its allowance for doubtful accounts is adequate with respect to overall member credit risks. Also, the Company's certificate of incorporation and by-laws specifically provide that the Company may set-off its obligation to make any payment to a member for such member's stock, notes, interest and declared and unpaid distributions against any obligation owed by the member to the Company. The Company, but not the member, may at its sole discretion exercise these set-off rights when any such funds become due to former members with outstanding accounts and notes receivable owed to the Company and current members with past due receivables owed to the Company.

***Impact of New Accounting Standards***

***New Accounting Pronouncements - Adopted***

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-02, "Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." ASU 2013-02 requires the Company to report, in one place, information about reclassifications out of AOCI. The Company is also required to present reclassifications by component when reporting changes in AOCI balances. For significant items reclassified out of AOCI to net income in their entirety in the period, the Company must report the effect of the reclassifications on the respective line items in the statement when net income is presented. ASU 2013-02 is effective for the Company for fiscal years and interim periods beginning after December 15, 2013. The Company adopted ASU 2013-02 in the first quarter of 2014. ASU 2013-02 does not have a material impact on the Company's consolidated financial statements.

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

*New Accounting Pronouncements - Issued*

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” The purpose of ASU 2014-09 is to develop a common revenue recognition standard for GAAP and International Financial Reporting Standards. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 allows either full retrospective adoption, meaning the standard is applied to all periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements. ASU 2014-09 is effective for the Company for annual reporting periods after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. The Company is still evaluating the impact that ASU 2014-09 will have on the Company’s consolidated financial statements.

**(2) Acquisitions**

On December 31, 2014, AWH acquired all of the outstanding member units of Jensen, a wholesale hardlines distributor, for \$33.6 million (subject to final working capital adjustments). The acquisition has been accounted for as a business combination. As of January 3, 2015, the Company recorded a preliminary allocation of the purchase price to acquired tangible assets and liabilities assumed based on their fair value at the acquisition date. The Company is in the process of determining the value, if any, for identifiable intangible assets. The Company expects to complete the purchase price allocation by the end of fiscal 2015. Based on the preliminary purchase price allocation, the Company recorded \$3.5 million of goodwill. Goodwill has an indefinite life and, therefore, is not amortized. The goodwill is expected to be deductible for tax purposes.

The following table summarizes the consideration paid for Jensen and the preliminary purchase price allocation at the acquisition date:

Fair value of assets acquired and liabilities assumed:	
Cash	\$ 2.9
Receivables	17.3
Inventories	26.6
Other current assets	0.2
PP&E	2.0
Goodwill	3.5
Current liabilities	(18.9)
	\$ 33.6

On February 19, 2014, AWH acquired all of the outstanding shares of capital stock of Emery, a distributor of hardlines products for independent lumber, paint, industrial and hardware outlets, for \$33.3 million. Immediately following the acquisition, AWH sold a 5 percent noncontrolling interest in Emery to Emery’s current Chief Executive Officer for approximately \$1.7 million. The acquisition has been accounted for as a business combination. As of January 3, 2015, the Company recorded the allocation of the purchase price to acquired tangible assets and liabilities assumed based on their fair value at the acquisition date. As a result, the Company recorded \$5.3 million of goodwill and \$2.7 million for the fair value of a customer relationship intangible asset. Goodwill has an indefinite life and, therefore, is not amortized, while the customer relationship intangible will be amortized over 10 years. The goodwill and customer relationship intangible asset are expected to be deductible for tax purposes.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

The following table summarizes the consideration paid for Emery and the preliminary purchase price allocation at the acquisition date:

Fair value of assets acquired and liabilities assumed:	
Cash	\$ 0.8
Receivables	11.6
Inventories	27.7
Other current assets	0.7
PP&E	3.8
Goodwill	5.3
Customer relationship intangible	2.7
Current liabilities	(19.3)
	<u>\$ 33.3</u>

**(3) Receivables, net**

Receivables, net include the following amounts:

	January 3, 2015	December 28, 2013
Trade	\$ 315.1	\$ 277.8
Other	62.3	55.8
Notes receivable – current portion	10.9	11.6
Less: allowance for doubtful accounts	(6.5)	(9.3)
Receivables, net	<u>\$ 381.8</u>	<u>\$ 335.9</u>

Other receivables are principally amounts due from suppliers for promotional and advertising allowances.

**(4) Inventories**

Inventories consist of wholesale merchandise inventories held for sale to retailers and retail merchandise inventory held for resale at company-operated retail locations. Substantially all of the Company's wholesale inventories are valued on the LIFO method. The excess of replacement cost over the LIFO value of inventory was \$94.0 million and \$96.3 million at January 3, 2015 and December 28, 2013, respectively.

Inventories consisted of:

	January 3, 2015	December 28, 2013
Wholesale merchandise inventory (LIFO)	\$ 623.6	\$ 439.2
Retail merchandise inventory at Company-operated stores (FIFO)	69.3	66.3
Inventories	<u>\$ 692.9</u>	<u>\$ 505.5</u>

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

**(5) Property and Equipment, net**

Property and equipment, net is summarized as follows:

	January 3, 2015	December 28, 2013
Land	\$ 15.9	\$ 15.9
Buildings and improvements	266.1	263.8
Warehouse equipment	127.1	122.4
Office equipment	227.8	203.0
Transportation equipment	43.2	45.3
Leasehold improvements	31.6	29.7
Construction in progress	4.3	23.1
Property and equipment, gross	716.0	703.2
Less: accumulated depreciation and amortization	(393.0)	(378.5)
Property and equipment, net	<u>\$ 323.0</u>	<u>\$ 324.7</u>

Depreciation and amortization expense for fiscal years 2014, 2013 and 2012 was \$48.8 million, \$44.7 million and \$40.1 million, respectively.

**(6) Notes Receivable, net**

The Company makes available to its retailers various lending programs whose terms exceed one year. At January 3, 2015 and December 28, 2013, the outstanding balance of the notes was \$34.0 million and \$44.2 million, respectively, of which the current portion of \$10.9 million and \$11.6 million, respectively, was recorded in Receivables, net. Payments on these notes are primarily collected by the Company through the application of future patronage distributions, retailer billings or stock repurchases.

At January 3, 2015 and December 28, 2013, \$20.8 million and \$27.1 million, respectively, of the Notes receivable were from the Company's Equity Match Financing ("EMF") program, which offered financing to qualified retailers to facilitate new store growth. These loans are repaid by the application of the non-cash portion of the annual patronage distribution. As a result, the Company reduces the Notes receivable balance in the Consolidated Balance Sheets by the amount of the non-cash portion of the annual patronage distribution that it expects to apply against outstanding EMF loans. Notes receivable consist of the following components:

	January 3, 2015	December 28, 2013
Notes receivable, gross	\$ 43.7	\$ 54.1
Less: estimated patronage applications from 2014 and 2013, respectively	(9.7)	(9.9)
Net	34.0	44.2
Less: current portion	(10.9)	(11.6)
Less: allowance for doubtful accounts	(10.9)	(11.4)
Notes receivable, net	<u>\$ 12.2</u>	<u>\$ 21.2</u>

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

For substantially all of the Company's Notes receivable, the amounts due are generally expected to be collected through the non-cash portion of the patronage distribution. In the event a retailer cancels its membership with the Company, any outstanding loans are transferred from Notes receivable to Accounts receivable and are due immediately. As the non-cash portion of the patronage distribution is used to settle the Notes receivable, there are no loans that are currently past due. The patronage distribution for each retailer can vary from year to year based on the Company's financial performance as well as the volume of patronage-based merchandise that each retailer purchases from the Company. The estimated maturities of the Notes receivable are as follows:

	January 3, 2015
0 – 4 years	\$ 23.2
5 – 8 years	13.9
9 – 12 years	6.6
Total	<u>\$ 43.7</u>

Pursuant to the Company's Amended and Restated Certificate of Incorporation and the Company's by-laws, notes receivable (like all obligations owed to the Company by the Company's retailers) are secured by the Company stock owned by the retailers. However, for some retailers, the redemption value of their stock does not fully cover their obligations.

The Company evaluates risk on its loan portfolio by categorizing each loan into an internal risk category. The Company's risk categories include:

Low – The retailer possesses a strong financial position, above average payment record to both Ace and other vendors, and the business is well established.

Medium – The retailer possesses an average financial position, an average payment record to both Ace and other vendors, and the business is somewhat established.

High – The retailer possesses a weak financial position, a substandard payment record to Ace or other vendors, or the business is somewhat new.

Based upon these criteria, the Company has classified its loan portfolio as follows:

	January 3, 2015	December 28, 2013
Corporate Credit Exposure:		
Low risk	\$ 21.1	\$ 31.7
Moderate risk	9.9	9.6
High risk	12.7	12.8
Total	<u>\$ 43.7</u>	<u>\$ 54.1</u>

The Company applies a consistent practice of establishing an allowance for notes that it feels may become uncollectible by monitoring the financial strength of its retailers. The collectability of certain notes is evaluated on an individual basis while the remaining notes are evaluated on a collective basis. The breakdown at January 3, 2015 and December 28, 2013 of notes evaluated individually versus notes evaluated collectively was as follows:

	January 3, 2015	December 28, 2013
Notes receivable:		
Ending balance individually evaluated for impairment	\$ 9.4	\$ 9.2
Ending balance collectively evaluated for impairment	34.3	44.9
Ending principal balance	<u>\$ 43.7</u>	<u>\$ 54.1</u>

The Company has evaluated the collectability of the notes and has established an allowance for doubtful accounts of \$10.9 million and \$11.4 million at January 3, 2015 and December 28, 2013, respectively. Management records the allowance for doubtful accounts based on the above information as well as judgments made considering a number of factors, primarily historical collection



**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

statistics, current member retailer credit information, the current economic environment and the offsetting amounts due to members for stock, notes, interest and declared and unpaid patronage distributions. The components of changes to the Notes receivable allowance for doubtful accounts for 2014 and 2013 were as follows:

	January 3, 2015	December 28, 2013
<b>Allowance for doubtful accounts:</b>		
Beginning balance	\$ 11.4	\$ 13.9
Charge offs	-	(2.9)
Provision	0.2	0.4
Reclassifications to accounts receivable allowance for doubtful accounts	(1.2)	(0.5)
Reclassifications from accounts receivable allowance for doubtful accounts	0.5	0.5
Ending balance	<u>\$ 10.9</u>	<u>\$ 11.4</u>

Notes bear interest at various rates based on the retailer's credit quality and are recorded at face value. Interest is recognized over the life of the note based on the outstanding balance and stated interest rate, which approximates the effective interest method. During fiscal years 2014, 2013 and 2012, \$1.8 million, \$2.3 million and \$2.4 million respectively, were recorded as interest income related to the notes.

Generally, in the event a retailer cancels their membership with the Company, any outstanding notes receivable, and related allowance for doubtful accounts, are transferred to trade receivables and the retailer is billed for any unpaid principal and interest balances. In fiscal 2014 and 2013, \$5.9 million and \$3.7 million, respectively, of Notes receivable were transferred to trade receivables as an event occurred which made the note due immediately. Upon transfer of the Notes receivable to Accounts receivable, \$1.2 million and \$0.5 million of the Notes receivable allowance for doubtful accounts was transferred to the Accounts receivable allowance for doubtful accounts to properly match the reserve against the asset on the Consolidated Balance Sheet.

**(7) Goodwill and Other Intangible Assets**

The carrying value of Goodwill and other intangible assets as of January 3, 2015 and December 28, 2013 are as follows:

	January 3, 2015	December 28, 2013
<b>Intangible assets:</b>		
Goodwill	\$ 25.7	\$ 16.9
Trademarks and trade name	7.6	7.6
Customer relationships	2.7	-
Total intangible assets	36.0	24.5
Less: accumulated amortization	1.0	0.4
Goodwill and other intangible assets	<u>\$ 35.0</u>	<u>\$ 24.1</u>

The trademarks and trade name are being amortized over 20 years. The customer relationship intangible is being amortized over 10 years. Net amortization expense related to all intangible assets was \$0.6 million and \$0.4 million for the years ended January 3, 2015 and December 28, 2013, respectively. The estimated net amortization expense for the next five fiscal years is \$0.7 million per year.

**(8) Patronage Distributions and Refund Certificates Payable**

The Company operates as a cooperative organization and has paid or may pay patronage distributions to member retailers on a portion of patronage based income derived from business done with such retailers. Patronage distributions are allocated in proportion to the volume of purchases by member retailers during the period. The cash portion of the patronage distribution was 40% for all years presented.

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

The patronage distribution composition is summarized as follows:

	<b>Years Ended</b>		
	January 3, 2015	December 28, 2013	December 29, 2012
Cash portion	\$ 53.7	\$ 39.9	\$ 30.0
Class C stock	56.5	40.9	25.7
Patronage refund certificates	10.7	5.9	7.2
Patronage financing deductions	10.8	11.4	10.6
Patronage distributions applied to variance allocation	-	0.1	0.2
Patronage due to subsidiary	-	-	1.8
<b>Total patronage distributions to third party retailers</b>	<b>\$ 131.7</b>	<b>\$ 98.2</b>	<b>\$ 75.5</b>

Patronage distributions are allocated on a fiscal year basis with issuance in the following year.

In fiscal years 2010 to 2013, a portion of the patronage distribution was distributed in the form of a patronage refund certificate having maturity dates and bearing interest as determined by the Company's Board of Directors. The Company also plans to issue patronage refund certificates with maturity dates and bearing interest as determined by the Company's Board of Directors in those instances where the maximum Class C stock requirements have been met for the 2014 patronage distribution.

The patronage refund certificates outstanding at January 3, 2015 are payable as follows:

	Amount	Interest Rate
2016	\$ 6.6	4.00%
2017	8.7	4.00%
2018	7.0	4.00%
2019	5.9	4.00%
2020	10.7	4.00%

**(9) Debt**

The Company has a secured credit facility with a group of banks that consists of a \$170.0 million amortizing term loan ("Term Loan Facility") and a \$400.0 million revolving credit facility ("Revolving Credit Facility"). The facility is expandable to \$720.0 million via a \$150.0 million accordion that is exercisable without the consent of existing lenders provided that the Company is not in default of the credit agreement and further provided that none of the existing lenders are required to provide any portion of the increased facility. Borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 50 basis points to 150 basis points or 150 to 250 basis points over the London Interbank Offered Rate ("LIBOR") depending on the Company's leverage ratio as defined under the agreement. The facility was priced at LIBOR plus 150 basis points at January 3, 2015. This facility requires maintenance of certain financial covenants including a maximum allowable average leverage ratio, a minimum fixed charge coverage ratio and a minimum asset coverage ratio, and expires on July 27, 2018. As of January 3, 2015, the Company was in compliance with its covenants and a total of \$254.5 million was outstanding under the credit facility.

The Term Loan Facility requires the Company to make principal repayments of \$5.0 million per quarter through March 2017, with no additional installments through maturity on July 27, 2018. Any remaining principal balance will be repaid at the maturity.

The Revolving Credit Facility includes a \$175.0 million sublimit for the issuance of standby and commercial letters of credit. As of January 3, 2015, a total of \$29.9 million in letters of credit were outstanding. The Revolving Credit Facility requires the Company to pay fees based on the unused portion of the line of credit at a rate of 15 to 35 basis points per annum depending on the Company's leverage ratio.

The credit facility allows the Company to make revolving loans and other extensions of credit to AIH in an aggregate principal amount not to exceed \$75.0 million at any time. As of January 3, 2015, there were no loans or other extensions of credit provided to AIH.

In order to reduce the risk of interest rate volatility, the Company entered into an interest rate swap derivative agreement in June 2012, which expires on March 13, 2017. This swap agreement fixes the LIBOR rate on the full balance of the Term Loan Facility at 1.13%, resulting in an effective rate of 2.63% after adding the 1.50% margin based on the current pricing tier per the credit agreement.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

The notional amount of the derivative agreement decreases to match the principal balance remaining as principal payments are made throughout the term of the loan agreement. The swap arrangement has been designated as a cash flow hedge and has been evaluated to be highly effective. As a result, the after-tax change in the fair value of the swap is recorded in AOCI as a gain or loss on derivative financial instruments.

The Company's ARH subsidiary has a \$60.0 million asset-based revolving credit facility ("ARH Facility"). The ARH Facility matures on June 28, 2019 and is expandable to \$85.0 million under certain conditions. In addition, the Company has the right to issue letters of credit up to a maximum of \$7.5 million. At the Company's discretion, borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 35 basis points to 75 basis points or LIBOR plus an applicable spread of 135 basis points to 175 basis points, depending on the Company's availability under the ARH Facility as measured on a quarterly basis.

The ARH Facility is collateralized by substantially all of ARH's personal property and intangible assets. Borrowings under the facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible collateral balances (primarily consisting of certain receivables and inventories). This agreement requires maintenance of certain financial covenants including a minimum fixed charge coverage ratio. As of January 3, 2015, ARH was in compliance with its covenants. At year-end, ARH had \$15.5 million in loans outstanding under its Facility.

The ARH Facility requirements include a lender-controlled cash concentration system that results in all of ARH's daily available cash being applied to the outstanding borrowings under this facility. Pursuant to FASB Accounting Standards Codification Section 470-10-45, "Classification of Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses," the borrowings under the ARH Facility have been classified as a Current maturity of long-term debt as of January 3, 2015.

Total debt outstanding is comprised of the following:

	January 3, 2015	December 28, 2013
Term Loan Facility	\$ 170.0	\$ 187.5
Revolving Credit Facility	84.5	-
ARH Facility	15.5	-
Installment notes with maturities through 2018 at a fixed rate of 6.00%	13.7	14.5
<b>Total debt</b>	<b>283.7</b>	<b>202.0</b>
Less: maturities within one year	(41.5)	(23.4)
<b>Long-term debt</b>	<b>\$ 242.2</b>	<b>\$ 178.6</b>

The aggregate scheduled maturities of long-term debt at January 3, 2015 are as follows:

<b>Fiscal Year</b>	<b>Amount</b>
2015	\$ 41.5
2016	23.6
2017	7.8
2018	210.8
<b>Total debt</b>	<b>\$ 283.7</b>

**(10) Retirement Plans**

The Company has healthcare plans under which a limited number of qualified retired employees receive certain health care, dental care, life insurance or related benefits. Amounts expensed under these plans totaled \$0.1 million or less in fiscal years 2014, 2013 and 2012.

The Company participates in one multi-employer plan covering former union employees. Amounts expensed for this plan totaled \$0.2 million in fiscal years 2014, 2013 and 2012, respectively. See Note 16 for detail on the Company's intention to withdraw from this plan.

The Company and its subsidiaries maintain profit sharing and 401k retirement plans for substantially all employees. Amounts expensed under these plans totaled \$20.4 million, \$17.2 million and \$17.1 million during fiscal 2014, 2013 and 2012, respectively.

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(In millions)

**(11) Accrued Expenses**

Accrued expenses include the following components:

	January 3, 2015	December 28, 2013
Salaries and wages	\$ 55.8	\$ 47.0
Insurance reserves	14.6	15.9
Deferred income	5.4	14.0
Vendor funds	17.5	13.4
Taxes	9.5	10.3
Profit sharing	11.0	8.6
Gift card	6.6	6.8
Interest	0.5	1.3
Other	41.6	48.6
Accrued expenses	<u>\$ 162.5</u>	<u>\$ 165.9</u>

**(12) Fair Value**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There is a three-level hierarchy for disclosure to show the extent and level of judgment used to estimate fair value measurements.

Level 1 — Uses unadjusted quoted prices that are available in active markets for the identical assets or liabilities as of the reporting date.

Level 2 — Uses inputs other than Level 1 that are either directly or indirectly observable as of the reporting date through correlation with market data, including quoted prices for similar assets and liabilities in active markets and quoted prices in markets that are not active. Level 2 also includes assets and liabilities that are valued using models or other pricing methodologies that do not require significant judgment since the input assumptions used in the models, such as interest rates and volatility factors, are corroborated by readily observable data.

Level 3 — Uses inputs that are unobservable and are supported by little or no market activity and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

The tables below set forth, by level, the Company's financial assets, liabilities and derivative instruments that were accounted for at fair value as of January 3, 2015 and December 28, 2013. The tables do not include cash on hand and also do not include assets and liabilities that are measured at historical cost or any basis other than fair value. The carrying values for other current financial assets and liabilities, such as accounts receivable and accounts payable, approximate fair value due to the short maturity of such instruments.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

<b>Items measured at fair value on a recurring basis</b>	Carrying Value Measured at Fair Value			
	January 3, 2015	Level 1	Level 2	Level 3
<b>Assets:</b>				
Cash equivalents:				
Money market funds	\$ 10.8	\$ 10.8	\$ -	\$ -
Marketable securities:				
Corporate fixed income securities	13.3	-	13.3	-
Fixed income and equity mutual fund securities	11.7	11.7	-	-
Mortgage-backed securities	6.6	-	6.6	-
U.S. government notes	10.2	10.2	-	-
Other	0.4	-	0.4	-
Total marketable securities	<u>\$ 42.2</u>	<u>\$ 21.9</u>	<u>\$ 20.3</u>	<u>\$ -</u>
Other long-term liabilities:				
Interest rate swap derivative	\$ 1.1	\$ -	\$ 1.1	\$ -

<b>Items measured at fair value on a recurring basis</b>	Carrying Value Measured at Fair Value			
	December 28, 2013	Level 1	Level 2	Level 3
<b>Assets:</b>				
Cash equivalents:				
Money market funds	\$ 1.7	\$ 1.7	\$ -	\$ -
Marketable securities:				
Corporate fixed income securities	13.1	-	13.1	-
Fixed income and equity mutual fund securities	24.7	24.7	-	-
Mortgage-backed securities	8.1	-	8.1	-
U.S. government notes	6.9	6.9	-	-
Other	1.0	-	1.0	-
Total marketable securities	<u>\$ 53.8</u>	<u>\$ 31.6</u>	<u>\$ 22.2</u>	<u>\$ -</u>
Other long-term liabilities:				
Interest rate swap derivative	\$ 1.8	\$ -	\$ 1.8	\$ -

*Money market funds, Fixed income and equity mutual fund securities and U.S. government notes* - The Company's valuation techniques used to measure the fair values of money market funds, fixed income and equity mutual fund securities and U.S. government notes, that were classified as Level 1 in the tables above, are derived from quoted market prices for identical instruments, as active markets for these instruments exist.

*Corporate fixed income securities and Mortgage-backed securities* - The Company's valuation techniques used to measure the fair values of corporate fixed income securities and mortgage-backed securities, that were classified as Level 2 in the tables above, are derived from the following: non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models, such as discounted cash flow techniques, with all significant inputs derived from or corroborated by observable market data.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

There were no material differences between the fair value and cost basis of the Company's marketable securities at January 3, 2015 and December 28, 2013, respectively. Gross proceeds from the sale of marketable securities and the related realized gains and losses for the fiscal years ended January 3, 2015, December 28, 2013 and December 29, 2012 were as follows:

	<b>Years Ended</b>		
	January 3, 2015	December 28, 2013	December 29, 2012
Gross proceeds	\$ 28.5	\$ 27.6	\$ 11.0
Gross realized gains	0.6	0.5	0.2
Gross realized losses	(0.7)	(0.2)	(0.1)

Gross realized gains and losses were determined using the specific identification method. For the fiscal year ended January 3, 2015, the Company reclassified \$0.6 million of unrealized gains and \$0.7 million of unrealized losses on marketable securities that were recorded in AOCI as of December 28, 2013 into realized income. These amounts were recorded to Other income, net in the Consolidated Statements of Income.

The following table summarizes the contractual maturity distributions of the Company's debt securities at January 3, 2015. Actual maturities may differ from the contractual or expected maturities since borrowers may have the right to prepay obligations with or without prepayment penalties.

Fair value of available-for-sale debt securities	Due in One Year or Less	Due After One Year through Five Years	Due After Five Years through Ten Years	Due After Ten Years	Total
Corporate fixed income securities	\$ 1.3	\$ 4.8	\$ 5.1	\$ 2.1	\$ 13.3
Mortgage-backed securities	-	-	-	6.6	6.6
U.S. government notes	-	5.2	2.9	2.1	10.2
Other	-	0.1	-	0.3	0.4
<b>Total</b>	<b>\$ 1.3</b>	<b>\$ 10.1</b>	<b>\$ 8.0</b>	<b>\$ 11.1</b>	<b>\$ 30.5</b>

The Company uses variable-rate LIBOR debt to finance its operations. These debt obligations expose the Company to interest rate volatility risk. The Company attempts to minimize this risk and fix a portion of its overall borrowing costs through the utilization of interest rate swap derivatives. Variable cash flows from outstanding debt are converted to fixed-rate cash flows by entering into receive-variable, pay-fixed interest-rate swaps. The Company does not use derivative instruments for trading or speculative purposes, and all derivative instruments are recognized in the Consolidated Balance Sheet at fair value. Hedge ineffectiveness is eliminated by matching all terms of the hedged item and the hedging derivative at inception and on an ongoing basis. The Company does not exclude any terms from consideration when applying the matched terms method.

On June 5, 2012, the Company entered into a 58-month interest rate swap agreement, which expires on March 13, 2017, with an amortizing notional amount of \$200.0 million. This instrument is being used to fix the LIBOR rate on the full balance of the term loan amount at 1.13%, resulting in an effective rate of 2.63% after adding the 1.50% margin based on the current pricing tier per the credit agreement — see Note 9 for more information. As of January 3, 2015, the notional amount of the 58-month interest rate swap agreement remaining was \$170.0 million, matching the outstanding balance of the term loan.

The fair value of the Company's interest rate swap is estimated using Level 2 inputs, which are based on model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. The Company also considers counterparty credit-risk and bilateral or "own" credit risk adjustments in estimating fair value, in accordance with the requirements of GAAP. As of January 3, 2015 and December 28, 2013, the fair value of the interest rate swap was a liability balance of \$1.1 million and \$1.8 million. The Company classifies derivative liabilities as Other long-term liabilities on the Consolidated Balance Sheet.

Because the interest rate swap has been designated as a cash flow hedge and has been evaluated to be highly effective, the change in the fair value is recorded in AOCI as a gain or loss on derivative financial instruments. The amount in AOCI is reclassified to earnings if the derivative instrument is sold, extinguished or terminated, or at the time it becomes expected to be sold, extinguished or terminated. As of January 3, 2015 and December 28, 2013, the net of tax amount recorded in AOCI for the fair value adjustment of the interest rate swap was an unrealized loss of \$0.7 million and \$1.1 million, respectively. This unrealized loss is not expected to be reclassified into interest expense within the next 12 months. The impact of any ineffectiveness is recognized in earnings. However, there was no hedge ineffectiveness related to the interest rate swap for the years ended January 3, 2015 and December 28, 2013.

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

The Company's debt instruments are recorded at cost on the Consolidated Balance Sheets. The fair value of long-term debt was approximately \$284.9 million at January 3, 2015, compared to the carrying value, including accrued interest, of \$284.2 million.

**(13) Income Taxes**

Income tax expense includes the following components:

	<b>Years Ended</b>		
	January 3, 2015	December 28, 2013	December 29, 2012
<b>Current:</b>			
Federal	\$ (0.2)	\$ (1.6)	\$ (0.1)
State	(1.2)	(0.6)	(0.1)
Foreign	(0.5)	(0.5)	(0.5)
Current income tax expense	(1.9)	(2.7)	(0.7)
<b>Deferred:</b>			
Federal	(4.5)	(2.0)	(2.6)
State	0.2	0.1	(0.3)
Foreign	(0.1)	0.1	0.1
Deferred income tax expense	(4.4)	(1.8)	(2.8)
Total income tax expense	<u>\$ (6.3)</u>	<u>\$ (4.5)</u>	<u>\$ (3.5)</u>

Income tax differs from the amount computed by applying the statutory U.S. Federal income tax rate of 35% to income before income taxes because of the effect of the following items:

	<b>Years Ended</b>		
	January 3, 2015	December 28, 2013	December 29, 2012
Expected tax at U.S. Federal income tax rate	\$ (51.7)	\$ (38.4)	\$ (30.0)
Patronage distribution deductions	46.1	34.4	26.4
Other, net	(0.7)	(0.5)	0.1
Income tax expense	<u>\$ (6.3)</u>	<u>\$ (4.5)</u>	<u>\$ (3.5)</u>

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

Deferred income taxes reflect the tax effects of temporary differences between the carrying amounts of existing assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows:

	January 3, 2015	December 28, 2013
<b>Deferred tax assets:</b>		
Capital loss carryforwards	\$ 0.1	\$ -
AMT and other tax credit carryforwards	6.5	10.2
Net operating loss carryforwards	9.3	5.8
Unearned insurance premium and loss reserves	0.2	0.6
Allowance for doubtful accounts	6.3	7.6
Inventory reserves	4.8	2.8
Deferred vendor rebates	9.8	8.5
Accrued compensation and benefits expense	20.3	19.4
Other reserves	17.9	18.1
Total deferred tax assets	75.2	73.0
Less: valuation allowance	(3.1)	(1.5)
Deferred tax assets	72.1	71.5
<b>Deferred tax liabilities:</b>		
Depreciation and deferred gains on property and equipment	16.8	17.4
Amortization of intangibles	2.0	2.0
Fair market value of leases	1.1	1.2
Prepaid expenses and deferred income	12.5	6.5
Inventory valuation	26.0	25.9
Deferred tax liabilities	58.4	53.0
Net deferred tax assets	\$ 13.7	\$ 18.5

A reconciliation of the net deferred tax assets to the Consolidated Balance Sheets is as follows:

	January 3, 2015	December 28, 2013
Net deferred tax assets – current	\$ 12.8	\$ 15.3
Net deferred tax assets – noncurrent	0.9	3.2
Net deferred tax assets	\$ 13.7	\$ 18.5

The current portion of the net deferred tax assets is included in Prepaid expenses and other current assets. The noncurrent portion of the net deferred tax assets is included in Other assets.

At January 3, 2015, the Company has federal and state net operating loss carryforwards of \$27.7 million available for offset against future taxable income. The net operating losses may be carried forward to the tax years 2031 through 2034. The Company has international net operating losses from its Hong Kong and Panama operations of \$2.0 million and \$0.2 million, respectively. The net operating losses from Hong Kong may be carried forward indefinitely. The net operating losses from Panama may be carried forward to the tax years 2017 through 2018.

At January 3, 2015, the Company has alternative minimum tax credit carryforwards of \$3.0 million. The carryforward period for alternative minimum tax credits is indefinite.

At January 3, 2015, the Company has state tax credit carryforwards of \$3.5 million available to offset future state income tax expense. The state tax credits may be carried forward to tax years 2015 through 2019. A valuation allowance of \$3.1 million has been established against the state tax credits as it is more likely than not that the benefit of the tax credits will not be realized.

The federal income tax returns of the consolidated group are subject to examination by the Internal Revenue Service (“IRS”), generally for three years after the returns are filed. The 2011 through 2014 tax years remain subject to examination by the IRS. For state purposes, the 2010 through 2014 tax years remain subject to examination.



**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

The Company recognizes interest and penalties related to uncertain tax positions in Income tax expense. Accrued interest and penalties included in the reserve for uncertain tax positions at January 3, 2015 and December 28, 2013 was \$0.3 million and \$0.1 million, respectively. The Company recognized an expense of \$0.2 million and a benefit of \$0.2 million related to interest and penalties within Income tax expense for the years ended January 3, 2015 and December 29, 2012, respectively. It is reasonably possible that the total amount of unrecognized tax benefits will increase or decrease within the next twelve months. The Company currently estimates that such increases and decreases will not be significant.

**(14) Capital Stock**

The Company's classes of stock are described below (not in millions):

	<b>Number of Shares at</b>	
	January 3, 2015	December 28, 2013
<b>Class A stock, voting, redeemable at par value:</b>		
Authorized	10,000	10,000
Issued and outstanding	2,751	2,764
<b>Class C stock, nonvoting, redeemable at not less than par value:</b>		
Authorized	6,000,000	4,000,000
Issued and outstanding	3,425,232	3,156,908
Issuable as patronage distributions	565,068	408,684
<b>Additional stock subscribed:</b>		
Class A stock	-	-
Class C stock	-	50

No dividends can be declared on any shares of any class of the Company's stock.

Upon termination of the Company's membership agreement with any retail outlet, all shares of stock of the Company held by the retailer owning or controlling such outlet must be sold back to the Company, unless a transfer of such shares is made to another party accepted by the Company as a member retailer with respect to the same outlet. A single Class A share is issued to a member retailer only when the share subscribed has been fully paid and Class C shares are issued only when all shares subscribed with respect to a retail outlet have been fully paid. Additional stock subscribed in the accompanying consolidated financial statements represents the paid portion of stock subscribed for stores that have not opened. All shares of stock are currently issued and repurchased at par value. The Company classifies the repurchase value of capital stock in Accrued expenses when the redemption of shares is probable to occur.

**(15) Commitments and Contingencies**

*Lease commitments*

The Company rents certain warehouse and distribution space, office space, retail locations, equipment and vehicles under operating leases. At January 3, 2015, annual minimum rental commitments under leases that have initial or remaining noncancelable terms in excess of one year, net of sublease income, are as follows:

<b>Fiscal Year</b>	<b>Amount</b>
2015	\$ 54.6
2016	51.6
2017	44.6
2018	36.8
2019	32.5
Thereafter	129.7
<b>Minimum lease payments</b>	<b>\$ 349.8</b>

Minimum lease payments include \$6.0 million of minimum lease payments for store leases that the Company has assigned to member retailers. As a condition of the sale of the former Company-owned stores, the Company remains contingently liable for

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(In millions)**

payment under approximately six lease arrangements. The leases have varying terms, the latest of which expires in 2025. The Company believes that due to the nature of the agreements, the possibility of payment on a majority of the leases is remote. The Company has recorded a contingent liability of \$1.2 million as of January 3, 2015, net of sublease rent collected, for leases in which the Company is currently making payments or believes that it is probable that it will make payments before the lease term expires. These liabilities are included in Accrued expenses in the Consolidated Balance Sheet as of January 3, 2015.

All other leases expire prior to the end of 2028. Under certain leases, the Company pays real estate taxes, insurance and maintenance expenses in addition to rental expense. ARH rents a majority of its retail store location properties, as well as its corporate headquarters and distribution center, under long-term operating leases that generally provide for payment of minimum annual rent payments, real estate taxes, insurance and maintenance and, in some cases, contingent rent (calculated as a percentage of sales) in excess of minimum rent. The amount of contingent rent paid since the date of the acquisition of ARH was not material. With the exception of store leases assigned to member retailers, management expects that in the normal course of business, leases that expire will be renewed or replaced by other leases. Rent expense was \$62.1 million, \$53.7 million and \$39.4 million in fiscal 2014, 2013 and 2012, respectively.

In connection with the restructuring of the Company's international operations, the Company has entered into service agreements for the receipt, handling, warehousing and re-dispatch of all shipments of merchandise for its Panama City, Panama, Shanghai, China and Dubai, United Arab Emirates operations. Annual minimum service payments under these agreements are not significant.

*Contingencies*

The Company has certain contingent liabilities resulting from litigation and claims incident to the ordinary course of business. Management believes that the probable resolution of such contingencies will not materially affect the financial position, results of operations, or liquidity of the Company.

*Other guarantees*

In the normal course of business, the Company enters into commercial commitments including standby letters of credit and guarantees that could become contractual obligations. Letters of credit are issued generally to insurance agencies and financial institutions in direct support of the Company's corporate and retailer insurance programs and retailer lending programs as well as international vendors. As of January 3, 2015, the Company had outstanding standby letters of credit of \$27.8 million and commercial letters of credit of \$29.9 million.

**(16) Warehouse Facility Closure Costs**

In June 2013, as part of the continued effort to support retail growth, the Company decided to cease its operations at the Toledo, Ohio, Retail Support Center (RSC) when its lease expired in December 2014 and replace it with a larger new RSC in West Jefferson, Ohio. The Company recorded a charge of \$6.2 million in 2013 for estimated expenses related to this RSC closure. This charge includes \$1.7 million for severance and employee related costs and \$4.5 million for future payments that are expected to be paid to the multi-employer pension fund that covers the union employees at the Toledo, Ohio RSC.

In the fourth quarter of 2014, the Company relocated the Fort Worth Crossdock facility to the new Wilmer RSC. The Company recorded \$0.5 million of expense primarily for the future cost of remaining lease payments on the property. In the fourth quarter of 2014, ARH decided it will shut down its warehouse in 2015. The Company recorded \$0.2 million of expense primarily for severance and employee related costs.

**ACE HARDWARE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
(In millions)

**(17) Summary of Quarterly Results**

The following table provides a summary of quarterly results (unaudited) for the eight quarters prior to and including the quarter ended January 3, 2015:

	<b>2014</b>			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Revenues	\$ 1,161.6	\$ 1,128.9	\$ 1,331.3	\$ 1,078.7
Gross profit	137.2	164.5	210.7	139.8
Operating expenses	124.9	123.7	138.7	113.3
Net income attributable to Ace Hardware Corporation	12.7	37.3	66.5	24.4

	<b>2013</b>			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Revenues	\$ 1,022.4	\$ 1,034.3	\$ 1,174.3	\$ 923.2
Gross profit	136.0	148.8	174.4	117.7
Operating expenses	111.7	111.8	128.5	111.4
Net income attributable to Ace Hardware Corporation	23.4	34.4	42.3	4.4

**(18) Supplemental Disclosures of Cash Flow Information**

During fiscal 2014, 2013 and 2012, current year accrued patronage distributions of \$10.8 million, \$11.4 million and \$10.6 million, respectively, were offset against current receivables owed to the Company by its member retailers with no net impact in the Consolidated Statements of Cash Flows. In addition, at the retailers request, fiscal 2014, 2013 and 2012, had \$3.5 million, \$3.4 million and \$3.7 million, respectively, of the prior year's patronage distributions offset against current receivables owed to the Company by its member retailers with no net impact in the Consolidated Statements of Cash Flows.

During fiscal 2014, 2013 and 2012, repurchases of stock from retailers of \$15.1 million, \$11.2 million and \$21.8 million, respectively, were offset against current receivables of \$6.4 million, \$2.3 million and \$8.3 million, respectively, and notes receivable of \$2.9 million, \$2.3 million and \$5.7 million, respectively. The remaining \$5.8 million, \$6.6 million and \$7.8 million, respectively, were primarily issued as notes payable with no net impact in the Consolidated Statements of Cash Flows.

During fiscal 2012, the Company entered into an interest rate swap derivative dated June 5, 2012. The fair value adjustments for the interest rate swap derivative were recorded as Other long-term liabilities of \$1.1 million and \$1.8 million in 2014 and 2013 respectively. The Company offset these adjustments in fair value, net of tax, against AOCI with no net impact in the Consolidated Statements of Cash Flows.

During fiscal 2014, the Company received \$2.3 million of property and equipment prior to year end, and accrued for these items as no cash payments were made. These capital expenditures were not included in the purchases of property and equipment in the Consolidated Statement of Cash Flows for fiscal year 2014.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis summarizes the significant factors affecting the Company's consolidated operating results and financial condition during the three-year period ended January 3, 2015 (the Company's fiscal years 2014, 2013 and 2012). Fiscal 2014 contains 53 weeks of operating results, while fiscal years 2013 and 2012 each contain 52 weeks of operating results. Unless otherwise noted, all references herein for the years 2014, 2013 and 2012 represent fiscal years ended January 3, 2015, December 28, 2013 and December 29, 2012, respectively. This discussion and analysis should be read in conjunction with the consolidated financial statements and the related notes included in this annual report that have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP").

### Company Overview

The Company is a wholesaler of hardware and other related products and provides services and best practices for retail operations. The overall home improvement industry is estimated to be over \$300 billion and consists of a broad range of products and services, including lawn and garden products, paint and sundries, certain building supplies and general merchandise typically used in connection with home and property improvement, remodeling, repair and maintenance. The industry is fragmented and competition exists between the large home improvement centers, retail hardware stores and other chains offering hardware merchandise.

The Company's retailers generally compete in the \$40 billion "convenience hardware" segment which is characterized by purchases primarily of products related to home improvement and repair, including paint and related products, lawn and garden equipment, and those products less focused on large-scale building, renovation and remodeling projects. The Company believes that the following competitive strengths distinguish it from its peers and contribute to its success in the convenience hardware market: (1) strong consumer recognition of the Ace Brand; (2) well-regarded for exceptional customer service and convenience; (3) strength of distribution operations; (4) consolidated purchasing power; (5) differentiated and localized product and service offerings; and (6) a diversified network of independent retailers.

The Company strives to be the best provider of products, services and operating methods for convenience hardware retailers. The four main drivers that support that goal and the Company's efforts to grow the business are improving the store model, accelerating new store openings, introducing store projects that drive store sales and profitability, and reducing the number of store closings.

On December 31, 2014, Ace Wholesale Holdings LLC ("AWH," a newly-formed subsidiary of the Company) acquired all of the outstanding member units of Jensen-Byrd Co., LLC ("Jensen"), a wholesale hardlines distributor in the pacific northwest. On February 19, 2014, AWH acquired all of the outstanding shares of capital stock of Emery-Waterhouse ("Emery"), a distributor of hardlines products for independent lumber, paint, industrial and hardware outlets in the northeast. Immediately following the acquisition of Emery, AWH sold a 5 percent noncontrolling interest in Emery to Emery's current Chief Executive Officer. The Company believes that these acquisitions will serve as a catalyst to further leverage wholesale purchasing power and advance the Company's strategic plans to be a leader in the wholesale distribution industry.

Effective December 16, 2012, Ace Retail Holdings LLC ("ARH" a newly-formed subsidiary of the Company) acquired all of the outstanding shares of capital stock of WHI Holding Corp. ("WHI"). WHI owns all outstanding shares of Westlake Hardware, Inc. ("Westlake"). Westlake is based in Kansas City, Missouri and operates 85 neighborhood hardware stores located throughout the Midwest under the name Westlake Ace Hardware.

### Domestic Store Count

The number of Ace domestic retail outlets during the past three fiscal years is summarized as follows:

	<b>Fiscal Years</b>		
	2014	2013	2012
Retail outlets at beginning of period	4,171	4,104	4,072
New retail outlets	201	152	159
Retail outlet cancellations	(121)	(85)	(127)
Retail outlets at end of period	<u>4,251</u>	<u>4,171</u>	<u>4,104</u>

## Results of Operations

### Comparison of the Year Ended January 3, 2015 to the Year Ended December 28, 2013

The following data summarizes the Company's performance in 2014 as compared to 2013 (in millions):

	2014		2013		Increase/(decrease)	
	\$	% of Revenues*	\$	% of Revenues*	\$	%
<b>Revenues:</b>						
Wholesale revenues	4,466.7	95.0%	3,928.6	94.6%	538.1	13.7%
Retail revenues	233.8	5.0%	225.6	5.4%	8.2	3.6%
<b>Total revenues</b>	<b>4,700.5</b>	<b>100.0%</b>	<b>4,154.2</b>	<b>100.0%</b>	<b>546.3</b>	<b>13.2%</b>
<b>Gross profit:</b>						
Wholesale gross profit	546.4	12.2%	478.4	12.2%	68.0	14.2%
Retail gross profit	105.8	45.3%	98.5	43.7%	7.3	7.4%
<b>Total gross profit</b>	<b>652.2</b>	<b>13.9%</b>	<b>576.9</b>	<b>13.9%</b>	<b>75.3</b>	<b>13.1%</b>
<b>Operating expenses:</b>						
Distribution operations expenses	119.2	2.7%	100.0	2.5%	19.2	19.2%
Selling, general and administrative expenses	154.1	3.4%	142.3	3.6%	11.8	8.3%
Retailer success and development expenses	135.1	3.0%	124.3	3.2%	10.8	8.7%
Retail operating expenses	91.5	39.1%	90.6	40.2%	0.9	1.0%
Warehouse facility closure costs	0.7	-	6.2	0.2%	(5.5)	(88.7%)
<b>Total operating expenses</b>	<b>500.6</b>	<b>10.6%</b>	<b>463.4</b>	<b>11.2%</b>	<b>37.2</b>	<b>8.0%</b>
Operating income	151.6	3.2%	113.5	2.7%	38.1	33.6%
Interest expense	(13.1)	(0.3%)	(14.1)	(0.3%)	1.0	7.1%
Other	2.4	0.1%	5.1	0.1%	(2.7)	(52.9%)
<b>Net income</b>	<b>140.9</b>	<b>3.0%</b>	<b>104.5</b>	<b>2.5%</b>	<b>36.4</b>	<b>34.8%</b>

\*Wholesale gross profit and expenses are shown as a percentage of wholesale revenues. Retail gross profit and expenses are shown as a percentage of retail revenues. Non-operating items are shown as a percentage of total revenues.

Consolidated revenues for the year ended January 3, 2015, totaled \$4.7 billion, an increase of \$546.3 million, or 13.2%, as compared to the prior year. Fiscal 2014 consisted of 53 weeks compared to 52 weeks in fiscal 2013. The 53<sup>rd</sup> week added approximately \$49.4 million in revenues. Excluding the 53<sup>rd</sup> week, revenues increased \$496.9 million or 12.0% as compared to fiscal 2013. A reconciliation of consolidated revenues follows (in millions):

	Amount	% Change vs. 2013
<b>2013 Revenues</b>	<b>\$ 4,154.2</b>	
<i>Wholesale Merchandise Revenues change based on new and cancelled domestic stores:</i>		
Revenues increase from new stores added since January 2013	168.4	4.1%
Net decrease from stores cancelled since January 2013	(38.0)	(0.9%)
Increase in wholesale merchandise revenues to comparable domestic stores	254.9	6.1%
Increase in AWH revenues	150.2	3.6%
Increase in ARH revenues	8.2	0.2%
Other wholesale revenue changes, net	2.6	0.1%
<b>2014 Revenues</b>	<b>\$ 4,700.5</b>	<b>13.2%</b>

Total wholesale revenues were \$4.5 billion for fiscal 2014, an increase of \$538.1 million, or 13.7%, as compared to the prior year.

New stores are defined as stores that were activated from January 2013 through December 2014. In 2014, the Company had an increase in wholesale merchandise revenues from new domestic stores of \$168.4 million. This increase was partially offset by a decrease in wholesale merchandise revenues due to domestic store cancellations of \$38.0 million. As a result, the Company realized a net increase in wholesale merchandise revenues of \$130.4 million related to the impact of both new stores affiliated with the Company and from stores that cancelled their membership in 2013 and 2014.

Wholesale merchandise revenues to comparable domestic stores increased \$254.9 million. The categories with the largest revenues increases were electrical, paint & solvents, hand tools, plumbing, and lawn & garden power equipment. Warehouse sales represented 78.0% of wholesale merchandise revenue in 2014 compared to 77.4% in 2013, while direct ship sales were 22.0%, down from 22.6% in 2013.

Revenues from the new AWH subsidiary were \$150.2 million during fiscal 2014. AWH began operations on February 19, 2014.

Retail revenues were \$233.8 million for fiscal 2014. This is an increase of \$8.2 million or 3.6% from fiscal 2013. Same-store-sales at ARH's stores were up 4.1% with increases in nearly all departments. Electrical, tools, cleaning and paint showed the largest increases.

Wholesale gross profit for fiscal 2014 was \$546.4 million, an increase of \$68.0 million from fiscal 2013. The increase in wholesale gross profit was driven by the increases in sales noted above. Wholesale gross margin percentage was 12.2% of wholesale revenues in fiscal 2014, showing no change from fiscal 2013's wholesale gross margin percentage.

Retail gross profit was \$105.8 million in fiscal 2014, an increase of \$7.3 million from fiscal 2013. Retail gross margin percentage was 45.3% of retail revenues in fiscal 2014, up from 43.7% in the prior year. The increase in the retail gross margin percentage was primarily the result of lower promotional discounting in 2014. Retail gross profit as reported in the Ace financial statements is based on the Ace wholesale acquisition cost of product rather than the WHI acquisition cost which includes Ace's normal markup from cost.

Wholesale operating expenses increased \$41.8 million, or 11.4% as compared to 2013. The increase was primarily driven by higher employee benefit and salary expenses, higher advertising expenses due to planned incremental promotional spending, and higher warehouse wages driven by the increase in sales volume and the addition of new warehouse facilities. As a percentage of wholesale revenues, wholesale operating expenses decreased from 9.3% of revenues in 2013 to 9.1% of revenues in 2014.

Retail operating expenses of \$91.5 million increased \$0.9 million, or 1.0%, in fiscal 2014 as compared to fiscal 2013. Retail operating expenses as a percent of retail revenues decreased from 40.2% of revenues in fiscal 2013 to 39.1% of revenues in fiscal 2014 primarily due to more efficient advertising spending.

In fiscal 2014, the Company recorded approximately \$0.7 million of expense primarily related to relocating the Fort Worth Crossdock Facility to Wilmer, Texas. In fiscal 2013, the Company recorded \$6.2 million of expense for the relocation of the Toledo Retail Support Center to West Jefferson, Ohio.

Interest expense decreased \$1.0 million or 7.1%, due to lower interest rates in 2014 partially offset by higher average outstanding balances as compared to 2013.

Other income (expense) showed an increase in expense of \$2.7 million primarily from higher income tax expense caused by an increase in non-patronage sourced income mainly from ARH and AWH and the non-recurrence of a one-time gain in 2013.

## Results of Operations

### Comparison of the Year Ended December 28, 2013 to the Year Ended December 29, 2012

The following data summarizes the Company's performance in 2013 as compared to 2012 (in millions):

	2013		2012		Increase/(decrease)	
	\$	% of Revenues*	\$	% of Revenues*	\$	%
<b>Revenues:</b>						
Wholesale revenues	3,928.6	94.6%	3,832.9	99.8%	95.7	2.5%
Retail revenues	225.6	5.4%	8.0	0.2%	217.6	100.0%
<b>Total revenues</b>	<b>4,154.2</b>	<b>100.0%</b>	<b>3,840.9</b>	<b>100.0%</b>	<b>313.3</b>	<b>8.2%</b>
<b>Gross profit:</b>						
Wholesale gross profit	478.4	12.2%	465.9	12.2%	12.5	2.7%
Retail gross profit	98.5	43.7%	3.2	40.0%	95.3	100.0%
<b>Total gross profit</b>	<b>576.9</b>	<b>13.9%</b>	<b>469.1</b>	<b>12.2%</b>	<b>107.8</b>	<b>23.0%</b>
<b>Operating expenses:</b>						
Distribution operations expenses	100.0	2.5%	98.1	2.6%	1.9	1.9%
Selling, general and administrative expenses	142.3	3.6%	138.1	3.6%	4.2	3.0%
Retailer success and development expenses	124.3	3.2%	117.6	3.1%	6.7	5.7%
Retail operating expenses	90.6	40.2%	3.3	41.3%	87.3	100.0%
Warehouse facility closure costs	6.2	0.2%	-	-	6.2	100.0%
Gain on sale of paint assets, net of acquisition and disposition costs	-	-	(7.0)	(0.2%)	7.0	100.0%
<b>Total operating expenses</b>	<b>463.4</b>	<b>11.2%</b>	<b>350.1</b>	<b>9.1%</b>	<b>113.3</b>	<b>32.4%</b>
Operating income	113.5	2.7%	119.0	3.1%	(5.5)	(4.6%)
Interest expense	(14.1)	(0.3%)	(23.9)	(0.6%)	9.8	41.0%
Loss on early extinguishment of debt	-	-	(19.9)	(0.5%)	19.9	100.0%
Other	5.1	0.1%	6.6	0.1%	(1.5)	(22.7%)
<b>Net income</b>	<b>104.5</b>	<b>2.5%</b>	<b>81.8</b>	<b>2.1%</b>	<b>22.7</b>	<b>27.8%</b>

\*Wholesale gross profit and expenses are shown as a percentage of wholesale revenues. Retail gross profit and expenses are shown as a percentage of retail revenues. Non-operating items are shown as a percentage of total revenues.

Consolidated revenues for the year ended December 28, 2013 totaled \$4.2 billion, an increase of \$313.3 million, or 8.2%, as compared to the prior year. A reconciliation of consolidated revenues follows (in millions):

	Amount	% Change vs. 2012
<b>2012 Revenues</b>	<b>\$ 3,840.9</b>	
<i>Wholesale Merchandise Revenues change based on new and cancelled domestic stores:</i>		
Revenues increase from new stores added since January 2012	91.4	2.4%
Net decrease from stores cancelled since January 2012	(38.2)	(1.0%)
Increase in wholesale merchandise revenues to comparable domestic stores	95.5	2.5%
Increase in ARH revenues	217.6	5.7%
Other wholesale revenue changes, net	(53.0)	(1.4%)
<b>2013 Revenues</b>	<b>\$ 4,154.2</b>	<b>8.2%</b>

Total wholesale revenues were \$3.9 billion for fiscal 2013, an increase of \$95.7 million, or 2.5%, as compared to the prior year.

New stores are defined as stores that were activated from January 2012 through December 2013. In 2013, the Company had an increase in wholesale merchandise revenues from new domestic stores of \$91.4 million. This increase was partially offset by a decrease in wholesale merchandise revenues due to domestic store cancellations of \$38.2 million. As a result, the Company realized a net increase in wholesale merchandise revenues of \$53.2 million related to the impact of both new stores affiliated with the Company and from stores that cancelled their membership in 2012 and 2013.

Wholesale merchandise revenues to comparable domestic stores increased \$95.5 million. The categories with the largest revenue increases were plumbing, heating/cooling, paint supplies and sundries and live goods. Warehouse sales represented 77.4% of wholesale merchandise revenue in 2013 compared to 78.0% in 2012, while direct ship sales were 22.6%, up from 22.0% in 2012.

Retail revenues were \$225.6 million for fiscal 2013. This is an increase of \$217.6 million from fiscal 2012 which resulted from the timing of the December 2012 acquisition of WHI. Same-store-sales at WHI's stores were down 0.8% primarily due to a decrease in the lawn and garden category in the first and second quarters of 2013.

Other wholesale revenue changes, net consist primarily of the \$81.5 million elimination of Ace sales to ARH, offset by a \$19.2 million increase in international revenues.

Wholesale gross profit for the year ended December 28, 2013 was \$478.4 million, an increase of \$12.5 million. Gross margin percentage was 12.2% of wholesale revenues, flat with 2012.

Retail gross profit was \$98.5 million, or 43.7% of retail revenues for the year ended December 28, 2013 compared to 40.0% in fiscal 2012. Retail gross profit as reported in the Ace financial statements is based on the Ace wholesale acquisition cost of product rather than the WHI acquisition cost which includes Ace's normal markup from cost.

Wholesale operating expenses increased \$12.8 million, or 3.6% as compared to 2012. The increase was primarily driven by higher employee benefit and salary expenses of \$6.3 million and higher advertising and marketing expenses of \$3.4 million.

The addition of retail operating expenses of \$90.6 million was a result of the acquisition of WHI in December 2012. This included approximately \$5.9 million of non-cash depreciation and amortization expense for assets and liabilities established as a part of the opening balance sheet of WHI.

The Company recorded a charge of \$6.2 million for estimated expenses related to the previously announced closure of the Toledo, Ohio, RSC. This charge includes estimated severance and employee related costs as well as future payments that are expected to be paid to the multi-employer pension fund that covers the former union employees at this facility.

The 2012 Gain on sale of paint assets, net of acquisition and disposition costs of \$7.0 million consisted of an \$8.9 million gain related to the sale of paint assets to The Valspar Corporation and \$1.9 million of expenses related to the acquisition of WHI.

Interest expense decreased \$9.8 million or 41.0%, due to the refinancing of the Company's credit facility and the redemption of the Company's senior secured notes during the second quarter of 2012, as well as lower average outstanding balances and lower interest rates in 2013.

The 2012 loss on the early extinguishment of debt of \$19.9 million resulted from the refinancing of the Company's credit facility and the redemption of the Company's senior secured notes. The \$19.9 million loss consisted of a \$13.1 million premium payment on the buyback of the notes and the non-cash write-off of \$6.8 million in unamortized deferred financing costs and bond discount costs related to the previous credit facility and senior secured notes.

Other income and expense declined \$1.5 million mainly as a result of an increase of income tax expense of \$1.0 million which was primarily caused by the acquisition of WHI.

## **Liquidity and Capital Resources**

The Company believes that existing cash balances, along with the existing line of credit and long-term financing, will be sufficient to finance the Company's working capital requirements, debt service, patronage distributions, capital expenditures, share redemptions from retailer cancellations and growth initiatives for at least the next 12 months.

The Company's borrowing requirements have historically arisen from, and are expected to continue to arise from, working capital needs, debt service, capital improvements and acquisitions, patronage distributions and other general corporate purposes. In the past, the Company has met its operational cash needs using cash flows from operating activities and funds from its revolving credit facility. The Company currently estimates that its cash flows from operating activities and working capital, together with its line of credit, will be sufficient to fund its short-term liquidity needs. Actual liquidity and capital funding requirements depend on numerous factors, including operating results, general economic conditions and the cost of capital.

The Company has a secured credit facility with a group of banks that consists of a \$170.0 million amortizing term loan and a \$400.0 million revolving credit facility. The facility is expandable to \$720.0 million via a \$150.0 million accordion that is exercisable without the consent of existing lenders provided that the Company is not in default of the credit agreement and further provided that none of the existing lenders are required to provide any portion of the increased facility. Borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 50 basis points to 150 basis points or 150 to 250 basis points over the London Interbank Offered Rate ("LIBOR") depending on the Company's leverage ratio as defined under the agreement. The facility was priced at LIBOR plus 150 basis points at January 3, 2015. This facility requires maintenance of certain financial covenants including a maximum allowable average leverage ratio, a minimum fixed charge coverage ratio and a minimum asset coverage ratio,



and expires on July 27, 2018. As of January 3, 2015, the Company was in compliance with its covenants and a total of \$254.5 million was outstanding under the credit facility.

The term loan requires the Company to make principal repayments of \$5.0 million per quarter through March 2017, with no additional installments until maturity on July 27, 2018. Any remaining principal balance will be repaid at maturity.

The revolving credit facility includes a \$175.0 million sublimit for the issuance of standby and commercial letters of credit. As of January 3, 2015, a total of \$29.9 million in letters of credit were outstanding. The revolving credit facility requires the Company to pay fees based on the unused portion of the line of credit at a rate of 15 to 35 basis points per annum depending on the Company's leverage ratio.

The credit facility allows the Company to make revolving loans and other extensions of credit to Ace Hardware International Holdings, Ltd. ("AIH") in an aggregate principal amount not to exceed \$75.0 million at any time. As of January 3, 2015, there were no loans or other extensions of credit provided to AIH.

In order to reduce the risk of interest rate volatility, the Company entered into an interest rate swap derivative agreement in June 2012, which expires on March 13, 2017. This swap agreement fixes the LIBOR rate on the full balance of the term loan at 1.13%, resulting in an effective rate of 2.63% after adding the 1.50% margin based on the current pricing tier per the credit agreement. The notional amount of the derivative agreement decreases to match the principal balance remaining as principal payments are made throughout the term of the loan agreement. The swap arrangement has been designated as a cash flow hedge and has been evaluated to be highly effective. As a result, the after-tax change in the fair value of the swap is recorded in Accumulated other comprehensive income (loss) as a gain or loss on derivative financial instruments.

The Company's ARH subsidiary has a \$60.0 million asset-based revolving credit facility ("ARH Facility"). The ARH Facility matures on June 28, 2019 and is expandable to \$85.0 million under certain conditions. In addition, the Company has the right to issue letters of credit up to a maximum of \$7.5 million. At the Company's discretion, borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 35 basis points to 75 basis points or LIBOR plus an applicable spread of 135 basis points to 175 basis points, depending on the Company's availability under the ARH Facility as measured on a quarterly basis.

The ARH Facility is collateralized by substantially all of ARH's personal property and intangible assets. Borrowings under the facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible collateral balances (primarily consisting of certain receivables and inventories). This agreement requires maintenance of certain financial covenants including a minimum fixed charge coverage ratio. As of January 3, 2015, ARH was in compliance with its covenants. At year-end, ARH had \$15.5 million in loans outstanding under its Facility.

The ARH Facility requirements include a lender-controlled cash concentration system that results in all of ARH's daily available cash being applied to the outstanding borrowings under this facility. Pursuant to Financial Accounting Standards Board (FASB) Accounting Standards Codification Section 470-10-45, "Classification of Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses," the borrowings under the ARH Facility have been classified as a Current maturity of long-term debt as of January 3, 2015.

Total debt, the majority of which is comprised of the \$170.0 million principal remaining on the term loan and \$100.0 million borrowed on lines of credit, was \$283.7 million as of January 3, 2015, compared to \$202.0 million as of December 28, 2013.

## Cash Flows

The Company had \$29.8 million and \$17.9 million of cash and cash equivalents at January 3, 2015 and December 28, 2013, respectively. Following is a summary of the Company's cash flows from operating, investing and financing activities for the fiscal years 2014 and 2013, respectively (in millions):

	2014	2013
Cash provided by operating activities before changes in assets and liabilities	\$ 195.1	\$ 160.9
Net changes in assets and liabilities	(136.2)	7.1
Net cash provided by operating activities	58.9	168.0
Net cash used in investing activities	(89.2)	(41.4)
Net cash provided by (used in) financing activities	42.2	(121.8)
Net change in cash and cash equivalents	<u>\$ 11.9</u>	<u>\$ 4.8</u>

The Company's operating activities generated \$58.9 million of cash in 2014 compared to \$168.0 million in 2013. Excluding the impact of net changes in assets and liabilities, cash provided by operating activities grew from \$160.9 million in 2013 to \$195.1 million in 2014. This increase was primarily the result of higher net income in 2014.

The net change in assets and liabilities was down from a \$7.1 million increase of cash in 2013 to a \$136.2 million decrease of cash in 2014. In 2014, inventories increased \$133.1 million as a result of the need to support higher sales revenues, increased seasonal build and the Company's intentional inventory build-up to maintain customer fill rates during the U.S. west coast import disruption. Increases in receivables and other assets of \$70.7 million as a result of higher revenues were largely offset by a \$66.5 million increase in accounts payable and accrued expenses. In 2013, receivables increased \$53.6 million due to increased dating made available to retailers on certain products, while inventories decreased \$52.2 million as a result of improved supply chain efficiencies.

Net cash used for investing activities was \$89.2 million in 2014 compared to \$41.4 million in 2013. Investing activities in 2014 primarily consisted of \$63.2 million used to purchase Emery and Jensen and \$41.1 million in capital expenditures, partially offset by the net liquidation of marketable securities. Investing activities in 2013 primarily consisted of the \$45.0 million in capital expenditures offset by \$2.9 million of cash generated as a result of the collection of notes receivable.

Net cash provided by financing activities was \$42.2 million in 2014 compared to net cash used in financing activities of \$121.8 million in 2013. During 2014, the Company had net borrowings under the revolving lines of credit of \$99.9 million, made patronage distributions of \$36.6 million, and decreased long-term debt by \$24.1 million. During 2013, the Company decreased total debt by a net of \$94.9 million and made patronage distributions of \$27.1 million.

### Off-balance sheet arrangements

In accordance with GAAP, operating leases for the Company's real estate and other assets are not reflected in the Consolidated Balance Sheets. In addition, the Company has certain other guarantees, as further described in the Notes to the Consolidated Financial Statements – Note 15 – Commitments and Contingencies. The Company believes the likelihood of any such payment under these guarantees is remote.

### Contractual Obligations and Commitments

Contractual obligations and commitments at January 3, 2015 are as follows (in millions):

	<b>Payments Due by Period</b>				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt (1)	\$ 283.7	\$ 41.5	\$ 31.4	\$ 210.8	\$ -
Interest payments on long-term debt (2)	22.7	7.2	12.0	3.5	-
Patronage refund certificates payable	38.9	6.6	8.7	12.9	10.7
Operating leases (3)	349.8	54.6	96.2	69.3	129.7
Purchase commitments (4)	51.6	27.2	22.2	2.2	-
<b>Total</b>	<b>\$ 746.7</b>	<b>\$ 137.1</b>	<b>\$ 170.5</b>	<b>\$ 298.7</b>	<b>\$ 140.4</b>

(1) Reflects principal payments.

(2) Reflects interest that would be paid if LIBOR rates and interest rate spreads remain unchanged from the January 3, 2015 rates and assumes a consistent outstanding revolving line of credit balance until the expiration of the facility in 2018.

(3) Total operating lease payments include \$6.0 million of minimum lease payments for store leases that the Company has assigned to member retailers.

(4) Represents minimum purchase commitments pursuant to contracts primarily with hardware, software and service providers.

The table above does not include any reserves for uncertain tax positions (including penalties and interest) as the Company is unable to make a reasonably reliable estimate of the timing of payments due to uncertainties in the timing of the effective settlement of tax positions.

### Application of Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses in the consolidated financial statements. On an ongoing basis, the Company evaluates its estimates and judgments based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates, and these estimates would vary under different assumptions or conditions. Management believes these estimates and assumptions are reasonable.

The Company annually reviews its financial reporting and disclosure practices and accounting policies to ensure that they provide accurate and comprehensive information relative to the current economic and business environment. The Company's significant accounting policies are described in the Notes to the Consolidated Financial Statements. The following represents those

critical accounting policies which involve a relatively higher degree of judgment, estimation and complexity and where materially different amounts could be reported under different conditions or using different assumptions.

*Valuation of Inventories* When necessary, the Company provides allowances to adjust the carrying value of inventories to the lower of cost or market, including costs to sell or dispose of surplus or damaged/obsolete inventory, and for estimated shrinkage. Estimates of the future demand for the Company's products are key factors used by management in assessing the net realizable value of the inventories. While management believes that the estimates used are appropriate, an unanticipated decline in revenues at retail outlets or a significant decline in demand for products in selected product categories could result in valuation adjustments.

*Vendor Funds* The Company receives funds from vendors in the normal course of business principally as a result of purchase volumes, revenues or promotions of vendors' products. Based on the provisions of the vendor agreements in place, management develops accrual rates by estimating the point at which the Company will have completed its performance under the agreement and the amount agreed upon will be earned. Due to the complexity and diversity of the individual vendor agreements, the Company performs analyses and reviews of historical trends throughout the year to ensure the amounts earned are appropriately recorded. As part of these analyses, the Company validates its accrual rates based on actual purchase trends and applies those rates to actual purchase volumes to determine the amount of funds that should be accrued by the Company and receivable from the vendor. Amounts accrued throughout the year could be impacted if actual purchase volumes differ from projected annual purchase volumes, especially in the case of programs that provide for increased funding when graduated purchase volumes are met. At year-end, the accrual reflects actual purchases made throughout the year.

Vendor funds are treated as a reduction of inventory cost, unless they represent a reimbursement of specific, incremental and identifiable costs incurred by the customer to sell the vendor's product, in which case the costs would be netted. Substantially all of the vendor funds that the Company receives do not meet the specific, incremental and identifiable criteria. Therefore, the Company treats a majority of these funds as a reduction in the cost of inventory as the amounts are accrued and recognized as a reduction of cost of revenues when the inventory is sold.

*Allowance for Doubtful Accounts* The allowance for doubtful accounts reflects management's estimate of the future amount of accounts and notes receivable that will not be collected. Management records allowances for doubtful accounts based on judgments made considering a number of factors, primarily historical collection statistics, current member retailer credit information, the current economic environment, the aging of receivables, the evaluation of compliance with lending covenants and the offsetting amounts due to members for stock, notes, interest and anticipated but unpaid patronage distributions. While the Company believes it has appropriately considered known or expected outcomes, its retailers' ability to pay their obligations, including those to the Company, could be adversely affected by declining revenues at retail resulting from such factors as contraction in the economy or competitive conditions in the wholesale and retail industry including increased competition from discount stores, chain stores and other mass merchandisers.

The Company's allowance for doubtful accounts at January 3, 2015 and December 28, 2013 was \$17.4 million and \$20.7 million, respectively. Actual credit losses could vary materially from the Company's estimates.

*Insurance Reserves* Insurance reserves for claims related to the Company's self-insured property, general liability, workers' compensation and auto liability insurance programs are dependent on assumptions used in calculating such amounts. These assumptions include projected ultimate losses and confidence levels of the reserve requirement and consider historical loss levels and other factors. While management believes that the assumptions used are appropriate, differences in actual claims experience or changes in assumptions may affect the Company's insurance reserves.

*Goodwill* Goodwill represents the excess of the cost of an acquired business over the amounts assigned to net assets. Goodwill is not amortized but is tested for impairment at a reporting unit level on an annual basis or more frequently, if circumstances change or an event occurs that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

Qualitative factors may be assessed to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If an election is made not to perform the qualitative assessment or the qualitative assessment indicates that the carrying amount is more likely than not higher than the fair value, goodwill is tested for impairment based on a two-step test. The first step compares the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired, thus the second step of the impairment test is unnecessary. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test shall be performed to measure the impairment loss, if any. The second step compares the implied fair value of reporting unit goodwill with the carrying amount of goodwill. If the carrying amount of reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market

conditions and selecting an appropriate control premium. The income approach is based on discounted cash flows which are derived from internal forecasts and economic expectations for each respective reporting unit. In 2014, the Company did not recognize any goodwill impairments. The balance of goodwill is \$25.7 million at January 3, 2015. Significant adverse changes to the Company's business environment and future cash flows could cause us to record impairment charges in future periods.

## **Impact of New Accounting Standards**

### *New Accounting Pronouncements - Adopted*

In February 2013, the FASB issued Accounting Standards Update ("ASU") No. 2013-02, "Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." ASU 2013-02 requires the Company to report, in one place, information about reclassifications out of Accumulated other comprehensive income (AOCI). The Company is also required to present reclassifications by component when reporting changes in AOCI balances. For significant items reclassified out of AOCI to net income in their entirety in the period, the Company must report the effect of the reclassifications on the respective line items in the statement when net income is presented. ASU 2013-02 is effective for the Company for fiscal years and interim periods beginning after December 15, 2013. The Company adopted ASU 2013-02 in the first quarter of 2014. ASU 2013-02 does not have a material impact on the Company's consolidated financial statements.

### *New Accounting Pronouncements - Issued*

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." The purpose of ASU 2014-09 is to develop a common revenue recognition standard for GAAP and International Financial Reporting Standards. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 allows either full retrospective adoption, meaning the standard is applied to all periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements. ASU 2014-09 is effective for the Company for annual reporting periods after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. The Company is still evaluating the impact that ASU 2014-09 will have on the Company's consolidated financial statements.

## **Qualitative and Quantitative Disclosure About Market Risk**

*Inflation and Changes in Prices* The Company's business is not generally governed by contracts that establish prices substantially in advance of the receipt of goods or services. As vendors increase their prices for merchandise supplied to the Company, the Company generally increases the price to its retailers in an equal amount plus the normal handling charge on such amounts. In the past, these increases have provided adequate gross profit to offset the impact of inflation.

*Foreign Currency* Although the Company has international operating entities, its exposure to foreign currency rate fluctuations is not significant to its financial condition and results of operations.

*Customer Credit Risk* The Company is exposed to the risk of financial non-performance by customers. The Company's ability to collect on sales to its customers is dependent on the liquidity of its customer base. Volatility in credit markets may reduce the liquidity of the Company's customer base. To manage customer credit risk, the Company monitors historical collection statistics, current member retailer credit information, the current economic environment, the aging of receivables, the evaluation of compliance with lending covenants and the offsetting amounts due to members for stock, notes, interest and anticipated but unpaid patronage distributions. From certain customers, the Company also obtains collateral as considered necessary to reduce risk of loss. The Company does not believe the loss of any single customer would have a material adverse effect on its results of operations.

## **Disclosure Regarding Forward-Looking Statements**

This document includes certain forward-looking statements about the expectations of the Company. Although the Company believes these statements are based on reasonable assumptions, actual results may vary materially from stated expectations. Such forward-looking statements may be identified by the use of forward-looking words or phrases such as "anticipate," "believe," "expect," "intend," "may," "planned," "potential," "should," "will," "would," "project," "estimate," "ultimate," or similar phrases. Actual results may differ materially from those indicated in the company's forward-looking statements and undue reliance should not be placed on such statements.

Factors that could cause materially different results include, but are not limited to, weather conditions; natural disasters; fair value accounting adjustments; inventory valuation; health care costs; insurance costs or recoveries; legal costs; borrowing needs; interest rates; credit conditions; economic and market conditions; accidents, leaks, equipment failures, service interruptions, and other

operating risks; legislative actions; tax rulings or audit results; asset sales; significant unplanned capital needs; changes in accounting principles, interpretations, methods, judgments or estimates; performance of major customers, transporters, suppliers and contractors; labor relations; and acts of terrorism.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company undertakes no obligation to publicly release any revision to these forward-looking statements to reflect events or circumstances after the date of this report.

## FIVE YEAR SUMMARY OF EARNINGS AND DISTRIBUTIONS

	<b>Years Ended</b>				
	January 3, 2015 (53 Weeks)	December 28, 2013 (52 Weeks)	December 29, 2012 (52 Weeks)	December 31, 2011 (52 Weeks)	January 1, 2011 (52 Weeks)
Revenues	\$ 4,700.5	\$ 4,154.2	\$ 3,840.9	\$ 3,709.2	\$ 3,530.7
Cost of revenues	4,048.3	3,577.3	3,371.8	3,261.9	3,086.4
Gross profit	652.2	576.9	469.1	447.3	444.3
Total operating and other expenses, net	511.3	472.4	387.3	369.6	369.2
Net income	\$ 140.9	\$ 104.5	\$ 81.8	\$ 77.7	\$ 75.1
Distribution of net income:					
Patronage distributions to third party retailers	\$ 131.7	\$ 98.2	\$ 75.5	\$ 74.5	\$ 69.9
Accumulated earnings	9.2	6.3	6.3	3.2	5.2
Net income attributable to Ace Hardware Corporation	\$ 140.9	\$ 104.5	\$ 81.8	\$ 77.7	\$ 75.1

## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

The consolidated financial statements presented in this Annual Report have been prepared with integrity and objectivity and are the responsibility of the management of Ace Hardware Corporation. These consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles and properly reflect certain estimates and judgments based upon the best available information.

The Company maintains a system of internal accounting controls, which is supported by an internal audit program and is designed to provide reasonable assurance, at an appropriate cost, that the Company's assets are safeguarded and transactions are properly recorded. This system is continually reviewed and modified in response to changing business conditions and operations and as a result of recommendations by the internal and external auditors. In addition, the Company has distributed to employees its policies for conducting business affairs in a lawful and ethical manner.

The consolidated financial statements of the Company have been audited by Ernst & Young LLP, independent accountants. Their accompanying report is based upon audits conducted in accordance with auditing standards generally accepted in the United States of America.

The Audit Committee of the Board of Directors meets periodically with the independent auditors and with the Company's internal auditors, both privately and with management present, to review accounting, auditing, internal control and financial reporting matters. The Audit Committee recommends to the full Board of Directors the selection of the independent auditors and regularly reviews the internal accounting controls, the activities of the outside auditors and internal auditors and the financial condition of the Company. Both the Company's independent auditors and the internal auditors have free access to the Audit Committee.

February 24, 2015

/s/ John Venhuizen

John Venhuizen  
President and Chief Executive Officer

/s/ William M. Guzik

William M. Guzik  
Executive Vice President and  
Chief Financial Officer and Chief Risk Officer



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