FOSSIL INC
Form 10-K
August 08, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

(Mark One)

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

For the Fiscal Year Ended January 6, 2007

OR

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

For the transition period from to

Commission File Number **0-19848**

FOSSIL, INC.
(Exact name of registrant as specified in its charter)

Delaware	**75-2018505**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2280 N. Greenville Avenue **Richardson, Texas**	**75082**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(972) 234-2525**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $.01 par value
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the

Act. Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

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

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

The aggregate market value of Common Stock, $0.01 par value per share (the "Common Stock"), held by nonaffiliates of the registrant, based on the sale trade price of the Common Stock as reported by the NASDAQ Global Select Market on July 8, 2007, was $1,335,760,495. For purposes of this computation, all officers, directors and 10% beneficial owners of the registrant are deemed to be affiliates. Such determination should not be deemed an admission that such officers, directors or 10% beneficial owners are, in fact, affiliates of the registrant.

As of July 26, 2007, 68,241,027 shares of Common Stock were outstanding.

FOSSIL, INC.

FORM 10-K

FOR THE FISCAL YEAR ENDED JANUARY 6, 2007

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In this Form 10-K, references to "we," "our," and the "Company" refer to Fossil, Inc. and its subsidiaries on a consolidated basis.

Explanatory Note

In June 2006, as a result of the wide-scale scrutiny of employee stock option grant practices including a report issued on June 13, 2006 by UBS Securities LLC mentioning the Company, we began a review of our historical stock option practices in order to determine whether there were any improprieties related to the timing of our past stock option grants. On November 14, 2006, the Company announced that a committee made up of five independent members of its Board of Directors (the "Special Committee") commenced a voluntary review of the Company's historical equity granting practices. The Special Committee was ultimately reconstituted on February 8, 2007, to consist of two independent members of the Board of Directors. The Special Committee's voluntary review was undertaken with assistance from independent legal counsel, Weil, Gotshal & Manges LLP, and forensic accounting assistance from FTI Consulting, Inc. On May 7, 2007, the Company issued a press release announcing the results of the Special Committee's review, which was delivered to the Company's Board of Directors on May 4, 2007, and set forth in the Company's Form 8-K filed on May 9, 2007. As a result of deficiencies identified by the Special Committee relating to the Company's equity granting practices, the Company's management commenced a more thorough evaluation of the appropriateness of accounting measurement dates used to determine the amounts of compensation charges and related tax effects previously disclosed in filings with the U.S. Securities and Exchange Commission (the "SEC"). The Company also announced on May 7, 2007 that, although this evaluation was still in process, based on preliminary estimates, the Company and its Audit Committee concluded that the cumulative impact of related errors on previously issued financial statements would result in the restatement of the Company's previously issued financial statements.

Unrelated to the Special Committee's review, management also identified that certain grants previously awarded to employees as incentive stock options should have been treated as non-qualified stock options. Due to different tax requirements associated with the exercise of incentive stock options versus non-qualified stock options, the Company has determined that certain employer and employee FICA taxes and employee withholding taxes were not properly withheld at the time such options were exercised by its employees.

In addition to the errors related to stock-based compensation discussed above, the Company has also corrected certain previously identified prior period errors that the Company believed were not material to the Company's consolidated financial statements, both individually and when considered in the aggregate.

The Company has restated its retained earnings balance at the beginning of fiscal year 2004 to include a reduction of $8.2 million related to the after tax impact of additional stock-based compensation expense and correction of other accounting errors from 1993 through 2003. This amount represents approximately 2.2% of the previously reported retained earnings balance.

In this Annual Report on Form 10-K, the Company has restated its consolidated financial statements for the years ended December 31, 2005 and January 1, 2005 (including retained earnings at the beginning of the fiscal year ended January 1, 2005) and the notes related thereto. Additionally, in this Form 10-K, the Company has restated the selected financial data for the years ended December 31, 2005, January 1, 2005, January 3, 2004 and January 4, 2003 included in Item 6 and the third and fourth quarters of 2005 included in "Selected Quarterly Financial Data" in Management's Discussion and Analysis of Financial Condition and Results of Operations.

The consolidated statements of income and comprehensive income and cash flows for the year ended December 31, 2005 have been restated to include: (i) additional pre-tax compensation stock-based expense of approximately $2.4 million related to the correction of measurement dates related to the Company's historical equity granting practices, (ii) an approximate $442,000 decrease in pre-tax income related to additional employer and employee FICA taxes due, including interest thereon, in connection with the correction of classifying certain incentive stock options to non-qualified stock options, (iii) an approximate $979,000 increase in pre-tax income to reverse the impact of certain sales returns recorded in fiscal year 2005 that should have been recorded in fiscal year 2004, (iv) an approximate $207,000 decrease in pre-tax income to adjust accrued liabilities related to certain management fees that should have been eliminated at the end of fiscal year 2004, (v) an approximate $1.5 million increase in pre-tax income related to the correction of an error in the Company's analysis for store impairment, (vi) a decrease in income tax expense of approximately $600,000 to reduce an accrual for tax penalties, (vii) an approximate $2.4 million increase in income tax expense to increase certain tax contingency reserves, and (viii) an approximate $48,000 decrease in income tax expense resulting from the impact of the pre-tax adjustments described in items (i) through (v) above.

The consolidated statements of income and comprehensive income and cash flow for the year ended January 1, 2005 have been restated to include: (i) additional pre-tax stock-based compensation expense of approximately $1.9 million related to the correction of measurement dates related to the Company's historical equity granting practices, (ii) an approximate $864,000 decrease in pre-tax income related to additional employer and employee FICA taxes due, including interest thereon, in connection with the Company's correction of classifying certain incentive stock options to non-qualified stock options, (iii) an approximate $979,000 decrease in pre-tax income related to increasing the Company's allowance for sales returns, (iv) an approximate $207,000 increase in pre-tax income to adjust accrued liabilities related to certain management fees that should have been eliminated at the end of fiscal year 2004, (v) an approximate $863,000 decrease in pre-tax income related to the correction of an error in the Company's analysis for store impairment, (vi) a $484,000 decrease in pre-tax income related to the correction of foreign currency losses previously reported, (vii) an approximate $2.4 million decrease in income tax expense to reduce certain tax contingency reserves, and (viii) an approximate $1.4 million decrease in income tax expense resulting from the impact of the pre-tax adjustments described in items (i) through (vi) above.

Previously filed annual reports on Form 10-K and quarterly reports on Form 10-Q affected by the restatement will not be amended and therefore should not be relied upon.

For additional information regarding this restatement, see Note 2, "Restatement of Consolidated Financial Statements" to the accompanying consolidated financial statements and the section entitled "Restatement of Consolidated Financial Statements" in Management's Discussion and Analysis of the Financial Condition and Results of Operations.

PART I

Item 1. Business

General

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

Domestically, we sell our products through a diversified distribution network that includes department stores, specialty retail locations, specialty watch and jewelry stores, owned retail and factory outlet stores, mass market stores, owned and affiliate internet sites and through our FOSSIL catalog. Our wholesale customer base includes Neiman Marcus, Nordstrom, Macy's, Dillard's, JCPenney, Kohl's, Sears, Wal-Mart and Target. We also sell our products in the United States through a network of company-owned stores, which included 79 retail stores located in premier retail sites and 74 outlet stores located in major outlet malls as of January 6, 2007. In addition, we offer an extensive collection of our FOSSIL brand products through our catalog and at our web site, www.fossil.com as well as proprietary and licensed watch and jewelry brands through other managed and affiliate websites.

Internationally, our products are sold to department stores, specialty retail stores, and specialty watch and jewelry stores in over 90 countries worldwide through 21 company-owned foreign sales subsidiaries and through a network of approximately 56 independent distributors. Our products are distributed in Africa, Asia, Australia, Europe, Central and South America, Canada, the Caribbean, Mexico, and the Middle East. Our products are offered on airlines, cruise ships and in international company-owned retail stores, which included 41 accessory retail stores and 4 outlet stores in select international markets as of January 6, 2007. Additionally, our products are sold through independently-owned FOSSIL retail stores and kiosks in certain international markets.

We are a Delaware corporation formed in 1991 and are the successor to a Texas corporation formed in 1984. In 1993, we completed an initial public offering of 13,972,500 shares of our common stock, as adjusted for four three-for-two stock splits to date. Domestically, we conduct a majority of our operations through Fossil Partners, L.P., a Texas limited partnership formed in 1994 of which we are the sole general partner. We also conduct operations domestically and in certain international markets through various owned subsidiaries. Our principal executive offices are located at 2280 N. Greenville Avenue, Richardson, Texas 75082, and our telephone number at such address is (972) 234-2525. Our common stock is traded on the NASDAQ Global Select Marketplace under the trading symbol FOSL. We make available free of charge through our website at www.fossil.com our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports. You may also obtain any materials we file with, or furnish to, the SEC on its website at www.sec.gov.

Business Segments

The operations and financial reporting of the Company are primarily divided into four distinct segments that include the United States wholesale segment, the Europe wholesale segment, the other International wholesale segment and our direct to consumer segment, which includes our company-owned retail stores and our e-commerce activities. Within the international and domestic wholesale segments of our business we generally sell to retailers in those countries that we have a physical presence as well as to distributors in countries where we do not have a physical presence. Except to the extent that differences between operating segments are material to an understanding of our business taken as a whole, the description of our business in this report is presented on a consolidated basis. For financial information about our operating segments and geographic areas, refer to Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in Part II, Item 7 and Note 14 – Major Customer, Segment and Geographical Information to our Consolidated Financial Statements set forth in Part II, Item 8 of this Annual Report on Form 10-K.

Business Strengths

We believe that we have several business strengths which allow us to differentiate ourselves and execute our key operating and financial goals. These business strengths include:

Brand Strength. We believe a brand's image, individuality, consistency and connection with its customers is paramount in building and sustaining the brand. We believe that our FOSSIL brand name is recognized on a global basis for vintage-inspired products for the authentic individual. The FOSSIL brand has scaled from its origins as a watch brand to encompass numerous other accessory categories, including handbags, belts, small leather goods, jewelry and sunglasses to a beginning emergence in apparel. We believe the FOSSIL brand is one of our most valuable assets, serves as a foundational piece of our business and remains very scalable across product lines, geographic areas and distribution channels. Since our inception in 1984, we have continued to develop, acquire or license other nationally or internationally recognized brand names in order to appeal to a wide range of consumers, including ADIDAS® BURBERRY® DIESEL® DKNY®, EMPORIO ARMANI®, MARC BY MARC JACOBS,™ MICHELE®, MICHAEL Michael Kors®, RELIC® and ZODIAC®. Our industry is highly competitive and subject to changing preferences in style, taste and price points. The success of our business model depends upon offering a wide range of branded products that appeal to the various tastes and fashion preferences of our customers. We must also maintain the relevance of these products by continually anticipating customer needs and desires as they relate to both the brands and categories of product we offer. We have teams of designers and product specialists assigned to each of the brands we offer. The objectives of these designers and brand specialists are to immerse themselves in their assigned brand and product area, identify their customers' preferences, interpret global fashion trends and develop style-right offerings to generate volume purchasing. By owning the vast majority of our global distribution we are also able to create and execute both consistent pricing strategies and brand image presentations that protect and enhance our proprietary brands and those of our licensors.

Licensing Strength. Since 1997, we have attracted highly recognized and respected brand names to license within our watch portfolio. We believe we attract such quality brands due to our ability to provide them with access to our global design, production, distribution and marketing infrastructure. Due to our vertical integration we, unlike many of our competitors, can offer an integrated solution to launch or increase their accessory category presence on a worldwide basis in a consistent, timely and focused manner. Our licensing relationships are exclusive to us and the licensors, which substantially removes certain risks to the licensor associated with dealing with multiple licensees in different geographic regions. Additionally, in order to develop a broader relationship and maintain brand consistency across the accessory categories, we have also broadened our infrastructure allowing us to expand our licensing activities to products beyond the watch category, as evidenced by our EMPORIO ARMANI and DIESEL jewelry product lines.

Breadth of Brands & Price Points. Through the multiple brands we distribute we have developed a broad spectrum of retail price points. Within our watch collections, retail price points vary from approximately $5 for brands sold in the mass market channel up to retail price points of $5,000 in the luxury distribution channels. The breadth of our brands allows us to anchor a brand to a given price point range and distribution channel, thereby maintaining a consistent brand image while focusing on the quality/value relationship important to the customer and not diluting the brand through overlapping distribution channels. The breadth of price points allows us to cater to various age and income groups while continuing to participate in sales interdependent of a shift in income or the price/value preferences of our customers.

International Penetration. Since our initial public offering in 1993, we have continued to extend our reach beyond the United States by forming and acquiring internationally-based subsidiaries, licensing and developing internationally recognized brands and investing in the growth of our business within the major countries of the world. For fiscal year 2006, 45.3% of our net revenues were generated outside of the United States.

Breadth of Distribution Channels. Our products are sold through multiple distribution channels including department stores, specialty retail stores, specialty watch and jewelry stores, mass market stores, sport stores, cruise ships, airlines, owned-retail, business to business, the internet and our catalog. As we continue to expand our presence in existing distribution channels and add new distribution channels, as well as develop new product lines and expand our geographic reach, our revenues become less dependent on any one product, brand, distribution channel or geographic region. Our owned-retail, internet and catalog venues allow us to enhance the related brand image by offering a targeted message to the customer, showcasing the array of product availability, influencing the merchandising and presentation of the products and testing new product introductions.

In-house Creative Team. Since our inception, we have developed a talented pool of creative individuals who design everything from our products to our packaging, graphics, presentation displays and marketing materials, allowing us to deliver a unique and cohesive style and image for each of our brands. We believe our emphasis on constant innovation and distinctive design has made us a leader in the branded accessory category. The breadth of talent and vertical integration of our design teams allows us to minimize the need for outside creative talent and advertising agencies which results in savings to the Company.

International Sourcing. The vast majority of our products are sourced internationally. Product sourcing from Asia is coordinated through our Hong Kong subsidiary Fossil (East) Limited (“Fossil East”), which we acquired in 1993. Of our watch production, approximately 65% of our annual non-Swiss made watch production is assembled through wholly or majority owned factories. This vertical integration of our business allows for better flow of communication, consistent quality, product design protection and improved supply chain speed while still allowing us to utilize non-owned production facilities for their unique capabilities and to cover production needs over internal capacities. Establishing our watch assembly facilities near the component manufacturers also allows us to avoid the capital expenditures involved with manufacturing facilities and operate a more efficient supply chain. We have also been successful in leveraging our jewelry production needs through our watch assembly factory infrastructure. Our other accessory and apparel products are purchased from third party manufactures with whom we have long-standing relationships and we typically represent a meaningful portion of their businesses.

Operating Cash Flow. The Company has historically experienced strong operating cash flows including $148 million in fiscal year 2006, and $264 million and $419 million over the past three years and five years, respectively. This strong cash flow has allowed us to operate at low debt levels while continually funding capital expenditures, acquisitions and common stock buy back programs.

Information Systems. Operating and managing a global public company requires a sophisticated and reliable management information system to assist in the planning, order processing, production, accounting and distribution functions of each relevant business. In 2003 we implemented an SAP Enterprise Resource Planning system and are continuing to roll this system out to our larger international subsidiaries. For those subsidiaries which do not currently demand the complexity of the SAP solution, we have implemented Microsoft's Navision Enterprise Resource Planning. Additionally, we have recently upgraded our e-commerce platform to an IBM mainframe system which will allow us to leverage the success of our U.S.-based web business across many of the countries wherein we currently distribute. We also recently implemented SAP's Retail Merchandise Planning to improve our ability to manage our growing owned-retail environment globally. We believe the implementation of these systems will allow us to gain better insight into our businesses in real-time on a global basis, assist us in meeting the needs of our customers in a professional and timely manner and provide a scalable infrastructure to accommodate further growth. Our company's products are principally distributed from two primary warehouses, one located in Texas, near our headquarters, and the other located in southern Germany. Both of these facilities utilize sophisticated automated material handling equipment and software designed to improve accuracy, speed and quality in our warehousing operations.

Growth Strategy

In order to expand our global market share in a profitable manner, we continually establish and implement business initiatives that we believe will build brand equity, increase revenues and improve profitability. Our key operating and financial goals are as follows:

Extend product categories of existing brands. We continually introduce new accessory product categories within our existing proprietary and licensed brands to further leverage our branded portfolio. A recent example of this is our jewelry collections offered under the EMPORIO ARMANI, DIESEL, FOSSIL and MICHELE brands which were introduced after first establishing a market for the brands in watches. Additionally, during the fall of 2007, we intend to leverage the FOSSIL brand name into cold weather accessories such as hats, gloves and scarves.

Introduce new brands. We continually introduce new brands through the development or acquisition of proprietary brands and licensing agreements related to recognizable global fashion brands to attract a wide range of consumers with differing tastes and lifestyles. For example, our current portfolio of proprietary and licensed watch brands allows us to compete for market share from the luxury and fine premium branded market to the mass market level. In 2006, we licensed the ADIDAS brand to gain a greater market share of watches sold through sporting goods channels and to sports-minded consumers.

Expand international business. Since our initial public offering in 1993, international expansion has been a key driver in our long term growth strategy. We have continued to increase our penetration of the international market by building brand name recognition, broadening the selection of merchandise through existing distribution channels by introducing new products or brands, extending product categories under our existing portfolio of brands, purchasing former distributors to gain increased control over international businesses, establishing owned or licensed retail stores and entering new geographic markets through owned subsidiary or distributor relationships. For example, in 2005, we acquired our distributors in Taiwan and Sweden, and in 2006, we acquired the assets of our distributor in Mexico and formed a distribution subsidiary in Shanghai, China.

Leverage infrastructure. We are building our design, marketing, manufacturing and distribution infrastructure to allow us to manage and grow our businesses. As we continue to develop additional products and brands and seek additional businesses and products to complement our existing product lines, we believe we will be able to leverage our infrastructure and continue to increase the efficiency of our operations.

Expand retail locations. Historically, we have expanded our company-owned retail and outlet locations by generally opening 10 to 20 new stores per year. Distribution through our company-owned retail stores has allowed us to raise awareness of the FOSSIL brand and showcase a broad assortment of FOSSIL branded products in a warm and inviting atmosphere. Our FOSSIL retail stores, combined with the FOSSIL branded catalog distribution and the internet website, have continued to build brand equity, present a consistent brand image, influence the merchandising and presentation of our products at other retailers and allowed us to test new product categories and designs. With the level of awareness we have achieved for the FOSSIL brand worldwide and the expansion of product categories offered under the brand, we believe our FOSSIL retail store growth can now be accelerated. Of the 198 company-owned retail stores open as of January 6, 2007, 183 of these stores are FOSSIL branded stores. We plan to open 50 to 60 additional FOSSIL branded stores in 2007 depending upon available retail locations and lease terms that meet our requirements. The majority of these new store openings will be for our full price accessory concept in the U.S. and Europe, and to a lesser extent, the Asia Pacific region.

Operating strategy

Fashion orientation and design innovation. We are able to market our products to consumers with differing tastes and lifestyles by offering a wide range of brands and product categories at a variety of price points. We attempt to stay abreast of emerging fashion and lifestyle trends affecting accessories and apparel and we respond to these trends by making adjustments in our product lines several times each year. We differentiate our products from those of our competitors principally through innovations in fashion details, including variations in the treatment of dials, crystals, cases, straps and bracelets for our watches, and innovative treatments and details in our other accessories.

Coordinated product promotion. We coordinate in-house product design, packaging, advertising, our website and catalog and in-store presentations to more effectively and cohesively communicate to our target markets the themes and images associated with our brands. For example, many of our watch products and certain of our accessory products are packaged in metal tins decorated with designs consistent with our marketing strategy and product image. In addition, we generally market our fashion accessory lines through the same distribution channels as our watch lines, using similar in-store presentations, graphics and packaging.

Captive suppliers. The two entities that assemble or source the majority of our watch production volume within China and Hong Kong are majority-owned by us. In addition, although we do not have long-term contracts with our unrelated accessory manufacturers in the Far East, we maintain long-term relationships with several manufacturers. These relationships have developed due to the number of years that we have been conducting business with and visiting the same manufacturers and because of the small amount of turnover in the employees of our manufacturers. We believe that we are able to exert significant operational control with regard to our principal watch assemblers because of our level of ownership and we believe that the existence of our relationships with our accessory manufacturers creates a significant competitive advantage, specifically because manufacturers have limited production capacity and our level of ownership of certain watch factories and relationships with manufacturers ensure that we are granted access. Further, the manufacturers understand our quality standards, thereby allowing us to produce quality products, reduce the delivery time to market and improve overall operating margins.

Actively manage retail sales. We manage the retail sales process with our wholesale customers by monitoring consumer sales and retail inventory levels by product category and style, primarily through electronic data interchange, and by assisting our wholesale customers in the conception, development and implementation of their marketing programs. Through our merchandising unit we work with retailers to ensure that our products are properly stocked and displayed in accordance with our visual standards. As a result, we believe we enjoy close relationships with our principal wholesale customers, often allowing us to influence the mix, quantity and timing of their purchasing decisions.

Centralized distribution. We distribute substantially all of our products sold domestically and certain of our products sold in international markets from our warehouse and distribution centers located in Texas. Internationally, we distribute our products primarily through our warehouse and distribution center located in Germany and supplement that distribution from other in-country warehouses located in other international locations. We believe our centralized distribution capabilities enable us to reduce inventory risk, increase flexibility in meeting the delivery requirements of our customers and maintain cost advantages as compared to our competitors.

Industry overview

Watch products

We believe that the current market for watches generally can be divided into four segments. One segment of the market consists of fine watches characterized by internationally known brand names such as Audemars Piguet, Cartier, Omega, Patek Philippe, Piaget and Rolex. Watches offered in this segment are usually made of precious metals or stainless steel and may be set with precious gems. These watches are almost exclusively manufactured in Switzerland and are sold by trade jewelers and in the fine jewelry departments of better department stores and other purveyors of luxury goods at retail prices ranging from $1,500 to in excess of $20,000. A portion of our MICHELE line competes in this market. A second segment of the market consists of fine premium branded and designer watches produced in Switzerland and the Far East such as Gucci, Movado, Raymond Weil, Seiko, Tag Heuer and Tissot. These watches are sold at retail prices generally ranging from $150 to $1,500. Our BURBERRY, EMPORIO ARMANI, MARC BY MARC JACOBS, MICHELE and ZODIAC lines generally compete in this market segment. A third segment of the market consists of watches sold by mass marketers, which typically consist of digital and analog watches manufactured in the Far East. Well known brands in this segment include Armitron, Casio and Timex. Retail prices in this segment range from $5 to $60. We compete in this segment through our Allude, Christian Benet and Trophy lines as well through the design and production of private label watch products for Wal-Mart and Target.

The fourth segment of the market consists of moderately priced watches characterized by contemporary fashion and well known fashion brand names. Moderately priced watches are typically produced in Japan, China or Hong Kong and are sold by department stores and specialty stores at retail prices ranging from $40 to $150. This market segment is targeted by us with our FOSSIL and RELIC lines and by our principal competitors, including the companies that market watches under the Anne Klein II, Guess?, Kenneth Cole and Swatch brand names, whose products attempt to reflect emerging fashion trends in accessories and apparel. Our DKNY, DIESEL, MARC BY MARC JACOBS and MICHAEL Michael Kors lines generally compete in this segment as well. With the addition of our ADIDAS line of women's, men's and children's sport timepieces in January 2006, we also compete in the sports specialty area of this segment. We believe that consumers have increasingly come to regard branded fashion watches not only as time pieces but also as fashion accessories. This trend has historically resulted in consumers owning multiple watches that may differ significantly in terms of style, features and cost.

Watches typically utilize either a mechanical or quartz-analog movement to maintain their time keeping function. Mechanical watches utilize intricate arrangements of wheels, jewels and winding and regulating mechanisms to keep time, while quartz-analog watches are precisely calibrated to the regular frequency of the vibration of a quartz crystal powered by a battery. Although, quartz-analog movements typically maintain their time keeping functions more precisely than mechanical movements, mechanical movements are generally associated with high-end luxury timepieces.

Fashion accessories

We believe that the fashion accessories market includes an array of products such as small leather goods, handbags, belts, eyewear, neckwear, underwear, lounge wear, jewelry, gloves, hats, hosiery and socks. We believe that consumers are becoming more aware of accessories as fashion statements, and as a result, are purchasing brand name, quality items that complement other fashion items. These fashion accessory products are generally marketed through mass merchandisers, department stores and specialty shops, depending upon price and quality. Higher price point items include products offered by such fashion names as Louis Vuitton and Prada.

Moderately priced fashion accessories are typically marketed in department stores and are characterized by contemporary fashion and well known brand names at reasonable price points, such as FOSSIL and RELIC. We currently offer small leather goods, handbags, belts, and eyewear for both men and women through department stores and specialty retailers in the moderate to upper-moderate price ranges. Our competitors in this market include companies such as Guess?, Nine West, Kenneth Cole and Liz Claiborne. In addition, we currently offer fashion jewelry sold under the DIESEL, EMPORIO ARMANI, FOSSIL and MICHELE brands. During the fall of 2007, we plan to launch the FOSSIL brand in certain cold weather accessory categories such as gloves, hats and scarves.

Apparel

In 2000, we introduced a line of FOSSIL apparel that is distributed exclusively through company-owned retail stores, our FOSSIL website and through our FOSSIL catalog distribution. Selling through company-owned distribution channels allows us to more effectively manage visual presentation, information feedback, inventory levels and operating returns. The apparel line is focused on the casual lifestyle of the savvy consumer who is youthful in their approach to life and is not tied to any one demographic or age. The apparel line consists primarily of jeans, tee shirts, and vintage-inspired fashion apparel. The suggested retail selling price of the apparel line is comparable to that of major competitors like American Eagle Outfitters and J. Crew. We have leveraged our existing graphic and store design infrastructure to create a unique, inviting and welcoming environment rich in details of design, product and merchandising to appeal to the consumers’ sense of discovery.

Products

We design, develop, market and distribute fashion accessories, including apparel, belts, handbags, jewelry, small leather goods, sunglasses and watches under proprietary and licensed brand names. The following table sets forth certain information with respect to the breakdown of our net sales and percentage of growth between proprietary, licensed and other brands within our wholesale and direct to consumer distribution channels for the fiscal years indicated. Other brands include private label brands as well as branded product we purchase for resale.

	Fiscal Year Ended				
	2006		2005		2004
	Dollars	% Growth	Dollars	% Growth	Dollars
Net Sales (dollars in thousands)					
Wholesale					
Proprietary	$ 580.6	7.2%	$ 541.8	6.2%	$ 510.4
Licensed	338.2	30.1%	259.9	6.4%	244.3
Other	74.4	8.6%	68.5	17.2%	58.4
	993.2	14.1%	870.2	7.0%	813.1
Direct to consumer					
Proprietary	182.1	23.3%	147.6	16.4%	126.8
Licensed	30.2	51.7%	19.9	55.5%	12.8
Other	8.5	57.4%	5.4	17.4%	4.6
	220.8	27.7%	172.9	19.9%	144.2
Total					
Proprietary	762.7	10.6%	689.4	8.2%	637.2
Licensed	368.4	31.7%	279.8	8.8%	257.1
Other	82.9	12.2%	73.9	17.3%	63.0
	$ 1,214.0	16.4%	$ 1,043.1	9.0%	$ 957.3

Watch products

We offer an extensive line of fashion watches under our proprietary brands and, pursuant to license agreements, under some of the most prestigious brands in the world. Sales of watches for fiscal years 2006, 2005 and 2004 accounted for approximately 65.3%, 66.4% and 68.5%, respectively, of our net sales.

Proprietary brands. The following table sets forth certain information with respect to certain of our owned-brand watches:

Brand(s)	**Suggested Price Point Range**	**Distribution Channels**
FOSSIL	$55 - 165	Major domestic department stores (Macy's, Dillard's, Belk, Nordstrom and Bloomingdales), U.S. specialty retailers (PacSun and the Buckle), major European department stores (Karstadt and Harrod's), major European specialty stores (H. Samuel and Christ), Canadian department stores (Hudson Bay and Sears), Australian department stores (Myers and Grace Brothers), www.fossil.com, our catalog and company-owned stores.
MICHELE	$500 - 5,000	Selective department stores (Neiman Marcus, Saks Fifth Avenue, Bloomingdales and Nordstrom), watch specialty stores, jewelry stores and the internet.
RELIC	$45 - 85	Major domestic retailers (JCPenney, Kohl's, Mervyn's and Sears).
ZODIAC	$175 - 695	Better department stores, watch specialty stores, jewelry stores worldwide and the internet.

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Licensed brands. We have entered into multi-year, worldwide exclusive license agreements for the manufacture, distribution and sale of watches bearing the brand names of certain globally recognized fashion companies. The following table sets forth specific information with respect to certain of our licensed watch products:

Brand(s)	**Suggested Price Point Range**	**Distribution Channels**
ADIDAS	$35 - 165	Major department stores, major sports stores, specialty retailers, jewelry stores and adidas stores worldwide
BURBERRY	$295 - 1,000	Better department stores, specialty retailers, and Burberry retail stores worldwide
DIESEL	$85 - 250	Better department stores, specialty retailers, and Diesel retail stores worldwide
DKNY	$75 - 250	Major department stores, jewelry stores, specialty retailers, and DKNY retail stores worldwide
EMPORIO ARMANI	$125 - 595	Major department stores, specialty retailers, major jewelry and watch stores, Emporio Armani boutiques worldwide and www.emporioarmani.com
MARC BY MARC JACOBS	$125 - 350	Better department stores, specialty retailers and Marc by Marc Jacobs boutiques worldwide
MICHAEL Michael Kors	$100 - 275	Better department stores, specialty retailers, jewelry stores, duty free stores worldwide and Michael Kors boutiques nationwide

The continuation of our material license agreements is important to the growth of our watch business, especially in Europe and Asia. Our material license agreements have various expiration dates between 2007 and 2012. The BURBERRY license expires on December 31, 2007. The EMPORIO ARMANI license agreements for watches and jewelry expire on December 31, 2008. We are currently in the later stages of negotiating with both EMPORIO ARMANI and BURBERRY for new licenses and anticipate finalizing the licenses prior to the end of fiscal year 2007. We have also entered into a number of license agreements for the sale of collectible watches. Under these agreements, we design and manufacture goods bearing the trademarks, trade names and logos of various entities and market these goods through our website and major department stores.

Private label and other. We design, market and arrange for the manufacture of watches and accessories on behalf of certain mass market retailers, companies and organizations as private label products or as premium and incentive items for use in various corporate events. Under these arrangements, we perform design and product development functions as well as act as a sourcing agent for our customers by contracting for and managing the manufacturing process, purchasing and inspecting the finished product and arranging for their shipment. Participation in the private label and premium businesses provides us with certain advantages, including increased manufacturing volume, which may reduce the costs of manufacturing our other products, and the strengthening of business relationships with our manufacturing sources. These lines provide income to us while reducing inventory risks and certain other carrying costs. In certain countries we have distribution rights for other brands not owned or licensed by us.

Fashion accessories

In order to leverage our design and marketing expertise and our close relationships with our principal retail customers, primarily in the United States and Europe, we have developed a line of fashion accessories for both men and women, including handbags, belts, small leather goods, jewelry and sunglasses. Our handbags are made of a variety of fine leathers and other materials that emphasize classic styles and incorporate a variety of creative designs. The sunglass line features optical quality lenses in both plastic and metal frames, with classic and fashion styling. Our small leather goods are typically made of fine leathers or other man-made materials and include items such as mini-bags, coin purses, key chains and wallets. Our jewelry lines include earrings, necklaces, rings and bracelets marketed under the EMPORIO ARMANI, DIESEL, FOSSIL and MICHELE brands. FOSSIL and DIESEL brand jewelry generally is offered in sterling silver or stainless steel with natural and synthetic materials. EMPORIO ARMANI brand jewelry is generally made of sterling silver, semi-precious stones or 18K gold, and MICHELE brand jewelry is generally made of 18K gold with precious or semi-precious stones. We currently sell our fashion accessories through a number of our existing major department store and specialty retail store customers as well as over the internet and through our catalog distribution. We generally market our fashion accessory lines through the same distribution channels as our watch business, using similar in-store presentations, graphics and packaging. These fashion accessories are typically sold in locations adjacent to watch departments, which may lead to purchases by persons who are familiar with our watch brands. Sales of our accessory lines for fiscal years 2006, 2005 and 2004 accounted for approximately 34.7%, 33.6% and 31.5%, respectively, of our net sales.

The following table sets forth certain information with respect to our fashion accessories:

Brand	**Accessory Category**	**Suggested Price Point Range**	**Distribution Channel**
FOSSIL	Handbags Small Leather Goods Belts Eyewear	\$88 – 230 \$14 – 68 \$22 – 38 \$34 – 149	Major domestic department stores (Dillard’s, Macy’s, Nordstrom and Belk), specialty retailers (PacSun and the Buckle), major European stores (Karstadt, El Corte Ingles, Galeries Lafayette, Christ), company-owned stores, our catalog and www.fossil.com
FOSSIL	Jewelry	\$26 – 139	Company-owned stores, department and jewelry stores (in each case, primarily in Europe), our catalog and www.fossil.com
EMPORIO ARMANI	Jewelry	\$85 – 1,200	Major domestic and international department stores, specialty retailers, jewelry stores, Emporio Armani boutiques and www.emporioarmani.com
DIESEL	Jewelry	\$25 – 295	Better department stores, domestic and international specialty retailers and Diesel retail stores worldwide
MICHELE	Jewelry	\$250 – 10,000	Primarily domestic luxury department stores and specialty retailers
RELIC	Sunglasses Handbags	\$22 – 32 \$34 – 44 \$16 – 24	Major retailers (JCPenney, Kohl’s and Sears)

Small Leather Goods	$16 – 24
Belts	

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Apparel

In 2000, we introduced a collection of FOSSIL brand apparel. The apparel collection is designed for both men and women and includes outerwear, tops, bottoms and tee shirts. The products' unique vintage-inspired style, packaging and graphics capture the energy and spirit of the FOSSIL brand. As of January 6, 2007, the FOSSIL apparel collection is offered through 32 company-owned stores located in leading malls and retail locations in the United States. The line is also available at our website.

Other products

Licensed eyewear. We are party to a license agreement with the Safilo Group for the manufacture, marketing and sale of optical frames under the FOSSIL and RELIC brands in the United States and Canada, which provides us royalty income based on a percentage of net sales and is subject to certain guaranteed minimum royalties.

Future products. During the fall of 2007, it is our intent to launch a line of cold weather accessories including hats, gloves and scarves under the FOSSIL brand for sale through major domestic department stores, owned-retail stores and through our website and catalog. We also continually evaluate other opportunities to leverage our brand portfolio into new product line offerings.

Design and development

We believe one of our key strengths is our internal creative team. Our watch, accessory and apparel products are created and developed by our in-house design staff primarily located in Hong Kong, Switzerland and the U.S. When developing product under our various licensed brands, we often coordinate our efforts with our licensors' design teams to provide for a more fluid design approval process and to fully incorporate the image of the respective brand into the product. Product design ideas are drawn from various sources and are reviewed and modified by the design staff to ensure consistency with our existing product offerings and the themes and images associated with our brands. Senior management is actively involved in the design process.

In order to respond effectively to changing consumer preferences, we attempt to stay abreast of emerging lifestyle and fashion trends affecting accessories and apparel. In addition, we attempt to take advantage of the constant flow of information from our customers regarding the retail performance of our products. We review weekly sales reports provided by a substantial number of our customers containing information with respect to sales and inventories by product category and style. Once a trend in the retail performance of a product category or style has been identified, the design and marketing staffs review their product design decisions to ensure that key features of successful products are incorporated into future designs. Other factors having an influence on the design process include the availability of components, the capabilities of the factories that will manufacture the products and the anticipated retail prices and profit margins for the products. Our creative teams have access to over 20 years of our company's product design archives and are kept up-to-date on all the various new component, hardware and materials that become available.

We differentiate our products from those of our competitors principally by incorporating into our product designs innovations in fashion details, including variations in the treatment of dials, crystals, cases, straps and bracelets for our watches, and details and treatments in our other accessories. We also own and license proprietary technology or integrate with our suppliers' technology for certain of our watch products. In certain instances, we believe that such innovations have historically allowed us to achieve significant improvements in consumer acceptance of our product offerings with only nominal increases in manufacturing costs. We believe that the substantial experience of our design staff will assist us in maintaining our current leadership position in the watch and handbag categories and in expanding the scope of our product offerings.

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Marketing and promotion

Our marketing strategy for each of our proprietary brands is to deliver a coordinated and consistent brand image to the consumer regardless of where the consumer may come in contact with the brand. This permeates from point of sale merchandise displays, print and media advertising, our website, our catalog, retail stores, and the product packaging to the product itself. We identify our advertising themes and coordinate our packaging, advertising and point of sale material around these themes. These themes are carefully coordinated in order to convey the flair for fun, fashion and humor that we associate with our products. Our vintage-inspired tin packaging concept for many of our watch products and certain of our accessories is an example of these marketing themes. While our marketing themes typically change each year, the core image of the brand is designed to endure, only changing slightly to keep it fresh and relevant to our targeted consumer. For our licensed brands, we incorporate many of the same concepts but derive the themes generally from the licensors.

We participate in cooperative advertising programs with our major retail customers, whereby we share the cost of certain of their advertising and promotional expenses. An important aspect of the marketing process involves the use of in-store visual support and other merchandising materials, including packages, signs, posters and fixtures. Through the use of these materials, we attempt to differentiate the space used to sell our products from other areas of our customers' stores. We also promote the use of our Shop-in-Shop concept for watches, handbags and small leather goods. The Shop-in-Shop concept involves the use of dedicated space within a customer's store to create a brand "shop" featuring our products and visual displays. We also provide our customers with a large number of preprinted customized advertising inserts and from time to time stage promotional events designed to focus public attention on our products.

Our in-house advertising department designs, develops and implements all of the packaging, advertising, marketing and other promotional aspects of our products. The advertising staff uses computer-aided design techniques to generate the images presented on product packaging and other advertising materials. Senior management worldwide is involved in monitoring our advertising and promotional activities to ensure that themes and ideas are communicated in a cohesive manner to our target audience.

We advertise, market and promote our products to consumers through a variety of media, including catalog inserts, billboards, print media, television, cinema and the internet. We also periodically advertise in trade publications such as *Women's Wear Daily* and *Daily News Record.* In addition, beginning in the Fall 2005, we began distributing Fossil catalogs. The catalogs feature selected FOSSIL brand products and are produced by our in-house staff. The timing and scope of the distribution of these catalogs is determined by our management based on consumer response. We believe these catalogs are a cost-effective way of enhancing the FOSSIL brand and driving sales to both our retail stores and our website, as well as our wholesale customers.

Sales and customers

Domestically, we sell our products in retail locations in the United States through a diversified distribution network that includes department stores, specialty retail locations, specialty watch and jewelry stores, mass market stores and the internet. Our department store doors include stores such as Neiman Marcus, Saks Fifth Avenue, Bloomingdales, Nordstrom, Macy's, Dillard's, JCPenney, Kohl's and Sears. We maintain sales offices in several major cities across the United States staffed with sales associates to assist in managing our department and specialty store accounts and employ a nationwide staff of merchandise coordinators who work with the stores to ensure that our products are displayed appropriately. We also sell certain of our watch and accessory products at company-owned FOSSIL retail stores and outlet stores located throughout the United States and through our website at www.fossil.com. In addition, we sell certain of our proprietary and licensed watch products, as well as upscale watch brands of other companies, such as Citizen and Swiss Army, at our company-owned Modern Watch Co. stores. Our apparel products are sold through select company-owned FOSSIL retail stores and through our website and catalog. We also sell our products at retail locations in major airports in the United States, on cruise ships and in independently-owned, authorized FOSSIL retail stores and kiosks in certain international markets.

Our foreign operations include a presence in Africa, Asia, Australia, Europe, Central and South America, Canada, the Caribbean, Mexico, and the Middle East. The Company maintains sales offices in Australia, Austria, Canada, China, Denmark, France, Germany, Hong Kong, Italy, Japan, Malaysia, Mexico, the Netherlands, New Zealand, Norway, Singapore, Sweden, Spain, Switzerland, Taiwan, and the United Kingdom. Our European headquarters is located in Basel, Switzerland. Internationally, our products are sold to department stores and specialty retail stores in over 90 countries worldwide through 21 company-owned foreign sales subsidiaries and through a network of approximately 56 independent distributors. Foreign distributors generally purchase products at uniform prices established by us for all international sales and resell them to department stores and specialty retail stores. We generally receive payment from our foreign distributors in U.S. currency. We generally do not have long-term contracts with any of our retail customers. All transactions between us and our retail customers are conducted on the basis of purchase orders, which generally require payment of amounts due to us on a net 30 day basis for most of our U.S. based customers and up to 120 days for certain international customers.

In connection with Federated Department Stores Inc.'s acquisition of May Department Stores Co. in 2005, net sales to this combined entity would approximate 9%, 10%, and 11% of our net sales in fiscal years 2006, 2005 and 2004, respectively. No other customer accounted for 10% or more of our net sales in fiscal years 2006, 2005 and 2004.

Domestic wholesale sales. For fiscal years 2006, 2005 and 2004, domestic wholesale sales accounted for approximately 36.5%, 39.5% and 39.9% of our net sales, respectively. In addition, in the same fiscal year periods, our 10 largest customers in the domestic channel represented approximately 25%, 27% and 22% of total net sales, respectively.

International wholesale sales. During the fiscal years 2006, 2005 and 2004, international wholesale sales accounted for approximately 45.3%, 43.9% and 45.1% of net sales, respectively.

Company-owned stores. Our various retail store formats focus on creating emotional connections with our customer through an intense branding experience and personalized customer service. We strive to provide inviting and welcoming environments for our customers that enhance our brand image and seek brand loyalty by continually delivering innovative vintage-inspired products that meet our customers' tastes.

Outlet Stores

In 1995, we commenced operations of FOSSIL outlet stores at selected major outlet malls throughout the United States. We opened our first FOSSIL outlet store outside the U.S. in 2005 and as of January 6, 2007 have increased our outlet locations to four outside of the U.S. These stores, which operate under the FOSSIL name, not only increase our brand awareness but also enable us to liquidate excess inventory generally at significantly better prices than we would obtain through third party liquidators. Our products in such stores are generally sold at discounts from 25% to 75% off the suggested retail price. The table below highlights certain information regarding our FOSSIL outlet stores during the last five years:

Fiscal Year	Open At Beginning of Period	Opened During Period	Closed During Period	Open at End of Period	Total Gross Square Footage (in thousands)	Percentage Increase in Square Footage	Average Gross Square Footage Per Retail Store
2002	44	4	1	47	131.2	8.6%	2,792
2003	47	7	1	53	148.7	13.3%	2,805
2004	53	7	-	60	165.0	11.0%	2,750

2005	60	13	1	72	193.4	17.2%	2,686
2006	72	8	2	78	204.0	5.5%	2,616

Accessory Stores

In 1996, we commenced operations of full priced FOSSIL accessory retail stores ("Accessory Stores") in the United States in order to broaden the recognition of the FOSSIL brand name. The Accessory Stores carry a full assortment of FOSSIL merchandise that is generally sold at the suggested retail price. We believe this store concept presents a key growth strategy for the Company on a worldwide basis. As of January 6, 2007, 31 of our 73 Accessory Stores were located outside of the United States, mainly in Europe and Australia. During fiscal 2007, we believe approximately one half of our planned Accessory Store openings will be in locations outside of the United States. The average size of our Accessory Store is 1,473 total square feet at the end of fiscal 2006 but varies in size based on the projected revenues and geographic location of each store. For example, our international-based stores are generally smaller in square footage than our U.S.-based stores due to higher store rents and typical smaller retail store configurations available in the market. The table below highlights certain information regarding our Accessory Stores for the last five years:

Fiscal Year	Open At Beginning of Period	Opened During Period	Closed During Period	Open at End of Period	Total Gross Square Footage (in thousands)	Percentage Increase In Square Footage	Average Gross Square Footage Per Retail Store
2002	32	8	-	40	65.9	18.9%	1,646
2003	40	4	-	44	76.2	15.8%	1,733
2004	44	5	-	49	82.7	8.5%	1,688
2005	49	10	-	59	94.8	14.6%	1,606
2006	59	18	4	73	107.6	13.5%	1,473

Our U.S. Accessory Stores operating model assumes a retail store size of approximately 1,400 square feet and sales per square foot of $570 during the first twelve months. Our targeted net investment to open an Accessory Store is approximately $650,000 which includes approximately $560,000 of build-out costs, net of landlord contributions, but including furniture and fixtures and pre-opening cost, and $90,000 of initial inventory. Our targeted return on invested capital for the first year is 30%. Our international Accessory Stores are generally smaller in size, however, they have historically delivered sales per square foot significantly higher than our U.S. Accessory Stores. The net investment to open an international store is generally less than that of our U.S. Accessory Store model, primarily due to the smaller footprint.

Other Company-owned Stores

In 2000, we began offering FOSSIL brand apparel through specially designed company-owned apparel stores. As of January 6, 2007, we operated 32 FOSSIL apparel stores in leading malls and retail locations throughout the U.S. Our apparel stores carry the full apparel line along with an assortment of certain FOSSIL watch and accessory products. In 2004, we commenced operations of our first Modern Watch Co. retail store through which we sell certain of our proprietary and licensed brand watches, as well as watches manufactured by other companies. As of January 6, 2007, we operated five Modern Watch Co. stores, all located in the U.S. As of January 6, 2007, we also operated ten non-FOSSIL retail stores outside the U.S. under various names.

During 2006, we entered into an agreement with the House of Frasier, a U.K.-based department store ("HOF"), which allows us to operate the watch department in certain HOF stores. Under this agreement, we own the inventory within the HOF store, provide the labor to operate the department and pay to HOF a commission on the retail watch sales generated in such stores. As of January 6, 2007, we operated the watch department in 25 HOF stores that generated net sales of approximately $4.7 million during 2006. Although we include the net sales derived from the HOF stores in our direct to consumer segment, we do not include the number of locations associated with this arrangement in our retail store count.

Internet sales. In November of 1996, we established our first e-commerce website with the launch of www.fossil.com. The site features a full selection of FOSSIL brand watches, sunglasses, leather goods, apparel and jewelry. The site also provides customer service, company news and shareholder information. Our site is continually updated to provide a fresh look and an easy-to-navigate format that enhances the brand image, while allowing consumers a pleasing shopping experience or a preview of what they may find at their local store carrying the brand. Since its launch, the www.fossil.com has been promoted consistently in support of online brand and direct sales goals. Online marketing efforts include: search/keyword marketing programs through major search partners including Google, Yahoo and MSN; online "storefront" relationships with websites such as America Online, Microsoft Network, Amazon and Yahoo; regular e-mail communications sent to over one million registered consumers using SilverPop; product and promotional banners presented on affiliate sites through integration partners Commission

Junction and Performics; and online brand initiatives in support of viral, sweepstakes and traditional brand initiatives. In support of certain seasonal initiatives we have partnered with groups such as MySpace, YouTube and Ad.com. We have leveraged our e-commerce infrastructure by opening additional sites to support our licensed and owned brands that include www.michele.com, www.zodiacwatches.com, www.emporioarmaniwatches.com, and www.dieseltimeframes.com as well as an international branding site located at http://global.fossil.com/. We also leverage our e-commerce infrastructure to support a business-to-business site that allows domestic specialty retail accounts access to real-time inventory, account information and automated order processing.

During fiscal years 2006, 2005 and 2004, respectively, our direct or to consumer segment that include sales from company-owned stores and e-commerce businesses accounted for approximately 18.2%, 16.6% and 15.0% of net sales, respectively.

Catalog. In fiscal 2006, we distributed approximately 4.2 million FOSSIL catalogs through our company-owned stores in the United States and in mailings to our database of customers collected principally through our website. While catalog sales represent a small portion of FOSSIL brand net sales, we view this initiative as a key communication and advertising tool for the brand, further enhancing and focusing the brand image as well as promoting sales across all of our distribution channels.

Sales personnel. We utilize an in-house sales staff and, to a lesser extent, independent sales representatives to promote the sale of our products to retail accounts. Our in-house sales personnel receive a salary and, in some cases, a commission based on a percentage of sales attributable to specified accounts. Independent sales representatives generally do not sell competing product lines and are under contracts with us that are generally terminable by either party upon 30 days prior notice. These independent contractors are compensated on a commission basis.

Customer service. We have developed an approach to managing the retail sales process that involves monitoring our customers' sales and inventories by product category and style, primarily through electronic data interchange. We review weekly selling and inventory information to ensure our products are properly stocked and replenished on a timely basis. We also assist many of our customers in the conception, development and implementation of their marketing programs. We place significant emphasis on the establishment of cooperative advertising programs with our major retail customers. We believe that management of the retail sales process has resulted in close relationships with our principal customers, often allowing us to influence the mix, quantity and timing of their purchasing decisions.

We believe that our sales approach has historically accounted for high retail turnover in our products, which can result in attractive profit margins for our retail customers. We believe that the resulting profit margins for our wholesale customers encourage them to devote greater selling space to our products within their stores. We are also able to work closely with buyers in determining the mix of products a store should carry. In addition, we believe that the buyers' familiarity with our sales approach has facilitated, and should continue to facilitate, the introduction of new products through our existing distribution network.

We permit the return of damaged or defective products. In addition, although we have no obligation to do so, we accept limited amounts of product returns from our customers in certain other instances. Accordingly, we provide allowances for the estimated amount of product returns. The allowances for product returns as of the end of fiscal years 2006, 2005 and 2004 were $38.3 million, $32.1 million and $29.8 million, respectively. We have not historically experienced returns in excess of our aggregate allowances.

Backlog

It is the practice of a substantial number of our customers not to confirm orders by delivering a formal purchase order until a relatively short time prior to the shipment of goods. As a result, the amount of unfilled customer orders includes confirmed orders and orders that we believe will be confirmed by delivery of a formal purchase order. A majority of such amounts represent orders that have been confirmed. The remainder of such amounts represents orders that we believe, based on industry practice and prior experience, will be confirmed in the ordinary course of business. Our backlog at a particular time is affected by a number of factors, including seasonality and the scheduling of the manufacture and shipment of products. Accordingly, a comparison of backlog from period to period is not necessarily meaningful and may not be indicative of eventual actual shipments. At the end of 2006 we had unfilled customer orders of approximately $115 million compared to $84 million and $116 million for fiscal years 2005 and 2004, respectively.

Manufacturing

Currently, of the watches we procure from the Far East, approximately 65% are produced through our two majority-owned entities that operate, or contract with, assembly factories located in China. The remaining 35% of the watches we procure from Fossil East are manufactured by approximately 50 contract manufacturers located primarily in Hong Kong and China. Although we have no ownership interest in these contract manufacturers, we still maintain control of the supply chain from design through final delivery of the finished product. We believe substantial ownership of the assembly factories that produce a majority of our fashion watches is critical to our operating model as we believe this allows us to keep our designs proprietary, control the size of our production runs and vertically manage our supply chain. Production of approximately 85% of the jewelry product we sell is managed through one of our majority-owned entities in Hong Kong that sources the manufacture of this product through an unrelated factory in China. The remaining 15% is manufactured by approximately ten factories located primarily in China. All of our leather accessory and apparel product production is outsourced. We believe that our policy of outsourcing the production of our leather and apparel product allows us flexibility in selection of our suppliers while avoiding significant capital expenditures, build-ups of work-in-process inventory and the costs of managing a substantial production work force. Our Swiss-made watches are assembled primarily in three third party factories within Switzerland.

The principal components used in the manufacture of our watches are cases, crystals, dials, movements, hands, bracelets and straps. These components are obtained by our manufacturing sources from a large number of suppliers located principally in China, Hong Kong, Italy, Japan, Korea, India, Switzerland, Taiwan and Thailand. The majority of the movements used in the assembly of our watches are supplied by four principal vendors. One case and bracelet vendor produces approximately 25% of our global demands. No other single component supplier accounted for more than 10% of component supplies in 2006. The principal materials used in the manufacture of our jewelry products are sterling silver, stainless steel, semi-precious stones, and natural and synthetic materials. These components are primarily obtained from the same manufacturing sources that we use for our watches. Except for the case and bracelet vendor, we do not believe that our business is materially dependent on any single component supplier.

We believe that we have established and maintain close relationships with a number of component manufacturers and assembly operations located in Hong Kong, China and Switzerland. In 2006, four separate watch manufacturers that are majority-owned by us each accounted for 10% or more of our watch production. The loss of any one of these manufacturers could temporarily disrupt shipments of certain of our watches. However, as a result of the number of component manufacturers and assembly operations from which we purchase our components and finished watches, we believe that we could arrange for the shipment of goods from alternative sources within approximately 90 days on terms that are not materially different from those currently available to us. Accordingly, we do not believe that the loss of any single assembly operation would have a material adverse effect on our business. However, our future success will generally depend upon our ability to maintain close relationships with, or ownership of, our current suppliers and to develop long-term relationships with other suppliers that satisfy our requirements for price and production flexibility.

Our products are manufactured according to plans that reflect management's estimates of product performance based on recent sales results, current economic conditions and prior experience with manufacturing sources. The average lead time from the commitment to purchase products through the production and shipment thereof ranges from two to four months in the case of watches, leather goods, jewelry, eyewear and apparel. We believe that the close relationships and, in certain cases, ownership interest, that we have established and maintain with our principal manufacturing sources constitute a significant competitive advantage and allow us to quickly and efficiently introduce innovative product designs and alter production in response to the retail performance of our products.

Quality control

Our quality control program attempts to ensure that our products meet the standards established by our product development staff. Samples of products are inspected by us prior to the placement of orders with manufacturing sources to ensure compliance with our specifications and we typically inspect prototypes of each product before production runs commence. The operations of our manufacturing sources located in Hong Kong and China are monitored on a periodic basis by Fossil East, and the operations of our manufacturing sources located in Switzerland are monitored on a periodic basis by Montres Antima SA, one of our foreign operating subsidiaries. Substantially all of our watches and certain of our other accessories are inspected by personnel of Fossil East or by the manufacturer prior to shipment to us. Final inspections on a sampling basis occur when the products are received in our distribution centers. We believe that our policy of inspecting our products at the assembly/manufacturing facility, prior to shipment and at our distribution facilities is important to maintain the quality, consistency and reputation of our products.

Distribution

Upon completion of assembly/manufacturing, the majority of our products are shipped to one of our warehousing and distribution centers in Texas or Germany, from which they are shipped to customers in selected markets. Our centralized warehouse and distribution facilities in Texas and Germany allow us to maximize our inventory management and distribution capabilities and more readily meet the varying distribution requirements placed on us by our customers at a lower cost. Our facilities in Texas and Germany are equipped with automated material handling equipment operated by world-class software from SAP AG and Manhattan Associates. The automated equipment and operating systems, in conjunction with the continual manual sampling of our outgoing orders prior to shipment, are important in maintaining the quality, accuracy, speed, and reputation of our products and distribution service.

Our warehouse and distribution facilities in Texas operate in a special purpose sub-zone established by the U.S. Department of Commerce Foreign Trade Zone Board. As a result of the establishment of the sub-zone, the following economic and operational advantages are available to us: (i) we may not have to pay duty on imported merchandise until it leaves the sub-zone and enters the U.S. market, (ii) we may not have to pay any U.S. duty on merchandise if the imported merchandise is subsequently shipped to locations outside the U.S., and (iii) we do not have to pay local property tax on inventory located within the sub-zone.

Management information systems

General. We believe that automation, reliable and scalable systems, accurate reporting and rapid flow of communication is essential to maintain our competitive position and support our key operating and financial goals. Therefore, we continue to invest in computer hardware, system application and telecommunication networks. Our management information systems consist of a wide spectrum of financial, distribution, human resources, merchandising, planning, point of sale, supply chain and other systems. Where possible and cost effective, we leverage our various systems on a global basis which enhances the accuracy, timeliness and accessibility of the relevant data.

Inventory control. We maintain inventory control systems at our facilities that enable us to track each item of merchandise from receipt from our manufacturing sources through shipment to our customers. To facilitate this tracking, a significant number of products sold by us are pre-ticketed and bar coded prior to shipment to our wholesale customers. Our inventory control systems report shipping, sales and individual stock keeping unit level inventory information. We manage the retail sales process by monitoring customer sales and inventory levels of our products by product category and style, primarily through electronic data interchange. We believe that our distribution capabilities enable us to reduce inventory risk and increase flexibility in responding to the delivery requirements of our customers. Our management believes that our electronic data interchange efforts will continue to grow in the future as customers focus further on increasing operating efficiencies. In addition, we maintain systems that are designed to track inventory movement through our company-owned stores. Detailed sales transaction records are accumulated on each store's point-of-sale system and polled nightly by us.

Enterprise resource planning. Over the next few years we intend to continue implementing our enterprise resource planning system from SAP AG throughout certain of our subsidiary operations located in Europe. This software is installed on a single site platform located in our U.S. headquarter facility and is operated off of an IBM mainframe. The software currently supports the human resources, sales and distribution, inventory planning, retail merchandising and operational and financial reporting systems of our U.S. businesses and certain subsidiary operations in Europe. The financial, sales and distribution, inventory planning and reporting system implementations were principally completed in the U.S., Germany and France during 2003, 2004 and 2005, respectively. The human resources and retail systems were implemented for our operations in the U.S. during 2005 and 2007, respectively. We do not believe our subsidiary operations in the Far East are of a size to effectively benefit from our SAP software application. However, we have implemented Microsoft's Navision Enterprise Resource Planning System as our standard throughout most of our Far East distribution subsidiary operations. During 2007, we are planning to implement this system in our principal Hong Kong office and China assembly facilities. The Navision system supports many of the same functions as our SAP system on a local country level.

Warranty and repair

Our FOSSIL watch products sold in the U.S. are covered by a limited warranty against defects in materials or workmanship for a period of 11 years from the date of purchase. RELIC watch products are covered by a comparable 12 year warranty while EMPORIO ARMANI, BURBERRY, MICHELE and ZODIAC watches are covered by a two year limited warranty. Other licensed watch products generally are covered by a one year limited warranty. Generally, all of our watch products sold in Canada, Europe and Asia are covered by a two year limited warranty. The majority of our defective watch products returned by consumers are processed at our centralized repair facilities in Texas and France. We also maintain repair facilities at a majority of our subsidiaries as well as through our network of distributors to handle repairs which are minor in nature or are not convenient to one of our centralized repair facilities. In most cases, defective products under warranty are repaired by our personnel or distributors. We attempt to retain adequate levels of component parts to facilitate after-sales service of our watches, even after the discontinuance of specific styles. In 2001, we developed and implemented a component parts system that tracks the inventory of our various component replacement parts that can be utilized by all authorized repair facilities for identifying stock needs and availability and for procurement. Watch and non-watch products under warranty that cannot be repaired in a cost-effective manner are replaced by us at no cost to the customer.

Governmental regulations

Imports and import restrictions . Most of our products are manufactured overseas. As a result, the U.S. and countries in which our products are manufactured or sold may from time to time modify existing or impose new quotas, duties (including antidumping or countervailing duties), tariffs or other restrictions in a manner that adversely affects us. For example, our products imported to the U.S. are subject to U.S. customs duties and, in the ordinary course of our business we may from time to time be subject to claims by the U.S. Customs Service for duties and other charges. Factors that may influence the modification or imposition of these restrictions include the determination by the U.S. Trade Representative that a country has denied adequate intellectual property rights or fair and equitable market access to U.S. firms that rely on intellectual property, trade disputes between the U.S. and a country that leads to withdrawal of “most favored nation” status for that country and economic and political changes within a country that are viewed unfavorably by the U.S. government. We cannot predict the effect, if any, these events would have on our operations, especially in light of the concentration of our manufacturing operations in Hong Kong and China.

General. Our sunglass products are subject to regulation by the U.S. Food and Drug Administration as medical devices, and certain of our dials and watch straps are subject to regulation by the U.S. Fish and Wildlife Service. We do not believe that compliance with such regulations is material to our operations. In addition, we are subject to various state and federal regulations generally applicable to similar businesses.

Intellectual property

Trademarks. We use the FOSSIL, RELIC, MICHELE, ZODIAC and other trademarks on certain of our watches, leather goods, apparel and other fashion accessories in the U.S. and in a significant number of foreign countries. We have taken steps to establish or provide additional protection for our trademarks by registering or applying to register our trademarks for relevant classes of products in each country wherein our products are sold in addition to certain foreign countries where it is our intent to market our products in the future. Each trademark is renewable indefinitely, so long as we continue to use the mark in the applicable jurisdiction and make the appropriate filings when required. We aggressively protect our trademarks and trade dress and pursue infringers both domestically and internationally. We also pursue counterfeiters both domestically and internationally through leads generated internally, as well as through business partners worldwide. In certain cases we track serial numbers of our products or we etch microscopic identification numbers on certain of our watches in order to identify potential customers who might be diverting product into a parallel market.

Patents. We continue to explore innovations in the design and manufacture of our watch products and are involved in the development of technology enhanced watches. As a result, we have been granted, and have pending, various U.S. and international design and utility patents related to certain of our watch designs and features. We also have been granted, and have pending, various U.S. patents related to certain of our other products and technologies. The expiration date of our two material U.S. patents is April 12, 2019.

License Agreements. A portion of our growth in sales and net income is, and is expected to continue to be, derived from the sales of products produced under licensing agreements with third parties. Under these license agreements, we generally have the right to produce, market and distribute certain products utilizing the brand names of other companies. Our material license agreements have various expiration dates between 2007 and 2012. The BURBERRY and EMPORIO ARMANI licenses expire on December 31, 2007 and 2008, respectively. We are currently negotiating with both parties for new license agreements.

Seasonality

Although the majority of our products are not seasonal, our business is seasonal by nature. A significant portion of our net sales and operating income are generated during the third and fourth quarter of our fiscal year, which includes the “back to school” and Christmas season. Additionally, as our owned-retail sales increase as a percentage of our sales mix, it will benefit our sales and profitability in the fourth quarter, generally at the expense of the first quarter when it is more difficult to leverage retail expenses against the stores’ sales. The amount of net sales and operating income generated during the fourth quarter also depends upon the anticipated level of retail sales during the Christmas season, as well as general economic conditions and other factors beyond our control. In addition, the amount of net sales and operating income generated during the first quarter depends in part upon the actual level of retail sales during the Christmas season. Lower levels of inventory held by our wholesale customers at the end of the Christmas season may result in higher levels of restocking orders placed by them.

Competition

The businesses in which we compete are highly competitive and fragmented. We believe that the current market for watches can be divided into four segments, ranging from lower price point watches that are typically distributed through mass market channels to luxury watches at higher price points that are typically distributed through fine watch departments of upscale department stores or upscale specialty watch and fine jewelry stores. Our watch business generally competes with a number of established manufacturers, importers and distributors in many of these segments, including, Armitron, Citizen, Gucci, Kenneth Cole, LVMH Group, Movado, Raymond Weil, Seiko, Swatch, Swiss Army, TAG Heuer and Timex. In addition, our leather goods, sunglass, jewelry and apparel businesses compete with a large number of established companies that have significantly greater experience than us in designing, developing, marketing and distributing such products. In all of our businesses, we compete with numerous manufacturers, importers and distributors who have significantly greater financial, distribution, advertising and marketing resources than us. Our competitors include distributors that import watches, accessories and apparel from abroad, domestic companies that have established foreign manufacturing relationships and companies that produce accessories and apparel domestically.

Although the level and nature of competition varies among our product categories and geographic regions, we believe that we compete on the basis of style, price, value, quality, brand name, advertising, marketing, distribution and customer service. In addition, we believe that our ability to identify and respond to changing fashion trends and consumer preferences, to maintain existing relationships and develop new relationships with manufacturing sources, to deliver quality merchandise in a timely manner and to manage the retail sales process are important factors in our ability to compete.

We consider the risk of significant new competitors is mitigated to some extent by barriers to entry such as high startup costs and the development of long-term relationships with customers and manufacturing sources. During the past few years, it has been our experience that better department stores and other major retailers have been increasingly unwilling to source products from suppliers who are not well capitalized or do not have a demonstrated ability to deliver quality merchandise in a timely manner. There can be no assurance, however, that significant new competitors will not emerge in the future.

Employees

As of the end of fiscal year 2006, we employed approximately 7,400 persons, including approximately 2,200 persons employed by our foreign operating subsidiaries.

None of our domestic or international employees are represented by a trade union, however certain European-based employees are represented by work councils, consisting of certain of the current employees who negotiate with management on behalf of all the employees. We have never experienced a work stoppage and consider our working relationship with our employees and work councils to be good.

Item 1A. Risk Factors

The statements contained in this Annual Report on Form 10-K that are not historical facts, including, but not limited to, statements regarding our expected financial position, business and financing plans found in Item 1. Business and Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words may, believes, expects, plans, intends, anticipates and similar expressions identify forward-looking statements. The actual results of the future events described in such forward-looking statements could differ materially from those stated in such forward-looking statements.

Our actual results may differ materially due to the risks and uncertainties discussed in this Annual Report, including those discussed below. Accordingly, readers of the Annual Report should consider these facts in evaluating the information and are cautioned not to place undue reliance on the forward-looking statements contained herein. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Risk Factors Relating to Our Business

The matters relating to the investigation by the Special Committee of the Board of Directors and the restatement of our consolidated financial statements may result in additional litigation and governmental enforcement actions.

On November 14, 2006, we announced that an internal review had discovered irregularities related to the issuance of certain equity grants made from fiscal years 1993 through 2006. We also announced that a Special Committee of outside directors (the "Special Committee") had been formed and had hired independent counsel, with the assistance of forensic accountants, to conduct a full investigation of our past equity granting practices. As described in the Explanatory Note immediately preceding Part I, Item 1, and in Note 2, "Restatement of Consolidated Financial Statements" in Notes to Consolidated Financial Statements in this Form 10-K, as a result of the internal review and independent investigation, we have concluded, and the Audit Committee agrees, that incorrect measurement dates were used for financial accounting purposes for certain equity grants made in prior periods. As a result, we have recorded additional non-cash stock-based compensation expense, and related tax effects, with regard to certain past equity grants and have restated certain previously filed financial statements included in this Form 10-K.

On November 14, 2006, we also self-reported to the staff of the SEC that the Special Committee was reviewing our historical equity granting practices. In a letter dated November 28, 2006, the SEC staff advised us that it had commenced an informal inquiry regarding our stock option grants and related accounting. We cooperated fully with this inquiry. In a letter dated July 20, 2007, the SEC staff has informed us that their investigation has been completed and they do not intend to recommend any enforcement action by the SEC. While we believe we have made appropriate judgments in determining the most appropriate measurement dates for our equity grants, the SEC may disagree with the manner in which we have accounted for and reported, or not reported, the financial impacts. Accordingly, there is a risk we may have to further restate our prior financial statements, amend prior filings with the SEC, or take other actions not currently contemplated.

Our past equity granting practices and the restatement of prior financial statements have exposed us to greater risks associated with litigation, regulatory proceedings and government enforcement actions. As described in Part I, Item 3, Legal Proceedings, several derivative complaints have been filed in federal courts against our current and former directors and certain of our executive officers pertaining to allegations relating to stock option grants. Litigation and any potential regulatory proceeding or action may be time consuming, expensive and distracting from the conduct of our business. No assurance can be given regarding the outcomes from litigation, regulatory proceedings or government enforcement actions relating to our past equity granting practices. Furthermore, if we are subject to adverse findings in litigation, regulatory proceedings or government enforcement actions, we could be required to pay damages or penalties or have other remedies imposed, which could harm our business, financial condition, results of operations and cash flows. We cannot provide assurance that we will not be subject to adverse publicity or adverse customer reactions in connection with these matters. In addition, if our business results deteriorate significantly, or if there is an event, outcome or action as a result of the pending civil litigation which is materially adverse to the Company, our credit ratings may be downgraded. A significant downgrade in ratings may increase the cost of borrowing for the Company or limit the Company's access to capital.

We also received NASDAQ Staff Determination notices on November 20, 2006 and March 13, 2007 stating we were not in compliance with NASDAQ Marketplace Rule 4310(c)(14) because we had not timely filed our Quarterly Report on Form 10-Q for the quarter ended October 7, 2006 and our Annual Report on Form 10-K for the period ended January 6, 2007, respectively, and were therefore subject to delisting from the NASDAQ Global Select Market. On May 18, 2007, we received notice from the NASDAQ Listing and Hearing Review Council (the "Council") indicating that the Council had called for review the April 24, 2007 decision of the NASDAQ Listing Qualifications Panel (the "Panel"). In addition, we received notice that the Council, pursuant to its discretionary authority under NASDAQ Marketplace Rule 4807(b), has also decided to stay the April 24, 2007 decision to suspend our securities from trading, pending further action by the Council. On May 21, 2007 we received an additional Determination letter from NASDAQ stating we were not in compliance with NASDAQ Marketplace Rule 4310(c)(14) because we had not timely filed our Quarterly Report on Form 10-Q for the quarter ended April 6, 2007, which did not impact the Council's previous decision regarding the stay. During the stay, our shares will remain listed on the NASDAQ Global Select Market. With the filing of this annual report on Form 10-K, and other delinquent filings to be made, we believe that we will remedy our non-compliance with Marketplace Rule 4310(c)(14), subject to NASDAQ's affirmative completion of its compliance protocols and its notification of the Company accordingly. However, if the SEC disagrees with the manner in which we have accounted for and reported, or not reported, the financial impact of past equity grants, there could be further delays in filing subsequent SEC reports that might result in delisting of our common stock from the NASDAQ Global Select Market.

Our success depends upon our ability to anticipate and respond to changing fashion trends.

Our success depends upon our ability to anticipate and respond to changing fashion trends and consumer preferences in a timely manner. The purchasing decisions of consumers are highly subjective and can be influenced by many factors, such as brand image, marketing programs and product design. Our success depends, in part, on our ability to anticipate, gauge and respond to these changing consumer preferences in a timely manner while preserving the authenticity and quality of our brands. Although we attempt to stay abreast of emerging lifestyle and fashion trends affecting accessories and apparel, any failure by us to identify and respond to such trends could adversely affect consumer acceptance of our existing brand names and product lines, which in turn could adversely affect sales of our products. If we misjudge the market for our products, we may be faced with a significant amount of unsold finished goods inventory.

Our success depends upon our ability to continue to develop innovative products

Our success also depends upon our ability to continue to develop innovative products in the respective markets in which we compete. If we are unable to successfully introduce new products, or if our competitors introduce superior products, customers may purchase increasing amounts of products from our competitors, which could adversely affect our revenues and results of operations.

We have recently expanded and intend to further expand the scope of our product offerings and new products introduced by us may not achieve consumer acceptance comparable to that of our existing product lines.

We have recently expanded and intend to further expand the scope of our product offerings. As is typical with new products, market acceptance of new designs and products we may introduce is subject to uncertainty. In addition, we generally make decisions regarding product designs several months in advance of the time when consumer acceptance can be measured. If trends shift away from our products, or if we misjudge the market for our product lines, we may be faced with significant amounts of unsold inventory or other conditions which could have a material adverse effect on our results of operations.

The failure of new product designs or new product lines to gain market acceptance could also adversely affect our business and the image of our brands. Achieving market acceptance for new products may also require substantial marketing efforts and expenditures to expand consumer demand. These requirements could strain our management, financial and operational resources. If we do not continue to develop innovative products that provide better design and performance attributes than the products of our competitors and that are accepted by consumers, or if our future product lines misjudge consumer demands, we may lose consumer loyalty, which could result in a decline in our revenues and market share.

The effects of economic cycles, terrorism, acts of war and retail industry conditions may adversely affect our business.

Our business is subject to economic cycles and retail industry conditions. Purchases of discretionary fashion accessories, such as our watches, handbags, sunglasses and other products, tend to decline during recessionary periods when disposable income is low and consumers are hesitant to use available credit. In addition, acts of terrorism, acts of war and military action both in the United States and abroad can have a significant effect on economic conditions and may negatively affect our ability to procure our products from manufacturers for sale to our customers. Any significant declines in general economic conditions, public safety concerns or uncertainties regarding future economic prospects that affect consumer spending habits could have a material adverse effect on consumer purchases of our products.

Seasonality of our business may adversely affect our net sales and operating income.

Our quarterly results of operations have fluctuated in the past and may continue to fluctuate as a result of a number of factors, including seasonal cycles, the timing of new product introductions, the timing of orders by our customers and the mix of product sales demand. Our business is seasonal by nature. A significant portion of our net sales and operating income are generated during the fourth quarter of our fiscal year, which includes the Christmas season. The amount of net sales and operating income generated during the fourth quarter depends upon the anticipated level of retail sales during the Christmas season, as well as general economic conditions and other factors beyond our control. In addition, the amount of net sales and operating income generated during the first quarter depends in part upon the actual level of retail sales during the Christmas season. The seasonality of our business may adversely affect our net sales and operating income during the first and fourth quarter of our fiscal year.

Our business could be harmed if we fail to maintain proper inventory levels.

We maintain an inventory of selected products that we anticipate will be in high demand. We may be unable to sell the products we have ordered in advance from manufacturers or that we have in our inventory. Inventory levels in excess of customer demand may result in inventory write-downs or the sale of excess inventory at discounted or closeout prices. These events could significantly harm our operating results and impair the image of our brands. Conversely, if we underestimate consumer demand for our products or if our manufacturers fail to supply quality products in a timely manner, we may experience inventory shortages, which might result in unfilled orders, negatively impact customer relationships, diminish brand loyalty and result in lost revenues, any of which could harm our business.

The loss of any of our license agreements, pursuant to which a number of our products are produced, may result in the loss of significant revenues and may adversely affect our business.

A portion of our growth in sales and net income is, and is expected to continue to be, derived from the sales of products produced under license agreements with third parties. Under these license agreements, we generally have the right to produce, market and distribute certain products utilizing the brand names of other companies. We sell products under certain licensed brands, including, but not limited to, ADIDAS, EMPORIO ARMANI, BURBERRY, DIESEL, DKNY, MARC BY MARC JACOBS and MICHAEL Michael Kors. Sales of our licensed products amounted to 30.3% of our sales for fiscal year 2006, with certain individual licensed brands accounting for a significant portion of our revenues. Our material license agreements have various expiration dates between 2007 and 2012. In addition, certain license agreements may require us to make minimum royalty payments, subject us to restrictive covenants or require us to comply with certain other obligations and may be terminated by the licensor if these or other conditions are not met or upon certain events. We may not be able to continue to meet our obligations or fulfill the conditions under these agreements in the future. In addition, we may be unable to renew our existing license agreements beyond the current term or obtain new license agreements to replace any lost license agreements on similar economic terms or at all. The failure by us to maintain or renew one or more of our existing material license agreements could result in a significant decrease in our revenues and have a material adverse affect on our results of operations.

Our license agreements may require minimum royalty commitments regardless of the level of product sales under these agreements.

With respect to our license agreements, we have in the past experienced, and could again in the future experience, instances where minimum royalty commitments under these agreements exceeded royalties payable based upon our sales of such licensed products. We incurred royalty expense of approximately $44.1 million, $34.6 million and $32.9 million in fiscal years 2006, 2005 and 2004, respectively. We also have several agreements in effect at the end of fiscal year 2006 which expire on various dates from December 2007 through December 2012 that require us to pay royalties ranging from 3% to 20% of defined net sales.

Fluctuations in the price, availability and quality of raw materials could cause delays and increase costs.

Fluctuations in the price, availability and quality of the raw materials used by us in our products, or used by our third-party manufacturers, could have a material adverse effect on our cost of sales or ability to meet our customers' demands. The price and availability of such raw materials may fluctuate significantly, depending on many factors, including natural resources, increased freight costs, increased labor costs and weather conditions. In the future we may not be able to pass all or a portion of such higher raw materials prices on to our customers.

We rely on third-party manufacturers and problems with, or loss of, our suppliers or raw materials could harm our business and results of operations.

All of our apparel, sunglass and leather goods and certain of our watch and jewelry products are produced by independent manufacturers. We do not have long-term contracts with these manufacturers. In addition, we face the risk that these third-party manufacturers with whom we contract to produce our products may not produce and deliver our products on a timely basis, or at all. As a result, we cannot be certain that these manufacturers will continue to manufacture products for us or that we will not experience operational difficulties with our manufacturers, such as reductions in the availability of production capacity, errors in complying with product specifications, insufficient quality control, shortages of raw materials, failures to meet production deadlines or increases in manufacturing costs. The failure of any manufacturer to perform to our expectations could result in supply shortages for certain products and harm our business.

Access to suppliers that are not Fossil subsidiaries is not guaranteed because we do not maintain long-term contracts but instead rely on long-standing business relationships, which may not continue in the future.

A majority of our watch products are currently sourced or manufactured to our specifications by two factories located in China and Hong Kong, which are either wholly-owned or majority-owned by us and by one factory whose owner has a minority interest in a trading company we own, and, to a lesser extent, by owned or independent manufacturers in China, Hong Kong and Switzerland. Certain of our other products are currently manufactured to our specifications by independent manufacturers in international locations, including China, Hong Kong, Italy, Korea, Mexico and Taiwan. We have no long-term contracts with these independent manufacturing sources and compete with other companies for production facilities. All transactions between us and our independent manufacturing sources are conducted on the basis of purchase orders. Our future success will depend upon our ability to maintain close relationships with our current suppliers and to develop long-term relationships with other suppliers that satisfy our requirements for price, quality and production flexibility.

If an independent manufacturer or license partner of ours fails to use acceptable labor practices, our business could suffer.

We have no control over the ultimate actions or labor practices of our independent manufacturers. The violation of labor or other laws by one of our independent manufacturers, or by one of our license partners, or the divergence of an independent manufacturer's or license partner's labor practices from those generally accepted as ethical in the United States or other countries in which the violation or divergence occurred, could interrupt or otherwise disrupt the shipment of finished products to us or damage our reputation. Any of these, in turn, could have a material adverse effect on our financial condition and results of operations. As a result, should one of our independent manufacturers be found in violation of state or international labor laws, we could suffer financial or other unforeseen consequences.

We extend unsecured credit to our customers and are therefore vulnerable to any financial difficulties they may face.

We sell our merchandise primarily to department stores and specialty retail stores in over 90 countries worldwide. We extend credit based on an evaluation of each customer's financial condition, usually without requiring collateral. Should any of our larger customers experience financial difficulties, we could curtail business with such customers or assume more credit risk relating to such customers' receivables. Our inability to collect on our trade accounts receivable relating to such customers could have a material adverse effect on the amount of revenues that we receive and our results of operations.

We do not maintain long-term contracts with our customers and are unable to control their purchasing decisions.

We do not maintain long-term purchasing contracts with our customers and therefore have no contractual leverage over their purchasing decisions. A decision by a major department store or other significant customer to decrease the amount of merchandise purchased from us or to cease carrying our products could have a material adverse effect on our revenues and operating strategy.

Our ability to continue our sales growth is dependent upon the implementation of our growth strategy, which we may not be able to achieve.

During recent years, we have experienced substantial growth in sales. Our ability to continue this growth is dependent on the successful implementation of our business strategy. This includes diversification of our product offerings, expansion of our company-owned accessory and outlet locations and certain strategic acquisitions. If we are not successful in the expansion of our product offerings or our new products are not profitable or do not generate sales comparable to those of our existing businesses, our results of operations could be negatively impacted. Another element of our business strategy is to place increased emphasis on growth in selected international markets. If our brand names and products do not achieve a high degree of consumer acceptance in these markets, our revenues could be adversely affected.

We also operate FOSSIL brand stores and other non-FOSSIL branded stores and have historically expanded our company-owned accessory and outlet locations to further strengthen our brand image. As of January 6, 2007, we operated 198 worldwide. The costs associated with leasehold improvements to current stores and the costs associated with opening new stores could materially increase our costs of operation, particularly if we decide to open more stores on a yearly basis than our historical averages.

We could be negatively impacted if we fail to successfully integrate the businesses we acquire.

As part of our growth strategy, we have made certain acquisitions, domestically and internationally, including acquisitions of FOSSIL stores previously operated under license agreements, acquisitions of certain watch brands, and acquisitions of independent distributors of our products. The integration of these and future acquisitions may not be successful or generate sales increases. When we have acquired businesses, we have acquired businesses that we believe could enhance our business opportunities and our growth prospects. All acquisitions involve risks that could materially adversely affect our business and operating results. These risks include:

- distraction of management from our business operations;
- loss of key personnel and other employees;
- costs, delays, and inefficiencies associated with integrating acquired operations and personnel;
- the impairment of acquired assets and goodwill; and
- acquiring the contingent and other liabilities of the businesses we acquire.

In addition, acquired businesses may not provide us with increased business opportunities, or result in the growth that we anticipate. Furthermore, integrating acquired operations is a complex, time-consuming, and expensive process. Combining acquired operations with us may result in lower overall operating margins, greater stock price volatility, and quarterly earnings fluctuations. Cultural incompatibilities, career uncertainties, and other factors associated with such acquisitions may also result in the loss of employees. Failure to acquire and successfully integrate complementary practices, or failure to achieve the business synergies or other anticipated benefits, could materially adversely affect our business and results of operations.

Our competitors are established companies that have greater experience than us in a number of crucial areas, including design and distribution.

There is intense competition in each of the businesses in which we compete. Our moderately priced watch business competes with a number of established manufacturers, importers and distributors such as Anne Klein II, Guess?, Kenneth Cole and Swatch. Our fine premium branded and designer watch business competes with a number of established manufacturers, importers and distributors such as Gucci, Rado, Raymond Weil, Seiko and Swiss Army. In addition, our leather goods, sunglass, jewelry and apparel businesses compete with a large number of established companies that have significantly greater experience than us in designing, developing, marketing and distributing such products. In all of our businesses, we compete with numerous manufacturers, importers and distributors who may have significantly greater financial, distribution, advertising and marketing resources than us. Our competitors include distributors that import watches, accessories and apparel from abroad, domestic companies that have established foreign manufacturing relationships and companies that produce accessories and apparel domestically. Our results of operations and market position may be adversely affected by our competitors and their competitive pressures in the watch, fashion accessory and apparel industries.

We have key facilities in the United States and overseas, the loss or regulation of any of which could harm our business.

Our administrative and distribution operations in the United States are conducted primarily from four separate facilities located in the Dallas, Texas area. Our operations internationally are conducted from various administrative, distribution and manufacturing facilities outside of the United States, particularly in Germany, Hong Kong and Switzerland. The complete or temporary loss of use of all or part of these facilities could have a material adverse effect on our business.

Our warehouse and distribution facilities in Dallas and Richardson, Texas are operated in a special purpose sub-zone established by the U.S. Department of Commerce Foreign Trade Zone Board. Although the sub-zone allows us certain tax advantages, the sub-zone is highly regulated by the U.S. Customs Service. This level of regulation may cause disruptions or delays in the distribution of our products out of these facilities. Under some circumstances, the U.S. Customs Service has the right to shut down the entire sub-zone and, therefore, our entire warehouse and distribution facilities. During the time that the sub-zone is shut down, we may be unable to adequately meet the supply requests of our customers and our company-owned retail stores, which could have an adverse effect on our sales, relationships with our customers, and results of operation, especially if the shut down were to occur during our third or fourth quarter.

Our implementation of a new enterprise resource planning system could disrupt our computer system and divert management time.

In 2003, we began implementing an enterprise resource planning system from SAP AG, a German software company. We implemented the new enterprise resource planning system in our U.S., Germany and France locations in 2003, 2004 and 2005, respectively. Over the next few years, we intend to replace our existing enterprise resource planning systems and other principal financial systems in certain other subsidiaries with software systems provided by SAP AG. Our current expansion plans may place significant strain on our management, working capital, financial and management control systems and staff. The failure to maintain or upgrade financial and management control systems, to recruit additional staff or to respond effectively to difficulties encountered during expansion could have a material adverse effect on our ability to respond to trends in our target markets, market our products and meet our customers' requirements. The sustained disruption or failure of our systems due to force majeure or as part of an upgrade, conversion or other systems maintenance could result in the same adverse effects.

Changes in the mix of product sales demand could negatively impact our gross profit margins.

Our gross profit margins are impacted by our sales mix. Sales from our company-owned full price retail stores and international and licensed watch businesses generally provide gross margins in excess of our historical consolidated gross profit margin, while accessory products generally provide gross profit margins below our historical consolidated gross profit margin. If future sales from our company-owned full price retail stores and international and licensed watch businesses do not increase at a faster rate than our domestic accessory business, our gross profit margins may grow at a slower pace, cease to grow, or decrease relative to our historical consolidated gross profit margin. We have also recently begun distributing private label product to the mass market channel at gross profit margins significantly lower than our historical consolidated gross profit margin. Although this business only represents approximately 2.5% of our consolidated net revenues, future growth in this channel at rates in excess of our consolidated net revenue growth rate could negatively impact our consolidated gross profit margins.

Our industry is subject to pricing pressures that may adversely impact our financial performance.

We manufacture many of our products offshore because such products generally cost less to make, primarily because labor costs are lower. Many of our competitors also source their product requirements offshore to achieve lower costs, possibly in locations with lower costs than our offshore operations, and those competitors may use these cost savings to reduce prices. To remain competitive, we must adjust our prices from time to time in response to these industry-wide pricing pressures. Our financial performance may be negatively affected by these pricing pressures if we are forced to reduce our prices and we cannot reduce our production costs or our production costs increase and we cannot increase our prices.

Our failure or inability to protect or enforce our intellectual property may harm our business.

Our trademarks, patents and other intellectual property rights are important to our success and competitive position. We are devoted to the establishment and protection of our trademarks, patents and other intellectual property rights in those countries where we believe it is important to our ability to sell our products. However, we cannot be certain that the actions we have taken will result in enforceable rights, will be adequate to protect our products in every country where we may want to sell our products, will be adequate to prevent imitation of our products by others or will be adequate to prevent others from seeking to prevent sales of our products as a violation of the trademarks, patents or other intellectual property rights of others. The inability or failure to obtain trademark, patent or other intellectual property rights could materially harm our business. Additionally, we rely on the patent, trademark and other intellectual property laws of the United States and other countries to protect our proprietary rights. Even if we are successful in obtaining appropriate trademark, patent and other intellectual property rights, we may be unable to prevent third parties from using our intellectual property without our authorization, particularly in those countries where the laws do not protect our proprietary rights as fully as in the United States. Because we sell our products internationally and are dependent on foreign manufacturing in Hong Kong and China, we are significantly dependent on foreign countries to protect our intellectual property. The use of our intellectual property or similar intellectual property by others could reduce or eliminate any competitive advantage we have developed, causing us to lose sales or otherwise harm our business. Further, if it became necessary for us to resort to litigation to protect our intellectual property rights, any proceedings could be burdensome and costly and we may not prevail.

Our products may infringe the intellectual property rights of others, which may cause us to incur unexpected costs or prevent us from selling our products.

We cannot be certain that our products do not and will not infringe the intellectual property rights of others. We may be subject to legal proceedings and claims in the ordinary course of our business, including claims of alleged infringement of the intellectual property rights of third parties by us or our customers in connection with their use of our products. Any such claims, whether or not meritorious, could result in costly litigation and divert the efforts of our personnel. Moreover, should we be found liable for infringement, we may be required to enter into licensing agreements (if available on acceptable terms or at all) or to pay damages and cease making or selling certain products. Moreover, we may need to redesign or rename some of our products to avoid future infringement liability. Any of the foregoing could cause us to incur significant costs and prevent us from manufacturing or selling our products.

An increase in product returns could negatively impact our operating results.

We recognize revenues as sales when merchandise is shipped and title transfers to the customer. We permit the return of damaged or defective products and accept limited returns and will request that a customer return a product if we feel the customer has an excess of any style that we have identified as being a poor performer for that customer or geographic location. Accordingly, we provide allowances for the estimated amounts of these returns at the time of revenue recognition based on historical experience. Any significant increase in product damages or defects and the resulting credit returns could have a material adverse impact on our operating results for the period or periods in which such returns materialize.

There are inherent limitations in all control systems, and misstatements due to error or fraud may occur and not be detected.

We are subject to the ongoing internal control provisions of Section 404 of the Sarbanes-Oxley Act of 2002. These provisions provide for the identification of material weaknesses in internal controls over financial reporting, which is a process to provide reasonable assurance regarding the reliability of financial reporting for external purposes in accordance with accounting principles generally accepted in the United States of America. Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our internal controls and disclosure controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, in our Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may be inadequate because of changes in conditions, such as growth of the company or increased transaction volume, or the degree of compliance with the policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

In addition, discovery and disclosure of a material weakness, by definition, could have a material adverse impact on our financial statements. Such an occurrence could discourage certain customers or suppliers from doing business with us, cause downgrades in our debt ratings leading to higher borrowing costs, and affect how our stock trades. This could in turn negatively affect our ability to access public debt or equity markets for capital.

Factors Relating to Our International Operations

Factors affecting international commerce and our international operations may seriously harm our financial condition.

We generate a significant portion of our revenues from outside of the United States, and we anticipate that revenue from our international operations could account for an increasingly larger portion of our revenues. Our international operations are directly related to, and dependent on, the volume of international trade and foreign market conditions. International commerce and our international operations are subject to many risks, some of which are discussed in more detail below, including:

- recessions in foreign economies;
- the adoption and expansion of trade restrictions;
- limitations on repatriation of earnings;
- difficulties in protecting our intellectual property or enforcing our intellectual property rights under the laws of other countries;
- longer receivables collection periods and greater difficulty in collecting accounts receivable;
- difficulties in managing foreign operations;
- social, political and economic instability;
- unexpected changes in regulatory requirements;
- our ability to finance foreign operations;
- tariffs and other trade barriers; and
- U.S. government licensing requirements for exports.

The occurrence or consequences of any of these risks may restrict our ability to operate in the affected regions and decrease the profitability of our international operations, which may seriously harm our financial condition.

We depend on independent distributors to sell our products in certain international markets.

We sell our products in certain international markets mainly through independent distributors. If a distributor fails to meet annual sales goals, it may be difficult and costly to locate an acceptable substitute distributor. If a change in our distributors becomes necessary, we may experience increased costs, as well as a substantial disruption in, and a resulting loss of, sales.

Foreign currency fluctuations could adversely impact our financial condition.

We generally purchase our products in U.S. dollars. However, we source a significant amount of our products overseas and, as such, the cost of these products purchased by our subsidiaries may be affected by changes in the value of the currencies, including the Australian Dollar, British Pound, Canadian Dollar, Chinese Yuan, Danish Krone, Euro, Japanese Yen, Malaysian Ringgit, Mexican Peso, Norwegian Kroner, Singapore Dollar, Swedish Krona, Swiss Franc and Taiwanese Dollar. Due to our dependence on manufacturing operations in China, changes in the value of the Chinese Yuan may have a material impact on our supply channels and our manufacturing costs, including component and assembly costs. Changes in the currency exchange rates may also affect the relative prices at which we and our foreign competitors sell products in the same market. Although we utilize forward contracts to mitigate foreign currency risks (mostly relating to the Euro and the British Pound), if we are unsuccessful in mitigating these risks, foreign currency fluctuations may have a material adverse impact on the results of our operations.

Because we are dependent on foreign manufacturing we are vulnerable to changes in economic and social conditions in Asia and disruptions in international travel and shipping.

Because a substantial portion of our watches and certain of our handbags, sunglasses and other products are manufactured in Hong Kong and China, our success will depend to a significant extent upon future economic and social conditions existing in Hong Kong and China. If the manufacturing sources in Hong Kong and China were disrupted for any reason, we would need to arrange for the manufacture and shipment of products by alternative sources. Because the establishment of new manufacturing relationships involves numerous uncertainties, including those relating to payment terms, costs of manufacturing, adequacy of manufacturing capacity, quality control and timeliness of delivery, we are unable to predict whether such relationships would be on terms that we regard as satisfactory. Any significant disruption in our relationships with our manufacturing sources located in Hong Kong and China would have a material adverse effect on our ability to manufacture and distribute our products. Restrictions on travel to and from these and other regions, similar to those imposed during the outbreak of Severe Acute Respiratory Syndrome in 2003, commonly known as SARS, and any delays or cancellations of customer orders or the manufacture or shipment of our products on account of SARS or other syndromes could have a material adverse effect on our ability to meet customer deadlines and timely distribute our products in order to match consumer tastes.

Risks associated with foreign government regulations and U.S. trade policy may affect our foreign operations and sourcing.

Our businesses are subject to risks generally associated with doing business abroad, such as foreign governmental regulation in the countries in which our manufacturing sources are located, primarily Hong Kong and other parts of China. While we have not experienced any material issues with foreign governmental regulations that would impact our arrangements with our foreign manufacturing sources, we believe that this issue is of particular concern with regard to China due to the less mature nature of the Chinese market economy and the historical involvement of the Chinese government in industry. If regulation were to render the conduct of business in a particular country undesirable or impracticable, or if our current foreign manufacturing sources were for any other reason to cease doing business with us, such a development could have a material adverse effect on our product sales and on our supply, manufacturing and distribution channels.

Our business is also subject to the risks associated with U.S. and foreign legislation and regulations relating to imports, including quotas, duties, tariffs or taxes, and other charges or restrictions on imports, which could adversely affect our operations and our ability to import products at current or increased levels. We cannot predict whether additional U.S. and foreign customs quotas, duties (including antidumping or countervailing duties), tariffs, taxes or other charges or restrictions, requirements as to where raw materials must be purchased, additional workplace regulations or other restrictions on our imports will be imposed upon the importation of our products in the future or adversely modified, or what effect such actions would have on our costs of operations. For example, our products imported to the United States are subject to U.S. customs duties and, in the ordinary course of our business we may from time to time be subject to claims by the U.S. Customs Service for duties and other charges. Factors that may influence the modification or imposition of these restrictions include the determination by the U.S. Trade Representative that a country has denied adequate intellectual property rights or fair and equitable market access to U.S. firms that rely on intellectual property, trade disputes between the United States and a country that leads to withdrawal of “most favored nation” status for that country and economic and political changes within a country that are viewed unfavorably by the U.S. government. Future quotas, duties or tariffs may have a material adverse effect on our business, financial condition and results of operations. Future trade agreements could also provide our competitors with an advantage over us, or increase our costs, either of which could have a material adverse effect on our business, results of operations and financial condition. Substantially all of our import operations are subject to:

- quotas imposed by bilateral textile agreements between the countries where our apparel-producing facilities are located and foreign countries; and

- and customs duties imposed by the governments where our apparel-producing facilities are located on imported products, including raw materials.

Our apparel-producing operations are also subject to the effects of international trade agreements and regulations such as the North American Free Trade Agreement, and the activities and regulations of the World Trade Organization, referred to as the WTO. Generally, such trade agreements benefit our apparel business by reducing or eliminating the duties and/or quotas assessed on products manufactured in a particular country. However, trade agreements can also impose requirements that negatively impact our apparel business, such as limiting the countries from which we can purchase raw materials and setting quotas on products that may be imported into the United States from a particular country. In addition, the WTO may commence a new round of trade negotiations that liberalize textile trade. This increased competition could have a material adverse effect on our business, results of operations and financial condition.

Risks Relating to Our Common Stock

Many factors may cause our net revenues, operating results and cash flows to fluctuate and possibly decline which may result in declines in our stock price.

Our net revenues, operating results and cash flows may fluctuate significantly because of a number of factors, many of which are outside of our control. These factors may include, but may not be limited to, the following:

- fluctuations in market demand for our products;
- increased competition and pricing pressures;

- our ability to anticipate changing customer demands and preferences;
- our failure to efficiently manage our inventory levels;
- our inability to manage and maintain our debt obligations;
- seasonality in our business;
- changes in our, and our competitors', business strategy or pricing;
- the timing of certain general and administrative expenses;
- completing acquisitions and the costs of integrating acquired operations;
- international currency fluctuations, operating challenges and trade regulations;
- acts of terrorism or acts of war; and
- government regulation.

One or more of the foregoing factors, as well as any other risk factors discussed in this Annual Report on Form 10-K, may cause our operating expenses to be unexpectedly high or result in a decrease in our revenue during any given period. If these or any other variables or unknowns were to cause a shortfall in revenues or earnings, an increase in our operating costs or otherwise cause a failure to meet public market expectations, our stock price may decline and our business could be adversely affected.

Two principal stockholders own a significant amount of our outstanding common stock.

Mr. Kosta Kartsotis, our CEO, and Mr. Tom Kartsotis, the Chairman of our Board of Directors, each own a substantial amount of our common stock. As a result, they are in a position to significantly influence the outcome of elections of our directors, the adoption, amendment or repeal of our bylaws and any other actions requiring the vote or consent of our stockholders, and to otherwise influence our affairs.

Our organizational documents contain anti-takeover provisions that could discourage a proposal for a takeover.

Our certificate of incorporation and bylaws, as well as the General Corporation Law of the State of Delaware, contain provisions that may have the effect of discouraging a proposal for a takeover. These include a provision in our certificate of incorporation authorizing the issuance of "blank check" preferred stock, the division of our Board of Directors into three classes to be elected on a staggered basis, one class each year, provisions in our bylaws establishing advance notice procedures with respect to certain stockholder proposals, and provisions requiring that action taken to remove a director without cause be approved either by an 80% vote of the Board of Directors or an 80% vote of the stockholders. Our bylaws may be amended by a vote of 80% of the Board of Directors, subject to repeal by a vote of 80% of the stockholders. In addition, Delaware law limits the ability of a Delaware corporation to engage in certain business combinations with interested stockholders. Finally, Messrs. Kartsotis have the ability, by virtue of their stock ownership, to significantly influence a vote regarding a change in control.

Future sales of our common stock in the public market could adversely affect our stock price.

Mr. Kosta Kartsotis and Mr. Tom Kartsotis each own a substantial amount of our common stock. The shares beneficially owned by Mr. Kosta Kartsotis and Mr. Tom Kartsotis may be sold in the open market in the future, subject to any volume restrictions and other limitations under the Securities Act of 1933 and Rule 144 thereunder. We may also decide to file a registration statement enabling Messrs. Kartsotis to sell additional shares. Any sales by Messrs. Kartsotis of substantial amounts of our common stock in the open market, or the availability of their shares for sale, could adversely affect the price of our common stock. The market price of our common stock could decline as a result of sales of substantial amounts of our common stock in the public market, or the perception that those sales could occur. These sales or the possibility that they may occur also could make it more difficult for us to raise funds in any equity offering in the future at a time and price that we deem appropriate.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Company Facilities. As of the end of fiscal year 2006, we owned or leased the following material facilities in connection with our domestic and international operations:

Location	Use	Square Footage	Owned / Leased
Richardson, Texas	Corporate headquarters	190,000	Owned
Richardson, Texas	Warehouse and distribution	138,000	Owned
Richardson, Texas	Office	131,541	Owned
Dallas, Texas	Office, warehouse and distribution	517,500	Owned
Eggstätt, Germany	Office, warehouse and distribution	230,000	Owned
Milton Keynes, United Kingdom	Office, warehouse and distribution	20,155	Owned
New York, New York	General office and showroom	26,552	Lease expiring in 2016
Hong Kong	Office, warehouse and distribution	44,590	Lease expiring in 2007
Basel, Switzerland	European headquarters	36,113	Lease expiring in 2013
China	Manufacturing	110,231	Lease expiring in 2008

We also lease certain other manufacturing and/or office, warehouse and/or distribution facilities in Atlanta, Georgia; Chicago, Illinois; Los Angeles, California; Miami, Florida; Biel, Switzerland; Sweden; Taiwan; Hong Kong; Malaysia; Mexico; Singapore; New Zealand; the United Kingdom; Australia; Japan; Canada; Netherlands; China; and Italy and own an office, warehouse and watch repair facility in France.

U.S.-based Apparel Retail Store Facilities. As of the end of fiscal year 2006, we had entered into 34 lease agreements for retail space at prime locations in the United States for the sale of our apparel line and certain of our accessory products, which include leases for two new stores that are scheduled to open in fiscal year 2007. The leases, including renewal options, expire at various times from 2010 to 2018. The leases provide for minimum annual rentals and, in certain cases, for the payment of additional rent when sales exceed specified net sales amounts. We are also required to pay our pro rata share of the common area maintenance costs, including real estate taxes, insurance, maintenance expenses and utilities.

U.S.-based Accessory Retail Store Facilities. As of the end of fiscal year 2006, we had entered into 49 lease agreements for retail space at prime locations in the United States for the sale of our full assortment of accessory products including our Modern Watch Co. stores, which include leases for two new stores, that are scheduled to open in fiscal year 2007. The leases, including renewal options, expire at various times from 2008 to 2018. The leases provide for minimum annual rentals and, in certain cases, for the payment of additional rent when sales exceed specified net sales amounts. We are also required to pay our pro rata share of the common area maintenance costs, including real estate taxes, insurance, maintenance expenses and utilities.

U.S.-based Outlet Store Facilities. We lease retail space at selected outlet centers throughout the United States for the sale of our products. As of the end of fiscal year 2006 we had entered into 74 such leases. The leases, including renewal options, expire at various times from 2006 to 2018, and provide for minimum annual rentals and for the payment of additional rent based on a percentage of sales above specified net sales amounts. We are also required to pay our pro rata share of the common area maintenance costs at each outlet center, including, real estate taxes, insurance, maintenance expenses and utilities.

International Store Facilities. At the end of fiscal year 2006, we had entered into 47 lease agreements for retail stores located outside the U.S., including leases for 2 stores that are scheduled to open in fiscal year 2007. The leases, including renewal options, expire at various times from 2007 to 2015. The leases provide for minimum annual rentals and, in certain cases, for the payment of additional rent when sales exceed specified net sales amounts. We are also required to pay our pro rata share of the common area maintenance costs, including real estate taxes, insurance, maintenance expenses and utilities.

We believe that our existing facilities are well maintained and in good operating condition.

Item 3. Legal Proceedings

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

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

As a result of our option investigation, we were delinquent in filing certain of our periodic reports with the SEC, and consequently we were not in compliance with NASDAQ's Marketplace Rules. As a result, we received a total of three delisting notices from the NASDAQ, and we underwent a review and hearing process with the NASDAQ to determine our listing status. NASDAQ ultimately permitted our securities to remain listed on the NASDAQ as a result of a stay from the NASDAQ Listing and Hearing Review Counsel.

With the filing of this annual report on Form 10-K and other delinquent filings, we believe that we will remedy our non-compliance with Marketplace Rule 4310(c)(14), subject to NASDAQ's affirmative completion of its compliance protocols and its notification of the Company accordingly. However, if the SEC disagrees with the manner in which we have accounted for and reported, or not reported, the financial impact of past equity grants, there could be further delays in filing subsequent SEC reports that might result in delisting of our common stock from the NASDAQ Global Select Market.

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

Item 4. Submission of Matters to a Vote of Security Holders

No matter was submitted to a vote of our stockholders during the fourth quarter of fiscal year 2006.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our Common Stock is listed on the NASDAQ Global Select Market under the symbol "FOSL." Quotation of our Common Stock began on the NASDAQ Global Select Market on April 8, 1993.

The following table sets forth the range of quarterly high and low sales prices per share of our Common Stock on the NASDAQ Global Select Market for the fiscal years ended January 6, 2007 and December 31, 2005.

	High	Low
Fiscal year beginning January 1, 2006:		
First Quarter	$ 23.840	$ 16.670
Second Quarter	19.250	15.890
Third Quarter	22.160	16.960
Fourth Quarter	23.400	20.590
Fiscal year beginning January 2, 2005:		
First Quarter	$ 28.950	$ 23.970
Second Quarter	25.910	18.900
Third Quarter	25.080	17.820
Fourth Quarter	22.090	14.960

As of July 26, 2007, there were 149 holders of record, although we believe that the number of beneficial owners is much larger.

Cash Dividend Policy. We did not pay any cash dividends in 2005 or 2006. We expect that we will retain all available earnings generated by our operations for the development and growth of our business and common stock buyback programs and do not anticipate paying any cash dividends in the foreseeable future. Any future determination as to a cash dividend policy will be made at the discretion of our Board of Directors and will depend on a number of factors, including our future earnings, capital requirements, financial condition and future prospects and such other factors as our Board of Directors may deem relevant.

Common Stock Performance Graph

The following performance graph compares the cumulative return of the Common Stock over the preceding five year periods with that of the Broad Market (CRSP Total Return Index of the NASDAQ Global Select Market (US)) and the NASDAQ Retail Trade Stocks. Each Index assumes $100 invested at December 31, 2001 and is calculated assuming quarterly reinvestment of dividends and quarterly weighting by market capitalization.

2006 COMPARATIVE TOTAL RETURNS
Fossil, Inc., NASDAQ Global Select Market and
NASDAQ Market Retail Trades Group
(Performance Results through 12/31/06)

	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
Fossil, Inc.	100.00	145.34	200.96	274.81	230.55	242.02
NASDAQ Global Select Market	100.00	69.13	103.36	112.49	114.88	126.21
NASDAQ Retail Trades	100.00	84.97	118.32	150.07	151.49	165.45

Recent Sales of Unregistered Securities

We had no sales of unregistered securities during the fourth quarter of fiscal year 2006.

Item 6. Selected Financial Data

The following information should be read in conjunction with our consolidated financial statements and notes thereon. The information presented in the following tables has been adjusted to reflect effects of the restatement of the Company's financial results, which is more fully described in the "Explanatory Note" immediately preceding Part I, Item 1 and Note 2, "Restatement of Consolidated Financial Statements" in Notes to Consolidated Financial Statements of this Form 10-K.

FINANCIAL HIGHLIGHTS

Fiscal Year	2006	2005 (1) As Restated	2004 (1) As Restated	2003 (5) As Restated	2002 (5) As Restated
	IN THOUSANDS, EXCEPT PER SHARE DATA				
Net sales	$ 1,213,965	$ 1,043,120	$ 957,309	$ 781,175	$ 663,338
Gross profit	608,919	535,140	502,610	398,018	334,008
Operating income	123,325	108,988	131,135	105,645	94,931
Income before taxes	118,795	102,948	136,208	106,492	94,680
Net income	77,582	75,670	89,545	66,076	57,728
Earnings per share: (4)					
Basic	1.15	1.07(2)	1.27(3)	0.95	0.84
Diluted	1.13	1.04(2)	1.23(3)	0.92	0.81
Weighted average common and common equivalent shares outstanding: (4)					
Basic	67,177	70,476	70,367	69,591	68,987
Diluted	68,817	72,424	72,998	71,935	71,316
Working capital	$ 357,608	$ 326,502	$ 369,864	$ 311,709	$ 242,404
Total assets	852,597	745,142	783,423	587,738	483,287
Other long term liabilities	7,893	6,692	1,487	-	-
Stockholders' equity	602,201	526,317	524,426	422,974	341,576
Return on average stockholders' equity	14.2%	14.0%	19.2%	17.8%	$ 23.6%

(1) See the "Explanatory Note" immediately preceding Part I, Item 1 and Note 2, "Restatement of Consolidated Financial Statements", in Notes to Consolidated Financial Statements of this Form 10-K.

(2) Includes a one time tax benefit of $12 million related to the repatriation of subsidiary earnings which were not considered permanently invested pursuant to the American Jobs Creation Act of 2004. Excluding this benefit, net income, basic earnings per share and diluted earnings per share would have been approximately $63.7 million, $0.90, and $0.88, respectively.

(3) Includes one time after tax charges related to cumulative rent expense adjustments and settlement of a supplier claim of $2.0 million and $550,000 respectively. Excluding these one-time charges, net income, basic earnings per share and diluted earnings per share were $92.1 million, $1.31 and $1.26, respectively.

(4) All share and per share price data have been adjusted to reflect three-for-two stock splits effected in the form of stock dividends paid on June 7, 2002, and April 8, 2004.

Management has provided the following non-GAAP financial information so that investors can more easily compare financial performance of the Company's current business operations from period to period. A reconciliation to the nearest GAAP financial measure is shown in the table below.

Fiscal Year	**2005**	**2004**
Net Income	75,670	89,545
Less one time tax benefit	12,000(2)	
Plus:		
Rent expense		2,000(3)
Supplier claim		550(3)
Proforma net income	63,670	92,095
Proforma earnings per share:		
Basic	0.90	1.31
Diluted	0.88	1.26

(5) The selected financial data for 2003 and 2002 has been restated to reflect adjustments related to stock-based compensation expense, other corrections of errors in our prior year financial statements and the associated tax impact as further described in the "Explanatory Note" immediately preceding Part I, Item 1 of this Form 10-K. As a result of these adjustments, net income was reduced by $2.3 million and $1.2 million for the years ended 2003 and 2002, respectively as follows:

	2003			2002		
	As Reported	**Adjustments**	**As Restated**	**As Reported**	**Adjustments**	**As Restated**
Net sales	$ 781,175	$ -	$ 781,175	$ 663,338	$ -	$ 663,338
Gross profit	399,023	(1,005)	398,018	333,003	1,005	334,008
Operating income	108,808	(3,163)	105,645	95,930	(999)	94,931
Income before taxes	109,471	(2,979)	106,492	95,979	(1,299)	94,680
Net income	68,335	(2,259)	66,076	58,907	(1,179)	57,728
Earnings per share:						
Basic	0.98	n/a	0.95	0.85	n/a	0.84
Diluted	0.93	n/a	0.92	0.81	n/a	0.81
Weighted average common and common equivalent shares outstanding:						
Basic	69,817	(226)	69,591	68,990	(3)	68,987
Diluted	73,182	(1,247)	71,935	72,357	(1,041)	71,316
Working capital	$ 313,561	$ (1,852)	$ 311,709	$ 241,177	$ 1,227	$ 242,404
Total assets	587,541	197	587,738	482,526	761	483,287
Other long term liabilities	-	-	-	-		-
Stockholders' equity	423,426	(452)	422,974	340,541	1,035	341,576
Return on average stockholders' equity	18.4%	n/a	17.8%	19.9%	n/a	23.6%

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Summary

We are a design, development, marketing and distribution company that specializes in consumer fashion accessories. Since our inception in 1984, we have grown into a global accessory company with a well-recognized branded portfolio of watches delivered over an extensive distribution network. Our extensive line of fashion watches includes our proprietary brands as well as brands licensed from some of the most prestigious companies in the world. We also offer complementary lines of handbags, small leather goods, belts, and sunglasses under the FOSSIL and RELIC brands, jewelry under the FOSSIL, MICHELE, DIESEL and EMPORIO ARMANI brands and FOSSIL apparel. Our centralized infrastructure in design/development and production/sourcing allows us to leverage the strength of our branded watch and jewelry portfolio over an extensive global distribution network.

Our products are sold primarily to department stores and specialty retail stores in over 90 countries worldwide through 21 company-owned foreign sales subsidiaries and through a network of approximately 56 independent distributors. Our wholesale business for leather and sunglass products is primarily conducted through U.S. and Germany department stores. Our foreign operations include wholly or majority-owned subsidiaries in Australia, Austria, Canada, China, Denmark, France, Germany, Hong Kong, Italy, Japan, Malaysia, Mexico, the Netherlands, New Zealand, Norway, Singapore, Sweden, Switzerland, Taiwan and the United Kingdom. In addition, our products are offered at 198 company-owned retail locations, located in the United States and certain international markets; authorized FOSSIL retail stores and kiosks located in several major airports, on cruise ships and in certain international markets; over the internet at www.fossil.com; and through our direct to consumer catalog. The expansion of our product lines worldwide and leveraging of our infrastructure have contributed to our operating profits and increasing net sales.

Restatement of Consolidated Financial Statements

In June 2006, as a result of the wide-scale scrutiny of employee stock option grant practices including a report issued on June 13, 2006 by UBS Securities LLC mentioning the Company, we began a review of our historical stock option practices in order to determine whether there were any improprieties related to the timing of our past stock option grants. We voluntarily undertook this limited review of the timing of stock option grants (the "June 2006 Internal Review") to provide our Audit Committee with information so that it could make a determination as to whether a further, more detailed review appeared necessary or appropriate. The June 2006 Internal Review was conducted primarily as a review of the hard copy files maintained by us pertaining to the approval of grants since we went public in April 1993 and was focused specifically on whether there was evidence in the reviewed material of intentional back-dating of grants to Section 16 officers during that period. On August 21, 2006, we provided the Audit Committee with a preliminary report on the results of the June 2006 Internal Review. Subsequent to that meeting, the Audit Committee instructed us to conduct further work with respect to such review.

On September 13, 2006, a derivative lawsuit was filed against certain present and former directors and executive officers of the Company and the Company, as a nominal defendant, in connection with our stock option practices from 1996 to 2006. On September 19, 2006, the Office of the Chief Accountant of the Securities and Exchange Commission released a letter (the "Hewitt Letter") discussing certain of the existing accounting guidance related to grants of stock options. The accounting guidance applicable to the grants in question was, in most cases, APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25). Subsequent to the Hewitt letter, we continued the June 2006 Internal Review with a focus on identifying whether the measurement dates of various grants were appropriate under APB No. 25.

On November 11, 2006, our Board of Directors convened a special meeting at which (i) the updated findings of the June 2006 Internal Review were presented and (ii) the Board of Directors formed a committee consisting of five independent members of the Board of Directors to serve as a special committee of the Board (the "Special Committee"). The Special Committee was ultimately reconstituted on February 8, 2007, to consist of two independent members of the Board. On November 14, 2006, we announced the appointment of the Special Committee to voluntarily review our historical equity granting practices. The Special Committee's voluntary review was undertaken with assistance from independent legal counsel, Weil, Gotshal & Manges LLP, and forensic accounting assistance from FTI Consulting, Inc.

On May 7, 2007, we issued a press release announcing the results of the Special Committee's review which are set forth in our Form 8-K filed on May 9, 2007. As a result of this review, we concluded, and the Audit Committee agreed, that incorrect measurement dates were used for financial reporting purposes for certain equity grants made between fiscal years 1993 to 2006 and that the cumulative impact of incorrectly accounting for certain equity grant measurement dates would result in a restatement of our previously issued consolidated financial statements. As a result, we also announced on May 7, 2007, that due to such restatements, investors should not rely on certain of our historical financial statements and on related reports from our registered independent public accounting firm.

During the course of its investigation, the Special Committee reviewed our historical equity granting practices, analyzed all stock option grant dates covering the period from our initial public offering in 1993 to December 31, 2006, conducted detailed reviews of stock option grants representing approximately 83% of the total option shares granted by us during such period, including all grants made in connection with our annual performance review process, collected and reviewed over one million documents and interviewed 58 former and current employees, directors and outside advisors.

Certain findings from the Special Committee's report include:

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With respect to annual mass grants made from 1994 to 2002, one new hire grant in 2003, two incentive grants in 1999 and 2001, and one promotional grant in 2000, all made under our Long-Term Incentive Plan for employees (the "LTIP"), favorable grant dates were selected with the benefit of hindsight.

- The 2003 to 2006 annual mass grants and certain new hire and other non-annual mass grants made under the LTIP were not properly authorized and/or used incorrect measurement dates, primarily as a result of administrative process deficiencies.

- We issued our 2003 and 2004 annual mass grants prior to favorable news releases, but no evidence was found that there was an intention to favorably set the timing of these option grants. One employee relocation grant in 1999 was timed to occur prior to a news release that was thought to be favorable.

- Two former and two current executives were involved in the grant date selection process for the annual mass employee grants under the LTIP, although the executives involved in the grant date selection process may have varied from year to year. The favorable grant dates selected were within the time period between the initial Compensation Committee meeting early in the year and the annual employee performance reviews, generally concluded by the end of April.

- While the two former executives were also beneficiaries of such grants, the grant date was the same as used for other employees in connection with our annual mass grants and at least one of the former executives believed selection of grant dates in that time period to be appropriate for the years in which such executive was involved.

- The two current executives involved in the process relied on our former general counsel as to legal matters and our financial department as to accounting matters and never received any stock options.

- Certain internal control weaknesses and process deficiencies permitted the use of incorrect measurement dates and the selection of favorable grant dates to occur.

- At the time, neither the Compensation Committee nor the Board of Directors (other than certain senior executives who also were Board members) was notified that grant dates were selected with the benefit of hindsight.

- There was no evidence of fictitious grants.

- There was no evidence of backdating, self-dealing, or other misconduct with respect to stock options issued to members of the Board of Directors under the Non-Employee Director Plan.

- The Board of Directors acted in good faith in exercising its duties with respect to the stock option program.

- Our current personnel and directors fully cooperated with the investigation.

In light of its findings, the Special Committee made recommendations to the Board of Directors for corporate governance, management and process improvements related to our equity granting practices. The Board of Directors adopted all of these recommendations and resulting changes have been, or are in the process of being, made. A summary of certain of these recommendations and results is set forth below:

- We are, or are in the process of, instituting internal audit procedures relating to the option approval and documentation process; engaging an independent compensation consultant and/or independent counsel (at least for a transitional period) and focusing on improving the Compensation Committee approval and oversight process; designating specific members of in-house legal, accounting, and human resources staffs to oversee documentation, accounting and disclosure of all equity grants; widely distributing and explaining enhanced equity grant processes and documentation requirements; increasing automation of the equity grant record keeping process; improving process and controls regarding delegated grant authority; and improving training and education designed to ensure that all relevant personnel involved in the administration of equity grants understand relevant policies and requirements.

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- The Board of Directors has reprimanded certain senior executives for violations of our code of conduct and one senior executive has resigned.

- The Board of Directors has established a lead independent director, and will endeavor to add two new independent members by the end of 2007 and two additional new independent members by the end of 2008, provide continuing professional education for its members and adhere to its current term-limit policy beginning in 2008.

- Annual grants will be determined in connection with annual performance reviews of employees, including executives. Generally, one annual grant date applies to all annual grants to United States employees, and another annual grant date applies to all annual grants to employees outside of the United States.

Historical Equity Granting Practices

The accounting under APB No. 25 relies heavily on the determination of the measurement date, which is defined as "the first date" on which are known both (i) the number of shares that an individual employee is entitled to receive and (ii) the stock option grant price, or purchase price, if any. Moreover, the final amount of compensation cost of a stock option is measured as the difference between the stock option grant price and the fair market value of the underlying stock at the measurement date. We typically granted stock options, restricted stock, restricted stock units and stock appreciation rights to employees during the first quarter of each year in connection with our annual performance review process although such grants for certain employees took place after the first quarter. Generally, these grants were made to employees, other than Section 16 employees, utilizing a process whereby our Compensation Committee, which exclusively included certain independent directors of the Company, would approve a pool of awards or have general discussion with our CEO or President regarding equity awards to be issued to non-Section 16 employees. Our CEO or President would then allocate such awards to individual employees and determine exercise prices. Subsequent to such allocation, the Compensation Committee would typically document their approval of the final allocation of such awards by signing a unanimous written consent ("UWC") at the next Board meeting (the "Mass Grant Process"). With respect to Section 16 employees, the amount, but not the terms, of equity grants were generally preliminarily reviewed or discussed by the Compensation Committee early in the calendar year and prior to establishing an exercise price. The terms, including exercise price, of the equity grants were determined by the Company at some time after the Compensation Committee meeting held early in the calendar year and on or before the next meeting of the Compensation Committee. The Compensation Committee would then document their approval of the final allocation of such awards by signing the UWC at the next Board meeting (the "Section 16 Process"). Previously, for equity grant awards in connection with our Mass Grant Process and Section 16 Process, we, in many cases, may have relied upon the "as of" date of the UWC as the accounting measurement date, which "as of" date, for certain years, was selected with the benefit of hindsight. However, based upon review of our equity granting process for awards made in connection with the Mass Grant Process and Section 16 Process, the measurement date of grants utilizing such "as of" dates did not meet the requirements of APB No. 25. Consequently, we believe such equity grant dates were selected in error because the grant price and the number of shares individual employees were entitled to receive were not determined with finality on the original grant date.

We also award equity grants outside of the Mass Grant Process and the Section 16 Process that are primarily related to newly hired employees, promotions and acquisition activities (the "New Hire Process"). Generally, grants awarded to employees during the New Hire Process were dated as of the date of hire, the date of promotion or other relevant date for which the employee grant was being made. Subsequent to the grant date and generally within the next 90 days, the Compensation Committee would approve these grants through the execution of a UWC, which generally occurred at our quarterly Board of Directors meeting. We administered the same equity granting process for both the Section 16 and non-Section 16 employees as it relates to these grants.

Determination of Revised Measurement Dates for Equity Grants

In analyzing our equity granting process from 1993 to 2006, we reviewed historical circumstances and patterns related to our equity granting practices, the requirements of our LTIP, Board of Directors meeting minutes, the minutes of our Compensation Committee or resolutions related to actions taken by the Compensation Committee, Form 4's, system meta-data, payroll information including documentation associated with annual performance reviews, new hires and promotions and other evidence including Company e-mail and related correspondence to determine the most appropriate measurement dates.

Section 16 Process. As it relates to the annual equity grants awarded to Section 16 employees, we relied upon evidence from the minutes of our Board of Directors or Compensation Committee meetings each year, Form 4's, payroll information including documentation associated with annual performance reviews or other evidential matter including Company e-mails. The most appropriate measurement dates selected by us were based upon evidence that management with the appropriate level of authority had approved a final listing of awards and grant terms, including price, by employee to each Section 16 employee that were either, (i) included in the minutes of the Board of Directors or Compensation Committee meetings, or an exhibit attached thereto, (ii) contained in an exhibit to a UWC that listed each Section 16 employee and the number of options being granted, or (iii) contained in such other verifiable evidence that included the employee's name, and number of options being granted and exercise price. In one case, subsequent to the measurement date being established, the number of options granted to a certain Section 16 employee had changed. In this instance we treated such revision as a modification and, accordingly, accounted for this modification in accordance with variable plan accounting under APB No. 25.

Mass Grant Process. The measurement dates were selected based upon evidence that a final listing of employees and grant terms, including exercise price, had been determined and approved by management with the appropriate level of authority. Evidence of a measurement date was based upon Company e-mails or other correspondence, including in many cases, certain payroll transmitted information, that provided evidence that the final allocation of equity awards had been completed. In a small number of cases we noted instances, where subsequent to the measurement date being established, the number of options granted to certain employees may have been changed. In these instances, we treated such revisions as a modification and, accordingly, accounted for these modifications in accordance with variable plan accounting under APB No. 25.

New Hire Grant Process. For grants awarded to employees during the New Hire Process, the process generally followed a pattern whereby the number of options granted to employees and the grant price were finalized as of the employee's date of hire, the date of promotion or other relevant date for which the employee grant was being made. We noted five instances where the original grant dates for stock options were made with the benefit of hindsight. Grant dates for these five awards, as well as other misdated awards related to the New Hire Process that were primarily the result of administrative process deficiencies, were revised to the most appropriate measurement dates and we have recorded the commensurate compensation expense for the periods affected.

Process for Other Equity Grants. We reviewed our equity granting practices related to non-stock option grants, primarily restricted stock grants, restricted stock units and stock appreciation rights. As these types of equity instruments were granted during the Mass Grant Process and the New Hire Process, we used the same methodology for determining the proper measurement dates for these types of equity grants as we did in reviewing our stock option grants. In the event that the measurement date for these awards did not conform to the requirements of APB No. 25, we revised such measurement dates and have adjusted the financial statements for the periods affected. We also reviewed all stock option grants to directors made under our Non-Employee Director Plan and determined that the original grant dates of stock option awards under this plan were in accordance with APB No. 25 and, consequently, no adjustments to compensation expense has been recorded in connection with such grants.

We believe that completion of certain administrative procedures to document completion of the equity grant process, including those outlined in our LTIP, were not a determining factor in selecting the most appropriate measurement date. As such, we further believe that the most appropriate measurement date selected does not misrepresent the equity granting action.

The summary of evidence we relied upon to determine the most appropriate measurement dates for stock option grants to employees from 1993 to 2006 is detailed below.

Evidence Relied Upon	Number of Grants	Percent of Total	Number of Options	Percent of Total
Payroll information	2,794	44.8%	6,714,275	34.4%
Board of Directors meeting minutes	1,212	19.4%	6,138,796	31.4%
Company e-mail	1,209	19.4%	2,862,825	14.6%
Compensation Committee meeting Minutes	458	7.4%	555,735	2.8%
International management meetings	275	4.4%	732,236	3.7%
Company equity grant administration database	81	1.3%	271,842	1.4%
Form 4	27	0.4%	815,093	4.2%
All other evidence	183	2.9%	1,454,112	7.5%
Total	6,239	100.0%	19,544,914	100.0%

Based upon the available facts and circumstances surrounding our equity grant practices, we developed a methodology for determining the most appropriate measurement dates. For example, in connection with our Mass Grant Process, when there was not conclusive documentation or evidence of an earlier day, we generally used the date of our payroll transmittal. We believe this date was an appropriate measurement date since all information related to our annual performance review process, which included compensation adjustments and equity grants, would have been communicated to our employees at a time no later than this date.

Our restatement for adjustments to pre-tax stock-based compensation expense for the years 1993 to 2005 was $13.9 million. Because the determination of the most appropriate measurement date is subjective, we performed a sensitivity analysis for all grants awarded during the Mass Grant Process, Section 16 Process and the New Hire Process. In performing this sensitivity analysis, we used the alternative measurements dates that corresponded to the highest and lowest price of our common stock during the relevant periods associated with such equity grants. The use of the date representing the lowest price of our common stock would have resulted in no change to the previously recorded pre-tax stock-based compensation amount. The use of the date representing the highest price of our common stock would have increased our restated amount of pre-tax stock-based compensation by approximately $2.1 million.

Tax Impact of Revised Measurements Dates for Equity Grants

We reviewed the implications of Section 162(m) of the Internal Revenue Code (“Section 162(m)”) which prohibits tax deductions for non-performance based compensation paid to the chief executive officer and the four highest compensated officers in excess of one million dollars in a taxable year. We concluded that no adjustments are required to our previously filed financials statements in connection with the provisions of Section 162(m).

As prescribed by Section 409A of the Internal Revenue Code (“Section 409A”), options determined to have been granted with an exercise price below the fair market value of our common stock on the grant date and vesting subsequent to December 31, 2004 and unexercised as of December 31, 2005 are considered to be “in-the-money” options and holders are subject to a 20% excise tax on any gains derived from the exercise of such options. For any options that vested subsequent to December 31, 2004 and were exercised from January 1, 2006 up to a certain time, we will reimburse holders for such excise tax and any interest or penalties related thereto. Including tax gross-up amounts to be paid, we expect to record a pre-tax charge of approximately $766,000 during fiscal year 2007 for such reimbursements.

Additionally, we have determined that options to purchase approximately 2.0 million shares of our common stock held by current employees are subject to adverse tax consequences under Section 409A. In order to mitigate the unfavorable tax consequences to our employees under Section 409A, we plan to provide holders of affected options the opportunity to increase the exercise price of such options to the fair market value of our common stock on the grant date. We also anticipate giving such option holders (excluding executive officers) a cash bonus for the increase in the exercise price and estimate cash payments to be made totaling approximately $2.0 million in January 2008 to option holders amending affected options. We expect to record this amount as additional compensation expense in fiscal year 2007. We will account for the modification of stock options in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123R"). The financial impact of this modification is not yet known but will be recorded in fiscal year 2007.

Prior to December 31, 2006, our executive officers elected to revise the original grant price of any in-the-money stock options that were vested and unexercised as of December 31, 2005 to the fair market value of our common stock on the grant date to avoid the adverse tax consequences of Section 409A. For all stock option grants awarded to our executive officers for which the original grant price was incorrect, and that have been exercised to date, we will request that such officers reimburse to us an amount equal to the difference between the original grant price and the fair market value of our common stock on the grant date multiplied by the number of shares of common stock so excercised, net of any allocable portion of income taxes paid in connection with such exercise, which we approximate to be $734,000.

Unrelated to the Special Committee's review, we also identified that certain grants previously awarded to employees as incentive stock options should have been treated as non-qualified stock options. Due to different tax requirements associated with the exercise of incentive stock options versus non-qualified stock options, we have determined that certain employer and employee FICA taxes and employee withholding taxes were not properly withheld at the time such options were exercised by its employees. As a result, we will pay on behalf of such employees, any additional taxes that should have been withheld and remitted to the appropriate taxing authority, as well as any amounts due from the Company. We approximate this amount to be $4.4 million, including interest and penalties, for which $1.4 million has been included in our restatement adjustments, $253,000 has been included in our 2006 general and administrative expenses and $2.8 million is expected to be recorded in fiscal year 2007.

Restatement Adjustments

After comparing the most appropriate measurement dates to the original grant dates we used in preparing our historical consolidated financial statements, we determined that certain equity grants were awarded at exercise prices below the fair market value of our common stock on the measurement date. As a result, we have recorded additional pre-tax stock-based compensation expense of approximately $2.4 million and $1.9 million relating to the correction of the measurement dates in restating our consolidated statements of income and comprehensive income for years ended December 31, 2005 and January 1, 2005, respectively. In addition, we are also restating our beginning retained earnings balance for the year ended January 1, 2005 by approximately $7.3 million for the cumulative impact of the additional compensation expense related to fiscal years 1993 through 2003.

In addition to the adjustments related to stock-based compensation discussed above, we are correcting other errors in our prior year financial statements. These errors were not previously recorded as we believed the amounts of these errors, both individually and in the aggregate, were not material to our consolidated financial statements. Accordingly, we have restated our consolidated statements of income and comprehensive income and cash flows for the year ended December 31, 2005 to include: (i) an approximate $442,000 decrease in pre-tax income related to additional employer and employee FICA taxes due, including interest thereon, in connection with the correction of classifying certain incentive stock options to non-qualified stock options, (ii) an approximate $979,000 increase in pre-tax income to reverse the impact of certain sales returns recorded in fiscal year 2005 that should have been recorded in fiscal year 2004, (iii) an approximate $207,000 decrease in pre-tax income to adjust accrued liabilities related to certain management fees that should have been eliminated at the end of fiscal year 2004, (iv) an approximate $1.5 million increase in pre-tax income related to the correction of an error in our analysis for store impairment, (v) a decrease in income tax expense of approximately $600,000 to reduce an accrual for tax penalties and (vi) an approximate $2.4 million increase in income tax expense to increase certain tax contingency reserves, and (vii) an approximate $48,000 decrease in income tax expense resulting from the impact of the pre-tax adjustments on additional stock-based compensation expense and the other adjustments described in items (i) through (iv) above.

The consolidated statements of income and comprehensive income and cash flows for the year ended January 1, 2005 have been restated to include the following adjustments related to other errors in our prior year financial statements: (i) an approximate $864,000 decrease in pre-tax income related to additional employer and employee FICA taxes due, including interest thereon, in connection with our correction of classifying certain incentive stock options to non-qualified stock options, (ii) an approximate $979,000 decrease in pre-tax income related to increasing our allowance for sales returns, (iii) an approximate $207,000 increase in pre-tax income to adjust accrued liabilities related to certain management fees that should have been eliminated at the end of fiscal year 2004, (iv) an approximate $863,000 decrease in pre-tax income related to the correction of an error in our analysis for store impairment, and (v) a $484,000 decrease in pre-tax income related to the correction of foreign currency losses previously reported, (vi) an approximate $2.4 million decrease in income tax expense to reduce certain tax contingency reserves and an approximate $1.4 million decrease in income tax expense resulting from the impact of the pre-tax adjustments described in items (i) through (v) above.

The accompanying management's discussion and analysis of financial condition and results of operation give effect to the restatement discussed in Note 2 "Restatement of Consolidated Financial Statements" included in Notes to Consolidated Financial Statements.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates and judgments, including those related to product returns, bad debts, inventories, long-lived asset impairment and impairment of goodwill and income taxes. We base our estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies require the most significant estimates and judgments.

Product Returns. We accept limited returns and will request that a customer return a product if we feel the customer has an excess of any style that we have identified as being a poor performer for that customer or geographic location. We continually monitor returns and maintain a provision for estimated returns based upon historical experience and any specific issues identified. While returns have historically been within our expectations and the provisions established, future return rates may differ from those experienced in the past. In the event that our products are performing poorly in the retail market and/or we experience product damages or defects at a rate significantly higher than our historical rate, the resulting credit returns could have an adverse impact on the operating results for the period or periods in which such returns materialize.

Bad Debt. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer's current credit worthiness, as determined by the review of their current credit information. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon historical experience and any specific customer collection issues identified. While such credit losses have historically been within our expectations and the provisions established, future credit losses may differ from those experienced in the past.

Inventories. Inventories are stated at the lower of average cost, including any applicable duty and freight charges, or market. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the average cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual future demand or market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

Long-lived Asset Impairment. We test for asset impairment of property, plant and equipment and intangibles other than tradenames whenever events or changes in circumstances indicate that the carrying value of an asset might not be recoverable from estimated future cash flows. We apply Statements of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* in order to determine whether or not an asset is impaired. When undiscounted cash flows estimated to be generated through the operations of our company-owned retail stores are less than the carrying value of the underlying assets, impairment losses are recorded in selling and distribution expenses. Should actual results or market conditions differ from those anticipated, additional losses may be recorded.

Impairment of Goodwill and Tradenames. We evaluate goodwill for impairment annually by comparing the fair value of the reporting unit to the book value. The fair value of our reporting units is estimated using discounted cash flow methodologies and market comparable information. Based on the analysis, if the estimated fair value of each reporting unit exceeds the book value of the reporting unit, no impairment loss is recognized. We evaluate tradenames annually by comparing the fair value of the asset to the book value. The fair value of the asset is estimated using discounted cash flow methodologies. In the fourth quarter of fiscal year 2006 and 2005, we performed the required annual impairment tests and determined that no goodwill or tradename impairment existed.

Income Taxes. We record valuation allowances against our deferred tax assets, when necessary, in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Realization of deferred tax assets (such as net operating loss carryforwards) is dependent on future taxable earnings and is therefore uncertain. At least quarterly, we assess the likelihood that our deferred tax asset balance will be recovered from future taxable income. To the extent we believe that recovery is not likely, we establish a valuation allowance against our deferred tax asset, increasing our income tax expense in the period such determination is made. In addition, we have not recorded U.S. income tax expense for foreign earnings that we have determined to be indefinitely reinvested, thus reducing our overall income tax expense. On an interim basis, we estimate what our effective tax rate will be for the full fiscal year. The estimated annual effective tax rate is then applied to the year-to-date pre-tax income excluding significant or infrequently occurring items, to determine the year-to-date tax expense. The income tax effects of infrequent or unusual items are recognized in the interim period in which they occur. As the fiscal year progresses, we continually refine our estimate based upon actual events and earnings by jurisdiction during the year. This continual estimation process periodically results in a change to our expected effective tax rate for the fiscal year. When this occurs, we adjust the income tax provision during the quarter in which the change in estimate occurs so that the year-to-date provision equals the expected annual rate.

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

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

In June 2006, the FASB released Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”). FIN 48 supplements FASB Statement No. 109, *Accounting for Income Taxes*, by defining the threshold for recognizing the benefits of tax return positions in the financial statements as "more-likely-than not" to be sustained by the taxing authority. Tax benefits associated with positions taken or to be taken on tax returns where there is uncertainty as to whether the position will be challenged by the taxing authorities will be impacted by FIN 48.

FIN 48 is effective for our fiscal year 2007. FIN 48 establishes a two-step process for the recognition and measurement of the amount of benefit to be recorded in the financial statements for tax positions taken or expected to be taken in a tax return. This process requires the enterprise first to determine whether is it more likely than not that the tax position taken will be sustained upon examination by the taxing authority, including resolution of any appeals or litigation, on the basis of the technical merits of the position. FIN 48 requires that an enterprise measure the amount of recognizable tax benefit for each tax position meeting the recognition threshold as the largest amount that is greater than 50 percent likely to be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. The cumulative effects of applying this interpretation will result in a decrease of $6.1 million to the 2007 opening balance of retained earnings as a change in accounting principle.

In June 2006 The Emerging Issues Task Force ("EITF") issued Issue 06-3, *How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* ("EITF 06 3"*).* Questions have arisen whether various non-income taxes assessed by governmental authorities should be presented gross or net in an entity's income statement. Non-income taxes include sales tax, use tax, excise tax, value added tax, and various taxes related to specific industries. This issue was added to the EITF's agenda, and the EITF was asked to determine the approach that should be taken in determining whether some or all of these taxes should be presented gross or net in an entity's income statement. The consensuses in EITF 06-3 are effective for our fiscal year 2007. The adoption of EITF 06-3 will not have a material impact on our consolidated results of operations or financial condition.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections,* ("SFAS 154").This standard replaces APB Opinion No. 20*, Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements.* This standard requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle. SFAS 154 also states that a change in the method of depreciating a long-lived asset be accounted for as a change in estimate that was effected by a change in accounting principle. Also, an error correction from previously issued financial statements should be called a "restatement". See the "Explanatory Note" immediately preceding Part 1, Item 1 and Note 2 "Restatement of Consolidated Financial Statements," in Notes to Consolidated Financial Statements of this Form 10-K. We believe we have complied with all requirements of SFAS 154.

In December 2004, FASB issued SFAS 123R. SFAS 123R requires all share-based payments, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Under SFAS 123R, public companies are required to measure the cost of services received in exchange for stock options and similar awards based on the grant-date fair value of the award and recognize this cost in the income statement over the period during which an award recipient is required to provide service in exchange for the award. The pro forma disclosures previously permitted under SFAS 123 are no longer an alternative to financial statement recognition.

Effective for our fiscal year 2006, we adopted SFAS 123R using the modified prospective method. Under this transition method, the measurement and the method of amortization of costs for share-based payments granted prior to, but not vested as of January 1, 2006, are based on the same estimate of the grant-date fair value and primarily the same amortization method that was previously used in the SFAS 123 pro forma disclosure. For equity awards granted after the date of adoption, we amortize share-based compensation expense on a straight-line basis over the vesting term. Compensation expense is recognized only for share-based payments expected to vest. We estimate forfeitures at the date of grant based on historical experience and future expectations. The effect of forfeitures on the pro forma expense amounts was recognized based on actual forfeitures. Prior to the adoption of SFAS 123R, we utilized the intrinsic-value based method of accounting under APB No. 25, and related interpretations, and adopted the disclosure requirements of SFAS No.123. In connection with our restatement, prior to December 31, 2005, for stock options issued with an exercise price below the fair market value of our common stock on the date of the grant, we recorded compensation expense for this intrinsic value in accordance with APB No. 25. The adoption of SFAS 123R resulted in share-based compensation expense of approximately $5.3 million ($3.4 million net of tax), or approximately $0.05

for both basic and diluted earnings per share for fiscal year 2006. Included in the $5.3 million was a benefit of approximately $165,000 resulting from the cumulative effect of changing from recognizing forfeitures on an actual basis to an estimated basis. In conjunction with the implementation of SFAS 123R, $5.2 million of deferred compensation, previously recorded as a separate component of stockholder's equity, was reclassified into additional paid-in capital.

Results of Operations

The following table sets forth, for the periods indicated, (i) the percentages of our net sales represented by certain line items from our consolidated statements of income and (ii) the percentage changes in these line items between the years indicated.

Fiscal Year	2006	Percentage change from 2005	2005	Percentage change from 2004	2004
Net sales	100.0%	16.4%	100.0%	9.0%	100.0%
Cost of sales	49.8	19.1	48.7	11.7	47.5
Gross profit	50.2	13.8	51.3	6.5	52.5
Operating expenses	40.0	13.9	40.9	14.7	38.8
Operating income	10.2	13.2	10.4	(16.9)	13.7
Interest expense	0.3	*	-	-	-
Other (expense) income - net	(0.1)	*	(0.5)	(212.0)	0.5
Income before income taxes	9.8	15.4	9.9	(24.4)	14.2
Income taxes	3.4	51.1	2.6	(41.5)	4.8
Net income	6.4%	2.5%	7.3%	(15.5)%	9.4%

* not meaningful

The following table sets forth our consolidated net sales by segment, and components of certain segments, and the percentage of net sales related to each respective segment, and components of certain segments, for the fiscal year indicated:

	Amounts in millions			Percentage of total		
Fiscal Year	2006	2005	2004	2006	2005	2004
International wholesale:						
Europe	$ 378.7	$ 316.3	$ 304.3	31.2%	30.3%	31.8%
Other	171.8	142.1	127.2	14.1%	13.6%	13.3%
Total international wholesale	550.5	458.4	431.5	45.3%	43.9%	45.1%
Domestic wholesale:						
Watch products	239.0	232.5	230.5	19.7%	22.3%	24.1%
Other products	203.7	179.2	151.1	16.8%	17.2%	15.8%
Total domestic wholesale	442.7	411.7	381.6	36.5%	39.5%	39.9%
Direct to consumer	220.8	173.0	144.2	18.2%	16.6%	15.0%
Total net sales	$ 1,214.0	$ 1,043.1	$ 957.3	100.0%	100.0%	100.0%

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Fiscal 2006 Compared to Fiscal 2005

Net Sales. The following table is intended to illustrate by factor the total year-over-year percentage change in sales by segment and on a consolidated basis:

Analysis of Percentage Change in Sales Versus Prior Year
Attributable to Changes in the Following Factors

	Exchange Rates	Acquisitions	Organic Growth	Total Change
Europe wholesale	2%	—%	18%	20%
Other international wholesale	—	9	12	21
Domestic wholesale	—	—	9	9
Direct to consumer	1	—	24	25
Total	1%	1%	14%	16%

Fiscal 2006 is a 53-week year as compared to a 52-week year for fiscal 2005. This extra week was included in the first quarter of fiscal year 2006. We estimate this extra week increased net sales and operating expenses by approximately $16 million and $5 million, respectively, as compared to fiscal year 2005. This discussion should be read in conjunction with the Consolidated Financial Statements and the related Notes attached hereto.

European Wholesale Net Sales. The following discussion excludes the impact on sales growth attributable to foreign currency rate changes and acquisitions as noted in the above table. European wholesale sales growth was primarily due to sales volume increases in FOSSIL jewelry and FOSSIL and licensed brand watches, as well as the contribution from our new ADIDAS watch licensed business that was launched in early 2006. FOSSIL jewelry sales grew by 25.3% as a result of continued market share growth in Germany and from expansion into other parts of Europe. Net sales increases in our FOSSIL watch brand of 3.6% are the result of renewed innovation and design in our product offerings. Licensed watch brand net sales increases of 21.3% are related to market share growth in certain European markets and new styles introduced across many of our licensed brands. We also believe our watch businesses in Europe benefited from overall improved economic conditions during 2006 in comparison to 2005. Net sales from the ADIDAS watch brand, a newly-licensed watch business we launched during the first quarter of fiscal year 2006, contributed approximately $14.7 million to European net sales.

Other International Wholesale Net Sales. The following discussion excludes the impact on sales growth attributable to foreign currency rate changes and acquisitions as noted in the above table. Other international wholesale sales include sales from our Asia Pacific and Canada subsidiaries, export sales from the United States and sales from our Mexico business that was acquired in early 2006. Net sales increases from this segment of our businesses were principally related to sales volume growth in our licensed brand watches. Licensed watches increased by 24.6%, principally related to renewed innovation and design in new styles introduced into this segment of our business during 2006 and further penetration of certain licensed brands into many of our Asian Pacific markets.

Generally, our international unit wholesale sales prices for watch styles, comparable to those styles in the United States, have historically been higher than our United States unit wholesale sales prices. We believe this is a result of a less competitive market for global fashion and designer brand watches in comparison to those sold in the United States. As a result, in the international market we believe our brands compete with more local and regional brands that do not possess the brand awareness or marketing strength in comparison to the brands included in our portfolio of watches. Furthermore, we believe the global recognition of our branded portfolio of watches positions us as a significant resource to retailers throughout the international marketplace. Our strategy is not to force any one brand into a specific market, but rather allow the market to dictate which brands are important based upon consumer preference. We believe our global distribution network and our design and marketing capabilities will allow us to acquire or license additional brands that will position us for further penetration internationally as we continue to take shelf space from lesser known local and regional brands. As an example, we believe the launch of the newly-acquired ADIDAS licensed watch business in 2006 will further advance our product offerings in certain international markets and allow for long-term leverage of our existing distribution infrastructure outside the United States while strengthening our competitive advantage. We believe ADIDAS compliments our existing portfolio of watches by providing us with a strong performance/sports brand. We also believe our jewelry businesses, including FOSSIL, EMPORIO ARMANI and DIESEL, allow us to leverage our customer base and infrastructure within the international markets as these brands are sold to many of the same customers that purchase our watch products. For fiscal year 2007, assuming foreign currency rates remain near their existing levels relative to the U.S. dollar, our management believes the international wholesale segment will continue to grow at rate slightly higher than our estimated consolidated net sales. We expect growth in the Asia Pacific markets to be more pronounced due to the lower level of penetration we currently have in this region, the impact of opening our mainland China office in the fourth quarter of 2006 and our plans to expand our distribution into India.

Domestic Wholesale Net Sales. Domestic watch sales increased 2.8% principally due to sales volume growth in mass market, licensed and RELIC brand watches. Our mass market watch business increased by $7.5 million, or 35.9%, and is primarily attributable to our successful partnership with Wal-Mart that resulted in being recognized as Wal-Mart's Vendor of the Year for 2006 in the jewelry, watch and accessory division. We anticipate continued growth based on the success of our offerings and the significant opportunity that exists to expand both the number of doors and the level of penetration within the mass market channel. Licensed brand watch sales increased by 24.8% principally resulting from market share gains from our BURBERRY licensed brand and sales resulting from the launch of MARC BY MARC JACOBS and ADIDAS. Net sales from our FOSSIL watch brand declined by approximately 8.1% during 2006. Excluding the effect of discontinued product sales from both 2006 and 2005, the decline was approximately 10.1%. Although the FOSSIL brand net sales declined on a comparative full year basis, the brand's performance strengthened consistently on a sequential quarter basis throughout 2006 and posted a 4.5% increase during the more seasonal fourth quarter of 2006. We believe this improved performance is related to renewed innovation and design in new styles introduced to the market during the year. Consumers seem to be responding to the newness and differentiation in our watch styles and have gravitated towards our higher price point styles resulting in average unit retail price increases of approximately 10% during the year. We also believe the introduction of our FOSSIL brand catalog in late 2005 and increased circulation in 2006, combined with continued investment in our web-based marketing programs were instrumental in the overall improvement of the FOSSIL watch business during 2006.

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Net sales from other domestic products, that primarily includes our leather and sunglass businesses rose 13.7% during the year as a result of sales volume growth in FOSSIL women's handbags and small leather goods, RELIC belts and gift categories and RELIC sunglasses. Although we have experienced strong double-digit net sales gains in our women's leather goods categories over the last two years and are operating in fewer doors given the consolidation of Federated/May, our women's leather business continues to be very healthy on a comparable door basis. Net sales from our women's handbag and small leather goods categories increased by 10.1% and 14.3%, respectively. We are continuing to drive higher average unit retails in our handbag business by introducing new fabrics and leather as well as unique treatments to our product assortment. Also fueling the increase in our FOSSIL leather goods category has been the successful introduction of our men's bag business to the line this year. Net sales from RELIC belts and gift categories increased by 38.5% primarily due to the strength of our offerings in JC Penney and Kohl's. Relic eyewear net sales increased by 67.9% during the year resulting from an expansion into new doors and additional displays.

The significant presence of the FOSSIL brand within the moderately priced department store channel and the RELIC brand in JC Penney and Kohl's continues to position our company as a leading supplier of watches and accessories in the United States. We believe, over the long term, opportunities exist for our domestic wholesale watch and accessories businesses to continue to improve and our expectations for net sales growth in the domestic wholesale segment of our business for fiscal year 2007 is in the mid single-digit range.

Direct to Consumer Net Sales. Net sales from our retail stores worldwide increased 27.6% during the year as a result of a 19.8% increase in the average number of stores opened during the year and comparable store sales increases of 7.4%. Net sales from our e-commerce business increased 18.7% as a result of sales volume growth in FOSSIL leather goods and from the launch of newly developed non-FOSSIL branded websites and FOSSIL catalog. We operated 198 stores at the end of the year consisting of 120 full-price stores, including 41 located outside the United States, and 78 outlet locations, including 4 stores outside the United States. This compares to 170 stores at the end of the prior year including 98 full-price stores, 30 of which are located outside the United States and 72 outlet locations, including one store outside the United States. We opened 36 new stores and closed 8 stores during the year. New accessory stores opened during 2006 reflect a redesign of our historical presentation to a more contemporary vintage image that focuses on a more aspirational lifestyle customer. The results of the new stores that have opened are meeting and in some cases surpassing our original expectations. Our retail strategy is to position our FOSSIL stores as the destination within the mall for customers to shop for accessories. We are currently targeting 50 to 60 new store openings in 2007, assuming the locations and economics meet our initial criteria. Our focus will be on our full-price accessory concept in the United States and Europe, and to a lesser extent the Asia Pacific region.

A store is included in comparable store sales in the thirteenth month of operation. Stores that experience a gross square footage increase of 10% or more due to an expansion and/or relocation are removed from the comparable store sales base, but are included in total sales. These stores are returned to the comparable store sales base in the thirteenth month following the expansion and/or relocation.

Gross Profit. Gross profit margin decreased 110 basis points in 2006 to 50.2% compared to 51.3% in 2005. This margin decline can be attributed primarily to a sales mix shift toward lower margin product sales in our international segment and the impact of increased discontinued product sales, through both non-traditional channels and our outlet stores at lower than historical gross profit margins. To a lesser extent, gross profit margin further declined as a result of an increased sales mix in our domestic segment of lower margin mass market watches and higher markdown levels, primarily in the domestic accessories business, due to the transition of May Company stores to Federated. Additionally, gross profit margins were negatively impacted as a result of certain new styles added to our global watch assortment which generated lower gross profit margins than historical averages. However, we currently have an initiative in place that we believe will result in improved gross product margins across our various product lines beginning in the second half of fiscal year 2007. Partially offsetting these gross profit margin decreases were increased sales, as a percentage of total sales, from our higher margin producing full-price company-owned retail stores.

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Our consolidated gross product margin is impacted by our diversified business model that includes but is not limited to: (i) a significant number of product categories we distribute, (ii) the multiple brands we offer within many of these categories, (iii) the geographical presence of our businesses, and (iv) the different distribution channels we sell to or through. The components of this diversified business model produce varying ranges of gross profit margin. Generally, on a historical basis, our fashion branded watch, jewelry and sunglass offerings produce higher gross profit margins than our leather goods categories. In addition, in most product categories that we offer, brands with higher retail price points generally produce higher gross profit margins compared to those of lower retail priced brands. From a segment standpoint, our direct to consumer business generally produces the highest gross profit margin to the Company as a result of these sales being direct to the ultimate consumer. Gross profit margins related to sales in our international wholesale segment are historically lower than our retail segment, but historically higher than our domestic wholesale segment primarily due to the following factors; (i) overall retail prices for comparable product sold in the United States are generally higher in our international businesses as a result of less competitive fashion and designer brands being offered in these markets, (ii) the product sales mix in our international wholesale segment, in comparison to our domestic wholesale segment, is comprised more predominantly of watches, and (iii) the watch sales mix in our international wholesale segment, in comparison to our domestic wholesale segment, is comprised more predominantly of higher priced licensed brands. As we move forward into 2007, we believe we have an opportunity to improve gross margins because we expect net sales growth to be more pronounced in our international wholesale and direct to consumer segments than our domestic wholesale segment. We also believe that our efforts to reduce our global inventory levels during 2006, which included significant levels of discontinued product sales at or slightly above cost, will allow us to improve our consolidated gross profit margin in 2007 as we expect reduced levels of discontinued product sales in 2007 in comparison to 2006.

Operating Expenses. Operating expenses increased approximately $59 million during 2006 and, as a percentage of net sales, decreased to 40.0% of net sales compared to 40.9% for the prior year. 2006 operating expenses increased approximately $3.4 million as a result of businesses acquired in 2006 and approximately $2.9 million due to foreign currency exchange rates. Excluding the operating expenses of acquired businesses and the impact of foreign currencies, operating expense increases during 2006 primarily reflect increases in payroll related costs, rent and depreciation and amortization expense. Increased payroll costs were mainly related to additional headcount to support new initiatives, including the ADIDAS watch and new DIESEL and MICHELE jewelry businesses launched in 2006, non-cash compensation expense due to the implementation of FAS 123R and increased payroll expense in connection with our retail store growth. Payroll expense increases also included an approximate $3.5 million associated with the additional week in the first quarter. Rent expense increased 21.0% primarily due to the expansion of our retail stores. Depreciation and amortization expense increases are primarily related to leasehold improvements and in-store fixturing associated with new retail store openings during 2005 and 2006, additional hardware and software additions and depreciation related to the SAP implementation in France finalized in May 2005. Our management anticipates 2007 operating expenses (excluding expenses recorded in connection with the Special Committee’s review of our equity granting practices), as a percentage of net sales, to decrease slightly in comparison to 2006 levels, assuming foreign currency rates remain near their existing levels relative to the U.S. dollar. We expect this decrease to be more pronounced in the second half of the year, primarily due to the seasonality of our net sales.

The following table sets forth consolidated operating expenses by segment and the percentage of net sales related to each respective segment for the periods indicated.

	Amounts in millions			
	2006		2005	
Fiscal Year	Operating Expense	% of Net Sales	Operating Expense	% of Net Sales
Europe wholesale	141.8	37%	116.5	37%
Other international wholesale	52.8	31%	43.3	30%
Domestic wholesale (1)	196.9	44%	188.4	46%
Direct to consumer	94.1	43%	78.0	45%
Total	485.6	40%	426.2	41%

(1) Certain corporate costs not allocated to individual operating segments for management reporting purposes and intercompany eliminations for specific income statement items are reflected in the domestic wholesale segment.

Operating Income. The decline in our gross profit margin was partially offset by the leverage in our operating expenses resulting in our operating profit margin decreasing to 10.2% in 2006 compared to 10.4% in the prior year. Excluding expenses recorded in connection with the Special Committee's review of our equity granting practices and additional cost related to the restatement of our historical financial statements, management believes operating margin for 2007 could increase by 100 to 200 basis points compared to 2006 based upon the estimated improved gross profit margin and leveraging of operating expenses. However, as we continue to grow in the watch, jewelry and retail store segments, we believe we may continue to experience a greater percentage of our operating income in the back half of the year.

Interest Expense. Interest expense increased by approximately $3.2 million to $3.6 million compared to $321,000 in 2005. This increase is related to the impact of higher outstanding borrowings under our revolving lines of credit that were principally used to fund approximately $85 million of common stock repurchases occurring during the fourth quarter of fiscal year 2005 and the first quarter of fiscal year 2006 and capital expenditures of $50.8 million during 2006.

Other Expense (Income) - Net. Other expense (income) - net primarily reflects interest income from cash investments, foreign currency transaction gains or losses, minority interest expense of our majority-owned consolidated subsidiaries and equity in the earnings of our non-consolidated joint venture in Spain. During 2006, other expense (income) - net decreased favorably by approximately $4.7 million principally due to $2 million of currency gains recorded in 2006 compared to $3.8 million of currency losses in 2005. This favorable increase was partially offset by a $1.2 million reduction in equity in the earnings of our joint venture in Spain.

Income Taxes. Our effective income tax rate increased to 34.7% during 2006 compared to 26.5% in the prior year. The lower effective tax rate in 2005 was the result of our ability, pursuant to the American Jobs Creation Act of 2004, to reduce previously recorded deferred tax liabilities by repatriating foreign earnings at an effective tax rate substantially below the statutory rate at which these deferred tax liabilities were established. The Company expects its effective tax rate to be in a range of 37% to 39% in 2007.

Fiscal 2005 Compared to Fiscal 2004

Net sales. The following table is intended to illustrate by factor the total year-over-year percentage change in sales by segment and on a consolidated basis:

Analysis of Percentage Change in Sales Versus Prior Year Attributable to Changes in the Following Factors

	Exchange Rates	Acquisitions	Organic Growth	Total Change
Europe wholesale	(1)%	1%	4%	4%
Other international wholesale	1	4	7	12
Domestic wholesale	-	2	6	8
Direct to consumer	-	-	20	20
Total	-%	2%	7%	9%

European Wholesale Net Sales. The following discussion excludes the impact on sales growth attributable to foreign currency rate changes and acquisitions as noted in the above table. European wholesale sales growth was driven by sales volume increases in FOSSIL jewelry and licensed watches. These increases were partially offset by sales volume declines in FOSSIL watches. The sales volume growth in FOSSIL jewelry was mainly attributable to further penetration of the line in Germany as well as recent expansion into new European markets, primarily Italy and the United Kingdom. Net sales increases in licensed watches were primarily related to further penetration within existing markets as these brands continue to gain recognition. FOSSIL watch sales decreases were primarily the result of declines in the sales of core styles and weak consumer response to new styles launched during 2005 and our belief that the watch category in general experienced declines during 2005.

Other International Wholesale Nets Sales. The following discussion excludes the impact on sales growth attributable to foreign currency rate changes and acquisitions as noted in the above table. Growth from other international wholesale sales was led by sales volume increases in our licensed watch businesses primarily resulting from expansion of these brands into additional retail locations. Fiscal 2005 net sales growth in our other international segment was negatively impacted by an approximate $4.7 million prior year special market sale that occurred in 2004.

Domestic Wholesale Net Sales. Excluding the impact on sales growth attributable to acquisitions, domestic watch sales decreased 1.4% principally as a result of a 12.4% decline in FOSSIL watch sales and a 17.8% decline in RELIC watch sales. These decreases were partially offset by growth in our mass market business that launched in mid-2004. We believe that the decrease in sales of FOSSIL and RELIC watches was primarily due to a cyclical shift in consumer discretionary spending patterns away from the watch category during 2005. During 2005, domestic sales of our accessory and sunglass businesses rose 18.5% resulting from sales volume growth in FOSSIL women’s and men’s leather products as well as RELIC sunglasses. The women’s handbag category was one of the benefactors of the shift in consumer discretionary spending in 2005 allowing us to not only experience increased sales in existing locations but also expand our presence in many other accessory product lines within the same customer base.

Direct to Consumer Net Sales. Net sales from our retail stores worldwide increased 19.1% during the year as a result of a 20.4% increase in the average number of stores opened during the year and comparable store sales increases of 1.1%. Net sales from our e-commerce business increased 16.7% as a result of sales volume growth in FOSSIL NCAA watches, MICHELE watches and FOSSIL leather products. In comparison to the prior year, 2005 comparable store sales increases were negatively impacted by declines in our FOSSIL watch business, which has historically accounted for approximately 60% to 65% of our overall retail store sales. Retail store sales were positively impacted by significant increases in sales from accessory products. We operated 170 stores at the end of the year, consisting of 72 outlet, including one located oustide the United States, and 98 full-price stores, consisting of 30 full-price stores located outside the United States. This compares to 136 stores at the end of the prior year consisting of 60 outlet and 76 full-price stores, including 23 stores located outside the United States. We opened 37 new stores and closed 3 stores during the year.

Gross Profit. Gross profit margin decreased 120 basis points in 2005 to 51.3% compared to 52.5% in 2004. This margin decline can be attributed primarily to a sales mix shift between the different segments of our business. As a percentage of consolidated net sales, 2005 net sales from our international and domestic wholesale watch segment declined by 300 basis points in comparison to 2004, while our domestic accessory segment experienced a sales mix increase of 170 basis points. Historically, gross profit margins generated from our international segment and domestic watch segment are generally higher than those experienced in our domestic accessories segment. In addition, we experienced higher freight cost as a percentage of net sales primarily due to fuel surcharges that were incurred during the second half of the year. Partially offsetting these gross profit margin decreases were increased sales, as a percentage of total sales, from our higher margin producing direct to consumer segment.

Operating Expenses. Operating expenses increased approximately $54.7 million during 2005 and, as a percentage of net sales, increased to 40.9% of net sales compared to 38.8% for the prior year. Included in 2005 operating expenses is approximately $6.0 million related to operating expenses of businesses acquired in 2005. Excluding the operating expenses of acquired businesses, operating expense increases during 2005 primarily reflect increases in payroll related costs, advertising expense and depreciation and amortization expense. Increased payroll costs were mainly related to additional headcount to support new initiatives, including the MARC JACOBS watch launch in 2005 and the ADIDAS watch and new DIESEL and MICHELE jewelry businesses launched in 2006. Additional payroll cost increases were associated with the expansion of our European shared services center to support our SAP software solution roll-outs and increased headcount in our European headquarters office in Basel, Switzerland. Advertising expense increased to $82.4 million. As a percentage of net sales, advertising expense remained constant with 2004 at 7.7%. Depreciation and amortization expense increases were primarily related to leasehold improvements and in-store fixturing associated with new company-owned retail store openings during 2004 and 2005, additional hardware and software additions and depreciation related to the SAP implementations in Germany and France finalized in August 2004 and May 2005, respectively.

Operating Income. Gross profit margin reductions and increased operating expenses as a percentage of net sales resulted in our operating profit margin decreasing to 10.4% in 2005 compared to 13.7% in the prior year.

Other Expense (Income) - Net. During 2005, other expense (income) - net decreased unfavorably by approximately $11 million as a result of $3.8 million of currency losses incurred in 2005 compared to $6.9 million of currency gains experienced in 2004.

Income Taxes. Our effective income tax rate decreased to 26.5% during 2005 compared to 34.3% in the prior year. During 2005, pursuant to the American Jobs Creation Act of 2004, we were able to repatriate $165 million of subsidiary earnings which were not considered permanently invested and as a result received an 85% dividends received deduction for these eligible dividends. Since we had previously provided for income taxes to be paid on these foreign earnings at the U.S. statutory rate of 35%, less appropriate foreign tax credits, we released approximately $18 million of our previously recorded deferred tax liabilities. This reduction, offset by the actual taxes paid on these dividends, contributed earnings of approximately $0.17 per diluted share during 2005 that will not reoccur in 2006. The repatriated funds will be used to invest in qualified expenditures in the United States in accordance with our approved Domestic Reinvestment Plan.

Effects of Inflation

We do not believe that inflation has had a material impact on results of operations for the periods presented. Substantial increases in costs, however, could have an impact on us and the industry. We believe that, to the extent inflation affects our costs in the future, we could generally offset inflation by increasing prices if competitive conditions permit.

Liquidity and Capital Resources

Historically, our general business operations have not required substantial cash needs during the first several months of our fiscal year. Generally, starting in the second quarter, our cash needs begin to increase, typically reaching a peak in the September-November time frame. Our cash holdings and securities available for sale as of the end of fiscal year 2006 increased to $140 million in comparison to $65 million at the end of the prior year. Of the $140 million of cash, cash equivalents and securities available for sale at fiscal year end 2006, $88.2 million is held in banks outside the United States. The increase in cash holdings and securities available for sale is primarily the result of $148 million of net cash generated from operating activities less $61 million of cash used in investing activities and $20 million of cash used in financing activities. Cash flows generated from operating activities were primarily related to net income of $78 million, non-cash items of approximately $26 million, $24 million of cash from increased accrued expenses and $18 million of cash from decreased inventory balances partially offset by $19 million of increases in accounts receivable balances. Cash flows used in investing activities were primarily related to fixed asset additions of $51 million. Cash used in financing activities were primarily related to $26 million in repurchases of common stock and

$3 million in distribution of minority interest earnings. These items were partially offset by approximately $5 million of proceeds from the exercise of stock options and $2 million of debt borrowings.

Aided by strong fourth quarter retail and web-based sales, accounts receivable at the end of 2006 increased by only 10.0%, well below our net sales growth rate of 20.5% for the fourth quarter, to $155 million compared to $141 million at the end of 2005. As a result, average day's sales outstanding decreased to 45 days from 51 days in the prior year. Fiscal 2006 ending inventory of $228 million represents a 5% decrease compared to $241 million in the prior year and the composition of the inventory is more current. The decrease in inventories is mainly attributable to the implementation of two key initiatives. First, we implemented strategies to adjust inventory purchases to match trailing trend results rather than purchasing inventory based on estimated but perhaps optimistic growth expectations. Secondly, we took advantage of opportunities for the reduction in our excess inventory by selling increased amounts of discountinued product through alternative channels as well as our own outlet stores.

At the end of 2006, we had working capital of $358 million compared to working capital of $327 million at the end of the prior year. We had approximately $11 million of outstanding borrowings at the end of 2006 related to short term borrowings in the UK and Japan. In the first quarter of 2006, our UK subsidiary entered into a revolving credit facility with its primary bank allowing borrowings of up to 4 million GBP. Outstanding borrowings under the UK-based facility were $7.7 million USD at the end of 2006 and bear interest at the aggregate of the margin, London Interbank Offered Rate ("LIBOR"), and Mandatory Lending Agreement ("MLA"), costs, (6.17% on a combined basis at year end), due May 2007. These borrowings were used to acquire a new facility for our U.K.-based operations. The remaining $3.4 million in borrowings are under a short-term facility in Japan bearing interest at the Euroyen rate (approximately 1.38% at year-end), due in June 2007. This facility is primarily utilized for working capital needs associated with our Japanese subsidiary.

At the end of 2006 we had no outstanding borrowings under our $100 million U.S. Short-Term Revolving Credit Facility which bears interest at our option of (i) the LIBOR base rate (5.32% at year-end) plus 50 basis points, or (ii) the lesser of (a) the higher of Wells Fargo's prime rate (8.25% at year-end) less 1.0%, or 3.0%, or (b) the maximum rate allowed by law. We have typically renewed this short-term credit facility in September each year.

During 2007, we anticipate capital expenditures of approximately $40 to $50 million to principally cover information technology additions, acquisition of facilities associated with our European headquarters in Basel, Switzerland, new company-owned retail store openings and other general maintenance requirements. We believe that cash flow from operations combined with existing cash on hand will be sufficient to fund our capital needs during 2007. We also have access to amounts available under our credit facilities should additional funds be required.

Contractual Obligations and Off-Balance Sheet Arrangements

The following table presents, as of January 6, 2007, a summary of our significant cash contractual obligations by payment date. Further discussion of the nature of each obligation is included in Note 8 and Note 11 to our Consolidated Financial Statements.

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
			(in thousands)		
Contractual Obligations					
Short-term debt (1)	$ 11,089	$ 11,089	$ -	$ -	$ -
Minimum royalty payments (2)	115,763	40,535	55,239	14,963	5,026
Future minimum rental payments	160,744	32,115	50,556	33,978	44,095
Purchase obligations (3)	51,828	51,828	0	0	0
Total contractual cash obligations	$ 339,424	$ 135,567	$ 105,795	$ 48,941	$ 49,121

(1) Consists of short-term credit borrowings in the United Kingdom and Japan and excludes contractual interest.

(2) Consists of primarily exclusive licenses to manufacture watches under trademarks not owned by us. Also includes amounts owed pursuant to various license and design service agreements under which we are obligated to pay the licensors a percentage of our net sales of these licensed products, subject to minimum scheduled royalty, design and advertising payments.

(3) Consists primarily of outstanding letters of credit, which represent inventory purchase commitments that typically mature in one to eight months and open non-cancelable purchase orders.

Selected Quarterly Financial Data

The table below sets forth selected quarterly financial information. The information is derived from our unaudited consolidated financial statements and includes, in the opinion of management, all normal and recurring adjustments that management considers necessary for a fair statement of results for such periods. The operating results for any quarter are not necessarily indicative of results for any future period. Certain line items presented in the tables below, when aggregated, may not agree to the corresponding line items on the Company's Consolidated Statements of Income and Comprehensive Income for fiscal years 2005 and 2004 due to rounding.

Fiscal Year 2006	**1st Qtr**	**2nd Qtr**	**3rd Qtr**	**4th Qtr**
	AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA			
Net sales	$ 264,225	$ 259,238	$ 299,697	$ 390,805
Gross profit	133,014	127,034	148,106	200,765
Operating expenses	116,022	110,838	115,153	143,581
Operating income	16,992	16,196	32,953	57,184
Income before income taxes	15,492	15,610	31,941	55,752
Provision for income taxes	5,776	4,372	10,400	20,665
Net income	9,716	11,238	21,541	35,087
Earnings per share:				
Basic	0.14	0.17	0.32	0.52
Diluted	0.14	0.16	0.31	0.51
Gross profit as a percentage of net sales	50.3%	49.0%	49.4%	51.4%
Operating expenses as a percentage of net sales	43.9%	42.8%	38.4%	36.7%
Operating income as a percentage of net sales	6.4%	6.2%	11.0%	14.6%

Fiscal Year 2005	**1st Qtr**	**2nd Qtr**	**3rd Qtr**	**4th Qtr**
	AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA			
				As Restated (1)
Net sales	$ 232,510	$ 226,235	$ 260,171	$ 324,203
Gross profit	121,162	117,252	136,210	160,514
Operating expenses	96,647	100,959	99,488	129,058
Operating income	24,515	16,293	36,722	31,456
Income before income taxes	21,912	13,881	34,385	32,770
Provision (benefit) for income taxes	(1,982)	4,228	12,691	12,341
Net income	23,894	9,653	21,694	20,429
Earnings per share:				
Basic	0.34	0.14	0.31	0.29
Diluted	0.32	0.13	0.30	0.29
Gross profit as a percentage of net sales	52.1%	51.8%	52.4%	49.5%
Operating expenses as a percentage of net sales	41.6%	44.6%	38.2%	39.8%
Operating income as a percentage of net sales	10.5%	7.2%	14.1%	9.7%

(1) See Note 2 in the "Restatement of Consolidated Financial Statements" in Notes to Consolidated Financial Statements of this Form 10-K. The following table gives effect to adjustments related to stock-based compensation

expense and the correction of other prior period errors:

Fourth Quarter- Fiscal Year 2005	**As Reported**	**Adjustments**	**As Restated**
Net sales	$ 324,203	$ -	$ 324,203
Gross profit	160,514	-	160,514
Operating expenses	127,129	1,929	129,058
Operating income	33,385	(1,929)	31,456
Income before income taxes	34,699	(1,929	