TIMBERLAND CO
Form 10-K
March 01, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**Washington, DC 20549**

**Form 10-K**
**ANNUAL REPORT PURSUANT TO SECTIONS 13 OR 15(d)**
**OF THE SECURITIES EXCHANGE ACT OF 1934**

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)**
**OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the fiscal year ended December 31, 2006**

**OR**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**
**OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the transition period from _____ to _____**

**Commission File Number 1-9548**

**The Timberland Company**
*(Exact Name of Registrant as Specified in Its Charter)*

| | |
|---|---|
| **Delaware**<br>*(State or Other Jurisdiction of Incorporation or Organization)* | **02-0312554**<br>*(I.R.S. Employer Identification No.)* |
| **200 Domain Drive, Stratham, New Hampshire**<br>*(Address of Principal Executive Offices)* | **03885**<br>*(Zip Code)* |

**Registrant s telephone number, including area code:**
**(603) 772-9500**

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

| **Title of Each Class** | **Name of Each Exchange on Which Registered** |
|---|---|
| Class A Common Stock, par value $.01 per share | New York Stock Exchange |

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
o Yes þ No

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. þ Yes o No

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 the 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 þ 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).
o Yes þ No

The aggregate market value of Class A Common Stock of the Company held by non-affiliates of the Company was $1,281,982,175 on June 30, 2006, which was the last business day of the Company s second fiscal quarter in 2006. For purposes of the foregoing sentence, the term affiliate includes each director and executive officer of the Company. See Item 12 of this Annual Report on Form 10-K.

On February 23, 2007, 50,295,386 shares of the Company s Class A Common Stock and 11,743,660 shares of Class B Common Stock were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Company s definitive Proxy Statement for the 2007 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A are incorporated by reference in Part III, Items 10, 11, 12, 13 and 14, of this Annual Report on Form 10-K.

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# PART I

## ITEM 1. *BUSINESS*

### Overview

The Timberland Company was incorporated in Delaware on December 20, 1978. We are the successor to the Abington Shoe Company, which was incorporated in Massachusetts in 1933. We refer to The Timberland Company, together with its subsidiaries, as we , our , us , Timberland or the Company.

We design, develop, engineer, market and distribute, under the Timberland®, Timberland PRO®, SmartWool®, Timberland Boot Company™, Miōn™, GoLite®, and Howies® brands, premium quality footwear, apparel and accessories products for men, women and children. These products provide functional performance, classic styling and lasting protection from the elements. We believe that the combination of these features makes our products an outstanding value and distinguishes us from our competitors.

Our products are sold primarily through independent retailers, better-grade department stores, athletic stores and other national retailers that reinforce the high level of quality, performance and service associated with Timberland. In addition, our products are sold in Timberland® specialty stores and Timberland® factory outlet stores dedicated exclusively to selling Timberland® and Timberland® sub-branded products, as well as through franchised retail stores in Europe. We also sell our products in the United States online at timberland.com and smartwool.com. Our products are sold throughout the United States, Canada, Europe, Asia, Latin America, South Africa and the Middle East.

Our principal strategic goal is to become the authentic outdoor brand of choice globally by offering an integrated product selection of footwear, apparel and accessories for men, women and children that is inspired by the outdoors. Our ongoing efforts to achieve this strategic goal include (i) enhancing our leadership position in our core footwear business globally through an increased focus on consumer segment development and technological innovation, (ii) expanding our global apparel business by leveraging the brand s rugged heritage and consumer trust, (iii) extending enterprise reach through the development of new brand platforms such as SmartWool®, Timberland Boot Company™, Miōn™, GoLite®, and Howies®, (iv) expanding our brands geographically, (v) driving operational and financial excellence, (vi) setting the standard for commitment to the community and (vii) striving to be a global employer of choice.

### Products

Our products fall into three primary groups: (1) footwear, (2) apparel and accessories (including product care and licensed products) and (3) royalties from third-party licensees and distributors. The following summarizes our revenue by product for the past three years:

| **Product** | **2006** | **2005** | **2004** |
|---|---|---|---|
| Footwear | 71.9% | 76.6% | 76.9% |
| Apparel and Accessories | 26.9% | 22.3% | 22.2% |
| Royalty and Other | 1.2% | 1.1% | 0.9% |

### Footwear

In 1973, we produced our first pair of waterproof leather boots under the Timberland® brand. We offer a broad variety of footwear products for men, women and children, featuring premium materials, state-of-the-art functional design and components and advanced construction methods. Our key Timberland® brand footwear categories are boots, men s and women s casual, kids and outdoor performance. The Timberland PRO® series for skilled tradespeople and working professionals is an additional footwear category we developed to address a consumer group s distinct needs. We continued our focus on developing products to meet the needs of distinct consumer groups in 2006 with the development of a new line of advanced footwear for trail running enthusiasts under the GoLite® brand. This footwear line is designed to meet the needs of high-altitude runners by being ultra-light and adaptable to the uneven, rugged terrain found in the mountains. Similarly, in 2005 we introduced Timberland Boot Company™ work-wear inspired footwear that is featured in our Timberland Boot

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Company™ concept stores in the United Kingdom and also introduced Miōn™ outdoor performance footwear designed to meet the needs of water adventurers. We intend to continue our efforts to extend our brand reach through these and other initiatives. This extension of the brand s reach through complementary sub-brands and new brands like the Timberland PRO® series, Timberland Boot Company™, Miōn™, and GoLite® brands and our development of our core footwear business is intended to advance our goal of becoming a leading global brand. Our advanced concepts footwear team, which we call the Invention Factory, continues to focus on developing the next innovations in footwear products and technologies, materials, constructions and processes such as our new GoLite® brand for high-altitude trail runners and our cross-category technology developments, including our new PreciseFit™ system which was included in certain footwear products for the first time in 2006. Technology that is or will be incorporated in most of our footwear products is discussed below in Footwear Technology.

***Boots***

Our key boots categories include Classic Boots, in basic, premium, chukka and oxford versions, as well as Roll-Tops and Chelseas. Another important boot category is our Classic Sport Boots. A few of the key products in this category include the Field Boot, Euro Hiker, Bromilly and Euro Dub Hiker, which are light and flexible, built to be rugged and durable, while still allowing for enhanced agility. Some of the principal features of these boot products include premium waterproof leather, direct-attach and seam-sealed waterproof construction, rubber lug outsoles for superior traction and abrasion resistance, shock diffusion plates, durable laces, padded collars for comfortable fit, enhanced insulation, rustproof hardware for durability and moisture-wicking components for comfort and breathability. We continued our focus on reducing the seasonality of our boots business by introducing a new Summer Mesh series with Timberland® Vent Tech material, which features lightweight breathable mesh construction. We added the Timberland® Vent Tech material into additional boot styles throughout 2006. In late 2006 we reintroduced key boot styles from past seasons in their exact form, detail for detail, under our Timberland Authentics line. Lifestyle footwear, as well as active and casual based sandals, broadens the core product range. Regional programs such as Rugged Street serve to drive consumer interest in new markets. We are also focused on expanding our women s boot business, supported by the introduction of women s specific collections like the Mirney and Winter Groove, which blend functional practicality with fashion elements.

***Men s Casual***

Our Timberland® men s casual footwear series includes Boat, Casual, Rugged Casual, Work Casual, Casual Sport, Sandals and Timberland® LTD. Featured footwear products in these categories include boat shoes, casual bucks, loafers, sandals, oxfords, chukkas, boots and slip-ons for use in the office, home or outdoors. Our focus in the development of this line of footwear is to combine the rugged heritage of Timberland with premium leathers and functional offerings. Men s casual footwear is rooted in craftsmanship and innovation, creating products that possess superior materials and enhanced comfort. Many of our men s footwear products incorporate our innovative Smart Comfort® system, which provides superior comfort while preserving the shape and style of the footwear. Expanding the reach of our casual product, in 2005 we introduced the Timberland Boot Company™ line in the United Kingdom to provide a relevant assortment with distinctive leathers and silhouettes built upon our heritage of leather innovation.

***Women s Casual***

Timberland® women s CasualGear footwear line builds on the Rugged Casual and Sport Casual footwear offering with the introduction of the Timberland® City product collection. This collection provides product for a more refined wearing occasion for our Engager consumer, a woman who is confident, active, cares about the environment and looks for ways to get involved. Timberland® City product encompasses higher heel heights, sleeker last shapes and a more refined styling overall. We have followed a good/better/best strategy in the construction of the line with Essentials, Key items and Premium product offerings: Essentials are seasonal and seasonless basics with replenishment capabilities; Key items are seasonal items with fresh style and color

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injections; and Premium items provide seasonal positioning styles that clearly articulate the seasonal creative story with elevated design details.

Our focus in the development of this line of footwear is to combine the rugged heritage of Timberland with premium leathers, craftsmanship and relevant functionality with feminine styling for the target consumer. To provide unparalleled comfort without sacrificing style, most of our women s product also incorporates our innovative Comforia™ system.

***Kid s Casual***

Timberland® kids footwear products are designed and engineered specifically for kids with the same high-quality standards and materials as our adult footwear products. This line includes Rugged Casual, Outdoor Performance/Adventure, Sport Casual and toddlers and infants product categories. Featured products focus on fit and functionality and include programs like Kerplunc, Rock Skipper sandals, Power Lounger, Hikers with Gore-Tex® and Snow Stomper winter boots. The toddlers and infants category provides premium leathers, linings and details designed and engineered specifically for the needs of this consumer. Many of our kids footwear products incorporate the Smart Comfort® system.

***Outdoors***

*Outdoor Performance*

Our Timberland® outdoor performance footwear series continues to address the needs of outdoor recreationalists of all levels, offering technical, end-use driven products for outdoor adventures from summit to sea and everywhere in between. Across this series of footwear we continue to target three core categories hiking, sport utility and tech casual.

In 2006, we added more technology and more innovation to our versatile collection of performance footwear. We continued to partner with elite athletes in the design and development of key programs. World-renowned high altitude adventurer Ed Viesturs helped to develop the Cadion hiking program, which has won acclaim as a market-leading lightweight hiker. We also marked 2006 with the continuation of the successful Power Lounger series versatile after-sport shoes featuring a SmartWool® lining, an industry first. The line continues to be built upon the Timberland® Agile IQ platform, which addresses key areas of traction, shock absorption and fit to deliver out of the box comfort and enhance control and position sense on the trail.

Building on the Company s long-term initiative to offer performance and value to the entry-level outdoor recreationalist consumer, we offered lines like the Ossipee and the Resolve, which help make the outdoors more accessible to a variety of consumers.

*Miōn*™ Footwear

Our performance water line was first introduced in 2005 under the Miōn™ brand name. Miōn™ water shoes include a performance water shoe, a performance sandal, a guide slide and a pro thong for men, women and children. Miōn™ footwear is designed for comfort and versatility in all wet conditions for the outdoor adventurer s active lifestyle. Miōn™ footwear features an Ergomorphic™ footbed that molds itself to each individual foot, a rib structure that wraps around the foot in critical areas to ensure the foot is held in place, a climbing-grade spiral cord that traces the rib structure to secure the foot and an outsole constructed of Gripstick™ wet/dry traction rubber, which combines multi-directional QuadCut™ siping and proprietary compounds that improve grip in wet conditions.

*GoLite® Footwear*

Our Invention Factory developed a new line of advanced footwear in 2006 for trail running enthusiasts under the GoLite® brand. This footwear line is inspired by the extreme challenges of sky runners, or high-altitude runners, and their need for ultra-light, technically advanced footwear. The advanced technology includes an independent spring suspension system that adapts to uneven, rugged terrain that improves the runner s stability and ability to remain vertical. This new line will appear in the market in early 2007. In connection with this new line, we acquired certain assets of GoLite LLC, including trademarks. GoLite LLC continues to market apparel, equipment and accessories as an independent company not affiliated with us.

***Timberland PRO® Series***

We continue to expand and broaden our offering of high performance work shoes specifically designed for working professionals who need the best in comfort, durability and protection under the Timberland PRO® series sub-brand. In 2006, we introduced the PowerWelt boot with Timberland PRO® Ever-Guard™ genuine leather. This revolutionary leather is ten times more abrasion resistant than traditional leather, heat resistant up to 346ºF and waterproof. This product is targeted to the general construction market and provides the ultimate protection against the most extreme environments. The PowerWelt boot comes with the PowerFit™ comfort system which we first successfully introduced under our TiTAN® collection. The PowerWelt boot launch was supported with a consumer and safety manager print campaign, as well as with 285 billboard advertisements placed in the United States market to support key regional and independent retailers in attracting our target consumer. We continued to offer the TiTAN® collection, targeted at those who prefer lightweight comfort, with various hiking silhouettes and oxford styles. All TiTAN® styles feature the innovative TiTAN® safety toe and our exclusive PowerFit™ comfort system, which provides superior fit, cushioning and shock absorption. In addition to the TiTAN® styles, the Timberland PRO® series offering continues to include waterproof models in the industrial hiking category a fast growing part of the work footwear market serving the younger tradesperson and workers in the light duty job category. We also continued to offer our first metatarsal protection footwear, MetGuard, which provides ultimate protection in heavy duty environments such as foundries and steel mills and FlexShield, which has built-in metatarsal protection aimed at those who work with heavy equipment. All of our waterproof styles utilize seam-sealed or membrane constructions and temperature regulating foot beds, and all of our safety toe styles meet ANSI/ASTM standards. Most styles also come with slip, abrasion and oil-resistant outsoles, as well as electrical hazard protection.

**Footwear Technology**

We continue to incorporate our patent pending, technological innovation, the Smart Comfort® system, in many of our men s, women s and kids footwear categories. The Smart Comfort® system allows the footwear to expand and contract with the changing shape of the foot during the walking motion, while preserving the essential style of the footwear. Footwear incorporating the Smart Comfort® system provides superior comfort in a product that retains its shape. The Smart Comfort® system s expandable upper allows the shoe to follow the natural movements of the foot without pinching the top of the foot. A three-zone, multi-density footbed system provides even pressure distribution under the foot. These systems work together to distribute forces and provide superior comfort everywhere the shoe touches the foot.

Our new patent-pending Timberland® PreciseFit™ system was incorporated into select styles of men s footwear lines in 2006. The PreciseFit™ system enables consumers to customize their fit through a system of forefoot inserts. Each pair of footwear includes a set of inserts of varying thicknesses that lock onto a removable footbed, creating optimal volume in each shoe and allowing for differences between the left and right foot. This tailored fit works in conjunction with the Smart Comfort® system to give consumers a high level of fit and comfort.

Many Timberland® footwear products offer or will be designed to offer other advanced technologies developed by us that combine some or all of the following features:

Footwear Modular System our patented modular shoe technology which enables the user to customize the walking platform/footbed and shell of a shoe for multiple end use situations;

Endoskeleton$^{tm}$ internal suspension system our patented technology designed to control heel impact deflection and provide arch support, forefoot flexibility and torsional stiffness for comfort and performance;

B.S.F.P.$^{tm}$ motion efficiency system our design which delivers improved traction, energy-return and length of wear;

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Independent Suspension Network™ system (ISN™)  our multi-density sole with independent lugs adapts to the terrain, keeping the foot level on uneven ground for superior stability, traction and comfort;

Advanced Combination Construction (ACC)  a construction method that delivers improved forefoot flexibility for maneuverability and rear foot stability on rugged terrain;

Timberland® Agile IQ system  our outdoor performance footwear technology which delivers improved traction, shock absorption and fit for improved control and sense of position;

Comforia™ system  our women s footwear technology enabling comfort with style, regardless of footwear style or heel height; and

Guaranteed waterproof construction.

**Apparel and Accessories**

***Timberland® and Timberland PRO® Series***

Timberland s apparel offer for men and kids continues to represent a rugged casual line that includes outerwear and sportswear that combine performance benefits and technical fabrics for the outdoors with versatile styling. Timberland also offers a women s apparel line that is primarily distributed in Europe. We believe that continuing to develop and expand our apparel business is important to our global brand aspirations. In 2005 we realigned our personnel, processes and products to re-establish the core positioning of the apparel offer in each geographical region to position the business for growth. With a goal to elevate the apparel offer of the brand from the grass roots up, we re-evaluated the price value equation of every existing product and redefined the materials and signature details that would tell a unique Timberland story and set criteria for future execution on all product lines. This involved a new focus on our design and manufacturing processes, resulting in a consolidation of our essentials, or basics, program, ensuring a global consistency in our design language, and creating economies of scale, without compromising our commitment to regional geographic differentiation. We also continued to leverage our International Design Centre (IDC) in London, which enables us to get closer to the target consumer to evaluate their needs.

During 2006, we continued to underpin the men s and women s apparel lines with a commitment to our  Earthkeepers initiative that reflects the intersection of product design and environmental stewardship. Organic cotton, recycled yarns, and low impact materials that are biodegradable and sustainable, along with earth friendly manufacturing processes, have all been introduced into the line to ensure we create an ongoing commitment to minimize our environmental impact. We also continued our efforts to refine the Timberland® Limited Collection, a premium offering of apparel for our international consumers. This line both compliments and elevates our overall apparel assortment.

On February 7, 2007, we announced that beginning in 2008 our Timberland® brand apparel line will be offered in North America pursuant to a licensing arrangement. We will reintroduce Timberland PRO® apparel in the United States and Canada in 2007 pursuant to a licensing arrangement and will continue to offer it in Europe pursuant to a licensing arrangement that has been in effect since 2004.

***SmartWool***

Our acquisition of SmartWool Corporation at the end of 2005 reflects our ongoing efforts to extend our enterprise s reach by offering our customers an expanded line of apparel and accessories. SmartWool is a leading provider of premium performance wool-based socks, apparel and accessories for men, women and children. Our key SmartWool® product categories are performance and lifestyle socks for men, women and children and 100% SmartWool® Next-to-Skin apparel in core base layer styles for men and women. Our classic outdoor socks includes the Hiking Light Crew and Hiking Medium Crew for the outdoor and snow-sport consumer. SmartWool has also expanded its apparel line through its Versawear offering of the men s Synergy Jacket, a breathable, wind-resistant piece offering ultimate layering options and women s Spectrum Hoodie, which provide users a natural fiber alternative to synthetic materials. SmartWool® accessories include hats, gloves and infant wear. SmartWool® products vaporize moisture, control temperature and odor and are guaranteed not to shrink. SmartWool® products are sold through independent retailers, better-grade department stores, athletic stores and smartwool.com.

***Howies Limited***

On December 1, 2006, we acquired Howies Limited, an active sports apparel brand founded on the idea of designing and manufacturing clothing for the inspired action sports and outdoor consumer. Howies is located in Cardigan Bay, Wales, U.K.

***Third-party Licensing***

Third-party licensing enables us to expand our brand reach to appropriate and well-defined categories and to benefit from the expertise of the licensees in a manner that reduces the risks to us associated with pursuing these opportunities. We receive a royalty on sales of our licensed products. Our Timberland® accessories products for men, women and children include all products other than footwear and apparel products. Many of these products, including packs and travel gear, watches, men s belts, wallets, socks, gloves, sunglasses, eyewear and ophthalmic frames, and hats and caps, are designed, manufactured and distributed pursuant to licensing agreements with third parties. We also license rights to children s apparel in the United States, Europe and Asia. We continue to focus on improving our licensed products and distribution and to build better integration across these products to present a seamless brand worldwide. In 2006, we launched a new assortment of watches and packs under new licensing agreements with worldwide leaders in those product categories. On February 7, 2007, we announced that beginning in 2008 our Timberland® brand apparel line will be offered in North America pursuant to a licensing arrangement. In addition, we entered into an agreement for the reintroduction of Timberland PRO® apparel in the United States and Canada to complement our successful Timberland PRO® footwear business. We continue to offer Timberland PRO® footwear and apparel in Europe under a license agreement which enables us to leverage our licensee s knowledge of the European safety market, as well as their existing customer relationships.

**Product Sales: Business Segments and Operations by Geographic Area**

Our products are sold in the United States and internationally primarily through independent retailers, better-grade department stores, athletic stores and other national retailers, which reinforce the high level of quality, performance and service associated with Timberland. In addition, our products are sold in Timberland® specialty stores and Timberland® factory outlet stores dedicated exclusively to selling Timberland® and Timberland® sub-branded products, as well as through franchised retail stores in Europe. We also sell our products in the United States online at timberland.com and smartwool.com.

We operate in an industry, which includes the designing, engineering, marketing and distribution of footwear and apparel and accessories products for men, women and children. We manage our business in the following three reportable segments, each segment sharing similar product, distribution and marketing: U.S. Wholesale, U.S. Consumer Direct and International.

The U.S. Wholesale segment is comprised of the sale of products to wholesale customers in the United States. The U.S. Wholesale segment also includes royalties from licensed products sold in the United States, the management costs and expenses associated with our worldwide licensing efforts and certain marketing expenses and value added services. The U.S. Consumer Direct segment includes the Company-operated specialty and factory outlet stores in the United States as well as our e-commerce business. The International segment consists of the marketing, selling and distribution of footwear, apparel and accessories and licensed products outside of the United States. Products are sold outside of the United States through our subsidiaries (which use wholesale and retail channels to sell footwear and apparel and accessories), independent distributors and licensees.

The following table presents the percentage of our total revenue generated by each of these reporting segments for the past three years:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| U.S. Wholesale | 40.8% | 42.1% | 44.3% |
| U.S. Consumer Direct | 12.6% | 13.6% | 14.3% |
| International | 46.6% | 44.3% | 41.4% |

More detailed information regarding these reportable segments, and each of the geographic areas in which we operate, is set forth in Note 17 to our consolidated financial statements, entitled Business Segments and Geographic Information, included in Item 8 of this Annual Report on Form 10-K.

**U.S. Wholesale**

Our wholesale customer accounts within the United States include independent retailers, better-grade department stores, outdoor specialty stores, national athletic accounts, general sporting goods retailers and other national accounts. Many of these wholesale accounts merchandise our products in selling areas dedicated exclusively to our products, or concept shops. These concept shops display the breadth of our product line and brand image to consumers, and are serviced through a combination of field and corporate-based sales teams responsible for these distribution channels. We also service our wholesale accounts through our principal showroom in New York City and regional showrooms in Atlanta, Georgia, Dallas, Texas and Miami, Florida. We have continued our efforts to expand the brand geographically by penetrating markets in areas beyond our traditional strength in the Northeast U.S.

**U.S. Consumer Direct**

At December 31, 2006, we operated 20 specialty stores and 61 factory outlet stores in the United States. We also sell products through our internet stores timberland.com and smartwool.com.

*Timberland® Specialty Stores.* These stores carry current season, first quality merchandise and provide:

- an environment to showcase our products as an integrated source of footwear and apparel and accessories;
- sales and consumer-trend information, which assists us in developing our marketing strategies and point-of-purchase marketing materials; and
- an opportunity to develop training and customer service programs, which also serve as models that may be adopted by our wholesale customers.

*Timberland® Factory Outlet Stores.* These stores serve as a primary channel for the sale of excess, damaged or discontinued products from our specialty stores. Our factory outlet stores also sell products specifically made for them. We view these factory outlet stores as a way to preserve the integrity of the Timberland® brand, while maximizing the return associated with the sale of such products.

*Timberland.com.* Our online store allows U.S. consumers to purchase current season, first quality merchandise over the internet. This internet site also provides information about Timberland, including the reports we file with or furnish to the Securities and Exchange Commission, investor relations, corporate governance, community involvement initiatives and employment opportunity information. Additionally, the site serves to reinforce our marketing efforts.

**International**

We sell our products internationally through operating divisions in the United Kingdom, Italy, France, Germany, Switzerland, Spain, Japan, Hong Kong, Singapore, Taiwan, Malaysia and Canada. Most of these operating divisions provide support for the sale of our products to wholesale customers and operate Timberland® specialty stores and factory outlet stores in their respective countries. At December 31, 2006, we operated 133 company-owned specialty stores and shops and 32 factory outlet stores in Europe and Asia. Two

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of our specialty stores in the United Kingdom focus solely on the marketing and sale of Timberland Boot Company™ products, which feature our line of work wear-inspired boots, jeans and jackets targeting a younger consumer. We intend to continue expanding the Timberland® brand into new markets and consumer segments to support our goal of becoming a top global brand.

Timberland® products are sold elsewhere in Europe, Asia, the Middle East, Africa, Central America and South America by distributors, franchisees and commissioned agents, some of which also may operate Timberland® specialty and factory outlet stores located in their respective countries. We expanded the Timberland® brand in China during 2006 through distributors.

**Distribution**

We distribute our products through three Company-managed distribution facilities which are located in Danville, Kentucky; Ontario, California and Enschede, Holland and through third-party managed distribution facilities which are located in Asia.

**Advertising and Marketing**

Timberland s mission is to equip people to make a difference in their world. This is reflected in the way we design, manufacture and market our products. Our marketing programs and promotions are designed to increase consumer awareness of and purchase intent for Timberland as a premium brand that equips consumers through the use of purposeful product. These programs and promotions are increasingly delivered throughout the year, rather than only during select seasons as has historically been the case.

In 2006, we further developed our consumer segmentation approach that we initiated in 2005. This approach helps us identify target consumers and provides insight into the needs and purchasing behavior of each unique consumer group that we target. Our deeper understanding of consumers enables us to focus our product development and go-to-market execution and further differentiate Timberland® products for consumers where they shop. We also continued to elevate our brand voice through the Make it better™ marketing campaign. This integrated communications platform spanned print, outdoor, internet, and point-of-sale with an overarching goal to inspire and engage our consumers through brand, values and product communication, demonstrated by our global launch of an award-winning PreciseFit™ footwear system proven to give the consumer a perfect fit.

In the spirit of our Make it better™ campaign, we launched several consumer engagement programs including:

(1) an innovative new packaging initiative with a category-leading nutrition label to transparently communicate our footprint to our consumers, including environmental impact and manufacturing information;

(2) a new website, 10061.com, focused on self-expression, art and community building; and

(3) a new retail store concept on Regent Street in London, U.K., designed to better communicate our brand values of boot, brand and belief, as well as provide a stronger platform to highlight our product and to enhance seasonal story telling.

Our print campaign focused on publications like Outside, Men s Journal, Men s Health, Backpacker and Bicycling. We also ran out-of-home advertising in markets such as New York, Washington, D.C., and Philadelphia. Our internet campaign utilized websites such as weather.com, askmen.com and yahoo.com. Our marketing efforts were supported by distributor and licensee funded marketing campaigns, developed in close concert with Timberland to ensure consistent and effective brand presentation.

**Seasonality**

In 2006, as has been historically the case, our revenue was higher in the last two quarters of the year than in the first two quarters. Accordingly, the amount of fixed costs related to our operations represented a larger percentage of revenue in the first two quarters of 2006 than in the last two quarters of 2006. We expect this seasonality to continue in 2007.

**Backlog**

At December 31, 2006, our backlog of orders from our customers was $372 million compared to $381 million at December 31, 2005 and $386 million at December 31, 2004. While all orders in the backlog are subject to cancellation by customers, we expect that the majority of such orders will be filled in 2007. We believe that backlog at year-end is an imprecise indicator of total revenue that may be achieved for the full year because backlog only relates to wholesale orders for the next season, is affected by the timing of customers orders and product availability and excludes potential sales in our retail stores during the year.

**Manufacturing**

We operate manufacturing facilities in the Dominican Republic. As we have previously reported, we closed our Puerto Rico footwear manufacturing facility at the end of 2005 and relocated some of the manufacturing capacity to our state-of-the-art footwear manufacturing facility in the Dominican Republic. We also expanded production capability in that location, including the manufacture of three different construction footwear types for our Timberland PRO® series work shoes. We believe we benefit from our internal manufacturing capability which provides us with sourcing for fashion and core assortment, planning efficiencies and lead time reduction, refined production techniques and favorable duty rates and tax benefits. During 2006, we manufactured approximately 9% of our footwear unit volume in the Dominican Republic. We manufactured approximately 10% and 9% of our footwear unit volume during 2005 and 2004, respectively, in Puerto Rico and the Dominican Republic. The remainder of our footwear products and all of our apparel and accessories products were produced by independent manufacturers and licensees in Asia, Europe, Mexico, Africa, and South and Central America. Approximately 91% of the Company s 2006 footwear unit volume was produced in Asia by independent manufacturers in China, Vietnam, Thailand, and Indonesia. Two of these manufacturers together produced approximately 44% of the Company s 2006 footwear volume. The Company continually evaluates footwear production sources in other countries to maximize cost efficiencies and to keep pace with advanced production techniques.

We maintain a product quality management group, which develops, reviews and updates our quality and production standards. To help ensure such standards are met, the group also conducts product quality audits at our factories and distribution centers and our independent manufacturers factories and distribution centers. We have offices in Bangkok, Thailand; Zhu Hai, China; Hong Kong; Istanbul, Turkey; Ho Chi Minh City, Vietnam; and Chennai, India to supervise our sourcing activities conducted in the Asia-Pacific region.

**Materials**

In 2006, eleven suppliers provided, in the aggregate, approximately 82% of our leather purchases. Two of these suppliers together provided approximately 30% of our leather purchases in 2006. We historically have not experienced significant difficulties in obtaining leather or other materials in quantities sufficient for our operations. However, our gross profit margins are adversely affected to the extent that the selling prices of our products do not increase proportionately with increases in the costs of leather and other materials. Any significant, unanticipated increase or decrease in the prices of these commodities could materially affect our results of operations. We attempt to manage this risk, as we do with all other footwear and non-footwear materials, on an ongoing basis by monitoring related market prices, working with our suppliers to achieve the maximum level of stability in their costs and related pricing, seeking alternative supply sources when necessary and passing increases in commodity costs to our customers, to the maximum extent possible, when they occur. No assurances can be given that such factors will protect us from future changes in the prices for such materials.

In addition, we have established a central network of suppliers through which our footwear manufacturing facilities and independent footwear manufacturers can purchase materials. We seek sources of materials local to manufacturers, in an effort to reduce lead times while maintaining our high quality standards. We believe that key strategic alliances with leading materials vendors help reduce the cost and provide greater consistency of materials procured to produce Timberland® products and improve compliance with our production standards. In 2006, we renewed contracts with global vendors for hand-sewn thread, leather laces, waterproof membrane gasket material, waterproof seam-seal adhesives and topline reinforcement tape. Global contracts remained in effect for packaging, laces, box toes and counters, cellulose and nonwoven insole board, Ströbel® construction insole materials and thread, synthetic suede lining materials, soling components and compounds, and packaging labels.

### Trademarks and Trade Names; Patents; Research & Development

Our principal trade name is The Timberland Company and our principal trademarks are TIMBERLAND and the TREE DESIGN LOGO, which have been registered in the United States and many foreign countries. Other trademarks or registered trademarks of The Timberland Company, or its affiliated companies, are: 24/7 Comfort Suspension, Air Raider, Amorphic Suspension, Anywhere Anyweather, ArchLogic, Balm Proofer, Boot Sauce, B.S.F.P., Cast-Bond, Comforia, Earthkeepers, EasyDry, Ergomorphic, Ever-Guard, Free to GoLite, GoLite, Green Index, Gripstick, GSR, Howies, Independent Suspension Technology, IntraMet, ISN, Isomorphic Suspension, Jackson Mountain, Ladder Lock, Made To Work, Make it better, Measure Up, Miōn, NEOform, Path of Service, PowerFit, PreciseFit, PRO 24/7, PRO 24/7 Comfort Suspension, Pull On Your Boots, Pull On Your Boots and Make a Difference, QuadCut, Renewbuck, SafeGrip, Smart Comfort, SmartWool, Splash Blaster, TBL, Timberland Boot Company, Timberland PRO, Timber Trail, TiTAN, Trail Grip, Weathergear, Waximum, Whole Body Stability, and Workboots For The Professional.

We regard our trade name and trademarks as valuable assets and believe that they are important factors in marketing our products. We seek to protect and vigorously defend our trade name and trademarks against infringement under the laws of the United States and other countries. In addition, we seek to protect and vigorously defend our patents, designs, copyrights and all other proprietary rights under applicable laws.

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We conduct research, design and development efforts for our products, including field testing of a number of our products to evaluate and improve product performance. Our Invention Factory, an advanced concepts footwear team, continued its efforts in 2006 to develop future technologies for our footwear products. We have also dedicated resources to an international design and development team based in Europe. Our expenses relating to research, design and development have not represented a material expenditure relative to our other expenses.

**Competition**

Our footwear and apparel and accessories products are marketed in highly competitive environments that are subject to changes in consumer preference. Product quality, performance, design, styling and pricing, as well as consumer awareness, are all important elements of competition in the footwear and the apparel and accessories markets served by us. Although the footwear industry is fragmented to a great degree, many of our competitors are larger and have substantially greater resources than us, including athletic shoe companies, several of which compete directly with some of our products. In addition, we face competition from retailers that have established products under private labels and from direct mail companies in the United States. The competition from some of these competitors is particularly strong where such competitor s business is focused on one or a few product categories or geographic regions in which we also compete. However, we do not believe that any of our principal competitors offers a complete line of products that provides the same quality and performance as the complete line of Timberland®, Timberland PRO®, SmartWool®, Timberland Boot Company™, Miōn™, GoLite®, and Howies® footwear and apparel and accessories products.

**Environmental Matters**

Compliance with federal, state and local environmental regulations has not had, nor is it expected to have, any material effect on our capital expenditures, earnings or competitive position based on information and circumstances known to us at this time.

**Employees**

We had approximately 6,300 and 5,800 full and part-time employees worldwide at December 31, 2006 and 2005, respectively. Our management considers our employee relations to be good. None of our employees is represented by a labor union, and we have never suffered a material interruption of business caused by labor disputes involving our own employees.

**Available Information**

Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, exhibits and amendments to those reports that are filed with or furnished to the Securities and Exchange Commission are made available free of charge through our website www.timberland.com, as soon as reasonably practicable after we electronically file them with, or furnish them to, the Securities and Exchange Commission. The charters for the Audit, Governance and Nominating, and Management Development and Compensation committees of our Board of Directors as well as our Corporate Governance Principles and Code of Ethics and other corporate information are available free of charge through our website www.timberland.com. You may request a copy of any of the above documents by writing to the Secretary, The Timberland Company, 200 Domain Drive, Stratham, New Hampshire 03885.

We submitted to the New York Stock Exchange in 2006 the CEO certification required by Section 303A.12(a) of the New York Stock Exchange Listed Company Manual.

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### Executive Officers of the Registrant

The following table lists the names, ages and principal occupations during the past five years of our executive officers. All executive officers serve at the discretion of our Company s Board of Directors.

| Name | Age | Principal Occupation During the Past Five Years |
|---|---|---|
| Sidney W. Swartz | 70 | Chairman of the Board since June 1986; Chief Executive Officer and President, June 1986 June 1998. |
| Jeffrey B. Swartz | 46 | President and Chief Executive Officer since June 1998. Jeffrey Swartz is the son of Sidney Swartz. |
| Kenneth P. Pucker(1) | 43 | Chief Operating Officer since July 2001; Executive Vice President since September 1999. |
| Brian P. McKeon(1) | 44 | Executive Vice President Finance and Administration since May 2002 and Chief Financial Officer since March 2000; Senior Vice President Finance and Administration, March 2000 May 2002. |
| Michael J. Harrison | 46 | Senior Vice President Worldwide Sales and Marketing since February, 2006; Senior Vice President and General Manager International, November 2003 February 2006; Telos Partners Ltd: Consultant, April 2001 October 2003; Procter & Gamble: Vice President, Western Europe, Cosmetics and Skin Care and Global Design, April 1999 April 2001. |
| Gary S. Smith | 43 | Senior Vice President Supply Chain Management since February 2002; McKinsey & Company: Partner, August 1994 February 2002. |
| Bruce A. Johnson | 50 | Senior Vice President Human Resources since June 2003; Dupont Textile and Interiors: Vice President Human Resources, June 2002 May 2003; The Timberland Company: Vice President Human Resources, June 2000 June 2002. |
| John Crimmins | 50 | Vice President, Corporate Controller and Chief Accounting Officer since August 2002; Interactiveprint: Chief Financial Officer, July 1999 January 2002. |
| Danette Wineberg | 60 | Vice President and General Counsel since October 1997 and Secretary since July 2001. |

(1) On February 7, 2007 the Company announced that Kenneth P. Pucker and Brian P. McKeon will be leaving the Company effective March 31, 2007.

## ITEM 1A. *RISK FACTORS*

### CAUTIONARY STATEMENTS FOR PURPOSES OF THE SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The Timberland Company (the Company ) wishes to take advantage of The Private Securities Litigation Reform Act of 1995, which provides a safe harbor for forward-looking statements to encourage companies to provide prospective information. Prospective information is based on management s then current expectations or forecasts. Such information is subject to the risk that such expectations or forecasts, or the assumptions used in making such expectations or forecasts, may become inaccurate. The following discussion identifies important factors that could affect the Company s actual results and could cause such results to differ materially from those contained in forward-looking statements made by or on behalf of the Company. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

## Risks Related to Our Business

***We operate in a highly competitive industry.***

We market our products in highly competitive environments. Many of our competitors are larger and have substantially greater resources for marketing, research and development and other purposes. These competitors include athletic and other footwear companies, branded apparel companies and private labels established by retailers. Furthermore, efforts by our footwear competitors to dispose of their excess inventory could put downward pressure on retail prices and could cause our wholesale customers to redirect some of their purchases away from our products.

***Our products may not appeal to consumers.***

As we continue to market established products and develop new products, our success depends in large part on our ability to anticipate, understand and react to changing consumer demands. We believe that our more fashion-focused boots, men s apparel and women s footwear products are more susceptible to changing fashion trends and consumer preferences than our other products. Consumer demand for our boot products has declined during the last two years as fashion trends have favored lower profile, casual footwear. Revenue declines associated with lower boot sales has adversely impacted our financial results and no assurances can be made that sales of our boot products will increase in the short-term or that we will be able to develop or market alternative products to mitigate the loss of such sales. Our products must appeal to a broad range of consumers whose preferences cannot be predicted with certainty and are subject to rapid change. The success of our products and marketing strategy will also depend on a favorable reception by our wholesale customers. We cannot ensure that any existing products or brands will continue to be successfully received by consumers or our wholesale customers. We cannot ensure that any new products or brands that we introduce will be successfully received by consumers or our wholesale customers. Any failure on our part to anticipate, identify and respond effectively to changing consumer demands and fashion trends could adversely affect retail and consumer acceptance of our products and leave us with unsold inventory or missed opportunities. If that occurs, we may be forced to rely on markdowns or promotional sales to dispose of excess, slow-moving inventory, which may harm our business. At the same time, our focus on tight management of inventory may result, from time to time, in not having an adequate supply of products to meet consumer demand and cause us to lose sales.

***We conduct business outside the United States which exposes us to foreign currency, import restrictions, taxes, duties and other risks.***

We manufacture and source a majority of our products outside the United States. Our products are sold in the U.S. and internationally. Accordingly, we are subject to the risks of doing business abroad, including, among other risks, foreign currency exchange rate risks, import restrictions, anti-dumping investigations, political or labor disturbances, expropriation and acts of war. Additionally, as a global company, our effective tax rate is highly dependent upon the geographic composition of worldwide earnings and tax regulations governing each region.

On March 22, 2006, the European Commission imposed provisional duties on leather upper footwear originating from China and Vietnam and imported into European Member States. These provisional duties, which began on April 7, 2006, were effective for a six month period and were phased in over a period of five months, beginning at a rate of about 4% and ending at a 19.4% rate for China sourced footwear and at a 16.8% rate for Vietnam sourced footwear. These duties became definitive on October 7, 2006, for a period of two years, with a final 16.5% rate for China sourced footwear and a 10% rate for Vietnam sourced footwear. Pursuant to European Union regulations, only provisional duties which do not exceed the definitive duty rates will be collected. Children s footwear with leather uppers was excluded from the provisional duties, but is subject to definitive duties. Our estimate is that the implementation of these duties will likely reduce our 2007 operating profits in the range of $10 million.

Although we pay for the purchase and manufacture of our products primarily in U.S. dollars, we are routinely subject to currency rate movements on non-U.S. denominated assets, liabilities and income as we sell goods in local currencies through our foreign subsidiaries. No assurances can be given that we will be protected from future changes in foreign currency exchange rates that may impact our financial condition or performance.

***We depend on independent manufacturers to produce the majority of our products and our business could suffer if we need to replace manufacturers or suppliers or find additional capacity.***

During 2006, we manufactured approximately 9% of our footwear unit volume. Independent manufacturers and licensees in Asia, Europe, Mexico, Africa and South and Central America produced the remainder of our footwear products and all of our apparel and accessories products. Independent manufacturers in China, Vietnam, Thailand and Indonesia produced approximately 91% of our 2006 footwear unit volume. Two of these manufacturers together produced approximately 44% of our 2006 footwear volume. If we experience a significant increase in demand or a manufacturer is unable to ship orders of our products in a timely manner or to meet our quality standards, then we could miss customer delivery date requirements for those items, which could result in cancellation of orders, refusal to accept deliveries or a reduction in purchase prices, any of which could have a material adverse effect on our financial condition and results of operations. We compete with other companies for the production capacity of our manufacturers and import quota capacity. Any long-term economic downturn could cause our suppliers to fail to make and ship orders placed by us. There is no assurance that we will be able to maintain current relationships with our current manufacturers or locate additional manufacturers that can meet our requirements or manufacture on terms that are acceptable to us.

***The loss of one or more of our major suppliers for materials may interrupt our supplies.***

We depend on a limited number of key sources for leather, our principal material, and other proprietary materials used in our products. In 2006, eleven suppliers provided, in the aggregate, approximately 82% of our leather purchases. Two of these suppliers provided approximately 30% of our leather purchases in 2006. While historically we have not experienced significant difficulties in obtaining leather or other materials in quantities sufficient for our operations, there have been significant changes in the prices for these materials. Our gross profit margins are adversely affected to the extent that the selling prices of our products do not increase proportionately with increases in the costs of leather and other materials. Any significant unanticipated increase or decrease in the prices of these commodities could materially affect our results of operations. Increasing oil-related product costs could also adversely impact gross margins.

***Our business could be adversely impacted by any disruption to our supply chain.***

Independent manufacturers manufacture a majority of our products outside of our principal sales markets, which requires us to transport our products through third parties over large geographic distances. Delays in the shipment or delivery of our products due to the availability of transportation, work stoppages or other factors could adversely impact our financial performance.

***Our business could be adversely impacted by the financial instability of our customers.***

We sell our products to wholesale customers and extend credit based on an evaluation of each customer s financial condition, usually without requiring collateral. The financial difficulties of a customer could cause us to curtail doing business with that customer. Our inability to collect from our customers could have an adverse effect on our business or our financial condition.

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***We depend on sales forecasts which may not be accurate and may result in higher infrastructure and product investments.***

We base our investments in infrastructure and product, in part, on sales forecasts. We do business in highly competitive markets, and our business is affected by a variety of factors, including brand awareness, product innovations, retail market conditions, economic and other factors, changing consumer preferences, fashion trends, seasonality and weather conditions. One of our principal challenges is to predict these factors to enable us to match the production of our products with demand. If sales forecasts are not achieved, these investments could represent a higher percentage of revenue, and we may experience higher inventory levels and associated carrying costs, all of which could adversely affect our financial performance.

***Declines in revenue in our retail stores could adversely affect profitability.***

We have made significant capital investments in opening retail stores and incur significant expenditures in operating these stores. The higher level of fixed costs related to our retail organization can adversely affect profitability, particularly in the first half of the year, as our revenue historically has been more heavily weighted to the second half of the year. Our ability to recover the investment in and expenditures of our retail organization can be adversely affected if sales at our retail stores are lower than anticipated. Our gross margin could be adversely affected if off-price sales increase as a percentage of revenue.

***We rely on our licensing partners to help us preserve the value of our brand.***

Since late 1994, we have entered into several licensing agreements which enable us to expand our brand to product categories and geographic territories in which we have not had an appreciable presence. The risks associated with our own products also apply to our licensed products. There are also any number of possible risks specific to a licensing partner s business, including, for example, risks associated with a particular licensing partner s ability to obtain capital, manage its labor relations, maintain relationships with its suppliers, manage its credit risk effectively and maintain relationships with its customers. Although our license agreements prohibit licensing partners from entering into licensing arrangements with certain of our competitors, generally our licensing partners are not precluded from offering, under other brands, the types of products covered by their license agreements with us. A substantial portion of sales of the licensed products by our domestic licensing partners are also made to our largest customers. While we have significant control over our licensing partners products and advertising, we rely on our licensing partners for, among other things, operational and financial control over their businesses.

***The loss of key executives could cause our business to suffer, and control by members of the Swartz family and the anti-takeover effect of multiple classes of stock could discourage attempts to acquire us.***

Sidney W. Swartz, our Chairman, Jeffrey B. Swartz, our President and Chief Executive Officer, and other executives have been key to the success of our business to date. The loss or retirement of these or other key executives could adversely affect us. Sidney W. Swartz, Jeffrey B. Swartz and various trusts established for the benefit of their families or for charitable purposes, hold approximately 71% of the combined voting power of our capital stock in the aggregate, enabling them to control our affairs and to influence the election of the three directors entitled to be elected by the holders of Class A common stock voting separately as a class. Members of the Swartz family will, unless they sell shares of Class B common stock that would reduce the Class B common stock outstanding to 12.5% or less of total Class A and Class B shares outstanding, have the ability, by virtue of their stock ownership, to prevent or cause a change in control of the Company.

***Our charter documents and Delaware law may inhibit a change of control that stockholders may consider favorable.***

Under our Certificate of Incorporation, the Board of Directors has the ability to issue and determine the terms of preferred stock. The ability to issue preferred stock coupled with the anti-takeover provisions of Delaware law could delay or prevent a change of control or change in management that might provide stockholders with a premium to the market price of their common stock.

***Our inability to attract and retain qualified employees could impact our business.***

We compete for talented employees within our industry. We must maintain competitive compensation packages to recruit and retain qualified employees. Our failure to attract and retain qualified employees could adversely affect the sales, design and engineering of our products.

***Our ability to protect our trademarks and other intellectual property rights may be limited.***

We believe that our trademarks and other proprietary rights are important to our success and our competitive position. We devote substantial resources to the establishment and protection of our trademarks on a worldwide basis. We cannot ensure that the actions we have taken to establish and protect our trademarks and other proprietary rights will be adequate to prevent imitation of our products by others or to prevent others from seeking to block sales of our products as a violation of the trademarks and proprietary rights of others. Also, we cannot ensure that others will not assert rights in, or ownership of, trademarks and other proprietary rights of ours or that we will be able to successfully resolve these types of conflicts to our satisfaction. We are also susceptible to injury from parallel trade and counterfeiting of our products. In addition, the laws of certain foreign countries may not protect proprietary rights to the same extent as do the laws of the United States.

***We cannot assure the successful implementation of our strategy.***

As part of our growth strategy, we seek to enhance the premium positioning of our brand, to extend our brands into complementary product categories and consumer groups, to expand geographically and to improve our operational performance. There can be no assurance that we will be able to successfully implement any or all of these strategies, which could lead to a decline in our results in operations, which in turn could have a negative effect on our stock.

***The value of our brand, and our sales, could be diminished if we are associated with negative publicity.***

While our staff and third-party compliance auditors periodically visit and monitor the operations of our vendors, independent manufacturers and licensees, we do not control these vendors or independent manufacturers or their labor practices. A violation of our vendor policies, labor laws or other laws by these vendors or independent manufacturers could interrupt or otherwise disrupt our sourcing or damage our brand image. Negative publicity, for these or other reasons, regarding our Company, brand or products, including licensed products, could adversely affect our reputation and sales.

**Risks Related to Our Industry**

***We face intense competition in the worldwide footwear and apparel industry, which may impact our sales.***

We face a variety of competitive challenges from other domestic and foreign footwear and apparel producers, some of which may be significantly larger and more diversified and have greater financial and marketing resources than we have. We compete with these companies primarily on the basis of anticipating and responding to changing consumer demands in a timely manner, maintaining favorable brand recognition, developing innovative, high-quality products in sizes, colors and styles that appeal to consumers, providing strong and effective marketing support, creating an acceptable value proposition for retail customers, ensuring product availability and optimizing supply chain efficiencies with manufacturers and retailers, and obtaining sufficient retail floor space and effective presentation of our products at retail. Increased competition in the worldwide footwear and apparel industries, including internet-based competitors, could reduce our sales, prices and margins and adversely affect our results of operations.

***A downturn in the economy may affect consumer purchases of discretionary items and retail products, which could adversely affect our sales.***

The industries in which we operate are cyclical. Many factors affect the level of consumer spending in the footwear and apparel industries, including, among others, general business conditions, interest rates, the availability of consumer credit, weather, taxation and consumer confidence in future economic conditions.

Consumer purchases of discretionary items, including our products, may decline during recessionary periods and also may decline at other times when disposable income is lower. A downturn in the economies in which we, or our licensing partners, sell our products, whether in the United States or abroad, may adversely affect our sales. Our gross margin could also be adversely affected if off-price sales increase as a percentage of revenue.

***Retail trends could result in downward pressure on our prices.***

With the growing trend toward retail trade consolidation, we increasingly depend upon a reduced number of key retailers whose bargaining strength is growing. Changes in the policies of these retail trade customers, such as increased at-once ordering, limitations on access to shelf space and other conditions may result in lower net sales. Further consolidations in the retail industry could result in price and other competition that could damage our business.

## ITEM 1B. *UNRESOLVED STAFF COMMENTS*

None.

## ITEM 2. *PROPERTIES*

We lease our worldwide headquarters located in Stratham, New Hampshire. The lease for this property expires in September 2010, with the option to extend the term for two additional five-year periods. We consider our headquarters facilities adequate and suitable for our current needs.

We lease our manufacturing facilities located in Santiago, Dominican Republic, under leasing arrangements, which expire on various dates through 2009. We own our distribution facility in Danville, Kentucky, and we lease our facilities in Ontario, California and Enschede, Holland. The Company and its subsidiaries lease all of their specialty and factory outlet stores. Our subsidiaries also lease office and warehouse space to meet their individual requirements.

## ITEM 3. *LEGAL PROCEEDINGS*

We are involved in various litigation and legal matters that have arisen in the ordinary course of business. We believe that the ultimate resolution of any existing matter will not have a material adverse effect on our consolidated financial statements.

## ITEM 4. *SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS*

During the fourth quarter of the fiscal year ended December 31, 2006, no matter was submitted to a vote of security holders through the solicitation of proxies or otherwise.

# PART II

## ITEM 5. *MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES*

Our Class A Common Stock is traded on the New York Stock Exchange under the symbol TBL. There is no market for shares of our Class B Common Stock; however, shares of Class B Common Stock may be converted into shares of Class A Common Stock on a one-for-one basis and will automatically be converted upon any transfer (except for estate planning transfers and transfers approved by the Board of Directors).

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The following table presents the high and low closing sales prices of our Class A Common Stock for the past two years, as reported by the New York Stock Exchange.

| | 2006 | | 2005 | |
|---|---|---|---|---|
| | High | Low | High | Low |
| First Quarter | $ 37.13 | $ 32.45 | $ 36.55 | $ 31.62 |
| Second Quarter | 35.01 | 26.10 | 39.69 | 34.53 |
| Third Quarter | 29.70 | 25.35 | 40.75 | 32.17 |
| Fourth Quarter | 33.37 | 28.24 | 33.76 | 27.40 |

As of February 23, 2007, the number of record holders of our Class A Common Stock was 821 and the number of record holders of our Class B Common Stock was 7. The closing sales price of our Class A Common Stock on February 23, 2007 was $28.41 per share.

We have never declared a dividend on either the Company s Class A or Class B Common Stock. Our ability to pay cash dividends is limited pursuant to loan agreements (see Note 11 to the Company s consolidated financial statements included in Item 8 of this Annual Report on Form 10-K). The Company has no plans to issue a cash dividend at this time.

**Performance Graph**

The following graph shows the five year cumulative total return of Class A Common Stock as compared with the Standard & Poor s (S&P) 500 Stock Index and the weighted average of the Standard & Poor s Footwear Index and the Standard & Poor s Apparel, Accessories and Luxury Goods Index. The total return for the Footwear and Apparel, Accessories and Luxury Goods indices is weighted in proportion to the percent of the Company s revenue derived from sales of footwear and from apparel and accessories (excluding royalties on products sold by licensees), respectively, for each year.

| | 2001(1) | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Timberland | 100.00 | 96.04 | 140.43 | 169.01 | 175.57 | 170.33 |
| S&P 500 Index | 100.00 | 77.90 | 100.25 | 111.15 | 116.61 | 135.03 |
| Weighted Average of S&P 500 Footwear Index and S&P 500 Apparel, Accessories and Luxury Goods Index | 100.00 | 85.26 | 121.64 | 159.50 | 161.21 | 192.30 |

**(1) Indexed to December 31, 2001**

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**ISSUER PURCHASES OF EQUITY SECURITIES(1)**

**For the Three Fiscal Months Ended December 31, 2006**

| Period* | Total Number of Shares Purchased ** | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| September 30 October 27 | 274,752 | $ 29.14 | 274,752 | 4,095,451 |
| October 28 November 24 | 249,078 | 30.46 | 249,078 | 3,846,373 |
| November 25 December 31 | 300,388 | 31.90 | 300,388 | 3,545,985 |
| Q4 Total | 824,218 | $ 30.54 | 824,218 | |

**Footnote(1)**

| | Announcement Date | Approved Program Size (Shares) | Expiration Date |
|---|---|---|---|
| Program 1 | 02/09/2006 | 6,000,000 | None |

No existing programs expired or were terminated during the reporting period. See Note 14 to our consolidated financial statements, entitled Stockholders Equity , in Item 8 of this Annual Report on Form 10-K for additional information.

* *Fiscal month*

** *Based on trade date not settlement date*

**ITEM 6. *SELECTED FINANCIAL DATA***

**Selected Statement of Income Data**

| Years Ended December 31, | 2006(1) | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|
| | (Dollars in thousands, except per share data) | | | | |
| Revenue | $ 1,567,619 | $ 1,565,681 | $ 1,500,580 | $ 1,342,123 | $ 1,190,896 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Net income before cumulative effect of change in accounting principle | | 106,432 | | 164,624 | | 152,693 | | 117,879 | | 90,200 |
| Net income(2) | | 106,432 | | 164,624 | | 152,693 | | 117,879 | | 95,113 |
| Earnings per share before cumulative effect of change in accounting principle | | | | | | | | | | |
| Basic | $ | 1.70 | $ | 2.48 | $ | 2.19 | $ | 1.66 | $ | 1.21 |
| Diluted | $ | 1.67 | $ | 2.43 | $ | 2.14 | $ | 1.62 | $ | 1.18 |
| Earnings per share net income | | | | | | | | | | |
| Basic | $ | 1.70 | $ | 2.48 | $ | 2.19 | $ | 1.66 | $ | 1.27 |
| Diluted | $ | 1.67 | $ | 2.43 | $ | 2.14 | $ | 1.62 | $ | 1.25 |

(1) Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards 123(R), *Share-Based Payment*. See Note 15 to our consolidated financial statements in Item 8 of this Annual Report on Form 10-K.

(2) In 2002, we recorded a $4,913 after-tax gain from the cumulative effect of a change in accounting principle.

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**Selected Consolidated Balance Sheet Data**

| December 31, | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|
| | | | (Dollars in thousands) | | |
| Cash and equivalents | $ 181,698 | $ 213,163 | $ 309,116 | $ 241,803 | $ 141,195 |
| Working capital | 366,292 | 372,260 | 422,855 | 342,569 | 286,027 |
| Total assets | 843,105 | 788,654 | 757,510 | 641,716 | 538,671 |
| Total long-term debt | | | | | |
| Stockholders equity | 560,817 | 528,187 | 511,507 | 428,463 | 372,785 |

**ITEM 7.** ***MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS***

The following discusses The Timberland Company s ( we , our , us , Timberland or the Company ) results of opera and liquidity and capital resources. The discussion, including known trends and uncertainties identified by management, should be read in conjunction with the consolidated financial statements and related notes. Included herein are discussions and reconciliations of total Company, total International, Europe and Asia revenue changes to constant dollar revenue changes, and operating expense, operating income, net income and diluted earnings per share ( EPS ) to operating expense, operating income, net income and diluted EPS, respectively, excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans. Constant dollar revenue changes, which exclude the impact of changes in foreign exchange rates, and operating expense, operating income, net income and diluted EPS excluding restructuring and related costs and including share-based employee compensation costs are not Generally Accepted Accounting Principle ( GAAP ) performance measures. We provide constant dollar revenue changes for total Company, total International, Europe and Asia results because we use the measure to understand revenue changes excluding any impact from foreign exchange rate changes. We provide operating expense, operating income, net income and diluted EPS excluding restructuring and related costs and including share-based employee compensation costs to understand operating expense, operating income, net income and diluted EPS excluding restructuring and related costs and to provide comparability to reported results that include share-based employee compensation costs as prescribed by Statement of Financial Accounting Standards ( SFAS ) 123(R), Share-Based Payment.

**Recent Developments**

***Global Reorganization***

As part of our commitment to better serve our consumers and improve our performance, in December 2006 we made a series of organizational changes that will better align our go-to-market infrastructure with the consumers we seek to serve. In this context we are assessing our business segment definitions and anticipate that beginning in the second quarter of 2007, we will shift to a reporting structure that mirrors the newly established consumer categories Authentic Youth, CasualGear, Outdoor Group and Industrial. Each of these categories will be led by a President, along with dedicated resources against merchandising, design, sales planning, category marketing and global sales. The President of each group will report directly to the Chief Executive Officer.

***North American Apparel Licensing Agreement***

In February, 2007, we announced that we entered into a licensing agreement with Phillips-Van Heusen for the design, sourcing and marketing of apparel in North America under the Timberland® brand, beginning with the Fall 2008 line.

Excluded from the agreement with Phillips-Van Heusen are Timberland® Outdoor Performance apparel, which Timberland will continue to design, source and market worldwide, as well as Timberland PRO® apparel, which is the subject of an exclusive license agreement with Block Corporation for the United States and Canada. As a result of our decision to license Timberland® brand apparel in North America, we will incur a pre-tax restructuring charge in the range of $4 million in 2007 to cover severance, outplacement services and asset disposal costs associated with implementation of this strategy. We anticipate that this action will result in cost savings in the range of $4 $5 million in 2007, weighted towards the second half of the year. These savings have been factored into the Company s financial outlook.

***Executive Departures***

In February, 2007, the Company also announced that Kenneth P. Pucker, Executive Vice President and Chief Operating Officer, and Brian McKeon, Executive Vice President Finance and Administration and Chief Financial Officer, will be leaving the Company effective March 31, 2007. Mr. Pucker has entered into a separation agreement with the Company, which provides for a cash payment and the vesting of certain shares previously awarded under the Company s incentive compensation plans. The Company will incur a restructuring charge of approximately $3.3 million in 2007 to record these items, including a recovery of approximately $0.8 million associated with the forfeiture of other shares awarded to Mr. Pucker but not vested upon termination.

## Overview

Our principal strategic goal is to become the authentic outdoor brand of choice globally. We continue to develop a diverse portfolio of footwear, apparel and accessories that reinforces the functional performance, benefits and classic styling that consumers have come to expect from our brand. We sell our products to consumers who embrace an outdoor-inspired lifestyle through high-quality distribution channels, including our own retail stores, which reinforce the premium positioning of the Timberland® brand.

To deliver against our long-term goals, we are focused on driving progress on key strategic fronts. These include enhancing our leadership position in our core footwear business, capturing the opportunity that we see for outdoor-inspired apparel, extending enterprise reach through development of new brand platforms and brand building licensing arrangements, expanding geographically and driving operational and financial excellence while setting the standard for commitment to the community and striving to be a global employer of choice.

Highlights of our 2006 financial performance include the following:

- Revenue of $1,567.6 million was relatively flat with the prior year.

- Gross margin was 47.3% in 2006, compared to 49.6% in 2005.

- Operating income for the year was $159.7 million, or 10.2% of revenue, compared to $245.4 million, or 15.7% of revenue, in 2005. Operating income excluding restructuring charges in both years and including share-based employee compensation costs related to stock option and employee stock purchase plans in 2005 was $163.6 million, or 10.4% of revenue, compared to $237.1 million, or 15.1% of revenue.

- Net income was $106.4 million in 2006 compared to $164.6 million in 2005. Excluding restructuring charges in both years and including share-based employee compensation costs related to stock option and employee stock purchase plans in 2005, net income was $108.9 million compared to $159.2 million in 2005.

- Diluted earnings per share decreased from $2.43 in 2005 to $1.67 in 2006. Excluding restructuring charges in both years and including share-based employee compensation costs related to stock option and employee stock purchase plans in 2005, diluted earnings per share decreased from $2.35 to $1.71.

- Net cash provided by operating activities decreased from $182.3 million in 2005 to $111.7 million in 2006.

- Cash at the end of the year was $181.7 million with no debt outstanding.

We continue to maintain our focus on serving as a reference for socially responsible companies through our commitment to community. During the fourth quarter of 2006, we held our annual North American sales meeting in New Orleans where we worked in unity with over 800 volunteers to assist in the on-going efforts to revitalize the city. We also remain committed to being an employer of choice as demonstrated by our recognition for the tenth consecutive year in *Fortune* magazine s list of 100 Best Companies to Work For.

For 2007, we are targeting solid growth across our casual, outdoor and industrial categories. We are also committed to improving performance in our boots and kids businesses, supported by a disciplined product supply and distribution strategy that is aligned with the premium position the Company seeks to maintain with consumers. In this context, we expect to see continued significant declines in boots and kids sales in 2007, likely in excess of $100 million globally. These impacts will likely limit overall revenue to prior year levels for the full year.

Lower boots and kids sales and impacts from higher relative product costs are expected to place continued pressure on operating margins, with expectations for potential full-year declines in the range of 300 basis points compared to prior year levels excluding restructuring costs. We expect sales and operating margin pressures will be greater early in 2007 given warm winter weather conditions, the lapping of prior year results and macro factors such as the implementation of European Union ( EU ) anti-dumping duties. We estimate these factors will contribute to a decline in operating profits excluding restructuring costs in the range of $40 million in the first half of 2007, with most of this decline in the first quarter.

## Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to sales returns and allowances, realization of outstanding accounts receivable, the carrying value of inventories, derivatives, other contingencies, impairment of assets, incentive compensation accruals, shared-based compensation and the provision for income taxes. We base our estimates on historical experience and on various other assumptions 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. Historically, actual results have not been materially different from our estimates. Because of the uncertainty inherent in these matters, actual results could differ from the estimates used in applying our critical accounting policies. Our significant accounting policies are described in Note 1 to the Company s consolidated financial statements in Item 8 of this Annual Report on Form 10-K.

We have identified the following as critical accounting policies, based on the significant judgments and estimates used in determining the amounts reported in our consolidated financial statements:

### *Sales Returns and Allowances*

Our revenue consists of sales to wholesale customers (including distributors, franchisees and commissioned agents), retail and e-commerce store revenues, license fees and royalties. We record wholesale and e-commerce store revenues when title passes and the risks and rewards of ownership have passed to our customer, based on the terms of sale. Title passes generally upon shipment to or upon receipt by our customer, depending on the country of sale and the agreement with our customer. Retail store revenues are recorded at the time of the sale. License fees and royalties are recognized as earned per the terms of our licensing and royalty agreements.

We record reductions to revenue for estimated wholesale and retail customer returns and allowances. We base our estimates on historical rates of customer returns and allowances, as well as the specific identification of outstanding returns and allowances, which are known to us but which have not yet been received. Our total reserves for sales returns and allowances were $35.9 million and $38.2 million at December 31, 2006 and 2005, respectively. The actual amount of customer returns and allowances may differ from our estimates. If we determine that increases or decreases to sales returns and allowances are appropriate, we record either a reduction or an increase in sales in the period in which we make such a determination.

***Allowance for Doubtful Accounts***

We make ongoing estimates for losses relating to our allowance for uncollectible accounts receivable resulting from the potential inability of our customers to make required payments. We estimate potential losses primarily based upon our historical rate of credit losses and our knowledge of the financial condition of our customers. Our allowances for doubtful accounts totaled $12.1 million and $8.8 million at December 31, 2006 and 2005, respectively. The increase in our allowances for doubtful accounts reflects erosion in the timeliness of collections in the U.S. and Europe. Historically, losses have been within our expectations. If the financial condition of our customers were to change, adjustments may be required to these estimates. Furthermore, we provide for estimated losses resulting from disputes, which arise with respect to the gross carrying value of our receivables. The settlement or resolution of these differences could result in future changes to these estimates. If we determine that increases or decreases to the allowance for doubtful accounts are appropriate, we record either an increase or decrease to selling expense in the period in which we make such a determination.

***Inventory Valuation***

We value our inventory at the lower of cost (first-in, first-out) or market value. Market value is estimated based upon assumptions made about future demand and retail market conditions. If we determine that the estimated market value of our inventory is less than the carrying value of the inventory, we provide a reserve for the difference as a charge to cost of sales. Our reserves related to inventory valuation totaled $9.9 million and $10.8 million at December 31, 2006 and 2005, respectively. If actual market conditions are more or less favorable than our estimates, adjustments to our inventory reserves may be required. The adjustments would decrease or increase our cost of sales in the period in which they are recognized.

***Derivatives***

We are routinely subject to currency rate movements on non-U.S. dollar denominated assets, liabilities and income as we purchase and sell goods in foreign markets in their local currencies. We use derivative instruments, specifically forward contracts, to hedge a portion of our forecasted foreign currency transactions. We use our operating budget and forecasts to estimate future economic exposure and to determine the appropriate levels and timing of related hedging transactions. We closely monitor our foreign currency exposure and adjust our hedge positions accordingly. Our estimates of anticipated transactions could fluctuate over time and could vary from the ultimate transactions (see Note 3 to our consolidated financial statements in Item 8 of this Annual Report on Form 10-K). Future operating results could be impacted by adjustments to these estimates.

***Contingencies***

In the ordinary course of business, we are involved in legal proceedings involving contractual and employment relationships, product liabilities, trademark rights and a variety of other matters. We record contingent liabilities when it is probable that a liability has been incurred and the amount of the loss is estimable. We disclose a contingent liability when there is at least a reasonable possibility that a loss has been incurred. Estimating probable losses requires analysis and judgment about the potential actions. Therefore, actual losses in any future period are inherently uncertain. We do not believe that any pending legal proceeding or claims will have a material impact on our consolidated financial statements. However, if actual or estimated probable future losses exceed our recorded liability, we would record additional expense during the period in which the loss or change in estimate occurred.

***Long-lived Assets***

When events or circumstances indicate that the carrying value of a long-lived asset may be impaired, we estimate the future undiscounted cash flows to be derived from the asset to determine whether or not a potential impairment exists. If the carrying value exceeds the estimate of future undiscounted cash flows, impairment is calculated as the excess of the carrying value of the asset over the estimate of its fair market value. We estimate future undiscounted cash flows using assumptions about expected future operating performance. Those estimates of undiscounted cash flows could differ from actual cash flows due to, among other things, technological changes, economic conditions or changes to business operations. For 2006 and 2005, no significant impairment related to the carrying value of our long-lived assets has been recorded.

***Incentive Compensation Accruals***

We use incentive compensation plans to link compensation to the achievement of specific annual performance targets. We accrue for this liability during each year based on certain estimates and assumptions. The amount paid, based on actual performance, could differ from our accrual.

***Share-based Compensation***

The Company estimates the fair value of its stock option awards and employee stock purchase plan (the ESP Plan ) rights on the date of grant using the Black-Scholes option valuation model. The Black-Scholes model includes various assumptions, including the expected volatility for stock options and ESP Plan rights and the expected term of stock options. These assumptions reflect the Company s best estimates, but they involve inherent uncertainties based on market conditions generally outside of the Company s control. As a result, if other assumptions had been used, share-based compensation expense, as calculated and recorded under SFAS 123(R) could have been materially impacted. Furthermore, if the Company uses different assumptions in future periods, share-based compensation expense could be materially impacted in future periods. See Note 15 to the Company s consolidated financial statements in Item 8 of this Annual Report on Form 10-K for additional information regarding the Company s adoption of SFAS 123(R).

In accordance with Financial Accounting Standards Board Staff Position FAS 123(R)-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards , in the fourth quarter of 2006 the Company elected to adopt the alternative transition method for purposes of calculating the pool of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123(R).

***Income Taxes***

We record deferred tax assets and liabilities based upon temporary book to tax differences. The carrying value of our net deferred tax assets assumes that we will be able to generate sufficient future taxable income in certain tax jurisdictions to realize the value of these assets. If we were unable to generate sufficient future taxable income in these jurisdictions, an adjustment could be required in the net carrying value of the deferred tax assets, which would result in additional income tax expense in our consolidated statements of income. Management evaluates the realizability of the deferred tax assets and assesses the need for any valuation adjustment quarterly.

We estimate the effective tax rate for the full fiscal year and record a quarterly income tax provision in accordance with the anticipated annual rate. As the fiscal year progresses, the estimate is refined based upon actual events and earnings by jurisdiction during the year. This continual estimation process periodically results in a change to the 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 reflects the expected annual rate. In the fourth quarter of 2006, we adjusted our effective tax rate estimate to 35.0% from our previous full year estimate of 35.6%.

We have provided reserves for certain tax matters, both domestic and foreign, which we believe could result in additional tax being due. Our tax reserves total approximately $16.0 million at December 31, 2006. Any additional assessment or reduction of these contingent liabilities will be reflected in the Company s effective tax rate.

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## Results of Operations

| Years Ended December 31, | 2006 | | 2005 | | 2004 | |
|---|---|---|---|---|---|---|
| | (Amounts in Thousands, Except Per Share Data) | | | | | |
| Revenue | $ 1,567,619 | 100.0% | $ 1,565,681 | 100.0% | $ 1,500,580 | 100.0% |
| Gross profit | 742,136 | 47.3 | 776,905 | 49.6 | 739,075 | 49.3 |
| Operating expense | 582,443 | 37.2 | 531,523 | 33.9 | 505,212 | 33.7 |
| Operating income | 159,693 | 10.2 | 245,382 | 15.7 | 233,863 | 15.6 |
| Interest income, net | 966 | 0.1 | 3,335 | 0.2 | 1,095 | 0.1 |
| Other income, net | 3,082 | 0.2 | 336 | 0.0 | 1,775 | 0.1 |
| Net income | $ 106,432 | 6.8 | $ 164,624 | 10.5 | $ 152,693 | 10.2 |
| Earnings per share | | | | | | |
| Basic | $ 1.70 | | $ 2.48 | | $ 2.19 | |
| Diluted | $ 1.67 | | $ 2.43 | | $ 2.14 | |
| Weighted-average shares outstanding | | | | | | |
| Basic | 62,510 | | 66,325 | | 69,628 | |
| Diluted | 63,690 | | 67,774 | | 71,311 | |

### 2006 Compared to 2005

***Revenue***

Consolidated revenue of $1,567.6 million was flat with the prior year. Benefits from the addition of SmartWool, which contributed an incremental $51.2 million to revenue growth, solid growth in international markets and gains in Timberland PRO® footwear and Timberland® brand apparel offset sales declines in boots and kids   footwear, primarily in the U.S.

***Segments Review***

We have three reportable business segments (see Note 17 to the consolidated financial statements in Item 8 of this Annual Report on Form 10-K): U.S. Wholesale, U.S. Consumer Direct and International.

U.S. Wholesale revenues were $640.0 million in 2006, down 3.0% compared to 2005. The decrease was driven primarily by declines in boots and kids   footwear. This decrease was partially offset by a full year of sales from SmartWool, which added $42.8 million in incremental revenue, and strong growth in Timberland PRO® footwear and Timberland® brand apparel sales.

U.S. Consumer Direct revenues declined 7.0% to $197.7 million in 2006. Comparable store sales declined 9.6%, reflecting both unseasonably warm weather trends which pressured sales and our decision to remove classic boot product from outlet stores in the second half of the year as part of our strategy to strengthen overall pricing for these products in the U.S. market. Strong growth in our e-commerce business, due primarily to incremental SmartWool sales, partially offset the decrease in comparable store sales.

International revenues grew 5.3% to $730.0 million in 2006, reflecting growth across Europe, Asia and Canada. Overall, International revenues grew to 46.6% of consolidated revenues. Europe   s revenue increased 2.6%, or 1.8% in constant dollars, to $547.1 million. Growth in our European distributor business, expansion in the key southern European markets of Italy and Spain and gains in Scandinavia offset softer sales results in France, Benelux and the U.K. Double digit growth in men s and women s casual footwear and solid gains in apparel and accessories were partially offset by declines in boots and outdoor performance and kids footwear.

Asia posted revenues of $145.4 million, up 9.0%, or 11.0% in constant dollars, over the prior year. Revenue increases are attributed to strong gains in Japan; our Asian distributor business, reflecting our continued expansion in China; and Taiwan. Asia s growth is supported by sales gains in all product categories. We continue to expand our retail presence in Asia, with a net addition of 14 stores and shops in 2006.

Canada expanded significantly over the prior year, growing 42.4% to $24.6 million. Sales results reflect benefits from the 2006 re-acquisition of distribution rights for apparel in Canada and gains in accessories and Timberland PRO® and women s casual footwear.

***Products***

Worldwide footwear revenue was $1,126.9 million, down 6.1% from the prior year. Footwear results were driven by a decline in boots and kids footwear sales, partially offset by higher sales of Timberland PRO® and men s and women s casual footwear. Unit sales were 9.2% lower than the prior year, reflecting lower sales of boots and kids footwear. The average selling price increased 3.5% as a result of business mix impacts reflecting growth in international markets.

Worldwide apparel and accessories revenue was $422.4 million in 2006, an increase of 21.1% compared to the prior year. This increase reflects a full year of SmartWool sales, which contributed an incremental $51.2 million in revenue, as well as solid growth in Timberland® brand apparel sales worldwide. Unit sales of apparel and accessories increased 48.8%, while the average selling price decreased 18.6%, reflecting impacts from the addition of SmartWool s products, which have lower average selling prices.

Royalty and other revenue, which consists primarily of royalties from third-party licensees and distributors, increased 9.2% to $18.3 million, reflecting increased sales of licensed kids apparel in the U.S. and growth in our international distributor business.

***Channels***

Worldwide wholesale revenue growth offset the decline in our global consumer direct business. Worldwide wholesale revenue was $1,191.6 million, a 1.2% increase over the prior year. Sales gains in apparel and accessories, Timberland PRO® footwear and men s and women s casual footwear offset lower sales of boots and kids footwear. Global consumer direct revenues were $376.0 million, 3.0% lower than the prior year. Worldwide comparable store sales declined 8.7%, reflecting unseasonably warm weather trends that pressured retail sales in the U.S. and Europe. This decrease more than offset benefits from global door expansion and strong performance from our e-commerce business. During 2006, we opened 35 stores, shops and outlets and closed 12 worldwide.

***Gross Profit***

Gross profit as a percentage of sales, or gross margin, was 47.3% in 2006, compared to 49.6% in 2005. This decrease reflects impacts from product mix impacts, including lower sales of boots and kids footwear; higher levels of off-price and discounted sales; and higher comparable product costs, including effects from anti-dumping duties on EU footwear, which added $5.5 million to product costs in 2006.

We include the costs of procuring inventory (inbound freight and duty, overhead and other similar costs) in cost of goods sold. These costs amounted to $97.9 million and $101.4 million in 2006 and 2005, respectively.

***Operating Expense***

Total operating expense was $582.4 million in 2006, $50.9 million, or 9.6% higher than in 2005. As a percentage of revenue, operating expense was 37.2%, up 330 basis points from the 33.9% reported in 2005. Excluding restructuring and related costs in both 2006 and 2005, and including share-based compensation costs in 2005, base operating expense increased $38.7 million, or 7.2%, driven by $26.4 million of incremental costs associated with new businesses and category development, including the addition of SmartWool, $18.2 million of cost growth related to

International expansion and $12.1 million of incremental costs associated with share-based compensation, as a result of new accounting requirements, offset by a $10.4 million reduction in marketing expenses and a $9.3 million decline in worldwide incentive compensation costs.

Selling expense for 2006 was $453.0 million, an increase of $35.6 million or 8.5% compared to the prior year. The increase was driven by $21.5 million in costs related to new businesses and category development,

$18.2 million in International business expansion and $8.2 million in share-based employee compensation costs. These increases were partially offset by decreases of $10.4 million in marketing costs and $5.3 in worldwide incentive compensation costs. Foreign exchange rate changes had minimal impact on selling expense growth.

We include the costs of physically managing inventory (warehousing and handling costs) in selling expense. These costs totaled $38.2 million and $37.8 million in 2006 and 2005, respectively.

Advertising expense, which is included in selling expense, was $28.1 million and $36.6 million in 2006 and 2005, respectively. The decrease reflects shifts in spending towards other brand building activities such as investments in our international business and retail expansion. Advertising costs are expensed at the time the advertising is used, predominantly in the season that the advertising costs are incurred. As of December 31, 2006 and December 31, 2005, we had $0.7 million and $1.2 million of prepaid advertising costs recorded on our consolidated balance sheets, respectively.

General and administrative expense was $125.5 million, an increase of $15.7 million or 14.3% over 2005. The increase was driven by $4.9 million related to new business initiatives, $3.9 million of share-based employee compensation costs, $2.9 million in costs associated with operating the new European finance shared service center and $2.4 million in legal and compliance costs. These increases were offset by a $4.0 million decline in worldwide incentive compensation costs. Foreign exchange rate changes added $2.2 million or 2.0% to overall general and administrative expenses growth.

### *Operating Income*

Operating income was $159.7 million in 2006 compared to $245.4 million in 2005. Operating income as a percentage of revenue fell from 15.7% in 2005 to 10.2% in 2006, reflecting pressure on gross margins as well as higher operating expenses over a flat revenue base.

Our U.S. Wholesale segment s operating income decreased 17.6% to $170.6 million in 2006, driven by declines in both revenue and gross margin and increased operating expense. Revenue was down 3.0%, driven by decreases in boots and kids footwear sales. Gross margin fell 160 basis points, pressured by negative product mix impacts related to lower sales of boots and kids footwear and increased off-price sales, partially offset by favorable impacts from new businesses. Operating expense increased 22.4%, primarily due to the addition of SmartWool.

Operating income for our U.S. Consumer Direct segment was $16.8 million for 2006 compared to $36.3 million in 2005. Revenue decreased 7.0%, reflecting a 9.6% decline in comparable store sales. Gross margin was down 440 basis points primarily due to lower U.S. outlet store margins, reflecting higher levels of off-price and discounted sales and negative product mix impacts related to lower boot sales. Operating expense increased 5.7%, impacted by costs associated with operating three additional stores in 2006.

International operating income was down 7.3% to $155.9 million in 2006, driven by an 8.4% increase in operating expense reflecting costs associated with International expansion and costs related to operating the new European finance shared service center. Additionally, gross margin was down 200 basis points, pressured by higher comparable product costs, including the effects of EU anti-dumping duties, and increased levels of off-price sales.

Our Unallocated Corporate expenses increased $17.3 million, or 10.4%, to $183.6 million in 2006. Unallocated Corporate expenses as a percentage of total revenue increased 110 basis points to 11.7% of total revenue. Excluding restructuring costs in both 2006 and 2005 and increased share-based employee compensation costs of $14.5 million in 2006, Unallocated Corporate expenses increased $5.8 million or 3.6% from the prior year and represent 10.7% of total revenue. This increase was driven by $5.3 million in unfavorable product cost variances reflecting decreased volume and higher than planned material costs, $2.1 million in global support services, $1.2 million in product management expenses and $1.0 million in one-time costs related to establishing the new European finance shared service center, offset by a $4.6 million reduction in worldwide incentive compensation costs.

*Other Income and Taxes*

Interest income, net, which is comprised of interest income offset by fees related to the establishment and maintenance of our revolving credit facility and interest paid on short-term borrowings, was $1.0 million and $3.3 million in 2006 and 2005, respectively. The decrease is primarily due to reduced cash balances resulting from our SmartWool acquisition, share repurchases and reduced profitability.

Other, net, included $2.0 million and $(0.2) million of foreign exchange gains/(losses) for 2006 and 2005, respectively, resulting from the timing of settlement of local currency denominated assets and payables. These results were driven by the volatility of exchange rates during the respective reporting periods and should not be considered indicative of expected future results.

The effective income tax rate was 35.0% in 2006, compared to 33.9% in 2005 (see Note 13 to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K). This increase reflects the geographic mix of our profits and provisions for specific tax reserves. The effective tax rate was adjusted in the fourth quarter of 2006 to decrease our full year 2006 tax rate estimate from 35.6% to 35.0%.

**2005 Compared to 2004**

***Revenue***

Consolidated revenue growth of 4.3% in 2005 reflected strong gains in our International operations, offset by a slight decline in our U.S. business. Revenue from the U.S. business totaled $872.4 million in 2005, down 0.8% from the prior year. International revenues were $693.3 million, 11.6% ahead of 2004, up 11.4% in constant dollars.

***Segments Review***

Revenues for our U.S. Wholesale business decreased 0.8% to $659.8 million. Growth in Timberland PRO® series footwear, apparel, men s casual footwear, kids footwear and accessories was offset by significant declines in our women s casual business, and moderate declines in boots. Declines in sales to independent accounts and department stores were partially offset by increases in sales through discount channels and athletic/national accounts.

The U.S. Consumer Direct business recorded $212.6 million in sales, down $1.5 million or 0.7% compared with 2004. Overall, comparable store sales excluding our e-commerce business were down 0.8%. Declines in women s casual footwear, apparel, boots and kids footwear were partially offset by gains in outdoor performance footwear, men s casual footwear and apparel.

International revenues increased 11.6% to $693.3 million benefiting from the execution of our growth strategies in Europe and Asia, as well as the continued growth of our Canadian subsidiary. Overall, International revenues increased to 44.3% of total consolidated revenues. The European business produced $533.1 million of revenue, growing 11.3%, or 11.0% on a constant dollar basis, driven by strong gains in the U.K., pan-European accounts and our European distributor business and growth in Italy, Germany, Scandinavia and Spain. Growth in Europe was driven by strong gains in footwear across major product categories and solid gains in apparel sales.

In Asia, revenues grew 10.0% to $133.4 million, up 11.1% excluding foreign exchange, driven by double-digit gains in Taiwan, Hong Kong, our Asian distributor business, Singapore and Malaysia and moderate growth in Japan. This growth reflects benefits from our efforts to upgrade Timberland s retail and wholesale distribution throughout the region. Asia s growth reflected strong gains in footwear and apparel sales.

***Products***

Worldwide footwear revenue was $1,200.1 million in 2005, up $46.8 million or 4.1% from 2004. Growth was driven by gains in kids , men s casual, outdoor performance, boots, and Timberland PRO® series footwear offset by a significant decline in our U.S. women s casual footwear business. Worldwide footwear unit sales were up 3.9% while the average price increased by 0.1%, reflecting impacts from product and geographic mix.

Worldwide apparel and accessories revenue increased by 4.7% to $348.9 million. Apparel and accessories unit sales increased by 4.4%, while average selling prices increased 0.2%, reflecting product and channel mix.

Royalty and other revenue was $16.7 million, up 19.0% from the prior year, driven by gains in licensed kids apparel worldwide and growth in licensed Timberland PRO® series in Europe.

***Channels***

Revenue growth reflected global gains across both our wholesale and consumer direct channels. Globally, our wholesale business recorded $1,178.0 million of revenue in 2005, a 4.7% increase. Consumer direct revenues were up 3.4% to $387.7 million. We opened 29 stores, shops and outlets worldwide in 2005 and closed 14.

***Gross Profit***

Our gross profit as a percentage of sales for 2005 was 49.6% as compared to 49.3% for 2004, an improvement of 30 basis points. Favorable foreign exchange benefits and international mix benefits were partially offset by U.S. product mix impacts and impacts from higher levels of off-price and discounted sales.

The costs of procuring inventory, included in cost of goods sold, amounted to $101.4 million and $97.3 million for 2005 and 2004, respectively.

***Operating Expense***

Operating expense was $531.5 million in 2005, $26.3 million, or 5.2% higher than the $505.2 million reported in 2004. The operating expense increase was driven by a $12.0 million increase in selling expense, a $10.0 million increase in general and administrative expense and restructuring and related costs of $4.3 million related to the consolidation of our Caribbean manufacturing facilities. Foreign exchange rate changes offset total operating expense growth by $1.9 million, or 0.4%. As a percentage of revenue, operating expense increased 20 basis points to 33.9% compared to 33.7% in 2004. Excluding restructuring and related costs, operating expense as a percentage of revenue was unchanged, and growth was controlled to 4.4%, with spending increases related primarily to growth in our International business.

Selling expense was $417.4 million, an increase of $12.0 million, or 3.0% compared with the prior year. The increase was driven by $8.7 million of costs related to International retail expansion, $5.6 million in distribution costs and $3.2 million in product development costs, offset by a decrease of $8.3 million in global incentive compensation programs. Foreign exchange rate changes also decreased selling expense by $1.9 million or 0.5%.

The costs of physically managing inventory, included in selling expense, totaled $37.8 million and $33.9 million in 2005 and 2004, respectively.

Advertising expense, which is also included in selling expense, was $36.6 million and $42.4 million in 2005 and 2004, respectively. The decrease primarily reflected reductions in U.S. cooperative advertising costs. Prepaid advertising recorded on our consolidated balance sheets was $1.2 million and $0.7 million as of December 31, 2005 and December 31, 2004, respectively.

General and administrative expense was $109.8 million, an increase of $10.0 million, or 10.1% compared with last year. As a percentage of revenue, general and administrative expense increased 30 basis points over 2004. The increase was driven by $3.8 million in investments in organizational capability, $3.0 million in legal and compliance costs and $2.2 million in global support services and business development costs. Foreign exchange rate changes had little impact on general and administrative expense.

***Operating Income***

Operating income was $245.4 million in 2005 and $233.9 million in 2004. As a percentage of revenue, operating income was 15.7% in 2005 and 15.6% in 2004. Excluding restructuring cost impacts, operating income as a percentage of revenue was 15.9% in 2005.

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Operating income for our U.S. Wholesale segment was $207.2 million, $6.1 million or 2.9% lower than the prior year. Revenue declines of 0.8% and gross margin deterioration of 140 basis points were offset by a 6.8% decline in operating expenses resulting from cost control measures. The margin deterioration was driven by a shift in product mix, impacted by lower U.S. boot sales, and relatively higher levels of off-price and discount sales.

Our U.S. Consumer Direct segment s operating income increased by 2.7% to $36.3 million. Revenue was down 0.7% to $212.6 million, reflecting a comparable stores sales decline of 0.8%. The sales decline was offset as gross margin improved by 80 basis points, reflecting less promotional activity than the prior year. Operating expenses remained flat to the prior year.

Operating income for our International segment grew by 28.7% to $168.2 million. Revenue growth of 11.6% and gross margin improvement of 220 basis points drove much of the increase. Both benefited from favorable foreign exchange rate changes. Lower product related costs and more favorable product mix also supported the margin improvement. Operating expense rates for our International segment decreased by 100 basis points as strong revenue growth enabled operating expense leverage despite continued investment in International retail expansion and organizational capability.

Our Unallocated Corporate expenses increased to $166.3 million or 10.6% of total revenue, a 90 basis point increase over the prior year. Excluding restructuring and related costs of $4.3 million resulting from the consolidation of our Caribbean manufacturing operations, Unallocated Corporate expenses increased 70 basis points to 10.4% of revenue. This increase reflects investments in global organization capability, higher legal and compliance costs and costs associated with business development activities.

***Other Income and Taxes***

Interest income, net was $3.3 million and $1.1 million in 2005 and 2004, respectively. Higher interest rates supported the increase in net interest income.

Other, net included $0.2 million of foreign exchange losses resulting from the timing of settlement of local currency denominated assets and liabilities. In 2004, we had a gain of $1.0 million. These results were driven by the volatility of exchange rates during the respective reporting periods, and should not be considered indicative of expected future results.

The effective income tax rate was 33.9% in 2005, compared to 35.5% in 2004 (see Note 13 to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K). We established a Hong Kong procurement company and an international treasury center in Switzerland in the fourth quarter of 2004, which better aligns our organizational structure with our expanding global presence and reduces our estimated taxes on foreign earnings.

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**Reconciliation of Total Company, Total International, Europe and Asia Revenue Changes to Constant Dollar Revenue Changes**

| | For the Year Ended December 31, 2006 | | For the Year Ended December 31, 2005 | |
|---|---|---|---|---|
| | $ Change (in Millions) | % Change | $ Change (in Millions) | % Change |
| Total Company | | | | |
| Revenue increase | $ 1.9 | 0.1% | $ 65.1 | 4.3% |
| Increase due to foreign exchange rate changes | 2.9 | 0.2% | 1.2 | |
| Revenue (decrease)/increase in constant dollars | $ (1.0) | (0.1)% | $ 63.9 | 4.3% |
| Total International | | | | |
| Revenue increase | $ 36.7 | 5.3% | $ 72.0 | 11.6% |
| Increase due to foreign exchange rate changes | 2.9 | 0.4% | 1.2 | 0.2% |
| Revenue increase in constant dollars | $ 33.8 | 4.9% | $ 70.8 | 11.4% |
| Europe | | | | |
| Revenue increase | $ 13.9 | 2.6% | $ 54.2 | 11.3% |
| Increase due to foreign exchange rate changes | 4.2 | 0.8% | 1.5 | 0.3% |
| Revenue increase in constant dollars | $ 9.7 | 1.8% | $ 52.7 | 11.0% |
| Asia | | | | |
| Revenue increase | $ 12.0 | 9.0% | $ 12.1 | 10.0% |
| (Decrease) due to foreign exchange rate changes | (2.6) | (2.0)% | (1.3) | (1.1)% |
| Revenue increase in constant dollars | $ 14.6 | 11.0% | $ 13.4 | 11.1% |

Management provides constant dollar revenue changes for total Company, total International, Europe, and Asia results because we use the measure to understand revenue changes excluding any impact from foreign exchange rate changes.

**Reconciliation of Operating Expense Excluding Restructuring and Related Costs and Including Share-Based Employee Compensation Costs Related to Stock Option and Employee Stock Purchase Plans**

| Dollars in Millions | For the Year Ended December 31, 2006 | December 31, 2005 | Change |
|---|---|---|---|
| Operating expense, as reported | $ 582.4 | $ 531.5 | |
| | (3.9) | (4.2) | |

| | | | | | |
|---|---|---|---|---|---|
| Deduct: Restructuring and related costs included in reported operating expense | | | | | |
| Operating expense excluding restructuring and related costs | | 578.5 | | 527.3 | |
| Deduct: Share-based employee compensation costs included in reported operating expense | | | | (7.1) | |
| Add: Total share-based employee compensation costs determined under fair value based method for all awards | | | | 19.6 | |
| Operating expense excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans | $ | 578.5 | $ | 539.8 | 7.2% |

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Management provides operating expense excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans to understand operating expense excluding restructuring and related costs and to provide comparability to reported results that include share-based employee compensation costs as prescribed by SFAS 123(R).

**Reconciliation of Operating Income to Operating Income Excluding Restructuring and Related Costs and Including Share-Based Employee Compensation Costs Related to Stock Option and Employee Stock Purchase Plans**

| Dollars in Millions | For the Year Ended December 31, 2006 | December 31, 2005 |
|---|---|---|
| Operating income, as reported | $ 159.7 | $ 245.4 |
| Add: Restructuring and related costs included in reported operating income | 3.9 | 4.2 |
| Operating income excluding restructuring and related costs | 163.6 | 249.6 |
| Add: Share-based employee compensation costs included in reported operating income | | 7.1 |
| Deduct: Total share-based employee compensation costs determined under fair value based method for all awards | | (19.6) |
| Operating income excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans | $ 163.6 | $ 237.1 |

Management provides operating income excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans to understand operating income excluding restructuring and related costs and to provide comparability to reported results that include share-based employee compensation costs as prescribed by SFAS 123(R).

**Reconciliation of Net Income to Net Income Excluding Restructuring and Related Costs and Including Share-Based Employee Compensation Costs Related to Stock Option and Employee Stock Purchase Plans**

| Dollars in Millions | For the Year Ended December 31, 2006 | December 31, 2005 |
|---|---|---|
| Net income, as reported | $ 106.4 | $ 164.6 |
| Add: Restructuring and related costs included in reported net income, net of related tax effect | 2.5 | 2.8 |
| Net income excluding restructuring and related costs | 108.9 | 167.4 |
| Add: Share-based employee compensation costs included in reported net income, net of related tax effect | | 4.7 |
| | | (12.9) |

| | | | | |
|---|---|---|---|---|
| Deduct: Total share-based employee compensation costs determined under fair value based method for all awards, net of related tax effect | | | | |
| Net income excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans | $ | 108.9 | $ | 159.2 |

Management provides net income excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans to understand net income excluding restructuring and related costs and to provide comparability to reported results that include share-based employee compensation costs as prescribed by SFAS 123(R).

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**Reconciliation of Diluted EPS to Diluted EPS Excluding Restructuring and Related Costs and Including Share-Based Employee Compensation Costs Related to Stock Option and Employee Stock Purchase Plans**

| | For The Year Ended December 31, 2006 | December 31, 2005 |
|---|---|---|
| Diluted EPS, as reported | $ 1.67 | $ 2.43 |
| Per share impact of restructuring and related costs | 0.04 | 0.04 |
| Diluted EPS excluding restructuring and related costs | 1.71 | 2.47 |
| Per share impact of share-based employee compensation costs related to stock option and employee stock purchase plans | | (0.12) |
| Diluted EPS excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans | $ 1.71 | $ 2.35 |

Management provides diluted EPS excluding restructuring and related costs and including share-based employee compensation costs related to stock option and employee stock purchase plans to understand earnings excluding restructuring and related costs and to provide comparability to reported results that include share-based employee compensation costs as prescribed by SFAS 123(R).

**Accounts Receivable and Inventory**

Accounts receivable was $204.4 million as of December 31, 2006, compared to $168.8 million as of December 31, 2005 and $155.0 million as of December 31, 2004. Days sales outstanding were 38 days as of December 31, 2006, compared with 33 days as of December 31, 2005 and 31 days as of December 31, 2004. Wholesale days sales outstanding were 45 days, 39 days and 38 days at the end of 2006, 2005 and 2004, respectively. The increase in 2006 accounts receivable and days sales outstanding were driven by sales timing and, to a lesser extent, some erosion in the timeliness of collections. In 2005, excluding $12.8 million from SmartWool, the relatively flat accounts receivable reflected solid collection efforts and improved timing of shipments in the fourth quarter.

Inventory increased 11.8% to $186.8 million as of December 31, 2006 from $167.1 million as of December 31, 2005 and $128.3 million as of December 31, 2004. The increase in inventory in 2006 is primarily related to increased retail inventory in the U.S. and Europe due to unseasonably warm weather and investments made in Asian retail to prepare for the Asian holiday season in January and February, 2007. In the fourth quarter of 2004, we established a Hong Kong procurement company and an international treasury center in Switzerland to better align our organizational structure with our expanding global presence and provide enhanced support to our global sourcing operations and International business. Related to the implementation of the new organizational structure, we modified certain sourcing arrangements, which resulted in earlier transfer of title for a portion of the Company s third party sourced product in 2005. Earlier transfer of title resulted in offsetting higher quarter end inventory and accounts payable balances, as we recognized an inventory asset and related payable roughly two weeks earlier than in the prior year period. Had similar sourcing arrangements been in effect for 2004, we estimate that inventory and accounts payable balances would have increased by approximately $35.2 million.

**Liquidity and Capital Resources**

***2006 Compared to 2005***

Net cash provided by operations for 2006 was $111.7 million, compared with $182.3 million in 2005. The reduction in cash provided in 2006 compared with 2005 was primarily due to reduced net income and an increase in our investment in working capital. In 2006, our net investment in working capital was $31.8 million, compared to $13.0 million in 2005. Working capital increases primarily reflect higher quarter-end receivable balances, impacted by sales timing and, to a lesser extent, some erosion in the timeliness of collections in the

U.S. and Europe, and higher retail inventory levels related to warm weather in the U.S and Europe as well as Asian retail investment. Growth in accounts receivable and inventory was somewhat offset by increased payables. Our cash provided by operations was positively impacted by increased accruals associated with the timing of VAT and other expenses. Timberland s use of cash related to income taxes payable is due to reduced profitability and a lower resulting tax payable than at the end of 2005.

Net cash used for investing activities amounted to $47.4 million in 2006, compared with $107.7 million in 2005. Net cash used for investing activities in 2006 included $6.4 million, net of cash acquired, primarily related to the acquisition of Howies Limited and $4.4 million of other outflows related to our acquisition of certain assets of GoLite LLC, including trademarks. Net cash used for investing activities in 2005 included $81.3 million, net of cash acquired, for the acquisition of SmartWool. Capital expenditures in 2006 were $36.6 million, compared to $26.2 million in 2005. The increase was primarily attributable to higher investments in retail stores and product related investments.

Net cash used for financing activities was $99.9 million in 2006, compared with $160.6 million in 2005. Cash flows from financing activities reflected share repurchases of $120.7 million in 2006, compared with $181.5 million in 2005. We received cash inflows of $16.4 million in 2006 from the issuance of common stock related to the exercise of employee stock options and employee stock purchases, compared with $20.8 million in 2005. An excess tax benefit from share-based compensation provided $4.4 million in cash inflows in 2006.

***2005 Compared to 2004***

Net cash provided by operations for 2005 was $182.3 million, compared with $184.7 million in 2004. Timberland s primary source of operating cash flow was net income of $164.6 million. A net decrease in operating working capital provided $7.7 million in cash flow primarily due to controlled growth of receivables and disciplined inventory management and the timing of vendor payments. Additional cash was provided from the timing of tax payments. Our cash provided by operations was negatively impacted by reduced accruals associated with foreign currency contracts, executive compensation and transportation costs, compared to 2004.

Net cash used for investing activities amounted to $107.7 million in 2005, compared with $25.8 million in 2004. The increase was primarily attributable to the use of $81.3 million, net of cash acquired, for the acquisition of SmartWool on December 20, 2005. Capital expenditures in 2005 were $26.2 million, compared to $24.1 million in 2004.

Net cash used for financing activities was $160.6 million in 2005, compared with $98.5 million in 2004. Cash flows from financing activities reflected increased share repurchases of $181.5 million in 2005, compared with $131.7 million in 2004. We received cash inflows of $20.8 million in 2005 from issuance of common stock primarily related to the exercise of employee stock options, compared with $33.1 million in 2004.

***Credit Facilities***

We have an unsecured committed revolving credit agreement with a group of banks which matures on June 2, 2011 ( Agreement ). The Agreement provides for $200 million of committed borrowings, of which up to $125 million may be used for letters of credit. Upon approval of the bank group, we may increase the committed borrowing limit by $100 million for a total commitment of $300 million. Under the terms of the Agreement, we may borrow at interest rates based on Eurodollar rates (approximately 5.3% as of December 31, 2006), plus an applicable margin of between 13.5 and 47.5 basis points based on a fixed charge coverage grid that is adjusted quarterly. As of December 31, 2006, the applicable margin under the facility was 35 basis points. We will pay a utilization fee of an additional 5 basis points if our outstanding borrowings under the facility exceed $100 million. We also pay a commitment fee of 6.5 to 15 basis points per annum on the total commitment, based on a fixed-charge coverage grid that is adjusted quarterly. As of December 31, 2006, the commitment fee was 10 basis points. The Agreement places certain limitations on additional debt, stock repurchases, acquisitions, amount of dividends we may pay and certain other financial and non-financial covenants. The primary financial covenants relate to maintaining a minimum fixed charge coverage ratio of

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3:1 and a maximum leverage ratio of 2:1. We measure compliance with the financial and non-financial covenants and ratios as required by the terms of the Agreement on a fiscal quarter basis.

On December 20, 2005, we entered into a $4.5 million committed revolving credit agreement that matured on December 19, 2006 to provide for SmartWool s working capital requirements. This facility was extended to March 19, 2007. Up to $3 million of the facility may be used for letters of credit.

We had uncommitted lines of credit available from certain banks totaling $50 million as of December 31, 2006. Any borrowings under these lines would be at prevailing money market rates (approximately 5.6% as of December 31, 2006). Further, we had an uncommitted letter of credit facility of $80 million to support inventory purchases. These arrangements may be terminated at any time at the option of the banks or the Company.

As of December 31, 2006 and 2005, we had no borrowings outstanding under any of our credit facilities.

Management believes that our capital needs and our share repurchase program for 2007 will be funded through our current cash balances, our existing credit facilities (which place certain limitations on additional debt, stock repurchases, acquisitions and on the amount of dividends we may pay, and also contain certain other financial and operating covenants) and cash from operations, without the need for additional permanent financing. However, as discussed in Item 1A, Risk Factors, of this Annual Report on Form 10-K, several risks and uncertainties could cause the Company to need to raise additional capital through equity and/or debt financing. From time to time the Company considers acquisition opportunities which, if pursued, could also result in the need for additional financing. However, if the need arises, our ability to obtain any additional credit facilities will depend upon prevailing market conditions, our financial condition and the terms and conditions of such additional facilities.

***Aggregate Contractual Obligations***

At December 31, 2006, we have the following contractual obligations due by period:

| | Total | Less Than 1 Year | 1-3 Years | 4-5 Years | More Than 5 Years |
|---|---|---|---|---|---|
| | (Dollars in Millions) | | | | |
| Operating leases (see Note 12) | $ 228.0 | $ 47.0 | $ 75.1 | $ 51.9 | $ 54.0 |
| Purchase obligations(1) | 436.6 | 436.4 | 0.1 | 0.1 | |
| Deferred compensation plan(2) (see Note 9) | 10.1 | 2.1 | 1.5 | 1.0 | 5.5 |
| Total | $ 674.7 | $ 485.5 | $ 76.7 | $ 53.0 | $ 59.5 |

(1) Purchase obligations consist of open production purchase orders for sourced footwear, apparel and accessories and materials used to manufacture footwear and open purchase orders for operating expense purchases relating to goods or services ordered in the normal course of business.

(2) Our deferred compensation plan liability was $10.1 million as of December 31, 2006 and 2005, and $8.2 million at December 31, 2004. In 2006, plan contributions were offset by distributions. The liability increased from 2004 to 2005 primarily due to contributions to the plan.

***Off Balance Sheet Arrangements***

As of December 31, 2006, 2005 and 2004, we had letters of credit outstanding of $28.8 million, $24.6 million and $35.1 million, respectively. These letters of credit were issued predominantly for the purchase of inventory. The increase in letters of credit outstanding in 2006 was driven by obligations associated with anti-dumping duties on European Union footwear sourced in China and Vietnam. As of December 31, 2006, the Company had $243.1 million in foreign currency contracts outstanding, all of which

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are due to settle within the next 13 months (see Note 4 to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K).

We have the following off-balance sheet arrangements:

| December 31, 2006 | Total Amounts Committed (Dollars in millions) | |
|---|---|---|
| Lines of credit | $ | |
| Letters of credit | | 28.8 |
| Foreign currency contracts | | 243.1 |
| Total | $ | 271.9 |

We use funds from operations and unsecured committed and uncommitted lines of credit as the primary sources of financing for our seasonal and other working capital requirements. Our principal risks to these sources of financing are the impact on our financial condition from economic downturns, a decrease in the demand for our products, increases in the prices of materials and a variety of other factors.

**Quarterly Results of Operations (Unaudited)**

The following is a tabulation of the quarterly results of operations for the years ended December 31, 2006 and 2005, respectively:

**Dollars in thousands, except per share data**

| 2006 Quarter Ended | March 31 | June 30 | September 29 | December 31 |
|---|---|---|---|---|
| Revenue | $ 349,811 | $ 226,605 | $ 502,980 | $ 488,223 |
| Gross profit | 176,103 | 102,821 | 236,656 | 226,556 |
| Net income/(loss) | 29,187 | (12,972) | 51,875 | 38,343 |
| Basic earnings/(loss) per share | $ .46 | $ (.21) | $ .84 | $ .63 |
| Diluted earnings/(loss) per share | $ .45 | $ (.21) | $ .82 | $ .61 |

| 2005 Quarter Ended | April 1 | July 1 | September 30 | December 31 |
|---|---|---|---|---|
| Revenue | $ 354,211 | $ 240,269 | $ 505,913 | $ 465,288 |
| Gross profit | 187,161 | 117,980 | 247,358 | 224,406 |
| Net income | 42,247 | 6,345 | 69,152 | 46,880 |
| Basic earnings per share | $ .63 | $ .09 | $ 1.04 | $ .73 |
| Diluted earnings per share | $ .61 | $ .09 | $ 1.02 | $ .71 |

**New Accounting Pronouncements**

A discussion of new accounting pronouncements is included in the Summary of Significant Accounting Policies note (see Note 1 to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K).

**Forward-looking Information**

As discussed in Item 1A, Risk Factors, investors should be aware of certain risks, uncertainties and assumptions that could affect our actual results and could cause such results to differ materially from those contained in forward-looking statements made by or on behalf of us. Such statements are based on current expectations only and actual future results may differ materially from those expressed or implied by such forward-looking statements due to certain risks, uncertainties and assumptions. These risks, uncertainties and assumptions include, but are not limited to:

Our ability to successfully market and sell our products in a highly competitive industry and in view of changing consumer trends, consumer acceptance of products, and other factors affecting retail market conditions, including the current U.S. economic environment and the global economic and political uncertainties resulting from the continuing war on terrorism;

Our ability to adapt to potential changes in duty structures in countries of import and export including anti-dumping measures imposed by the European Union with respect to leather footwear imported from China and Vietnam;

Our ability to locate and retain independent manufacturers to produce lower cost, high-quality products with rapid turnaround times;

Our ability to manage our foreign exchange rate risks;

Our reliance on a limited number of key suppliers;

Our ability to obtain adequate materials at competitive prices;

Our ability to successfully invest in our infrastructure and product based upon advance sales forecasts;

Our ability to recover our investment in, and expenditures of, our retail organization through adequate sales at such retail locations; and

Our ability to respond to actions of our competitors, some of whom have substantially greater resources than we have.

We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

**ITEM 7A.** ***QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***

In the normal course of business, our financial position and results of operations are routinely subject to a variety of risks, including market risk associated with interest rate movements on borrowings and investments and currency rate movements on non-U.S. dollar denominated assets, liabilities and income. We regularly assess these risks and have established policies and business practices that should mitigate a portion of the adverse effect of these and other potential exposures.

We utilize cash from operations and U.S. dollar denominated borrowings to fund our working capital and investment needs. Short-term debt, if required, is used to meet working capital requirements and long-term debt, if required, is generally used to finance long-term investments. In addition, we use derivative instruments in our hedging of foreign currency transactions. These derivative instruments are viewed as risk management tools and are not used for trading or speculative purposes. Cash balances are invested in high-grade securities with terms less than three months.

We have available unsecured committed and uncommitted lines of credit as sources of financing for our working capital requirements. Borrowings under these credit agreements bear interest at variable rates based on either lenders cost of funds, plus an applicable spread, or prevailing money market rates. As of December 31, 2006, 2005 and 2004, we had no short-term or long-term debt outstanding.

Our foreign currency exposure is generated primarily from our European operating subsidiaries and, to a lesser degree, our Asian and Canadian operating subsidiaries. We seek to minimize the impact of these foreign currency fluctuations through a risk management program that includes the use of derivative financial instruments, primarily foreign currency forward contracts. These foreign currency forward contracts will expire in 13 months or less. Based upon sensitivity analysis as of December 31, 2006, a 10% change in foreign exchange rates would cause the fair value of our financial instruments to increase/decrease by approximately $24.4 million, compared with $14.9 million as of December 31, 2005. The increase as of December 31, 2006, compared with December 31, 2005, is primarily related to an increase in our foreign currency denominated net assets as of December 31, 2006, compared with December 31, 2005, as well as our choice to hedge a larger portion of our forecasted 2007 exposure at December 31, 2006 than the portion of our forecasted 2006 exposure that was hedged at December 31, 2005, as determined in accordance with our foreign exchange exposure management policy.

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of The Timberland Company
Stratham, New Hampshire

We have audited the accompanying consolidated balance sheets of The Timberland Company and subsidiaries (the Company ) as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of The Timberland Company and subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, the Company adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share-Based Payment*, effective January 1, 2006.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 1, 2007 expressed an unqualified opinion on management s assessment of the effectiveness of the Company s internal control over financial reporting and an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Boston, Massachusetts
March 1, 2007

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**ITEM 8.** ***FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA***

**CONSOLIDATED BALANCE SHEETS**
**As of December 31, 2006 and 2005**

| | 2006 | 2005 |
|---|---|---|
| | (Dollars in thousands) | |
| **ASSETS** | | |
| Current assets | | |
| Cash and equivalents | $ 181,698 | $ 213,163 |
| Accounts receivable, net of allowance for doubtful accounts of $12,104 in 2006 and $8,755 in 2005 | 204,405 | 168,831 |
| Inventory, net | 186,765 | 167,132 |
| Prepaid expenses | 40,742 | 33,502 |
| Deferred income taxes | 21,730 | 26,934 |
| Derivative assets | 176 | 6,044 |
| Total current assets | 635,516 | 615,606 |
| Property, plant and equipment, net | 94,640 | 82,372 |
| Deferred income taxes | 14,536 | |
| Goodwill | 39,717 | 39,503 |
| Intangible assets, net | 47,865 | 40,909 |
| Other assets, net | 10,831 | 10,264 |
| Total assets | $ 843,105 | $ 788,654 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities | | |
| Accounts payable | $ 110,031 | $ 97,294 |
| Accrued expense | | |
| Payroll and related | 38,416 | 48,721 |
| Other | 83,978 | 53,121 |
| Income taxes payable | 33,874 | 44,210 |
| Derivative liabilities | 2,925 | |
| Total current liabilities | 269,224 | 243,346 |
| Deferred compensation and other long-term liabilities | 13,064 | 16,046 |
| Deferred income taxes | | 1,075 |
| Stockholders equity | | |
| Preferred Stock, $.01 par value; 2,000,000 shares authorized; none issued | | |
| Class A Common Stock, $.01 par value (1 vote per share); 120,000,000 shares authorized; 72,664,889 shares issued at December 31, 2006 and 71,804,959 shares issued at December 31, 2005 | 727 | 718 |

| | | |
|---|---|---|
| Class B Common Stock, $.01 par value (10 votes per share); convertible into Class A shares on a one-for-one basis; 20,000,000 shares authorized; 11,743,660 shares issued and outstanding at December 31, 2006 and December 31, 2005 | 117 | 117 |
| Additional paid-in capital | 219,421 | 214,483 |
| Deferred compensation | | (27,166) |
| Retained earnings | 845,436 | 739,004 |
| Accumulated other comprehensive income | 12,678 | 8,696 |
| Treasury Stock at cost; 22,428,168 Class A shares at December 31, 2006 and 18,921,290 Class A shares at December 31, 2005 | (517,562) | (407,665) |
| Total stockholders equity | 560,817 | 528,187 |
| Total liabilities and stockholders equity | $ 843,105 | $ 788,654 |

The accompanying notes are an integral part of these consolidated financial statements.

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## CONSOLIDATED STATEMENTS OF INCOME
### For the Years Ended December 31, 2006, 2005 and 2004

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| | (Amounts in thousands, except per share data) | | |
| Revenue | $ 1,567,619 | $ 1,565,681 | $ 1,500,580 |
| Cost of goods sold | 825,483 | 788,776 | 761,505 |
| Gross profit | 742,136 | 776,905 | 739,075 |
| Operating expense | | | |
| Selling | 453,026 | 417,441 | 405,412 |
| General and administrative | 125,549 | 109,831 | 99,800 |
| Restructuring and related costs | 3,868 | 4,251 | |
| Total operating expense | 582,443 | 531,523 | 505,212 |
| Operating income | 159,693 | 245,382 | 233,863 |
| Other income | | | |
| Interest income, net | 966 | 3,335 | 1,095 |
| Other, net | 3,082 | 336 | 1,775 |
| Total other income | 4,048 | 3,671 | 2,870 |
| Income before provision for income taxes | 163,741 | 249,053 | 236,733 |
| Provision for income taxes | 57,309 | 84,429 | 84,040 |
| Net income | $ 106,432 | $ 164,624 | $ 152,693 |
| Earnings per share | | | |
| Basic | $ 1.70 | $ 2.48 | $ 2.19 |
| Diluted | $ 1.67 | $ 2.43 | $ 2.14 |
| Weighted-average shares outstanding | | | |
| Basic | 62,510 | 66,325 | 69,628 |
| Diluted | 63,690 | 67,744 | 71,311 |

The accompanying notes are an integral part of these consolidated financial statements.

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## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
## For the Years Ended December 31, 2006, 2005 and 2004

| | Class A Common Stock | Class B Common Stock | Additional Paid-in Capital | Deferred Compensation | Retained Earnings | Accumulated Other Comprehensive Income/(Loss) | Treasury Stock | Comprehensive Income | Tota Stockho Equi |
|---|---|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | | | |
| ce, January 1, 2004 | $ 431 | $ 69 | $ 175,629 | $ (8,209) | $ 723,705 | $ 1,306 | $ (464,468) | | $ 428 |
| ce/conversion of of common stock | 23 | (10) | 46,338 | (18,007) | | | 4,253 | | 32 |
| tization of deferred ensation | | | | 3,108 | | | | | 3 |
| ction in loan on ted stock | | | | 524 | | | | | |
| chase of common | | | | | | | (131,662) | | (131 |
| enefit from stock plans | | | 16,862 | | | | | | 16 |
| rehensive income: | | | | | | | | | |
| come | | | | | 152,693 | | | $ 152,693 | 152 |
| ation adjustment | | | | | | 8,305 | | 8,305 | 8 |
| e in fair value of tives, net of taxes | | | | | | 617 | | 617 | |
| rehensive income | | | | | | | | $ 161,615 | |
| ce, December 31, | 454 | 59 | 238,829 | (22,584) | 876,398 | 10,228 | (591,877) | | 511 |
| ce of shares of on stock | 8 | | 22,162 | (11,636) | | | 10,682 | | 21 |
| ment of shares of on stock | (100) | | (53,565) | | (301,604) | | 355,269 | | |
| tization of deferred ensation | | | | 7,054 | | | | | 7 |
| chase of common | | | | | | | (181,739) | | (181 |
| enefit from stock plans | | | 7,057 | | | | | | 7 |
| 1 stock split | 356 | 58 | | | (414) | | | | |
| rehensive income: | | | | | | | | | |
| come | | | | | 164,624 | | | $ 164,624 | 164 |
| ation adjustment | | | | | | (16,453) | | (16,453) | (16 |
| e in fair value of tives, net of taxes | | | | | | 14,921 | | 14,921 | 14 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| rehensive income | | | | | | | | $ 163,092 | |
| ce, December 31, | 718 | 117 | 214,483 | (27,166) | 739,004 | 8,696 | (407,665) | | 528 |
| ssification of ed ensation(1) | | | (27,166) | 27,166 | | | | | |
| ce of shares of on stock | 9 | | 6,842 | | | | 9,553 | | 16 |
| chase of common | | | | | | | (119,450) | | (119 |
| -based ensation expense | | | 20,951 | | | | | | 20 |
| enefit from based ensation | | | 4,311 | | | | | | 4 |
| rehensive income: | | | | | | | | | |
| come | | | | | 106,432 | | | $ 106,432 | 106 |
| ation adjustment | | | | | | 12,376 | | 12,376 | 12 |
| ge in fair value of tives, net of taxes | | | | | | (8,394) | | (8,394) | (8 |
| rehensive income | | | | | | | | $ 110,414 | |
| ce, December 31, | $ 727 | $ 117 | $ 219,421 | $ | $ 845,436 | $ 12,678 | $ (517,562) | | $ 560 |

The accompanying notes are an integral part of these consolidated financial statements.

(1) The amount in deferred compensation was reclassified to additional paid-in capital upon adoption of Statement of Financial Accounting Standards ( SFAS ) 123(R), Share-Based Payment. See Note 15 for additional information related to the Company s adoption of SFAS 123(R).

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**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**For the Years Ended December 31, 2006, 2005 and 2004**

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| | | (Dollars in thousands) | |
| Cash flows from operating activities: | | | |
| Net income | $ 106,432 | $ 164,624 | $ 152,693 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Deferred income taxes | (10,008) | (10,361) | (1,825) |
| Share-based compensation | 21,584 | 7,054 | 3,108 |
| Depreciation and other amortization | 27,885 | 24,475 | 23,496 |
| Tax benefit/(expense) from share-based compensation, net of excess benefit | (95) | 7,057 | 16,862 |
| Other non-cash charges/(credits) | (2,327) | 2,451 | 86 |
| Increase/(decrease) in cash from changes in working capital: capital items, net of effects of business acquisition and disposition: | | | |
| Accounts receivable | (27,681) | (11,723) | (24,781) |
| Inventory | (16,315) | (32,502) | (7,325) |
| Prepaid expense | (5,007) | (7,728) | (711) |
| Accounts payable | 9,728 | 51,893 | 9,823 |
| Accrued expense | 17,790 | (22,250) | 6,308 |
| Income taxes payable | (10,296) | 9,292 | 6,943 |
| Net cash provided by operating activities | 111,690 | 182,282 | 184,677 |
| Cash flows from investing activities: | | | |
| Acquisition of business, net of cash acquired | (6,381) | (81,807) | |
| Additions to property, plant and equipment | (36,590) | (26,172) | (24,095) |
| Other | (4,409) | 248 | (1,732) |
| Net cash used by investing activities | (47,380) | (107,731) | (25,827) |
| Cash flows from financing activities: | | | |
| Common stock repurchases | (120,719) | (181,469) | (131,662) |
| Issuance of common stock | 16,407 | 20,838 | 33,123 |
| Excess tax benefit from share-based compensation | 4,406 | | |
| Net cash used by financing activities | (99,906) | (160,631) | (98,539) |
| Effect of exchange rate changes on cash and equivalents | 4,131 | (9,873) | 7,002 |
| Net increase/(decrease) in cash and equivalents | (31,465) | (95,953) | 67,313 |
| Cash and equivalents at beginning of year | 213,163 | 309,116 | 241,803 |
| Cash and equivalents at end of year | $ 181,698 | $ 213,163 | $ 309,116 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Supplemental disclosures of cash flow information: | | | | | | |
| Interest paid | $ | 1,569 | $ | 374 | $ | 368 |
| Income taxes paid | $ | 73,341 | $ | 78,259 | $ | 61,748 |

The accompanying notes are an integral part of these consolidated financial statements.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**(Amounts in Thousands, Except Share and Per Share Data)**

## 1. Summary of Significant Accounting Policies

| | 2016 | 2015 |
|---|---|---|
| Letters of credit for facility leases | $ 2,516 | $ 3,710 |
| Pharmacy benefit management services | 1,169 | 2,479 |
| Other | 99 | 96 |
| Total restricted cash | 3,784 | 6,285 |
| Non-current restricted cash | 1,579 | 1,582 |
| Current restricted cash | $ 2,205 | |

$
4,703

Change in Accounting Principle

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions, including accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. The Company elected to early adopt ASU 2016-09 during the second quarter of 2016.

ASU 2016-09 requires that certain amendments resulting from the adoption of the new pronouncement be applied using a modified-retrospective transition method by means of a cumulative-effect adjustment to retained earnings as of the beginning of the period in which the guidance is adopted. Therefore, the Company adjusted retained earnings on January 1, 2016, for amendments related to an accounting policy election to recognize share-based award forfeitures as they occur rather than applying an estimated forfeiture rate.

The following table summarizes the impact of the change in accounting principle to the Company's Consolidated Statement of Operations for the three months ended March 31, 2016 (in thousands):

| | As Reported | Adjustments | As Adjusted |
|---|---|---|---|
| Cost of revenue (exclusive of depreciation and amortization expenses) | $28,562 | $ 104 | $28,666 |
| Selling, general and administrative expenses | 32,095 | 263 | 32,358 |
| Total operating expenses | 224,628 | 367 | 224,995 |
| Operating income (loss) | (175,179) | (367) | (175,546) |
| Income (loss) before income taxes and non-controlling interests | (174,900) | (367) | (175,267) |
| Net income (loss) | (173,912) | (367) | (174,279) |
| Net income (loss) attributable to non-controlling interests | (51,100) | (110) | (51,210) |
| Net income (loss) attributable to Evolent Health, Inc. | (122,812) | (257) | (123,069) |

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The following table summarizes the impact of the change in accounting principle to the Company's Consolidated Balance Sheets, including the net amount charged to retained earnings as of March 31, 2016 (in thousands):

| | As Reported | Adjustments | As Adjusted |
|---|---|---|---|
| Retained earnings (accumulated deficit) | $183,876 | $(257 )[1] | $183,619 |
| Total shareholders' equity (deficit) attributable to Evolent Health, Inc. | 541,524 | (257 ) | 541,267 |
| Non-controlling interests | 234,138 | (110 ) | 234,028 |
| Total equity (deficit) | 775,662 | (367 ) | 775,295 |
| Total liabilities and shareholders' equity (deficit) | 856,463 | (367 ) | 856,096 |

[1] Includes a cumulative-effect adjustment to beginning retained earnings of $0.5 million and an adjustment of $0.1 million for the three months ended March 31, 2016, related to the policy election to recognize share-based award forfeitures as they occur, as opposed to applying an estimated forfeiture rate. Approximately $0.1 million of the net adjustment was allocated to non-controlling interest.

In addition, the adoption of ASU 2016-09 changed how the Company recognizes excess tax benefits ("windfalls") or deficiencies ("shortfalls") related to share-based compensation. Prior to the adoption of ASU 2016-09, these windfalls and shortfalls were credited or charged, respectively, to additional paid-in capital in the Company's Consolidated Balance Sheets. Under the revised standard, these windfalls and shortfalls are recognized prospectively as discrete tax benefit or discrete tax expense, respectively, in the Company's Consolidated Statement of Operations. For the six months ended June 30, 2016, the Company did not recognize a discrete tax benefit related to net windfall tax benefits from share-based compensation, as the Company does not expect to realize these excess tax deductions in 2016 by reduction of taxes payable, and valuation allowance is necessary.

3. Recently Issued Accounting Standards

Adoption of New Accounting Standards

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting. The update simplifies several aspects of the accounting for employee share-based payment transactions, including accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. This standard is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods, with early adoption permitted for any interim or annual period. The Company elected to early adopt this ASU during the second quarter of 2016, as described in Note 2 above.

Future Adoption of New Accounting Standards

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments. With respect to assets measured at amortized cost, such as held-to-maturity assets, the update requires presentation of the amortized cost net of a credit loss allowance. The update eliminates the probable initial recognition threshold that was previously required prior to recognizing a credit loss on financial instruments. The credit loss estimate can now reflect an entity's current estimate of all future expected credit losses as opposed to the previous standard, when an entity only considered past events and current conditions. With respect to available for sale debt securities, the update requires that credit losses be presented as an allowance rather than as a write-down. The update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. We will adopt the requirements of this standard effective January 1, 2020 and are currently evaluating the impact of the adoption on our financial condition and results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases, in order to establish the principles to report transparent and economically neutral information about the assets and liabilities that arise from leases.  This update introduces a new standard on accounting for leases, including a lessee model that brings most leases on the balance sheet. The new standard also aligns many of the underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., those related to evaluating when profit can be recognized). The standard also requires lessors to increase the transparency of their exposure to changes in value of their residual assets and how they manage that exposure. The ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. We will adopt the requirements of this standard effective January 1, 2019, and are currently evaluating the impact of the adoption on our financial condition and results of operations.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, in order to clarify the principles of recognizing revenue. This standard establishes the core principle of recognizing revenue to depict the transfer of promised goods or services in an amount that reflects the consideration the entity expects to be entitled in exchange for those goods or services. The FASB defines a five-step process that systematically identifies the various components of the revenue recognition process, culminating with the recognition of revenue upon satisfaction of an entity's performance obligation. By completing all five steps of the process, the core principles of revenue recognition will be achieved. In March 2016, the FASB issued an update to the new revenue standard (ASU 2014-09) in the form of ASU 2016-08, which amended the principal-versus-agent implementation guidance and illustrations in the new revenue guidance. The update clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued another update to the new revenue standard in the form of ASU 2016-10, which amended the guidance on identifying performance obligations and the implementation guidance on licensing. These ASUs were followed by two further updates issued during May 2016, including ASU 2016-11, which rescinds certain SEC guidance, such as the adoption of ASUs 2014-09 and 2014-16, including accounting for consideration given by a vendor to a customer, and ASU 2016-12, which is intended to clarify the objective of the collectability criterion while identifying the contract(s) with a customer. The new revenue standard (including updates) will be effective for annual and interim reporting periods beginning after December 15, 2017, with early adoption permitted only as of annual reporting periods beginning after December 15, 2016. We will adopt the requirements of this standard effective January 1, 2018, and, while we are evaluating the impact to our financial condition and results of operations, we expect the adoption of this ASU to require the inclusion of additional disclosures surrounding the nature and timing of our revenue.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements – Going Concern: Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. This standard requires management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards by requiring an assessment for a period of one year after the date that the financial statements are issued. Further, based on certain conditions and circumstances, additional disclosures may be required. This standard is effective beginning with the first annual period ending after December 15, 2016, and for all annual and interim periods thereafter. Early application is permitted. The Company does not expect this standard to have an impact on the Company's financial statements or related disclosures.

We have evaluated all other issued and unadopted ASUs and believe the adoption of these standards will not have a material impact on our results of operations, financial position, or cash flows.

4. Acquisitions and Business Combinations

Business Combinations

Passport

On February 1, 2016, the Company entered into a strategic alliance with University Health Care d/b/a Passport Health Plan ("Passport"), a nonprofit community-based and provider-sponsored health plan administering Kentucky Medicaid and federal Medicare Advantage benefits to over 280,000 Kentucky Medicaid and Medicare Advantage beneficiaries. As part of the transaction, we issued 1.1 million Class A common shares to acquire capabilities and assets from Passport to enable us to build out a Medicaid Center of Excellence based in Louisville, Kentucky. Additional equity consideration of up to $10.0 million may be earned by Passport should we obtain new third party Medicaid businesses in future periods. This transaction also includes a 10-year arrangement under which we will provide various health plan management and managed care services to Passport. The Company has accounted for the transactions with Passport as a business combination using purchase accounting.

The fair value of the total consideration transferred in connection with the close of the transaction was $18.2 million, of which the Class A common shares were valued at $10.5 million and the contingent equity consideration was valued at $7.8 million. The contingent consideration is recorded within "Other long-term liabilities" on our consolidated balance sheets. The fair value of the shares issued was determined based on the closing price of the Company’s Class A common stock on the NYSE as of February 1, 2016, and the quantity of shares issued was determined under a pricing collar set forth in the purchase agreement. The fair value of the contingent equity consideration was estimated based on the real options approach, a form of the income approach, which estimated the probability of the Company achieving future revenues under the agreement. Key assumptions include the discount rate and the probability-adjusted recurring revenue forecast. A further discussion of the fair value measurement of the contingent consideration is provided in Note 14.

The purchase price was allocated to the assets acquired based on their estimated fair values as of February 1, 2016, as follows (in thousands):

| | |
|---|---|
| Purchase price | $18,200 |
| Less amount allocated to prepaid asset | 6,900 |
| Goodwill | $11,300 |

The prepaid asset is related to an acquired facility license agreement as the Company was provided with leased facilities which house the acquired Passport employees at no future cost. The fair value of the acquired facility license agreement was determined by comparing the current market value of similar lease spaces to the facilities occupied by the acquired Passport personnel to obtain a market value of the occupied space, with the present value of the determined market value of the occupied space classified as the acquired facility license agreement prepaid asset. The goodwill is attributable partially to the acquired assembled workforce. The transaction was a taxable event for the Company and the amount of goodwill determined for tax purposes is deductible.

Results for the three and six months ended June 30, 2016, include revenues and related expenses from our services agreement with Passport and amortization of the acquired intangibles for the period February 1, 2016, through June 30, 2016. The Consolidated Statements of Operations includes $9.7 million and $16.1 million of revenues and $(1.0) million and $(1.4) million of net income (loss) attributable to Passport for the three and six months ended June 30, 2016, respectively.

The Offering Reorganization

Evolent Health, Inc. was incorporated as a Delaware corporation on December 12, 2014, for the purpose of pursuing the Company's IPO. Immediately prior to the completion of the IPO in June 2015, we amended and restated our certificate of incorporation to, among other things, authorize two classes of common stock, Class A common stock and Class B common stock. Each share of our Class A common stock and Class B common stock entitles its holder to one vote on all matters to be voted on by stockholders, and holders of Class A common stock and holders of Class B common stock vote together as a single class on all matters presented to stockholders for their vote or approval (except as otherwise required by law). Pursuant to the Offering Reorganization:

- Evolent Health Holdings merged with and into Evolent Health, Inc. and the surviving corporation of the merger was Evolent Health, Inc.;
- An affiliate of TPG merged with and into Evolent Health, Inc. and the surviving corporation of the merger was Evolent Health, Inc.;
- Each of the then-existing stockholders of Evolent Health Holdings received four shares of our Class A common stock and the right to certain payments under the Tax Receivables Agreement ("TRA") in exchange for each share of Class A common stock held in Evolent Health Holdings;
- TPG received 2.1 million shares of Class A common stock of Evolent Health, Inc., together with the right to certain payments under the TRA in exchange for 100% of the equity that it held in its affiliate that was merged with Evolent Health, Inc.; and
- We issued shares of our Class B common stock and the right to certain payments under the TRA to The Advisory Board Company ("The Advisory Board"), TPG and another investor each of which was a member of Evolent Health LLC prior to the Offering Reorganization.

The existing shareholders of Evolent Health Holdings held the same economic and voting interest before and after the merger of Evolent Health Holdings with and into Evolent Health, Inc., which represents a transaction among entities with a high degree of common ownership. As such, the merger is viewed as non-substantive and the consolidated financial statements of Evolent Health, Inc. reflect the historical accounting of Evolent Health Holdings except that the legal capital reflects the capital of Evolent Health, Inc.

In addition, in connection with the Offering Reorganization, Evolent Health LLC amended and restated its operating agreement to establish two classes of equity (voting Class A common units and non-voting Class B common units); after the amendment, the pre-reorganization members of Evolent Health LLC (other than Evolent Health, Inc.) hold 100% of the Class B common units and Evolent Health, Inc. holds the Class A voting common units. Evolent Health LLC's Class B common units can be exchanged (together with a corresponding number of shares of our Class B common stock) for one share of our Class A common stock.

As of June 30, 2016, we own 70.9% of the economic interests and 100% of the voting rights in Evolent Health LLC. Our operations will continue to be conducted through Evolent Health LLC and subsequent to the Offering Reorganization the financial results of Evolent Health LLC are consolidated in the financial statements of Evolent Health, Inc. Evolent Health, Inc. is a holding company whose principal asset is all of the Class A common units it holds in Evolent Health LLC, and its only business is to act as sole managing member of Evolent Health LLC.

Pro Forma Financial Information (Unaudited)

The unaudited pro forma statement of operations data presented below gives effect to (1) the Passport transaction as if it had occurred on January 1, 2015, and (2) the consolidation of Evolent Health LLC as if it had occurred on January 1, 2014. The following pro forma information includes adjustments to:

- Remove transaction costs related to the Passport transaction of $0.2 million recorded during the six months ended June 30, 2016, and reclassify said amounts to the six months ended June 30, 2015;
- Remove transaction costs related to the Passport transaction of $0.2 million recorded in the fourth quarter of 2015 and reclassify said amounts to the six months ended June 30, 2015;
- Remove the gain recognized upon the consolidation of the previously held equity method investment in 2015 and reclassify said amount to 2014;
- Remove transaction costs related to the Offering Reorganization of $1.2 million in 2015 and reclassify said amount to 2014;
- Record amortization expenses related to intangible assets beginning January 1, 2014, for intangibles related to the Offering Reorganization;
- Record rent expense related to Passport prepaid lease beginning January 1, 2015; and
- Record adjustments of income taxes associated with these pro forma adjustments.

This pro forma data is presented for informational purposes only and does not purport to be indicative of the results of future operations or of the results that would have occurred had the transactions described above occurred in the specified prior periods. The pro forma adjustments were based on available information and assumptions that the Company believes are reasonable to reflect the impact of these transactions on the Company's historical financial information on a pro forma basis (in thousands).

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Revenue | $56,518 | $44,676 | $109,160 | $89,826 |
| Net income (loss) | (11,999) | (30,886) | (184,031) | (45,481) |
| Net income (loss) attributable to non-controlling interests | (3,612) | (11,828) | (53,845) | (17,930) |
| Net income (loss) attributable to Evolent Health, Inc. | (8,387) | (19,058) | (130,186) | (27,551) |
| Net income (loss) available to common shareholders: | | | | |
| Basic | (0.20) | (0.61) | (3.06) | (0.94) |
| Diluted | (0.20) | (0.61) | (3.06) | (0.94) |

Acquisitions

Vestica

On March 1, 2016, the Company entered into an Asset Purchase Agreement between Vestica Healthcare, LLC ("Vestica") and Evolent Health, LLC. As part of the transaction, we paid $7.5 million to acquire certain assets from Vestica to further align our interests with one of our existing partners. In addition, Vestica can earn an additional $4.0 million in consideration based on certain future events, which is being held in escrow. This transaction also includes an arrangement under which Vestica will continue to perform certain services on our behalf related to the acquired assets.

We accounted for the transaction as an asset acquisition where the assets acquired were measured based on the amount of cash paid to Vestica as well as transaction costs incurred as the fair value of the assets given was more readily determinable than the fair value of the assets received. We classified and designated identifiable assets acquired and we assessed and determined the useful lives of the acquired intangible assets subject to amortization. As a result, we recorded a $7.5 million customer relationship intangible asset with a useful life of thirteen years. The transaction was a taxable event.

5. Investments

The amortized cost, gross unrealized gains and losses, and fair value of our investments as measured using Level 2 inputs (in thousands) were as follows:

| | As of June 30, 2016 | | | | As of December 31, 2015 | | | |
|---|---|---|---|---|---|---|---|---|
| | Amortized Costs | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Amortized Costs | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Treasury bills | $28,213 | $ 139 | $ — | $28,352 | $28,306 | $ 115 | $ 181 | $28,240 |
| Corporate bonds | 23,571 | 120 | 3 | 23,688 | 25,757 | 110 | 80 | 25,787 |
| Total investments | $51,784 | $ 259 | $ 3 | $52,040 | $54,063 | $ 225 | $ 261 | $54,027 |

The amortized cost and fair value of our investments by contractual maturities (in thousands) were as follows:

| | As of June 30, 2016 | | As of December 31, 2015 | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | $27,577 | $27,697 | $9,445 | $9,451 |
| Due after one year through five years | 24,207 | 24,343 | 44,618 | 44,576 |
| Total | $51,784 | $52,040 | $54,063 | $54,027 |

As of June 30, 2016, and December 31, 2015, the Company did not hold any securities in an unrealized loss position for more than 12 months. The aggregate fair value of securities held by the Company in an unrealized loss position for less than 12 months as of June 30, 2016, and December 31, 2015, was $8.8 million and $49.9 million, respectively. As of June 30, 2016, securities held by the Company which were in an unrealized loss position for less than 12 months consisted of 5 corporate bonds.

Our investments are classified as held-to-maturity as we have both the intent and ability to hold the investments until their individual maturities. There were no identified events or changes in circumstances that had a significant adverse effect on the values of these investments. If there was evidence of a decline in fair value below the amortized cost basis which is other than temporary the cost basis of the individual security would be written down to fair value as a new cost basis and the amount of the write-down would be included in earnings. The new cost basis would not be changed for subsequent recoveries in fair value.

6. Property and Equipment, Net

The following summarizes our property and equipment (in thousands):

| | As of June 30, 2016 | As of December 31, 2015 |
|---|---|---|
| Computer hardware | $251 | $232 |
| Furniture and equipment | 1,604 | 1,604 |
| Internal-use software development costs | 13,506 | 6,363 |
| Leasehold improvements | 5,830 | 5,830 |
| Total property and equipment | 21,191 | 14,029 |
| Accumulated depreciation and amortization | (2,723 ) | (1,233 ) |
| Total property and equipment, net | $18,468 | $12,796 |

We had no property and equipment prior to the Offering Reorganization.

The Company capitalized $3.7 million and $7.1 million of internal-use software development costs for the three and six months ended June 30, 2016, respectively, and $1.0 million of internal-use software development costs for the three and six months ended June 30, 2015. The net book value of capitalized internal-use software development costs was $13.0 million and $6.3 million as of June 30, 2016, and December 31, 2015, respectively.

Depreciation expense related to property and equipment was $0.8 million and $1.5 million for the three and six months ended June 30, 2016, respectively, and $0.2 million for the three and six months ended June 30, 2015, of which amortization expense related to capitalized internal-use software development costs was $0.3 million and $0.5 million for the three and six months ended June 30, 2016, respectively, and less than $0.1 million for the three and six months ended June 30, 2015.

7. Goodwill and Intangible Assets, Net

Goodwill

As part of the Offering Reorganization, we recorded $608.9 million in goodwill on our Consolidated Balance Sheets. Goodwill has an estimated indefinite life and is not amortized; rather it is reviewed for impairment at least annually or whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

In interim periods between annual goodwill reviews, we also evaluate qualitative factors that could cause us to believe our estimated fair value of our single reporting unit may be lower than the carrying value and trigger a Step 1 test including, but not limited to (i) macroeconomic conditions, (ii) industry and market considerations, (iii) our overall financial performance including an analysis of our current and projected cash flows, revenue and earnings, (iv) a sustained decrease in share price and (v) other relevant entity-specific events including changes in strategy, partners, or litigation. As a result of the Offering Reorganization, we revalued our consolidated balance sheet to the market value of our IPO share price of $17.00.

Subsequent to our 2015 annual impairment testing in the fourth quarter of 2015, our common stock price declined significantly, reaching our historic low in the first quarter of 2016. During the three months ended March 31, 2016, our common stock traded between $8.48 and $12.32, or an average common stock price of $10.33 compared to an average common stock price of $19.51 and $14.73 during the three month periods ended September 30, 2015, and December 31, 2015, respectively. A sustained decline in our common stock price and the resulting impact on our market capitalization is one of several qualitative factors we consider each quarter when evaluating whether events or changes in circumstances indicate it is more likely than not that a potential goodwill impairment exists. We concluded that the further decline in common stock price observed during the first quarter of 2016 did represent a sustained decline and that triggering events occurred during the period requiring an interim goodwill impairment test as of March 31, 2016. As such, we performed a Step 1 impairment test of our goodwill as of March 31, 2016.

Step 1 Results

To determine the implied fair value for our single reporting unit, we used both a market multiple valuation approach (“market approach”) and a discounted cash flow valuation approach (“income approach”). In determining the estimated fair value, we considered the level of our Class A common stock price and assumptions that we believed market participants would make in valuing our reporting unit, including a control premium, as well as discounted cash flow calculations of management’s estimates of future financial performance and management’s long-term plans. This analysis also required us to make judgments about revenues, expenses, fixed asset and working capital requirements, the timing of exchanges of our Class B common shares, capital market assumptions and discount rates.

In our March 31, 2016, Step 1 test, our most sensitive assumption for purposes of the market approach was our estimate of the control premium, and the most sensitive assumption related to the income approach, other than our cash flows, was the discount rate. As of March 31, 2016, our single reporting unit failed the Step 1 analysis as we determined that its implied fair value was less than its carrying value based on the weighting of the fair values determined under both the market and income approaches. As fair value was less than carrying value, we performed a Step 2 test to determine the implied fair value of our goodwill.

Step 2 Results

In our March 31, 2016, Step 2 test, the fair value of all assets and liabilities were estimated, including our tangible assets (corporate trade name, customer relationships and technology) for the purpose of deriving an estimate of the implied fair value of goodwill. The implied fair value of goodwill was then compared to the carrying amount of goodwill resulting in an impairment charge of $160.6 million on our Consolidated Statements of Operations.

The impairment was driven primarily by the sustained decline in our share price as our estimates of our future cash flows and the control premium have remained consistent, combined with an increase in the discount rate period over period. As noted above, our determination of fair value used a weighting of the fair values determined under both the market and income approaches, with the market approach driving the significant reduction in overall firm value and related impairment of goodwill.

Intangible Assets, Net

Details of our intangible assets (in thousands) are presented below:

| | As of June 30, 2016 | | | |
|---|---|---|---|---|
| | Weighted-Average Remaining Useful Life | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
| Corporate trade name | 18.9 | $19,000 | $1,029 | $17,971 |
| Customer relationships | 23.3 | 127,500 | 5,389 | 122,111 |
| Technology | 5.9 | 30,000 | 4,640 | 25,360 |
| Total | | $176,500 | $11,058 | $165,442 |

| | As of December 31, 2015 | | | |
|---|---|---|---|---|
| | Weighted-Average Remaining Useful Life | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
| Corporate trade name | 19.4 | $19,000 | $554 | $18,446 |
| Customer relationships | 24.4 | 120,000 | 2,797 | 117,203 |
| Technology | 6.4 | 30,000 | 2,497 | 27,503 |
| Total | | $169,000 | $5,848 | $163,152 |

We had no intangible assets prior to the Offering Reorganization.

We recorded additional customer relationship intangible assets of $7.5 million in relation to the closing of the Vestica transaction during the first quarter of 2016.

Amortization expense related to intangible assets was $2.6 million and $5.2 million for the three and six months ended June 30, 2016, respectively, and $0.8 million for the three and six months ended June 30, 2015.

8. Commitments and Contingencies

UPMC Reseller Agreement

The Company and the University of Pittsburgh Medical Center ("UPMC") are parties to a Reseller, Services and Non-Competition Agreement, dated August 31, 2011 (the “Original UPMC Reseller Agreement”), which was amended and restated by the parties on June 27, 2013 (as amended, the “UPMC Reseller Agreement”). Under the terms of the UPMC Reseller Agreement, UPMC has appointed the Company as a non-exclusive reseller of certain services, subject to certain conditions and limitations specified in the UPMC Reseller Agreement. In consideration for the Company’s obligations under the UPMC Reseller Agreement and subject to certain conditions described therein, UPMC has agreed not to sell certain products and services directly to the Company’s customers and top prospects.

The Advisory Board Company Reseller Agreement

The Company and The Advisory Board are parties to a Services, Reseller, and Non-Competition Agreement, dated August 31, 2011 (the “Original Advisory Board Reseller Agreement”), which was amended and restated by the parties on June 27, 2013, and May 1, 2015 (as so amended, the “Advisory Board Company Reseller Agreement”). Under the terms of the Advisory Board Company Reseller Agreement, The Advisory Board shall provide certain services to the

Company on an as-requested basis.  In addition, The Advisory Board has a right of first offer to provide certain specified services during the term of the Agreement and has the rights to collect certain fees for specified referrals.

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Contingencies

Tax Receivables Agreement

In connection with the Offering Reorganization, the Company entered into the TRA with certain of its investors, which provides for the payment by the Company to these investors of 85% of the amount of the tax benefits, if any, that the Company is deemed to realize as a result of increases in our tax basis related to exchanges of Class B common units as well as tax benefits attributable to the future utilization of pre-IPO net operating losses ("NOL"s). These payment obligations are obligations of the Company. For purposes of the TRA, the benefit deemed realized by the Company will be computed by comparing its actual income tax liability to the amount of such taxes that the Company would have been required to pay had there been no increase to the tax basis of the assets of the Company as a result of the exchanges or had the Company had no NOL carryforward balance. The actual amount and timing of any payments under the TRA will vary depending upon a number of factors, including:

- The timing of the exchanges and the price of the Class A shares at the time of the transaction, triggering a tax basis increase in the Company's asset and a corresponding benefit to be realized under the TRA; and
- The amount and timing of our taxable income - the Company will be required to pay 85% of the tax savings as and when realized, if any. If the Company does not have taxable income, it will not be required to make payments under the TRA for that taxable year because no tax savings were actually realized.

Due to the items noted above, the fact that no share exchanges have occurred as of June 30, 2016, and that the Company’s historical losses have not been utilized, the Company has not recorded a liability pursuant to the TRA.

Litigation Matters

We are engaged from time to time in certain legal disputes arising in the ordinary course of business, including employment claims. When the likelihood of a loss contingency becomes probable and the amount of the loss can be reasonably estimated, we accrue a liability for the loss contingency. We continue to review accruals and adjust them to reflect ongoing negotiations, settlements, rulings, advice of legal counsel, and other relevant information. To the extent new information is obtained, and our views on the probable outcomes of claims, suits, assessments, investigations, or legal proceedings change, changes in our accrued liabilities would be recorded in the period in which such determination is made. We had no material accruals as of June 30, 2016, and December 31, 2015.

Commitments

Lease Commitments

The Company has entered into lease agreements for its office location in Arlington, Virginia. In connection with these lease agreements, the Company is required to maintain a $2.5 million letter of credit, which declines annually throughout the term of the lease. As of June 30, 2016, the restricted funds held in connection with the lease were $2.5 million.

Total rental expense on operating leases was $1.1 million and $2.2 million for the three and six months ended June 30, 2016, respectively, and $0.4 million for the three and six months ended June 30, 2015.

Indemnifications

The Company’s customer agreements generally include a provision by which the Company agrees to defend its partners against third party claims (a) for death, bodily injury, or damage to personal property caused by Company negligence or willful misconduct, (b) by former or current Company employees arising from such managed service agreements, (c) for intellectual property infringement under specified conditions and (d) for Company violation of applicable laws, and to indemnify them against any damages and costs awarded in connection with such claims. To date, the Company has not incurred any material costs as a result of such indemnities and has not accrued any liabilities related to such obligations in the accompanying financial statements.

Registration rights agreement

We entered into a registration rights agreement with The Advisory Board, UPMC, TPG and another investor to register for sale under the Securities Act of 1933, as amended ("Securities Act"), shares of our Class A common stock, including those delivered in exchange for Class B common units in the circumstances described above. Subject to certain conditions and limitations, this agreement provides these investors with certain demand, piggyback and shelf registration rights. The registration rights granted under the registration rights agreement will terminate upon the date the holders of shares that are a party thereto no longer hold any such shares that are entitled to registration rights. Pursuant to our contractual obligations under this agreement, we filed a registration statement on Form S-3 with the SEC on July 28, 2016. See Note 16 below.

We will pay all expenses relating to any demand, piggyback or shelf registration, other than underwriting discounts and commissions and any transfer taxes, subject to specified conditions and limitations. The registration rights agreement includes customary indemnification provisions, including indemnification of the participating holders of shares of Class A common stock and their directors, officers and employees by us for any losses, claims, damages or liabilities in respect thereof and expenses to which such holders may become subject under the Securities Act, state law or otherwise.

Credit and Concentration Risk

The Company is subject to significant concentrations of credit risk related to cash and cash equivalents, investments and accounts receivable. The Company's cash and cash equivalents and investments are held at financial institutions that management believes to be of high credit quality. While the Company maintains its cash and cash equivalents and investments with financial institutions with high credit ratings, it often maintains these deposits in federally insured financial institutions in excess of federally insured limits. The Company has not experienced any losses on cash and cash equivalents or investments to date.

The following table summarizes those partners who represented at least 10% of our revenue for the periods presented:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Customer A | 17.1% | * | 15.1% | * |
| Customer B | 16.2% | 17.3% | 17.2% | 17.3% |
| Customer C | 15.5% | 11.4% | 14.9% | 11.4% |
| Customer D | * | 10.2% | * | 10.2% |
| Customer E | * | 10.6% | * | 10.6% |
| Customer F | * | 16.2% | * | 16.2% |
| Customer G | * | 15.4% | * | 15.4% |

* Represents less than 10.0% of the respective balance

The following table summarizes those partners who represented at least 10% of our trade accounts receivable for the periods presented:

| | As of June 30, 2016 | As of December 31, 2015 |
|---|---|---|

| | | |
|---|---|---|
| Customer B | 10.6% | 12.9 % |
| Customer C | 18.7% | * |
| Customer D | * | 11.4 % |
| Customer E | 38.6% | 28.1 % |
| Customer F | * | 23.2 % |

* Represents less than 10.0% of the respective balance

The Company is subject to significant concentration risk as materially all of our cash and cash equivalents are held in a single money market fund. As of June 30, 2016, $83.4 million of cash and cash equivalents were held in a money market fund.

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9. Earnings (Loss) Per Common Share

The following table sets forth the computation of basic and diluted earnings per share available for common stockholders (in thousands, except per share data):

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Net income (loss) | $(11,999) | $356,488 | $(186,278) | $345,169 |
| Less: | | | | |
| Net income (loss) attributable to non-controlling interests | (3,612) | (3,424) | (54,822) | (3,424) |
| Undeclared cumulative preferred dividends | — | 894 | — | 2,184 |
| Net income (loss) available for common shareholders - Basic | (8,387) | 359,018 | (131,456) | 346,409 |
| Add: | | | | |
| Net income (loss) attributable to non-controlling interests | — | (3,424) | — | (3,424) |
| Undeclared cumulative preferred dividends converted during the period | — | 894 | — | 2,184 |
| Net income (loss) available for common shareholders - Diluted (1) (2) | $(8,387) | $356,488 | $(131,456) | $345,169 |
| | | | | |
| Weighted-average common shares outstanding - Basic | 42,594 | 13,976 | 42,390 | 8,513 |
| Dilutive effect of options | — | 1,854 | — | 1,509 |
| Assumed conversion of convertible preferred stock at beginning-of-period | — | 15,806 | — | 18,949 |
| Assumed conversion of Class B common shares to Class A common shares | — | 5,007 | — | 2,517 |
| Weighted-average common shares outstanding - Diluted (2)(3) | 42,594 | 36,643 | 42,390 | 31,488 |
| | | | | |
| Earnings (Loss) per Common Share | | | | |
| Basic | $(0.20) | $25.69 | $(3.10) | $40.69 |
| Diluted | (0.20) | 9.73 | (3.10) | 10.96 |

(1) For periods of net loss, net income (loss) available for common shareholders is the same for both basic and diluted purposes.

(2) Each Class B common unit of Evolent Health LLC can be exchanged (together with a corresponding number of shares of our Class B common stock) for one share of our Class A common stock. As holders exchange their Class B common shares for Class A common shares, our interest in Evolent Health LLC will increase. Therefore, shares of our Class B common stock are not considered dilutive shares for the purposes of calculating our diluted earnings (loss) per common share as related adjustment to net income (loss) available for common shareholders would equally offset the additional shares, resulting in the same earnings (loss) per common share.

(3) For periods of net loss, shares used in the earnings (loss) per common share calculation represent basic shares as using diluted shares would be anti-dilutive.

Anti-dilutive shares (in thousands) excluded from the calculation of weighted-average common shares presented above are presented below:

| | For the Three Months Ended | For the Six Months Ended |
|---|---|---|

| | June 30, | | June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Exchangeable Class B common stock | 17,525 | — | 17,525 | — |
| Restricted stock and restricted stock units | 158 | — | 85 | — |
| Options | 1,353 | — | 904 | — |
| Total | 19,036 | — | 18,514 | — |

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10. Stock-based Compensation

Total compensation expense (in thousands) by award type and line item in our consolidated financial statements (in thousands) were as follows:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Award Type | | | | |
| Stock options | $4,044 | $1,166 | $8,341 | $1,166 |
| Restricted stock | — | 4,875 | — | 4,875 |
| Restricted stock units ("RSU") | 665 | 113 | 1,172 | 113 |
| Total | $4,709 | $6,154 | $9,513 | $6,154 |
| | | | | |
| Line Item | | | | |
| Cost of revenue | $406 | $409 | $905 | $409 |
| Selling, general and administrative expenses | 4,303 | 5,745 | 8,608 | 5,745 |
| Total | $4,709 | $6,154 | $9,513 | $6,154 |

No stock-based compensation in the totals above was capitalized as software development costs for the three and six months ended June 30, 2016. Less than $0.1 million of stock-based compensation included in the totals above was capitalized as software development costs for the three and six months ended June 30, 2015. We did not recognize stock compensation in 2015 prior to the Offering Reorganization.

As described in Note 2, the Company elected to early adopt ASU 2016-09 during the second quarter of 2016. This resulted in additional stock compensation expense of approximately $0.4 million for the three months ended March 31, 2016.

Stock-based awards granted were as follows:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Stock options | 42,870 | 803,243 | 1,167,770 | 1,789,243 |
| RSUs | 27,618 | 318,336 | 413,331 | 318,336 |

11. Income Taxes

For interim periods, we recognize an income tax provision/(benefit) based on our estimated annual effective tax rate expected for the full year.

The Company recorded $0.4 million and $1.4 million in income tax benefit for the three and six months ended June 30, 2016, respectively, which resulted in effective tax rates of 3.0% and 0.7%, respectively. As of December 31, 2015, $6.2 million of our book and tax basis difference deferred tax liability was expected to reverse outside of our NOL carryforward period. Current tax losses generated in 2016 by the Company allow this deferred tax liability to become a source of income for the realization of our deferred tax assets, which resulted in recording a tax benefit of $0.4 million as of June 30, 2016. For the three and six months ended June 30, 2015, the effective tax rates were 7.6%

and 7.8%, respectively, due to changes in our deferred tax liability related to the increased difference in the book basis compared to the tax basis in our partnership interest in Evolent Health LLC, resulting in $29.3 million in income tax provision.

As of each applicable period-end, the Company has not recognized any uncertain tax positions, penalties or interest as we have concluded that no such positions exist. The Company is not currently subject to income tax audits in any U.S. or state jurisdictions for any tax year.

Tax Receivables Agreement

In connection with the Offering Reorganization, the Company entered into the TRA with certain of its investors, which provides for the payment by the Company to these investors of 85% of the amount of the tax benefits, if any, that the Company is deemed to realize as a result of increases in our tax basis related to exchanges of Class B common units as well as tax benefits attributable to the future utilization of pre-IPO NOLs. See Note 11 in our 2015 Form 10-K for a detailed discussion of our TRA.

12. Investments In and Advances to Affiliates

Georgia Physicians for Accountable Care LLC

During the second quarter of 2016, the Company acquired 21,429 Class B Units of Georgia Physicians for Accountable Care, LLC ("GPAC") for $3.0 million in cash. The investment represents a 27% economic interest and a 28% voting interest in GPAC. The Company has determined it has significant influence but that it does not have control over GPAC. Accordingly, the investment is accounted for under the equity method of accounting and the Company will be allocated its proportional share of GPAC's profits and losses for each reporting period. For the three and six months ended June 30, 2016, Evolent Health, Inc.'s proportional share of the losses of GPAC was less than $0.1 million.

Concurrently, the Company also signed a long-term services agreement with GPAC to provide certain management, operational and support services to help GPAC manage elements of its service offerings. Revenue related to the long-term services agreement for the three and six months ended June 30, 2016, was less than $0.1 million.

Evolent Health LLC

Prior to the Offering Reorganization, we did not control Evolent Health LLC, but were able to exert significant influence and, accordingly, accounted for our investment in Evolent Health LLC using the equity method of accounting. Subsequent to the Offering Reorganization, the Company consolidates the results of operations of Evolent Health LLC.

The allocation of profits and losses to the shareholders of Evolent Health LLC were based upon the second amended and restated operating agreement of Evolent Health LLC. As part of recording our equity portion of the losses of Evolent Health LLC, the Company applied the hypothetical liquidation at book value basis of accounting which allocates profits and losses to the members based upon the value that would accrue to each member at each period end based upon a theoretical liquidation at book value at that time.

During the three and six months ended June 30, 2015, Evolent Health, Inc.'s proportional share of the losses of Evolent Health LLC was $16.8 million and $28.2 million, respectively, which included $0.3 million and $0.8 million, respectively, related to the amortization of a basis differential.

The following is a summary of the operating results of Evolent Health LLC (in thousands) for the periods that it was accounted for as an equity method investment:

| | April 1, 2015 through June 3, 2015 | January 1, 2015 through June 3, 2015 |
|---|---|---|
| Total revenue | $24,774 | $61,814 |

| | | |
|---|---|---|
| Cost of revenue (exclusive of depreciation and amortization) | 18,385 | 44,839 |
| Gross profit | 6,389 | 16,975 |
| Operating income (loss) | (24,771 ) | (44,119 ) |
| Net income (loss) | (24,764 ) | (44,079 ) |

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13. Non-controlling Interests

Prior to the Offering Reorganization, we did not consolidate Evolent Health LLC, and therefore did not allocate our profits and losses to non-controlling interests. As of June 30, 2016, we owned 70.9% of Evolent Health LLC. Changes in non-controlling interests (in thousands) were:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Non-controlling interests as of beginning-of-period | $234,028 | $— | $285,238 | $— |
| Increase in non-controlling interests as a result of the Offering Reorganization | — | 332,793 | — | 332,793 |
| Decrease in non-controlling interests as a result of the merger of the TPG affiliate with and into Evolent Health, Inc. | — | (34,875) | — | (34,875) |
| Net income (loss) attributable to non-controlling interests | (3,612) | (3,424) | (54,822) | (3,424) |
| Non-controlling interests as of end-of-period | $230,416 | $294,494 | $230,416 | $294,494 |

14. Fair Value Measurement

Our Consolidated Balance Sheets include various financial instruments (primarily restricted cash, investments, accounts receivable,
accounts payable, accrued expenses, deferred revenue, other current liabilities and other long-term liabilities) that are carried at cost and that approximate fair value. Fair value is the price that would be received from the sale of an asset or paid to transfer a liability assuming an orderly transaction in the most advantageous market at the measurement date. GAAP establishes a hierarchical disclosure framework which prioritizes and ranks the level of observability of inputs used in measuring fair value. These tiers include:

- Level 1 - inputs to the valuation methodology are quoted prices available in active markets for identical instruments as of the reporting date;
- Level 2 - inputs to the valuation methodology are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date and the fair value can be determined through the use of models or other valuation methodologies; and
- Level 3 - inputs to the valuation methodology are unobservable inputs in situations where there is little or no market activity for the asset or liability.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument.

The following table summarizes the Company’s assets and liabilities measured at fair value on a recurring basis (in thousands):

| | As of June 30, 2016 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets | | | | |
| Cash and cash equivalents (1) | $83,420 | $— | $— | $83,420 |
| U.S. Treasury bills (2) | — | 28,352 | — | 28,352 |

| | | | | |
|---|---|---|---|---|
| Corporate bonds [2] | — | 23,688 | — | 23,688 |
| Total | $83,420 | $52,040 | $— | $135,460 |
| | | | | |
| Liabilities | | | | |
| Contingent consideration [3] | $— | $— | $7,766 | $7,766 |
| Total | $— | $— | $7,766 | $7,766 |

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| | As of December 31, 2015 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets | | | | |
| Cash and cash equivalents [1] | $122,328 | $— | $ — | $122,328 |
| U.S. Treasury bills [2] | — | 28,240 | — | 28,240 |
| Corporate bonds [2] | — | 25,787 | — | 25,787 |
| Total | $122,328 | $54,027 | $ — | $176,355 |

[1] Represents the cash and cash equivalents that were held in a money market fund as of June 30, 2016, and December 31, 2015, as presented in the tables above.
[2] Our investments are classified as held-to-maturity and therefore are carried at amortized cost. Fair value of the investments are included within footnote disclosures only. See Note 5 for further discussion of our held-to-maturity securities.
[3] Related to the contingent earn-out consideration for Passport Health as described further in Note 4.

There were no transfers between fair value levels for the three and six month periods ended June 30, 2016 and 2015, respectively.

As discussed in Note 4, the strategic alliance with Passport includes a provision for additional equity consideration contingent upon the Company obtaining new third party Medicaid business in future periods. Management engaged an external valuation firm to provide a valuation consistent with the guidance found in ASC 820, Fair Value Measurement. Management reviewed and agreed with the methodology applied and conclusions reached by the external valuation firm.

In the absence of observable market prices, the fair value is based on the best information available and involves a significant degree of judgment, taking into consideration a combination of internal and external factors, including the appropriate risk adjustments for non-performance and liquidity risks.

The significant unobservable inputs used in the fair value measurement of the Company's contingent consideration are expected recurring revenue projections for Passport and the applicable discount rate. A significant decrease in the assumed recurring revenue projections or increase in discount rate in isolation would result in a significantly lower fair value.

The changes in our contingent consideration, measured at fair value, for which the Company uses Level 3 inputs to determine fair value are as follows (in thousands):

| | For the Three Months Ended June 30, 2016 |
|---|---|
| Balance as of beginning of period | $7,766 |
| Balance as of end of period | $7,766 |

For the Six

| | Months Ended June 30, 2016 |
|---|---|
| Balance as of beginning of period | $— |
| Additions | 7,766 |
| Balance as of end of period | $7,766 |

The Company did not have any Level 3 assets or liabilities as of June 30, 2015.

The following table summarizes the fair value (in thousands), valuation techniques and significant unobservable inputs of our Level 3 fair value measurements as of June 30, 2016:

| | Fair Value | Valuation Technique | Significant Unobservable Inputs | Assumption or Input Ranges |
|---|---|---|---|---|
| Contingent consideration [1] | $7,766 | Real options approach | Risk-adjusted expected growth rates | 22.8% - 282.2% |
| | | | Discount rate/time value | 3.4% - 5.6% |

[1] Related to additional Passport earn-out consideration as described further in Note 4.

The Company did not hold any assets or liabilities that had Level 3 inputs as of June 30, 2015, or December 31, 2015.

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15. Related Parties

As discussed in Note 12, Evolent acquired a 27% economic interest in GPAC during the second quarter of 2016 and is considered to have significant influence. As a result, the Company accounts for the investment under the equity method of accounting and is allocated its proportional share of GPAC's profits and losses for each reporting period. In addition, the Company signed a long-term services agreement with GPAC to provide certain management, operational and support services to help GPAC manage elements of its service offerings.

The Company also works closely with both of its founding investors, The Advisory Board and UPMC. The relationship with The Advisory Board is centered on providing certain specified services and making valuable connections with CEOs of health systems that could become partners. The Company's relationship with UPMC is a subcontractor relationship where UPMC has agreed to execute certain tasks (primarily third-party administration or "TPA" services) relating to certain customer commitments. We also conduct business with a company in which UPMC holds a significant equity interest.

Additionally, prior to the Offering Reorganization, we issued shares of our stock to certain of our partners while concurrently entering into revenue contracts with those partners. Those partners were considered related parties and the balances and/or transactions with them were reported on our consolidated financial statements for the periods in which they held an equity interest in Evolent Health, Inc. Subsequent to December 31, 2015, only one of our partners holds an equity interest in Evolent Health, Inc. That same partner represents a significant portion of our revenue and has a member of their management on our board of directors. That partner, our founding investors and their related businesses are considered related parties and the balances and/or transactions with them are reported on our consolidated financial statements.

16. Subsequent Events

On July 12, 2016, the Company entered into an agreement to acquire the majority of Valence Health. Valence Health provides value-based care solutions for hospitals, health systems and physicians to help them achieve clinical and financial rewards for more effectively managing patient populations. Consideration for the transaction will include both cash and shares of Evolent Class A common stock. Pursuant to the terms of the agreement, the Company is expected to pay an aggregate of approximately $142.8 million to $144.1 million in consideration based on the closing price of the Company's Class A common stock on the New York Stock Exchange on July 12, 2016, consisting of 5.3 million to 5.8 million shares of the Company's Class A common stock and approximately $35.0 million to $44.0 million in cash. We expect to pay the cash portion of the consideration with cash on hand. The aggregate consideration payable in the transaction is subject to certain post-closing adjustments based on working capital, indebtedness, certain liabilities and transaction expenses as of the closing date of the transaction. The Company will also pay additional contingent share consideration, if earned, in the form of an earn-out of up to $50.0 million payable in shares of the Company's Class A common stock, the payment of which is subject to the satisfaction of certain conditions and the achievement of new business activity completed by the acquired portion of Valence Health over the balance of calendar year 2016 impacting 2017 results. Shares of Class A common stock to be issued in relation to the earn-out are limited to 3.9 million shares with full payment, if any, to be made by January 30, 2017. The shares of Class A common stock to be paid at closing and any shares payable under the earn-out are expected to be issued in transactions exempt from registration under the Securities Act of 1933, as amended.

The consummation of the acquisition is subject to closing conditions, including, among others, the approval of Valence Health's stockholders, the absence of certain legal impediments to the consummation of the transaction, the receipt of specified consents and approvals, the early termination or expiration of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and, subject to materiality exceptions, the accuracy of representations and warranties made by the Company and Valence Health, respectively, and compliance by the Company and Valence Health with their respective obligations under the merger agreement. The transaction is not subject to any financing condition and is expected to close prior to November 10, 2016.

On July 28, 2016, we filed a registration statement on Form S-3 under the Securities Act of 1933, as amended, to register the possible resale of 44,028,589 shares of our Class A common stock by certain selling stockholders. The shares of Class A common stock included in this registration statement include shares to be issued upon the exchange of an equivalent number of Class B common units (together with an equal number of shares of our Class B common stock) of our operating subsidiary, Evolent Health LLC, by certain selling stockholders pursuant to their contractual rights under an exchange agreement. Please refer to our 2015 Form 10-K for further information about the IPO and rights of our Class A common stock and Class B common unit holders.

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

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) is intended to help the reader understand the Company's financial condition as of June 30, 2016, compared with December 31, 2015, and the results of operations for the three and six months ended June 30, 2016, compared with the corresponding periods in 2015. The MD&A is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and the accompanying notes to consolidated financial statements (“Notes”) presented in “Item 1. Financial Statements”; our 2015 Form 10-K, including the sections entitled “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations”; and our current reports on Form 8-K filed in 2016.

INTRODUCTION

Background and Recent Events

Evolent was originally organized as a corporation in August 2011 and was capitalized through contributions of cash and intangible assets in exchange for preferred stock.

On September 23, 2013, Evolent Health, Inc. undertook a reorganization (the “Series B Reorganization”) in which Evolent Health Holdings was formed and Evolent Health, Inc. converted into Evolent Health LLC, a limited liability company. Evolent Health Holdings did not control Evolent Health LLC after the Series B Reorganization, but was able to exert significant influence and, accordingly, accounted for its investment in Evolent Health LLC using the equity method of accounting.

Evolent Health, Inc., the registrant, was incorporated as a Delaware corporation on December 12, 2014, for the purpose of the Company’s IPO. Immediately prior to the completion of the IPO in June 2015, we amended and restated our certificate of incorporation to, among other things, authorize two classes of common stock, Class A common stock and Class B common stock. Pursuant to the Offering Reorganization, Evolent Health, Inc. merged with Evolent Health Holdings and an affiliate of TPG. In accordance with the terms of the mergers, each of the then-existing stockholders of Evolent Health Holdings, including UPMC, The Advisory Board, TPG, as well as certain other entities, existing partners and employees, received a certain number of shares of our Class A common stock in exchange for each share of common stock it held in Evolent Health Holdings, and TPG received a certain number of shares of our Class A common stock in exchange for 100% of the equity that it held in its affiliate that was merged with Evolent Health, Inc. In addition, pursuant to the Offering Reorganization, we issued shares of our Class B common stock to TPG and The Advisory Board, each of which was a member of Evolent Health LLC prior to the Offering Reorganization. Shares of our Class B common stock vote together with shares of our Class A common stock as a single class, except as otherwise required by law or pursuant to our amended and restated certificate of incorporation or amended and restated bylaws. Each Class B common unit of Evolent Health LLC can be exchanged (together with a corresponding number of shares of our Class B common stock) for one share of our Class A common stock and is otherwise non-transferable pursuant to an exchange agreement.

Substantially all of our operations will continue to be conducted through Evolent Health LLC, and subsequent to the Offering Reorganization, the financial results of Evolent Health LLC are consolidated in the financial statements of Evolent Health, Inc. Evolent Health, Inc. is a holding company whose principal asset is all of the Class A common units it holds in Evolent Health LLC, and its only business is to act as sole managing member of Evolent Health LLC.

Business Overview

We are a market leader and a pioneer in the new era of healthcare delivery and payment, in which leading providers are taking on increasing clinical and financial responsibility for the populations they serve. Our purpose-built platform, powered by our technology, proprietary processes and integrated services, enables providers to migrate their economic orientation from fee-for-service reimbursement to value-based payment models. By partnering with providers to accelerate their path to value-based care, we enable our provider partners to expand their market opportunity, diversify their revenue streams, grow market share and improve the quality of the care they provide.

We consider value-based care to be the necessary convergence of healthcare payment and delivery. We believe the pace of this convergence is accelerating, driven by price pressure in traditional fee-for-service ("FFS") healthcare, a regulatory environment that is incentivizing value-based care models, a rapid expansion of retail insurance driven by the emergence of the organizations that provide a marketplace for individuals to purchase standardized and government regulated health insurance policies ("health insurance exchanges") and innovation in data and technology. We believe providers are positioned to lead this transition to value-based care because of their control over large portions of healthcare delivery costs, their primary position with consumers and their strong local brand.

We market and sell our services primarily to major providers throughout the United States. We typically work with our partners in two phases. In the transformation phase, we initially work with our partners to develop a strategic plan for their transition to a value-based care model which includes sizing the market opportunity for our partner and creating a Blueprint for executing that opportunity. During the second portion of the transformation phase, which typically lasts twelve to fifteen months, we generally work with our partner to implement the Blueprint by establishing the resources necessary to launch its strategy and capitalize on the opportunity. During the transformation phase, we seek to enter into long-term agreements which we call the platform and operations phase and for which we deliver a wide range of services that support our partner in the execution of its new strategy. Contracts in the platform and operations phase can range from three to ten years in length. In the platform and operations phase, we establish a local market presence and embed our resources alongside our partners. Revenue from these long-term contracts is not guaranteed because certain of these contracts are terminable for convenience by our partners after a notice period has passed, and certain partners would be required to pay us a termination fee in certain circumstances.

As of June 30, 2016, we had entered into long-term contractual relationships with thirteen partners and a significant portion of our revenue is concentrated with several partners. Our three largest partners, Indiana University Health, Passport Health Plan and MedStar Health, Inc., comprised 17.2%, 15.1% and 14.9%, respectively, of our revenue for the six months ended June 30, 2016, or 47.2% in the aggregate.

On February 1, 2016, the Company entered into a strategic alliance with University Health Care, Inc. d/b/a Passport Health Plan (“Passport”), a leading nonprofit community-based and provider-sponsored health plan administering Kentucky Medicaid and federal Medicare Advantage benefits to over 280,000 Kentucky Medicaid and Medicare Advantage beneficiaries. As part of the transaction, we issued 1.1 million Class A common shares to acquire capabilities and assets from Passport to enable us to build out a Medicaid Center of Excellence based in Louisville, Kentucky. Additional equity consideration of up to $10.0 million may be earned by Passport should we obtain new third party Medicaid business in future periods. This transaction also includes a 10-year arrangement under which we will provide various health plan management and managed care services to the Passport. We believe the Medicaid Center of Excellence, which combines Passport’s capabilities with our existing capabilities and technology platform, will enhance our ability to further expand into the growing market in provider-sponsored, community-based Medicaid health plans throughout the United States. See Note 4 in "Item 1. Financial Statements" for details of the accounting for this transaction. Passport comprised 15.1% of our revenue for the six months ended June 30, 2016, and we expect the 10-year service arrangement will continue to contribute significantly to our future operations.

On July 12, 2016, the Company entered into an agreement to acquire the majority of Valence Health. Valence Health provides value-based care solutions for hospitals, health systems and physicians to help them achieve clinical and financial rewards for more effectively managing patient populations. Consideration for the transaction will include both cash and shares of Evolent Class A common stock. Pursuant to the terms of the agreement, the Company is expected to pay an aggregate of approximately $142.8 million to $144.1 million in consideration based on the closing price of the Company's Class A common stock on the New York Stock Exchange on July 12, 2016, consisting of 5.3 million to 5.8 million shares of the Company's Class A common stock and approximately $35.0 million to $44.0 million in cash. We expect to pay the cash portion of the consideration with cash on hand. The aggregate consideration payable in the transaction is subject to certain post-closing adjustments based on working capital, indebtedness, certain liabilities and transaction expenses as of the closing date of the transaction. The Company will also pay additional contingent share consideration, if earned, in the form of an earn-out of up to $50.0 million payable in shares of the Company’s Class A common stock, the payment of which is subject to the satisfaction of certain conditions and the achievement of new business activity completed by the acquired portion of Valence Health over the balance of calendar year 2016 impacting 2017 results. Shares of Class A common stock to be issued in relation to the earn-out are limited to 3.9 million shares with full payment, if any, to be made by January 30, 2017. The transaction is expected to close prior to November 10, 2016, pending regulatory approval and other closing conditions, and we will finalize the accounting for this transaction upon close. We expect the acquisition of Valence Health to contribute significantly to our future operations.

We have incurred operating losses since our inception, as we have invested heavily in resources to support our growth. We intend to continue to invest aggressively in the success of our partners, expand our geographic footprint and further develop our capabilities. We also expect to continue to incur operating losses for the foreseeable future and may need to raise additional capital through equity and debt financings in order to fund our operations. Additional funds may not be available on terms favorable to us or at all. If we are unable to achieve our revenue growth and cost management objectives, we may not be able to achieve profitability. As of June 30, 2016, we believe we have sufficient liquidity for the next twelve months.

We manage our operations and allocate resources as a single reportable segment. All of our revenue is recognized in the United States and all of our long-lived assets are located in the United States.

Critical Accounting Policies and Estimates

The MD&A included in our 2015 Form 10-K contains a detailed discussion of our critical accounting policies and estimates. The following information updates the “Critical Accounting Policies and Estimates” provided in our 2015 Form 10-K and, accordingly, should be read in conjunction with the “Critical Accounting Policies and Estimates” discussed in our 2015 Form 10-K.

Goodwill

We recognize the excess of the purchase price, plus the fair value of any non-controlling interests in the acquiree, over the fair value of identifiable net assets acquired as goodwill. Goodwill is not amortized, but is reviewed at least annually on October 31 for indications of impairment, with consideration given to financial performance and other relevant factors. We perform a two-step test in our evaluation of the carrying value of goodwill, if qualitative factors determine it is necessary to complete the two-step goodwill impairment test. In Step 1 of the evaluation, the fair value is determined and compared to the carrying value. If the fair value is greater than the carrying value, then the carrying value is deemed to be recoverable, and Step 2 is not required. If the fair value estimate is less than the carrying value, it is an indicator that impairment may exist, and Step 2 is required. In Step 2, the implied fair value of goodwill is determined. The fair value as determined in Step 1 is assigned to the entity’s net assets (recognized and unrecognized) as if the entity was acquired in a business combination as of the date of the impairment test. If the implied fair value of goodwill is lower than its carrying amount, goodwill is impaired and written down to its fair value; and a charge is reported in impairment of goodwill on our Consolidated Statements of Operations.

Factors could cause us to believe our estimated fair value of our single reporting unit may be lower than the carrying value and trigger a Step 1 test, but may not require a Step 2 test if the fair value of the reporting unit is greater than its carrying value.  In the event a Step 2 test is conducted, it may not result in goodwill impairment because the implied fair value of goodwill may exceed our carrying amount of goodwill. The implied fair value of goodwill is most sensitive to our estimates of revenue growth, expense management, working capital investment, margins and discount rates.

In interim periods between annual goodwill reviews, we also evaluate qualitative factors that could cause us to believe our estimated fair value of our single reporting unit may be lower than the carrying value and trigger a Step 1 test including, but not limited to (i) macroeconomic conditions, (ii) industry and market considerations, (iii) our overall financial performance including an analysis of our current and projected cash flows, revenue and earnings, (iv) a sustained decrease in share price and (v) other relevant entity-specific events including changes in strategy, partners, or litigation. As a result of the Offering Reorganization, we revalued our consolidated balance sheet to the market value of our IPO share price of $17.00.

Subsequent to our 2015 annual impairment testing in the fourth quarter of 2015, our common stock price declined significantly, reaching our historic low in the first quarter of 2016. During the three months ended March 31, 2016, our common stock traded between $8.48 and $12.32, or an average common stock price of $10.33 compared to an average common stock price of $19.51 and $14.73 during the three month periods ended September 30, 2015, and December 31, 2015, respectively. A sustained decline in our common stock price and the resulting impact on our market capitalization is one of several qualitative factors we consider each quarter when evaluating whether events or changes in circumstances indicate it is more likely than not that a potential goodwill impairment exists. We concluded that the further decline in common stock price observed during the first quarter of 2016 did represent a sustained decline and that triggering events occurred during the period requiring an interim goodwill impairment test as of March 31, 2016. As such, we performed a Step 1 impairment test of our goodwill as of March 31, 2016.

Step 1 Results

To determine the implied fair value for our single reporting unit, we used both a market multiple valuation approach ("market approach") and a discounted cash flow valuation approach ("income approach"). In determining the estimated fair value, we considered the level of our Class A common stock price and assumptions that we believed market participants would make in valuing our reporting unit, including a control premium, as well as discounted cash flow calculations of management's estimates of future financial performance and management's long-term plans. This analysis also required us to make judgments about revenues, expenses, fixed asset and working capital requirements, the timing of exchanges of our Class B common shares, capital market assumptions and discount rates.

In our March 31, 2016, Step 1 test, our most sensitive assumption for purposes of the market approach was our estimate of the control premium, and the most sensitive assumption related to the income approach, other than our cash flows, was the discount rate. As of March 31, 2016, our single reporting unit failed the Step 1 analysis as we determined that its implied fair value was less than its carrying value based on the weighting of the fair values determined under both the market and income approaches. As fair value was less than carrying value, we performed a Step 2 test to determine the implied fair value of our goodwill.

Step 2 Results

In our Step 2 test, the fair value of all assets and liabilities were estimated, including our tangible assets (corporate trade name, customer relationships and technology) for the purpose of deriving an estimate of the implied fair value of goodwill. The implied fair value of goodwill was then compared to the carrying amount of goodwill resulting in an impairment charge of $160.6 million on our Consolidated Statements of Operations.

The impairment was driven primarily by the sustained decline in our share price as our estimates of our future cash flows and the control premium have remained consistent, combined with an increase in the discount rate period over period. As noted above, our determination of fair value used a weighting of the fair values determined under both the market and income approaches, with the market approach driving the significant reduction in overall firm value and related impairment of goodwill.

We may be required to recognize additional impairments in the future as a result of market conditions or other factors related to our performance, including changes in our forecasted results, investment strategy or interest rates. Any further impairment charges that we may record in the future could be material to our results of operations.

Stock-based Compensation

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions, including accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. The Company elected to early adopt ASU 2016-09 during the second quarter of 2016.

ASU 2016-09 requires that amendments resulting from the adoption of the new pronouncement be applied using a modified-retrospective transition method by means of a cumulative-effect adjustment to retained earnings as of the beginning of the period in which the guidance is adopted. Therefore, the Company adjusted retained earnings on January 1, 2016, for amendments related to an accounting policy election to recognize share-based award forfeitures as they occur rather than applying an estimated forfeiture rate.

In adopting ASU 2016-09, we recorded adjustments to beginning retained earnings as of January 1, 2016, and retained earnings, cost of revenue and selling general and administrative expenses as of and for the three months ended March 31, 2016. The amounts were immaterial to our Consolidated Balance Sheets and Results of Operations.

In addition, the adoption of ASU 2016-09 changed how the Company recognizes excess tax benefits ("windfalls") or deficiencies ("shortfalls") related to share-based compensation. Prior to adopting the new pronouncement, these windfalls and shortfalls were credited or charged, respectively, to additional paid-in capital in the Company's Consolidated Balance Sheets. Under ASU 2016-09, these windfalls and shortfalls are recognized prospectively as discrete tax benefit or discrete tax expense, respectively, in the Company's Consolidated Statement of Operations. For the six months ended June 30, 2016, the Company did not recognize a discrete tax benefit related to net windfall tax benefits from share-based compensation, as the Company does not expect to realize these excess tax deductions in 2016 by reduction of taxes payable, and valuation allowance is necessary.

RESULTS OF OPERATIONS

Evolent Health, Inc. is a holding company and its principal asset is all of the Class A common units in its operating subsidiary, Evolent Health LLC, which has owned all of our operating assets and substantially all of our business since inception. Prior to the Offering Reorganization on June 4, 2015, the predecessor of Evolent Health, Inc. accounted for Evolent Health LLC as an equity method investment. The financial results of Evolent Health LLC have been consolidated in the financial statements of Evolent Health, Inc. following the Offering Reorganization. As a result, the financial statements of Evolent Health, Inc. for the three and six months ended June 30, 2015, do not reflect a complete view of the operational results for those periods.

Key Components of our Results of Operations

Revenue

We derive our revenue from two sources: transformation and platform and operations services. We collect a fixed fee from our partners during the transformation phase and revenue is recognized based upon proportionate performance over the life of the engagement. Transformation revenue can fluctuate based on both the timing of when contracts are executed with partners, the scope of the delivery and the timing of work being performed. During the platform and operations phase, our revenue structure shifts to a primarily variable fee structure which typically includes a monthly payment that is calculated based on a specified rate, or per member per month ("PMPM"), multiplied by the number of members that our partners are managing under a value-based care arrangement or a percentage of plan premiums. The platform and operations agreements often include contingent fees such as service level agreements, shared medical savings arrangements and other performance measures which are recognized when the amount is estimable and there is evidence to support meeting the criteria. In some cases, we recognize revenue when the cash is received as we have limited data to support our estimate. Our platform and operations revenue may vary based on the nature of the population, the timing of new populations transitioning to our platform and the type of services being utilized by our partners. After a specified period, certain of our platform and operations contracts are terminable for convenience by our partners after a notice period has passed and the partner has paid a termination fee. We also have arrangements with multiple deliverables (including both transformation and platform and operations components) and we evaluate the deliverables to determine whether they represent a separate unit of accounting. Revenue is then allocated to the units of accounting based on each unit’s relative selling price.

Cost of revenue (exclusive of depreciation and amortization)

Our cost of revenue includes direct expenses and shared resources that perform services in direct support of clients. Costs consist primarily of employee related expenses (including compensation, benefits and stock-based compensation), TPA support and other services provided by one of our investors, UPMC, as well as other professional fees.

Selling, general and administrative expenses

Our selling, general and administrative expenses consist primarily of employee-related expenses (including compensation, benefits and stock-based compensation) for selling and marketing, corporate development, finance, legal, human resources, corporate information technology, professional fees and other corporate expenses associated with these functional areas. Selling, general and administrative expenses also include costs associated with our centralized infrastructure and research and development activities to support our network development capabilities, PBM administration, technology infrastructure, clinical program development and data analytics.

Depreciation and amortization expense

Depreciation and amortization expenses consist of the amortization of intangible assets associated with the step up in fair value of Evolent Health LLC's assets and liabilities for the Offering Reorganization, amortization of intangible assets recorded as part of the transactions closed during the first quarter of 2016, depreciation of property and equipment and amortization of bond premiums.

Evolent Health, Inc. Results

| | For the Three Months Ended June 30, | | Change Over Prior Period [1] | For the Six Months Ended June 30, | | Change Over Prior Period [1] |
|---|---|---|---|---|---|---|
| (in thousands) | 2016 | 2015 | % | 2016 | 2015 | % |
| Revenue | | | | | | |
| Transformation | $10,388 | $2,703 | 284.3% | $18,502 | $2,703 | N/A |
| Platform and operations | 46,130 | 7,711 | N/A | 87,465 | 7,711 | N/A |
| Total revenue | 56,518 | 10,414 | N/A | 105,967 | 10,414 | N/A |
| | | | | | | |
| Expenses | | | | | | |
| Cost of revenue (exclusive of depreciation and amortization expenses presented separately below) | 32,779 | 7,887 | N/A | 61,445 | 7,887 | N/A |
| Selling, general and administrative expenses | 32,756 | 13,082 | 150.4% | 65,115 | 13,082 | N/A |
| Depreciation and amortization expenses | 3,612 | 984 | 267.1% | 6,983 | 984 | N/A |
| Goodwill impairment | — | — | N/A | 160,600 | — | N/A |
| Total operating expenses | 69,147 | 21,953 | 215.0% | 294,143 | 21,953 | N/A |
| Operating income (loss) | $(12,629) | $(11,539) | 9.4 % | $(188,176) | $(11,539) | N/A |
| | | | | | | |
| Transformation revenue as a % of total revenue | 18.4 % | 26.0 % | | 17.5 % | 26.0 % | |
| Platform and operations revenue as a % of total revenue | 81.6 % | 74.0 % | | 82.5 % | 74.0 % | |
| Cost of revenue as a % of total revenue | 58.0 % | 75.7 % | | 58.0 % | 75.7 % | |
| Selling, general and administrative expenses as a % of total revenue | 58.0 % | 125.6 % | | 61.4 % | 125.6 % | |

(1) As a result of the Offering Reorganization, the operational results for the three and six months ended June 30, 2015, do not reflect a complete view of the Company's operations for those periods. Therefore, we believe that a comparison of the three and six month periods ended June 30, 2016, which reflect the full operations of Evolent Health LLC for those respective periods, to the three and six month periods ended June 30, 2015, would not yield a meaningful comparison for the reader. As such, we have excluded the presentation of certain changes from the table above and denoted them with "N/A." See "Part II - Item 8. Financial Statements and Supplementary Data - Note 4" in our 2015 Form 10-K and Note 4 in this Form 10-Q for additional details of the Offering Reorganization.

Evolent Health, Inc.'s results for the three and six months ended June 30, 2016, reflect a complete view of the operational results as the results of operations of Evolent Health LLC have been included for the full period. Revenue for the three and six months ended June 30, 2016, was $56.5 million and $106.0 million, respectively, as compared to $10.4 million in the same periods in the prior year.
Transformation revenue for the three and six months ended June 30, 2016, was $10.4 million and $18.5 million, respectively, as compared to $2.7 million in the same periods in the prior year. Platform and operations revenue for the three and six months ended June 30, 2016, was $46.1 million and $87.5 million, respectively, as compared to $7.7 million in the same periods in the prior year. Cost of revenue for the three and six months ended June 30, 2016, was $32.8 million and $61.4 million, respectively, as compared to $7.9 million in the same periods in the prior year. Selling, general and administrative expenses for the three and six months ended June 30, 2016, was $32.8 million and

$65.1 million, respectively, as compared to $13.1 million in the same periods in the prior year. Depreciation and amortization expenses for the three and six months ended June 30, 2016, was $3.6 million and $7.0 million, respectively, as compared to $1.0 million in the same periods in the prior year. Revenue and operating expenses increased over the prior year periods as a result of the consolidation of Evolent Health LLC.

Goodwill impairment

During the first quarter of 2016 we recorded an impairment charge of $160.6 million on our Consolidated Statements of Operations as the implied fair value of goodwill was less than the carrying amount. See "Critical Accounting Policies and Estimates" above for further details of the impairment charge to goodwill.

Interest income (expense), net

As a result of the Offering Reorganization, the cash and cash equivalents and investments of Evolent Health LLC are now consolidated and reflected on our Consolidated Balance Sheets. Interest income consists of interest from investing cash in money market funds and interest from both our short-term and long-term investments. We expect our average cash and cash equivalents to decline in future periods as we use those funds for operations.

Gain on consolidation

As part of the Offering Reorganization and as a result of gaining control of Evolent Health LLC, we recognized a gain of $414.1 million for the three and six months ended June 30, 2015. We accounted for obtaining control of Evolent Health LLC as a step acquisition and, accordingly, recognized the fair value of Evolent Health LLC’s assets and liabilities as of the effective date of the Offering Reorganization, including goodwill of $608.9 million and intangible assets of $169.0 million (consisting of $19.0 million, $120.0 million and $30.0 million for the corporate trade name, existing customer relationships and existing technology, respectively).

Income (loss) from affiliate

During the second quarter of 2016, the Company acquired an equity stake in GPAC for $3.0 million in cash. The Company will be allocated its proportional share of GPAC's profits and losses for each reporting period. For the three and six months ended June 30, 2016, Evolent Health, Inc.'s proportional share of the losses of GPAC was less than $0.1 million.

Evolent Health, Inc.’s proportionate share of the losses of Evolent Health LLC for the three and six months ended June 30, 2015, was $16.8 million and $28.2 million, respectively, which included $0.3 million and $0.8 million, respectively, related to the amortization of a basis differential.

As a result of the Offering Reorganization, the financial results of Evolent Health LLC are now consolidated and reflected in our financial results. As such, we did not recognize income (loss) from the Evolent Health LLC affiliate in the three and six month periods ended June 30, 2016.

Provision (benefit) for income taxes

Our income tax benefit relates to federal and state jurisdictions in the United States. The difference between our effective tax rate and our statutory rate is due primarily to the fact that we have certain permanent items which include, but are not limited to, income attributable to non-controlling interests and the impact of certain tax deduction limits related to meals and entertainment and other permanent nondeductible expenses. The Company reports taxes only on its share of Evolent Health LLC's income and the consolidated income tax benefit therefore excludes earnings allocable to non-controlling interests. The Company expects this factor will continue to impact the consolidated effective tax rate until all Class B common units and shares are exchanged for Class A common shares of Evolent Health, Inc.

The Company recorded $0.4 million and $1.4 million in income tax benefit for the three and six months ended June 30, 2016, respectively, compared to an income tax provision of $29.3 million for the three and six months ended June 30, 2015. As of December 31, 2015, $6.2 million of our book and tax basis difference deferred tax liability was expected to reverse outside of our NOL carryforward period. Current tax losses generated in 2016 by the Company allow this deferred tax liability to become a source of income for the realization of our deferred tax assets, while the Company still maintains its valuation allowance. As a result, the Company recorded income tax benefits of $0.4 million and $1.4 million for the three and six ended June 30, 2016, respectively, and expects to continue to generate such tax benefits in future periods.

During the three and six months ended June 30, 2016, management examined all sources of taxable income that may be available for the realization of its net deferred tax assets. Given the Company's cumulative loss position, management concluded that there are no current sources of taxable income and we are currently reflecting a full valuation allowance in our financial statements.

Net income (loss) attributable to non-controlling interests

As a result of the Offering Reorganization and as of June 4, 2015, we now consolidate the results of Evolent Health LLC as we have 100% of the voting rights of the entity; however, as of June 30, 2016, we own 70.9% of the economic rights of the results of operations of Evolent Health LLC and eliminate the non-controlling interest from our results of operations. For the three and six months ended June 30, 2016, our results reflect net losses of $3.6 million and $54.8 million, respectively, attributable to non-controlling interests, which represents 28.6% and 29.1% of the operating losses of Evolent Health LLC, respectively. For the corresponding periods in 2015, our results reflect a net loss of $3.4 million attributable to non-controlling interests, which represents 29.7% of the operating losses of Evolent Health LLC for the three and six months ended June 30, 2015.

As the Company's results for the three and six months ended June 30, 2015, do not reflect a complete view of Evolent Health LLC's operations for those periods, we believe that a comparison of results beyond the discussion provided above would not be meaningful for the reader and, as such, have provided a comparison of our Adjusted Results below. See "Evolent Health, Inc. Adjusted Results" for further discussion of the adjusted operating results.

NON-GAAP FINANCIAL MEASURES

As described above, Evolent Health, Inc. is a holding company and its principal asset is all of the Class A common units in its operating subsidiary, Evolent Health LLC, which has owned all of our operating assets and substantially all of our business since inception. Prior to the Offering Reorganization on June 4, 2015, the predecessor of Evolent Health, Inc. accounted for Evolent Health LLC as an equity method investment. The financial results of Evolent Health LLC have been consolidated in the financial statements of Evolent Health, Inc. following the Offering Reorganization. As a result, the financial statements of Evolent Health, Inc. for the three and six months ended June 30, 2015, do not reflect a complete view of the operational results for the respective periods. In order to provide a consistent presentation for the periods before and after June 4, 2015, and effectively provide comparative results, the adjusted results of Evolent Health, Inc. presented and discussed below reflect the Offering Reorganization as if it had occurred on January 1, 2015, and therefore include the operations of Evolent Health LLC for the period from January 1, 2015, through June 3, 2015, as well as for the period from June 4, 2015, through June 30, 2015, when the results were consolidated. Including Evolent Health LLC’s results for this period is not consistent with GAAP and should not be considered as an alternative to comparable GAAP measures. The non-GAAP measures below reflect certain income statement line items as adjusted to reflect results from operations for the three and six month periods ended June 30, 2015, as if the Offering Reorganization had occurred on January 1, 2015. The presentation also reflects other adjustments.

In addition to disclosing financial results that are determined in accordance with GAAP, we present and discuss Adjusted Revenue, Adjusted Transformation Revenue, Adjusted Platform and Operations Revenue, Adjusted Cost of Revenue, Adjusted Selling, General and Administrative Expenses, Adjusted Depreciation and Amortization Expenses and Adjusted Operating Income (Loss), which are all non-GAAP financial measures, as supplemental measures to help investors evaluate our fundamental operational performance. We believe these measures are useful across time in evaluating our fundamental core operating performance. Management also uses certain of these measures to manage our business, including in preparing its annual operating budget, financial projections and compensation plans. We believe that certain of these measures are also useful to investors because similar measures are frequently used by securities analysts, investors and other interested parties in their evaluation of companies in similar industries. Adjusted Revenue, Adjusted Transformation Revenue and Adjusted Platform and Operations Revenue are defined as revenue, transformation revenue, and platform and operations revenue, respectively, adjusted to include revenue, transformation revenue and platform and operations revenue, as applicable, of Evolent Health LLC for periods prior to the Offering Reorganization, and to exclude the impact of purchase accounting adjustments. Management uses Adjusted Revenue, Adjusted Transformation Revenue and Adjusted Platform and Operations Revenue as supplemental performance measures because they reflect a complete view of the operational results. The measures are also useful to investors because they reflect the full view of our operational performance in line with how we generate our long term forecasts.

Adjusted Cost of Revenue and Adjusted Selling, General and Administrative Expenses are defined as cost of revenue and selling, general and administrative expenses, respectively, adjusted to include cost of revenue and adjusted selling, general and administrative expenses, as applicable, of Evolent Health LLC for periods prior to the Offering Reorganization, and to exclude the impact of stock-based compensation expenses and transaction costs related to acquisitions and business combinations, the Offering Reorganization and IPO. Management uses Adjusted Cost of Revenue and Adjusted Selling, General and Administrative Expenses as supplemental performance measures which are also useful to investors because they facilitate an understanding of our long term operational costs while removing the effect of costs that are one time (transaction costs) or non-cash (stock-based compensation expenses) in nature. Additionally, these supplemental performance measures facilitate an understanding a breakdown of our Adjusted Total Operating Expenses.

Adjusted Depreciation and Amortization Expenses is defined as depreciation and amortization expenses adjusted to include depreciation and amortization expenses of Evolent Health LLC for periods prior to the Offering Reorganization. Management uses

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Adjusted Depreciation and Amortization Expenses as a supplemental performance measure because it reflects a complete view of the operational results. The measure is also useful to investors because it facilitates understanding a breakdown of our Adjusted Total Operating Expenses.

Adjusted Total Operating Expenses is defined as the sum of Adjusted Cost of Revenue, Adjusted Selling, General and Administrative Expenses and Adjusted Depreciation and Amortization Expenses, and reflects the adjustments made in those non-GAAP measures.

Adjusted Operating Income (Loss) is defined as Adjusted Revenue less Adjusted Total Operating Expenses, and reflects the adjustments made in those non-GAAP measures.

These adjusted measures do not represent and should not be considered as alternatives to GAAP measurements, and our calculations thereof may not be comparable to similarly entitled measures reported by other companies. A reconciliation of these adjusted measures to their most comparable GAAP financial measures is presented in the tables below.

Evolent Health, Inc. Adjusted Results

| | For the Three Months Ended June 30, 2016 | | | For the Three Months Ended June 30, 2015 | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| (in thousands) | Evolent Health, Inc. as Reported | Adjustments | Evolent Health, Inc. as Adjusted | Evolent Health, Inc. as Reported | Add: Evolent Health LLC Operations (1) | Adjustments | Evolent Health, Inc. as Adjusted | Evolent Health, Inc. as Adjusted Change Over Prior Period * $ | % |
| Revenue | | | | | | | | | |
| Transformation (2) | $10,388 | $— | $10,388 | $2,703 | $5,380 | $364 | $8,447 | $1,941 | 23.0% |
| Platform and operations (2) | 46,130 | — | 46,130 | 7,711 | 19,394 | 911 | 28,016 | 18,114 | 64.7% |
| Total revenue | 56,518 | — | 56,518 | 10,414 | 24,774 | 1,275 | 36,463 | 20,055 | 55.0% |
| Expenses | | | | | | | | | |
| Cost of revenue (exclusive of depreciation and amortization presented separately below) (3) | 32,779 | (636) | 32,143 | 7,887 | 18,385 | (1,343) | 24,929 | 7,214 | 28.9% |
| Selling, general and administrative expenses (4) | 32,756 | (4,475) | 28,281 | 13,082 | 30,006 | (21,306) | 21,782 | 6,499 | 29.8% |
| Depreciation and amortization expenses | 3,612 | — | 3,612 | 984 | 1,154 | — | 2,138 | 1,474 | 68.9% |
| Total operating expenses | 69,147 | (5,111) | 64,036 | 21,953 | 49,545 | (22,649) | 48,849 | 15,187 | 31.1% |
| Operating income (loss) | $(12,629) | $5,111 | $(7,518) | $(11,539) | $(24,771) | $23,924 | $(12,386) | $4,868 | 39.3% |
| | | | | | | | | | |
| Transformation revenue as a % of total revenue | 18.4% | | 18.4% | 26.0% | | | 23.2% | | |
| Platform and operations revenue as a % of total revenue | 81.6% | | 81.6% | 74.0% | | | 76.8% | | |
| Cost of revenue as a % | | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| of total revenue | 58.0 | % | 56.9 | % | 75.7 | % | 68.4 | % |
| Selling, general and administrative expenses as a % of total revenue | 58.0 | % | 50.0 | % | 125.6 | % | 59.7 | % |

(1) Represents the operational results of Evolent Health LLC for the period April 1, 2015, through June 3, 2015.

(2) As part of the Offering Reorganization and as a result of gaining control of Evolent Health LLC, we recorded the fair value of deferred revenue resulting in a $4.9 million reduction to the book value. See "Part II - Item 8. Financial Statements and Supplementary Data - Note 4" in our 2015 Form 10-K and Note 4 in this Form 10-Q for additional details of the Offering Reorganization. Adjustments to transformation revenue and platform and operations revenue relate to purchase accounting adjustments which reflect the portion of the adjustment that would have been recognized in the respective period.

(3) Adjustments to cost of revenue include $0.4 million and $1.3 million in stock-based compensation expense for the three months ended June 30, 2016 and 2015, respectively. Stock-based compensation expense includes the value of equity awards granted to employees and non-employee directors of the Company or Evolent Health LLC.

(4) Adjustments to selling, general and administrative expenses include $4.3 million and $18.5 million in stock-based compensation expense for the three months ended June 30, 2016 and 2015, respectively. Stock-based compensation expense includes the value of equity awards granted to employees and non-employee directors of the Company or Evolent Health LLC. Adjustments also include transaction costs of $0.2 million and $2.8 million for the three months ended June 30, 2016 and 2015, respectively, resulting from acquisitions and business combinations and costs relating to our Offering Reorganization and IPO.

* The dollar and percentage changes over prior period based on GAAP results are not presented as the GAAP results of Evolent Health, Inc. for the three months ended June 30, 2015 do not reflect a complete view of the operational results for the period as described in “Evolent Health, Inc. Adjusted Results.”

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| | For the Six Months Ended June 30, 2016 | | | For the Six Months Ended June 30, 2015 | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | Add: | | | Evolent Health, Inc. as Adjusted Change Over Prior Period * | |
| (in thousands) | Evolent Health, Inc. as Reported | Adjustments | Evolent Health, Inc. as Adjusted | Evolent Health, Inc. as Reported | Evolent Health LLC Operations (1) | Adjustments | Evolent Health, Inc. as Adjusted | $ | % |
| Revenue | | | | | | | | | |
| Transformation (2) | $18,502 | $87 | $18,589 | $2,703 | $15,755 | $364 | $18,822 | $(233 ) | (1.2 )% |
| Platform and operations (2) | 87,465 | — | 87,465 | 7,711 | 46,059 | 911 | 54,681 | 32,784 | 60.0 % |
| Total revenue | 105,967 | 87 | 106,054 | 10,414 | 61,814 | 1,275 | 73,503 | 32,551 | 44.3 % |
| Expenses | | | | | | | | | |
| Cost of revenue (exclusive of depreciation and amortization presented separately below) (3) | 61,445 | (1,145 ) | 60,300 | 7,887 | 44,839 | (1,783 ) | 50,943 | 9,357 | 18.4 % |
| Selling, general and administrative expenses (4) | 65,115 | (8,825 ) | 56,290 | 13,082 | 58,457 | (29,884 ) | 41,655 | 14,635 | 35.1 % |
| Depreciation and amortization expenses | 6,983 | — | 6,983 | 984 | 2,637 | — | 3,621 | 3,362 | 92.8 % |
| Goodwill impairment (5) | 160,600 | (160,600 ) | — | — | — | — | — | — | N/A |
| Total operating expenses | 294,143 | (170,570 ) | 123,573 | 21,953 | 105,933 | (31,667 ) | 96,219 | 27,354 | 28.4 % |
| Operating income (loss) | $(188,176) | $170,657 | $(17,519) | $(11,539) | $(44,119) | $32,942 | $(22,716) | $5,197 | 22.9 % |
| | | | | | | | | | |
| Transformation revenue as a % of total revenue | 17.5 % | | 17.5 % | 26.0 % | | | 25.6 % | | |
| Platform and operations revenue as a % of total revenue | 82.5 % | | 82.5 % | 74.0 % | | | 74.4 % | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Cost of revenue as a % of total revenue | 58.0 | % | 56.9 | % | 75.7 | % | 69.3 | % |
| Selling, general and administrative expenses as a % of total revenue | 61.4 | % | 53.1 | % | 125.6 | % | 56.7 | % |

(1) Represents the operational results of Evolent Health LLC for the period January 1, 2015, through June 3, 2015.

(2) As part of the Offering Reorganization and as a result of gaining control of Evolent Health LLC, we recorded the fair value of deferred revenue resulting in a $4.9 million reduction to the book value. See "Part II - Item 8. Financial Statements and Supplementary Data - Note 4" in our 2015 Form 10-K and Note 4 in this Form 10-Q for additional details of the Offering Reorganization. Adjustments to transformation revenue and platform and operations revenue relate to purchase accounting adjustments which reflect the portion of the adjustment that would have been recognized in the respective period.

(3) Adjustments to cost of revenue include $0.9 million and $1.8 million in stock-based compensation expense for the six months ended June 30, 2016 and 2015, respectively. Stock-based compensation expense includes the value of equity awards granted to employees and non-employee directors of the Company or Evolent Health LLC.

(4) Adjustments to selling, general and administrative expenses include $8.6 million and $26.1 million in stock-based compensation expense for the six months ended June 30, 2016 and 2015, respectively. Stock-based compensation expense includes the value of equity awards granted to employees and non-employee directors of the Company or Evolent Health LLC. Adjustments also include transaction costs of $0.2 million and $3.8 million for the six months ended June 30, 2016 and 2015, respectively, resulting from acquisitions and business combinations and costs relating to our Offering Reorganization and IPO.

(5) The adjustment represents a write down of goodwill as described in "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates."

* The dollar and percentage changes over prior period based on GAAP results are not presented as the GAAP results of Evolent Health, Inc. for the three months ended June 30, 2015 do

not reflect a complete view of the operational results for the period as described in “Evolent Health, Inc. Adjusted Results.”

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Comparison of the Adjusted Results of the Three Months Ended June 30, 2016 to 2015

Adjusted Revenue

Adjusted Revenue increased by $20.1 million or 55.0%, to $56.5 million for three months ended June 30, 2016, as compared to the same period in 2015.

Adjusted Transformation Revenue accounted for 18.4% and 23.2% of our total Adjusted Revenue for the three months ended June 30, 2016 and 2015, respectively. Adjusted Transformation Revenue increased by $1.9 million, or 23.0%, for the three months ended June 30, 2016, as compared to the same period in 2015, due primarily to the timing of work being performed on existing contracts and timing of new contracts executed with new and existing partners. Over time, we expect Adjusted Transformation Revenue to decrease as a percentage of total Adjusted Revenue as we expect Adjusted Transformation Revenue to be relatively stable as we seek to add a similar number of partners each year combined with the higher growth we are experiencing in our platform and operations revenues.

Adjusted Platform and Operations Revenue increased by $18.1 million, or 64.7%, for the three months ended June 30, 2016, as compared to the same period in 2015, primarily as a result of enrollment growth of 134.8% from approximately 0.6 million lives on our platform as of June 30, 2015, to approximately 1.4 million lives on our platform as of June 30, 2016. We ended the quarter with thirteen partners in the platform and operations phase as compared to ten as of June 30, 2015.

Adjusted Cost of Revenue

Adjusted Cost of Revenue increased $7.2 million to $32.1 million, or 56.9% of Adjusted Revenue, for the three months ended June 30, 2016, as compared to $24.9 million, or 68.4% of Adjusted Revenue, for the same period in 2015. The increase in our Adjusted Cost of Revenue period over period was due primarily to additional personnel costs, professional fees and TPA fees of $2.5 million, $2.5 million and $1.3 million, respectively, to support our growing customer base and service offerings. Additional increases of $0.8 million in costs to support of our growth period over period were due to recruitment, retention and other general costs. Our Adjusted Cost of Revenue decreased as a percentage of our total Adjusted Revenue period over period due primarily to scale economics with our existing clients. We expect this trend to continue over the long term.

Adjusted Selling, General and Administrative Expenses

Adjusted Selling, General and Administrative Expenses increased $6.5 million, or 29.8%, to $28.3 million, or 50.0% of Adjusted Revenue, for the three months ended June 30, 2016, as compared to $21.8 million, or 59.7% of Adjusted Revenue, for the three months ended June 30, 2015. The increase in our Adjusted Selling, General and Administrative Expenses period over period was due primarily to additional personnel costs, including investments in business development, research and development and general overhead of $5.1 million. Additionally, our professional fees, rental costs and insurance costs related to our growth increased $0.8 million, $0.3 million and $0.2 million, respectively period over period. While our selling, general and administrative expenses are expected to grow as our business grows, we expect them to decrease as a percentage of our total revenue over the long term.

Adjusted Depreciation and Amortization Expenses

Adjusted Depreciation and Amortization Expenses increased $1.5 million or 68.9%, to $3.6 million for the three months ended June 30, 2016, as compared to $2.1 million in the same period in 2015. The increase in Adjusted Depreciation and Amortization Expenses was due primarily to the amortization of the intangible assets recorded as a result of the Offering Reorganization in 2015 and the transactions closed in the first quarter of 2016. We expect depreciation and amortization expenses to increase in future periods as we continue to capitalize internal-use software.

Comparison of the Adjusted Results of the Six Months Ended June 30, 2016 to 2015

Adjusted Revenue

Adjusted Revenue increased by $32.6 million or 44.3%, to $106.1 million for the six months ended June 30, 2016, as compared to the same period in 2015.

Adjusted Transformation Revenue accounted for 17.5% and 25.6% of our total Adjusted Revenue for the six months ended June 30, 2016 and 2015, respectively. Adjusted Transformation Revenue decreased $0.2 million, or 1.2%, for the six months ended June 30, 2016, as compared to the same period in 2015, due primarily to the timing of work being performed on existing contracts and timing of new contracts executed with new and existing partners. Over time, we expect Adjusted Transformation Revenue to decrease as a percentage of total Adjusted Revenue as we expect Adjusted Transformation Revenue to be relatively stable as we seek to add a similar number of partners each year combined with the higher growth we are experiencing in our platform and operations revenues.

Adjusted Platform and Operations Revenue increased by $32.8 million, or 60.0%, for the six months ended June 30, 2016, as compared to the same period in 2015, primarily as a result of enrollment growth of 134.8% from approximately 0.6 million lives on our platform as of June 30, 2015, to approximately 1.4 million lives on our platform as of June 30, 2016.

Adjusted Cost of Revenue

Adjusted Cost of Revenue increased $9.4 million to $60.3 million, or 56.9% of Adjusted Revenue, for the six months ended June 30, 2016, as compared to $50.9 million, or 69.3% of Adjusted Revenue, for the same period in 2015. The increase in our Adjusted Cost of Revenue period over period was due primarily to additional personnel costs, professional fees and other general costs of $4.6 million, $2.9 million and $1.7 million, respectively, to support our growing customer base and service offerings. Our Adjusted Cost of Revenue decreased as a percentage of our total Adjusted Revenue in 2016 due primarily to scale economics with our existing clients. We expect this trend to continue over the long term.

Adjusted Selling, General and Administrative Expenses

Adjusted Selling, General and Administrative Expenses increased $14.6 million, or 35.1%, to $56.3 million, or 53.1% of Adjusted Revenue, for the six months ended June 30, 2016, as compared to $41.7 million, or 56.7% of Adjusted Revenue, for the six months ended June 30, 2015. The increase in our Adjusted Selling, General and Administrative Expenses period over period was due primarily to additional personnel costs, including investments in business development, research and development and general overhead of $10.6 million. Additionally, our professional fees, technology service costs, rental costs, insurance costs and other costs related to our growth increased $1.3 million, $1.0 million, $0.7 million, $0.5 million and $0.5 million, respectively, period over period. While our selling, general and administrative expenses are expected to grow as our business grows, we expect them to decrease as a percentage of our total revenue over the long term.

Adjusted Depreciation and Amortization Expenses

Adjusted Depreciation and Amortization Expenses increased $3.4 million to $7.0 million for the six months ended June 30, 2016, as compared to $3.6 million in the same period in 2015. The increase in Adjusted Depreciation and Amortization Expenses was due primarily to the amortization of the intangible assets recorded as a result of the Offering Reorganization in 2015 and the transactions closed in the first quarter of 2016. We expect depreciation and amortization expenses to increase in future periods as we continue to capitalize internal-use software.

REVIEW OF CONSOLIDATED FINANCIAL CONDITION

Liquidity and Capital Resources

Since its inception, the Company has incurred operating losses and net cash outflows from operations. The Company incurred operating losses of $12.6 million and $188.2 million for the three and six months ended June 30, 2016, respectively, and operating losses of $11.5 million for the three and six months ended June 30, 2015. Net cash used in operating activities was $21.9 million and $5.8 million for the six months ended June 30, 2016 and 2015, respectively. As of June 30, 2016, the Company had $105.1 million of cash and cash equivalents.

We believe our current cash, short-term investments and other sources of liquidity will be sufficient to meet our working capital and capital expenditure requirements for the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our sales and marketing activities and the timing and extent of our spending to support our investment efforts and expansion into other markets. We may also seek to invest in, or acquire complementary businesses, applications or technologies.

Cash and Cash Equivalents, Restricted Cash and Investments

As of June 30, 2016, the Company had $105.1 million of cash and cash equivalents, $3.8 million in restricted cash and $51.8 million of investments.

Cash Flows

We did not have cash flows from operating, investing or financing activities prior to the Offering Reorganization on June 4, 2015.

Operating Activities

Cash flows used in operating activities of $21.9 million for the six months ended June 30, 2016, were due primarily to our net loss of $186.3 million, offset by non-cash items including goodwill impairment of $160.6 million. Our operating cash outflows were also driven by the timing of customer and vendor payments, including the timing of payments related to PBM services, partially offset by an increase in deferred revenue during the period.

Cash flows used in operating activities of $5.8 million for the six months ended June 30, 2015, were due primarily to the Company's net income of $345.2 million, along with the addition of certain non-cash items, such as loss from affiliates of $28.2 million, and a change in our deferred tax provision of $29.3 million. These amounts were offset by the non-cash gain from the Offering Reorganization of $414.1 million.

Investing Activities

Cash flows used in investing activities of $18.5 million for the six months ended June 30, 2016, were due primarily to $11.5 million used in the acquisition of Vestica, as described in Note 4 in "Item 1. Financial Statements," and $3.0 million used to acquire an equity investment in GPAC as described in Note 12 in "Item 1. Financial Statements." Purchases of property and equipment resulted in a further cash outflow of $7.3 million, which was partially offset by the maturity of securities in the amount of $2.1 million and a $1.2 million reduction in restricted cash due to an amendment to our line of credit.

Cash flows provided by investing activities of $16.1 million for the six months ended June 30, 2015, were due primarily to proceeds received from the consolidation of Evolent Health LLC of approximately $13.1 million and maturities and sales of investments of $4.0 million. These amounts were offset by purchases of property and equipment in the amount of $1.0 million during the period.

Financing Activities

Cash flows used by financing activities of approximately $0.2 million for the six months ended June 30, 2016, were primarily related to proceeds from stock option exercises during the quarter, offset by taxes withheld for restricted stock vests.

Cash flows provided by financing activities of $209.1 million for the six months ended June 30, 2015, were primarily attributable to proceeds from the initial public offering, net of related offering costs.

Contractual Obligations

Our contractual obligations (in thousands) as of June 30, 2016, were as follows:

| | Less Than 1 Year | 1 to 3 Years | 3 to 5 Years | Total |
|---|---|---|---|---|
| Operating leases for facilities | $3,294 | $6,837 | $5,363 | $15,494 |
| Purchase obligations | 2,928 | 1,170 | — | 4,098 |
| Total | $6,222 | $8,007 | $5,363 | $19,592 |

During the six months ended June 30, 2016, there were no material changes outside the ordinary course of business in the contractual obligations set forth above.

Restricted Cash and Letters of Credit

Restricted cash of $3.8 million is carried at cost and includes $2.5 million in collateral for letters of credit required as security deposits for facility leases, $1.2 million in pharmacy benefit management services and $0.1 million in other restricted balances as of June 30, 2016.

Uses of Capital

Our principal uses of cash are in the operation and expansion of our business and the pursuit of strategic acquisitions. The Company does not have any outstanding debt and does not anticipate paying a cash dividend on our Class A common stock in the foreseeable future.

OTHER MATTERS

Off-balance Sheet Arrangements

Through June 30, 2016, the Company had not entered into any off-balance sheet arrangements, other than the operating leases noted above, or had any holdings in variable interest entities.

Related Party Transactions

In the ordinary course of business, we enter into transactions with related parties, including our partners and our existing investors, TPG, UPMC and The Advisory Board. Information regarding transactions and amounts with related parties is discussed in Note 15 in our notes to consolidated financial statements included in "Item 1. Financial Statements" as well as under the heading "Certain Relationships and Related Party Transactions" in our proxy statement on Schedule 14A filed with the SEC on April 28, 2016.

Other Factors Affecting Our Business

In general, our business is subject to a changing social, economic, legal, legislative and regulatory environment. Although the eventual effect on us of the changing environment in which we operate remains uncertain, these factors and others could have a material effect on our results of operations, liquidity and capital resources. Factors that could cause actual results to differ materially from those set forth in this section are described in "Part I - Item 1A. Risk Factors" in our 2015 Form 10-K and "Forward-Looking Statements – Cautionary Language" above.

Recent Accounting Pronouncements

See Note 3 in our notes to consolidated financial statements included in "Item 1. Financial Statements" for a discussion of recent accounting pronouncements that have been implemented during the periods presented or that have been issued and are to be implemented in the future.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risks in the ordinary course of our business. Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates.

Interest Rate Risk

As of June 30, 2016, cash and cash equivalents and restricted cash was $108.9 million, which consisted of bank deposits with FDIC participating banks of $25.5 million and cash equivalents deposited in a money-market fund of $83.4 million. Additionally, as of June 30, 2016, we held $51.8 million in investments. The cash on deposit with banks is not susceptible to interest rate risk. Our investments are classified as held-to-maturity and therefore are not subject to interest rate risk.

As of June 30, 2016, the Company did not have any indebtedness. We do not enter into investments for trading or speculative purposes and have not used any derivative financial instruments to manage our interest rate risk exposure.

Inflation Risk

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

Equity Market Risk

We have exposure to equity market risk related to the potential exchange of our Class B common shares. Pursuant to and subject to the terms of an exchange agreement and the third amended and restated LLC agreement of Evolent Health LLC, holders of our Class B common shares may at any time and from time to time exchange their Class B common shares, together with an equal number of Class B common units of Evolent Health LLC, for shares of our Class A common stock on a one-to-one basis. A decision to exchange these shares may be, in part, driven by equity market conditions and, more specifically, the price of our Class A common stock. An exchange of our Class B common shares would:

- Increase our ownership in our consolidated operating subsidiary, Evolent Health LLC. See "Item 1. Financial Statements - Note 4” for additional information;

- Increase the number of outstanding shares of our Class A common shares. See “Item 1. Financial Statements - Note 9” for information relating to potentially dilutive securities and the impact on our historical earnings per share; and
- Increase our tax basis in our share of Evolent Health LLC’s tangible and intangible assets and possibly subject us to payments under the TRA agreement. See “Part II - Item 8. Financial Statements and Supplementary Data - Note 11” in our 2015 Form 10-K for further information on tax matters related to the exchange of Class B common shares.

## Item 4. Controls and Procedures

### Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act")), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, and in light of the material weakness in the design and operation of our internal control over financial reporting relating to our financial statement close process as disclosed in our 2015 Form 10-K, our principal executive officer and principal financial officer have concluded that, as of June 30, 2016, our disclosure controls and procedures were not effective. The company has continued to take steps to address the underlying causes of the material weakness as described further in “Remediation Efforts to Address Material Weakness in Internal Control over Financial Reporting” below. As a result of the remediation taken to date, and the implementation of certain other substantive and analytical review procedures as of and for the three and six months ended June 30, 2016, we believe that the consolidated financial statements included in this Quarterly Report on Form 10-Q fairly state, in all material respects, our financial position, results of operations and cash flows for the periods presented.

### Remediation Efforts to Address Material Weakness in Internal Control over Financial Reporting

The material weakness that we identified resulted from an insufficient complement of resources with an appropriate level of accounting knowledge, experience and training to address accounting for complex, non-routine transactions. We are currently in the process of remediating the material weakness and have taken and continue to take steps that we believe will address the underlying causes of the material weakness, primarily by hiring additional accounting and finance personnel with technical accounting and financial reporting experience, enhancing our training programs within our accounting and finance department, enhancing our internal review procedures during the financial statement close process and implementing an improved control environment. During the preparation of this quarterly report, our management has implemented certain additional substantive and analytical review procedures to ensure that information required to be disclosed by us in this report is recorded, processed, summarized and reported, within the time periods specified in the Commission’s rules and forms.

### Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting, other than those disclosed under “Remediation Efforts to Address Material Weakness in Internal Control over Financial Reporting” above, during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### Inherent Limitations of Internal Controls

Our management, including our Principal Executive Officer and Principal Financial Offer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error 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. 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, within the 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 a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. 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, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

Information regarding reportable legal proceedings is contained in Note 8 in "Part I – Item 1. Financial Statements."

Item 1A. Risk Factors

Part I, Item 1A. "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2015 includes a discussion of our risk factors. The information presented below updates, and should be read in conjunction with, the risk factors and information disclosed in our Form 10-K. Except as presented below, there have been no material changes from the risk factors described in our Form 10-K.

We may make acquisitions, investments and alliances, including the pending acquisition of Valence Health, which may be difficult to integrate, divert management resources, result in unanticipated costs or dilute our stockholders.

Part of our business strategy is to acquire or invest in companies, products or technologies that complement our current products and services, enhance our market coverage or technical capabilities or offer growth opportunities. As an example, in February 2016 we entered into a strategic alliance with a leading nonprofit community-based and provider-sponsored health plan administering Kentucky Medicaid and federal Medicare Advantage benefits. More recently, on July 12, 2016, we entered into an agreement to acquire the majority of Valence Health Inc.'s business, subject to closing conditions including regulatory approvals, the timing or certainty of which cannot be predicted. We cannot assure you that the transaction will close on a timely basis or at all.

The pending acquisition of Valence Health, as well as future acquisitions, investments and alliances could pose numerous risks to our operations, including:

- difficulty integrating the purchased operations, products or technologies;
- substantial unanticipated integration costs, delays and challenges that may arise in integration;
- assimilation of the acquired businesses, which may divert significant management attention and financial resources from our other operations and could disrupt our ongoing business;
- the loss of key employees, particularly those of the acquired operations;
- difficulty retaining or developing the acquired business' customers;
- adverse effects on our existing business relationships with customers, suppliers, other partners, standing with regulators;
- challenges related to the integration of businesses that operate in new geographic areas and new markets;
- failure to realize the potential cost savings or other financial benefits or the strategic benefits of the acquisitions, including failure to consummate the Valence Health acquisition or any other proposed or contemplated transaction;
- liabilities from the acquired businesses for infringement of intellectual property rights, data privacy violations or other claims and failure to obtain indemnification for such liabilities or claims.

We may be unable to complete acquisitions or integrate the operations, products or personnel gained through the pending Valence Health acquisition or any other such transaction without a material adverse effect on our business, financial condition and results of operations. Transaction agreements may impose limitations on our ability, or as is the case in the pending Valence Health acquisition, the ability of the business to be acquired, to conduct business. Events outside our control, including operating changes or regulatory changes, could also adversely affect our ability to realize anticipated revenues, synergies, benefits and cost savings. In addition, revenues of Valence Health prior to and after consummation of the acquisition may be less than expected. Any integration may be unpredictable, or subject to delays or changed circumstances, and we and any targets may not perform in accordance with our expectations.

In connection with these acquisitions, investments or alliances, we could incur significant costs, debt, amortization expenses related to intangible assets or large and immediate write-offs or other impairments or charges, assume liabilities or issue stock that would dilute our current stockholders' ownership. For example, upon consummation of the Valence Health acquisition, as part of the closing consideration we expect to issue from 5.3 million to 5.8 million shares of the Company's Class A common stock, with up to 3.9 million additional shares of Class A common stock potentially payable in an earn-out. In addition, the market price for our Class A common stock could be affected, following the consummation of the Valence Health acquisition or any other transaction, by factors that have not historically affected the market price for our Class A common stock.

The growth of our business relies, in part, on the growth and success of our partners and certain revenues from our engagements, which are difficult to predict and are subject to factors outside of our control.

We enter into agreements with our partners under which a significant portion of our fees are variable, including fees which are dependent upon the number of members that are covered by our partner's healthcare plan each month, expansion of our partners and the services that we provide, as well as performance-based metrics. The number of members covered by a partner's healthcare plan is often impacted by factors outside of our control, such as the actions of our partner or third parties. Accordingly, revenue under these agreements is unpredictable. If the number of members covered by one or more of our partner's plans were to be reduced by a material amount, such decrease would lead to a decrease in our revenue, which could harm our business, financial condition and results of operations. In addition, growth forecasts of our partners are subject to significant uncertainty and are based on assumptions and estimates that may prove to be inaccurate. Even if the markets in which our partners compete meet the size estimates and growth forecasted, their health plan membership could fail to grow at similar rates, if at all. In addition, a portion of the revenue under certain of our long-term contracts is tied to the customer's continued participation in specified payer programs over which we have no control. If the customer ceases to participate in any such program, such decision would lead to a decrease in our expected revenue under the relevant contract.

In addition, the transition to value-based care may be challenging for our partners. For example, fully capitated provider risk arrangements have had a history of financial challenges for providers. Our partners may also have difficulty in value-based care if premium pricing is under pressure. Furthermore, revenue under our partner contracts may differ from our projections because of the termination of the contract for cause or at specified life cycle events, or because of fee reductions that are occasionally given after the contract is initially signed.

Our partners derive a substantial portion of their revenue from third-party private and governmental payers, including, in the case of Passport, Medicaid. Revenue under certain of our agreements, including our agreement with Passport, could be negatively impacted as a result of governmental funding reductions impacting government sponsored programs, changes in reimbursement rates, and premium pricing reductions, as well as the inability of our partners to control and, if necessary, reduce health care costs, all of which are out of our control. Because certain of our partners' revenues are highly reliant on third-party payor reimbursement funding rates and mechanisms, overall reductions of rates from such payors could adversely impact the liquidity of our partners, resulting in their inability to make payments to us on agreed payment terms.

We have recorded a significant amount of goodwill, and we may never realize the full value of our intangible assets, causing us to record impairments that may negatively affect our results of operations.

Our total assets include substantial goodwill. At June 30, 2016, we had $448.3 million of goodwill on our Consolidated Balance Sheet associated with the Offering Reorganization. Goodwill represents the excess of the purchase price, plus the fair value of any non-controlling interests in the acquiree, over the fair value of identifiable net assets acquired. Goodwill is not amortized, but is reviewed at least annually for indications of impairment, with consideration given to financial performance and other relevant factors. In the first quarter of 2016, we recorded an impairment charge of $160.6 million on our Consolidated Statements of Operations.

While our annual goodwill impairment test is conducted at October 31, we have processes to monitor for interim triggering events. Under GAAP, we review our goodwill for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Factors that may be considered a change in circumstances indicating that the carrying value of our goodwill may not be recoverable include macroeconomic conditions, industry and market considerations, our overall financial performance including an analysis of our current and projected cash flows, revenue and earnings, a sustained decrease in our share price and other relevant entity-specific events including changes in strategy, customers or litigation.

Subsequent to our 2015 annual impairment testing in the fourth quarter of 2015, our common stock price declined significantly, reaching our historic low in the first quarter of 2016. During the three months ended March 31, 2016, our common stock traded between $8.48 and $12.32, or an average common stock price of $10.33 compared to an average common stock price of $19.51 and $14.73 during the three month periods ended September 30, 2015, and December 31, 2015, respectively. A sustained decline in our common stock price and the resulting impact on our market capitalization is one of several qualitative factors we consider each quarter when evaluating whether events or changes in circumstances indicate it is more likely than not that a potential goodwill impairment exists. We concluded that the further decline in common stock price observed during the first quarter of 2016 did represent a sustained decline and that triggering events occurred during this period requiring an interim goodwill impairment test as of March 31, 2016, ultimately resulting in an impairment charge of $160.6 million. A detailed discussion of our impairment testing is included in “Part II - Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies”.

We may be required to recognize additional impairments in the future as a result of market conditions or other factors related to our performance, including changes in our forecasted results, investment strategy or interest rates. Any further impairment charges that we may record in the future could be material to our results of operations.

If a substantial number of shares become available for sale and are sold in a short period of time, the market price of our Class A common stock could decline.

If our existing stockholders sell substantial amounts of our Class A common stock in the public market, the market price of our Class A common stock could decrease significantly. The perception in the public market that our existing stockholders might sell shares of Class A common stock could also depress our market price. As of August 5, 2016, there were 42,685,401 shares of Class A common stock outstanding. In addition, approximately 2.7 million options that are held by our employees are currently exercisable or will be exercisable in 2016. Certain of our executive officers, directors and employees are subject to the holding period requirements of Rule 144. After the holding periods have elapsed and, in the case of restricted stock, after the shares have vested, additional shares will be eligible for sale in the public market. The market price of shares of our Class A common stock may drop significantly when the restrictions on resale by our existing stockholders lapse.

In connection with the pending acquisition of Valence Health, we expect to issue 5.3 million to 5.8 million shares of our Class A common stock upon consummation of the acquisition and up to 3.9 million shares of Class A common stock may be issued under an earn-out in transaction exempt from registration under the Securities Act. See “Part I - Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Business Overview” for additional information. The market price of shares of our Class A common stock may drop significantly as a result of the consummation of the acquisition.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

The exhibits included in this report are listed in the Exhibit Index beginning on page E-1, which is incorporated herein by reference.

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Signatures

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

| | |
|---|---|
| By: | /s/ Nicholas McGrane |
| Name: | Nicholas McGrane |
| Title: | Chief Financial Officer |

| | |
|---|---|
| By: | /s/ Lydia Stone |
| Name: | Lydia Stone |
| Title: | Principal Accounting Officer and Controller |

Dated: August 9, 2016

EVOLENT HEALTH, INC.
Exhibit Index for the Report on Form 10-Q
For the Quarter Ended June 30, 2016

| | | |
|---|---|---|
| 2.1 | * | Agreement and Plan of Merger, dated July 12, 2016, by and among Evolent Health, Inc., Electra Merger Sub, LLC, Valence Health, Inc. and North Bridge Growth Management Company LLC and Philip Kamp, in their capacity as securityholders' representative, filed as Exhibit 2.1 to the Company's Report on Form 8-K filed with the SEC on July 14, 2016, and incorporated herein by reference |
| 3.1 | | Amended and Restated Certificate of Incorporation of Evolent Health, Inc., filed as Exhibit 3.1 to the Company's Report on Form 8-K with the SEC on June 15, 2016, and incorporated herein by reference |
| 3.2 | | Amended and Restated By-laws of Evolent Health, Inc., filed as Exhibit 3.1 to the Report on Form 8-K filed with the SEC on May 6, 2016, and incorporated herein by reference |
| 31.1 | | Certification of the Chief Executive Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | | Certification of the Chief Financial Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 99.1 | | Unaudited Pro Forma Combined Financial Information of Evolent Health, Inc. for the Year Ended December 31, 2015 |
| 101.INS | | XBRL Instance Document |
| 101.SCH | | XBRL Taxonomy Extension Schema Document |
| 101.CAL | | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB | | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF | | XBRL Taxonomy Extension Definition Linkbase Document |

* The Company agrees to furnish supplementally to the SEC a copy of any omitted schedule or exhibit upon the request of the SEC in accordance with Item 601(b)(2) of Regulation S-K

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