

SKULLCANDY, INC.

FORM 10-K (Annual Report)

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Address	1441 West Ute Blvd SUITE 250 park City, UT 84098
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Industry	Audio & Video Equipment
Sector	Consumer Cyclical

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-K

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2015**

or

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

For the transition period from _____ **to** _____

Commission file number 001-35240

SKULLCANDY, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or Other Jurisdiction of
Incorporation or Organization)

1441 West Ute Boulevard, Suite 250
Park City, Utah

(Address of principal executive offices)

56-2362196

(I.R.S. Employer
Identification Number)

84098

(Zip Code)

**Registrant's telephone number, including area code: (435) 940-1545
Securities registered pursuant to Section 12(b) of the Act:**

Title of Class

Common Stock, \$0.0001 par value per share

Name of Exchange on which registered

The NASDAQ Global Market

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. Yes 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. Yes 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. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

As of June 30, 2015, the last business day of the registrant's most recently completed second quarter, the aggregate value of the registrant's common stock held by non-affiliates was approximately \$166,613,792.

As of February 29, 2016, there were 28,548,378 shares of the registrant's common stock, par value \$0.0001, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Annual Meeting of Shareholders to be held May 18, 2016 are incorporated by reference into Part III of this Annual Report on Form 10-K where indicated.

SKULLCANDY, INC.
ANNUAL REPORT ON FORM 10-K
For Fiscal Year Ended December 31, 2015

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PART I

Item 1. Business



This annual report contains forward-looking statements. The words “may,” “will,” “plan,” “believe,” “expect,” “anticipate,” “intend,” “estimate” and other expressions that are predictions of or indicate future events and trends and that do not relate to historical matters identify forward-looking statements. Although forward-looking statements reflect our current views, reliance should not be placed on forward-looking statements because they involve known and unknown risks, uncertainties and other factors, which may cause the actual results, performance or achievements to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. Forward-looking statements speak only as of the date the statements are made. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events, changed circumstances or otherwise. These forward-looking statements are subject to numerous risks and uncertainties, including the risks and uncertainties described under “Risk Factors” in Item 1A of this Annual Report on Form 10-K for the year ended December 31, 2014, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and elsewhere in this annual report. Moreover, we operate in an evolving environment. New risk factors and uncertainties emerge from time to time and it is not possible for our management to predict all risk factors and uncertainties, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors may cause actual results to differ materially from those contained in any forward-looking statement. Therefore we qualify all of our forward-looking statements by these cautionary statements.

Overview

Skullcandy, Inc. creates world-class audio experiences through its Skullcandy® and Astro Gaming® brands. Founded at the intersection of music, sports, technology and creative culture, Skullcandy brand creates world-class audio and gaming products for the risk takers, innovators, and pioneers who inspire us all to live life at full volume. From new innovations in the science of sound and human potential, to collaborations with up-and-coming musicians and athletes, Skullcandy lives by its mission to inspire life at full volume through forward-thinking technologies and ideas, and leading edge design and materialization. Astro Gaming creates premium video gaming equipment for professional gamers, leagues, and gaming enthusiasts. Astro Gaming was founded in the pits of competitive gaming and has become synonymous with pinnacle gaming experiences. Skullcandy and Astro Gaming products are sold and distributed through a variety of channels around the world from the Company’s global locations in Park City, San Francisco, London, Tokyo, Zurich, Mexico City, and Shanghai, as well as through partners in some of the most important culture, sports, and gaming hubs in the world. The Skullcandy brand website can be found at <http://www.skullcandy.com>. The Astro Gaming website can be found at <http://www.astrogaming.com>.

We were incorporated in Delaware in 2003. Our principal executive offices are located at 1441 West Ute Boulevard, Suite 250, Park City, Utah 84098, and our telephone number is (435) 940-1545. Our principal website address is www.skullcandy.com. Information contained on our website does not constitute part of, and is not incorporated by reference into, this report.

Corporate Information

This annual report on Form 10-K contains references to our trademarks Skullcandy® and Astro Gaming®. All other trademarks or trade names referred to in this annual report are the property of their respective owners.

Our Competitive Strengths

We believe the following strengths differentiate us from our competitors.

Leading, Authentic Lifestyle Brand

Skullcandy fuses music, art, fashion and sports, all of which permeate youth culture, into our products. The Skullcandy brand symbolizes a fun, young and irreverent lifestyle combined with creativity for an active consumer. Astro Gaming lives at the epicenter of technology, lifestyle and design in the video gaming arena.

Brand Authenticity Reinforced Through High Impact Ambassadors

Skullcandy was one of the first headphone brands to work with leading athletes, DJs, musicians, artists and events within sports and the indie and hip-hop music genres. We partner with leading athletes such as NBA all-star Kyrie Irving, three-time world champion surfer Mick Fanning, legendary snowboarder Travis Rice, X-Games gold medalists Mark McMorris and Silje Norendal, international skateboarders Eric Koston and Sean Malto as well as NFL great Stevie Johnson and numerous other musicians, athletes and youth culture influencers. Astro Gaming is the leader in premium gaming audio and partners with industry influencers such as Naded, TmarTn, Scuf Gaming and Redbull eSports. These ambassadors and partners embody our brands and also provide us with trend and product ideas.

Track Record of Innovation

Skullcandy was founded on innovation and we have significant product and innovation capabilities with our in-house product development and advanced concepts engineering team, or ACE. Skullcandy's leading proprietary innovations include the following: Crusher technology which recreates the experience of feeling soundwaves at a live concert, and being more immersed through tactile vibrations in all forms of entertainment such as television, movies and gaming; Sticky Gel and Fix technologies, which provide ultra-secure fit and comfort designed so earbuds "never fall out"; and Off-Axis technology, which provides for enhanced sound quality and fit. We focus on disruptive innovations that change how our constantly connected influencer consumer experiences audio entertainment. We have also engineered and incorporated Skullcandy Supreme Sound, our proprietary and patent-pending audio profile, into our product designs. Astro Gaming developed the TR series A40 headset and mixamp. The headset ships as an open backed audio system with cloth ear cushions, open audio speaker tags and a uni-directional mic. For a closed backed, noise isolated system, we sell a TR A40 MOD kit that comes with leather ear cushions, silicone overmolded tags that seal the headset audio ports and a bi-directional microphone that cancels out background noise. While the Mixamp ships specifically tuned for an open audio system, it also supports a closed back audio configuration with downloadable profiles that can be installed through our Audio Command Center software. All of these components together are specifically designed and turned to improve the sport of gaming across multiple gaming platforms such as Xbox, PlayStation, PC's and Mac's.

In recent years we have increased employee headcount and spend towards research and innovation. We have over 80 issued patents, with many others pending, and one-third of our workforce is dedicated to research, innovation or product development.

Targeted Distribution Model

We control the distribution and mix of our products to protect our brands and their authenticity. We pioneered the distribution of headphones in specialty retailers focused on action sports, youth lifestyle, and gaming. Building on this foundation, we have successfully expanded our distribution to leading consumer electronics, sporting goods, mobile phone and big-box retailers.

Proven Management Team and Deep-Rooted Company Culture

We have assembled a proven and talented management team that is led by Hoby Darling, our President and Chief Executive Officer, who joined the Company in March 2013 and brings deep brand, product and distribution expertise having previously worked with leading brands including Nike, Converse and Volcom. Our management team shares a passion for youth culture, and possesses substantial experience in product development, marketing, merchandising, digital operations and finance. Our culture and brand image enable us to successfully attract and retain highly talented employees who share our passion for innovation, creativity, sports and youth culture.

Financial Information About Segments and Geographic Regions

We manage our business in two operating segments which are comprised of Domestic and International. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the Chief Operating Decision Makers, deciding how to allocate resources and in assessing performance. Our operating segments and reporting segments are the same. The Domestic segment primarily consists of Skullcandy and Astro Gaming product sales to customers in the United States. The Domestic segment also includes the majority of general corporate overhead and related costs which are not allocated to the International segment. The International segment primarily includes Skullcandy and Astro product sales to customers in Europe, Asia, Canada, Mexico, and all other geographic areas outside the United States that are served by our International operations. We operate exclusively in the consumer products category in which we develop and distribute headphones and other audio accessories. All intercompany revenues, expenses, payables and receivables are eliminated in consolidation and are generally not reviewed when evaluating segment performance. Each segment's performance is evaluated based on gross invoicing, net sales, gross profit and gross margin.

Our Products

Overview

We currently focus our product offerings in two overall categories: audio and gaming. We market products in each of these categories implementing a multi-brand, multi-product strategy that enables us to reach new consumers and enhance our products across various sales channels. Audio products represented approximately 77% of consolidated net sales and gaming headphones represented 23% of consolidated net sales for the year ended December 31, 2015 .

Audio

Our audio headphone product offerings have evolved from one product in 2003 to over 35 products as of December 31, 2015 , which include wireless headphones and speakers, sports performance, and women's offerings. Our audio headphone products represented the majority of our net sales in the year ended December 31, 2015 .

Gaming

Our gaming headphone products include products under the Astro Gaming brand and the Skullcandy Gaming brand. Astro Gaming markets high-performance and feature-rich products for dedicated gamers. The brand's flagship products, the A40 and A50, are premium wireless, Xbox One and PlayStation 4 compatible Dolby Headphone-enabled 7.1 surround sound gaming headsets that delivers a fully immersive gaming experience. The Skullcandy Gaming brand draws from our unique heritage to inject lifestyle and street culture into the world of gaming. We developed Skullcandy Gaming to offer a differentiated brand and product experience delivering high-performance gaming headsets developed by Astro Gaming at more accessible prices.

Product Design and Development

We are a company built on our passion for product and design innovation. Our success is tied to our ability to consistently deliver innovative and disruptive designs, products, features and benefits to our customers.

Our product design and development teams work closely with our music, gaming, sports and other ambassadors, the category management team and in-house team of engineers, designers and artists to plan, conceptualize, develop and commercialize our products. Our team is comprised of individuals intimately connected to the Skullcandy and Astro culture and lifestyle who incorporate their passion for the brand into their work.

We utilize innovative materials, technologies and processes in the design, development and manufacturing of our products. Our design team is continuously identifying and tracking trends in the market and with our ambassadors and influencers that are the most meaningful to a brand and product-performance conscious consumers. Our engineers and quality teams are dedicated to creating remarkable products that exceed our customers' expectations regarding acoustic and gaming performance, fit, comfort, durability and style. We utilize a field testing program along with our athletes, musicians, gamers and influencers to validate assumptions in our conceptualization and planning phases and also to validate our product performance during development.

Our product development team is capable of speed-to-market projects, strategic stage-gate engineering, and hybrid-vendor internally engineered processes for designing, validating and launching new products. By having our industrial design team in-house, working alongside our model and prototyping shop, and our mechanical, acoustic and electrical engineering teams, we are able to reduce the concept-to-market timeline while enhancing our quality, innovation and performance. Our in-house industrial design, engineering, advanced concept engineering and reliability testing teams enable designs to be rapidly created, prototyped and validated quickly before designs are released for commercialization.

Products are generally engineered in-house to our proprietary audio profiles through a collaborative and iterative process. Through our in-house engineering of the mechanical and acoustic components of our products we are not only able to balance performance, quality and cost, but optimize our products for elevated performance, quality, compatibility and margin.

We currently utilize third party contract manufacturers to facilitate the commercialization of our products from tooling through the sampling of products. Our internal reliability testing laboratory is used for mechanical, electrical, chemical, acoustic, transportation and environmental validation and we also utilize third party testing companies for reliability and compliance testing. We are able to closely monitor our production in our foreign vendors' facilities by utilizing our Shenzhen China office resources and local staff to support quality, delivery, capacity, and sourcing efforts.

We can typically bring new products from concept to market in approximately 8 to 18 months depending on the technology integration and complexity of the product. In situations where we are launching new products based on existing designs that do not require new tooling, we can accelerate the concept-to-market process to approximately 4 to 9 months.

Marketing

Our marketing department employs a multi-pronged marketing strategy that includes athletes, musicians, artists, gamers and influencer ambassadors, as well as a combination of interactive events and traditional advertising. Engaging in activities and marketing initiatives that are organic to our core consumer strengthens our brand authenticity and creates awareness for new consumers. Our brand authenticity is driven by the Skullcandy and Astro Gaming family of athletes, artists, gamers and trendsetters and as well as our ability to provide innovative, trend right product.

Our intention is to grow our brands globally, and we plan to maintain and build on our authenticity, create lasting partnerships and bring music, sport, technology, gaming, entertainment and youth culture deeper into our consumers' lifestyle. We believe that grassroots activation, cultural engagement and creative collaboration will continue to drive the growth of our brands.

Brand Ambassadors

We build relationships that run deeper than a traditional sponsorship agreement by seeking to create unique opportunities for each member of the "Skullcandy and Astro family." Our athletes, artists, musicians and trendsetters are ambassadors for our brand who live the values of our brand anthem and we incorporate them into the Skullcandy brand in a way that goes beyond traditional endorsements. High profile ambassadors include NBA Superstar Kyrie Irving, NFL great Stevie Johnson, as well as action sports stars Mark McMorris, Travis Rice, Robbie Maddison, Eric Koston, Sean Malto, Mick Fanning and Leila Hurst. Professional Gaming teams include Team EnVyUs who have seven CSGO Championship titles, 2 time X-Games Gold Medalists OpTic Gaming, as well YouTubers Naded, TmarTn and Scump.

We have a contractual relationship with many members of the Skullcandy and Astro Family. Our arrangements are designed to incentivize them to maintain a visible profile with our products, while engraining the ambassador in our culture and brand. Our contracts typically have a one to four-year term and grant us a license for the use of names and likenesses, and require the ambassador to maintain exclusive association within each of our product categories. Skullcandy and Astro ambassadors also give us access to their fans through social media, with posts, images, and mentions on YouTube, Twitter, Instagram and Facebook. Our sponsored ambassadors and Skullcandy and Astro family members wear our products during public appearances, in magazine shoots and on the podium after certain competitive victories.

In addition to the brand ambassadors listed above, we have informal relationships with athletes, gamers and artists around the world. These athletes and artists support our brand by wearing products and participating in events, social media, advertising, appearances and other marketing activities. We compensate these brand ambassadors with whom we do not have contractual relationships by providing them with complimentary merchandise and promoting them on our websites and social media platforms.

Event Sponsorship

We participate in grassroots and major events that support our commitment to our sports, e-sports and music cultures. Spectators and participants at these events are exposed to and experience our brand through an interactive environment that includes music listening stations, gaming headphone demos and promotional product giveaways.

Some events we have sponsored or activated with include the NBA All-Star weekend, Redbull film projects, Redbull eSports, Major League Gaming tournaments, the Sundance Film Festival, SXSW, The Neon Carnival at Coachella, Nike partnerships across basketball and skate and the X-Games.

Content Creation and Partnerships

Content Creation. We believe that advertising content is an efficient and effective way to reach our target audience. We publish custom videos each year on our Skullcandy and Astro Gaming YouTube channels. We also maintain an active presence on various social media sites, with an emphasis on YouTube, Instagram, Facebook, Kik and Twitter. Social media allows us to have a direct conversation with our consumers and publish our digital content. We also use social media to promote our events globally and extend the event's energy to those who were unable to attend. We also actively leverage the social media platforms of our athletes, gamers, artists and trendsetters.

Our in-house creative media team supports media placement into endemic channels that support the lifestyles that we believe are important to our target consumers. The content generated by the in-house team is distributed to and used globally to promote the Skullcandy and Astro brands in both print and in the digital space.

Strategic Brand Partnerships. To build on our own branding efforts, we seek to partner with like-minded brands on marketing opportunities. These include brands such as Nike, Adidas, Redbull, Scuf Gaming, Kontrol Freek, Toyota, Toshiba,

Microsoft and Electronic Arts. We believe these brand relationships create leverage and opportunities for us to tell the Skullcandy and Astro Gaming brand stories.

Interactive Media

Websites. Our websites include, *skullcandy.com*, *skullcandy.tv*, *ca.skullcandy.com*, *eu.skullcandy.com*, *uk.skullcandy.com*, *astrogaming.com*, *astrogaming.co.uk* and *astrogaming.fr*. These websites are part of our interactive media and e-commerce business strategy where visitors can view videos, listen to music by our sponsored artists, read blog updates on events, athletes, musicians and artists, and shop for Skullcandy and Astro Gaming products.

Social Media. We utilize social media, such as Instagram, Facebook, Kik and Twitter to enable a direct conversation and connection with our target consumers. We communicate local and national event participation, provide and solicit product feedback, launch brand contests and discuss news about our sponsored athletes, musicians and artists. Similarly, some of our sponsored athletes, musicians and artists use their respective Instagram, Facebook and Twitter accounts to provide endorsements of our products and engage our target consumers with insights as to how they use our products to enhance their sports, art, or lives.

Distribution and Sales

Domestic (U.S.). As we have grown our retailer base from independent retailers to large regional and national retailers, we have sought to protect and enhance our brands' images by carefully controlling the distribution of our products as well as the product mix we offer to each retailer.

Our specialty retailers include independent retailers focused on action sports, gaming and the youth lifestyle, as well as a number of national and regional retailers with an action sports, gaming or music orientation, such as Tilly's, GameStop, Journey's and Jack's Surfboards. These specialty retailers provide a direct connection to our consumer influencers and serve as the platform upon which we develop, reinforce and maintain our reputation that our brands have an authentic lifestyle.

We have a sales and distribution strategy intended to allow us to build relevant and exclusive products for our specialty retailers while giving us a runway to build demand creation and scale production before launching into large format retailers. This is designed to build the authenticity of our brands with our specialty retailers while creating a robust product pipeline for the future. Keeping our product mix specialized and focused on our consumer is the essence of our sales, marketing, and product strategy. We currently sell into a broad spectrum of retailers, including those focused on consumer electronics, such as Best Buy, those focused on sporting goods, such as Dick's Sporting Goods and large retailers, such as Wal-Mart, Target and Fred Meyer. We are selective about the national retail partners that we align with as well as with the product mix we offer to these retailers in order to reinforce our Skullcandy's brand positioning as the original performance lifestyle audio brand, Astro Gaming's brand positioning as the premium leader of gaming headphones that lives at the epicenter of technology, lifestyle and design. Historically, we have managed our relationships with these large retailers through independent, commission-based sales representatives. However, we continue to build out our team of in-house sales professionals focused on driving the business with our top retailers and connecting our internal sales, marketing and product teams. Our national sales team enables us to improve the frequency and level of interaction with these retailers. Our other large retailers are managed by our regional sales managers through independent sales representatives where we can put the best team in place to meet the needs of our retailers and our business.

Domestic sales of our products, which primarily consist of Skullcandy and Astro Gaming product sales to customers in the United States represented 72% of net sales for the year ended December 31, 2015. During 2015, one retailer accounted for more than 10% of our consolidated net sales. We have entered into vendor program agreements with this retailer and many of our other large retailers, that govern the terms of sale, rebates and obligations of each party, but each purchase is typically made on a purchase order basis. None of our retailers have minimum or long-term purchase obligations. If any of our large retailers choose to slow its rate of purchases of our products, decrease its purchases of our products, or no longer purchase our products, our net sales and results of operations could be adversely affected.

International. International sales of our products outside the United States, represented 28% of net sales for the year ended December 31, 2015. Prior to August 2011, we sold our products internationally almost exclusively through third party distributors. We have relationships with distributors serving more than 80 countries.

Manufacturing and Sourcing

We do not own any manufacturing facilities and utilize third party manufacturing for all of our products. We do not have any long-term contracts with our existing manufacturers. We procure finished and packaged products from our contract manufacturers so that we require no subassembly.

During 2015 we utilized approximately ten independent manufacturers throughout Asia. We generally are focused on fewer, yet higher quality suppliers to take advantage of service, quality, and product cost savings improvements. We will continue to focus on geographical diversification of our manufacturing base by working with our key manufacturing partners.

In order to better manage our manufacturers and orders and significantly enhance quality, we have an office in Shenzhen, China. This office provides commercialization support, quality assurance, strategic sourcing support and production control. Our Asia operations group monitors and continually evaluates all manufacturers for quality, delivery, costs, quality systems and social compliance. We believe that the oversight provided by this team enables us to increase quality, service and delivery performance.

Order Fulfillment and Inventory Management

We have a contract with a third party supply chain provider, for use of their distribution facility in Auburn, Washington. This contract expires March 2017. We warehouse and ship nearly all products for Domestic retailers, distributors, online customers and some international distributors from this facility. We believe we have sufficient capacity at this facility for existing and expected needs.

We have extended our distribution agreement with our third party supply chain provider in Tiel, Netherlands through June 2016. This facility provides fulfillment for our European and other international customers. As part of the new agreement we transitioned from the existing warehouse to a new warehouse located in the same logistics compound. This transition occurred in October of 2014.

To assist in our international growth, we have partnered with third party logistics providers in Shanghai, China for the fulfillment of domestic China retail and web orders, Surrey, BC Canada for the fulfillment of domestic Canada retail and web orders and Tokyo, Japan for the fulfillment of domestic Japan retail and web orders.

In the past we have experienced increased lead-time from some of our manufacturers in China as well as logistic disruptions and we may encounter such increased lead-times in the future. We believe we will be able to compensate for potential inventory shortages with improved supply management and vendor sourcing. Changing economic conditions in China may cause further issues with lead-time. Because we operate on a build-to-forecast model, extended lead-time can cause unexpected inventory shortages or excesses which may reduce our net sales. We are implementing strategies to mitigate some of these risks with various transportation options and multiple services.

Management Information Systems

We utilize an integrated information system called SAP Business ByDesign. This Enterprise Resource Planning, or ("ERP"), software manages purchasing, planning, inventory tracking, financial information, and retail, distributor and direct order fulfillment. SAP Business ByDesign is a hosted solution. All data resides on SAP servers and is accessed over secure Internet connections. We currently have electronic integration between our ERP and multiple third party logistics warehouses that manage inventory and fulfillment activities worldwide.

Competition

The consumer electronics industry is highly competitive, with the introduction of new competitors, as well as increased competition from established companies expanding their product portfolio, and rapidly consolidating. We face competition from consumer electronics brands that have historically dominated the audio and gaming headphone market, in addition to sport brand and lifestyle companies that also produce headphone products. These companies include, among others, Sony, Bose, LG, Turtle Beach and Apple (which includes Beats by Dr. Dre, which was purchased by Apple in 2014). These competitors may have significant competitive advantages, including greater financial, distribution, marketing and other resources, longer operating histories, better brand recognition among certain groups of consumers, and greater economies of scale. In addition, these competitors have long-term relationships with many of our larger retailers that are potentially more important to those retailers. As a result, these competitors may be better equipped to influence consumer preferences or otherwise increase their market share by:

- quickly adapting to changes in consumer preferences;
- readily taking advantage of acquisition and other opportunities;
- discounting excess inventory;
- devoting greater resources to the marketing and sale of their products, including significant advertising, media placement and product endorsement;
- adopting aggressive pricing policies; and
- engaging in lengthy and costly intellectual property and other legal disputes.

Additionally, the industry in which we compete generally has low barriers to entry that allow the introduction of new products or new competitors at a fast pace. Some retailers have begun to introduce their own private label headphones, which

could reduce the volume of product they buy from us, as well as decrease the shelf space they allocate to our products. If we are unable to protect our brand image and authenticity, while carefully balancing our growth, we may be unable to effectively compete with these new market entrants or new products. The inability to compete effectively against new and existing competitors could have an adverse effect on our sales and results of operations, preventing us from achieving future growth.

Intellectual Property

We utilize the trade name “Skullcandy” and the Skullcandy logo and trademark on our Skullcandy products. We believe that having distinctive marks that are registered and readily identifiable is an important factor in identifying our brand and in distinguishing our products from those of our competitors. We consider the Skullcandy trademark and our skull logo trademark and copyrighted design to be among our most valuable assets and we have registered these trademarks in 75 countries. We also have many trademark registrations in the U.S. and abroad for Astro Gaming and consistently assess additional registrations across all our brands for our unique and well-known product names and marketing phrases. Each trademark registered with the U.S. Patent and Trademark Office has a duration of ten years and trademarks registered outside of the United States normally have a duration of ten years depending upon the jurisdiction. Trademarks are generally subject to an indefinite number of renewals upon appropriate application.

We value our position as a leader in the lifestyle and performance audio space and have assembled a talented team of designers and engineers that focus on creating innovative new products, technologies, and cutting edge designs that differentiate our products from those of our competitors at key price points. Each new product and project is analyzed from a design and utility perspective to identify new inventive concepts and opportunities for intellectual property protection. Presently, we have over 180 issued patents or pending patent applications around the world and we continue to focus our patent filing efforts on technologies that can provide meaningful benefits to our consumers. We have design patents covering a broad range of our Skullcandy and Astro Gaming products. We have been awarded utility patents on certain features and technologies used in some of our products for both Skullcandy and Astro Gaming. These applications are in various stages of examination with intellectual property offices in our key markets. We cannot guarantee that any pending future patent applications we have filed will result in issued patents, or that if patents are issued to us, that such patents will provide meaningful protection against competitors or against competitive technologies.

Employees

As of December 31, 2015, we had approximately 300 full-time employees. None of our employees are currently covered by a collective bargaining agreement. We consider our relationship with our employees to be good and have not experienced a labor-related work stoppage.

Available Information

Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are filed with the U.S. Securities and Exchange Commission, or the SEC. Such reports and other information filed by us with the SEC are available free of charge at the investor relations section of our website www.skullcandy.com as soon as reasonable practicable after such reports are electronically filed with, or furnished to, the SEC. Copies are also available, without charge, by writing to Skullcandy, Inc., Corporate Secretary, 1441 West Ute Boulevard, Suite 250, Park City, Utah 84098. Reports filed with the SEC may be viewed at www.sec.gov or obtained at the SEC Public Reference Room located at 100 F Street, NE, Washington, D.C. 20549. Information regarding the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The inclusion of our website address in this annual report does not include or incorporate by reference the information on our website into this annual report.

Item 1A. Risk Factors.

You should carefully consider the following risk factors, which address the material risks concerning our business, together with the other information contained in this annual report. If any of the risks discussed in this annual report occur, our business, prospects, liquidity, financial condition and results of operations could be materially and adversely affected, in which case the trading price of our common stock could decline significantly and you could lose part or all of your investment. Some statements in this annual report, including statements in the following risk factors, constitute forward-looking statements. Please refer to the initial paragraph of this annual report entitled “Business.”

We may be unable to achieve future growth, which may have a material adverse effect on our future operating results.

During 2015 net sales increased \$18.5 million or 7.5% , to \$266.3 million compared to 2014 . We cannot assure you that we will be able to continue the increase in our net sales. Our future success will depend upon various factors, including the strength of our brand image, market demand for our current and future products, competitive conditions, and compatibility of our products with portable media devices and smartphones and the implementation of our growth strategy. We intend to finance our anticipated growth through cash flows generated from sales to our retailers and distributors. However, if our net sales decline, we may not have the cash flow necessary to pursue our growth strategy.

If our design and marketing efforts do not effectively raise the recognition and reputation of our brands, we may not be able to successfully implement our growth strategy.

We believe that our ability to raise the recognition and favorable perception of our brands is critical to implement our growth strategy, which includes further penetrating our domestic retail channel, accelerating our international growth and expanding complementary product categories. To extend the reach of our brands, we believe we must devote significant time and resources to product design, marketing and promotions. These expenditures, however, may not result in a sufficient increase in net sales to cover such expenses. Furthermore, we must balance our growth with the effect it has on the authenticity of our brand. For example, our credibility and brand image could be weakened if our consumers perceive our distribution channels to be too broad or our retailers to not fit with our lifestyle image. If any of these events occur, our consumer base and our net sales may decline and we may not be able to successfully implement our growth strategy.

If we are unable to continue to develop innovative and popular products, our brand image may be harmed and demand for our products may decrease.

Consumer electronics and youth culture lifestyle are subject to constantly and rapidly changing consumer preferences based on industry trends and performance features. Our success depends largely on our ability to lead, anticipate, gauge and respond to these changing consumer preferences and trends in a timely manner, while preserving and strengthening the perception and authenticity of our brand. We must continue to develop innovative, trend-setting and stylish products that provide better design and performance attributes than the products of our competitors. Market acceptance of new designs and products is subject to uncertainty and we cannot assure you that our efforts will be successful. The inability of new product designs or new product lines to gain market acceptance could adversely affect our brand image, our business and financial condition. Achieving market acceptance for new products may also require substantial marketing efforts and expenditures to increase consumer demand, which could constrain our management, financial and operational resources. If new products we introduce do not experience broad market acceptance or demand for our existing products wanes, our net sales and market share could decline.

We may not be able to compete effectively, which could cause our net sales and market share to decline.

The consumer electronics industry is highly competitive, and characterized by frequent introduction of new competitors, as well as increased competition from established companies expanding their product portfolio, aggressive price cutting and resulting downward pressure on gross margins and rapid consolidation of the market resulting in larger competitors. We face competition from consumer electronics brands that have historically dominated the stereo headphone market, in addition to sport brand and lifestyle companies that also produce headphone products. These companies include, among others, Sony, Bose, LG, Turtle Beach and Apple (which includes Beats by Dr. Dre, which was purchased by Apple in 2014). These competitors may have significant competitive advantages, including greater financial, distribution, marketing and other resources, longer operating histories, better brand recognition among certain groups of consumers, and greater economies of scale. In addition, these competitors have long-term relationships with many of our larger retailers that are potentially more important to those retailers. As a result, these competitors may be better equipped to influence consumer preferences or otherwise increase their market share by:

- quickly adapting to changes in consumer preferences;
- readily taking advantage of acquisition and other opportunities;
- discounting excess inventory;
- devoting greater resources to the marketing and sale of their products, including significant advertising, media placement and product endorsement;
- adopting aggressive pricing policies; and
- engaging in lengthy and costly intellectual property and other legal disputes.

Additionally, the industry in which we compete generally has low barriers to entry that allow the introduction of new products or new competitors at a fast pace. Some retailers have begun to introduce their own private label headphones, which could reduce the volume of product they buy from us, as well as decrease the shelf space they allocate to our products. If we are unable to protect our brand image and authenticity, while carefully balancing our growth, we may be unable to effectively

compete with these new market entrants or new products. The inability to compete effectively against new and existing competitors could have an adverse effect on our net sales and results of operations, preventing us from achieving future growth.

If we are unable to obtain intellectual property rights and/or enforce those rights against third parties who are violating those rights, our business could suffer.

We rely on various intellectual property rights, including patents, trademarks, trade secrets and trade dress to protect our brand name, reputation, product appearance and technology. If we fail to obtain, maintain, or in some cases enforce our intellectual property rights, our competitors may be able to copy our designs, or use our brand name, trademarks or technology. As a result, if we are unable to successfully protect our intellectual property rights, or resolve any conflicts effectively, our results of operations may be harmed.

We are susceptible to counterfeiting of our products, which may harm our reputation for producing high-quality products and force us to incur expenses in enforcing our intellectual property rights. Such claims and lawsuits can be expensive to resolve, require substantial management time and resources, and may not provide a satisfactory or timely result, any of which would harm our results of operations. It can be particularly difficult and expensive to detect and stop counterfeiting, whether in the United States or abroad. Despite our efforts to enforce our intellectual property, counterfeiters may continue to violate our intellectual property rights by using our trademarks or imitating or copying our products, which could harm our brand, reputation and financial condition. Since our products are sold internationally, we are also dependent on the laws of a range of countries to protect and enforce our intellectual property rights. These laws may not protect intellectual property rights to the same extent or in the same manner as the laws of the United States.

We also face competition from competitors in the United States and abroad that are not “counterfeiters” but that may be using our patented technology, using confusingly similar trademarks, or copying the “look-and-feel” of our products. We may have to engage in expensive and distracting litigation to enforce and defend our patents, trademarks, trade dress, or other intellectual property rights. Our enforcement of our intellectual property rights also places such assets at risk. For example, it is common for a competitor that is accused of infringing a patent, trademark, or other intellectual property right to challenge the validity of that intellectual property right. If that intellectual property right is invalidated, it is no longer available to assert against other competitors. Finally, competitors may also circumvent a patent by designing around the patent.

Further, we are a party to licenses that grant us rights to intellectual property, including trademarks that are necessary or useful to our business. For example, we license the right to market certain products with the trade names and imagery of brands such as Koston, the NBA, FC Barcelona, Microsoft and Real Tree. One or more of our licensors may allege that we have breached our license agreement with them, and accordingly seek to terminate our license. If successful, this could result in our loss of the right to use the licensed intellectual property, which could adversely affect our ability to commercialize our technologies or products, as well as harm our competitive business position and our business prospects.

If the popularity or growth of the portable media device, smartphone and gaming console markets stagnates or our products are no longer compatible with these devices, our business and financial condition may be negatively affected.

We have experienced growth in the past due in part to the popularity of, and increase in demand for, portable media devices, smartphones and gaming consoles. We expect that sales of such products will continue to drive a substantial portion of our net sales in the future. However, the markets for portable media devices, smartphones and gaming consoles continue to evolve rapidly and are dominated by several large companies. Increased competition in the headphone market from established media device companies, including enhanced headphones bundled by the manufacturer, a decline in demand or popularity for such products due to technological changes or otherwise, legal restrictions or the inability to use our products with portable media devices, smartphones or gaming consoles, may negatively affect our business and financial condition.

Our results of operations could be materially harmed if we are unable to accurately forecast demand for our products.

To ensure adequate inventory supply, we must forecast inventory needs and place orders with our manufacturers before firm orders are placed by our retailers and distributors. In addition, a portion of our net sales are generated by orders for immediate delivery, particularly during our historical peak season from August through December. If we fail to accurately forecast retailer and distributor demand we may experience excess inventory levels or a shortage of product to deliver to our retailers or distributors. Factors that could affect our ability to accurately forecast demand for our products include:

- changes in consumer demand for our products;
- lack of consumer acceptance for our new products;
- product introductions and/or discounting by competitors;
- changes in general market conditions or other factors, which may result in cancellations of advance orders or a reduction or increase in the rate of reorders;

- weakening of economic conditions or consumer confidence in future economic conditions, which could reduce demand for discretionary items; and
- terrorism or acts of war, or the threat thereof, which could adversely affect consumer confidence and spending or interrupt production and distribution of product and raw materials.

Inventory levels in excess of retailer and distributor demand may result in inventory write-downs or write-offs and the sale of excess inventory at discounted prices, which would have an adverse effect on our gross margin. In addition, if we underestimate the demand for our products, our manufacturers may not be able to produce a sufficient number of products to meet such unanticipated demand, and this could result in delays in the shipment of our products and damage to our reputation and retailer or distributor relationships.

We must order components for our products and build inventory in advance of product announcements and shipments. Consistent with industry practice, components are normally acquired through a combination of purchase orders, supplier contracts, and open orders, in each case based on projected demand. Because our markets are volatile, competitive and subject to rapid technology and price changes, there is a risk we will forecast incorrectly and order or produce excess or insufficient amounts of components or products, or not fully utilize firm purchase commitments.

Our net sales and operating income fluctuate on a seasonal basis and decreases in sales or margins during our peak seasons could have a disproportionate effect on our overall financial condition and results of operations.

Historically, we have experienced greater net sales in the second half of a calendar year relative to those in the first half, due to a concentration of shopping around the fall and holiday seasons. As a result, our net sales and gross margins are typically higher in the third and fourth quarters and lower in the first and second quarters, as fixed operating costs are spread over the differing levels of sales volume. Given the strong seasonal nature of our sales, appropriate forecasting is critical to our operations. We anticipate that this seasonal impact on our net sales is likely to continue and any shortfall in expected third and fourth quarter net sales would cause our annual results of operations to suffer significantly.

One of our retailers accounts for a significant amount of our net sales, and the loss of, or reduced purchases from, this or other retailers could have a material adverse effect on our operating results.

One of our retailers accounted for more than 10% of our net sales in 2015 and 2014. We do not have long-term contracts with any of our retailers and all of our retailers generally purchase from us on a purchase order basis. As a result, this retailer generally may, with no notice or penalty, cease ordering and selling our products, or materially reduce their orders. If certain retailers, individually or in the aggregate, choose to no longer sell our products, to slow their rate of purchase of our products or to decrease the number of products they purchase, our results of operations would be adversely affected.

We may be adversely affected by the financial condition of our retailers and distributors.

Some of our retailers and distributors have experienced financial difficulties in the past. A retailer or distributor experiencing such difficulties generally will not purchase and sell as many of our products as it would under normal circumstances and may cancel orders. In addition, a retailer or distributor experiencing financial difficulties generally increases our exposure to uncollectible receivables. We extend credit to our retailers and distributors based on our assessment of their financial condition, generally without requiring collateral, and sometimes are not able to obtain information regarding their current financial status. Failure of these retailers or distributors to remain current on their obligations to us could result in losses that exceed the reserves we set aside in anticipation of this risk. Additionally, while we have credit insurance against some of our larger retailers, there is no assurance that such insurance will sufficiently cover any losses. We are also exposed to the risk of our customers declaring bankruptcy, exposing us to claims of preferential payment claims. Financial difficulties on the part of our retailers or distributors could have a material adverse effect on our results of operations and financial condition.

Changes in the mix of retailers and distributors to whom we sell our products could impact our gross margin and brand image, which could have a material adverse effect on our results of operations.

We sell our products through a mix of retailers, including specialty, consumer electronics, big-box, sporting goods and mobile phone retailers and to distributors. The retail landscape is changing with consumers shopping habits shifting away from the traditional brick and mortar stores to online sales. Any changes to our current mix of retailers and distributors could adversely affect our gross margin and could negatively affect both our brand image and our reputation. We generally realize lower gross margins when we sell through our distributors, and therefore our gross margins may be adversely impacted if we increase product sales made through distributors as opposed to direct to our retailers. In addition, we sell certain products at higher margins than others and any significant changes to our product mix made available to our retailers could adversely affect our gross margin. A negative change in our gross margin or our brand image could have a material adverse effect on our results of operations and financial condition.

To remain competitive and stimulate customer demand, we must keep up with changes in technology and successfully manage frequent product introductions and transitions.

Due to the highly volatile and competitive nature of the industries in which we compete, we must continually introduce new products, services and technologies, enhance existing products and services, and effectively stimulate customer demand for new and upgraded products. In addition, our products must remain compatible with smartphones, tablets, computers and other similar consumer electronic devices that transmit audio. The success of new product introductions depends on a number of factors including: remaining compatible with changes in technology; timely and successful product development; market acceptance; our ability to manage the risks associated with the new product production ramp-up issues, the effective management of purchase commitments and inventory levels in line with anticipated product demand, the availability of products in appropriate quantities and costs to meet anticipated demand, and the risk that new products may have quality or other defects or deficiencies in the early stages of introduction. Accordingly, if technology changes and our products are no longer compatible or we cannot effectively introduce new products and manage transitions, our financial condition would be negatively impacted.

We face business, political, operational, financial and economic risks because a portion of our net sales are generated internationally and substantially all of our products are manufactured outside of the United States.

For the year ended December 31, 2015 international net sales were \$75.4 million, or 28.3% of net sales. In addition, substantially all of our products are manufactured in China. In the past we have experienced increased lead-time from some of our manufacturers in China and we may encounter such increased lead-times in the future. Changing economic conditions in China may cause further issues with lead-time and impact the financial solvency of our third party manufacturers. Because we operate on a build-to-forecast model, extended lead-time can cause unexpected inventory shortages or excesses which may reduce our net sales.

In addition, we face business, political, operational, financial and economic risks inherent in international business, many of which are beyond our control, including:

- difficulties obtaining domestic and foreign export, import and other governmental approvals, permits and licenses, and compliance with foreign laws, which could halt, interrupt or delay our operations if we cannot obtain such approvals, permits and licenses, and that could have a material adverse effect on our results of operations;
- difficulties encountered by our international distributors or us in staffing and managing foreign operations or international sales, including higher labor costs, which could increase our expenses and decrease our net sales and profitability;
- transportation delays and difficulties of managing international distribution channels, which could halt, interrupt or delay our operations;
- longer payment cycles for, and greater difficulty collecting, accounts receivable, which could reduce our net sales and harm our financial results;
- changes in the financial solvency of our third party manufacturers would impact our ability to receive inventory timely;
- trade restrictions, higher tariffs, currency fluctuations or the imposition of additional regulations relating to import or export of our products, especially in China, where substantially all of our products are manufactured, which could force us to seek alternate manufacturing sources or increase our expenses, either of which could have a material adverse effect on our results of operations;
- political and economic instability, including wars, terrorism, political unrest, boycotts, strikes, curtailment of trade and other business restrictions, any of which could materially and adversely affect our net sales and results of operations; and
- natural disasters, which could have a material adverse effect on our results of operations;
- disruptions in the global transportation network such as a port strike, and work stoppages or other labor unrest.

Any of these factors could reduce our net sales, decrease our gross margins and increase our expenses. Should we establish our own operations in international territories where we currently utilize distributors, we will become subject to greater risks associated with operating outside of the United States.

We are subject to laws and regulations worldwide, changes to which could increase our costs and individually or in the aggregate adversely affect our business.

We are subject to laws and regulations affecting our domestic and international operations in a number of areas. These U.S. and foreign laws and regulations affect our activities including, but not limited to, areas of labor, advertising, digital content, consumer protection and compliance, e-commerce, promotions, quality of services, mobile communications,

intellectual property ownership and infringement, tax, import and export requirements, anti-corruption, foreign exchange controls and cash repatriation restrictions, data privacy requirements, environmental, health, and safety.

By way of example, laws and regulations related to consumer electronics in the many jurisdictions in which we operate are extensive and subject to change. Such changes could include, among others, restrictions on the production, manufacture, distribution, and use of devices. These devices are also subject to certification and regulation by governmental and standardization bodies. These certification processes are extensive and time consuming, and could result in additional testing requirements, product modifications, delays in product shipment dates, or preclude us from selling certain products. Compliance with these laws, regulations and similar requirements may be onerous and expensive, and they may be inconsistent from jurisdiction to jurisdiction, further increasing the cost of compliance and doing business. Any such costs, which may rise in the future as a result of changes in these laws and regulations or in their interpretation could individually or in the aggregate make our products and services less attractive to our customers, delay the introduction of new products in one or more regions, or cause us to change or limit its business practices. We have implemented policies and procedures designed to ensure compliance with applicable laws and regulations, but there can be no assurance that our employees, contractors, or agents will not violate such laws and regulations or our policies and procedures.

If our relationship with our manufacturers terminates or is otherwise impaired, we would likely experience increased costs, disruptions in the manufacture and shipment of our products and a material loss of net sales.

We have no long-term contracts with our manufacturers and, as a result, our manufacturers could cease to provide products to us without notice. We have a limited number of manufactures we use and some of our products are produced by one manufacturer. We cannot be certain that we will not experience operational difficulties with our manufacturers, including reductions in the availability of production capacity, errors in complying with product specifications and regulatory schemes covering our products in our key markets, insufficient quality control, failures to meet production deadlines, increases in manufacturing costs and increased lead times. In the event our manufacturers experience operational or financial difficulties, or terminate our relationship, our results of operations could be adversely affected.

We have created a manufacturer selection and qualification program and are actively looking for new manufacturing sources in other countries and other regions of China. Qualifying new manufacturing sources may result in increased costs, disruptions and delays in the manufacture and shipment of our products while seeking alternative manufacturing sources, and a corresponding loss of net sales. In addition, any new manufacturer may not perform to our expectations or produce quality products in a timely, cost-efficient manner, either of which could make it difficult for us to meet our retailers' and distributors' orders on satisfactory commercial terms.

The failure of any manufacturer to perform to our expectations could result in supply shortages or delivery delays, either of which could harm our business.

Any shortage of raw materials or components could impair our ability to ship orders of our products in a cost-efficient manner or could cause us to miss the delivery requirements of our retailers or distributors, which could harm our business.

The ability of our manufacturers to supply our products is dependent, in part, upon the availability of raw materials and certain components. Our manufacturers may experience shortages in the availability of raw materials or components, which could result in delayed delivery of products to us or in increased costs to us. For example, we are dependent on the supply of certain components for our production of iPhone compatible headphones. These components are in high demand and we have experienced supply shortages in the past. Any shortage of raw materials or components or inability to control costs associated with manufacturing could increase the costs for our products or impair our ability to ship orders in a timely cost-efficient manner. As a result, we could experience cancellation of orders, refusal to accept deliveries or a reduction in our prices and margins, any of which could harm our financial performance and results of operations.

Our products and services may experience quality problems from time to time that can result in decreased sales and operating margin and harm to our reputation.

From time to time, our products may contain design and manufacturing defects. There can be no assurance we will be able to detect and fix all defects in the hardware we sell. Failure to do so could result in lost revenue, significant warranty and other expenses, and harm to our reputation.

Our business could suffer if any of our manufacturers fail to use acceptable labor practices.

We do not control our manufacturers or their labor practices. The violation of labor or other laws by a manufacturer utilized by us, or the divergence of an independent manufacturer's labor practices from those generally accepted as ethical or legal in the United States, could damage our reputation or disrupt the shipment of finished products to us if such manufacturer is ordered to cease its manufacturing operations due to violations of laws or if such manufacturer's operations are adversely

affected by such failure to use acceptable labor practices. If this were to occur, it could have a material adverse effect on our financial condition and results of operations.

If we experience problems with our distribution network for domestic and international retailers, our ability to deliver our products to the market could be adversely affected.

We rely on our distribution facilities operated by third party supply chain providers for the majority of our domestic and international product distribution. Our distribution facilities utilizes computer controlled and automated equipment, which means the operations are complicated and may be subject to a number of risks related to security or computer viruses, the proper operation of software and hardware, power interruptions or other system failures. We have experienced some of these problems in the past and we cannot assure you that we will not experience similar problems in the future. We maintain business interruption insurance, but it may not adequately protect us from the adverse effects that could be caused by significant disruptions in our distribution facilities, such as the long-term loss of retailers or an erosion of our brand image. In addition, our distribution capacity is dependent on the timely performance of services by third parties, including the shipping of product to and from our warehouse facilities. If we encounter problems with the facilities, our ability to meet retailer expectations, manage inventory, complete sales and achieve objectives for operating efficiencies could be materially adversely affected.

Our current executive officers are critical to our success and the loss of any of these individuals, or other key personnel, could harm our business and brand image.

We are heavily dependent upon the contributions, talent and leadership of our current executive officers. The loss of executive officers or the inability to attract or retain qualified executive officers could delay the development and introduction of, and harm our ability to sell our products and damage our brand, which could have a material adverse effect on our results of operations. Changes in management may have a negative effect on our business and operations. Our future success also depends on our ability to attract and retain additional qualified design and marketing personnel. We face significant competition for these individuals worldwide and we may not be able to attract or retain these employees.

Claims that we violate a third party's intellectual property rights may give rise to burdensome litigation, result in potential liability for damages or impede our development efforts.

We cannot assure you that our products or activities do not violate the patents or other intellectual property rights of third parties. Patent infringement, trade secret misappropriation and other intellectual property claims and proceedings brought against us, whether successful or not, could result in substantial costs and harm our reputation. Such claims and proceedings can also distract and divert management and key personnel from other tasks important to the success of our business. In addition, intellectual property litigation could force us to do one or more of the following:

- cease developing, manufacturing, or selling products that incorporate the challenged intellectual property;
- obtain and pay for licenses from the holder of the infringed intellectual property right, which licenses may not be available on reasonable terms, or at all;
- redesign or reengineer products;
- change our business processes; and
- pay substantial damages, court costs and attorneys' fees, including potentially increased damages for any infringement or violation found to be willful.

In the event of an adverse determination in an intellectual property suit or proceeding, or our failure to license essential technology, our sales could be harmed and/or our costs could increase, which could harm our financial condition.

We may be subject to product liability or warranty claims that could result in significant direct or indirect costs, or we could experience greater returns from retailers than expected, which could harm our net sales.

We generally provide a limited lifetime warranty on all of our products. In addition, if a consumer breaks his or her headphones, we generally offer such consumer the option to buy another pair of headphones at a 50% discount to the retail price. The occurrence of any quality problems due to defects in our products could make us liable for damages and warranty claims in excess of our current reserves. In addition to the risk of direct costs to correct any defects, warranty claims or other problems, any negative publicity related to the perceived quality of our products could also affect our brand image, decrease retailer and distributor demand and our operating results and financial condition could be adversely affected.

We have entered into contracts with various customers and distributors granting a right of return allowance with respect to defective products. We have also executed an open return program with a major retailer allowing for an unlimited amount of returns. Estimates for these items are based on actual experience and are recorded at the time net sales are recognized. If we experience a greater number of returns than expected, our net sales could be harmed.

Our stock price is subject to volatility.

Our stock has experienced substantial price volatility. Additionally, Skullcandy, the technology industry, and the stock market as a whole have experienced extreme stock price and volume fluctuations that have affected stock prices in ways that may have been unrelated to these companies' operating performance. Factors such as the depth and liquidity of the market for our common stock, investor perceptions of us and our business, actions by institutional shareholders, strategic actions by us, litigation, changes in accounting standards, policies, guidance, interpretations and principles, additions or departures of key personal and our results of operations, financial performance and future prospects may cause the market price and demand for our common stock to fluctuate substantially, which may limit or prevent investors from realizing the liquidity of their shares.

Our credit facility provides our lenders with a first-priority lien against substantially all of our assets and contains financial covenants and other restrictions on our actions and it could therefore limit our operational flexibility.

Our credit facility contains certain financial covenants and other restrictions that limit our ability, among other things, to:

- undergo a merger or consolidation;
- sell certain assets;
- create liens;
- guarantee certain obligations of third parties;
- make certain investments or capital expenditures;
- materially change our line of business;
- declare dividends or make certain distributions;
- make advances, loans or extensions of credit; and
- incur additional indebtedness or prepay existing indebtedness.

In addition, we have granted the lenders a first-priority lien against substantially all of our assets. Failure to comply with the operating restrictions or financial covenants in the credit facility could result in a default which could cause the lender to accelerate the timing of payments and exercise its lien on substantially all of our assets. This could cause us to cease operations and result in a complete loss of your investment in our common stock.

Changes in tax laws and unanticipated tax liabilities could adversely affect our effective income tax rate and profitability.

We are subject to income taxes in the United States and numerous foreign jurisdictions. Our effective income tax rate could be adversely affected in the future by a number of factors, including: changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of deferred tax assets and liabilities, changes in tax laws, and any repatriation of non-US earnings for which we have not previously provided for U.S. taxes. We regularly assess all of these matters to determine the adequacy of our tax provision.

Currency exchange rate fluctuations may disrupt our business and make our products less competitive, having a material adverse impact on our business

With approximately 28.3% of our net sales for the year ended December 31, 2015 arising from foreign net sales, a growing percentage of our net revenues are derived from markets outside the U.S. Our international businesses operate in functional currencies other than the U.S. dollar. Products sold by our international businesses and the cost of these products may be affected by relative changes in the value of the local currencies of our subsidiaries and our manufacturers. Price increases caused by currency exchange rate fluctuations may make our products less competitive or have an adverse effect on our net revenues, margins and operating results. Currency exchange rate fluctuations may also disrupt the business of the contract manufacturers from which we source our products by making their purchases of raw materials more expensive and more difficult to finance. As a result, currency fluctuations may have a material adverse effect on our financial condition. While our hedging program is focused on currency risk exposures on some of our operations, we cannot provide assurance that our hedging program will be successful in minimizing exposures to foreign currency fluctuations. The effectiveness of our hedges in part depends on our ability to accurately forecast future cash flows, which is particularly difficult during periods of uncertain demand for our products and services and highly volatile exchange rates. Further, hedging activities may only offset a portion, or none at all, of the material adverse financial effects of unfavorable movements in foreign exchange rates over the limited time the hedges are in place and we may incur significant losses from hedging activities due to factors such as demand volatility and currency variations.

Additionally, concerns regarding the short- and long-term stability of the euro and its ability to serve as a single currency for countries in the Eurozone could lead individual countries to revert, or threaten to revert, to their former local currencies, potentially dislocating the euro. If this were to occur, the assets we hold in a country that re-introduces its local currency could be significantly devalued, the cost of raw materials or our manufacturing operations could substantially

increase, and the demand and pricing for our products could be materially adversely affected. Furthermore, if it were to become necessary for us to conduct business in additional currencies, we could be subject to additional earnings volatility as amounts in these currencies are translated into U.S. dollars.

An information systems interruption or breach in security could adversely affect us

Privacy, security, and compliance concerns have continued to increase as technology has evolved. We rely on accounting, financial and operational management information systems to conduct our operations. Any disruption in these systems could adversely affect our ability to conduct our business. Furthermore, as part of our normal business activities, we collect and store common confidential information about customers, employees, vendors, and suppliers. This information is entitled to protection under a number of regulatory regimes. Any failure to maintain the security of the data, including the penetration of our network security and the misappropriation of confidential and personal information, could result in business disruption, damage to our reputation, financial obligations to third parties, fines, penalties, regulatory proceedings and private litigation with potentially large costs, and also result in deterioration in customers confidence in us and other competitive disadvantages, and thus could have a material adverse impact on our financial condition and results of operations.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our executive, administrative and Skullcandy brand offices are located in Park City, Utah, where we lease approximately 34,000 square feet of space pursuant to a lease that expires in February 2017. Our marketing offices were formerly located in San Clemente, California, where we lease approximately 11,000 square feet of office space pursuant to a lease that expires in December 2016. However, we closed that office in September 2013, and we currently sublet the office space to a third party and intend to sublet such space for the remainder of the original lease term. Our Astro Gaming offices are located in San Francisco, California where we lease approximately 7,500 square feet of space pursuant to a lease that expires in April 2016. Our Asia operations offices are located in the Nanshan District of Shenzhen, China, where we lease approximately 9,300 square feet pursuant to a lease that expires in September 2016. Our China sales and marketing office is located in the Jing'an District of Shanghai where we lease approximately 7,800 square feet pursuant to a lease that expires in February 2018. Our European headquarters are located in Zurich, Switzerland, where we lease approximately 4,700 square feet pursuant to a lease that expires in January 2017. Our Japan sales and marketing office is located in Tokyo, Japan where we lease approximately 1,000 square feet of space pursuant to a lease that expires in May 2016. Our Canada sales and marketing office is located in Vancouver, British Columbia, Canada where we lease approximately 1,100 square feet of space pursuant to a lease that expires May 2016. Our Mexico sales and marketing office is located in Mexico City, Mexico where we lease approximately 2,000 square feet of space pursuant to a lease that expires in February 2017.

Item 3. Legal Proceedings

On November 5, 2015, Peter Kravitz, as Liquidating Trustee of the RSH Liquidating Trust, filed a complaint against us in the U.S. States Bankruptcy Court for the District Court of Delaware alleging payments received by us were preferential payments and seeking the return of approximately \$4.0 million in payments. We operated under a consignment relationship with the former Radio Shack entity. Therefore, we believe the payments we received are not considered preferential and we intend to vigorously defend ourselves in this action.

On February 12, 2016, an alleged shareholder filed a putative securities class action complaint against us and certain of our officers and directors in the United States District Court for the District of Utah, captioned *Davis v. Skullcandy, Inc., et al.*, No. 2:16-cv-00121-RJS. The complaint purports to be brought on behalf of shareholders who purchased our common stock between August 7, 2015 and January 11, 2016. It asserts that we and certain of our officers and directors violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 by making allegedly false or misleading statements concerning our positioning and expectations for future growth. The complaint seeks damages in an unspecified amount and equitable relief against the defendants. We believe the lawsuit is without merit and we intend to vigorously defend ourselves in this action.

The Company is subject to various other claims, complaints and legal actions in the normal course of business from time to time. The Company does not believe it has any other currently pending litigation of which the outcome could have a material adverse effect on its operations or financial position.

Item 4. Mine Safety Disclosures

Not applicable.

PART II**Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.****Price Range of Common Stock**

Our common stock began trading on the NASDAQ Global Market under the symbol “SKUL” on July 20, 2011. As of February 29, 2016, the price of our common stock was \$3.54. The price range per share of common stock presented below represents the highest and lowest sales prices for our common stock on NASDAQ for each full quarterly period for the last two years.

	High		Low	
<u>2015</u>				
Fourth Quarter	\$	6.34	\$	4.07
Third Quarter	\$	7.98	\$	5.50
Second Quarter	\$	11.47	\$	7.50
First Quarter	\$	11.31	\$	9.03
<u>2014</u>				
Fourth Quarter	\$	9.52	\$	7.50
Third Quarter	\$	8.34	\$	6.76
Second Quarter	\$	9.64	\$	6.86
First Quarter	\$	10.04	\$	7.09

Holders of Record

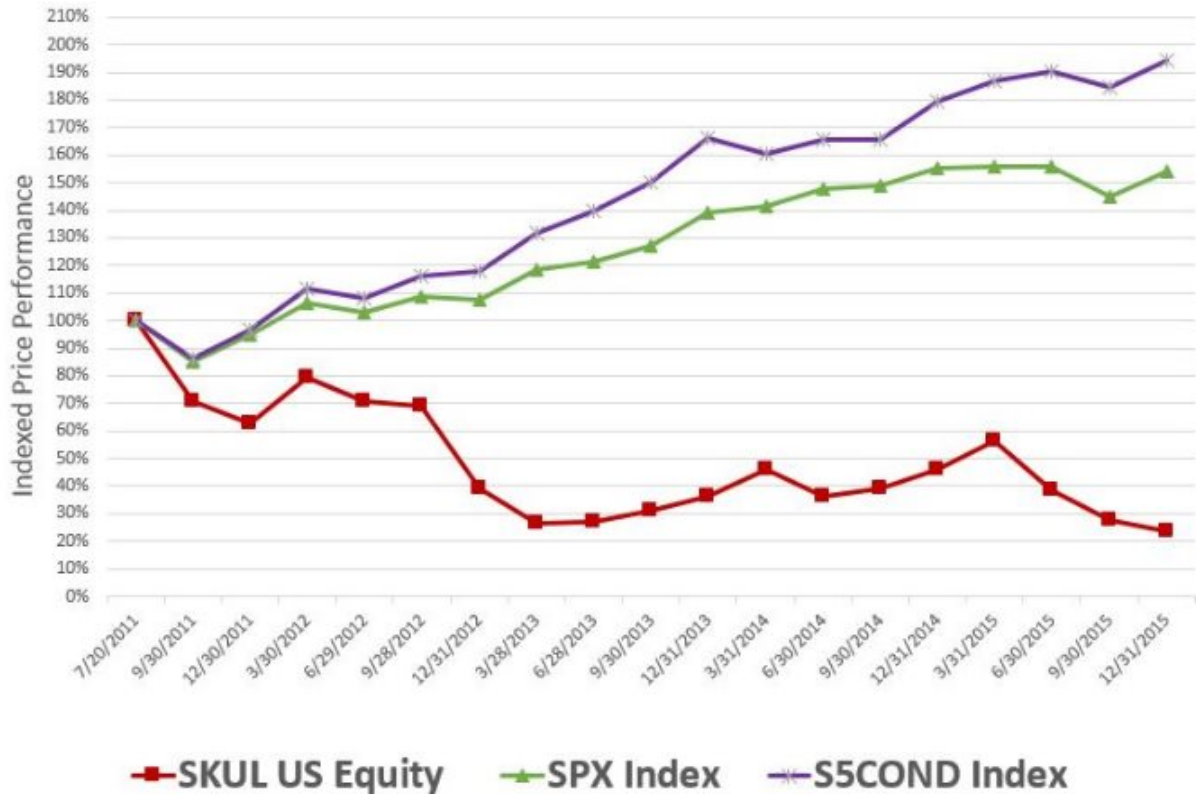
As of February 29, 2016, there were 11 stockholders of record of our common stock. This figure does not include a substantially greater number of “street name” holders or beneficial holders of our common stock whose shares are held of record by banks, brokers and other financial institutions.

Stock Performance Graph and Cumulative Total Return

Notwithstanding any statement to the contrary in any of our previous or future filings with the SEC, the following information relating to the price performance of our common stock shall not be deemed to be “filed” with the SEC or to be “soliciting material” under the Securities Exchange Act of 1934, as amended, or the Exchange Act, and it shall not be deemed to be incorporated by reference into any of our filings under the Securities Act or the Exchange Act, except to the extent we specifically incorporate it by reference into such filing.

The following graph shows a comparison from July 20, 2011 (the date our common stock commenced trading on NASDAQ) through December 31, 2015 of the cumulative total return assuming a \$100 investment in our common stock, the S&P 500 Index and the S&P 500 Consumer Durables Index. Data for the S&P 500 Index and the S&P 500 Consumer Durables Index assume reinvestment of dividends. The comparisons in this graph below are based on historical data and are not intended to forecast or be indicative of future performance of our common stock.

July 20, 2011- December 31, 2015



Dividend Policy

We have never paid any dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Any future determination to pay cash dividends will be at the discretion of our board of directors and will depend on our financial condition, operating results, capital requirements and such other factors as our board of directors deems relevant. In addition, our credit facility restricts our ability to pay dividends under certain circumstances.

Unregistered Sale of Equity Securities and Issuer Purchases of Equity Securities

We did not sell any unregistered equity securities or purchase any of our securities during the period ended December 31, 2015 .

Securities Authorized for Issuance under Equity Compensation Plans

See Part III, Item 12 of this annual report for disclosure relating to our equity compensation plans. Such information will be included in our Proxy Statement, which is incorporated herein by reference.

Item 6. Selected Consolidated Financial Data

The selected consolidated statement of operations data for the years ended December 31, 2015 , 2014 , and 2013 and the selected consolidated balance sheet data as of December 31, 2015 and 2014 have been derived from our audited consolidated financial statements included elsewhere in this 10-K, which have been audited by Ernst & Young LLP, our independent registered public accounting firm. The selected consolidated statements of operations data for the years ended December 31, 2012 and 2011, and the selected consolidated balance sheet data at December 31, 2013, 2012 and 2011 have been derived from our audited consolidated financial statements not included in this annual report and which have been audited by Ernst & Young LLP. You should read this information together with “Management’s Discussion and Analysis of Financial

Condition and Results of Operations” and our consolidated financial statements and related notes, each included elsewhere in this annual report. Our historical results are not necessarily indicative of the results to be expected in any future period.

	Year ended December 31,				
	2015	2014	2013	2012	2011
	(in thousands, except share and per share data)				
Consolidated Statements of Operations Data:					
Net sales	\$ 266,316	\$ 247,812	\$ 210,092	\$ 297,686	\$ 232,469
Cost of goods sold	156,441	137,178	116,958	158,254	116,930
Gross profit	109,875	110,634	93,134	139,432	115,539
Selling, general and administrative expenses	100,903	98,847	98,129	97,948	73,378
Income (loss) from operations	8,972	11,787	(4,995)	41,484	42,161
Other expense	1,578	1,560	516	453	1,761
Interest (income) expense	(2)	131	382	641	7,473
Income (loss) before income taxes and noncontrolling interests	7,396	10,096	(5,893)	40,390	32,927
Income taxes (benefit)	2,103	2,523	(2,882)	14,574	14,306
Net income (loss)	5,293	7,573	(3,011)	25,816	18,621
Net (loss) income attributable to noncontrolling interests	(588)	(26)	25	63	4
Preferred stock dividends	—	—	—	—	(17)
Net income (loss) attributable to Skullcandy, Inc.	\$ 5,881	\$ 7,599	\$ (3,036)	\$ 25,879	\$ 18,600
Net income (loss) per common share attributable to Skullcandy, Inc.:					
Basic	\$ 0.21	\$ 0.27	\$ (0.11)	\$ 0.94	\$ 0.93
Diluted	\$ 0.20	\$ 0.27	\$ (0.11)	\$ 0.92	\$ 0.79
Weighted average shares outstanding:					
Basic	28,415,066	28,058,603	27,740,945	27,405,017	20,078,579
Diluted	28,828,758	28,570,472	27,740,945	27,980,983	23,573,962

	As of December 31,				
	2015	2014	2013	2012	2011
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash, cash equivalents, and short-term investments	\$ 23,573	\$ 36,633	\$ 38,835	\$ 19,345	\$ 23,302
Working capital	\$ 125,019	\$ 116,420	\$ 105,970	\$ 101,832	\$ 72,180
Total assets	\$ 197,690	\$ 212,166	\$ 182,914	\$ 188,275	\$ 168,611
Total debt	\$ —	\$ —	\$ —	\$ —	\$ 9,884
Total stockholders' equity	\$ 160,088	\$ 153,537	\$ 141,714	\$ 142,122	\$ 106,812

Item 7.

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

The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements as a result of various factors, including, without limitation, those set forth in "Risk Factors," "Special Note Regarding Forward-Looking Statements" and other matters included elsewhere in this Form 10-K. The following discussion of our financial condition and results of operations should be

read in conjunction with our consolidated financial statements and the related notes thereto included elsewhere in this annual report, as well as the information presented under "Selected Consolidated Financial Data."

Basis of Presentation

Our net sales are derived primarily from the sale of headphones and audio accessories under the Skullcandy and Astro Gaming brand names. Amounts billed to retailers for shipping and handling are included in net sales. Sales are reported net of estimated product returns and pricing adjustments. The Domestic segment primarily consists of Skullcandy and Astro Gaming product sales to customers in the United States. The international segment primarily includes product sales to customers outside the United States.

Gross profit is influenced by cost of goods sold, which consists primarily of product costs, packaging, freight, duties and warehousing. We are experiencing higher product costs due to increasing labor and other costs in China. If we are unable to pass along these costs to our retailers and distributors or shift our sales mix to higher margin products, our gross profit as a percentage of net sales, or gross margin, may decrease.

Our selling, general and administrative expenses consist primarily of marketing and advertising expenses, wages, related payroll and employee benefit expenses, including stock-based compensation, commissions to outside sales representatives, legal and professional fees, travel expenses, utilities, other facility related costs, such as rent and depreciation, amortization of intangible assets and consulting expenses. The primary components of our marketing and advertising expenses include in-store advertising and maintenance of in-store assets, brand building fixtures, content creation, sponsorship of trade shows and events, promotional products and sponsorships for athletes, musicians and artists.

Results of Operations

The following table sets forth selected items in our statements of operations in dollars and as a percentage of net sales for the periods presented:

	Year ended December 31,					
	2015		2014		2013	
Net sales	\$ 266,316	100.0 %	\$ 247,812	100.0%	\$ 210,092	100.0 %
Cost of goods sold	156,441	58.7 %	137,178	55.4%	116,958	55.7 %
Gross profit	109,875	41.3 %	110,634	44.6%	93,134	44.3 %
Selling, general and administrative expenses	100,903	37.9 %	98,847	39.9%	98,129	46.7 %
Income (loss) from operations	8,972	3.4 %	11,787	4.8%	(4,995)	(2.4)%
Other expense	1,578	0.6 %	1,560	0.6%	516	0.2 %
Interest (income) expense	(2)	— %	131	0.1%	382	0.2 %
Income (loss) before income taxes and noncontrolling interests	7,396	2.8 %	10,096	4.1%	(5,893)	(2.8)%
Income taxes	2,103	0.8 %	2,523	1.0%	(2,882)	(1.4)%
Net income (loss)	5,293	2.0 %	7,573	3.1%	(3,011)	(1.4)%
Net (loss) income attributable to noncontrolling interests	(588)	— %	(26)	—%	25	— %
Net income (loss) attributable to Skullcandy, Inc.	\$ 5,881	2.2 %	\$ 7,599	3.1%	\$ (3,036)	(1.4)%

Year Ended December 31, 2015 Compared to Year Ended December 31, 2014

Net Sales

The following table reflects our net sales for the years ended December 31, 2015 and 2014 (in thousands):

	Year Ended December 31,		\$ Change	% Change
	2015	2014		
Net sales				
Domestic	\$ 190,926	\$ 174,663	\$ 16,263	9.3%
International	75,390	73,149	2,241	3.1%
Total net sales	<u>\$ 266,316</u>	<u>\$ 247,812</u>	<u>\$ 18,504</u>	<u>7.5%</u>

The following are components of revenue growth compared to the prior year:

	Domestic	International
	2015 vs. 2014	2015 vs. 2014
Volume	0.1%	13.1 %
Price	9.2%	(8.9)%
Foreign currency impact	—%	(1.1)%
	<u>9.3%</u>	<u>3.1 %</u>

Total net sales increased 7.5% , or 10.2% on a currency neutral basis, with increased sales in both segments. Domestic net sales increased primarily due to product mix shift towards higher priced wireless headphones and gaming products. This trend of slow domestic volume and increased average selling price is expected to continue as the headphone market continues its transition towards wireless products and away from traditional wired products. International net sales increased primarily due to increased sales of both gaming and audio products in Europe and Japan, and to a lesser extent Canada. International net sales were partially offset by foreign currency effect which led to a decrease in average selling price.

Gross Profit and gross margin

Our overall gross margins fluctuate based on our sales volume mix between our segments, changes in customer pricing, inventory management decisions, discounts and promotions, product mix of sales, and operational and fulfillment costs.

The following tables reflect our gross profit and gross margin for the years ended December 31, 2015 and 2014 (in thousands):

	Year Ended December 31,		\$ Change	% Change
	2015	2014		
Gross profit				
Domestic	\$ 80,311	\$ 78,495	\$ 1,816	2.3 %
International	29,564	32,139	(2,575)	(8.0)%
Total gross profit	\$ 109,875	\$ 110,634	\$ (759)	(0.7)%
	Year Ended December 31,		Basis Point Change	
	2015	2014		
Gross margin %				
Domestic %	42.1%	44.9%	(280)	
International %	39.2%	43.9%	(470)	
Total gross margin %	41.3%	44.6%	(330)	

Gross margins across both segments decreased due to a shift in product sales mix towards lower margin audio and gaming products and increased warehousing, partially offset by minimal decreases in freight related expenses. We estimate that of the 330 basis point decline in total gross margin, that approximately 120 basis points related to foreign currency depreciation.

Selling, General and Administrative Expenses

The following table reflects our selling, general and administrative expenses for the years ended December 31, 2015 and 2014 (in thousands):

	Year Ended December 31,		\$ Change	% Change
	2015	2014		
Selling, general and administrative expenses	\$ 100,903	\$ 98,847	\$ 2,056	2.1%
Selling, general and administrative expenses as a percent of net sales	37.9%	39.9%		

While SG&A expenses as a percentage of net sales decreased due to better operating leverage of our expenses, the overall increase in SG&A expenses is primarily due to increased bad debt expense of \$1.6 million related to a China distributor, increased demand creation and product creation expenses, partially offset by decreases in personnel related expenses.

We expect to make critical investments in the business to support long-term growth. In particular, we intend to continue to invest in marketing, demand creation and product creation efforts at the same level or higher levels while also continuing to invest in increased amounts for product innovation and for development efforts.

Income from Operations

Income from operations was \$9.0 million and \$11.8 million for the year ended December 31, 2015 and 2014, respectively. Income from operations as a percentage of net sales was 3.4% and 4.8% for the year ended December 31, 2015 and 2014, respectively.

Other Expense

Other expense was \$1.6 million for the year ended December 31, 2015 and 2014, which includes currency effects in Europe, Canada, Japan, China and Mexico.

Interest (Income) Expense

Interest (income) expense was \$(2,000) and \$131,000 for the year ended December 31, 2015 and 2014, respectively. The interest income in the year ended December 31, 2015 primarily includes the interest earned from short-term investments, while the interest expense in the year ended December 31, 2014 was partially due to amortization of deferred financing fees,

which included write downs of deferred financing fees in conjunction with debt modifications and commitment fees associated with our credit facility. As of December 31, 2015 and 2014 there were no borrowings outstanding on the revolving credit facility.

Income Taxes

Income tax expense was \$2.1 million and \$2.5 million for the year ended December 31, 2015 and 2014 , respectively. Our effective tax rate for the year ended December 31, 2015 and 2014 was 28.4% and 24.9% , respectively, which increased on a yearly basis due to the change in mix between income in different taxing jurisdictions, specifically more income being allocated to the US which has one of the highest tax rates.

Noncontrolling Interest

For the years ended December 31, 2015 and 2014, we had a joint venture in Mexico to facilitate distribution of our products in Mexico in which we owned a majority of the joint venture and the voting rights and control the day-to-day operations.

Noncontrolling interest for the year ended December 31, 2015 and 2014 consists solely of losses from our Mexico joint venture that are attributable to the other partner in the joint venture. On December 31, 2015, we acquired the minority interest in our Mexico joint venture and now operate a wholly-owned subsidiary in this market.

Net Income Attributable to Skullcandy, Inc.

The resulting net income attributable to Skullcandy, Inc. for the year ended December 31, 2015 and 2014 was \$5.9 million and \$7.6 million , respectively.

Year Ended December 31, 2014 Compared to Year Ended December 31, 2013
Net Sales

The following table reflects our net sales for the year ended December 31, 2014 and 2013 (in thousands):

	Twelve months ended December 31,		\$ Change	% Change
	2014	2013		
Net sales				
Domestic	\$ 174,663	\$ 147,156	\$ 27,507	18.7%
International	73,149	62,936	10,213	16.2%
Total net sales	\$ 247,812	\$ 210,092	\$ 37,720	18.0%

The following are components of revenue growth compared to the prior year:

	Domestic	International
	2014 vs. 2013	2014 vs. 2013
Volume	11.7%	12.9%
Price	7.0%	2.9%
Foreign currency impacts	—%	0.4%
	18.7%	16.2%

Total net sales increased with our increased sales in segments. Domestic net sales increased primarily due to increased sales volumes of earbuds, gaming products, wireless speakers and expanded distribution. International net sales increased primarily due to increased sales in Canada, and to a lesser extent Mexico and China as a result of expanded distribution.

Gross Profit

Our overall gross margins fluctuate based on our sales volume mix between our segments, changes in customer pricing, inventory management decisions, discounts and promotions, product mix of sales, and operational and fulfillment costs.

The following table reflects our gross profit and gross margin for the year ended December 31, 2014 and 2013 (in thousands):

	Twelve months ended December 31,		\$ Change	% Change
	2014	2013		
Gross profit				
Domestic	\$ 78,495	\$ 65,078	\$ 13,417	20.6%
International	32,139	28,056	4,083	14.6%
Total gross profit	\$ 110,634	\$ 93,134	\$ 17,500	18.8%

	Twelve months ended December 31,		Basis Point Change
	2014	2013	
Gross margin %			
Domestic %	44.9%	44.2%	70
International %	43.9%	44.6%	(70)
Total gross margin %	44.6%	44.3%	30

Total gross margin increased due to a shift in product sales mix into higher margin products, including licensing, and decreases in logistic costs as percentage of net sales and warranty expenses as a result of improved product quality.

Selling, General and Administrative Expenses

The following table reflects our selling, general and administrative expenses for the year ended December 31, 2014 and 2013 (in thousands):

	Year Ended December 31,		\$ Change	% Change
	2014	2013		
Selling, general and administrative expenses	\$ 98,847	\$ 98,129	\$ 718	0.7%
Selling, general and administrative expenses as a percent of net sales	39.9%	46.7%		

While SG&A expenses as a percentage of net sales decreased due to better operating leverage of our expenses, the overall increase in SG&A expenses is primarily due to an increase in marketing, demand creation and product creation expenses, personnel related expenses and increased third party commission expense as a result of higher sales, partially offset by decreases in bad debt expense.

We expect to make critical investments in the business to support long-term growth. In particular, we intend to continue to invest in marketing, demand creation and product creation efforts at the same level or higher levels while also continuing to invest in increased amounts for product innovation and for development efforts.

Income (Loss) from Operations

Income (loss) from operations was \$11.8 million and \$(5.0) million for the year ended December 31, 2014 and 2013, respectively. Income (loss) from operations as a percentage of net sales was 4.8% and (2.4)% for the year ended December 31, 2014 and 2013, respectively.

Other Expense

Other expense was \$1.6 million and \$516,000 for the year ended December 31, 2014 and 2013, respectively, which increased as a result of currency effects in Europe, Canada, Japan and Mexico.

Interest Expense

Interest expense was \$131,000 and \$382,000 for the year ended December 31, 2014 and 2013, respectively, which primarily includes the amortization of deferred financing fees, write downs of deferred financing fees in conjunction with debt modifications, commitment fees associated with our credit facility offset by income earned through short-term investments. As of December 31, 2014 and 2013 there were no borrowings outstanding on the revolving credit facility.

Income Taxes

The income tax expense (benefit) was \$2.5 million and \$(2.9) million for the year ended December 31, 2014 and 2013, respectively. Our effective tax rate for the year ended December 31, 2014 and 2013 was 24.9% and 48.7%, respectively, which decreased on a yearly basis due to the change in mix between income in different taxing jurisdictions, many of which are lower than the US Federal Income tax rate.

Noncontrolling Interest

For the years ended December 31, 2014 and 2013, we had a joint venture in Mexico to facilitate distribution of our products in Mexico in which we owned a majority of the joint venture and the voting rights and control the day-to-day operations. Noncontrolling interest for the years ended December 31, 2014 and 2013 consists solely of income (loss) from our Mexico joint venture that are attributable to the other partner in the joint venture.

Net Income (Loss) Attributable to Skullcandy, Inc.

The resulting net income (loss) attributable to Skullcandy, Inc. for the year ended December 31, 2014 and 2013 was \$7.6 million and \$(3.0) million, respectively.

Selected Quarterly Financial Data (Unaudited)

The following table sets forth our unaudited quarterly consolidated statement of operations data for the eight quarters ended December 31, 2015. The information for each quarter is derived from our unaudited interim consolidated financial statements, which we have prepared on the same basis as the audited consolidated financial statements appearing elsewhere in this annual report. This information includes all adjustments that management considers necessary for the fair presentation of such data and include certain immaterial error corrections, reclassifications and rounding differences. The quarterly data should be read together with our consolidated financial statements and related notes appearing elsewhere in this annual report.

	Dec. 31, 2015	Sept. 30, 2015 (1)	Jun. 30, 2015 (2)	Mar. 31, 2015 (3)	Dec. 31, 2014	Sept. 30, 2014	Jun. 30, 2014	Mar. 31, 2014
(in thousands, except per share data)								
Net sales	\$ 96,051	\$ 67,230	\$ 57,393	\$ 45,642	\$ 96,815	\$ 58,055	\$ 53,861	\$ 39,080
Cost of goods sold	57,367	39,225	32,866	26,983	54,899	31,731	29,632	20,917
Gross profit	38,684	28,005	24,527	18,659	41,916	26,324	24,229	18,163
Selling, general and administrative expenses	30,171	24,923	23,502	22,307	31,098	22,741	22,928	22,080
Income (loss) from operations	8,513	3,082	1,025	(3,648)	10,818	3,583	1,301	(3,917)
Other expense (income)	434	261	(111)	995	790	934	(375)	170
Interest expense (income)	10	(1)	5	(16)	(11)	(9)	181	11
Income before income taxes	8,069	2,822	1,131	(4,627)	10,039	2,658	1,495	(4,098)
Income taxes (benefit)	2,218	697	(19)	(793)	2,808	507	(85)	(706)
Net income (loss)	5,851	2,125	1,150	(3,834)	7,231	2,151	1,580	(3,392)
Net (loss) income attributable to noncontrolling interests	(245)	(176)	(65)	(103)	(150)	45	8	71
Net income (loss) attributable to Skullcandy, Inc.	\$ 6,096	\$ 2,301	\$ 1,215	\$ (3,731)	\$ 7,381	\$ 2,106	\$ 1,572	\$ (3,463)
Net income (loss) per common share attributable to Skullcandy, Inc.								
Basic	\$ 0.21	\$ 0.08	\$ 0.04	\$ (0.13)	\$ 0.26	\$ 0.07	\$ 0.06	\$ (0.12)
Diluted	0.21	0.08	0.04	(0.13)	0.26	0.07	0.06	(0.12)
Weighted average common shares outstanding								
Basic	28,534	28,478	28,380	28,267	28,201	28,136	28,041	27,835
Diluted	28,643	28,754	28,952	28,267	28,774	28,488	28,507	27,835

(1) Results contain immaterial error corrections that increase gross profit and operating expense by \$453,000 due to reclassifications of certain gaming licenses, marketing development fees, and slotting fees between SG&A and costs of goods sold. In total, these reclassifications did not result in any adjustment to operating income, net income, or earnings per share.

(2) Results contain the same reclassifications noted at (1) above and in total reduced gross profit and operating expenses by \$313,000 and did not result in any adjustment to operating income, net income, or earnings per share.

(3) Results contain the same reclassifications noted at (1) above and in total reduced gross profit and operating expenses by \$59,000 and did not result in any adjustment to operating income, net income, or earnings per share.

Historically, we have experienced greater net sales in the second half of the year than those in the first half due to a concentration of shopping during the fall and holiday seasons. We anticipate that this trend of seasonal impact on our net sales is likely to continue. In 2015, approximately 36% of our net sales and 35% of our gross profit were generated in the fourth quarter of the year. Accordingly, our results of operations for any particular quarter are not indicative of the results we expect for the full year. As a result of the effects of seasonality, particularly in preparation for the fall and holiday shopping seasons, our inventory levels and other working capital requirements generally begin to increase during the second quarter and into the third quarter of each year. During these peak periods, we have historically had sufficient working capital to avoid drawing down on our credit facility.

Liquidity and Capital Resources

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Our primary cash needs are working capital and capital expenditures. Historically, we have generally financed these needs with operating cash flows. This source of liquidity may be impacted by fluctuations in demand for our products, ongoing investments in our infrastructure and expenditures on marketing and advertising.

The following table sets forth, for the periods indicated, our beginning balance of cash, net cash flows provided by and used in operating, investing and financing activities and our ending balance of cash:

	Year ended December 31,		
	2015	2014	2013
	(in thousands)		
Cash and cash equivalents at beginning of year	\$ 21,623	\$ 38,835	\$ 19,345
Net cash (used in) provided by operating activities	(1,536)	7,147	23,456
Net cash provided by (used in) investing activities	4,034	(26,074)	(4,131)
Net cash (used in) provided by financing activities	(813)	1,660	(159)
Effect of exchange rate changes on cash and cash equivalents	(278)	55	324
Cash and cash equivalents at end of year	<u>\$ 23,030</u>	<u>\$ 21,623</u>	<u>\$ 38,835</u>

Net Cash (Used in) Provided by Operating Activities

Cash from operating activities consists primarily of net income (loss) adjusted for certain non-cash items including depreciation and amortization expense, loss on disposal of property and equipment, provision for doubtful accounts, deferred income taxes, non-cash interest expense, amortization of stock-based compensation expense and the effect of changes in working capital and other activities.

In 2015, net cash used in operating activities was \$1.5 million and consisted of net income of \$5.3 million plus \$19.4 million for non-cash items, less \$26.2 million for working capital and other activities. Non-cash items consisted primarily of \$10.3 million of depreciation and amortization, \$4.0 million of stock-based compensation amortization and \$2.3 million of provisions for doubtful account. Working capital and other activities consisted primarily of decreases in accounts receivable of \$14.2 million, decreases in accounts payable of \$13.1 million, and decreases in accrued liabilities of \$8.5 million; partially offset by increases in inventory of \$12.5 million.

In 2014, net cash provided by operating activities was \$7.1 million and consisted of net income of \$7.6 million plus \$14.3 million for non-cash items, less \$14.7 million for working capital and other activities. Non-cash items consisted primarily of \$9.6 million of depreciation and amortization and \$3.4 million of stock-based compensation amortization. Working capital and other activities consisted primarily of increases in accounts receivable of \$18.1 million, increases in inventory of \$15.2 million, partially offset by a decreases in accounts payable of \$11.7 million and decreases in accrued liabilities of \$7.0 million.

In 2013, net cash provided by operating activities was \$23.5 million and consisted of net loss of \$(3.0) million plus \$11.8 million for non-cash items, less \$14.7 million for working capital and other activities. Non-cash items consisted primarily of \$9.4 million of depreciation and amortization, \$2.2 million for the loss on disposal of fixed assets, \$1.3 million for the provision for doubtful accounts and \$3.6 million of stock-based compensation expense. Working capital and other activities consisted primarily of decreases in accounts receivable of \$17.3 million, partially offset by a decrease in accounts payable of \$6.3 million.

Net Cash Provided by (Used in) Investing Activities

In 2015, net cash provided by investing activities consisted primarily of proceeds of \$14.5 million from sale of our short-term investments, partially offset by \$10.5 million for capital expenditures for in-store displays.

In 2014, net cash used in investing activities consisted primarily of \$11.1 million for purchase of property and equipment and \$15.0 million of purchases of short-term investments.

In 2013, net cash used in investing activities consisted primarily of \$4.1 million for purchase of property and equipment.

Net Cash (Used in) Provided by Financing Activities

In 2015, net cash used in financing activities was \$813,000 and related to taxes paid to net share settle of equity awards and purchase of noncontrolling interest.

In 2014, net cash provided by financing activities was \$1.7 million and consisted primarily of proceeds from the exercise of stock options.

In 2013, net cash used in financing activities was \$0.2 million and consisted primarily of debt issuance costs.

We believe that our cash, cash flow from operating activities and available borrowings under our credit facility will be sufficient to meet our capital requirements for at least the next twelve months.

Indebtedness

On August 19, 2013, we entered into a credit agreement and revolving line of credit, or the credit facility, with Wells Fargo Bank National Association which was subsequently amended on April 29, 2014, which provides a line of credit of up to \$10 million, and expires on August 19, 2018. As a subfeature, the credit facility provided for letters of credit up to \$5 million. The credit facility is secured with a first-priority lien against substantially all of our assets.

The credit facility required us to be in compliance with specified affirmative financial covenants, including (a) total liabilities divided by tangible net worth not greater than 1.0 to 1.0 as of the last day of each fiscal quarter; (b) current ratio not less than 2.00 to 1.00 as of the last day of each fiscal quarter; (c) and EBITDA coverage ratio of not less than 2.0 to 1.0 as of the last day of each fiscal.

Our credit facility was amended April 7, 2015 and contains certain financial covenants and other restrictions that limit our ability, among other things, to: (a) make fixed asset purchases greater than \$19 million in aggregate for fiscal year 2015, \$23 million for fiscal year 2016, and \$15 million for any fiscal year thereafter; (b) incur operating lease expenses in any fiscal year greater than \$3 million in aggregate; and (c) create, incur, assume or permit to exist any indebtedness or liabilities resulting from borrowings, loans or advances, whether secured or unsecured, matured or unmatured, liquidated or unliquidated, joint or several, except (1) the liabilities of the Company and each of its subsidiaries to Wells Fargo, (2) permitted investments, (3) uncapped permitted indebtedness, and (4) capped permitted indebtedness up to \$2 million in the aggregate outstanding at any one time. Additional covenants and other restrictions exist that limit our ability, among other things, to: undergo a merger or consolidation, sell certain assets, create liens, guarantee certain obligations of third parties, make certain investments or acquisitions, and declare dividends or make distributions.

At December 31, 2015, we were in compliance with all applicable covenants in our credit facility.

Contractual Obligations and Commitments

The following table summarizes, as of December 31, 2015, the total amount of future payments due in various future periods:

	Payments Due by Period				
	Total	Less Than One Year	1-3 Years	4-5 Years	More Than Five Years
	(in thousands)				
Operating lease obligations	\$ 22,700	\$ 1,581	\$ 3,593	\$ 4,347	\$ 13,179
Sponsorship agreements	960	954	6	—	—
Other contractual obligations	2,099	1,833	266	—	
Total	<u>\$ 25,759</u>	<u>\$ 4,368</u>	<u>\$ 3,865</u>	<u>\$ 4,347</u>	<u>\$ 13,179</u>

We lease office space under non-cancelable operating leases. The leases expire at various dates through 2027, excluding extensions at our option, and contain provisions for rental adjustments, including in certain cases, adjustments based on increases in the Consumer Price Index. The leases generally contain renewal provisions for varying periods of time.

We have contractual relationships with certain of our sponsored athletes, musicians and artists, whereby we compensate them for promoting our products or pay them a royalty on sales of their signature headphones. Sponsorship arrangements are typically structured to give our sponsored team members financial incentives to maintain a highly visible profile with our products. Our contracts typically have a one-to three-year term, and grant us a license for the use of their names and likenesses, and typically require them to maintain exclusive association with our headphones. In turn, we agree to make cash payments to our sponsored team members for wearing our products during various public appearances, in magazine shoots and on the podium after certain competitive victories. In addition to cash payments, we also generally provide limited

complimentary products for their use, and reimburse certain travel expenses incurred in conjunction with promoting our products.

Our other contractual obligations consist of warehouse distribution services with our third party supply chain providers.

Indemnification

We agreed to indemnify our officers and directors for certain events or occurrences, while the officer or director is or was serving at our request in such capacity. The maximum amount of potential future indemnification is unlimited; however, we have a director and officer insurance policy that limits our exposure and could enable us to recover a portion of any future amounts paid. We are unable to reasonably estimate the maximum amount that could be payable under these arrangements since these obligations are not capped but are conditional to the unique facts and circumstances involved. Accordingly, we have no liabilities recorded for these agreements as of December 31, 2015 .

Off-Balance Sheet Arrangements

We currently do not have any off-balance sheet arrangements or financing activities with special-purpose entities.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. To prepare these financial statements, we must make estimates and assumptions that affect the reported amounts of assets and liabilities. These estimates also affect our reported net sales and expenses. Judgments must also be made about the disclosure of contingent liabilities. Actual results could be significantly different from these estimates. We believe that the following discussion addresses the accounting policies that are necessary to understand and evaluate our reported financial results.

Revenue Recognition and Sales Returns and Allowances

Net sales are recognized when title and risk of loss pass to the retailer, distributor or customer and when collectability is reasonably assured. Generally, we extend credit to our retailers and distributors and do not require collateral. Our payment terms are typically net-30 with terms up to net-120 for certain international customers. We recognize revenue net of estimated product returns and pricing adjustments. Further, we provide for product warranties in accordance with the contract terms given to various retailers and end users by accruing estimated warranty costs at the time of revenue recognition based on historical experience. Regarding sales returns, we have entered into contracts with various retailers granting a conditional right of return allowance with respect to defective products. The contracts with each retailer specify the defective allowance percentage of gross sales. We have executed an open return program with a major retailer allowing for an unlimited amount of returns. Estimates for these returns are based on actual experience and are recorded as a reduction of revenue at the time of recognition or when circumstances change resulting in a change in estimated returns.

Accounts Receivable

Throughout the year, we perform credit evaluations of our retailers and distributors, and we adjust credit limits based on payment history and the retailer's or distributor's current creditworthiness. We continuously monitor our collections, maintain credit insurance, and have an allowance for doubtful accounts based on our historical experience and any specific customer collection issues that have been identified. The Company records a specific reserve for individual accounts when the Company becomes aware of a customer's likely inability to meet its financial obligations, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. If circumstances related to customer change, the Company would further adjust estimates of the recoverability of receivables. Bad debt expense is reported as a component of selling, general and administrative expenses. Historically, our losses associated with uncollectible accounts have been consistent with our estimates, but there can be no assurance that we will continue to experience the same credit loss rates that we have experienced in the past. Unforeseen, material financial difficulties of our retailers or distributors could have an adverse impact on our profits.

Inventories

We value inventories at the lower of the cost or the current estimated market value of the inventory. Substantially all of our inventory is comprised of finished goods. We regularly review our inventory quantities on hand and adjust inventory values for excess and obsolete inventory based primarily on estimated forecasts of product demand and market value. Demand for our

products could fluctuate significantly. The demand for our products could be negatively affected by many factors, including, but not limited to the following:

- unanticipated changes in consumer preferences;
- weakening economic conditions;
- terrorist acts or threats;
- reduced consumer confidence in the retail market; and
- unseasonable weather.

Some of these factors could also interrupt the production and importation of our products or otherwise increase the cost of our products. As a result, our operations and financial performance could be negatively affected. Additionally, our estimate of product demand and market value could be inaccurate, which could result in excess and obsolete inventory.

Long-Lived Assets Including Goodwill and Intangible Assets

We review property and equipment and certain identifiable intangible assets for impairment. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amounts to future undiscounted cash flows the assets are expected to generate. If property, plant and equipment and certain identifiable intangibles are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds its fair market value. We did not record any impairments on our long-lived assets during 2015, 2014 and 2013.

Prior to the acquisitions of Astro Gaming in April 2011 and Kungsbacka 57 AB in August 2011, we did not have goodwill. We do not amortize goodwill and intangible assets with indefinite useful lives, rather such assets are required to be tested for impairment at least annually or sooner whenever events or changes in circumstances indicate that the assets may be impaired. We perform our goodwill and intangible asset impairment tests in the fourth quarter of each fiscal year. We have not recognized any impairments on our goodwill, however we recorded a \$688,000 impairment charge in the quarter ended March 31, 2014 related to our indefinite lived intangible trademarks and domain names which is reflected in the year ended December 31, 2014. We did not recognize any other goodwill or intangible asset impairment charges in 2015, 2014 and 2013.

We amortize our intangible assets with definite lives over their estimated useful lives and review these assets for impairment. We are currently amortizing our acquired intangible assets with definite lives over periods ranging between three to eight years.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred income tax assets and liabilities are established for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities at tax rates expected to be in effect when such assets or liabilities are realized or settled. Deferred income tax assets are reduced by valuation allowances when necessary.

Assessing whether deferred tax assets are realizable requires significant judgment. We consider all available positive and negative evidence, including historical operating performance and expectations of future operating performance. The ultimate realization of deferred tax assets is often dependent upon future taxable income and therefore can be uncertain. To the extent we believe it is more likely than not that all or some portion of the asset will not be realized, valuation allowances are established against our deferred tax assets, which increase income tax expense in the period when such a determination is made.

Income taxes include tax benefits for uncertain tax positions that are more likely than not to be sustained upon audit based on the technical merits of the tax position. Settlements with tax authorities, the expiration of statutes of limitations for particular tax positions, or obtaining new information on particular tax positions may cause a change to the effective tax rate. We recognize accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes on the consolidated statements of operations.

Recently Issued Accounting Pronouncements

In July 2015, the Financial Accounting Standards Board (“FASB”) issued guidance which requires inventory within the scope of the standard to be measured at the lower of cost and net realizable value. Previous guidance required inventory to be measured at the lower of cost or market (where market was defined as replacement cost, with a ceiling of net realizable value and floor of net realizable value less a normal profit margin). The updated guidance is effective for interim and annual

reporting periods beginning after December 15, 2016, with early adoption permitted. We are currently evaluating the impact, if any, the adoption of this standard will have on the consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers." Under the new standard, revenue is recognized at the time a good or service is transferred to a customer for the amount of consideration received for that specific good or service. It is effective for annual reporting periods beginning after December 15, 2016, including interim reporting periods, and early adoption is not permitted. Entities may use a full retrospective approach or report the cumulative effect as of the date of adoption. We have not yet determined the adoption approach and are currently evaluating the impact, if any, the adoption of this standard will have on our Consolidated Financial Statements.

Item 7A. Qualitative and Quantitative Disclosures about Market Risk

Interest Rate Risk

At December 31, 2015 we maintained a credit facility which was amended during the period and provided for revolving loans of a line of credit of up to \$10 million. As a subfeature, the credit facility provided for letters of credit up to \$5 million. At December 31, 2015, there were no borrowings outstanding. We currently do not engage in any interest rate hedging activity. Based on the average interest rate on the credit facility during the year ended December 31, 2015, and to the extent that borrowings were outstanding, we do not believe that a 10% change in the interest rate would have a material effect on our results of operations or financial condition.

Foreign Currency Risk

In the normal course of business, we are exposed to foreign currency exchange rate risks that could impact our results of operations. We are exposed to gains and losses resulting from fluctuations in foreign currency exchange rates relating to certain sales and expenses of our international subsidiaries that are denominated in currencies other than their functional currencies. We are exposed to gains and losses resulting from the effect that fluctuations in foreign currency exchange rates have on the reported results in our consolidated financial statements due to the translation of the operating results and financial position of our international subsidiaries. Changes in foreign currency rates affect our consolidated statement of operations and distort comparisons between periods. For example, when the U.S. dollar strengthens compared to the Euro, there is a negative effect on our reported results from our European operation because it takes more profits in Euro to generate the same amount of profits in stronger U.S. dollars. We do not enter into foreign currency exchange contracts to hedge the translation of operating results and financial position of our international subsidiaries, therefore we are subject to foreign currency impacts. However, a 10% change in U.S. dollar exchange rates in effect at December 31, 2015, would not have a material effect on our results of operations or financial condition.

We use various foreign currency exchange contracts as part of our overall strategy to manage the level of exposure to the risk of fluctuations in foreign currency exchange rates. On the date we enter into a derivative contract, we designate the derivative as a hedge of the identified exposure. We formally document all relationships between hedging instruments and hedged items, as well as the risk-management objective and strategy for entering into various hedge transactions. We identify in this documentation the asset, liability, firm commitment, or forecasted transaction that has been designated as a hedged item and indicate how the hedging instrument is expected to hedge the risks related to the hedged item. We formally measure effectiveness of our hedging relationships both at the hedge inception and on a quarterly basis in accordance with our risk management policy. Derivatives that do not qualify or are no longer deemed effective to qualify for hedge accounting but are used by management to mitigate exposure to currency risks are marked to fair value with corresponding gains or losses recorded in earnings. We enter into forward exchange and other derivative contracts with major banks and are exposed to foreign currency losses in the event of nonperformance by these banks. We anticipate, however, that these banks will be able to fully satisfy their obligations under the contracts. Accordingly, we do not obtain collateral or other security to support the contracts.

The net fair value of foreign currency forward contracts (including adjustments for credit risk) as of December 31, 2015 was an asset of \$453,000 and \$55,000 as of December 31, 2014. The potential decrease in fair value of foreign currency forward contracts (excluding adjustments for credit risk), assuming a 10% adverse change in the underlying foreign currency exchange rates versus the U.S. Dollar, would not have a material effect on our results of operations or financial condition.

Inflation

Inflationary factors, such as increases in the cost of our product and overhead costs, may adversely affect our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of

gross margin and selling, general and administrative expenses as a percentage of net sales if the selling prices of our products do not increase with these increased costs.

Outstanding Orders

We typically receive the bulk of our orders from retailers approximately three weeks prior to the date the products are to be shipped and from distributors approximately six weeks prior to the date the products are to be shipped. Generally, these orders are not subject to cancellation prior to the date of shipment. Retailers regularly request reduced order lead-time, which puts pressure on our supply chain. Our open order book varies by season, with the highest level occurring during the fourth quarter.

Item 8. Financial Statements and Supplementary Data.

The Consolidated Financial Statements and Schedules listed in the Index to Financial Statements, Schedules and Exhibits on page F-1 are filed as part of this annual report.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, our management evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Our management is responsible for establishing and maintaining effective internal control over financial reporting and for the assessment of the effectiveness of internal control over financial reporting. Our internal control over financial reporting is a process designed, as defined in Rule 13a-15(F) under the Exchange Act, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with U.S. generally accepted accounting principles. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and in reaching a reasonable level of assurance.

We have carried out an evaluation under the supervision and with the participation of our management, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2015.

Management's Report on Internal Control over Financial Reporting

In connection with the preparation of our annual consolidated financial statements, our management has undertaken an assessment of the effectiveness of our internal control over financial reporting based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework), or the COSO Framework. Management's assessment included evaluation of elements such as the design and operating effectiveness of key financial reporting controls, process documentation, accounting practices, and our overall control environment. Based on this evaluation, management concluded our internal controls and procedures over financial reporting were effective as of December 31, 2015. We reviewed the results of management's assessment with the Audit Committee of our Board of Directors.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements, or prevent or detect all error and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Ernst & Young LLP, our independent registered public accounting firm, has issued a report on the effectiveness of our internal control over financial reporting as of December 31, 2015, which is included herein.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Skullcandy, Inc.

We have audited Skullcandy Inc.'s internal control over financial reporting as of December 31, 2015, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the "COSO criteria"). Skullcandy, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate. In our opinion, Skullcandy, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Skullcandy, Inc. as of December 31, 2015 and 2014, and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2015 of Skullcandy, Inc. and our report dated March 4, 2016 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Salt Lake City, Utah
March 4, 2016

Item 9B. Other Information.

None.

PART III

We are incorporating by reference the information required by Part III of this annual report from our proxy statement for the Annual Meeting of Shareholders to be held May 18, 2016.

Item 10. Directors, Executive Officers and Corporate Governance.

The information called for by this Item is incorporated by reference from our 2016 Proxy Statement.

Item 11. Executive Compensation.

The information called for by this Item is incorporated by reference from our 2016 Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information called for by this Item is incorporated by reference from our 2016 Proxy Statement.

Item 13. Certain Relationships and Related Transactions and Director Independence.

The information called for by this Item is incorporated by reference from our 2016 Proxy Statement.

Item 14. Principal Accountant Fees and Services.

The information called for by this Item is incorporated by reference from our 2016 Proxy Statement.

PART IV

Item 15. Exhibits, Consolidated Financial Statements and Financial Statement Schedules.

Documents filed as part of this annual report include:

1. *Consolidated Financial Statements.* We have filed the consolidated financial statements listed in the index to Consolidated Financial Statements, Schedules and Exhibits on page F-1 as part of this annual report on Form-10K.
2. *Financial Statement Schedules and Other.* All financial statement schedules have been omitted because they are not applicable, not material or the required information is shown in the consolidated financial statements or the notes thereto.
3. *Exhibits.* The exhibits listed below are filed as part of this annual report on Form 10-K.
4. (A) Exhibits

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
3.1	Amended and Restated Certificate of Incorporation of Skullcandy, Inc. (incorporated by reference to Exhibit 3.3 to Skullcandy, Inc.'s Registration Statement on Form S-1/A, filed on July 6, 2011)
3.2	Amended and Restated Bylaws of Skullcandy, Inc. (incorporated by reference to Exhibit 3.5 to Skullcandy, Inc.'s Registration Statement on Form S-1/A, filed on July 6, 2011)
4.1	Form of Stock Certificate (incorporated by reference to Exhibit 4.1 to Skullcandy, Inc.'s Registration Statement on Form S-1/A, filed on July 6, 2011)
4.2A	Security Holders Agreement, dated November 28, 2008, by and among Skullcandy, Inc., the security holders listed on Exhibit A thereto and Goode Skullcandy Holdings LLC (incorporated by reference to Exhibit 4.2 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
4.2B	Amendment to Security Holders Agreement, dated June 16, 2011, by and among Skullcandy, Inc. and the investors listed on the signature pages thereto (incorporated by reference to Exhibit 4.2(B) to Skullcandy, Inc.'s Registration Statement on Form S-1/A, filed on July 6, 2011)

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
4.3	Modification Agreement, dated December 31, 2010, by and among Skullcandy, Inc., the selling holders listed thereto and Goode Skullcandy Holdings LLC (incorporated by reference to Exhibit 4.3 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.1	Lease Agreement, dated August 27, 2007, by and between Skullcandy, Inc. and Cottonwood Newpark One, L.C. (incorporated by reference to Exhibit 10.8 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.2	Lease Addendum No. 1, dated June 18, 2008, by and between Skullcandy, Inc. and Cottonwood Newpark One, L.C. (incorporated by reference to Exhibit 10.9 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.3	Lease Addendum No. 2, dated July 21, 2010, by and between Skullcandy, Inc. and Cottonwood Newpark One, L.C. (incorporated by reference to Exhibit 10.10 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.4	Lease Addendum No. 3, dated September 2, 2010, by and between Skullcandy, Inc. and Cottonwood Newpark One, L.C. (incorporated by reference to Exhibit 10.11 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.5	Lease Addendum No. 5, dated November 16, 2012, by and between Skullcandy, Inc. and Cottonwood Newpark One, L.C.
10.6	Lease Addendum No. 6, dated June 3, 2014, by and between Skullcandy, Inc. and Cottonwood Newpark One, L.C. (incorporated by reference to Exhibit 10.7 on Skullcandy, Inc.'s Form 10-Q, filed on August 6, 2014)
10.7	Lease Addendum No. 7, dated October 20, 2014, by and between Skullcandy, Inc. and Cottonwood Newpark One, L.C. (incorporated by reference to Exhibit 10.2 on Skullcandy, Inc.'s Form 10-Q, filed on November 11, 2014)
10.8	Master Services Agreement, dated July 16, 2010, by and between Skullcandy, Inc. and UPS Supply Chain Solutions, Inc. (incorporated by reference to Exhibit 10.12 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.9	2005 Stock Plan (incorporated by reference to Exhibit 10.13 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.10	Form of Stock Option Agreement under the 2005 Stock Plan (incorporated by reference to Exhibit 10.8 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.11A	Form of Stock Option Agreement under the 2005 Stock Plan — With Early Exercise Option (incorporated by reference to Exhibit 10.14(B) to Skullcandy, Inc.'s Registration Statement on Form S-1/A, filed on July 6, 2011)
10.12	2008 Equity Incentive Plan (incorporated by reference to Exhibit 10.15 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.13	Form of Stock Option Agreement under the 2008 Equity Incentive Plan (incorporated by reference to Exhibit 10.16 to Skullcandy, Inc.'s Registration Statement on Form S-1, filed on January 28, 2011)
10.14	Form of Stock Option Agreement under the 2011 Incentive Award Plan (incorporated by reference to Exhibit 10.18 to Skullcandy, Inc.'s Registration Statement on Form S-1/A, filed on July 6, 2011)
10.15	Board of Directors Services Agreement, dated March 21, 2011, by and between Skullcandy, Inc. and Richard Alden (incorporated by reference to Exhibit 10.20 to Skullcandy, Inc.'s Registration Statement on Form S-1/A, filed on April 28, 2011)
10.16	Form of Indemnification Agreement (incorporated by reference to Exhibit 10.25 to Skullcandy, Inc.'s Registration Statement on Form S-1/A, filed on July 6, 2011)
10.17	Form of Performance-Vesting Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 99.1 to Skullcandy, Inc.'s Current Report on Form 8-K, filed on May 25, 2012)
10.18	Amended and Restated Skullcandy, Inc. 2011 Incentive Award Plan (incorporated by reference to Annex A to Skullcandy, Inc.'s Definitive Proxy Statement on Schedule 14A filed on April 30, 2012)
10.19	Skullcandy, Inc. Nonqualified Inducement Stock Option Grant Notice and Stock Option Agreement (incorporated by reference to Exhibit 99.1 to Skullcandy, Inc.'s Registration Statement on Form S-8, filed on May 10, 2013)

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
10.20	Skullcandy, Inc. Inducement Restricted Stock Unit Award Grant Notice and Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 99.2 to Skullcandy, Inc.'s Registration Statement on Form S-8, filed on May 10, 2013)
10.21	Credit Agreement dated as of August 19, 2013, by and between Skullcandy, Inc., a Delaware corporation and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.1 to Skullcandy, Inc.'s Current Report on Form 8-K, filed on August 21, 2013)
10.22	Amended and restated revolving line of credit note dated April 29, 2014 by Skullcandy, Inc., a Delaware corporation (incorporated by reference to Exhibit 10.1 on Form 8-K, filed on April 29, 2014)
10.23	First Amendment to Credit Agreement dated April 29, 2014 by and between Skullcandy, Inc., a Delaware corporation and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.1 on Form 8-K/A, filed on August 6, 2014)
10.24	Astro Gaming Supplemental Compensation Plan (incorporated by reference to Exhibit 10.35 to Skullcandy, Inc.'s Form 10-K, filed March 17, 2014)
10.25	Amended and restated employment agreement between Skullcandy, Inc. and S. Hoby Darling, incorporated by reference to Exhibit 10.1 on Skullcandy Inc.'s Form 10-Q, filed on August 9, 2014
10.26	Amended and restated employment agreement between Skullcandy, Inc. and Jason Hodell, incorporated by reference to Exhibit 10.2 on Skullcandy Inc.'s Form 10-Q, filed on August 9, 2014
10.27	Amended and restated employment agreement between Skullcandy, Inc. and Sam Paschel Jr., incorporated by reference to Exhibit 10.3 on Skullcandy Inc.'s Form 10-Q, filed on August 9, 2014
10.28	Amended and restated employment agreement between Skullcandy, Inc. and Patrick Grosso, incorporated by reference to Exhibit 10.4 on Skullcandy Inc.'s Form 10-Q, filed on August 9, 2014
10.29	Amended and restated employment agreement between Skullcandy, Inc. and David Raffone (incorporated by reference to Exhibit 10.5 on Skullcandy Inc.'s Form 10-Q, filed on August 9, 2014)
10.30	Second Amendment to Credit Agreement dated April 7, 2015 by Skullcandy, Inc., a Delaware corporation (incorporated by reference to Exhibit 10.1 on Form 8-K, filed on April 10, 2015)
10.31	Form of Lease Agreement dated as of August 19, 2015 between Boyer Snyderville 2, L.C. and Skullcandy, Inc., (incorporated by reference to Exhibit 10.1 on Skullcandy Inc.'s Form 10-Q, filed on November 9, 2015)
10.32	Form of Expansion Space Agreement dated as of August 19, 2015 between Boyer Snyderville Junction L.C. and Skullcandy, Inc., (incorporated by reference to Exhibit 10.2 on Skullcandy Inc.'s Form 10-Q, filed on November 9, 2015)
10.33	Form of Work Letter dated as of August 19, 2015 between Boyer Snyderville 2, L.C. and Skullcandy, Inc., (incorporated by reference to Exhibit 10.3 on Skullcandy Inc.'s Form 10-Q, filed on November 9, 2015)
10.34	Lease Addendum No.8 between Cottonwood Newpark One, L.C. and Skullcandy, Inc., (incorporated by reference to Exhibit 10.4 on Skullcandy Inc.'s Form 10-Q, filed on November 9, 2015)
10.35	Lease Addendum No.9 between Cottonwood Newpark One, L.C. and Skullcandy, Inc., (incorporated by reference to Exhibit 10.5 on Skullcandy Inc.'s Form 10-Q, filed on November 9, 2015)
10.36	Form of Lease Agreement dated September 29, 2015 between 140 Partners, L.P. and Skullcandy, Inc., (incorporated by reference to Exhibit 10.6 on Skullcandy Inc.'s Form 10-Q, filed on November 9, 2015)
21.1	List of Subsidiaries
23.1	Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS*	XBRL Instance
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase
101.DEF*	XBRL Taxonomy Extension Definition Linkbase
101.LAB*	XBRL Taxonomy Extension Label Linkbase
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase

* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and is otherwise not subject to liability under these sections.

SIGNATURES

Pursuant to the requirements of the Section 13 or 15(d) Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SKULLCANDY, INC.

By: _____ /s/ JASON HODELL

Jason Hodell

Chief Financial Officer and Chief Operating Officer

March 4, 2016

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 4, 2016 .

<u>SIGNATURE</u>	<u>TITLE</u>
_____/s/ S. HOBY DARLING S. Hoby Darling	President, Chief Executive Officer and Director (Principal Executive Officer)
_____/s/ JASON HODELL Jason Hodell	Chief Financial Officer and Chief Operating Officer (Principal Accounting and Financial Officer)
_____/s/ DOUG COLLIER Doug Collier	Chairman of the Board
_____/s/ RICK ALDEN Rick Alden	Director
_____/s/ JAY BROWN Jay Brown	Director
_____/s/ JEFF KEARL Jeff Kearl	Director
_____/s/ S COTT O LIVET Scott Olivet	Director
_____/s/ HEIDI O'NEILL Heidi O'Neill	Director
_____/s/ G REG W ARNOCK Greg Warnock	Director

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Skullcandy, Inc.

We have audited the accompanying consolidated balance sheets of Skullcandy, Inc. as of December 31, 2015 and 2014, and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2015. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing 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 also 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, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Skullcandy, Inc. at December 31, 2015 and 2014, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2015, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board, Skullcandy, Inc.'s internal control over financial reporting as of December 31, 2015, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated March 4, 2016 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Salt Lake City, Utah
March 4, 2016

SKULLCANDY, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	As of December 31,	
	2015	2014
Assets		
Current assets:		
Cash and cash equivalents	\$ 23,030	\$ 21,623
Short-term investments	543	15,010
Total cash, cash equivalents, and short-term investments	23,573	36,633
Accounts receivable, net of allowance for doubtful accounts of \$3.3 million and \$1.9 million	84,909	74,358
Inventories, net	41,686	54,981
Prepaid expenses and other current assets	6,189	4,050
Deferred taxes	3,999	3,052
Total current assets	160,356	173,074
Property and equipment, net	14,830	12,911
Intangibles	7,433	8,814
Goodwill	13,867	13,867
Deferred financing fees	31	41
Non-current deferred taxes	923	3,459
Other non-current assets	250	—
Total assets	\$ 197,690	\$ 212,166
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 13,216	\$ 27,309
Accrued liabilities	21,931	29,161
Current deferred taxes	190	184
Total current liabilities	35,337	56,654
Non-current deferred taxes	1,148	1,418
Non-current liabilities	1,117	557
Total liabilities	37,602	58,629
Stockholders' equity:		
Preferred stock, par value \$0.0001 per share:		
Authorized shares - 10,000		
Issued and outstanding shares	—	—
Common stock, par value \$0.0001 per share:		
Authorized shares - 200,000		
Issued shares - 33,065 and 32,605		
Outstanding shares - 28,544 and 28,239	3	3
Treasury stock:		
Shares at cost - 4,826 and 4,826	(43,294)	(43,294)
Additional paid-in capital	137,535	136,132
Accumulated other comprehensive loss	(818)	(625)
Retained earnings	66,662	60,781
Total stockholders' equity	160,088	152,997
Noncontrolling interests	—	540
Total stockholders' equity attributable to Skullcandy	160,088	153,537
Total liabilities and stockholders' equity	\$ 197,690	\$ 212,166

See the accompanying notes to consolidated financial statements.

SKULLCANDY, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share data)

	Year Ended December 31,		
	2015	2014	2013
Net sales	\$ 266,316	\$ 247,812	\$ 210,092
Cost of goods sold	156,441	137,178	116,958
Gross profit	109,875	110,634	93,134
Selling, general and administrative expenses	100,903	98,847	98,129
Income (loss) from operations	8,972	11,787	(4,995)
Other expense	1,578	1,560	516
Interest (income) expense	(2)	131	382
Income (loss) before income taxes and noncontrolling interests	7,396	10,096	(5,893)
Income tax expense (benefit)	2,103	2,523	(2,882)
Net income (loss)	5,293	7,573	(3,011)
Net (loss) income attributable to noncontrolling interests	(588)	(26)	25
Net income (loss) attributable to Skullcandy, Inc.	\$ 5,881	\$ 7,599	\$ (3,036)
Net income (loss) per common share attributable to Skullcandy, Inc.			
Basic	\$ 0.21	\$ 0.27	\$ (0.11)
Diluted	0.20	0.27	(0.11)
Weighted average common shares outstanding			
Basic	28,415,066	28,058,603	27,740,945
Diluted	28,828,758	28,570,472	27,740,945

See the accompanying notes to consolidated financial statements.

SKULLCANDY, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands of dollars)

	Twelve Months Ended December 31,		
	2015	2014	2013
Net income (loss)	\$ 5,293	\$ 7,573	\$ (3,011)
Change in unrealized gain (loss) on foreign currency cash flow hedges, net of tax expense of \$98, \$20 and \$20, for the years ended December 31, 2015, 2014 and 2013, respectively	181	268	(178)
Change in unrecognized actuarial loss, net of tax benefit of \$1 and \$45 for the years ended December 31, 2015 and 2014, respectively	(3)	(441)	—
Change in unrealized gain (loss) on short-term investments, net of tax benefit of \$1 and \$9 for the years ended December 31, 2015 and 2014, respectively	29	(30)	—
Foreign currency translation adjustment	(400)	(251)	29
Comprehensive income (loss)	5,100	7,119	(3,160)
Comprehensive (loss) income attributable to noncontrolling interests	(588)	(26)	25
Comprehensive income (loss) attributable to Skullcandy, Inc.	\$ 5,688	\$ 7,145	\$ (3,185)

See the accompanying notes to consolidated financial statements.

SKULLCANDY, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands of dollars)

	Common Stock		Treasury Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Skullcandy Stockholders' Equity	Noncontrolling Interests	Total Stockholders' Equity
	Shares	Amount							
Balance at December 31, 2012	27,699	\$ 3	\$ (43,294)	\$ 128,676	\$ (22)	\$ 56,218	\$ 141,581	\$ 541	\$ 142,122
Net income (loss)	—	—	—	—	—	(3,036)	(3,036)	25	(3,011)
Exercise of stock options	44	—	—	174	—	—	174	—	174
Vesting of restricted stock	35	—	—	—	—	—	—	—	—
Stock-based compensation	—	—	—	3,632	—	—	3,632	—	3,632
Tax benefit related to stock options	—	—	—	(92)	—	—	(92)	—	(92)
Deferred tax asset true up to APIC pool	—	—	—	(962)	—	—	(962)	—	(962)
Unrealized loss on foreign currency cash flow hedges, net of tax	—	—	—	—	(178)	—	(178)	—	(178)
Foreign currency translation	—	—	—	—	29	—	29	—	29
Balance at December 31, 2013	27,778	\$ 3	\$ (43,294)	\$ 131,428	\$ (171)	\$ 53,182	\$ 141,148	\$ 566	\$ 141,714
Net income (loss)	—	—	—	—	—	7,599	7,599	(26)	7,573
Exercise of stock options	288	—	—	2,128	—	—	2,128	—	2,128
Issuance of common stock for restricted share units	209	—	—	—	—	—	—	—	—
Shares withheld related to issuance of common stock for restricted share units	(36)	—	—	(354)	—	—	(354)	—	(354)
Stock-based compensation	—	—	—	3,398	—	—	3,398	—	3,398
Unrealized gain on foreign currency cash flow hedges, net of tax	—	—	—	—	268	—	268	—	268
Unrealized loss on short-term investments, net of tax	—	—	—	—	(30)	—	(30)	—	(30)
Unrealized loss on pension liability, net of tax	—	—	—	—	(441)	—	(441)	—	(441)
Tax benefit related to stock options	—	—	—	(468)	—	—	(468)	—	(468)
Foreign currency translation	—	—	—	—	(251)	—	(251)	—	(251)
Balance at December 31, 2014	28,239	\$ 3	\$ (43,294)	\$ 136,132	\$ (625)	\$ 60,781	\$ 152,997	\$ 540	\$ 153,537
Net income (loss)	—	—	—	—	—	5,881	5,881	(588)	5,293
Exercise of stock options	50	—	—	359	—	—	359	—	359
Issuance of common stock for restricted share units	311	—	—	—	—	—	—	—	—
Shares withheld related to issuance of common stock for restricted share units	(56)	—	—	(489)	—	—	(489)	—	(489)
Stock-based compensation	—	—	—	3,992	—	—	3,992	—	3,992
Unrealized gain on foreign currency cash flow hedges, net of tax	—	—	—	—	181	—	181	—	181
Unrealized gain on short-term investments, net of tax	—	—	—	—	29	—	29	—	29
Unrealized loss on pension liability, net of tax	—	—	—	—	(3)	—	(3)	—	(3)
Purchase of non-controlling interest	—	—	—	(800)	—	—	(800)	48	(752)
Reduction in deferred tax assets due to expired options	—	—	—	(1,728)	—	—	(1,728)	—	(1,728)
Tax impacts to APIC pool related to share based award activity	—	—	—	69	—	—	69	—	69
Foreign currency translation	—	—	—	—	(400)	—	(400)	—	(400)
Balance at December 31, 2015	28,544	\$ 3	\$ (43,294)	\$ 137,535	\$ (818)	\$ 66,662	\$ 160,088	\$ —	\$ 160,088

See accompanying notes to consolidated financial statements.

SKULLCANDY, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year Ended December 31,		
	2015	2014	2013
Operating activities			
Net income (loss)	\$ 5,293	\$ 7,573	\$ (3,011)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation of fixed assets and amortization of intangible assets	10,305	9,623	9,428
Loss on disposal of property and equipment and intangible assets	69	670	2,187
Provision for doubtful accounts	2,324	619	1,312
Deferred income taxes	899	(210)	(4,927)
Non-cash interest expense	10	188	177
Amortization of stock-based compensation expense	3,992	3,398	3,632
Foreign currency remeasurement loss	1,810	797	—
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable	(14,161)	(18,113)	17,305
Inventories	12,453	(15,183)	1,140
Prepaid expenses and other	(2,995)	(112)	1,504
Accounts payable	(13,055)	10,882	(6,339)
Accrued liabilities	(8,480)	7,015	1,048
Net cash (used in) provided by operating activities	(1,536)	7,147	23,456
Investing activities			
Purchase of property and equipment	(10,461)	(11,064)	(4,111)
Purchase of intangible assets	—	—	(20)
Purchases of short-term investments	—	(15,010)	—
Proceeds from sales of short-term investments	14,495	—	—
Net cash provided by (used in) investing activities	4,034	(26,074)	(4,131)
Financing activities			
Debt issuance costs	—	—	(241)
Proceeds from exercise of stock options	359	2,128	174
Taxes paid related to net share settlement of equity awards	(489)	—	—
Income tax benefit (detriment) from share based compensation	69	(468)	(92)
Purchase of minority interest	(752)	—	—
Net cash (used in) provided by financing activities	(813)	1,660	(159)
Effect of exchange rate changes on cash and cash equivalents	(278)	55	324
Net increase (decrease) in cash and cash equivalents	1,407	(17,212)	19,490
Cash and cash equivalents, beginning of year	21,623	38,835	19,345
Cash and cash equivalents, end of year	\$ 23,030	\$ 21,623	\$ 38,835
Supplemental cash flow information:			
Cash paid for interest	\$ —	\$ —	\$ 1
Cash paid for income tax	3,782	1,430	7,042
Supplemental non-cash activities:			
Purchases of property and equipment financed through accounts payable	\$ 569	\$ —	\$ —

See the accompanying notes to consolidated financial statements.

SKULLCANDY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of the Business

Skullcandy, Inc. creates world-class audio experiences through its Skullcandy® and Astro Gaming® brands. Founded at the intersection of music, sports, technology and creative culture, Skullcandy brand creates world-class audio and gaming products for the risk takers, innovators, and pioneers who inspire us all to live life at full volume. From new innovations in the science of sound and human potential, to collaborations with up-and-coming musicians and athletes, Skullcandy lives by its mission to inspire life at full volume through forward-thinking technologies and ideas, and leading edge design and materialization. Astro Gaming creates premium video gaming equipment for professional gamers, leagues, and gaming enthusiasts. Astro Gaming was founded in the pits of competitive gaming and has become synonymous with pinnacle gaming experiences. Skullcandy and Astro Gaming products are sold and distributed through a variety of channels around the world from the Company's global locations in Park City, San Francisco, London, Tokyo, Zurich, Mexico City, and Shanghai, as well as through partners in some of the most important culture, sports, and gaming hubs in the world. The Skullcandy brand website can be found at <http://www.skullcandy.com>. The Astro Gaming website can be found at <http://www.astrogaming.com>.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries as well as the results of a joint venture in Mexico. All intercompany balances and transactions have been eliminated. The accompanying consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States (GAAP). Historically, the Company has experienced greater net sales in the second half of the year than those in the first half due to a concentration of shopping during the fall and holiday seasons. The Company anticipates that this trend and seasonal impact on net sales is likely to continue.

The Company entered into a joint venture in Mexico on September 19, 2011. The Company had the majority ownership and voting rights and controls the day-to-day operations of the entity. Accordingly, it has consolidated the results of the joint venture operations in its consolidated financial statements. The noncontrolling interests, which reflect the portion of the earnings (losses) of operations which are applicable to the other noncontrolling partner, have been classified as non-controlling interests in the accompanying financial statements. On December 31, 2015, the Company acquired the minority interest in its Mexico joint venture to gain full control of the efforts in this market and now operates a wholly-owned subsidiary in this market. As the Company retained its controlling financial interest in the subsidiary, this transaction was accounted for as an equity transaction. The carrying amount of the noncontrolling interest was reduced to zero to reflect the purchase, and the difference between the price paid by the Company and the adjustment to the carrying value of the noncontrolling interest was recorded as an adjustment to equity attributable to the parent.

Recently Issued Accounting Pronouncements

In July 2015, the Financial Accounting Standards Board ("FASB") issued guidance which requires inventory within the scope of the standard to be measured at the lower of cost and net realizable value. Previous guidance required inventory to be measured at the lower of cost or market (where market was defined as replacement cost, with a ceiling of net realizable value and floor of net realizable value less a normal profit margin). The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company is currently evaluating the impact, if any, the adoption of this standard will have on the consolidated financial statements.

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, "Revenue from Contracts with Customers." Under the new standard, revenue is recognized at the time a good or service is transferred to a customer for the amount of consideration received for that specific good or service. In July 2015, the FASB decided to defer the effective date of its new revenue standard by one year. It is effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods, and early adoption is permitted with the originally proposed effective date for reporting periods beginning after December 15, 2016. Entities may use a full retrospective approach or report the cumulative effect as of the date of adoption. The Company has not yet determined the adoption approach and is currently evaluating the impact, if any, the adoption of this standard will have on the Consolidated Financial Statements.

Management Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all cash on deposit and money market accounts with original maturities when purchased of less than three months to be cash and cash equivalents. The Company maintains cash and cash equivalents in bank deposit and other investment accounts which, at times, may exceed federally insured limits.

Short-Term Investments

In general, the majority of the Company's short-term investments have a maturity at the date of purchase within one year and consist predominantly of highly liquid investment-grade low risk income earning mutual funds, diversified among industries and individual issuers, that are predominantly U.S. dollar-denominated short-term debt securities. Investments with maturities from one to five years may be classified, based on the Company's determination, as short-term based on their highly liquid nature and because they represent an investment of cash that is available for current operations. Short-term investments classified as available-for-sale are recorded at fair value using the specific identification method with the unrealized gains and losses reflected in accumulated other comprehensive income (loss) until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis and are recorded in interest (income) expense in the consolidated statements of income. The Company periodically evaluates unrealized losses in its investment securities for other-than-temporary impairment, using both qualitative and quantitative criteria. In the event a security is deemed to be other-than-temporarily impaired, the Company recognizes the credit loss component in interest (income) expense in the consolidated statements of income.

Concentrations

Financial instruments that potentially subject the Company to concentrations of credit risk consist of cash and trade accounts receivable. Credit is extended to customers based on an evaluation of the customer's financial condition and collateral is not required. All customers listed below are in the Domestic segment. The most significant customers that accounted for a significant portion of net sales and accounts receivable are as follows:

	Net Sales Customer A	Net Sales Customer B
For the year ended December 31, 2015	19%	*
For the year ended December 31, 2014	12%	*
For the year ended December 31, 2013	14%	10%

*Indicates less than 10% of net sales for the period.

Customer A accounted for 26% and 25% of the Company's accounts receivable as of December 31, 2015 and 2014, respectively. Customer B accounted for less than 10% of the Company's accounts receivable as of December 31, 2015 and 2014, respectively. No other single customer accounted for greater than 10% of the Company's accounts receivable balance as of December 31, 2015 and 2014.

The Company maintains its cash balances at various financial institutions, which are predominantly in the United States. At times such balances may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash.

In 2015 and 2014, substantially all of the Company's products were manufactured in China.

Accounts Receivable and Allowance for Doubtful Accounts

As a general policy, collateral is not required for accounts receivable. Throughout the year, the Company performs credit evaluations of its retailers and distributors, and adjusts credit limits based on payment history and the retailer's or distributor's current creditworthiness. The Company continuously monitors collections, maintains credit insurance, and has an allowance for doubtful accounts based on historical experience and any specific customer collection issues that have been identified. The Company records a specific reserve for individual accounts when the Company becomes aware of a customer's likely inability to meet its financial obligations, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. If circumstances related to customer change, the Company would further adjust estimates of the recoverability of receivables. When the Company determines that there are accounts receivable that are uncollectible, they are charged off against the allowance for doubtful accounts. In the event the Company determines that a smaller or larger reserve is appropriate, it would record a benefit or charge to bad debt expense in the period in which such a determination was made. Bad debt expense is reported as a component of selling, general and administrative expenses. Historically, losses associated with uncollectible accounts have been consistent with estimates, but there can be no assurance that the Company will continue to experience the same credit loss rates that it has experienced in the past. Unforeseen, material financial difficulties of its retailers or distributors could have an adverse impact on profits.

Inventories

The Company values inventories at the lower of the cost or the current estimated market value of the inventory. Cost is determined by using the first-in, first-out method and market value is estimated based upon assumptions made about future demand and retail market conditions. The Company regularly review inventory quantities on hand and adjust inventory values for excess and obsolete inventory based primarily on estimated forecasts of product demand and market value.

As of December 31, 2015 and 2014, the Company had reserves for excess and obsolete inventory of approximately \$2.3 million and \$1.5 million, respectively. As of December 31, 2015 and 2014, substantially all of the Company's inventory was comprised of finished goods.

Taxes

Income taxes are accounted for under the asset and liability method. Deferred income tax assets and liabilities are established for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities at tax rates expected to be in effect when such assets or liabilities are realized or settled. Deferred income tax assets are reduced by valuation allowances when necessary.

Assessing whether deferred tax assets are realizable requires significant judgment. The Company considers all available positive and negative evidence, including historical operating performance and expectations of future operating performance. The ultimate realization of deferred tax assets is often dependent upon future taxable income and therefore can be uncertain. To the extent the Company believes it is more likely than not that all or some portion of the asset will not be realized, valuation allowances are established against deferred tax assets, which increase income tax expense in the period when such a determination is made.

Income taxes include tax benefits for uncertain tax positions that are more likely than not to be sustained upon audit based on the technical merits of the tax position. Settlements with tax authorities, the expiration of statutes of limitations for particular tax positions, or obtaining new information on particular tax positions may cause a change to the effective tax rate. The Company recognizes accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes on the consolidated statements of operations.

Taxes assessed by governmental authorities that are imposed concurrent with sales-producing transactions are recorded on a net basis.

Long-Lived Assets Including Goodwill and Intangible Assets

Property and equipment is stated at cost less accumulated depreciation. Depreciation is calculated using the straight-line method and recorded as expense over the estimated useful lives of the assets which range from three to seven years, or the remaining lease term, if shorter. Upon retirement or disposition of property and equipment, the cost and accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in net income for that period. Major additions and betterments are capitalized to the asset accounts while maintenance and repairs, which do not improve or extend the lives of assets, are expensed as incurred.

The Company reviews property and equipment and certain identifiable intangible assets for impairment. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amounts to future undiscounted cash flows the assets are expected to generate. If property, equipment and certain identifiable intangibles are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds its fair market value. The Company did not record impairments on long-lived assets during 2015, 2014 and 2013.

Prior to the acquisitions of Astro Gaming in April 2011 and Kungsbacka 57 AB in August 2011, the Company did not have goodwill. The Company does not amortize goodwill and intangible assets with indefinite useful lives, rather such assets are required to be tested for impairment at least annually or sooner whenever events or changes in circumstances indicate that the assets may be impaired. The Company performs goodwill and intangible asset impairment tests in the fourth quarter of each fiscal year. The Company did not recognize any impairments on goodwill, however the Company did record a \$688,000 impairment charge in the quarter ended March 31, 2014 related to indefinite lived intangible trademarks and domain names which is reflected in the year ended December 31, 2014. No goodwill or intangible asset impairment charges were recognized in 2015, 2014 and 2013.

The Company amortizes intangible assets with definite lives over their estimated useful lives and review these assets for impairment. The Company is currently amortizing the acquired intangible assets with definite lives over periods ranging between 3 to 8 years.

Accrued Liabilities

Accrued liabilities consisted of the following:

	December 31,	
	2015	2014
	(in thousands)	
Sales returns and allowances	\$ 7,037	\$ 7,168
Accrued co-op advertising	3,153	2,762
Accrued payroll and benefits	4,253	7,474
Warranty accrual	792	753
Income taxes payable	1,231	2,492
Sales commissions	486	665
Accrued royalties	1,903	1,657
Other accrued liabilities	3,076	6,190
Accrued liabilities	<u>\$ 21,931</u>	<u>\$ 29,161</u>

Non-current liabilities consist of uncertain tax positions and the Company's net pension liability related to a defined benefit pension plan for employees located in Switzerland. This net pension liability totaled \$734,000 and \$557,000 as of December 31, 2015 and 2014, respectively.

Revenue Recognition and Sales Returns and Allowances

Net sales are recognized when title and risk of loss pass to the retailer, distributor or customer and when collectability is reasonably assured. Generally, the Company extends credit to its retailers and distributors and do not require collateral. Our payment terms are typically net-30 with terms up to net-120, and higher for certain international customers. The Company recognizes revenue net of estimated product returns and pricing adjustments, including any point of purchase fees. Further, the Company provides product warranties in accordance with the contract terms given to various retailers and end users by accruing estimated warranty costs at the time of revenue recognition based on historical experience. Charges to customers for shipping and handling are included in net sales and the corresponding shipping and handling expenses are included in cost of goods sold in the accompanying consolidated statements of operations. The Company has entered into contracts with various retailers granting a conditional right of return allowance with respect to defective products. The contracts with each retailer specify the defective allowance percentage of gross sales. The Company has executed an open return program with a major retailer allowing for an unlimited amount of returns. Estimates are based on actual experience and are recorded as a reduction of revenue at the time of recognition or when circumstances change resulting in a change in estimated returns.

Product Warranty Obligations

The Company provides for product warranties in accordance with the contract terms given to various customers and end users by accruing estimated warranty costs at the time of revenue recognition. Warranties are generally fulfilled by replacing defective products with new products. Historically, the Company has offered limited warranties on sales and therefore accrues for average returns and replacements.

Activity in the warranty accrual balance, which is included in accrued liabilities on the consolidated balance sheets, was as follows:

	Warranty Accrual
	(in thousands)
Balance at December 31, 2013	1,582
Warranty Claims	(989)
Warranty Costs Accrued	160
Balance at December 31, 2014	\$ 753
Warranty Claims	(834)
Warranty Costs Accrued	873
Balance at December 31, 2015	\$ 792

Demand Creation and Research and Innovation

The Company expenses demand creation marketing costs, or advertising costs, generally as they are incurred and they appear in the selling, general and administrative portion of the consolidated statement of operations. Total demand creation marketing spend encompasses in-store displays, in-store fixtures, print, TV & online media purchases, athletes & team sponsorships, trade show or event costs, retailer co-op advertising programs, promotional items, certain licensing fees, content creation and royalty spending. The Company has certain sponsorship arrangements with athletes and musicians and recognizes the expense associated with contractual sponsorships in accordance with the terms of the contract. Various sponsorship arrangements specify a payment upon consummation of the contract as well as monthly installments. Prepayments are expensed ratably over the term of the contract. Other sponsorship arrangements specify a payment based on discrete performance criteria, such as a podium appearance, and are expensed upon achievement of the performance criteria. Total demand creation marketing spend was approximately \$28.2 million, \$26.0 million and \$27.1 million for the years ended December 31, 2015, 2014 and 2013, respectively. Amounts capitalized on the balance sheet as prepayments were \$373,000 and \$260,000 as of December 31, 2015 and 2014, respectively. Amounts paid to individuals and teams for contractual sponsorships were approximately \$1.3 million, \$1.8 million and \$2.3 million for the years ended December 31, 2015, 2014 and 2013, respectively.

In recent years the Company has increased employee headcount and spend towards research and innovation. Total research and innovation spend was approximately \$1.4 million, \$1.0 million and \$454,000 for the years ended December 31, 2015, 2014 and 2013, respectively.

Net Income (Loss) Per Share

Basic net income (loss) per common share attributable to Skullcandy, Inc. is computed by dividing the net income (loss) attributable to Skullcandy, Inc. for the period by the weighted average number of shares of common stock outstanding during the reporting period. Diluted net income per common share attributable to Skullcandy, Inc. reflects the effects of potentially dilutive securities, which consist of unvested restricted stock and stock options. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per common share attributable to Skullcandy, Inc. is as follows:

	Year Ended December 31,		
	2015	2014	2013
	(in thousands)		
Numerator			
Net income (loss) attributable to Skullcandy, Inc.	\$ 5,881	\$ 7,599	\$ (3,036)
Denominator			
Weighted average common stock outstanding for basic net income per common share	28,415	28,059	27,741
Effect of dilutive shares	414	512	—
Weighted average common shares and dilutive securities outstanding	28,829	28,570	27,741

For the years ended December 31, 2015, 2014 and 2013, 1.5 million, 1.3 million and 2.6 million shares subject to stock options and restricted stock were excluded from the diluted calculation as their inclusion would have been anti-dilutive.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with accounting guidance that requires all stock-based compensation awards granted to employees, directors and any others to be measured at fair value and recognized as an expense in the financial statements. In addition, this guidance requires that excess tax benefits related to stock-based compensation awards be reflected as financing cash flows.

During 2013, the Company completed an employee stock option exchange program and accounted for the stock option exchange program in accordance with accounting guidance which requires the stock option exchange to be a value neutral transaction, or for any incremental compensation expense to be recorded in the period of exchange.

Fair Value of Financial Instruments

The carrying amounts shown for the Company's cash and cash equivalents, short-term investments, accounts receivable and accounts payable approximate fair value because of the short term maturity of those instruments.

Foreign Currency

The Company translates the financial statements of its international subsidiaries that have the local currency as their functional currency to U.S. dollars using month-end rates of exchange for assets and liabilities, and average rates of exchange for revenues, costs, and expenses. The Company records translation gains and losses in accumulated other comprehensive income as a component of stockholders' equity. The Company recorded \$(400,000), \$(251,000) and \$29,000 of net translation (loss) gain in years ended December 31, 2015, 2014 and 2013, respectively. The Company records net gains and losses resulting from foreign exchange transactions as a component of other expense. These gains and losses are net of those realized on foreign exchange contracts. The Company recorded foreign exchange transaction losses of \$918,000, \$575,000 and \$421,000 for the years ended December 31, 2015, 2014 and 2013, respectively.

Financial Derivatives and Hedging Activities

The Company uses financial derivatives to manage exposure to changes in foreign currencies. The Company records all derivatives on the consolidated balance sheets at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting, and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting.

The effective portion of the gain or loss on derivative instruments designated and qualifying as a hedge of the exposure to variability in expected future cash flows related to forecasted transactions is deferred and reported as a component of accumulated other comprehensive income. Deferred gains or losses are reclassified to the Company's consolidated statements of operations at the time the hedged forecasted transaction is recorded in the consolidated statements of operations. The effectiveness of cash flow hedges is assessed at inception and quarterly thereafter. If the instrument becomes ineffective or it becomes probable that the originally-forecasted transaction will not occur, the related change in fair value of the derivative instrument is also reclassified from accumulated other comprehensive income and recognized in earnings. The Company does not offset fair value amounts recognized for derivative instruments.

3. Investments

As of December 31, 2015, the Company had the following available-for-sale securities (in thousands):

	Cost Basis	Unrealized gains (losses), net	Fair Value
Available-for-sale:			
Debt mutual funds	\$ 543	\$ (2)	\$ 541

During the year ended December 31, 2015, the Company sold \$14.5 million of its short-term investments and recognized an insignificant amount of realized losses. The Company did not recognize any other-than-temporary impairment, gains or losses from any transfer from securities from the available-for-sale category into the trading category, and recognized insignificant proceeds or realized gains or losses for the years ended December 31, 2015, 2014 and 2013, and does not expect any significant other-than temporary impairment in future periods.

As of December 31, 2014, the Company had the following available-for-sale securities (in thousands):

	Cost Basis	Unrealized gains (losses), net	Fair Value
Available-for-sale:			
Debt mutual funds	\$ 15,040	\$ (30)	\$ 15,010

4. Allowance for Doubtful Accounts and Sales Returns

Following is a rollforward of the allowance for doubtful accounts and for sales returns and allowances, which are classified as a reduction of accounts receivable and in accrued liabilities, respectively:

	Doubtful Accounts	Sales Returns & Allowances
	(in thousands)	
Balance, December 31, 2012	\$ 2,561	\$ 4,069
Provision	1,312	25,305
Deductions	(1,992)	(22,364)
Balance, December 31, 2013	1,881	7,010
Provision	619	30,404
Deductions	(565)	(30,246)
Balance, December 31, 2014	1,935	7,168
Provision	2,251	33,082
Deductions	(933)	(33,213)
Balance, December 31, 2015	\$ 3,253	\$ 7,037

5. Property and Equipment, Net

Property and equipment, net, consisted of the following:

	December 31,	
	2015	2014
	(in thousands)	
Cost:		
Leasehold improvements	\$ 3,281	\$ 3,074
Furniture and fixtures	9,341	13,112
Other equipment	12,214	10,145
Computer equipment and software	6,998	7,596
Vehicles	212	253
	32,046	34,180
Less accumulated depreciation	(17,216)	(21,269)
Property and equipment, net	\$ 14,830	\$ 12,911

Depreciation expense related to property and equipment was \$8.9 million , \$8.1 million and \$7.9 million , for the years ended December 31, 2015 , 2014 and 2013 , respectively.

6. Goodwill and Intangibles

The Company performs its goodwill and intangible asset impairment tests in the fourth quarter of each fiscal year. The Company did not record any impairment charges on goodwill or intangibles in the year ended December 31, 2015 . In the year ended December 31, 2014, the Company did not record any impairment charge on goodwill, but did record a \$688,000 impairment charge in the quarter ended March 31, 2014 related to indefinite lived intangible trademarks and domain names which is reflected in the year ended December 31, 2014 . This impairment charge was included in selling, general and administrative expense. The Company did not recognize any other goodwill or intangible asset impairment charges in 2015 , 2014 and 2013 .

Intangible assets subject to amortization consist principally of amounts assigned to non-compete agreements and customer relationships. The trade/brand name is not subject to amortization. Intangible assets as of December 31, 2015 consist of the following:

December 31, 2015				
(in thousands)				
	Weighted Average Remaining Life	Gross Carrying Amount	Accumulated Amortization, including Impairment Charges	Net Book Value
Customer relationships	3.7	\$ 10,850	\$ 5,787	\$ 5,063
Trade/brand name	Indefinite	2,200	—	2,200
Registration of trademarks and domain names	Indefinite	857	687	170
Total		\$ 13,907	\$ 6,474	\$ 7,433

December 31, 2014				
(in thousands)				
	Weighted Average Remaining Life	Gross Carrying Amount	Accumulated Amortization, including Impairment Charges	Net Book Value
Customer relationships	4.7	10,850	4,406	6,444
Trade/brand name	Indefinite	2,200	—	2,200
Registration of trademarks and domain names	Indefinite	857	687	170
Total		\$ 13,907	\$ 5,093	\$ 8,814

Aggregate amortization expense for amortizing intangible assets was \$1.4 million, \$1.5 million and \$1.5 million for the years ended December 31, 2015, 2014 and 2013, respectively. Estimated annual amortization expense for each of the next five years is as follows:

	2016	2017	2018	2019	2020
(in thousands)					
Estimated annual amortization expense	\$ 1,381	\$ 1,381	\$ 1,381	\$ 921	\$ —

7. Financial Derivatives and Hedging Activities

As part of the Company's overall risk management practices, the Company enters into financial derivatives primarily designed to either hedge foreign currency risks associated with forecasted international sales transactions – "cash flow hedges"; or to mitigate the impact that changes in currency exchange rates have on balance sheet monetary assets and liabilities – "foreign currency hedges."

The Company records all derivatives on the consolidated balance sheets at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting, and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting.

The effective portion of the gain or loss on derivative instruments designated and qualifying for hedge accounting is deferred in other comprehensive income. Any ineffectiveness in these designated hedging relationships is recognized in current period earnings. Similarly, the changes in fair value for all trades that are not designated for hedge accounting are recognized in current period earnings. Deferred gains or losses from designated hedging relationships are reclassified into earnings in the period that the hedged forecasted sales transactions effect earnings. The effectiveness of cash flow hedges is assessed at inception and quarterly thereafter. If the instrument were to no longer qualify for hedge accounting or it becomes probable that the originally-forecasted hedged transactions will not occur, then hedge accounting would cease and the related change in fair value of the ineffective portion of the derivative instrument would be reclassified from accumulated other comprehensive income (loss) and recognized in earnings. The Company does not offset fair value amounts recognized for derivative instruments.

Credit risk related to derivative transactions reflects the risk that a party to the transaction could fail to meet its obligation under the derivative contracts. The Company's derivative transactions are subject to master netting arrangements. Therefore, the Company's exposure to the counterparty's credit risk is generally limited to the amounts, if any, by which the counterparty's obligations to the Company exceed the Company's obligations to the counterparty. The Company's policy is to

enter into contracts only with financial institutions which meet certain minimum credit ratings to help mitigate counterparty credit risk.

As a result of the Company's hedging program, the Company recognized the following in the consolidated statements of operations for the years ended December 31, 2015, 2014, and 2013, respectively (in thousands).

	For the years ended December 31,		
	2015	2014	2013
Total impact on net sales	\$ 82	\$ 574	\$ (435)
Total impact on other income (expense)	1,479	269	(134)
	<u>\$ 1,561</u>	<u>\$ 843</u>	<u>\$ (569)</u>

Derivatives Designated as Hedging Instruments—Cash Flow Hedges

The Company uses currency forward contracts as cash flow hedges to manage its exposure to fluctuations in the Euro (EUR) to U.S. Dollar (USD) and Great British Pound (GBP) to U.S. Dollar exchange rates on a portion of forecasted international net sales expected to be realized over a maximum of twelve months. Currency forward contracts involve fixing the exchange rate for delivery of a specified amount of foreign currency on a specified date.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges of foreign exchange risk is deferred as a component of accumulated other comprehensive income in the accompanying consolidated balance sheets and is subsequently reclassified into earnings in the period that the hedged forecasted sales transactions effect earnings. The ineffective portion of the changes in fair value of derivatives designated as cash flow hedges are recognized directly to earnings and reflected in the accompanying consolidated statements of operations.

As of December 31, 2015, the Company had the following outstanding derivatives that were used to hedge foreign exchange risks associated with forecasted transactions and designated as hedging instruments (in thousands, except for the number of instruments):

	Number of Instruments	Sell Notional	Buy Notional
Sell EUR/Buy USD Forward Contract	17	€ 5,086	US\$ 5,595
Sell GBP/Buy USD Forward Contract	16	£ 7,667	US\$ 11,583
	<u>33</u>		<u>US\$ 17,178</u>

These contracts have maturities of 12 months or less.

The following table summarizes the amount of income recognized from derivative instruments for the periods indicated and the line items in the accompanying statements of operations where the results are recorded for cash flow hedges (in thousands):

	Change in Amount of Unrealized Gain (loss) Recognized in OCI on Derivative (Effective Portion)			Location of Realized Gain (loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Realized Gain (loss) Reclassified from Accumulated OCI into Income (Effective Portion)			Location of Realized Gain (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Realized Gain (loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)		
	2015	2014	2013		2015	2014	2013		2015	2014	2013
	Sell EUR/Buy USD Forward Contract	\$ 94	\$ 414		\$ (376)	Net sales	\$ 88		\$ 273	\$ (277)	Net sales
Sell GBP/Buy USD Forward Contract	158	219	(82)	Net sales	(114)	113	18	Net sales	—	(17)	2
	<u>\$ 252</u>	<u>\$ 633</u>	<u>\$ (458)</u>		<u>\$ (26)</u>	<u>\$ 386</u>	<u>\$ (259)</u>		<u>\$ —</u>	<u>\$ 107</u>	<u>\$ 9</u>

The Company expects all of the amounts recorded as a component of accumulated other comprehensive income (loss) will be realized in the consolidated statements of operations over the next twelve months and the amount will vary depending on market rates.

Derivatives Not Designated as Hedging Instruments—Foreign Currency Derivatives

The Company also enters into forward foreign exchange contracts to mitigate the impact changes in currency exchange rates have on balance sheet monetary assets and liabilities as well as certain other forecasted sales. None of these

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contracts are designated as hedges for accounting purposes and, accordingly, changes in value of the foreign exchange forward contracts, and in the offsetting underlying on-balance-sheet transactions (for derivatives hedging monetary assets and liabilities), are reflected in the accompanying consolidated statements of operations under the caption "Other (income) expense." As of December 31, 2015, the Company had the following outstanding derivatives that were not designated as hedging instruments (in thousands, except for the number of instruments):

	Number of Instruments		Sell Notional		Buy Notional
Sell EUR/Buy USD Forward Contract	14	€	3,149	US\$	3,414
Sell GBP/Buy USD Forward Contract	2	£	4,577	US\$	6,773
Sell CAD/Buy USD Forward Contract	21	C\$	16,241	US\$	11,947
Sell CHF/Buy USD Forward Contract	13	Fr.	3,087	US\$	2,949
Sell MXN/Buy USD Forward Contract	17	\$	87,103	US\$	5,104
Sell JPY/Buy USD Forward Contract	1	¥	325,323	US\$	2,700
Sell CNY/Buy USD Forward Contract	1	¥	50,858	US\$	7,740
	69			US\$	40,627

These contracts generally have maturities of within the next twelve months.

The following table summarizes the amount of income from derivative instruments recognized for the periods indicated and the accounts in the accompanying consolidated statements of operations where the results are recorded for economic foreign currency hedges (in thousands):

	Location of Gain (loss) Recognized in Income on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative		
		2015	2014	2013
Forecasted sales hedges				
Sell EUR/Buy USD Forward Contract	Net sales	\$ 101	\$ 116	\$ (138)
Sell GBP/Buy USD Forward Contract	Net sales	7	72	(48)
Sell CAD/Buy USD Forward Contract	Other income (expense)	358	—	—
Sell CHF/Buy USD Forward Contract	Other income (expense)	(128)	—	—
Sell MXN/Buy USD Forward Contract	Other income (expense)	218	—	—
		\$ 556	\$ 188	\$ (186)
Monetary assets and liability hedges				
Sell EUR/Buy USD Forward Contract	Other income (expense)	\$ 102	\$ 183	\$ (95)
Sell GBP/Buy USD Forward Contract	Other income (expense)	262	86	(39)
Sell CAD/Buy USD Forward Contract	Other income (expense)	404	—	—
Sell MXN/Buy USD Forward Contract	Other income (expense)	249	—	—
Sell JPY/Buy USD Forward Contract	Other income (expense)	(8)	—	—
Sell CNY/Buy USD Forward Contract	Other income (expense)	22	—	—
		\$ 1,031	\$ 269	\$ (134)

The impact of monetary asset and liability hedges not designated as hedging instruments was offset by the remeasurement of the underlying balance sheet item.

The following table summarizes the fair values of derivative instruments as of the periods indicated and the line items in the accompanying consolidated balance sheets where the instruments are recorded (in thousands):

	Derivatives Asset		Derivative Liabilities	
	As of December 31,		As of December 31,	
	2015	2014	2015	2014
Derivatives designated as cash flow hedges				
Balance Sheet Location	Prepaid expenses and other current assets	Prepaid expenses and other current assets	Accrued liabilities	Accrued liabilities
Sell EUR/Buy USD Forward Contract	\$ 47	\$ —	\$ 16	\$ —
Sell GBP/Buy USD Forward Contract	273	—	—	—
	\$ 320	\$ —	\$ 16	\$ —
Derivatives not designated as hedging instruments				
Balance Sheet Location	Prepaid expenses and other current assets	Prepaid expenses and other current assets	Accrued liabilities	Accrued liabilities
Sell EUR/Buy USD Forward Contract	\$ 45	\$ 50	\$ 57	\$ —
Sell GBP/Buy USD Forward Contract	27	7	—	2
Sell CAD/Buy USD Forward Contract	211	—	14	—
Sell CHF/Buy USD Forward Contract	3	—	116	—
Sell MXN/Buy USD Forward Contract	86	—	5	—
Sell JPY/Buy USD Forward Contract	—	—	1	—
Sell CNY/Buy USD Forward Contract	—	—	30	—
	\$ 372	\$ 57	\$ 223	\$ 2

The amounts set forth in the table above represent the gross asset or liability. These derivatives are subject to master netting agreements giving effect to rights of offset with each counterparty. Taking into consideration this right of offset, the derivatives are in a net asset position of \$453,000 and \$55,000 as of December 31, 2015 and 2014, respectively.

8. Fair Value Measurements

The fair value of the Company's financial instruments reflects the amounts that the Company estimates to receive in connection with the sale of an asset or paid in connection with the transfer of a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value hierarchy prioritizes the use of inputs used in valuation techniques into the following three levels:

Level 1—quoted prices in active markets for identical assets and liabilities.

Level 2—observable inputs other than quoted prices in active markets for identical assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Some of the Company's marketable securities primarily utilize broker quotes in a non-active market for valuation of these securities.

Level 3—unobservable inputs.

The majority of the Company's financial instruments are valued using quoted prices in active markets or based on other observable inputs. The following table sets forth the fair value of the Company's financial assets that are re-measured on a regular basis:

The fair value of these financial instruments was determined using the following levels of inputs as of December 31, 2015 (in thousands):

Fair Value Measurements at December 31, 2015

	Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:				
Derivative financial instruments	\$ —	\$ 692	\$ —	\$ 692
Cash equivalents - Money market funds	400	—	—	400
Debt mutual funds	—	541	—	541
Total assets	\$ 400	\$ 1,233	\$ —	\$ 1,633
Liabilities:				
Derivative financial instruments	—	239	—	239

There were no financial assets and liabilities measured on a recurring basis using significant unobservable inputs (Level 3) and there were no transfers in or out of Level 1, 2, or 3 during the year ended December 31, 2015 .

The fair values of the foreign exchange forward contracts are considered to be Level 2. Foreign currency forward contracts are valued using readily available foreign currency forward and interest rate curves. The fair value of each contract is determined by comparing the contract rate to the forward rate and discounting to the present value. Contracts in a gain position are recorded in the consolidated balance sheet under the caption "Prepaid expenses and other current assets" and the value of contracts in a loss position is recorded under the caption "Accrued liabilities."

The fair value of these financial instruments was determined using the following levels of inputs as of December 31, 2014 (in thousands):

Fair Value Measurements at December 31, 2014							
	Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)		Total
Assets:							
Derivative financial instruments	\$	—	\$	57	\$	—	\$ 57
Cash equivalents - Money market funds		2,000		—		—	2,000
Debt mutual funds		—		15,010		—	15,010
Total assets	\$	2,000	\$	15,067	\$	—	\$ 17,067
Liabilities:							
Derivative financial instruments		—		2		—	2

9. Debt

Credit Facility

On August 19, 2013, the Company entered into a credit agreement and revolving line of credit, or the credit facility, with Wells Fargo Bank, National Association which was subsequently amended on April 29, 2014, which provides a line of credit up to \$10 million, and expires on August 19, 2018. As a subfeature, the credit facility provided for letters of credit up to \$5 million. The credit facility is secured with a first-priority lien against substantially all of the assets of the Company.

The credit facility required the Company to be in compliance with specified affirmative financial covenants, including: (a) total liabilities divided by tangible net worth not greater than 1.0 to 1.0 as of the last day of each fiscal quarter; (b) current ratio not less than 2.00 to 1.00 as of the last day of each fiscal quarter; and (c) EBITDA coverage ratio of not less than 2.0 to 1.0 as of the last day of each fiscal quarter.

The Company's credit facility also contains certain financial covenants and other restrictions that limit the Company's ability, among other things, to: (a) make fixed asset purchases in any fiscal year greater than \$19 million in aggregate for fiscal year 2015, \$23 million for fiscal year 2016, and \$15 million for any fiscal year thereafter; (b) incur operating lease expenses in any fiscal year greater than \$3 million in aggregate; and (c) create, incur, assume or permit to exist any indebtedness or liabilities resulting from borrowings, loans or advances, whether secured or unsecured, matured or unmatured, liquidated or unliquidated, joint or several, except (1) the liabilities of the Company and each of its subsidiaries to Wells Fargo, (2) permitted investments, (3) uncapped permitted indebtedness, and (4) capped permitted indebtedness up to \$2 million in the aggregate outstanding at any one time. Additional covenants and other restrictions exist that limit the Company's ability, among other things, to: undergo a merger or consolidation, sell certain assets, create liens, guarantee certain obligations of third parties, make certain investments or acquisitions, and declare dividends or make distributions.

At December 31, 2015, the Company was in compliance with all applicable covenants in the credit facility.

10. Income Taxes

Income tax expense consisted of the following components:

	Year Ended December 31,		
	2015	2014	2013
	(in thousands)		
Current:			
Federal	\$ 2,362	\$ 3,012	\$ 306
State	(52)	302	95
Foreign	338	(116)	1,718
Total current	2,648	3,198	2,119
Deferred:			
Federal	36	(385)	(3,759)
State	97	(123)	(212)
Foreign	(678)	(167)	(1,030)
Total deferred	(545)	(675)	(5,001)
Total provision (benefit) for income taxes	\$ 2,103	\$ 2,523	\$ (2,882)

The Company has not provided U.S. income taxes and foreign withholding taxes on the undistributed earnings of foreign subsidiaries as of December 31, 2015 because the Company intends to permanently reinvest such earnings outside the U.S. If these foreign earnings were to be repatriated in the future, the related U.S. tax liability may be reduced by any foreign income taxes previously paid on these earnings.

A reconciliation from the U.S. statutory federal income tax rate to the effective income tax rate is as follows:

	Year Ended December 31,	
	2015	2014
U.S. federal statutory income tax rate	34.0 %	34.0 %
State tax, net of federal tax impact	2.2 %	1.5 %
Stock-based compensation	(0.2)%	(1.2)%
Reduction in deferred tax assets due to expired options	6.7 %	— %
Tax credits	(9.4)%	(3.3)%
Foreign rate differential	(2.3)%	(6.5)%
Meals and entertainment	1.5 %	— %
Other	(4.1)%	0.4 %
	28.4 %	24.9 %

Total earnings before income tax expense and noncontrolling interests were comprised of the following:

	December 31,	
	2015	2014
	(in thousands)	
Domestic operations	\$ 7,897	\$ 7,782
Foreign operations	(501)	2,314
Earnings before income tax expense and noncontrolling interests	\$ 7,396	\$ 10,096

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their tax bases. Significant components of deferred income tax assets and (liabilities) are as follows:

	December 31,	
	2015	2014
	(in thousands)	
Current deferred tax assets (liabilities):		
Bad debt reserve	\$ (98)	\$ 33
Obsolete inventory reserve	71	(53)
Allowance for sales returns	1,826	1,668
Warranty reserve	277	269
Intercompany revenues	—	127
Net operating loss	364	289
Uniform capitalization regulation accrual	554	489
Accrued severance method change	(81)	—
Accrued liabilities	867	—
Other	43	46
Total net current deferred tax assets	3,823	2,868
Noncurrent deferred tax assets (liabilities):		
Fixed assets	(1,178)	(656)
Stock compensation	2,596	4,580
Net operating loss	657	604
Amortization of intangible assets	(1,943)	(1,935)
Accrued severance	(163)	—
State research and development credit carryovers	390	—
Other	96	52
Total net noncurrent deferred tax assets before valuation allowance	455	2,645
Valuation allowance	(695)	(604)
Total net noncurrent deferred tax assets (liabilities), net of valuation allowance	(240)	2,041
Total net deferred tax assets	\$ 3,583	\$ 4,909

As of December 31, 2015, the Company had \$1.0 million in deferred tax assets associated with foreign net operating loss carryforwards which will begin to expire in 5 to 10 years. As of December 31, 2015 the Company has established a valuation allowance of \$492,000 against the portion of the net operating loss carryovers which are more likely than not to not be realized. Our state credits have a carry forward period of 10 to 14 years and will begin expiring in 8 to 12 years.

Deferred tax assets and liabilities are classified as current or non-current, depending on the classification of the assets and liabilities to which they relate. Deferred taxes arising from temporary differences that are not related to an asset or liability are classified as current or non-current, depending on the periods in which the temporary differences are expected to reverse.

The Company has not recorded a deferred tax liability for \$21.2 million of undistributed earnings of subsidiaries located outside of the United States. Although tax liabilities might result from the payment of dividends out of such earnings, or as a result of a sale or liquidation of non-U.S. subsidiaries, these earnings are permanently reinvested outside of the United States and the Company does not have any plans to repatriate these earnings or to sell or liquidate any of these non-U.S. subsidiaries. To the extent that the Company is able to repatriate the unremitted earnings in a tax efficient manner, or in the event of a change in capital situation or investment strategy in which such funds become needed for funding U.S. operations, the Company would be required to accrue and pay U.S. taxes to repatriate these funds, net of foreign tax credits. The determination of the tax liability upon repatriation is not practicable.

The Company has gross unrecognized tax benefits that are accounted for under authoritative guidance for accounting for uncertainty in income taxes. This guidance prescribes a comprehensive model for financial recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. Under this guidance, companies may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the tax authorities based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement.

During the year ended December 31, 2015 , the aggregate changes in the total gross amount of unrecognized tax benefits were as follows (in thousands):

December 31, 2014	\$	352
Decrease of unrecognized tax benefits taken in prior years		(167)
Increase in unrecognized tax benefits related to current year		199
December 31, 2015	\$	<u>384</u>

The Company does not anticipate any significant change within 12 months of this reporting date of its uncertain tax positions, and the Company does not anticipate any events which could cause a change to these uncertainties. The Company recognizes accrued interest and penalties related to uncertain tax positions as part of income tax expense. As of December 31, 2015 and 2014 , the Company has no significant accrued interest and penalties. As of December 31, 2015 , the U.S. Federal statute of limitations remains open for the tax years ended December 31, 2011 and forward. The majority of the state statutes of limitations remain open for the tax years ended December 31, 2011 and forward.

During the years ended December 31, 2015 and 2014 , the Company recorded a tax expense of \$1.7 million and \$468,000 , respectively directly to deferred tax assets and additional paid-in-capital for expired, exercised, or vested equity awards.

11. Segment Information

The Company manages its business in two operating segments which are comprised of Domestic and International. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the Chief Operating Decision Makers ("CODM") in deciding how to allocate resources and in assessing performance. The Company has determined that the CODM is the Chief Executive Officer and the Chief Financial Officer, collectively. The Company's operating segments and reporting segments are the same. The Domestic segment primarily consists of Skullcandy and Astro Gaming product sales to customers in the United States. The Domestic segment also includes the majority of general corporate overhead and related costs which are not allocated for segment reporting purposes, therefore the Company believes that the best metric for segment performance is gross profit. The International segment primarily includes Skullcandy product sales to customers in Europe, Asia, Canada, Mexico, and all other geographic areas outside the United States that are served by the Company's International operations. The Company primarily operates in the consumer products category in which the Company develops and distributes headphones and other audio products. All intercompany revenues, expenses, payables and receivables are eliminated in consolidation and are not reviewed when evaluating segment performance.

Information related to the Company's segments is as follows:

	December 31,	
	2015	2014
(in thousands)		
Net sales		
Domestic	\$ 190,926	\$ 174,663
International	75,390	73,149
Consolidated net sales	<u>\$ 266,316</u>	<u>\$ 247,812</u>
Gross profit		
Domestic	\$ 80,311	\$ 78,495
International	29,564	32,139
Consolidated gross profit	<u>\$ 109,875</u>	<u>\$ 110,634</u>
Income from operations		
Domestic	\$ 6,495	\$ 5,248
International	2,477	6,539
Consolidated income from operations	<u>\$ 8,972</u>	<u>\$ 11,787</u>

	December 31,	
	2015	2014
(in thousands)		
Identifiable assets		
Domestic	\$ 129,102	\$ 140,176
International	68,588	71,990
Consolidated	<u>\$ 197,690</u>	<u>\$ 212,166</u>
Long-lived assets including intangible assets		
Domestic	15,397	13,596
International	6,866	8,129
Consolidated	<u>\$ 22,263</u>	<u>\$ 21,725</u>
Goodwill		
Domestic	6,805	6,805
International	7,062	7,062
Consolidated	<u>\$ 13,867</u>	<u>\$ 13,867</u>

12. Employee Benefit Plans

The Company maintains a salary deferral 401(k) plan for all full-time employees in the United States. This plan allows employees to contribute a portion of their pretax salary up to the maximum dollar limitation prescribed by the Internal Revenue Service. The Company made matching contributions to the plan totaling \$489,000, \$506,000 and \$541,000 for the years ended December 31, 2015, 2014 and 2013, respectively and the expenses are included in selling, general and administrative expenses.

The Company also maintains a defined benefit pension plan for employees located in Switzerland. The Company had 28 and 26 insured employees as of December 31, 2015 and 2014, respectively, with employer contributions totaling \$366,000 and \$287,000 for the years ended December 31, 2015 and 2014, respectively. The net pension liability is included in non-current liabilities on the Company's Consolidated Balance Sheets and totaled \$734,000 and \$557,000 as of December 31, 2015 and 2014, respectively.

13. Stock-Based Compensation

Overview

The Company has an incentive award plan that provides for the grant of incentive and nonqualified options ("Stock Options" or "Options") to purchase the Company's common stock, performance-based restricted stock units ("PSUs") and restricted stock units ("RSUs") to selected officers, other key employees and directors. Options are granted at a price not less

than the fair market value on the date of grant and generally become exercisable between one and four years after the date of grant in accordance with an applicable vesting schedule, and generally expire 10 years from the date of grant.

RSUs granted to members of the Board of Directors vest annually subject to continued service on the Board.

The Company recorded \$4.0 million, \$3.4 million and \$3.6 million in share-based compensation expense for the years ended December 31, 2015, 2014 and 2013, respectively. All share-based compensation expense is included in selling, general and administrative expenses.

The unrecognized share-based compensation cost as of December 31, 2015 was \$5.9 million, which is expected to be recognized over the weighted average remaining vesting period of 2.64 years. As of December 31, 2015, there were approximately 3.8 million shares of common stock available for future issuances.

The Company estimates a forfeiture rate based on an analysis of our actual historical forfeitures along with future expectations and continue to evaluate the appropriateness of the forfeiture rate based on actual forfeiture experience, analysis of employee turnover behavior and other factors at each period end. Under the true-up provisions of the authoritative guidance related to stock-based compensation, the Company will modify the expense if the actual forfeiture rate is different than what the Company estimated.

Stock Options

The Company utilized the Black-Scholes-Merton valuation model for estimating the fair value of options granted. The Company calculated the fair value of each option grant on the respective dates of grant using the following weighted average assumptions:

	Year Ended December 31,		
	2015	2014	2013
Fair value of options granted	\$ 4.94	\$ 4.75	\$ 4.08
Risk-free interest rate	1.64%	1.90%	1.21%
Expected term (in years)	6.3	6.3	6.3
Expected dividend yield	—%	—%	—%
Expected volatility	48.4%	54.0%	53.6%

Option valuation methods, including Black-Scholes-Merton, require the input of highly subjective assumptions, which are discussed below.

Risk-Free Interest Rate

The interest rates used are based on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award.

Expected Term

For options granted prior to 2012, options granted generally vest as follows: 25% of the shares on the first anniversary of the vesting commencement date and the remaining 75% proportionately each month over the next 36 months. For options granted in 2012 or later, options granted generally vest as follows: 25% of the shares vest on each anniversary of the vesting commencement date. Options granted generally expire 10 years from the date of grant. In order to compute the expected term for the four-year period immediately following our IPO, the Company elected to use the simplified method due to insufficient historical exercise data available to provide a reasonable basis upon which to estimate the expected term.

Expected Dividend Yield

The dividend rate used is zero as the Company has never paid any cash dividends on its common stock and does not anticipate doing so in the foreseeable future. The Company is also restricted from paying dividends on common stock under its credit facility.

Expected Volatility

Authoritative accounting guidance on stock-based compensation indicates that companies should consider volatility over a period generally commensurate with the expected or contractual term of the stock option. Adequate Company-specific

data does not exist for this time period, due to the Company's IPO in 2011. The volatility variable used is a benchmark of other comparable companies' volatility rates.

Changes in stock options issued are as follows (in thousands):

	Options Outstanding	Price Range	Weighted-Average Price	Weighted-Average Contractual Term (in years)	Aggregate Intrinsic Value (1)
Balance at December 31, 2012	3,984	0.37 – 20.00	\$ 13.68		
Granted	1,345	5.07 - 6.29	\$ 5.33		
Exercised	(44)	1.85 - 5.26	\$ 3.98		
Forfeited	(2,753)	5.33 - 20.00	\$ 14.93		
Balance at December 31, 2013	2,532	0.37 – 20.00	\$ 8.06		
Granted	410	7.45 - 9.11	\$ 8.96		
Exercised	(288)	5.26 - 8.06	\$ 7.40		
Forfeited	(805)	0.37 - 20.00	\$ 9.91		
Balance at December 31, 2014	1,850	0.37 – 20.00	\$ 7.56		
Granted	350	7.25 - 10.94	\$ 10.21		
Exercised	(50)	5.26 - 9.11	\$ 7.13		
Forfeited	(97)	5.33 - 11.99	\$ 8.36		
Balance at December 31, 2015	2,052	0.37 – 20.00	\$ 7.98	7.28	\$ 231
Vested	916	0.37 – 20.00	\$ 8.49	6.16	\$ 231
Unvested	1,136	5.07 - 12.42	\$ 7.57	8.18	\$ —
Exercisable as of December 31, 2015	916	0.37 – 20.00	\$ 8.49	6.16	\$ 231

(1) The aggregate intrinsic value is equal to the difference between the exercise price of the underlying stock option awards and the fair value of Company's common stock as of December 31, 2015 .

The aggregate intrinsic value of stock options exercised during the year ended December 31, 2015 was approximately \$138,000 , which was the difference between the exercise price of the underlying stock options awards and the fair value of the Company's common stock on the date of exercise.

Stock Option Exchange

On August 6, 2013, the Company commenced a voluntary employee stock option exchange program (the "Exchange Program") to permit the Company's eligible employees to exchange some or all of their eligible outstanding options ("Original Options") to purchase the Company's common stock with an exercise price greater than or equal to \$9.62 per share, whether vested or unvested, for a lesser number of new stock options ("New Options"). In accordance with the terms and conditions of the Exchange Program, on September 4, 2013, the Company closed the exchange program and accepted outstanding options to purchase an aggregate of 1,120,847 shares of the Company's common stock, with exercise prices ranging from \$9.62 to \$ 20.00 , and issued, in exchange, an aggregate of 532,427 New Options with an exercise price of \$5.33 . The New Options cliff vest in increments of 25% on each anniversary. The exchange resulted in a decrease in the Company's common stock subject to outstanding stock options by 588,420 shares, which increased the number of future shares available to be issued.

The Company did not record additional compensation cost related to the exchange as the estimated fair value of the new options did not exceed the fair value of the exchanged stock options calculated immediately prior to the exchange. The Company will recognize the remaining unamortized compensation cost related to the exchanged options over the vesting period of the New Options.

Performance-Based Restricted Stock Units

The following table summarizes PSU activity under the Company's incentive award plan for the twelve months ended December 31, 2015 :

	PSUs Outstanding	Weighted- Average Grant Date Fair Value	Weighted- Remaining Contractual Life
Balance at December 31, 2012	270	\$ 12.10	
Granted	—	\$ —	
Vested	—	\$ —	
Forfeited or Canceled	(158)	\$ 11.88	
Balance at December 31, 2013	<u>112</u>	<u>\$ 12.42</u>	5.60
Granted	7	\$ 7.10	
Vested	—	\$ —	
Forfeited or Canceled	(112)	\$ 12.27	
Balance at December 31, 2014	<u>7</u>	<u>\$ 7.10</u>	9.37
Granted	12	\$ 10.58	
Vested	—	\$ —	
Forfeited or Canceled	—	\$ —	
Balance at December 31, 2015	<u>19</u>	<u>\$ 9.28</u>	8.90

Restricted Stock Units

The following table summarizes RSU activity under the Company's incentive award plan for the year ended December 31, 2015 :

	RSUs Outstanding	Weighted- Average Grant Date Fair Value	Weighted- Remaining Contractual Life
Balance at December 31, 2012	53	\$ 12.06	
Granted	855	\$ 5.27	
Vested	(35)	\$ 13.85	
Forfeited	(92)	\$ 5.73	
Balance at December 31, 2013	<u>781</u>	<u>\$ 5.28</u>	9.60
Granted	444	\$ 8.47	
Vested	(209)	\$ 5.50	
Forfeited	(184)	\$ 5.75	
Balance at December 31, 2014	<u>832</u>	<u>\$ 6.83</u>	8.97
Granted	552	\$ 7.25	
Vested	(311)	\$ 6.78	
Forfeited	(62)	\$ 7.24	
Balance at December 31, 2015	<u>1,011</u>	<u>\$ 7.03</u>	8.80

Outstanding RSUs had an estimated market value of \$4.8 million at the end of December 31, 2015 . The estimated market value of the shares that vested during the years ended December 31, 2015 , 2014 and 2013 was approximately \$2.6 million , \$1.5 million and \$0.2 million , respectively.

14. Commitments and Contingencies

The Company has contractual relationships with certain of its sponsored athletes, DJs, musicians and artists, whereby the Company compensates them for promoting its products or pays them a royalty on sales of their signature headphones. The contracts typically have a one -to three -year term. In addition to cash payments, the Company generally provides limited complimentary products for its sponsors use, and reimburses certain travel expenses incurred in conjunction with promoting the Company's products. Future minimum payments under the sponsorship agreements are (in thousands):

Year ending December 31:		
2016	\$	954
2017		6
Total minimum sponsorship payments	\$	960

Future minimum payments under operating lease obligations are (in thousands):

Year ending December 31:		
2016	\$	1,581
2017		1,493
2018		2,100
2019		2,145
2020		2,202
Thereafter		13,179
Total minimum lease payments	\$	22,700

Operating lease obligations primarily relate to the Company's lease of office space in several countries with various expiration dates through 2027. The terms of these leases often include periods of free rent, or rent holidays and increasing rental rates over time. The Company recognizes rent expense on a straight-line basis and has accrued for rent expense recorded but not paid. Rent expense for the years ended December 31, 2015, 2014 and 2013 totaled \$2.1 million, \$1.9 million and \$2.1 million, respectively. Estimated sublease income of \$218,000 and \$0 is expected to be received in 2016 and 2017, respectively.

Other contractual obligations consist of warehouse distribution services with the Company's third party supply chain providers, which are (in thousands):

Year ending December 31:		
2016	\$	1,833
2017		266
Total minimum other contractual obligations	\$	2,099

The Company also has other commitments and contingencies which include employment agreements with its executives and fully cancellable purchase orders none of which generally extend beyond one year.

On November 5, 2015, Peter Kravitz, as Liquidating Trustee of the RSH Liquidating Trust, filed a complaint against the Company in the U.S. States Bankruptcy Court for the District Court of Delaware alleging payments received by the Company were preferential payments and seeking the return of approximately \$4.0 million in payments. The Company operated under a consignment relationship with the former Radio Shack entity. Therefore, the Company believes the payments received are not considered preferential and intends to vigorously defend this action.

On February 12, 2016, an alleged shareholder filed a putative securities class action complaint against the Company and certain Company officers and directors in the United States District Court for the District of Utah, captioned *Davis v. Skullcandy, Inc., et al.*, No. 2:16-cv-00121-RJS. The complaint purports to be brought on behalf of shareholders who purchased common stock between August 7, 2015 and January 11, 2016. It asserts that the Company and certain officers and directors violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 by making allegedly false or misleading statements concerning positioning and expectations for future growth. The complaint seeks damages in an unspecified amount and equitable relief against the defendants. The Company believes the lawsuit is without merit and intends to vigorously defend this action.

The Company is subject to various claims, complaints and legal actions in the normal course of business. The Company does not believe it has any currently pending litigation of which the outcome will have a material adverse effect on its operations or financial position.

15. Costs Associated with Exit or Disposal Activities

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During the years ended December 31, 2015 and 2014, the Company did not incur any material charges associated with exit or disposal activities, and the Company had no such liability as of December 31, 2015 or December 31, 2014 .

In June 2013, the Company announced plans to consolidate its marketing, creative, business development and legal departments as well as certain sales and international personnel to the Company's headquarters in Park City, Utah and close the office in San Clemente, California. For the year ended December 31, 2013, the Company recorded expense of approximately \$2,227,000 , of which \$1,304,000 related to severance, \$588,000 in charges related to property and equipment expected to be disposed, \$147,000 in charges associated with subleasing the former office space, and \$188,000 related to relocation and professional service expenses. Expenses were recorded in selling, general and administrative expenses within the Domestic segment. All material charges associated with exit or disposal activities were settled during the year ended December 31, 2013 , and the Company had no such liability remaining as of December 31, 2013 .

Name	Jurisdiction of Formation	Trade Names
Skullcandy North America, LLC	Delaware	
Skullcandy, Inc.	Delaware	
Skullcandy International Holdings B.V.	Netherlands	
AG Acquisition Group	Delaware	Astro Gaming
Skullcandy Mexico S DE RL DE CV	Mexico	
Skullcandy International GmbH	Switzerland	
Skullcandy Nordic AB	Sweden	
Skullcandy Servicios Mexico S DE RL DE CV SRL	Mexico	
Skullcandy Hong Kong Limited	Hong Kong	
Skullcandy Europe B.V.	Netherlands	
Skullcandy Japan GK	Japan	
Skullcandy Audio (Shenzhen) Co., Ltd.	China	
Skullcandy Audio (Shanghai) Co., Ltd.	China	

Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in the following Registration Statements:

- (1) Registration Statement (Form S-8 No. 333-197884) pertaining to the Skullcandy, Inc. Amended and Restated Skullcandy, Inc. 2011 Incentive Award Plan
- (2) Registration Statement (Form S-8 No. 333-194607) pertaining to the Skullcandy, Inc. Nonqualified Inducement Stock Option Grant Notice and Stock Option Agreement
- (3) Registration Statement (Form S-8 No. 333-188532) pertaining to the Skullcandy, Inc. Nonqualified Inducement Stock Option Grant Notice and Stock Option Agreement and Skullcandy, Inc. Inducement Restricted Stock Unit Award Grant Notice and Restricted Stock Unit Award Agreement
- (4) Registration Statement (Form S-8 No. 333-175734) pertaining to the Skullcandy, Inc. Amended and Restated 2005 Stock Plan; the Skullcandy, Inc. 2008 Equity Incentive Plan; and the Skullcandy, Inc. 2011 Incentive Award Plan

of our reports dated March 4, 2016 , with respect to the consolidated financial statements of Skullcandy, Inc. and the effectiveness of internal control over financial reporting of Skullcandy, Inc. included in this Annual Report (Form 10-K) of Skullcandy, Inc. for the year ended December 31, 2015.

/s/ Ernst & Young LLP
Salt Lake City, Utah
March 4, 2016

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(a)
OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Jason Hodell, certify that:

1. I have reviewed this annual report on Form 10-K of Skullcandy, Inc.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

March 4, 2016

By: /s/ JASON HODELL

Jason Hodell,

Chief Financial Officer and Chief Operating Officer (Principal Accounting and Financial Officer)

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Hoby Darling, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Annual Report on Form 10-K of Skullcandy, Inc. for the year ended December 31, 2015 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such report fairly presents, in all material respects, the financial condition and results of operations of Skullcandy, Inc.

March 4, 2016

By: /s/ S. HOBY DARLING

S. Hoby Darling,

President and Chief Executive Officer (Principal Executive Officer)

I, Jason Hodell, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Annual Report on Form 10-K of Skullcandy, Inc. for the year ended December 31, 2015 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such report fairly presents, in all material respects, the financial condition and results of operations of Skullcandy, Inc.

March 4, 2016

By: /s/ JASON HODELL

Jason Hodell,

Chief Financial Officer and Chief Operating Officer (Principal Accounting and Financial Officer)