
ACE
FINANCIALS
2012
ANNUAL
REPORT

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

## Report of Independent Auditors

The Board of Directors
Ace Hardware Corporation

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Ace Hardware Corporation, which comprise the consolidated balance sheets as of December 29, 2012 and December 31, 2011, and the related consolidated statements of income, comprehensive income, equity, and cash flows for each of the three fiscal years in the period ended December 29, 2012, and the related notes to the consolidated financial statements.

### Management's Responsibility for the Financial Statements

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

### Auditor's Responsibility

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

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

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

### Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Ace Hardware Corporation at December 29, 2012 and December 31, 2011, and the consolidated results of its operations and its cash flows for each of the three fiscal years in the period ended December 29, 2012 in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

Chicago, Illinois
March 20, 2013

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

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | $ 13.1 | $ 15.8 |
| Marketable securities | 54.1 | 51.0 |
| Receivables, net of allowance for doubtful accounts of $7.2 and $9.8, respectively | 296.7 | 307.6 |
| Inventories | 557.7 | 535.3 |
| Prepaid expenses and other current assets | 45.2 | 28.2 |
| Total current assets | 966.8 | 937.9 |
| Property and equipment, net | 320.0 | 307.1 |
| Notes receivable, net of allowance for doubtful accounts of $13.9 and $12.1, respectively | 32.4 | 41.2 |
| Goodwill and other intangible assets | 24.2 | 1.0 |
| Other assets | 69.6 | 58.8 |
| Total assets | $ 1,413.0 | $ 1,346.0 |
| **Liabilities and Equity** | | |
| Current maturities of long-term debt | $ 49.5 | $ 5.8 |
| Accounts payable | 505.5 | 464.3 |
| Patronage distributions payable in cash | 30.0 | 30.4 |
| Patronage refund certificates payable | - | 17.3 |
| Accrued expenses | 144.8 | 119.8 |
| Total current liabilities | 729.8 | 637.6 |
| Long-term debt | 240.7 | 293.5 |
| Patronage refund certificates payable | 22.6 | 15.8 |
| Other long-term liabilities | 64.8 | 51.3 |
| Total liabilities | 1,057.9 | 998.2 |
| Member Retailers' Equity: | | |
| Class A voting common stock, $1,000 par value, 10,000 shares authorized, 2,736 and 2,758 issued and outstanding, respectively | 2.7 | 2.8 |
| Class C nonvoting common stock, $100 par value, 4,000,000 shares authorized, 3,008,903 and 2,982,828 issued and outstanding, respectively | 300.9 | 298.3 |
| Class C nonvoting common stock, $100 par value, issuable to retailers for patronage distributions, 257,613 and 246,727 shares issuable, respectively | 25.7 | 24.7 |
| Additional stock subscribed, net | - | - |
| Contributed capital | 19.7 | 20.9 |
| Accumulated deficit | (0.1) | (6.7) |
| Accumulated other comprehensive loss | (1.2) | - |
| Equity attributable to Ace member retailers | 347.7 | 340.0 |
| Equity attributable to noncontrolling interests | 7.4 | 7.8 |
| Total equity | 355.1 | 347.8 |
| Total liabilities and equity | $ 1,413.0 | $ 1,346.0 |

See accompanying notes to the consolidated financial statements.

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

| | Years Ended | | |
|---|---|---|---|
| | **December 29, 2012 (52 Weeks)** | **December 31, 2011 (52 Weeks)** | **January 1, 2011 (52 Weeks)** |
| Revenues: | | | |
| Wholesale revenues | $ 3,832.9 | $ 3,709.2 | $ 3,530.7 |
| Retail revenues | 8.0 | - | - |
| Total revenues | 3,840.9 | 3,709.2 | 3,530.7 |
| Cost of revenues: | | | |
| Wholesale cost of revenues | 3,367.0 | 3,261.9 | 3,086.4 |
| Retail cost of revenues | 4.8 | - | - |
| Total cost of revenues | 3,371.8 | 3,261.9 | 3,086.4 |
| Gross profit: | | | |
| Wholesale gross profit | 465.9 | 447.3 | 444.3 |
| Retail gross profit | 3.2 | - | - |
| Total gross profit | 469.1 | 447.3 | 444.3 |
| Distribution operations expenses | 98.1 | 95.2 | 87.3 |
| Selling, general and administrative expenses | 138.1 | 135.8 | 141.0 |
| Retailer success and development expenses | 117.6 | 111.5 | 112.7 |
| Retail operating expenses | 3.3 | - | - |
| Gain on sale of paint assets, net of acquisition and disposition costs | (7.0) | - | - |
| Total operating expenses | 350.1 | 342.5 | 341.0 |
| Operating income | 119.0 | 104.8 | 103.3 |
| Interest expense | (23.9) | (36.4) | (35.2) |
| Loss on early extinguishment of debt | (19.9) | (0.1) | - |
| Interest income | 4.2 | 5.1 | 5.2 |
| Other income, net | 6.3 | 7.6 | 4.8 |
| Income tax expense | (3.5) | (3.1) | (3.0) |
| Net income | 82.2 | 77.9 | 75.1 |
| Less: net income attributable to noncontrolling interests | 0.4 | 0.2 | - |
| Net income attributable to Ace Hardware Corporation | $ 81.8 | $ 77.7 | $ 75.1 |
| Accrued patronage distributions | $ 75.5 | $ 74.5 | $ 69.9 |

See accompanying notes to the consolidated financial statements.

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

| | Years Ended | | |
|---|---|---|---|
| | December 29, 2012 (52 Weeks) | December 31, 2011 (52 Weeks) | January 1, 2011 (52 Weeks) |
| Net income | $ 82.2 | $ 77.9 | $ 75.1 |
| Other comprehensive income (loss), net of tax: | | | |
| Foreign currency translation | (0.1) | - | - |
| Unrecognized postretirement cost | - | 0.1 | (0.1) |
| Unrealized gain (loss) on investments | 1.5 | (1.0) | 1.0 |
| Unrealized loss on derivative financial instrument | (2.6) | - | - |
| Total other comprehensive income (loss), net | (1.2) | (0.9) | 0.9 |
| Comprehensive income | 81.0 | 77.0 | 76.0 |
| Less: Comprehensive income attributable to noncontrolling interest | 0.4 | 0.2 | - |
| Comprehensive income attributable to Ace Hardware Corporation | $ 80.6 | $ 76.8 | $ 76.0 |

See accompanying notes to the consolidated financial statements.

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

| | Shareholders of Ace Hardware Corporation | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Capital Stock | | | | | | | | |
| | Class A | Class C | Class C Stock Issuable to Retailers for Patronage Dividends | Additional Stock Subscribed | Contributed Capital | Accumulated Deficit | Accumulated Other Comprehensive Income (Loss) | Noncontrolling Interests | Total Equity |
| Balances at January 2, 2010 | $ 3.0 | $ 287.7 | $ 30.2 | $ 0.2 | $ 7.0 | $ (20.6) | $ - | $ - | $ 307.5 |
| Net income | - | - | - | - | - | 75.1 | - | - | 75.1 |
| Other comprehensive income | - | - | - | - | - | - | 0.9 | - | 0.9 |
| Net payments on subscriptions | - | - | - | 0.7 | - | - | - | - | 0.7 |
| Stock issued | - | 30.1 | (30.2) | (0.5) | - | - | - | - | (0.6) |
| Stock repurchased | (0.1) | (11.3) | - | - | - | - | - | - | (11.4) |
| Patronage distributions issuable | - | - | 22.4 | - | - | - | - | - | 22.4 |
| Patronage distributions payable | - | - | - | - | - | (66.4) | - | - | (66.4) |
| Other | - | (0.6) | - | - | - | 0.8 | - | - | 0.2 |
| Balances at January 1, 2011 | $ 2.9 | $ 305.9 | $ 22.4 | $ 0.4 | $ 7.0 | $ (11.1) | $ 0.9 | $ - | $ 328.4 |
| Net income | - | - | - | - | - | 77.7 | - | 0.2 | 77.9 |
| Other comprehensive loss | - | - | - | - | - | - | (0.9) | - | (0.9) |
| Net payments on subscriptions | - | - | - | 0.8 | - | - | - | - | 0.8 |
| Stock issued | 0.1 | 23.9 | (22.4) | (1.2) | - | - | - | - | 0.4 |
| Sale of noncontrolling interests | (0.1) | (13.1) | - | - | 13.9 | - | - | 7.6 | 8.3 |
| Stock repurchased | (0.1) | (18.4) | - | - | - | - | - | - | (18.5) |
| Patronage distributions issuable | - | - | 24.7 | - | - | - | - | - | 24.7 |
| Patronage distributions payable | - | - | - | - | - | (73.7) | - | - | (73.7) |
| Other | - | - | - | - | - | 0.4 | - | - | 0.4 |
| Balances at December 31, 2011 | $ 2.8 | $ 298.3 | $ 24.7 | $ - | $ 20.9 | $ (6.7) | $ - | $ 7.8 | $ 347.8 |
| Net income | - | - | - | - | - | 81.8 | - | 0.4 | 82.2 |
| Other comprehensive loss | - | - | - | - | - | - | (1.2) | - | (1.2) |
| Net payments on subscriptions | - | - | - | 0.9 | - | - | - | - | 0.9 |
| Stock issued | 0.1 | 24.2 | (24.7) | (0.9) | - | - | - | - | (1.3) |
| Sale of noncontrolling interests | - | - | - | - | 0.3 | - | - | - | 0.3 |
| Stock repurchased | (0.2) | (21.6) | - | - | (1.6) | - | - | (0.8) | (24.2) |
| Patronage distributions issuable | - | - | 25.7 | - | - | - | - | - | 25.7 |
| Patronage distributions payable | - | - | - | - | - | (75.3) | - | - | (75.3) |
| Other | - | - | - | - | 0.1 | 0.1 | - | - | 0.2 |
| Balances at December 29, 2012 | $ 2.7 | $ 300.9 | $ 25.7 | $ - | $ 19.7 | $ (0.1) | $ (1.2) | $ 7.4 | $ 355.1 |

See accompanying notes to the consolidated financial statements.

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

| | Years Ended | | |
|---|---|---|---|
| | December 29, 2012 (52 Weeks) | December 31, 2011 (52 Weeks) | January 1, 2011 (52 Weeks) |
| **Operating Activities** | | | |
| Net income | $ 82.2 | $ 77.9 | $ 75.1 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 40.1 | 38.7 | 38.3 |
| Amortization of deferred gain on sale leaseback | (1.2) | (1.2) | (1.2) |
| Amortization of deferred financing costs | 1.9 | 2.8 | 2.8 |
| Loss (gain) on disposal of assets, net | 0.4 | (1.6) | (0.5) |
| Provision for doubtful accounts | 2.6 | 4.5 | 6.7 |
| Loss on early extinguishment of debt | 19.9 | 0.1 | - |
| Gain on sale of paint assets, net of acquisition and disposition costs | (7.0) | - | - |
| Other, net | 0.2 | 0.1 | - |
| Changes in operating assets and liabilities, exclusive of effect of acquisitions and dispositions: | | | |
| Receivables | (7.8) | (35.8) | (85.1) |
| Inventories | 24.9 | (24.5) | (71.9) |
| Other current assets | (4.4) | 7.6 | (5.5) |
| Other long-term assets | (9.9) | (11.2) | (2.3) |
| Accounts payable and accrued expenses | 30.7 | 36.7 | 17.8 |
| Other long-term liabilities | 1.2 | 2.7 | (4.3) |
| Deferred taxes | 2.9 | (0.4) | 1.9 |
| Net cash provided by (used in) operating activities | 176.7 | 96.4 | (28.2) |
| **Investing Activities** | | | |
| Purchases of marketable securities | (12.0) | (41.5) | (24.1) |
| Proceeds from sale of marketable securities | 11.0 | 40.4 | 22.7 |
| Purchases of property and equipment | (46.4) | (25.6) | (36.0) |
| Cash paid for acquired business, net of cash acquired | (52.0) | - | - |
| Proceeds from sale of paint manufacturing assets | 34.8 | - | - |
| Decrease in notes receivable, net | 1.8 | 0.4 | 1.0 |
| Other | 0.2 | 0.1 | (0.6) |
| Net cash used in investing activities | (62.6) | (26.2) | (37.0) |
| **Financing Activities** | | | |
| Net borrowings under (payments of) revolving lines of credit | 43.6 | (22.5) | 22.5 |
| Proceeds from issuance of long-term debt | 200.0 | - | - |
| Redemption of senior notes | (301.3) | - | - |
| Principal payments on long-term debt | (9.5) | (6.5) | (5.3) |
| Payments of deferred financing costs | (5.2) | - | - |
| Payments of cash portion of patronage distribution | (27.7) | (26.4) | (29.2) |
| Payments of patronage refund certificates | (17.4) | (17.9) | (19.5) |
| Proceeds from sale of noncontrolling interests | 0.3 | 8.7 | - |
| Other | 0.4 | 0.8 | 0.3 |
| Net cash used in financing activities | (116.8) | (63.8) | (31.2) |
| Increase (decrease) in cash and cash equivalents | (2.7) | 6.4 | (96.4) |
| Cash and cash equivalents at beginning of period | 15.8 | 9.4 | 105.8 |
| Cash and cash equivalents at end of period | $ 13.1 | $ 15.8 | $ 9.4 |
| Supplemental disclosure of cash flow information: | | | |
| Interest paid | $ 24.1 | $ 34.4 | $ 33.3 |
| Income taxes paid | $ 1.0 | $ 0.7 | $ 1.2 |

See accompanying notes to the consolidated financial statements.

## 1) Summary of Significant Accounting Policies

### *The Company and Its Business*

Ace Hardware Corporation ("the Company") is a wholesaler of hardware, paint and other related products. The Company also provides to its retail members value-added services such as advertising, marketing, merchandising and store location and design services. The Company's goods and services are sold predominately within the United States, primarily to retailers that operate hardware stores and with whom the Company has a retail membership agreement. As a retailer-owned cooperative, the Company distributes substantially all of its patronage sourced income in the form of patronage distributions to member retailers based on their volume of merchandise purchases. See Note 7, Patronage Distributions and Refund Certificates Payable, for further discussion regarding patronage distributions.

As a result of its acquisition of its largest Ace-branded customer in December 2012, the Company is now also a retailer of hardware, paint and other related products. For more information on this acquisition, see Note 2.

Until December 2012, the Company was also in the paint manufacturing business. In December 2012, the Company sold all of its paint manufacturing assets, including two manufacturing facilities located near Chicago, to The Valspar Corporation. As a result, the Company is no longer engaged in the business of manufacturing paint. For more information on the sale, see Note 2.

In 2011, the Company restructured its international operations into a stand-alone legal entity with its own management team and board of directors as opposed to a division within the Ace cooperative structure. This entity also has its own subsidiaries. The entity Ace Hardware International Holdings, Ltd. ("AHI") is a majority-owned and controlled subsidiary of the Company with a noncontrolling interest owned by its international retailers. International retailers no longer own shares of stock in the Company or receive patronage dividends.

### *Basis of Presentation*

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). The Company's fiscal year ends on the Saturday nearest December 31st. Accordingly, fiscal years 2012, 2011 and 2010 ended on December 29, 2012, December 31, 2011 and January 1, 2011, respectively, and consisted of 52 weeks each.

Subsequent events have been evaluated through March 20, 2013, the date these statements were available to be issued.

### *Principles of Consolidation*

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

### *Use of Estimates*

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

### *Reclassifications*

Certain prior period amounts have been reclassified to conform to the current financial statement presentation, with no net effect on the consolidated financial statements.

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

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

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

In the normal course of NAIL's operations, letters of credit of $29.3 million and $29.7 million at December 29, 2012 and December 31, 2011, respectively, were issued in favor of the insurance company that reinsures a portion of NAIL's loss exposure. At December 29, NAIL has pledged substantially all of its cash and cash equivalents and marketable securities as collateral for these letters of credit.

***Revenue Recognition***

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

***Receivables***

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

***Notes Receivable***

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

***Allowance for Doubtful Accounts***

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

***Inventories***

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

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

***Vendor Funds***

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

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

***Property and Equipment***

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

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

***Internal-Use Software***

Included in fixed assets is the capitalized cost of internal-use software. The Company capitalizes costs incurred during the application development stage of internal-use software and amortizes these costs over its estimated useful life. Costs incurred related to design or maintenance of internal-use software are expensed as incurred. For the years ended 2012, 2011 and 2010, the Company capitalized $1.6 million, $0.9 million and $2.8 million, respectively, of software development costs related to internal programming time. Amortization of these previously capitalized amounts was $1.4 million, $1.1 million and $0.8 million for 2012, 2011 and 2010, respectively.

***Leases***

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

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

***Advertising Expense***

The Company expenses advertising costs when incurred. Gross advertising expenses amounted to $103.8 million, $98.6 million and $102.1 million in 2012, 2011 and 2010, respectively.

***Retirement Plans***

The Company participates in a multi-employer defined benefit retirement plan covering a limited number of union employees. Costs with respect to the noncontributory pension plan are determined actuarially and consist of current costs and amounts to amortize unrecognized prior service costs and unrecognized gains and losses. The Company also sponsors health benefit plans for its retired officers and a limited number of non-officer employees. The Company also sponsors a defined contribution profit sharing plan for substantially all employees. The Company's contribution under this plan is determined annually by the Board of Directors and charged to expense in the period in which it is earned by employees.

***Income Taxes***

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

***Self Insurance***

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

***Concentration of Credit Risk***

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

***Impact of New Accounting Standards***

***New Accounting Pronouncements - Adopted***

In July 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-05, "Comprehensive Income (Topic 220): Presentation of Comprehensive Income," ("ASU 2011-05"), which was subsequently amended by ASU No. 2011-12, "Deferral of the Effective Date for Amendments to the Presentation of Reclassification of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05," ("ASU 2011-12"). ASU 2011-05 eliminates the option the Company previously followed to report other comprehensive income and its components in the statement of changes in equity. ASU 2011-05 requires that all nonowner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-12 deferred certain aspects of ASU 2011-05. This guidance does not change the items that are reported in net income and other comprehensive income. The Company has selected the option of two separate but consecutive statements, and has included these statements in this Annual Report.

***New Accounting Pronouncements – Issued***

In July 2012, the FASB issued ASU 2012-02, "Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment," ("ASU 2012-02"), which amends the guidance in Accounting Standards Codification ("ASC") 350-30 on testing indefinite-lived intangible assets, other than goodwill, for impairment. The FASB issued ASU 2012-02 in response to feedback on ASU 2011-08, "Intangibles – Goodwill and Other (Topic 350): Testing for Goodwill Impairment," which amended the goodwill impairment testing requirements by allowing an entity to perform a qualitative impairment assessment before proceeding to the two-step impairment test. Similarly, under ASU 2012-02, an entity testing an indefinite-lived intangible asset for impairment has the option of performing a qualitative assessment before calculating the fair value of the asset. Although ASU 2012-02 revises the examples of events and circumstances that an entity should consider in interim periods, it does not revise the requirements to test indefinite-lived intangible assets annually for impairment and between annual tests if there is a change in events or circumstances. This new guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, and is not expected to impact the Company's consolidated financial statements.

(In millions)

**(2) Acquisition and Dispositions**

Effective December 16, 2012, Ace Retail Holdings LLC ("ARH" a newly-formed subsidiary of the Company) acquired all of the outstanding shares of capital stock of WHI Holding Corp. ("WHI"). WHI owns all outstanding shares of Westlake Hardware, Inc. ("Westlake"). Westlake is based in Kansas City, Missouri and operates 85 neighborhood hardware stores located throughout the Midwest under the name Westlake Ace Hardware. The total purchase price of approximately $90.0 million, consisted of the initial purchase price of $88.0 million plus the $2.0 million increase in net working capital, as defined in the agreement, between the target amount and actual amount at closing. The purchase price consisted of approximately $55.0 million paid in cash at closing and the assumption of approximately $35.0 million of bank debt owed by Westlake. By securing the Company's largest customer, the Company has preserved the Ace brand in these markets and believes that ARH is a vehicle for growth and profit. The Company incurred transaction costs of $1.9 million which were included in Gain on sale of paint assets, net of acquisition and disposition costs in the Consolidated Statement of Income.

As a result of this acquisition the Company recorded $15.6 million of goodwill and $7.6 million for an intangible trade name. Goodwill has an indefinite life and, therefore, is not amortized, but will be tested annually for impairment in the fourth quarter. The intangible trade name will be amortized over its 20 year estimated useful life. The Company will test the intangible trade name annually for impairment in the fourth quarter. The goodwill and intangible trade name are not expected to be deductible for tax purposes.

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

| | |
|---|---|
| Cash paid | $ 55.0 |
| | |
| Fair value of assets acquired and liabilities assumed: | |
| Cash | $ 3.0 |
| Receivables | 8.8 |
| Inventories | 68.8 |
| Other current assets | 3.3 |
| PP&E | 20.3 |
| Goodwill | 15.6 |
| Trade name | 7.6 |
| Other long-term assets | 12.7 |
| Current liabilities | (33.0) |
| Long-term liabilities | (17.1) |
| Bank debt assumed | (35.0) |
| | $55.0 |

The results of operations of ARH were not material to the Company's consolidated financial statements in fiscal 2012.

On December 28, 2012, the Company sold its paint manufacturing assets, including two manufacturing facilities located near Chicago, to The Valspar Corporation ("Valspar") in exchange for consideration of approximately $45.0 million. As a result of the sale the Company recorded a gain of $8.9 million. The gain was included in Gain on sale of paint assets, net of acquisition and disposition costs in the Consolidated Statement of Income and was net of transactions costs of $1.8 million. In addition to the asset sale, the Company and Valspar announced a long-term strategic supply relationship where Valspar will manufacture and supply Ace-branded paint products as well as make a comprehensive line of Valspar-branded paints available to the Company's retail locations.

(In millions)

**(3) Receivables, net**

Receivables, net include the following amounts:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Trade | $ 238.9 | $ 253.3 |
| Other | 54.9 | 55.0 |
| Notes receivable – current portion | 10.1 | 9.1 |
| Less: allowance for doubtful accounts | (7.2) | (9.8) |
| Receivables, net | $ 296.7 | $ 307.6 |

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

**(4) Inventories**

Inventories consist of wholesale merchandise inventories held for sale to retailers and retail merchandise inventory held for resale at company-operated retail locations. Substantially, all of the Company's wholesale inventories are valued on the LIFO method. The excess of replacement cost over the LIFO value of inventory was $99.0 million and $93.9 million at December 29, 2012 and December 31, 2011, respectively. There were no LIFO decrements in 2012 or 2011.

Inventories consisted of:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Manufacturing inventories: | | |
| Raw materials | $ - | $ 9.1 |
| Work-in-process and finished goods | - | 20.0 |
| Total manufacturing inventories (FIFO) | - | 29.1 |
| Wholesale merchandise inventory (LIFO) | 490.9 | 506.2 |
| Retail merchandise inventory at Company-operated stores (FIFO) | 66.8 | - |
| Inventories | $ 557.7 | $ 535.3 |

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

Property and equipment, net is summarized as follows:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Land | $ 16.1 | $ 17.1 |
| Buildings and improvements | 261.2 | 280.7 |
| Warehouse equipment | 119.9 | 107.1 |
| Office equipment | 185.0 | 174.3 |
| Manufacturing equipment | - | 18.3 |
| Transportation equipment | 45.7 | 41.7 |
| Leasehold improvements | 24.9 | 14.2 |
| Construction in progress | 11.0 | 2.1 |
| | 663.8 | 655.5 |
| Less: accumulated depreciation and amortization | (343.8) | (348.4) |
| Property and equipment, net | $ 320.0 | $ 307.1 |

Depreciation and amortization expense for fiscal years 2012, 2011 and 2010 was $40.1 million, $38.7 million and $38.3 million, respectively.

(In millions)

## (6) Notes Receivable, net

The Company makes available to its retailers various lending programs whose terms exceed one year. At December 29, 2012 and December 31, 2011, the outstanding balance of the notes was $56.4 million and $62.4 million, respectively, of which the current portion of $10.1 million and $9.1 million, respectively, was recorded in receivables, net. Payments on these notes are primarily collected by the Company through the application of future patronage distributions, retailer billings or stock repurchases.

At December 29, 2012 and December 31, 2011, $33.2 million and $37.3 million, respectively, of the notes receivable were from the Company's Equity Match Financing ("EMF") program, which offered financing to qualified retailers to facilitate new store growth. These loans are repaid by the application of the non-cash portion of the annual patronage distribution. As a result, the company reduces the note receivable balance in the consolidated balance sheets by the amount of the non-cash portion of the annual patronage distribution that it expects to apply against outstanding EMF loans. Notes receivable consist of the following components:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Notes receivable, gross | $ 65.3 | $ 70.4 |
| Less estimated patronage applications | (8.9) | (8.0) |
| Net | 56.4 | 62.4 |
| Less current portion | (10.1) | (9.1) |
| Less allowance for doubtful accounts | (13.9) | (12.1) |
| Notes receivable, net | $ 32.4 | $ 41.2 |

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

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| 0 – 4 years | $ 19.8 | $ 19.3 |
| 5 – 8 years | 38.6 | 41.9 |
| 9 – 12 years | 6.9 | 9.2 |
| Total | $ 65.3 | $ 70.4 |

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

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

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

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

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

(In millions)

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

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Corporate Credit Exposure: | | |
| Low risk | $ 41.1 | $ 49.7 |
| Moderate risk | 8.4 | 9.8 |
| High risk | 15.8 | 10.9 |
| Total | $ 65.3 | $ 70.4 |

The Company applies a consistent practice of establishing an allowance for notes that it feels may become uncollectible by monitoring the financial strength of its retailers. The collectability of certain notes is evaluated on an individual basis while the remaining notes are evaluated on a collective basis. The breakdown at December 29, 2012 and December 31, 2012 of notes evaluated individually versus notes evaluated collectively was as follows:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Notes receivable: | | |
| Ending balance individually evaluated for impairment | $ 11.9 | $ 9.9 |
| Ending balance collectively evaluated for impairment | 53.4 | 60.5 |
| Ending principal balance | $ 65.3 | $ 70.4 |

The Company has evaluated the collectability of the notes and has established an allowance for doubtful accounts of $13.9 million and $12.1 million at December 29, 2012 and December 31, 2011, respectively. Management records the allowance for doubtful accounts based on the above information as well as judgments made considering a number of factors, primarily historical collection statistics, current member retailer credit information, the current economic environment and the offsetting amounts due to members for stock, notes, interest and declared and unpaid patronage distributions. The components of changes to the notes receivable allowance for doubtful accounts for 2012 and 2011 were as follows:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Allowance for doubtful accounts: | | |
| Beginning balance | $ 12.1 | $ 12.1 |
| Provision | 1.1 | 1.4 |
| Reclassifications to accounts receivable allowance for doubtful accounts | (1.0) | (2.1) |
| Reclassifications from accounts receivable allowance for doubtful accounts | 1.3 | 0.7 |
| Other | 0.4 | - |
| Ending balance | $ 13.9 | $ 12.1 |

Notes bear interest at various rates based on the retailer's credit quality and are recorded at face value. Interest is recognized over the life of the note based on the outstanding balance and stated interest rate, which approximates the effective interest method. During fiscal years 2012, 2011 and 2010, $2.4 million, $2.5 million and $2.4 million respectively, were recorded as interest income related to the notes.

In the event a retailer cancels their membership with the Company, any outstanding notes receivable, and related allowance for doubtful accounts, are transferred to trade receivables and the retailer is billed for any unpaid principal and interest balances. For both 2012 and 2011, $7.1 million of notes receivable were transferred to trade receivables as an event occurred which made the note due immediately. Upon transfer of the notes receivable to accounts receivable, $1.0 million and $2.1 million of the notes receivable allowance for doubtful accounts was transferred to the accounts receivable allowance for doubtful accounts to properly match the reserve against the asset on the balance sheet. As a result of any outstanding notes receivable being transferred to trade receivables before any write offs occur, all notes receivable write-offs are included in the overall trade receivable write-offs in the consolidated financial statements, and will not be presented as write-offs within the allowance for doubtful accounts of the Company's notes receivable.

(In millions)

## (7) Patronage Distributions and Refund Certificates Payable

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

In 2010, the Board of Directors revised the patronage distribution plan to change the amount of the patronage distribution paid in cash to 40% from 35% effective for the 2010 fiscal year which was paid in 2011. The cash portion of the patronage distribution was 40% for the 2012 patronage distribution to be paid in 2013 and for the 2011 patronage distribution paid in 2012.

The patronage distribution composition is summarized as follows:

| | Years Ended | | |
|---|---|---|---|
| | December 29, 2012 | December 31, 2011 | January 1, 2011 |
| Cash portion | $ 30.0 | $ 30.4 | $ 28.5 |
| Class C stock | 25.7 | 24.7 | 22.4 |
| Patronage refund certificates | 7.2 | 9.1 | 7.6 |
| Patronage financing deductions | 10.6 | 9.5 | 8.0 |
| Patronage distributions applied to variance allocation | 0.2 | 0.8 | 3.4 |
| Patronage due to subsidiary | 1.8 | - | - |
| Total patronage distributions | $ 75.5 | $ 74.5 | $ 69.9 |

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

In 2010 and 2011, a portion of the patronage distribution was distributed in the form of a patronage refund certificate having maturity dates and bearing interest as determined by the Company's Board of Directors. The Company also plans to issue patronage refund certificates with maturity dates and bearing interest as determined by the Company's Board of Directors in those instances where the maximum Class C stock requirements have been met for the 2012 patronage distribution.

The patronage refund certificates outstanding at December 29, 2012 are payable as follows:

| | Amount | Interest Rate |
|---|---|---|
| 2016 | $ 6.6 | 4.00% |
| 2017 | 8.8 | 4.00% |
| 2018 | 7.2 | 4.00% |

## (8) Debt

On April 13, 2012, the Company entered into a new 5-year secured credit facility with a group of banks. The new credit facility consists of a $200.0 million amortizing term loan and a $400.0 million revolving credit facility. The facility is expandable to $750.0 million via a $150.0 million accordion that is exercisable without the consent of existing lenders provided that the Company is not in default of the credit agreement and further provided that none of the existing lenders is required to provide any portion of the increased facility. Borrowings under this facility bear interest at a rate of 175 to 275 basis points over the London Interbank Offered Rate ("LIBOR") depending on the Company's leverage ratio as defined under the agreement. The facility was priced at LIBOR plus 225 basis points at December 29, 2012. This facility requires maintenance of certain financial covenants including a maximum allowable average leverage ratio, a minimum fixed charge coverage ratio and a minimum asset coverage ratio. As of December 29, 2012, the Company was in compliance with its covenants and a total of $242.5 million was outstanding under the credit facility.

The term loan was funded on June 1, 2012 and requires the Company to make principal repayments of $2.5 million per quarter during the first two years of the agreement and $5.0 million per quarter thereafter. Any remaining principal balance will be repaid at the maturity of the agreement on April 13, 2017.

The revolving credit facility includes a $175.0 million sublimit for the issuance of standby and commercial letters of credit. As of December 29, 2012 a total of $34.9 million in letters of credit were outstanding. The revolving credit facility also requires the Company to pay fees based on the unused portion of the line of credit at a rate of 20 to 40 basis points per annum depending on the Company's leverage ratio.

(In millions)

The proceeds from the term loan and borrowings under the revolving credit facility were used to retire the remaining $288.2 million of 9.125% senior secured notes in June 2012 at a repurchase price of $301.3 million. This repurchase premium of $13.1 million, along with the non-cash write-off of deferred financing costs and bond discount costs related to the previous credit facility and senior secured notes of $6.8 million, were recorded as a loss on early extinguishment of debt in the consolidated statements of income during 2012. The Company incurred fees of $5.2 million in connection with the new credit facility, which will be amortized over the life of the loan.

The credit facility allows the Company to make revolving loans and other extensions of credit to AHI in an aggregate principal amount not to exceed $75.0 million at any time. At December 29, 2012, there were no loans or other extensions of credit provided to AHI.

In order to reduce the risk of interest rate volatility, the Company entered into an interest rate swap derivative agreement in June 2012, which expires on March 13, 2017. This swap agreement fixes the LIBOR rate on the full balance of the term loan at 1.13%, resulting in an effective rate of 3.38% after adding the 2.25% margin based on the current pricing tier per the credit agreement. The notional amount of the derivative agreement will decrease to match the principal balance remaining as principal payments are made throughout the term of the loan agreement. The swap arrangement has been designated as a cash flow hedge and has been evaluated to be highly effective. As a result, the after-tax change in the fair value of the swap is recorded in accumulated other comprehensive income/loss as a gain or loss on derivative financial instruments. See Note 11 for more information.

As part of the WHI acquisition, the Company assumed a $60.0 million asset-based revolving credit facility with an outstanding balance of $35.0 million on December 16, 2012 (the "ARH Facility"). The ARH Facility matures on December 16, 2017 and is expandable to $85.0 million under certain conditions. In addition, the Company has the right to issue letters of credit up to a maximum of $7.5 million. At the Company's discretion, borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 75 basis points to 100 basis points or LIBOR plus an applicable spread of 175 basis points to 200 basis points, depending on the Company's availability under the ARH Facility and measured on a quarterly basis.

The ARH Facility is collateralized by substantially all of ARH's personal property and intangible assets. Borrowings under the facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible collateral balances (primarily consisting of certain receivables and inventories). This agreement requires maintenance of certain financial covenants including a minimum fixed charge coverage ratio. As of December 29, 2012, ARH was in compliance with its covenants and a total of $33.6 million was outstanding under the ARH Facility and there were outstanding letters of credit of $2.9 million.

The ARH Facility requirements include a lender-controlled cash concentration system that results in all of ARH's daily available cash being applied to the outstanding borrowings under this facility. Pursuant to FASB ASC Section 470-10-45, "Classification of Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses," the borrowings under the ARH Facility have been classified as a Current maturity of long-term debt as of December 29, 2012.

Long-term debt is comprised of the following:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| $200.0 million Term Loan Facility, installments of $2.5 million quarterly for the first two years and $5.0 million thereafter until maturity on April 13, 2017, bearing interest at LIBOR plus the applicable spread | $ 197.5 | $ - |
| $400.0 million Revolving Credit Facility maturing on April 13, 2017 and bearing interest at LIBOR plus the applicable spread | 45.0 | - |
| $288.2 million face value Senior Notes less unamortized discount of $2.2 million due at maturity with interest payable semi-annually, bearing an interest coupon rate of 9.125% and a maturity date of June 1, 2016 | - | 285.9 |
| $60.0 million Asset-Based Revolving Credit Facility maturing on December 16, 2017 and bearing interest at LIBOR plus the applicable spread | 33.6 | |
| Installment notes with maturities through 2016 at a fixed rate of 6.00% | 14.1 | 13.4 |
| Total debt | 290.2 | 299.3 |
| Less: maturities within one year | (49.5) | (5.8) |
| Long-term debt | $ 240.7 | $ 293.5 |

**(In millions)**

The aggregate scheduled maturities of long-term debt at December 29, 2012 are as follows:

| Fiscal Year | Amount |
|---|---|
| 2013 | $ 49.5 |
| 2014 | 21.4 |
| 2015 | 18.2 |
| 2016 | 26.1 |
| 2017 | 175.0 |
| Total debt | $ 290.2 |

### (9) Retirement Plans

The Company has healthcare plans under which a limited number of qualified retired employees receive certain health care, dental care, life insurance or related benefits. Amounts expensed under these plans totaled $0.1 million in fiscal years 2012, 2011 and 2010.

The Company participates in one multi-employer plan covering union employees. Amounts expensed for this plan totaled $0.2 million, $0.2 million and $0.1 million in fiscal years 2012, 2011 and 2010, respectively.

The Company also maintains a profit sharing plan for substantially all employees. The Company made cash contributions to the plan of $16.9 million, $14.2 million and $16.4 million during fiscal 2012, 2011 and 2010, respectively.

### (10) Accrued Expenses

Accrued expenses include the following components:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Salaries and wages | $ 43.7 | $ 38.1 |
| Insurance reserves | 15.8 | 12.7 |
| Vendor funds | 14.9 | 3.5 |
| Interest | 1.2 | 3.9 |
| Profit sharing | 8.6 | 8.3 |
| Other | 60.6 | 53.3 |
| Accrued Expenses | $ 144.8 | $ 119.8 |

### (11) Fair Value

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

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

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

(In millions)

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

The tables below set forth, by level, the Company's financial assets, liabilities and derivative instruments that were accounted for at fair value as of December 29, 2012 and December 31, 2011. The tables do not include cash on hand and also do not include assets and liabilities that are measured at historical cost or any basis other than fair value. The carrying values for other current financial assets and liabilities, such as accounts receivable and accounts payable, approximate fair value due to the short maturity of such instruments.

| **Items measured at fair value on a recurring basis** | Carrying Value Measured at Fair Value December 29, 2012 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets: | | | | |
| Cash equivalents: | | | | |
| Money market funds | $ 1.0 | $ 1.0 | $ - | $ - |
| | | | | |
| Marketable securities: | | | | |
| Corporate fixed income securities | 11.2 | - | 11.2 | - |
| Equity securities | 22.5 | 22.5 | - | - |
| Mortgage-backed securities | 9.1 | - | 9.1 | - |
| U.S. government notes | 10.3 | 10.3 | - | - |
| Other | 1.0 | - | 1.0 | - |
| Total marketable securities | $ 54.1 | $ 32.8 | $ 21.3 | $ - |
| Other long-term liabilities: | | | | |
| Interest rate swap derivative | $ 4.3 | $ - | $ 4.3 | $ - |

| **Items measured at fair value on a recurring basis** | Carrying Value Measured at Fair Value December 31, 2011 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets: | | | | |
| Cash equivalents: | | | | |
| Money market funds | $ 1.0 | $ 1.0 | $ - | $ - |
| | | | | |
| Marketable securities: | | | | |
| Corporate fixed income securities | 8.8 | - | 8.8 | - |
| Equity securities | 20.3 | 20.3 | - | - |
| Mortgage-backed securities | 9.8 | - | 9.8 | - |
| U.S. government notes | 11.0 | 11.0 | - | - |
| Other | 1.1 | - | 1.1 | - |
| Total marketable securities | $ 51.0 | $ 31.3 | $ 19.7 | $ - |

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

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

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

**(In millions)**

On June 5, 2012, the Company entered into a 58-month interest rate swap agreement, which expires on March 13, 2017, with an amortizing notional amount of $200.0 million. This instrument is being used to fix the LIBOR rate on the full balance of the term loan amount at 1.13%, resulting in an effective rate of 3.38% after adding the 2.25% margin based on the current pricing tier per the credit agreement — see Note 8 for more information. As of December 29, 2012 the notional amount of the 58-month interest rate swap agreement remaining was $197.5 million, matching the outstanding balance of the term loan.

The fair value of the Company's interest rate swap is estimated using Level 2 inputs, which are based on model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. The Company also considers counterparty credit-risk and bilateral or "own" credit risk adjustments in estimating fair value, in accordance with the requirements of GAAP. As of December 29, 2012, the fair value of the interest rate swap was a liability balance of $4.3 million. The Company classifies derivative liabilities as Other long-term liabilities on the consolidated balance sheet.

Because the interest rate swap has been designated as a cash flow hedge and has been evaluated to be highly effective, the change in the fair value is recorded in accumulated other comprehensive income/loss ("AOCI") as a gain or loss on derivative financial instruments. The amount in AOCI is reclassified to earnings if the derivative instrument is sold, extinguished or terminated, or at the time it becomes expected to be sold, extinguished or terminated. As of December 29, 2012, the amount recorded in AOCI for the fair value adjustment of the interest rate swap was an unrealized loss of $2.6 million, net of tax. This unrealized loss is not expected to be reclassified into interest expense within the next 12 months. The impact of any ineffectiveness is recognized currently in earnings. Hedge ineffectiveness related to the interest rate swap for the year ended December 29, 2012, was insignificant and was recorded in interest expense in the consolidated statement of income.

There were no material differences between the fair value and cost basis of the Company's marketable securities at December 29, 2012 and December 31, 2011, respectively. Gross proceeds from the sale of marketable securities and the related realized gains and losses for the fiscal years ended December 29, 2012, December 31, 2011, and January 1, 2011 were as follows:

| | **Years Ended** | | |
|---|---|---|---|
| | December 29, 2012 | December 31, 2011 | January 1, 2011 |
| Gross proceeds | $ 11.0 | $ 40.4 | $ 22.7 |
| Gross realized gains | 0.2 | 2.1 | - |
| Gross realized losses | (0.1) | (0.2) | - |

Gross realized gains and losses were determined using the specific identification method.

The following table summarizes the contractual maturity distributions of the Company's debt securities at December 29, 2012. Actual maturities may differ from the contractual or expected maturities since borrowers may have the right to prepay obligations with or without prepayment penalties.

| Fair value of available-for-sale debt securities | Due in One Year or Less | Due After One Year through Five Years | Due After Five Years through Ten Years | Due After Ten Years | Total |
|---|---|---|---|---|---|
| Corporate fixed income securities | $ 1.0 | $ 3.9 | $ 5.0 | $ 1.3 | $ 11.2 |
| Mortgage-backed securities | - | - | - | 9.1 | 9.1 |
| U.S. government notes | 5.3 | 1.4 | 1.1 | 2.5 | 10.3 |
| Other | - | - | 0.8 | 0.2 | 1.0 |
| Total | $ 6.3 | $ 5.3 | $ 6.9 | $ 13.1 | $ 31.6 |

The Company's debt instruments are recorded at cost on the consolidated balance sheets. The fair value of long-term debt was approximately $291.6 million at December 29, 2012, compared to the carrying value, including accrued interest, of $291.1 million.

(In millions)

## (12) Income Taxes

Income tax expense includes the following components:

| | Years Ended | | |
|---|---|---|---|
| **Current:** | December 29, 2012 | December 31, 2011 | January 1, 2011 |
| Federal | $ (0.1) | $ (2.5) | $ (0.7) |
| State | (0.1) | 0.1 | (0.2) |
| Foreign | (0.5) | (0.7) | (0.3) |
| Current income tax expense | (0.7) | (3.1) | (1.2) |
| **Deferred:** | | | |
| Federal | (2.6) | 0.6 | (1.4) |
| State | (0.3) | (0.6) | (0.4) |
| Foreign | 0.1 | - | - |
| Deferred income tax expense | (2.8) | - | (1.8) |
| Total income tax expense | $ (3.5) | $ (3.1) | $ (3.0) |

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

| | Years Ended | | |
|---|---|---|---|
| | December 29, 2012 | December 31, 2011 | January 1, 2011 |
| Expected tax at U.S. Federal income tax rate | $ (30.0) | $ (28.4) | $ (27.3) |
| Patronage distribution deductions | 26.4 | 26.1 | 24.4 |
| Other, net | 0.1 | (0.8) | (0.1) |
| Income tax expense | $ (3.5) | $ (3.1) | $ (3.0) |

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

| **Deferred tax assets:** | December 29, 2012 | December 31, 2011 |
|---|---|---|
| AMT and other tax credit carryforwards | $ 10.7 | $ 12.7 |
| Net operating loss carryforwards | 6.4 | 8.2 |
| Unearned insurance premium and loss reserves | 1.0 | 1.6 |
| Allowance for doubtful accounts | 7.9 | 7.8 |
| Inventory reserves | 3.7 | 5.8 |
| Deferred vendor rebates | 8.5 | 7.5 |
| Accrued compensation and benefits expense | 17.0 | 16.0 |
| Other reserves | 14.9 | 11.1 |
| Total deferred tax assets | 70.1 | 70.7 |
| Less: valuation allowance | - | (0.2) |
| Deferred tax assets | 70.1 | 70.5 |
| **Deferred tax liabilities:** | | |
| Depreciation and deferred gains on property and equipment | 18.6 | 13.4 |
| Amortization of intangibles | 2.1 | - |
| Fair market value of leases | 1.3 | - |
| Prepaid expenses and deferred income | 1.1 | 0.2 |
| Inventory valuation | 25.9 | 26.9 |
| Deferred tax liabilities | 49.0 | 40.5 |
| Net deferred tax assets | $ 21.1 | $ 30.0 |

A reconciliation of the net deferred tax assets to the consolidated balance sheets is as follows:

| | December 29, 2012 | December 31, 2011 |
|---|---|---|
| Net deferred tax assets – current | $ 12.3 | $ 11.0 |
| Net deferred tax assets – noncurrent | 8.8 | 19.0 |
| Net deferred tax assets | $ 21.1 | $ 30.0 |

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

At December 29, 2012, the Company has federal and state net operating loss carryforwards available for offset against future taxable income. The net operating losses may be carried forward through the tax years 2030 through 2032.

At December 29, 2012, the Company has alternative minimum tax credit carryforwards of $10.0 million and foreign tax credits of $0.7 million available to offset future tax expense. The carryforward period for alternative minimum tax credits is indefinite. Foreign tax credits may be carried forward to tax years 2016 through 2020.

At December 29, 2012, the Company did not establish a valuation allowance against the effect of the deferred tax assets as management believes that it is more likely that not that there will be future income sufficient to realize these deferred tax assets.

The federal income tax returns of the consolidated group are subject to examination by the Internal Revenue Service (“IRS”), generally for three years after the returns are filed. The 2009 through 2012 tax years remain subject to examination by the IRS. For state purposes, the 2008 through 2012 tax years remain subject to examination.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. Accrued interest and penalties included in the reserve for uncertain tax positions at December 29, 2012 and December 31, 2011 was $0.1 million and $0.3 million, respectively. The Company recognized a benefit of $0.2 million, an immaterial benefit and an expense of $0.1 million related to interest and penalties within income tax expense for the years ended December 29, 2012, December 31, 2011 and January 1, 2011. It is reasonably possible that the total amount of unrecognized tax benefits will increase or decrease within the next twelve months. The Company currently estimates that such increases and decreases will not be significant.

### (13) Capital Stock

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

| | Number of Shares at | |
|---|---|---|
| | December 29, 2012 | December 31, 2011 |
| Class A stock, voting, redeemable at par value: | | |
| Authorized | 10,000 | 10,000 |
| Issued and outstanding | 2,736 | 2,758 |
| Class C stock, nonvoting, redeemable at not less than par value: | | |
| Authorized | 4,000,000 | 4,000,000 |
| Issued and outstanding | 3,008,903 | 2,982,828 |
| Issuable as patronage distributions | 257,613 | 246,727 |
| Additional stock subscribed: | | |
| Class A stock | - | - |
| Class C stock | 50 | 100 |

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

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

(In millions)

During 2011, the Company restructured its international operations into a stand-alone legal entity with its own management team and board of directors as opposed to a division within the Ace cooperative structure. As part of this restructuring, the Company received cash consideration of $8.7 million and redeemed all shares of stock in the Company owned by its international retailers along with patronage refund certificates issued as part of the 2010 patronage distribution in exchange for stock in this new subsidiary.

## (14) Commitments and Contingencies

*Lease commitments*

The Company rents certain warehouse and distribution space, office space, retail locations, equipment and vehicles under operating leases. At December 29, 2012, annual minimum rental commitments under leases that have initial or remaining noncancelable terms in excess of one year, net of sublease income, are as follows:

| **Fiscal Year** | Amount |
|---|---|
| 2013 | $ 49.1 |
| 2014 | 44.0 |
| 2015 | 36.3 |
| 2016 | 30.9 |
| 2017 | 25.2 |
| Thereafter | 133.2 |
| Minimum lease payments | $ 318.7 |

Minimum lease payments include $8.1 million of minimum lease payments for store leases that the Company has assigned to member retailers. As a condition of the sale of the former Company-owned stores, the Company remains contingently liable for payment under approximately 14 lease arrangements. The leases have varying terms, the latest of which expires in 2020. The Company believes that due to the nature of the agreements, the possibility of payment on a majority of the leases is remote. The Company has recorded a contingent liability of $1.1 million as of December 29, 2012 for leases in which the Company is currently making payments or believes that it is probable that it will make payments before the lease term expires. These liabilities are included in accrued expenses in the consolidated balance sheet as of December 29, 2012.

All other leases expire prior to 2028. Under certain leases, the Company pays real estate taxes, insurance and maintenance expenses in addition to rental expense. ARH rents a majority of its retail store location properties, as well as its corporate headquarters and distribution center, under long-term operating leases that generally provide for payment of minimum annual rent payments, real estate taxes, insurance and maintenance and, in some cases, contingent rent (calculated as a percentage of sales) in excess of minimum rent. The amount of contingent rent paid since the date of the acquisition of ARH was not material. With the exception of store leases assigned to member retailers, management expects that in the normal course of business, leases that expire will be renewed or replaced by other leases. Rent expense was $39.4 million, $40.4 million and $41.0 million in 2012, 2011 and 2010, respectively.

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

*Contingencies*

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

*Other guarantees*

In the normal course of business, the Company enters into commercial commitments including standby letters of credit and guarantees that could become contractual obligations. Letters of credit are issued generally to insurance agencies and financial institutions in direct support of the Company's corporate and retailer insurance programs and retailer lending programs as well as international vendors. As of December 29, 2012, the Company had outstanding standby letters of credit of $35.7 million and commercial letters of credit of $28.4 million.

(In millions)

### (15) Summary of Quarterly Results

The following table provides summary quarterly results (unaudited) for the eight quarters prior to and including the quarter ended December 29, 2012:

| | 2012 | | | |
|---|---|---|---|---|
| | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| Revenues | $ 911.9 | $ 949.9 | $ 1,070.9 | $ 908.2 |
| Gross Profit | 104.4 | 123.8 | 133.5 | 107.4 |
| Operating expenses | 79.7 | 86.8 | 93.1 | 90.5 |
| Net income attributable to Ace Hardware Corporation | 22.4 | 34.3 | 14.9 | 10.2 |

| | 2011 | | | |
|---|---|---|---|---|
| | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| Revenues | $ 921.7 | $ 912.0 | $ 1,021.5 | $ 854.0 |
| Gross Profit | 109.1 | 114.4 | 125.0 | 98.8 |
| Operating expenses | 83.4 | 90.0 | 83.7 | 85.4 |
| Net income attributable to Ace Hardware Corporation | 19.2 | 17.0 | 34.6 | 6.9 |

### (16) Supplemental Disclosures of Cash Flow Information

During fiscal 2012, 2011 and 2010, current year patronage distributions of $10.6 million, $9.5 million and $8.0 million, respectively, were offset against current receivables owed to the Company by its member retailers with no net impact in the consolidated statements of cash flows. In addition at the retailers request, fiscal 2012, 2011 and 2010, had $3.7 million, $2.2 million and $3.8 million, respectively, of prior year patronage distributions offset against current receivables owed to the Company by its member retailers with no net impact in the consolidated statements of cash flows.

During fiscal 2012, 2011 and 2010, repurchases of stock from retailers of $21.7 million, $18.4 million and $12.0 million, respectively, were offset against current receivables of $8.3 million, $5.3 million and $7.1 million, respectively, and notes receivable of $5.7 million, $4.8 million and $1.6 million, respectively. The remaining $7.7 million, $8.3 million and $3.3 million, respectively, were primarily issued as notes payable with no net impact in the consolidated statements of cash flows.

During fiscal 2012, the Company entered into an interest rate swap derivative dated June 5, 2012. The fair value adjustment for the interest rate swap derivative was recorded as a noncurrent liability of $4.3 million as of December 29, 2012. The Company offset this adjustment in fair value, net of tax, against AOCI with no net impact in the consolidated statement of cash flows.

In 2011, the Company restructured its international operations into a stand-alone legal entity with its own management team and board of directors as opposed to a division within the Ace cooperative structure. During fiscal 2011, the Company redeemed all shares of stock in the Company owned by its international retailers along with patronage refund certificates issued as part of the 2010 patronage distribution in exchange for stock in this new subsidiary, with no net impact on the consolidated statement of cash flows. Class A shares of $0.1 million, Class C shares of $13.1 million and patronage refund certificates of $0.5 million, respectively, were redeemed and are presented as either noncontrolling interests or additions to contributed capital on the consolidated balance sheet as of December 29, 2012. The Company also received $8.7 million of cash consideration in fiscal 2011 which is reflected in the financing activities section of the consolidated statement of cash flows. During the year ended December 29, 2012, repurchases of stock from international retailer cancellations of $2.5 million were primarily offset against current receivables.

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

The following discussion and analysis summarizes the significant factors affecting the Company's consolidated operating results and financial condition during the three-year period ended December 29, 2012 (the Company's fiscal years 2012, 2011 and 2010). Each of the fiscal years presented contains 52 weeks of operating results. Unless otherwise noted, all references herein for the years 2012, 2011 and 2010 represent fiscal years ended December 29, 2012, December 31, 2011 and January 1, 2011, respectively. This discussion and analysis should be read in conjunction with the consolidated financial statements and the related notes included in this annual report that have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP").

**Company Overview**

The Company is a wholesaler of hardware and other related products and provides services and best practices for retail operations. The overall home improvement industry is estimated to be approximately $284 billion and consists of a broad range of products and services, including lawn and garden products, paint and sundries, certain building supplies and general merchandise typically used in connection with home and property improvement, remodeling, repair and maintenance. The industry is fragmented and competition exists between the large home improvement centers, retail hardware stores and other chains offering hardware merchandise.

The Company's retailers generally compete in the $38 billion "convenience hardware" segment which is characterized by purchases primarily of products related to home improvement and repair, including paint and related products and lawn and garden equipment, and those products less focused on large-scale building, renovation and remodeling projects. The Company believes that the following competitive strengths distinguish it from its peers and contribute to its success in the convenience hardware market: (1) strong consumer recognition of the Ace Brand; (2) well-regarded for exceptional customer service and convenience; (3) strength of distribution operations; (4) consolidated purchasing power; (5) differentiated product and service offerings; and (6) a diversified network of independent retailers.

The Company strives to be the best provider of products, services and operating methods for convenience hardware retailers. The four main drivers that support that goal and the Company's efforts to grow the business are improving the store model, accelerating new store openings, introducing store projects that drive store sales and profitability, and reducing the number of store closings. The Company has recently announced its "2020 Vision" strategy that has very specific and detailed plans and programs to positively impact each of the four drivers.

The Company completed a number of significant transactions in 2012 that are designed to strengthen the Company's balance sheet and prepare it to execute 2020 Vision. These include the acquisition of the Company's largest customer, the sale of the Company's paint manufacturing assets, and the refinancing of the Company's debt. Each of these is described in more detail below.

Effective December 16, 2012, Ace Retail Holdings LLC ("ARH" a newly-formed subsidiary of the Company) acquired all of the outstanding shares of capital stock of WHI Holding Corp. ("WHI"). WHI owns all outstanding shares of Westlake Hardware, Inc. ("Westlake"). Westlake is based in Kansas City, Missouri and operates 85 neighborhood hardware stores located throughout the Midwest under the name Westlake Ace Hardware. The total purchase price of approximately $90.0 million, consisted of the initial purchase price of $88.0 million plus the $2.0 million increase in net working capital, as defined in the agreement, between the target amount and actual amount at closing. The purchase price consisted of approximately $55.0 million paid in cash at closing and the assumption of approximately $35.0 million of bank debt owed by Westlake. By securing the Company's largest customer, the Company has preserved the Ace brand in these markets and believes that ARH is a vehicle for growth and profit that may potentially help the Company accelerate new store openings and reduce store closings. The results of operations of ARH were not material to the Company's consolidated financial statements in fiscal 2012.

On December 28, 2012, the Company sold its paint manufacturing assets, including two manufacturing facilities located near Chicago, to The Valspar Corporation ("Valspar") in exchange for consideration of approximately $45.0 million. As a result of the sale the Company recorded a gain of $8.9 million. The gain was included in Gain on sale of paint assets, net of acquisition and disposition costs in the Consolidated Statement of Income and was net of transactions costs of $1.8 million. In addition to the asset sale, the Company and Valspar announced a long-term strategic supply relationship where Valspar will manufacture and supply Ace-branded paint products as well as make a comprehensive line of Valspar-branded paints available to the Company's retail locations.

The sale of the paint manufacturing assets is an important part of the Company's plan to reinvent its paint department and is one of the main components of 2020 Vision. Monetizing these assets will allow the Company to make significant investments in in-store paint equipment, merchandising and marketing on behalf of retailers who elect to participate in the program. The long-term strategic supply agreement with Valspar, one of the largest liquid paint manufacturers in the world, will ensure that the Company has access to high-quality and innovative liquid paint products and technology.

During the second quarter of 2012, the Company completed the refinancing of its revolving credit facility and redeemed the remaining senior secured notes outstanding. This refinancing activity has resulted and will continue to result in significant interest savings. As a result of the refinancing activity, the Company recognized a $19.9 million loss on the early extinguishment of debt.

The refinancing of the Company under a five year agreement at substantially lower interest rates improves the Company's capitalization, profits and cash flow and helps position it to be able to make the investments that are contemplated by 2020 Vision.

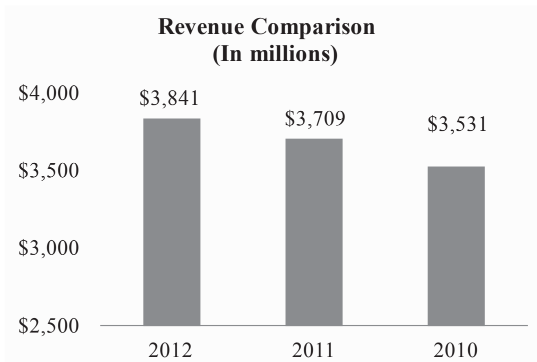
The Company paid $27.7 million of cash patronage distributions in 2012 related to net income of $77.7 million in 2011 compared to $26.4 million related to 2010 net income of $75.1 million paid in 2011. The cash portion of the patronage distribution paid to retail shareholders by the Company was 40% of total patronage for the distributions paid in 2012 and 2011.

**Financial Summary**

The Company's revenues increased $131.7 million, or 3.6%, during the year ended December 29, 2012 as compared to the prior year. The Company's net income for the year ended December 29, 2012 increased $4.1 million, or 5.3%.

Management utilizes a variety of key performance measures to evaluate the performance of the Company's business. These measures include revenues, store count, gross profit percentage, operating expenses and debt levels.

**Revenues**




The Company's total revenues increased 3.6% and 5.1% in 2012 and 2011, respectively.

With regard to wholesale merchandise revenues to comparable stores, the Company deems comparable stores to be those that opened at any time prior to the beginning of the preceding fiscal year. Wholesale merchandise revenues to comparable domestic stores positively impacted revenues by 2.5% and 3.5% in 2012 and 2011, respectively. In 2013, Ace will seek to drive sales to comparable stores through existing and new alliances with vendors, new product additions and introductions, a strong in-stock position and various advertising, marketing and other initiatives.

Despite the challenging economic environment, the Company believes its foundation is solid, built on a strong, nationally recognized brand and an efficient distribution system. New Ace retail stores positively impacted wholesale revenues by 2.0% in both 2012 and 2011, respectively, as a result of the Company's incremental sales to those members during their first and second years with the Company. Management also monitors the current year decline in revenues from stores that have cancelled their membership with Ace in the current or prior year periods. Revenue decreases from store cancellations negatively impacted wholesale revenues by 1.4% and 1.5% in 2012 and 2011, respectively. The Company realized a net increase in wholesale revenues of $22.4 million in 2012 compared to $18.8 million in 2011 related to the impact of both new stores affiliated with the Company and from stores that cancelled their membership in 2012 and 2011.

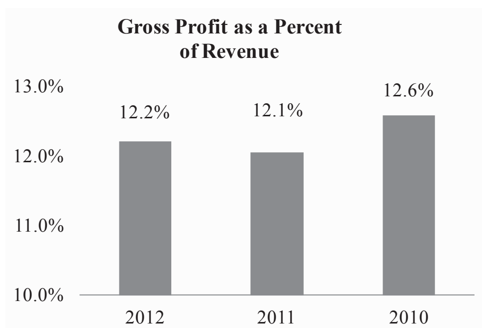
**Domestic Store Count**

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

| | Fiscal Years Ended | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| Retailer outlets at beginning of period | 4,072 | 4,108 | 4,159 |
| New retailer outlets | 159 | 127 | 101 |
| Retailer outlet cancellations | (127) | (163) | (152) |
| Retailer outlets at end of period | 4,104 | 4,072 | 4,108 |

Management believes that new store openings is a key metric in evaluating the health of Ace because of the sales it expects to make to these stores in future periods. Management also monitors the number of stores that have cancelled their membership with Ace in the current and prior year periods. The Company posted a net domestic store count increase of 32 outlets in 2012 and declines of 36 outlets and 51 outlets in 2011 and 2010, respectively. With an improving economy in 2012 the Company believes that Ace's business model and variety of programs has and will encourage existing retailers to open branch locations and new investors to become Ace retailers.

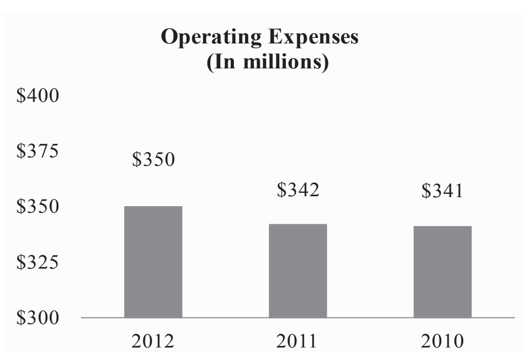
**Gross Profit**

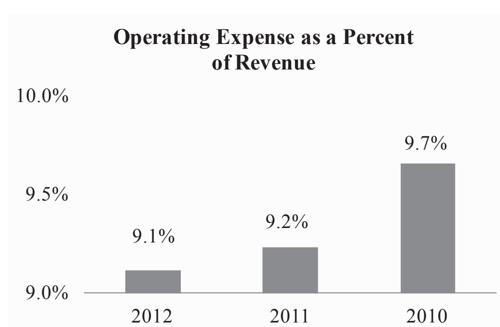



The increase in wholesale gross profit percentage in 2012 was due to a more favorable merchandise sales mix, a reduction in LIFO expense and higher margins on services revenues, primarily due to cost savings and the timing of marketing programs. The decrease in gross profit percentage in 2011 was driven by higher LIFO expense as compared to 2010 reflecting inflationary price increases on inventory purchases and higher inbound freight costs.

In order to better compete in today's challenging environment, the Company seeks to maintain competitive prices to its retailers. The Company's inventory line review process enables it to evaluate gross profit levels while creating profit opportunities at retail through product assortments, retail pricing services, opening stock order and inventory discounts, and reduced cost of goods in certain categories via direct importing. Direct import sourcing enables the Company to deliver high quality merchandise at a lower cost to its retailers.

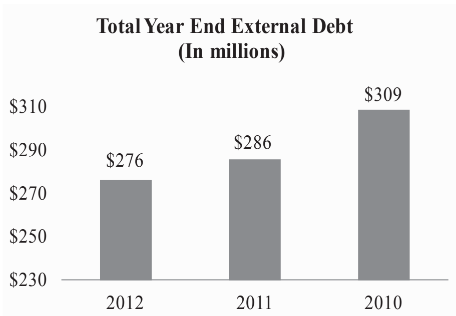
**Operating Expenses**

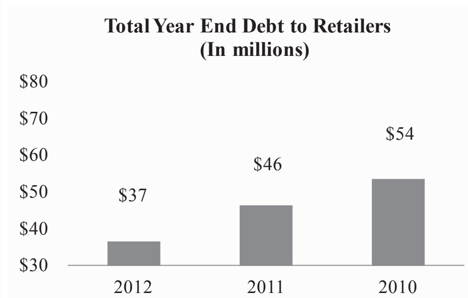



The Company manages its overall expense structure through high accountability of senior management, a comprehensive budget process and by monitoring operating metrics. These metrics include labor productivity, variances compared to prior years and budget and expense as a percent of revenue. Operating expenses for 2012 increased versus 2011, primarily as a result of increased employee benefit and salary expenses as well as retail operating expenses incurred after the acquisition of WHI. These increases were partially offset by the gain on the sale of paint assets, net of acquisition and disposition costs. Operating expenses were essentially flat in 2011 versus 2010 as higher distribution operations expenses associated with the Company's international expansion and higher insurance expenses due to increased claims activity were offset by lower bad debt expenses and reduced advertising and marketing costs. As a percentage of revenue, operating expenses were down in 2011 and 2012 as a result of increased revenues and effective cost controls. The Company is committed to assisting retailers and continues to make significant investments to drive retail growth and development.

**Debt**




For 2012, total year end external debt includes borrowings under the Company's revolving line of credit facility, the Company's term loan and ARH's revolving line of credit facility. For 2011 and 2010, total year end external debt includes borrowings under the Company's revolving line of credit facility and the Company's senior secured notes. The Company's external debt position decreased in 2012 primarily due to improved working capital.

Total year end debt to retailers includes patronage refund certificates payable and other notes payable to current and former retailers. The Company's debt to retailers decreased in the current year due to the maturity of previously issued patronage refund certificates, partially offset by new patronage refund certificates applicable to the 2012 patronage distribution.

**Results of Operations**

***Comparison of the Year Ended December 29, 2012 to the Year Ended December 31, 2011***

The following data summarizes the Company's performance in 2012 as compared to 2011 (in millions):

| | 2012 | | 2011 | | Increase/(decrease) | |
|---|---|---|---|---|---|---|
| | $ | % of Total Revenues | $ | % of Total Revenues | $ | % |
| **Revenues:** | | | | | | |
| Wholesale revenues | 3,832.9 | 99.8% | 3,709.2 | 100.0% | 123.7 | 3.3% |
| Retail revenues | 8.0 | 0.2% | - | - | 8.0 | 100.0% |
| **Total revenues** | 3,840.9 | 100.0% | 3,709.2 | 100.0% | 131.7 | 3.6% |
| **Gross profit:** | | | | | | |
| Wholesale gross profit | 465.9 | 12.1% | 447.3 | 12.1% | 18.6 | 4.2% |
| Retail gross profit | 3.2 | 0.1% | - | - | 3.2 | 100.0% |
| **Total gross profit** | 469.1 | 12.2% | 447.3 | 12.1% | 21.8 | 4.9% |
| **Operating expenses:** | | | | | | |
| Distribution operations expenses | 98.1 | 2.6% | 95.2 | 2.6% | 2.9 | 3.0% |
| Selling, general and administrative expenses | 138.1 | 3.5% | 135.8 | 3.7% | 2.3 | 1.7% |
| Retailer success and development expenses | 117.6 | 3.1% | 111.5 | 3.0% | 6.1 | 5.5% |
| Retail operating expenses | 3.3 | 0.1% | - | - | 3.3 | 100.0% |
| Gain on sale of paint assets, net of acquisition and disposition costs | (7.0) | (0.2%) | - | - | (7.0) | (100.0%) |
| Total operating expenses | 350.1 | 9.1% | 342.5 | 9.3% | 7.6 | 2.2% |
| Operating income | 119.0 | 3.1% | 104.8 | 2.8% | 14.2 | 13.5% |
| Interest expense | (23.9) | (0.6%) | (36.4) | (1.0%) | 12.5 | (34.3%) |
| Loss on early extinguishment of debt | (19.9) | (0.5%) | (0.1) | - | (19.8) | (100.0%) |
| Other | 6.6 | 0.1% | 9.4 | 0.3% | (2.8) | (29.8%) |
| Net income | 81.8 | 2.1% | 77.7 | 2.1% | 4.1 | 5.3% |

Consolidated revenues for the year ended December 29, 2012 totaled $3.8 billion, an increase of $131.7 million, or 3.6%, as compared to the prior year. Total wholesale merchandise revenues were $3.5 billion for fiscal 2012, an increase of $122.8 million, or 3.6%, as compared to the prior year. A reconciliation of consolidated revenues follows (in millions):

| | Amount | % Change vs. 2011 |
|---|---|---|
| **2011 Revenues** | $ 3,709.2 | |
| *Wholesale Merchandise Revenues change based on new and cancelled domestic stores:* | | |
| Revenues increase from new stores added since January 2011 | 73.0 | 2.0% |
| Net decrease from stores cancelled since January 2011 | (50.6) | (1.4%) |
| Increase in wholesale merchandise revenues to comparable domestic stores | 91.4 | 2.5% |
| Increase in international merchandise revenues | 9.0 | 0.2% |
| Increase in retail revenues | 8.0 | 0.2% |
| Other revenue changes | 0.9 | 0.1% |
| **2012 Revenues** | $ 3,840.9 | 3.6% |

New stores are defined as stores that were activated from January 2011 through December 2012. In 2012, the Company had an increase in wholesale merchandise revenues from new domestic stores of $73.0 million. This increase was partially offset by a decrease in wholesale merchandise revenues due to domestic store cancellations of $50.6 million. As a result, the Company realized a net increase in wholesale merchandise revenues of $22.4 million related to the impact of both new stores affiliated with the Company and from stores that cancelled their membership in 2011 and 2012.

Wholesale merchandise revenues to comparable domestic stores increased $91.4 million. The categories with the largest revenues increases were electrical, paint supplies, lawn and garden and cleaning supplies. International merchandise revenues increased $9.0 million primarily due to higher revenues to retailers in the Caribbean market.

Retail revenues of $8.0 million represent sales made by ARH retail stores after the acquisition date.

Gross profit for the year ended December 29, 2012 was $469.1 million, an increase of $21.8 million from 2011, and the gross margin percentage was 12.2% of revenues, up from 12.1% in the prior year. The improvement in gross margin percentage was driven entirely by a higher merchandise gross profit in the current year of $10.3 million resulting from a more favorable mix and lower LIFO expense as well as higher retail service gross profit in the current year of $8.6 million primarily as a result of higher income from delivery and traffic services, vendor services, international royalties and fees and bankcard services. Warehouse sales represented 78.0% of wholesale merchandise revenue in 2012 compared to 77.8% in 2011, while direct ship sales were 22.0%, down from 22.2%.

Operating expenses increased $7.6 million, or 2.2%, to $350.1 million during 2012 as compared to 2011. The increase in operating expenses reflects higher employee benefit and salary expenses of approximately $14.1 million in 2012 compared to the prior year, as well as $3.3 million of retail operating expenses incurred after the acquisition of WHI. These increases were partially offset by the $7.0 million from the gain on sale of paint assets, net of acquisition and disposition costs.

Interest expense decreased $12.5 million due to the refinancing of the Company's credit facility and the redemption of the Company's senior secured notes during the second quarter of 2012.

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

Other income and expense declined $2.8 million from the prior year primarily due to higher gains realized in 2011 as compared to 2012 on the sale of investment securities held by the Company's New Age Insurance, Ltd. ("NAIL") subsidiary.

## Results of Operations

***Comparison of Year Ended December 31, 2011 to Year Ended January 1, 2011***

The following data summarizes the Company's performance in 2011 as compared to 2010 (in millions):

| | 2011 | | 2010 | | Increase/(decrease) | |
|---|---|---|---|---|---|---|
| | $ | % of Revenues | $ | % of Revenues | $ | % |
| Revenues | 3,709.2 | 100.0% | 3,530.7 | 100.0% | 178.5 | 5.1% |
| Gross profit | 447.3 | 12.1% | 444.3 | 12.6% | 3.0 | 0.7% |
| Operating expenses: | | | | | | |
| Distribution operations expenses | 95.2 | 2.6% | 87.3 | 2.5% | 7.9 | 9.0% |
| Selling, general and administrative expenses | 135.8 | 3.7% | 141.0 | 4.0% | (5.2) | (3.7)% |
| Retailer success and development expenses | 111.5 | 3.0% | 112.7 | 3.2% | (1.2) | (1.1)% |
| Total operating expenses | 342.5 | 9.3% | 341.0 | 9.7% | 1.5 | 0.4% |
| Operating income | 104.8 | 2.8% | 103.3 | 2.9% | 1.5 | 1.5% |
| Interest expense | (36.4) | (1.0%) | (35.2) | (1.0%) | (1.2) | 3.4% |
| Loss on early extinguishment of debt | (0.1) | - | - | - | (0.1) | (100.0%) |
| Other | 9.4 | 0.3% | 7.0 | 0.2% | 2.4 | 34.3% |
| Net income | 77.7 | 2.1% | 75.1 | 2.1% | 2.6 | 3.5% |

Consolidated revenues for the year ended December 31 2011 totaled $3.7 billion, an increase of $178.5 million, or 5.1%, as compared to the prior year. Total merchandise revenues were $3.4 billion for fiscal 2011, an increase of $161.9 million, or 5.0%, as compared to the prior year. A reconciliation of consolidated revenues follows (in millions):

| | Amount | % Change vs. 2011 |
|---|---|---|
| **2010 Revenues** | $ 3,530.7 | |
| *Wholesale Merchandise Revenues change based on new and cancelled domestic stores:* | | |
| Revenues increase from new stores added since January 2010 | 70.1 | 2.0% |
| Net decrease from stores cancelled since January 2010 | (51.3) | (1.5%) |
| Increase in merchandise revenues to comparable domestic stores | 123.7 | 3.5% |
| Increase in international merchandise revenues | 19.4 | 0.6% |
| Other revenue changes | 16.6 | 0.5% |
| **2011 Revenues** | $ 3,709.2 | 5.1% |

New stores are defined as stores that were activated from January 2010 through December 2011. In 2011, the Company had an increase in revenues from new domestic stores of $70.1 million. This increase was offset by a decrease in revenues from domestic store cancellations of $51.3 million.

Merchandise revenues to comparable domestic stores increased $123.7 million. On a regional basis, domestic revenues were most positively impacted in the California, New York, Texas, Florida and Arizona markets. On a category basis, domestic revenues were positively impacted in substantially all categories with the biggest increases in the tools, lawn and garden, paint, plumbing and electrical categories.

International merchandise revenues increased $19.4 million due to strong revenues to retailers in the Middle East and Asia regions, partially offset by lower revenues in the Caribbean region.

Gross profit increased $3.0 million but the gross profit percentage decreased 50 basis points to 12.1% in 2011 from 12.6% in 2010. The decrease in gross profit percentage in 2011 was driven by higher LIFO expense as compared to 2010, reflecting inflationary price increases on inventory purchases and higher inbound freight costs. Warehouse revenues represented 77.8% of merchandise revenues in 2011 compared to 77.9% in 2010, while direct ship revenues were 22.2%, up from 22.1%.

Operating expenses increased $1.5 million but decreased as a percent of revenues to 9.3% in 2011 from 9.7% in 2010. The primary driver for the increase in operating expenses was higher distribution operations expenses of $7.9 million primarily related to the Company's international expansion and higher insurance expenses as a result of increased claims activity. Partially offsetting the increase, selling, general and administrative expenses decreased $5.2 million primarily due to lower bad debt expenses. Retailer success and development expenses declined $1.2 million primarily due to a reduction in advertising and marketing costs.

Interest expense increased $1.2 million compared to the prior year primarily due to increased borrowings under the Company's revolving credit facility. Average interest rates on debt, excluding patronage refund certificates, decreased to 8.5% in 2011 from 9.1%

in 2010, while average debt levels, excluding patronage refund certificates, increased $39.3 million to $347.8 million in 2011 from $308.5 million in 2010.

Other income and expense increased $2.4 million primarily due to gains realized on the sale of investment securities held by the Company's New Age Insurance, Ltd. ("NAIL") subsidiary. The Company sold investments as it reallocated its investment portfolio in accordance with its strategy to diversify and mitigate risk.

**Liquidity and Capital Resources**

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

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

On April 13, 2012, the Company entered into a new 5-year secured credit facility with a group of banks. The new credit facility consists of a $200.0 million amortizing term loan and a $400.0 million revolving credit facility. The facility is expandable to $750.0 million via a $150.0 million accordion that is exercisable without the consent of existing lenders provided that the Company is not in default of the credit agreement and further provided that none of the existing lenders is required to provide any portion of the increased facility. Borrowings under this facility bear interest at a rate of 175 to 275 basis points over the London Interbank Offered Rate ("LIBOR") depending on the Company's leverage ratio as defined under the agreement. The facility was priced at LIBOR plus 225 basis points at December 29, 2012. This facility requires maintenance of certain financial covenants including a maximum allowable average leverage ratio, a minimum fixed charge coverage ratio and a minimum asset coverage ratio. As of December 29, 2012, the Company was in compliance with its covenants and a total of $242.5 million was outstanding under the credit facility.

The term loan was funded on June 1, 2012 and requires the Company to make principal repayments of $2.5 million per quarter during the first two years of the agreement and $5.0 million per quarter thereafter. Any remaining principal balance will be repaid at the maturity of the agreement on April 13, 2017.

The revolving credit facility includes a $175.0 million sublimit for the issuance of standby and commercial letters of credit. As of December 29, 2012 a total of $34.9 million in letters of credit were outstanding. The revolving credit facility also requires the Company to pay fees based on the unused portion of the line of credit at a rate of 20 to 40 basis points per annum depending on the Company's leverage ratio.

The proceeds from the term loan and borrowings under the revolving credit facility were used to retire the remaining $288.2 million of 9.125% senior secured notes in June 2012 at a repurchase price of $301.3 million. This repurchase premium of $13.1 million, along with the non-cash write-off of deferred financing costs and bond discount costs related to the previous credit facility and senior secured notes of $6.8 million, were recorded as a loss on early extinguishment of debt in the consolidated statements of income during 2012. The Company incurred fees of $5.2 million in connection with the new credit facility, which will be amortized over the life of the loan.

The credit facility allows the Company to make revolving loans and other extensions of credit to Ace Hardware International Holdings, Ltd. ("AHI") in an aggregate principal amount not to exceed $75.0 million at any time. At December 29, 2012, there were no loans or other extensions of credit provided to AHI.

In order to reduce the risk of interest rate volatility, the Company entered into an interest rate swap derivative agreement in June 2012, which expires on March 13, 2017. This swap agreement fixes the LIBOR rate on the full balance of the term loan at 1.13%, resulting in an effective rate of 3.38% after adding the 2.25% margin based on the current pricing tier per the credit agreement. The notional amount of the derivative agreement will decrease to match the principal balance remaining as principal payments are made throughout the term of the loan agreement. The swap arrangement has been designated as a cash flow hedge and has been evaluated to be highly effective. As a result, the change in the fair value of the swap is recorded in accumulated other comprehensive income/loss as a gain or loss on derivative financial instruments. See Note 11 for more information.

As part of the WHI acquisition, the Company assumed a $60.0 million asset-based revolving credit facility with an outstanding balance of $35.0 million on December 16, 2012 (the "ARH Facility"). The ARH Facility matures on December 16, 2017 and is expandable to $85.0 million under certain conditions. In addition, the Company has the right to issue letters of credit up to a maximum of $7.5 million. At the Company's discretion, borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 75 basis points to 100 basis points or LIBOR plus an applicable spread of 175 basis points to 200 basis points, depending on the Company's availability under the ARH Facility and measured on a quarterly basis.

The ARH Facility is collateralized by substantially all of ARH's personal property and intangible assets. Borrowings under the facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible collateral balances (primarily consisting of certain receivables and inventories). This agreement requires maintenance of certain financial covenants including a minimum fixed charge coverage ratio. As of December 29, 2012, ARH was in compliance with its covenants and a total of $33.6 million was outstanding under the ARH Facility and there were outstanding letters of credit of $2.9 million.

The ARH Facility requirements include a lender-controlled cash concentration system that results in all of ARH's daily available cash being applied to the outstanding borrowings under this facility. Pursuant to FASB ASC Section 470-10-45, "Classification of Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses," the borrowings under the ARH Facility have been classified as a Current maturity of long-term debt as of December 29, 2012.Total debt, the majority of which is comprised of $197.5 million principal remaining on the $200.0 million amortizing term loan, $45.0 million of borrowings under the revolving credit facility outlined above and $33.6 million of debt for the Westlake revolving credit facility was $290.2 million as of December 29, 2012, compared to $299.3 million at December 31, 2011.

Total debt, the majority of which is comprised of $197.5 million principal remaining on the $200.0 million amortizing term loan, $45.0 million of borrowings under the revolving credit facility outlined above and $33.6 million of debt for the ARH revolving credit facility was $290.2 million as of December 29, 2012, compared to $299.3 million at December 31, 2011.

**Cash Flows**

The Company had $13.1 million and $15.8 million of cash and cash equivalents at December 29, 2012 and December 31, 2011, respectively. Drivers of the decrease in cash and cash equivalents during the year ended December 29, 2012 included the net payment to retire the previous credit facility and senior secured notes as part of the debt refinancing of $101.3 million, the net cash payment for the purchase of WHI of $52.0 million, the payments for additions to property and equipment of $46.4 million, the payment of the cash portion of patronage distributions of $27.7 million, the payment of patronage refund certificates of $17.4 million, the principal payments on long-term debt of $9.5 million and the payment of deferred financing costs of $5.2 million. Offsetting the decrease in cash and cash equivalents were operating cash inflows of $176.7 million, net borrowings under the revolving lines of credit of $43.6 million, and cash received of $34.8 million for the sale of the paint manufacturing facilities.

Following is a summary of the Company's cash flows from operating, investing and financing activities for the fiscal years 2012 and 2011, respectively (in millions):

| | 2012 | 2011 |
|---|---|---|
| Cash provided by operating activities before changes in assets and liabilities | $ 139.1 | 121.3 |
| Net changes in assets and liabilities | 37.6 | (24.9) |
| Net cash provided by operating activities | 176.7 | 96.4 |
| Net cash used in investing activities | (62.6) | (26.2) |
| Net cash used in financing activities | (116.8) | (63.8) |
| Net change in cash and cash equivalents | $ (2.7) | $ 6.4 |

The Company's operating activities generated $176.7 million of cash in 2012 compared to $96.4 million in 2011. Excluding the impact of net changes in assets and liabilities, cash provided by operating activities grew from $121.3 million in 2011 to $139.1 million in 2012. This increase was primarily the result of higher operating income in 2012 and lower interest expense.

The net change in assets and liabilities was up from a $24.9 million use of cash in 2011 to a $37.6 million increase of cash in 2012. In 2012, inventories caused a net inflow of $24.9 million compared to a net outflow of $24.5 million in 2011. This inventory reduction was largely the result of the sale of the paint manufacturing facilities and inventory to Valspar. Also, in 2012 receivables increased $7.8 million compared to $35.8 million in 2011. This lower increase was primarily due to the purchase of WHI and the corresponding elimination of receivables from WHI.

Net cash used for investing activities was $62.6 million in 2012 compared to $26.2 million for 2011. Investing activities in 2012 primarily consisted of the $52.0 million net cash used to purchase WHI and $46.4 million in capital expenditures offset by $34.8 million cash generated by the sale of the paint manufacturing facilities and $1.8 million of cash generated as a result of the collection of notes receivable. Investing activities in 2011 primarily consisted of $25.6 million in capital expenditures.

Net cash used in financing activities was $116.8 million in 2012 compared to $63.8 million in 2011. During 2012, the Company decreased total third-party debt by a net of $67.2 million, made patronage distributions of $27.7 million, redeemed $17.4 million of patronage refund certificates and paid $5.2 million in deferred financing costs. During 2011, the Company decreased total third-party debt by a net of $29.0 million, made patronage distributions of $26.4 million, redeemed $17.9 million of patronage refund certificates and received $8.7 million in proceeds from the sale of noncontrolling interests in AHI.

**Off-balance sheet arrangements**

In accordance with GAAP, operating leases for the Company's real estate and other assets are not reflected in the consolidated balance sheets. In addition, the Company has certain other guarantees, as further described in the Notes to the Consolidated Financial States – Note 14 – Commitments and Contingencies. The Company believes the likelihood of any such payment under these guarantees is remote.

**Contractual Obligations and Commitments**

Contractual obligations and commitments at December 29, 2012 are as follows (in millions):

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
| Long-term debt (1) | $ 211.6 | $ 15.9 | $ 39.6 | $ 156.1 | $ - |
| Revolving credit facilities (1) | 78.6 | 33.6 | - | 45.0 | - |
| Interest payments on long-term debt (2) | 38.2 | 10.7 | 17.6 | 9.9 | - |
| Patronage refund certificates payable | 22.6 | - | - | 15.5 | 7.1 |
| Operating leases (3) | 318.7 | 49.1 | 80.3 | 56.1 | 133.2 |
| Purchase commitments (4) | 55.1 | 33.4 | 19.3 | 2.4 | - |
| Total | $ 724.8 | $ 142.7 | $ 156.8 | $ 285.0 | $ 140.3 |

(1) Reflects principal payments.
(2) Reflects interest that would be paid if LIBOR rates and interest rate spreads remain unchanged from the December 29, 2012 rates and assumes a consistent outstanding revolving line of credit balance until the expiration of the facility in 2017.
(3) Total operating lease payments include $8.1 million of minimum lease payments for store leases that the Company has assigned to member retailers.
(4) Represents minimum purchase commitments pursuant to contracts primarily with hardware, software and service providers.

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

**Application of Critical Accounting Policies and Estimates**

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

The Company annually reviews its financial reporting and disclosure practices and accounting policies to ensure that they provide accurate and comprehensive information relative to the current economic and business environment. The Company's significant accounting policies are described in the Notes to the Consolidated Financial Statements. The following represents those critical accounting policies which involve a relatively higher degree of judgment, estimation and complexity and where materially different amounts could be reported under different conditions or using different assumptions.

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

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

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

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

The Company's allowance for doubtful accounts at December 29, 2012 and December 31, 2011 was $21.1 million and $21.9 million, respectively. Actual credit losses could vary materially from the Company's estimates.

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

**Impact of New Accounting Standards**

***New Accounting Pronouncements - Adopted***

In July 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-05, "Comprehensive Income (Topic 220): Presentation of Comprehensive Income," ("ASU 2011-05"), which was subsequently amended by ASU No. 2011-12, "Deferral of the Effective Date for Amendments to the Presentation of Reclassification of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05," ("ASU 2011-12"). ASU 2011-05 eliminates the option the Company previously followed to report other comprehensive income and its components in the statement of changes in equity. ASU 2011-05 requires that all nonowner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-12 deferred certain aspects of ASU 2011-05. This guidance does not change the items that are reported in net income and other comprehensive income. The Company has selected the option of two separate but consecutive statements, and has included these statements in this Annual Report.

***New Accounting Pronouncements – Issued***

In July 2012, the FASB issued ASU 2012-02, "Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment," ("ASU 2012-02"), which amends the guidance in Accounting Standards Codification ("ASC") 350-30 on testing indefinite-lived intangible assets, other than goodwill, for impairment. The FASB issued ASU 2012-02 in response to feedback on ASU 2011-08, "Intangibles – Goodwill and Other (Topic 350): Testing for Goodwill Impairment," which amended the goodwill impairment testing requirements by allowing an entity to perform a qualitative impairment assessment before proceeding to the two-step impairment test. Similarly, under ASU 2012-02, an entity testing an indefinite-lived intangible asset for impairment has the option of performing a qualitative assessment before calculating the fair value of the asset. Although ASU 2012-02 revises the examples of events and circumstances that an entity should consider in interim periods, it does not revise the requirements to test indefinite-lived intangible assets annually for impairment and between annual tests if there is a change in events or circumstances. This new guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, and is not expected to impact the Company's consolidated financial statements.

**Qualitative and Quantitative Disclosure About Market Risk**

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

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

*Customer Credit Risk* The Company is exposed to the risk of financial non-performance by customers. The Company's ability to collect on sales to its customers is dependent on the liquidity of its customer base. Continued volatility in credit markets may reduce the liquidity of the Company's customer base. To manage customer credit risk, the Company monitors credit ratings of customers. From certain customers, the Company also obtains collateral as considered necessary to reduce risk of loss. The Company does not believe the loss of any single customer would have a material adverse effect on its results of operations.

**Disclosure Regarding Forward-Looking Statements**

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

Factors that could cause materially different results include, but are not limited to, weather conditions; natural disasters; fair value accounting adjustments; inventory valuation; health care costs; insurance costs or recoveries; legal costs; borrowing needs; interest rates; credit conditions; economic and market conditions; accidents, leaks, equipment failures, service interruptions, and other operating risks; legislative actions; tax rulings or audit results; asset sales; significant unplanned capital needs; changes in accounting principles, interpretations, methods, judgments or estimates; performance of major customers, transporters, suppliers and contractors; labor relations; and acts of terrorism.

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

**Non-GAAP Financial Measures**

The Company defines "EBITDA" as earnings before interest, taxes, depreciation and amortization. The Company cautions readers that amounts presented in accordance with its definition of EBITDA may not be comparable to similar measures disclosed by other companies, because not all companies calculate EBITDA in the same manner.

EBITDA, as presented in this Annual Report, is a supplemental measure of the Company's performance that is not required by or presented in accordance with GAAP. It is not a measurement of the Company's financial performance under GAAP and should not be considered as an alternative to net income or any other performance measures derived in accordance with GAAP or as an alternative to cash flows from operating activities as a measure of the Company's liquidity.

| | Years Ended | | |
|---|---|---|---|
| | December 29, 2012 (52 Weeks) | December 31, 2011 (52 Weeks) | January 1, 2011 (52 Weeks) |
| **EBITDA Reconciliation:** | | | |
| Net income | $ 82.2 | $ 77.9 | $ 75.1 |
| Income tax expense | 3.5 | 3.1 | 3.0 |
| Interest expense (including loss on early extinguishment of debt in 2012 and 2011) | 43.8 | 36.5 | 35.2 |
| Depreciation and amortization | 40.1 | 38.7 | 38.3 |
| **EBITDA** | $ 169.6 | $ 156.2 | $ 151.6 |

The Company presents EBITDA because the Company considers it an important supplemental measure of its performance and believes it is frequently used in the evaluation of companies in its industry. In addition, the instruments governing the Company's indebtedness use EBITDA (with additional adjustments) to measure the Company's compliance with covenants such as maximum leverage and minimum fixed charge ratios. The Company also includes a quantitative reconciliation of EBITDA to the most directly comparable GAAP financial performance measure, which is net income.

## FIVE YEAR SUMMARY OF EARNINGS AND DISTRIBUTIONS

| | Years Ended | | | | |
|---|---|---|---|---|---|
| | December 29, 2012 (52 Weeks) | December 31, 2011 (52 Weeks) | January 1, 2011 (52 Weeks) | January 2, 2010 (52 Weeks) | January 3, 2009 (53 Weeks) |
| Revenues | $ 3,840.9 | $ 3,709.2 | $ 3,530.7 | $ 3,457.2 | $ 3,857.0 |
| Cost of revenues | 3,371.8 | 3,261.9 | 3,086.4 | 3,009.6 | 3,392.6 |
| Gross profit | 469.1 | 447.3 | 444.3 | 447.6 | 464.4 |
| Total operating and other expenses, net | 387.3 | 369.6 | 369.2 | 351.9 | 378.6 |
| Net income | $ 81.8 | $ 77.7 | $ 75.1 | $ 95.7 | $ 85.8 |
| Distribution of net income: | | | | | |
| Patronage distributions | $ 75.5 | $ 74.5 | $ 69.9 | $ 89.0 | $ 78.3 |
| Accumulated earnings | 6.3 | 3.2 | 5.2 | 6.7 | 7.5 |
| Net income attributable to Ace Hardware Corporation | $ 81.8 | $ 77.7 | $ 75.1 | $ 95.7 | $ 85.8 |

## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

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

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

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

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

March 20, 2013

/s/ Ray A. Griffith
Ray A. Griffith
Chief Executive Officer

/s/ William M. Guzik
William M. Guzik
Senior Vice President and
Chief Financial Officer