NAUTILUS, INC.
Form 10-Q
November 06, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2014

or

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

For the transition period from to

Commission file number: 001-31321

NAUTILUS, INC.
(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| Washington<br>(State or other jurisdiction of incorporation or organization) | 94-3002667<br>(I.R.S. Employer Identification No.) |

17750 S.E. 6th Way
Vancouver, Washington 98683
(Address of principal executive offices, including zip code)
(360) 859-2900
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer [ ] Accelerated filer [x] Non-accelerated filer [ ] Smaller reporting company [ ]
(do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

The number of shares outstanding of the registrant's common stock as of October 31, 2014 was 31,307,428 shares.

NAUTILUS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2014

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
NAUTILUS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited and in thousands)

| | As of September 30, 2014 | December 31, 2013 |
|---|---|---|
| Assets | | |
| Cash and cash equivalents | $23,740 | $40,979 |
| Available-for-sale securities | 17,993 | — |
| Trade receivables, net of allowances of $42 and $53 | 18,265 | 25,336 |
| Inventories | 21,349 | 15,824 |
| Prepaids and other current assets | 6,238 | 6,927 |
| Income taxes receivable | 23 | 80 |
| Deferred income tax assets | 7,370 | 4,441 |
| Total current assets | 94,978 | 93,587 |
| | | |
| Property, plant and equipment, net | 9,755 | 8,499 |
| Goodwill | 2,626 | 2,740 |
| Other intangible assets, net | 11,085 | 12,615 |
| Long-term deferred income tax assets | 18,323 | 25,725 |
| Other assets | 349 | 401 |
| Total assets | $137,116 | $143,567 |
| | | |
| Liabilities and Shareholders' Equity | | |
| Trade payables | $21,161 | $37,192 |
| Accrued liabilities | 8,383 | 9,123 |
| Warranty obligations, current portion | 2,121 | 1,610 |
| Total current liabilities | 31,665 | 47,925 |
| Warranty obligations, non-current | — | 28 |
| Income taxes payable, non-current | 3,627 | 2,577 |
| Other long-term liabilities | 1,219 | 1,472 |
| Total liabilities | 36,511 | 52,002 |
| Commitments and contingencies (Note 12) | | |
| Shareholders' equity: | | |
| Common stock - no par value, 75,000 shares authorized, 31,299 and 31,162 shares issued and outstanding | 7,638 | 6,769 |
| Retained earnings | 92,970 | 84,552 |
| Accumulated other comprehensive income (loss) | (3) | 244 |
| Total shareholders' equity | 100,605 | 91,565 |
| Total liabilities and shareholders' equity | $137,116 | $143,567 |

See accompanying Notes to Condensed Consolidated Financial Statements.

2

NAUTILUS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited and in thousands, except per share amounts)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net sales | $59,067 | $46,256 | $179,517 | $141,712 |
| Cost of sales | 30,272 | 24,479 | 87,461 | 71,912 |
| Gross profit | 28,795 | 21,777 | 92,056 | 69,800 |
| Operating expenses: | | | | |
| Selling and marketing | 17,086 | 14,152 | 54,549 | 46,546 |
| General and administrative | 5,745 | 4,907 | 16,507 | 13,836 |
| Research and development | 1,683 | 1,382 | 5,338 | 3,812 |
| Total operating expenses | 24,514 | 20,441 | 76,394 | 64,194 |
| Operating income | 4,281 | 1,336 | 15,662 | 5,606 |
| Other income (expense): | | | | |
| Interest income | 18 | 4 | 42 | 5 |
| Interest expense | (9) | (10) | (21) | (25) |
| Other, net | 43 | 271 | (74) | 292 |
| Total other income (expense) | 52 | 265 | (53) | 272 |
| Income from continuing operations before income taxes | 4,333 | 1,601 | 15,609 | 5,878 |
| Income tax provision (benefit) | 1,669 | 101 | 5,699 | (33,814) |
| Income from continuing operations | 2,664 | 1,500 | 9,910 | 39,692 |
| Discontinued operations: | | | | |
| Loss from discontinued operations before income taxes | (241) | (106) | (1,075) | (367) |
| Income tax provision (benefit) from discontinued operations | (64) | 10 | 417 | (81) |
| Loss from discontinued operations | (177) | (116) | (1,492) | (286) |
| Net income | $2,487 | $1,384 | $8,418 | $39,406 |
| | | | | |
| Basic income per share from continuing operations | $0.09 | $0.05 | $0.32 | $1.28 |
| Basic loss per share from discontinued operations | (0.01) | — | (0.05) | (0.01) |
| Basic net income per share(1) | $0.08 | $0.04 | $0.27 | $1.27 |
| | | | | |
| Diluted income per share from continuing operations | $0.08 | $0.05 | $0.31 | $1.26 |
| Diluted loss per share from discontinued operations | (0.01) | — | (0.05) | (0.01) |
| Diluted net income per share (1) | $0.08 | $0.04 | $0.27 | $1.25 |
| Shares used in per share calculations: | | | | |
| Basic | 31,287 | 31,128 | 31,231 | 31,045 |
| Diluted | 31,655 | 31,488 | 31,641 | 31,419 |

(1)May not add due to rounding.

See accompanying Notes to Condensed Consolidated Financial Statements.

NAUTILUS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited and in thousands)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | $2,487 | $1,384 | $8,418 | $39,406 |
| Other comprehensive income (loss): | | | | |
| Unrealized gain (loss) on marketable securities, net of income tax expense of $0, $0, $0 and $0 | 4 | — | (6) | — |
| Foreign currency translation, net of income tax expense (benefit) of $5, $(7), $6 and $14 | (253) | 112 | (241) | (220) |
| Comprehensive income | $2,238 | $1,496 | $8,171 | $39,186 |

See accompanying Notes to Condensed Consolidated Financial Statements.

NAUTILUS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited and in thousands)

| | Nine months ended September 30, 2014 | 2013 |
|---|---|---|
| Cash flows from operating activities: | | |
| Income from continuing operations | $9,910 | $39,692 |
| Loss from discontinued operations | (1,492) | (286) |
| Net income | 8,418 | 39,406 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depreciation and amortization | 2,887 | 2,481 |
| Bad debt expense | 38 | 510 |
| Inventory lower-of-cost-or-market adjustments | 305 | 92 |
| Stock-based compensation expense | 887 | 292 |
| Loss on asset dispositions | 13 | 9 |
| Deferred income taxes, net of valuation allowance | 4,142 | (34,156) |
| Excess tax deficiency related to stock-based awards | 288 | — |
| Changes in operating assets and liabilities: | | |
| Trade receivables, net | 6,855 | 4,048 |
| Inventories | (5,844) | 1,167 |
| Prepaids and other current assets | 763 | 998 |
| Income taxes | 469 | (183) |
| Trade payables | (16,079) | (5,719) |
| Accrued liabilities, including warranty obligations | 196 | (1,999) |
| Net cash provided by operating activities | 3,338 | 6,946 |
| Cash flows from investing activities: | | |
| Purchases of available-for-sale securities | (20,973) | — |
| Proceeds from maturities of available-for-sale securities | 2,980 | — |
| Proceeds from sale of assets of discontinued operations | — | 113 |
| Purchases of property, plant and equipment | (2,558) | (2,847) |
| Net cash used in investing activities | (20,551) | (2,734) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of stock options | 270 | 355 |
| Excess tax deficiency related to stock-based awards | (288) | — |
| Net cash provided by (used in) financing activities | (18) | 355 |
| Effect of exchange rate changes on cash and cash equivalents | (8) | (80) |
| Increase (decrease) in cash and cash equivalents | (17,239) | 4,487 |
| Cash and cash equivalents: | | |
| Beginning of period | 40,979 | 23,207 |
| End of period | $23,740 | $27,694 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | $21 | $25 |
| Cash paid for income taxes, net | 384 | 246 |
| Supplemental disclosure of non-cash investing activities: | | |
| Capital expenditures incurred but not yet paid | $107 | $— |

See accompanying Notes to Condensed Consolidated Financial Statements.

5

NAUTILUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(1) GENERAL INFORMATION

Basis of Consolidation and Presentation

The accompanying condensed consolidated financial statements present the financial position, results of operations and cash flows of Nautilus, Inc. and its subsidiaries, all of which are wholly owned. Intercompany transactions and balances have been eliminated in consolidation.

The accompanying condensed consolidated financial statements have not been audited. We have condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). Management believes the disclosures contained herein are adequate to make the information presented not misleading. However, these condensed consolidated financial statements should be read in conjunction with our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013 (the “2013 Form 10-K”).

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Further information regarding significant estimates can be found in our 2013 Form 10-K.

In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments necessary to present fairly our financial position as of September 30, 2014 and December 31, 2013, our results of operations and comprehensive income for the three and nine months ended September 30, 2014 and 2013 and our cash flows for the nine months ended September 30, 2014 and 2013. Interim results are not necessarily indicative of results for a full year. Our revenues typically vary seasonally and this seasonality can have a significant effect on operating results, inventory levels and working capital needs.

Unless indicated otherwise, all information regarding our operating results pertain to our continuing operations.

New Accounting Pronouncements

ASU 2014-15
In August 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-15, "Presentation of Financial Statements - Going Concern (Subtopic 205-40)". ASU 2014-15 provides guidance related to management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosure. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for interim and annual periods thereafter. Early application is permitted. We do not expect the adoption of ASU 2014-15 to have a material effect on our financial position, results of operations or cash flows.

ASU 2014-12
In June 2014, the FASB issued ASU No. 2014-12, "Compensation - Stock Compensation (Topic 718)". ASU No. 2014-12 addresses accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. ASU 2014-12 indicates that, in such situations, the performance target should be treated as a performance condition and, accordingly, the performance target should not be reflected in estimating the grant-date fair value of the award. Instead, compensation cost should be recognized in the period in

which it becomes probable that the performance target will be achieved. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. We do not expect the adoption of ASU 2014-12 to have a material effect on our financial position, results of operations or cash flows.

ASU 2014-09

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers". ASU 2014-09 clarifies the principles for recognizing revenue and develops a common revenue standard for U.S. GAAP and the International Accounting Standards Board that:

- removes inconsistencies and weaknesses in revenue requirements;
- provides a more robust framework for addressing revenue issues;
- improves comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets;

- provides more useful information to users of financial statements through improved disclosure requirements; and
- simplifies the preparation of financial statements by reducing the number of requirements to which an entity must refer.

ASU 2014-09 is effective for annual and interim periods beginning on or after December 15, 2016. While we do not expect the adoption of ASU 2014-09 to have a material effect on our business, we are still evaluating any potential impact that adoption of the ASU may have on our financial position, results of operations or cash flows.

ASU 2014-08
In April 2014, the FASB issued ASU No. 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360) and Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity". ASU 2014-08 amends the definition for what types of asset disposals are to be considered discontinued operations, and amends the required disclosures for discontinued operations and assets held for sale. ASU 2014-08 also enhances the convergence of the FASB’s and the International Accounting Standard Board’s reporting requirements for discontinued operations. ASU 2014-08 is effective for annual periods beginning on or after December 15, 2014, and interim periods within annual periods beginning on or after December 15, 2015. We do not expect the adoption of ASU 2014-08 to have a material effect on our financial position, results of operations or cash flows.

ASU 2013-11
In July 2013, the FASB issued ASU No. 2013-11, “Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists”. ASU 2013-11 amends the guidance related to the presentation of unrecognized tax benefits and allows for the reduction of a deferred tax asset for a net operating loss (“NOL”) carryforward whenever the NOL or tax credit carryforward would be available to reduce the additional taxable income or tax due if the tax position is disallowed. ASU 2013-11 is effective for annual and interim periods for fiscal years beginning after December 15, 2013. Since ASU 2013-11 relates only to the presentation of unrecognized tax benefits, our adoption of ASU 2013-11 in January 2014 did not have a material effect on our financial position, results of operations or cash flows.

(2) DISCONTINUED OPERATIONS

On September 25, 2009, in light of continuing operating losses in our Commercial business and in order to focus exclusively on managing our Direct and Retail businesses, we committed to a plan for the complete divestiture of our Commercial business, which qualified for held-for-sale accounting treatment. The Commercial business is presented as Discontinued Operations in our Condensed Consolidated Statements of Operations for all periods.

The disposal of the Commercial business assets was completed in April 2011. We reached substantial completion of asset liquidation at December 2012. However, we continue to have legal and accounting expenses as we work with authorities on final deregistration of certain European entities and product liability expenses associated with product previously sold into the Commercial channel. There was no revenue related to the Commercial business for the year ended December 31, 2013, or the three or nine-month periods ended September 30, 2014.

The following table summarizes liabilities for exit costs related to discontinued operations, included in Accrued Liabilities and Other Long-Term Liabilities in our Condensed Consolidated Balance Sheets (in thousands):

| | Facilities Leases |
|---|---|
| Balance, December 31, 2013 | $831 |
| Adjustments | — |
| Payments | (192) |
| Balance, September 30, 2014 | $639 |

We expect the lease obligations to be paid out through 2016.

(3) MARKETABLE SECURITIES

We classify our marketable securities as available-for-sale and, accordingly, record them at fair value. Unrealized holding gains and losses are excluded from earnings and are reported net of tax in other comprehensive income until realized. Dividend and interest income is recognized when earned. Realized gains and losses are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

We periodically evaluate whether declines in fair values of our investments below their cost are "other-than-temporary." This evaluation consists of qualitative and quantitative factors regarding the severity and duration of the unrealized loss, as well as our ability and intent to hold the investment until a forecasted recovery occurs.

For additional information, refer to Note 8, Fair Value Measurements.

(4) INVENTORIES

Inventories are carried at the lower of cost or market. Cost is determined using the first-in, first-out method. We periodically review inventory for excess, obsolete and slow moving items and make provisions as necessary to properly reflect inventory value.

Inventories consisted of the following (in thousands):

| | As of September 30, 2014 | December 31, 2013 |
|---|---|---|
| Finished goods | $20,205 | $14,259 |
| Parts and components | 1,144 | 1,565 |
| Total inventories | $21,349 | $15,824 |

(5) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consisted of the following (in thousands):

| | Estimated Useful Life (in years) | As of September 30, 2014 | December 31, 2013 |
|---|---|---|---|
| Automobiles | 5 | $19 | $— |
| Leasehold improvements | 5 to 20 | 2,845 | 2,869 |
| Computer software and equipment | 3 to 7 | 28,781 | 35,554 |
| Machinery and equipment | 3 to 5 | 6,893 | 5,648 |
| Furniture and fixtures | 5 | 814 | 688 |
| Work in progress | N/A | 335 | 4,281 |
| Total cost | | 39,687 | 49,040 |
| Accumulated depreciation | | (29,932) | (40,541) |
| Total property, plant and equipment, net | | $9,755 | $8,499 |

## (6) GOODWILL AND OTHER INTANGIBLE ASSETS

### Goodwill

All goodwill is assigned to our Direct reporting segment. The rollforward of goodwill was as follows (in thousands):

| | |
|---|---|
| Balance, January 1, 2013 | $2,940 |
| Currency exchange rate adjustment | (200) |
| Balance, December 31, 2013 | 2,740 |
| Currency exchange rate adjustment | (114) |
| Balance, September 30, 2014 | $2,626 |

### Other Intangible Assets

Other intangible assets consisted of the following (in thousands):

| | Estimated Useful Life (in years) | As of September 30, 2014 | December 31, 2013 |
|---|---|---|---|
| Other intangible assets: | | | |
| Indefinite-lived trademarks | N/A | $9,052 | $9,052 |
| Patents | 8 to 16 | 18,154 | 18,154 |
| | | 27,206 | 27,206 |
| Accumulated amortization - patents | | (16,121) | (14,591) |
| Other intangible assets, net | | $11,085 | $12,615 |

Amortization expense was as follows (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Patent amortization | $510 | $513 | $1,530 | $1,538 |

Future amortization of patents is as follows (in thousands):

| | |
|---|---|
| Remainder of 2014 | $510 |
| 2015 | 828 |
| 2016 | 430 |
| 2017 | 143 |
| 2018 | 65 |
| Thereafter | 57 |
| | $2,033 |

## (7) ACCRUED LIABILITIES

Accrued liabilities consisted of the following (in thousands):

| | As of September 30, 2014 | December 31, 2013 |
|---|---|---|
| Payroll and related liabilities | $4,292 | $4,244 |
| Other | 4,091 | 4,879 |
| Total accrued liabilities | $8,383 | $9,123 |

(8) FAIR VALUE MEASUREMENTS

Factors used in determining the fair value of financial assets and liabilities are summarized into three broad categories:

- Level 1 - observable inputs such as quoted prices (unadjusted) in active liquid markets for identical securities as of the reporting date;
- Level 2 - other significant directly or indirectly observable inputs, including quoted prices for similar securities, interest rates, prepayment speeds and credit risk; or observable market prices in markets with insufficient volume and/or infrequent transactions; and
- Level 3 - significant inputs that are generally unobservable inputs for which there is little or no market data available, including our own assumptions in determining fair value.

Assets measured at fair value on a recurring basis were as follows (in thousands):

| | September 30, 2014 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Cash Equivalents | | | | |
| Money market funds | $2,557 | $— | $— | $2,557 |
| Commercial paper | — | 1,500 | — | 1,500 |
| Variable-rate demand notes | — | 8,000 | — | 8,000 |
| Total Cash Equivalents | 2,557 | 9,500 | — | 12,057 |
| | | | | |
| Available-for-Sale Securities | | | | |
| Certificates of deposit | — | 5,147 | — | 5,147 |
| Corporate bonds | — | 7,846 | — | 7,846 |
| Commercial paper | — | 5,000 | — | 5,000 |
| Total Available-for-Sale Securities | — | 17,993 | — | 17,993 |
| Total assets measured at fair value | $2,557 | $27,493 | $— | $30,050 |

We did not have any liabilities measured at fair value on a recurring basis as of September 30, 2014 or December 31, 2013 and we did not have any assets measured as fair value on a recurring basis as of December 31, 2013.

We recognize transfers between levels at the actual date of the event or change in circumstance that caused the transfer. There were no transfers between levels during the three- and nine-months ended September 30, 2014.

We did not have any changes to our valuation techniques during the nine months ended September 30, 2014.

We classify our marketable securities as available-for-sale and, accordingly, record them at fair value based on quoted market prices. The factors or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities. Unrealized holding gains and losses are excluded from earnings and are reported net of tax in other comprehensive income until realized. During the first nine months of 2014 and 2013, we did not record any other-than-temporary impairments on our financial assets required to be measured at fair value on a nonrecurring basis.

We recognize or disclose the fair value of certain assets, such as non-financial assets, primarily Property, Plant and Equipment, Goodwill, Other Intangible Assets and certain other long-lived assets in connection with impairment evaluations. All of our nonrecurring valuations use significant unobservable inputs and therefore fall under Level 3 of the fair value hierarchy. We did not perform any valuations on assets or liabilities that are valued at fair value on a nonrecurring basis during the first nine months of 2014 or during all of 2013 except for the annual Goodwill and indefinite-lived trade names impairment evaluation that was prepared effective October 1, 2013.

The carrying value of Cash and Cash Equivalents, Trade Receivables, Prepaids and Other Current Assets, Trade Payables and Accrued Liabilities approximates their fair values due to the short-term nature of their maturities.

(9) PRODUCT WARRANTIES

Our products carry limited, defined warranties for defects in materials or workmanship which, according to their terms, generally obligate us to pay the costs of supplying and shipping replacement parts to customers and, in certain instances, pay for labor and other costs to service products. Outstanding product warranty periods range from sixty days to, in limited circumstances, the lifetime of certain product components. We record a liability at the time of sale for the estimated costs of fulfilling future warranty claims. If necessary, we adjust the liability for specific warranty-related matters when they become known and are reasonably estimable. Estimated warranty expense is included in Cost of Sales, based on historical warranty claim experience and available product quality data. Warranty expense is affected by the performance of new products, significant manufacturing or design defects not discovered until after the product is delivered to the customer, product failure rates, and higher or lower than expected repair costs. If warranty expense differs from previous estimates, or if circumstances change such that the assumptions inherent in previous estimates are no longer valid, the amount of product warranty obligations is adjusted accordingly.

Changes in our product warranty obligations were as follows (in thousands):

| | Nine months ended September 30, | |
|---|---|---|
| | 2014 | 2013 |
| Balance, beginning of period | $1,638 | $2,492 |
| Accruals | 1,719 | 951 |
| Adjustments | — | (186) |
| Payments | (1,236) | (1,416) |
| Balance, end of period | $2,121 | $1,841 |

(10) INCOME PER SHARE

Basic per share amounts were computed using the weighted average number of common shares outstanding. Diluted per share amounts were calculated using the number of basic weighted average shares outstanding increased by dilutive potential common shares related to stock-based awards, as determined by the treasury stock method. The weighted average numbers of shares outstanding used to compute income per share were as follows (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Shares used to calculate basic income per share | 31,287 | 31,128 | 31,231 | 31,045 |
| Dilutive effect of outstanding options, performance stock units and restricted stock units | 368 | 360 | 410 | 374 |
| Shares used to calculate diluted income per share | 31,655 | 31,488 | 31,641 | 31,419 |

The weighted average numbers of shares outstanding listed in the table below were anti-dilutive and excluded from the computation of diluted income per share, primarily because the average market price did not exceed the exercise price. These shares may be dilutive potential common shares in the future (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Stock options | 212 | 298 | 247 | 303 |
| Performance stock units | 198 | 84 | 20 | 17 |

(11) SEGMENT AND ENTERPRISE-WIDE INFORMATION

We have two reportable segments - Direct and Retail. Contribution is the measure of profit or loss, defined as Net Sales less product costs and directly attributable expenses. Directly attributable expenses include Selling and Marketing expenses, General and Administrative expenses, and Research and Development expenses that are directly related to segment operations. Segment assets are those directly assigned to an operating segment's operations, primarily Accounts Receivable, Inventories and Intangible Assets. Unallocated assets primarily include shared information technology infrastructure, distribution centers, corporate headquarters, Cash and Cash Equivalents, Marketable Securities, Prepaids and Other Current Assets, Deferred Income Tax Assets, Other Assets, and capital expenditures.

Following is summary information by reportable segment (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net sales: | | | | |
| Direct | $34,498 | $25,729 | $117,589 | $93,678 |
| Retail | 23,467 | 19,369 | 58,609 | 44,678 |
| Unallocated royalty income | 1,102 | 1,158 | 3,319 | 3,356 |
| Consolidated net sales | $59,067 | $46,256 | $179,517 | $141,712 |
| Contribution: | | | | |
| Direct | $4,133 | $1,316 | $18,375 | $8,533 |
| Retail | 3,703 | 2,875 | 7,537 | 4,975 |
| Unallocated royalty income | 1,102 | 1,158 | 3,319 | 3,356 |
| Consolidated contribution | $8,938 | $5,349 | $29,231 | $16,864 |
| | | | | |
| Reconciliation of consolidated contribution to income from continuing operations: | | | | |
| Consolidated contribution | $8,938 | $5,349 | $29,231 | $16,864 |
| Amounts not directly related to segments: | | | | |
| Operating expenses | (4,657) | (4,013) | (13,569) | (11,258) |
| Other income (expense), net | 52 | 265 | (53) | 272 |
| Income tax (expense) benefit | (1,669) | (101) | (5,699) | 33,814 |
| Income from continuing operations | $2,664 | $1,500 | $9,910 | $39,692 |

There was no material change in the allocation of assets by segment during the first nine months of 2014 and, accordingly, assets by segment are not presented.

For the three and nine months ended September 30, 2014, Amazon.com accounted for 10.3% and 10.1%, respectively, of our total Net Sales. During the three months ended September 30, 2013, Amazon.com accounted for 10.6% of total Net Sales. No customer represented 10.0% or more of total Net Sales for the nine months ended September 30, 2013.

(12) COMMITMENTS AND CONTINGENCIES

Guarantees, Commitments and Off-Balance Sheet Arrangements
As of September 30, 2014, we had approximately \$0.6 million in standby letters of credit with certain vendors with expiration dates through April 2015.

We have long lead times for inventory purchases and, therefore, must secure factory capacity from our vendors in advance. As of September 30, 2014, we had approximately \$35.1 million in noncancelable market-based purchase obligations, primarily for inventory purchases expected to be received within the next twelve months. Purchase obligations can vary from quarter-to-quarter and versus the same period in prior years due to a number of factors, including the amount of products that are shipped directly to Retail customer warehouses versus through Nautilus warehouses.

In the ordinary course of business, we enter into agreements that require us to indemnify counterparties against third-party claims. These may include: agreements with vendors and suppliers, under which we may indemnify them against claims arising from use of their products or services; agreements with customers, under which we may indemnify them against claims arising from their use or sale of our products; real estate and equipment leases, under which we may indemnify lessors against third-party claims relating to the use of their property; agreements with licensees or licensors, under which we may indemnify the licensee or licensor against claims arising from their use of our intellectual property or our use of their intellectual property; and agreements with parties to debt arrangements, under which we may indemnify them against claims relating to their participation in the transactions.

The nature and terms of these indemnification obligations vary from contract to contract, and generally a maximum obligation is not stated within the agreements. We hold insurance policies that mitigate potential losses arising from certain types of indemnification obligations. Management does not deem these obligations to be significant to our financial position, results of operations or cash flows and, therefore, no related liabilities were recorded as of September 30, 2014.

Legal Matters
In 2004, we were sued in the Southern District of New York by BioSig Instruments, Inc. for alleged patent infringement in connection with our incorporation of heart rate monitors into certain cardio products. No significant activity in the litigation occurred until 2008. In 2012, the United States District Court granted summary judgment to us on grounds that BioSig's patents were invalid as a matter of law. BioSig appealed the grant of summary judgment and, in April 2013, the United States Court of Appeals for the Federal Circuit reversed the District Court's decision on summary judgment and remanded the case to the District Court for further proceedings. On January 10, 2014, the U.S. Supreme Court granted our petition for a writ of certiorari to address the legal standard applied by the Federal Circuit in determining whether the patents may be valid under applicable law. The case was argued before the Supreme Court on April 28, 2014. By decision dated June 2, 2014, the Supreme Court unanimously reversed the Federal Circuit, holding that its standard of when a patent may be “indefinite” was incorrect and remanding to the Federal Circuit for reconsideration under the correct standard. The remand hearing in the Federal Circuit was held on October 29, 2014. We do not believe that our use of heart rate monitors utilized or purchased from third parties, and otherwise, infringe the BioSig patents.

In August 2014, we initiated an arbitra