Quanex Building Products CORP
Form 10-Q
March 11, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended January 31, 2011

OR

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

For the transition period from __________ to __________.

Commission File Number 1-33913

QUANEX BUILDING PRODUCTS CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE	**26-1561397**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1900 West Loop South, Suite 1500, Houston, Texas 77027
(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: **(713) 961-4600**

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 þ No o

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 (Section 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 þ No o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

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

Class	**Outstanding at March 4, 2011**
Common Stock, par value $0.01 per share	37,901,434

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

QUANEX BUILDING PRODUCTS CORPORATION
CONSOLIDATED BALANCE SHEETS
(Unaudited)

	January 31, 2011	October 31, 2010
	(In thousands except share amounts)	
ASSETS		
Current assets:		
Cash and equivalents	$ 182,466	$ 187,178
Accounts receivable, net of allowance of $1,031 and $1,037	49,388	87,007
Inventories	56,097	45,200
Deferred income taxes	14,406	10,547
Prepaid and other current assets	8,170	8,229
Current assets of discontinued operations		462
Total current assets	310,527	338,623
Property, plant and equipment, net	134,452	135,517
Deferred income taxes	29,754	30,563
Goodwill	25,189	25,189
Intangible assets, net	43,897	44,668
Other assets	16,793	16,690
Total assets	$ 560,612	$ 591,250
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 53,424	$ 70,986
Accrued liabilities	30,673	43,447
Current maturities of long-term debt	327	327
Current liabilities of discontinued operations		30
Total current liabilities	84,424	114,790
Long-term debt	1,601	1,616
Deferred pension and postretirement benefits	3,934	3,667
Non-current environmental reserves	12,027	12,027
Other liabilities	23,150	17,718
Total liabilities	125,136	149,818
Stockholders equity:		
Preferred stock, no par value, shares authorized 1,000,000; issued and outstanding none		
Common stock, $0.01 par value, shares authorized 125,000,000; issued 37,901,434 and 37,862,441, respectively	379	379

Additional paid-in-capital		239,302		238,079
Retained earnings		203,945		210,366
Accumulated other comprehensive income (loss)		(1,663)		(1,757)
		441,963		447,067
Less treasury stock at cost, 398,109 and 351,626 shares, respectively		(6,487)		(5,635)
Total stockholders equity		435,476		441,432
Total liabilities and stockholders equity	$	560,612	$	591,250

The accompanying notes are an integral part of the financial statements.

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QUANEX BUILDING PRODUCTS CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended January 31, 2011	2010
	(In thousands, except per share amounts)	
Net sales	$ 159,808	$ 151,422
Cost and expenses:		
Cost of sales (exclusive of items shown separately below)	139,655	126,134
Selling, general and administrative	20,294	16,107
Depreciation and amortization	7,525	7,334
Operating income (loss)	(7,666)	1,847
Interest expense	(121)	(124)
Other, net	100	78
Income (loss) from continuing operations before income taxes	(7,687)	1,801
Income tax benefit (expense)	2,959	(718)
Income (loss) from continuing operations	(4,728)	1,083
Income (loss) from discontinued operations, net of taxes	(12)	(889)
Net income (loss)	$ (4,740)	$ 194
Basic earnings per common share:		
Earnings (loss) from continuing operations	$ (0.13)	$ 0.03
Income (loss) from discontinued operations		(0.02)
Basic earnings (loss) per share	$ (0.13)	$ 0.01
Diluted earnings per common share:		
Earnings (loss) from continuing operations	$ (0.13)	$ 0.03
Income (loss) from discontinued operations		(0.02)
Diluted earnings (loss) per share	$ (0.13)	$ 0.01
Weighted-average common shares outstanding:		
Basic	37,092	37,340
Diluted	37,092	37,797

The accompanying notes are an integral part of the financial statements.

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QUANEX BUILDING PRODUCTS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOW
(Unaudited)

	Three Months Ended January 31, 2011	2010
	(In thousands)	
Operating activities:		
Net income (loss)	$ (4,740)	$ 194
(Income) loss from discontinued operations	12	889
Adjustments to reconcile net income (loss) to cash provided by operating activities from continuing operations:		
Depreciation and amortization	7,542	7,352
Deferred income taxes	(3,197)	654
Stock-based compensation	1,291	1,097
Changes in assets and liabilities, net of effects from acquisitions and dispositions:		
Decrease (increase) in accounts receivable	37,513	24,262
Decrease (increase) in inventory	(10,889)	(2,200)
Decrease (increase) in other current assets	(598)	257
Increase (decrease) in accounts payable	(19,164)	(18,382)
Increase (decrease) in accrued liabilities	(9,903)	(5,929)
Increase (decrease) in income taxes payable	191	23
Increase (decrease) in deferred pension and postretirement benefits	268	721
Other, net	2,356	23
Cash provided by (used for) operating activities from continuing operations	682	8,961
Cash provided by (used for) operating activities from discontinued operations	(68)	(202)
Cash provided by (used for) operating activities	614	8,759
Investing activities:		
Capital expenditures	(4,124)	(3,727)
Executive life insurance proceeds	683	
Other, net	74	
Cash provided by (used for) investing activities from continuing operations	(3,367)	(3,727)
Cash provided by (used for) investing activities from discontinued operations		
Cash provided by (used for) investing activities	(3,367)	(3,727)
Financing activities:		
Repayments of long-term debt	(15)	(14)
Common stock dividends paid	(1,501)	(1,132)
Issuance of common stock from stock option exercises, including related tax benefits	579	26
Purchase of treasury stock	(1,504)	

Other, net	392	(201)
Cash provided by (used for) financing activities from continuing operations	(2,049)	(1,321)
Cash provided by (used for) financing activities from discontinued operations	(392)	201
Cash provided by (used for) financing activities	(2,441)	(1,120)
Effect of exchange rate changes on cash and equivalents	22	8
Less: (Increase) decrease in cash and equivalents from discontinued operations	460	1
Increase (decrease) in cash and equivalents from continuing operations	(4,712)	3,921
Cash and equivalents at beginning of period	187,178	123,499
Cash and equivalents at end of period	$ 182,466	$ 127,420

The accompanying notes are an integral part of the financial statements.

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QUANEX BUILDING PRODUCTS CORPORATION
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(Unaudited)

Three Months Ended January 31, 2011	**Common Stock**	**Additional Paid-in Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total Stockholders Equity**
	(In thousands, except per share amounts)					
Balance at October 31, 2010	$ 379	$ 238,079	$ 210,366	$ (1,757)	$ (5,635)	$ 441,432
Net income (loss)			(4,740)			(4,740)
Common dividends ($0.04 per share)			(1,501)			(1,501)
Treasury shares purchased, at cost					(1,504)	(1,504)
Stock-based compensation activity:						
Stock-based compensation earned		1,223				1,223
Stock options exercised			(96)		652	556
Restricted stock awards						
Stock-based compensation tax benefit						
Other			(84)	94		10
Balance at January 31, 2011	$ 379	$ 239,302	$ 203,945	$ (1,663)	$ (6,487)	$ 435,476

The accompanying notes are an integral part of the financial statements.

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QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business and Basis of Presentation

Quanex Building Products Corporation and its subsidiaries (Quanex or the Company) are managed on a decentralized basis and operate in two business segments: Engineered Products and Aluminum Sheet Products. The Engineered Products segment produces engineered systems, products and components primarily serving the window and door industry, while the Aluminum Sheet Products segment produces mill finished and coated aluminum sheet serving the broader building products markets and secondary markets such as capital goods and transportation. The primary market drivers are residential housing starts and remodeling expenditures. Quanex believes it is a technological leader in the production of aluminum flat-rolled products, flexible insulating glass spacer systems, extruded vinyl profiles, thin film solar panel sealants, and precision-formed metal and wood products which primarily serve the North American building products markets. The Company uses low-cost production processes, and engineering and metallurgical expertise to provide customers with specialized products for specific applications.

On December 12, 2007, Quanex Building Products Corporation was incorporated in the state of Delaware as a subsidiary of Quanex Corporation to facilitate the separation of Quanex Corporation s vehicular products and building products businesses. The separation occurred on April 23, 2008 through the spin-off of Quanex Corporation s building products business to its shareholders immediately followed by the merger of Quanex Corporation (consisting principally of the vehicular products business and all non-building products related corporate accounts) with a wholly-owned subsidiary of Gerdau S.A. (Gerdau). This is hereafter referred to as the Separation .

In January 2010, management committed to a plan to close its start-up facility in China due to the contraction of demand and the Company s ability to serve the overseas thin film solar panel market from its U.S. operations. Accordingly, the China assets and liabilities, results of operations and cash flows are reported as discontinued operations for all periods presented. Unless otherwise noted, all disclosures in the notes accompanying the consolidated financial statements reflect only continuing operations.

The interim unaudited consolidated financial statements of the Company include all adjustments which, in the opinion of management, are necessary for a fair presentation of the Company s financial position and results of operations. All such adjustments are of a normal recurring nature. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. The preparation of these financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying footnotes. Estimates and assumptions about future events and their effects cannot be perceived with certainty. Estimates may change as new events occur, as more experience is acquired, as additional information becomes available and as the Company s operating environment changes. Actual results could differ from estimates. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended October 31, 2010.

2. New Accounting Pronouncements

In December 2010, the Financial Accounting Standards Board (FASB) issued ASC Topic No. 2010-29 *Business Combinations (ASC Topic 805) Disclosure of Supplementary Pro Forma Information for Business Combinations* which amended ASC Topic 805 Business Combinations to specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination that occurred during the year had occurred as of the beginning of the comparable prior annual reporting period only. The ASC also expands the supplemental pro forma disclosures under ASC Topic 805 to include a description of the nature and the amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The ASC is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010 (November 1, 2011 for the Company). Early adoption is permitted. The Company will disclose information in accordance with the ASC within all financial statements issued after the effective date.

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QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

In December 2010, the FASB issued ASC Topic No. 2010-28 *Intangibles Goodwill and Other (ASC Topic 350) When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts* which amended ASC Topic 350 Goodwill and Other. The ASC requires an entity with reporting units that have carrying amounts that are zero or negative to assess whether it is more likely than not that the reporting units goodwill is impaired. If the entity determines that it is more likely than not that the goodwill of one or more of its reporting units is impaired, the entity is required to perform Step 2 of the goodwill impairment test for those reporting unit(s) and record any resulting impairment as a cumulative-effect adjustment to beginning retained earnings. The provisions of this ASC are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010 (November 1, 2011 for the Company). Early adoption is not permitted. The Company does not expect the adoption of this ASC to have a material impact on the Company s consolidated financial statements.

In January 2010, the FASB issued ASC Topic No. 2010-06, *Fair Value Measurements and Disclosures (ASC Topic 820) Improving Disclosures About Fair Value Measurements*. The ASC requires new disclosures about transfers into and out of Levels 1 (fair value determined based on quoted prices in active markets for identical assets and liabilities) and 2 (fair value determined based on significant other observable inputs) and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements. It also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure fair value. Except for the detailed Level 3 roll-forward disclosures, the new standard is effective for the Company for interim and annual reporting periods beginning after December 31, 2009 (February 1, 2010 for the Company). The requirement to provide detailed disclosures about the purchases, sales, issuances and settlements in the roll-forward activity for Level 3 fair value measurements is effective for the Company for interim and annual reporting periods beginning after December 31, 2010 (February 1, 2011 for the Company). Other than requiring additional disclosures, none that currently impact the Company; the adoption of this new guidance does not have a material impact on the Company s Consolidated Financial Statements.

3. Acquired Intangible Assets

Intangible assets consist of the following (in thousands):

	As of January 31, 2011		As of October 31, 2010	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Customer relationships	$ 21,200	$ 6,556	$ 21,200	$ 6,291
Trademarks and trade names	33,530	9,522	33,530	9,156
Patents	11,560	6,315	11,560	6,175
Total	$ 66,290	$ 22,393	$ 66,290	$ 21,622

QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The aggregate amortization expense for the three month period ended January 31, 2011 was $0.8 million. The aggregate amortization expense for the three month period ended January 31, 2010 was $0.8 million. Estimated amortization expense for the next five years, based upon the amortization of pre-existing intangibles follows:

Fiscal Years Ending October 31,	Estimated Amortization (In thousands)
2011 (remaining nine months)	$ 2,312
2012	$ 3,082
2013	$ 3,020
2014	$ 2,986
2015	$ 2,921

4. Inventories

Inventories consist of the following:

	January 31, 2011	October 31, 2010
	(In thousands)	
Raw materials	$ 22,590	$ 18,823
Finished goods and work in process	31,039	23,756
	53,629	42,579
Supplies and other	2,468	2,621
Total	$ 56,097	$ 45,200

Fixed costs related to excess manufacturing capacity, if any, have been expensed in the period, and therefore, are not capitalized into inventory. The values of inventories in the consolidated balance sheets are based on the following accounting methods:

	January 31, 2011	October 31, 2010
	(In thousands)	
LIFO	$ 28,654	$ 20,122
FIFO	27,443	25,078
Total	$ 56,097	$ 45,200

An actual valuation of inventory under the last in, first out (LIFO) method can be made only at the end of each year based on the inventory costs and levels at that time. Accordingly, interim LIFO calculations must be based on management s estimates of expected year-end inventory costs and levels. Because these are subject to many factors beyond management s control, interim results are subject to the final year-end LIFO inventory valuation which could significantly differ from interim estimates. To estimate the effect of LIFO on interim periods, the Company performs a projection of the year-end LIFO reserve and considers expected year-end inventory pricing and expected inventory levels. Depending on this projection, the Company may record an interim allocation of the projected year-end LIFO calculation. This projection resulted in zero interim LIFO allocation for the three months ended January 31, 2011. With respect to inventories valued using the LIFO method, replacement cost exceeded the LIFO value by approximately $10.1 million as of January 31, 2011 and October 31, 2010.

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QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

5. Earnings and Dividends Per Share

Earnings Per Share

Basic and diluted earnings per share from continuing operations for the three months ended January 31, 2011 are identical as the Company reported a loss from continuing operations. The computational components of basic and diluted earnings per share from continuing operations for the three months ended January 31, 2010 are below (shares and dollars in thousands except per share amounts):

	For the Three Months Ended January 31, 2010		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic earnings and earnings per share	$ 1,083	37,340	$ 0.03
Effect of dilutive securities:			
Common stock equivalents arising from stock options		200	
Restricted stock		155	
Common stock held by rabbi trust		102	
Diluted earnings and earnings per share	$ 1,083	37,797	$ 0.03

The computation of diluted earnings per share excludes outstanding options and other common stock equivalents in periods where inclusion of such potential common stock instruments would be anti-dilutive in the periods presented. When income from continuing operations is a loss, all potential dilutive instruments are excluded from the computation of diluted earnings per share as they would be anti-dilutive. Accordingly, for the three months ended January 31, 2011, 0.2 million of restricted stock and 0.4 million of common stock equivalents were excluded from the computation of diluted earnings per share as the Company had a loss from continuing operations.

For the three months ended January 31, 2011 and 2010, the Company had 0.5 million and 0.5 million, respectively, of securities that are potentially dilutive in future earnings per share calculations. Such dilution will be dependent on the excess of the market price of the Company s stock over the exercise price and other components of the treasury stock method.

Dividends Per Share

The Company pays a quarterly cash dividend on the Company s common stock. During the three months ended January 31, 2011, the Company paid $0.04 cash dividend per common share. During the three months ended January 31, 2010, the Company paid $0.03 cash dividend per common share.

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QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

6. Comprehensive Income

Comprehensive income comprises net income and all other non-owner changes in equity, including foreign currency translation, pension related adjustments and realized and unrealized gains and losses on derivatives, if any. Comprehensive income for the three months ended January 31, 2011 and 2010 was as follows:

	Three Months Ended January 31,	
	2011	2010
	(In thousands)	
Comprehensive income (loss):		
Net income (loss)	$ (4,740)	$ 194
Foreign currency translation adjustment	92	13
Other	2	
Total comprehensive income (loss), net of taxes	$ (4,646)	$ 207

7. Long-Term Debt and Capital Lease Obligations

Long-term debt consists of the following:

	January 31, 2011	October 31, 2010
	(In thousands)	
Revolving Credit Facility	$	$
City of Richmond, Kentucky Industrial Building Revenue Bonds	1,000	1,000
Scott County, Iowa Industrial Waste Recycling Revenue Bonds	800	800
Capital lease obligations and other	128	143
Total debt	$ 1,928	$ 1,943
Less maturities due within one year included in current liabilities	327	327
Long-term debt	$ 1,601	$ 1,616

Credit Facility

The Company s $270.0 million Senior Unsecured Revolving Credit Facility (the Credit Facility) was executed on April 23, 2008. The Credit Facility has a five-year term and is unsecured. The Credit Facility expires April 23, 2013 and provides for up to $50.0 million for standby letters of credit, limited to the undrawn amount available under the Credit Facility. Borrowings under the Credit Facility bear interest at a spread above LIBOR based on a combined leverage and ratings grid. Proceeds from the Credit Facility may be used to provide availability for acquisitions, working capital, capital expenditures and general corporate purposes.

QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Under the Credit Facility, the Company is obligated to comply with certain financial covenants requiring the Company to maintain a Consolidated Leverage Ratio of no more than 3.25 to 1 and a Consolidated Interest Coverage Ratio of no less than 3.00 to 1. As defined by the Credit Facility s indenture, the Consolidated Leverage Ratio is the ratio of consolidated indebtedness as of such date to consolidated EBITDA for the previous four fiscal quarters; and the Consolidated Interest Coverage Ratio is the ratio of consolidated EBITDA to consolidated interest expense, in each case for the previous four consecutive fiscal quarters. EBITDA is defined by the indenture to include proforma EBITDA of acquisitions and to exclude certain items like non-cash charges. Additionally, the Credit Facility contains certain limitations on additional indebtedness, asset or equity sales, and acquisitions. Dividends and other distributions are permitted so long as after giving effect to such dividend or stock repurchase, there is no event of default.

As of January 31, 2011, the Company had no borrowings under the Credit Facility, and the Company was in compliance with all Credit Facility financial covenants. The availability under the Credit Facility is a function of both the facility amount utilized and meeting covenant requirements. Although there were no borrowings on the Credit Facility and only $5.7 million of outstanding letters of credit under the Credit Facility, the aggregate availability under the Credit Facility was limited by the Consolidated Leverage Ratio resulting in an availability of $190.3 million at January 31, 2011.

8. Retirement Plans

The Company has a number of retirement plans covering substantially all employees. The Company provides both defined benefit and defined contribution plans. In general, the plant or location of his/her employment determines an employee s coverage for retirement benefits.

Pension Plan

The Company has a non-contributory, single employer defined benefit pension plan that covers substantially all non-union employees. Effective January 1, 2007, the Company amended this defined benefit pension plan to include a new cash balance formula for all new salaried employees hired on or after January 1, 2007 and for any non-union employees who were not participating in a defined benefit plan prior to January 1, 2007. All new salaried employees are eligible to receive credits equivalent to 4% of their annual eligible wages, while some of the employees at the time of the plan amendment were grandfathered and are eligible to receive credits ranging up to 6.5% based upon a percentage they received in the defined contribution plan prior to the amendment of the pension plan. Additionally, every year the participants will receive an interest related credit on their respective balance equivalent to the prevailing 30-year Treasury rate. Benefits for participants in this plan prior to January 1, 2007 continue to be based on a more traditional formula for retirement benefits where the plan pays benefits to employees upon retirement, using a formula based upon years of service and pensionable compensation prior to retirement. Of the Company s participants, 99% are under the cash balance formula.

The components of net periodic pension cost are as follows:

	Three Months Ended January 31,	
	2011	2010
	(In thousands)	
Pension Benefits		
Service cost	$ 937	$ 752
Interest cost	200	132
Expected return on plan assets	(258)	(127)
Amortization of unrecognized net loss	22	35
Net periodic pension cost	$ 901	$ 792

QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The Company s pension funding policy generally has been to make the minimum annual contributions required by applicable regulations while considering targeted funded percentages. In fiscal 2010, the Company decided to modify its funding strategy and accelerate contributions to target a 100% funding threshold. Additionally, the Company will consider funding fiscal year requirements early in the fiscal year to potentially maximize returns on assets. During the three months ended January 31, 2011, the Company contributed $0.7 million, to its defined benefit plan. The Company estimates that it will contribute approximately $1.2 million for the remainder of fiscal 2011. Expected contributions are dependent on many variables, including the variability of the market value of the assets as compared to the obligation and other market or regulatory conditions. In addition, the Company takes into consideration its business investment opportunities and resulting cash requirements. Accordingly, actual funding may differ greatly from current estimates.

Defined Contribution Plans

The Company has defined contribution plans to which both employees and the Company make contributions. Effective April 1, 2009, the Company temporarily suspended its matching contributions to the Quanex Building Products Salaried and Non-Union Employee 401(k) Plan as part of its efforts to reduce controllable spending. Effective February 1, 2010, these matching contributions were reinstated. The Company matches 50% up to the first 5% of employee deferrals. For the three months ended January 31, 2011, the Company contributed $0.8 million. For the three months ended January 31, 2010, the Company made no contributions.

9. Industry Segment Information

Quanex has two reportable segments: Engineered Products and Aluminum Sheet Products. The Engineered Products segment produces systems, finished products and components serving the OEM residential window and door industry, while the Aluminum Sheet Products segment produces mill finished and coated aluminum sheet serving the home construction and remodeling markets and transportation market. The main market drivers of both segments are residential remodeling activity and housing starts. Additionally, the Aluminum Sheet Products segment results are influenced by aluminum prices.

The Company measures its inventory at the segment level on a FIFO or weighted-average basis; however at the consolidated Company level, approximately half of the inventory is measured on a LIFO basis. The LIFO reserve is computed on a consolidated basis as a single pool and is thus treated as a corporate expense. See Note 4 to the financial statements for more information. LIFO inventory adjustments along with corporate office charges and intersegment eliminations are reported as Corporate, Intersegment Eliminations or Other. The Company accounts for intersegment sales and transfers as though the sales or transfers were to third parties, that is, at current market prices. Intersegment sales, related cost of sales, and intercompany profit are eliminated in consolidation at Corporate. Corporate assets primarily include cash and equivalents partially offset by the Company s consolidated LIFO inventory reserve:

QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

	Three Months Ended January 31, 2011	2010
	(In thousands)	
Net Sales:		
Engineered Products	$ 84,010	$ 72,809
Aluminum Sheet Products	79,138	81,563
Intersegment Eliminations	(3,340)	(2,950)
Consolidated	$ 159,808	$ 151,422
Operating Income (Loss):		
Engineered Products	$ (649)	$ 4,077
Aluminum Sheet Products	551	3,634
Corporate & Other	(7,568)	(5,864)
Consolidated	$ (7,666)	$ 1,847

	January 31, 2011	October 31, 2010
	(In thousands)	
Identifiable Assets:		
Engineered Products	$ 245,371	$ 258,919
Aluminum Sheet Products	136,303	152,113
Corporate, Intersegment Eliminations & Other	178,938	179,756
Discontinued Operations [1]		462
Consolidated	$ 560,612	$ 591,250
Goodwill:		
Engineered Products	$ 25,189	$ 25,189
Consolidated	$ 25,189	$ 25,189

10. Stock-Based Compensation

Effective with the Separation on April 23, 2008, the Company established the Quanex Building Products Corporation 2008 Omnibus Incentive Plan (the 2008 Plan). The 2008 Plan provides for the granting of stock options, stock appreciation rights, restricted stock, restricted stock units (RSUs), performance stock awards, performance unit awards, annual incentive awards, other stock-based awards and cash-based awards. The 2008 Plan is administered by the Compensation and Management Development Committee of the Board of Directors and allows for immediate, graded or cliff vesting options, but options must be exercised no later than ten years from the date of grant. The aggregate number of shares of common stock authorized for grant originally under the 2008 Plan was 2,900,000. In

February 2011, the 2008 Plan was amended by shareholders to increase the aggregate number of shares available for awards by an additional 2,400,000 shares. Any officer, key employee and/or non-employee director of the Company or any of its affiliates is eligible for awards under the 2008 Plan. The initial awards granted under the 2008 Plan were on April 23, 2008; service is the vesting condition.

[1] In January 2010, management committed to a plan to shut down the operations of its start-up facility in China; therefore, the China assets are included in discontinued operations for all periods presented.

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QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The Company s practice is to grant options and restricted stock or RSUs to non-employee directors on October 31st of each year, with an additional grant of options to each director on the date of his or her first anniversary of service. Additionally, the Company s practice is to grant options and restricted stock or RSUs to employees at the Company s December board meeting and occasionally to key employees as deemed appropriate at other times during the year. The exercise price of the option awards is equal to the closing market price on these pre-determined dates. The Company generally issues shares from treasury stock, if available, to satisfy stock option exercises. If there are no shares in treasury stock, the Company issues additional shares of common stock. The Company has not capitalized any stock-based compensation cost as part of inventory or fixed assets during the three months ended January 31, 2011 and 2010.

Restricted Stock Awards

Under the 2008 Plan, common stock may be awarded to key employees, officers and non-employee directors. The recipient is entitled to all of the rights of a shareholder, except that during the forfeiture period the shares are nontransferable. The awards vest over a specified time period, but typically either immediately vest or cliff vest over a three-year period with service as the vesting condition. Upon issuance of stock under the plan, fair value is measured by the grant-date price of the Company s shares. This fair value is then expensed over the restricted period with a corresponding increase to additional paid-in-capital. A summary of non-vested restricted stock award changes during the three months ended January 31, 2011 follows:

	Shares	Weighted Average Grant-Date Fair Value Per Share
Non-vested at October 31, 2010	378,616	$ 13.07
Granted	64,200	
Forfeited	(25,207)	
Non-vested at January 31, 2011	417,609	$ 13.62

The weighted-average grant-date fair value of restricted stock granted during the three months ended January 31, 2011 and 2010 was $16.90 and $16.21 per share, respectively. There were no restricted shares that vested during the three months ended January 31, 2011 or January 31, 2010. Total unrecognized compensation cost related to unamortized restricted stock awards was $2.3 million as of January 31, 2011. That cost is expected to be recognized over a weighted-average period of 2.0 years.

QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Stock Options

As described in the Company s Annual Report on Form 10-K for the fiscal year ended October 31, 2010, the Company uses the Black-Scholes-Merton option-pricing model to estimate the fair value of its stock options. The fair value of each option was estimated on the date of grant. The following is a summary of valuation assumptions and resulting grant-date fair values for grants during the following periods:

	Three Months Ended January 31, 2011	Three Months Ended January 31, 2010
Weighted-average expected volatility	53.0%	55.0%
Expected term (in years)	4.9-5.1	4.9-5.1
Risk-free interest rate	1.6%	2.1%
Expected dividend yield over expected term	1.0%	1.0%
Weighted-average grant-date fair value per share	$ 7.30	$ 7.32

Below is a table summarizing the stock option shares activity for the 2008 Plan since October 31, 2010:

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (000s)
Outstanding at October 31, 2010	1,724,301	$ 13.24		
Granted	352,600	16.90		
Exercised	(40,166)	13.86		
Forfeited	(1,167)	12.45		
Outstanding at January 31, 2011	2,035,568	13.86	7.8	$ 11,463
Vested or expected to vest at January 31, 2011	1,942,684	13.81	7.8	$ 11,025
Exercisable at January 31, 2011	1,070,889	$ 13.02	7.2	$ 6,933

The total intrinsic value of options (the amount by which the market price of the stock on the date of exercise exceeded the exercise price of the option) exercised during the three months ended January 31, 2011 and 2010 was $0.2 million and $31 thousand, respectively. The total fair value of shares vested during the three months ended January 31, 2011 was $1.3 million. Total unrecognized compensation cost related to stock options granted under the 2008 Plan was $3.9 million as of January 31, 2011. That cost is expected to be recognized over a weighted-average period of 2.0 years.

11. Income Taxes

The provision for income taxes is determined by applying an estimated annual effective income tax rate to income from continuing operations before income taxes. The rate is based on the most recent annualized forecast of pretax income, permanent book versus tax differences and tax credits. The Company s estimated annual effective tax rate for the three months ended January 31, 2011 is 38.5% compared to the estimated annual effective tax rate of 39.9% for the three months ended January 31, 2010.

Prepaid and other current assets on the Consolidated Balance Sheets include an income tax receivable of $2.6 million as of January 31, 2011 and October 31, 2010.

The non-current deferred income tax asset amount reflected on the Consolidated Balance Sheets as of January 31, 2011 of $29.8 million includes a net non-current deferred income tax asset of $41.1 million, an estimated state net operating loss (NOL) benefit of $1.1 million, and a non-current liability for an unrecognized tax benefit of $12.4 million, related to the Separation.

QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Non-current unrecognized tax benefit of $6.4 million as of January 31, 2011 is related to the Separation and state tax items regarding the interpretations of tax laws and regulations and is recorded in Other liabilities on the Consolidated Balance Sheets. The total unrecognized tax benefit at January 31, 2011 is $18.8 million (including $0.9 million for which the disallowance of such items would not affect the annual effective tax rate).

Judgment is required in assessing the future tax consequences of events that have been recognized in the Company s financial statements or income tax returns. The final outcome of the future tax consequences of legal proceedings, if any, as well as the outcome of competent authority proceedings, changes in regulatory tax laws, or interpretation of those tax laws could impact the Company s financial statements. The Company is subject to the effects of these matters occurring in various jurisdictions. The Company has no knowledge of any event that would materially increase or decrease the unrecognized tax benefit within the next twelve months.

12. Contingencies

Environmental

Quanex is subject to extensive laws and regulations concerning the discharge of materials into the environment and the remediation of chemical contamination. To satisfy such requirements, Quanex must make capital and other expenditures on an ongoing basis. The Company accrues its best estimates of its remediation obligations and adjusts such accruals as further information and circumstances develop. Those estimates may change substantially depending on information about the nature and extent of contamination, appropriate remediation technologies, and regulatory approvals. In accruing for environmental remediation liabilities, costs of future expenditures are not discounted to their present value, unless the amount and timing of the expenditures are fixed or reliably determinable. When environmental laws might be deemed to impose joint and several liability for the costs of responding to contamination, the Company accrues its allocable share of liability taking into account the number of parties participating, their ability to pay their shares, the volumes and nature of the wastes involved, the nature of anticipated response actions, and the nature of the Company s alleged connections. The cost of environmental matters has not had a material adverse effect on Quanex s operations or financial condition in the past, and management is not currently aware of any conditions that it believes are likely to have a material adverse effect on Quanex s operations, financial condition or cash flows.

As described below, the Company currently is engaged in remediation activities at one of its plant sites. The total associated environmental reserve and corresponding recovery as of January 31, 2011 and October 31, 2010 were as follows:

	January 31, 2011	October 31, 2010
	(In thousands)	
Current	$ 1,372	$ 1,564
Non-current[1]	12,027	12,027
Total environmental reserves	13,399	13,591
Receivable for recovery of remediation costs[2]	$ 12,506	$ 12,747

Approximately $1.3 million of the January 31, 2011 reserve represents administrative costs; the balance represents estimated costs for investigation, studies, cleanup, and treatment. The reserve has not been discounted. As discussed below, an associated $12.5 million and $12.7 million undiscounted recovery from indemnitors of remediation costs at one plant site is recorded as of January 31, 2011 and October 31, 2010, respectively.

[1] Reported in Accrued liabilities on the Consolidated Balance Sheets.

[2] Reported in Accounts receivable and Other assets on the Consolidated Balance Sheets.

QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The Company s Nichols Aluminum-Alabama, LLC (NAA) subsidiary operates a plant in Decatur, Alabama that is subject to an Alabama Hazardous Wastes Management and Minimization Act Post-Closure Permit. Among other things, the permit requires NAA to remediate, as directed by the state, historical environmental releases of wastes and waste constituents. Consistent with the permit, NAA has undertaken various studies of site conditions and, during the first quarter 2006, started a phased program to treat in-place free product petroleum that had been released underneath the plant. During the second quarter 2010, NAA submitted to the state the first component of its proposed workplan for implementing a site-wide remedy; the full workplan was submitted to the state during the third quarter 2010. Based on those plans, which NAA expects to refine subject to state approval, the Company s remediation reserve at NAA s Decatur plant is $13.4 million. NAA was acquired through a stock purchase in which the sellers agreed to indemnify Quanex and NAA for identified environmental matters related to the business and based on conditions initially created or events initially occurring prior to the acquisition. Environmental conditions are presumed to relate to the period prior to the acquisition unless proved to relate to releases occurring entirely after closing. The limit on indemnification is $21.5 million excluding legal fees. While the Company s current estimates indicate it will not reach this limit, changing circumstances could result in additional costs or expense that are not foreseen at this time. In accordance with the indemnification, the indemnitors paid the first $1.5 million of response costs and have been paying 90% of ongoing costs. Based on its experience to date, its estimated cleanup costs going forward, and costs incurred to date as of January 31, 2011, the Company expects to recover from the sellers shareholders an additional $12.5 million. Of that, $12.1 million is recorded in Other assets on the Consolidated Balance Sheets, and the balance is reflected in Accounts receivable on the Consolidated Balance Sheets.

The Company s final remediation costs and the timing of those expenditures will depend upon such factors as the nature and extent of contamination, the cleanup technologies employed, the effectiveness of the cleanup measures that are employed, and regulatory concurrences. While actual remediation costs, therefore, may be more or less than amounts accrued, the Company believes it has established adequate reserves for all probable and reasonably estimable remediation liabilities. It is not possible at this point to reasonably estimate the amount of any obligation for remediation in excess of current accruals because of uncertainties as to the extent of environmental impact, cleanup technologies, and concurrence of governmental authorities. The Company currently expects to pay the accrued remediation reserve through at least fiscal 2034, although some of the same factors discussed earlier could accelerate or extend the timing.

Other

From time to time, the Company and its subsidiaries are involved in various litigation matters arising in the ordinary course of their business. Although the ultimate resolution and impact of such litigation on the Company is not presently determinable, the Company s management believes that the eventual outcome of such litigation will not have a material adverse effect on the overall financial condition, results of operations or cash flows of the Company.

13. Warranty Obligations

The Company s estimated obligations for warranty are accrued concurrently with the revenue recognized. The Company makes provisions for its warranty obligations based upon historical experience incurred for such obligations adjusted, as necessary, for current conditions and factors. Due to the significant uncertainties and judgments involved in estimating the Company s warranty obligations, including changing product designs, variance in customer installation process and future claims experience varying from historical claims experience, the ultimate amount incurred for warranty costs could change in the near and long term from the current estimate.

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QUANEX BUILDING PRODUCTS CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table provides a reconciliation of the activity related to the Company s accrued warranty, including both the current (reported in Accrued liabilities on the Consolidated Balance Sheets) and long-term portions (reported in Other liabilities on the Consolidated Balance Sheets), for the three months ended January 31, 2011 and 2010:

	January 31, 2011 (In thousands)
Balance at October 31, 2010	$ 3,697
Provision for warranty expense	2,232
Warranty costs paid	(309)
Total accrued warranty	$ 5,620
Less long-term portion	4,159
Current accrued warranty	$ 1,461

During the three months ended January 31, 2011, the reserve was increased by $2.1 million related to a rise in projected claim experience for a legacy product that was discontinued some years ago.

14. Fair Value Measurement of Assets and Liabilities

The Company holds Money Market Fund investments that are classified as cash equivalents and are measured at fair value on a recurring basis, based on quoted prices in active markets for identical assets (Level 1). The Company had cash equivalent investments totaling approximately $178.4 million and $180.6 million at January 31, 2011 and October 31, 2010, respectively. Inputs and valuation techniques used to measure the fair value of the Company s pension plan assets vary according to the type of security being valued. All of the equity and debt securities held directly by the plans are actively traded and fair values are determined based on quoted market prices. As of January 31, 2011 and October 31, 2010, the fair value of pension plan assets was $13.3 million and $12.9 million, respectively. As of January 31, 2011, the Company did not have any assets or liabilities obtained from readily available pricing sources for comparable instruments (Level 2) or requiring measurement at fair value without observable market values that would require a high level of judgment to determine fair value (Level 3).

15. Stock Repurchase Program and Treasury Stock

On May 27, 2010, the Board of Directors approved a stock repurchase program of 1.0 million shares. The Company s objectives of this program are to manage the dilution created by shares issued under stock-based compensation plans and to repurchase shares opportunistically. The Company records treasury stock purchases under the cost method whereby the entire cost of the acquired stock is recorded as treasury stock. The Company uses a moving-average method on the subsequent reissuance of shares, and any resulting proceeds in excess of cost are credited to additional paid in capital while any deficiency is charged to retained earnings.

As of October 31, 2010, the number of shares in treasury was 351,626. During the three months ended January 31, 2011, the Company purchased 86,649 shares at a cost of $1.5 million offset by shares issued for stock option exercises for a net increase to the number of shares in treasury to 398,109 as of January 31, 2011. The remaining shares authorized for repurchase in the program was 663,351 as of January 31, 2011.

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

General

The discussion and analysis of Quanex Building Products Corporation and its subsidiaries financial condition and results of operations should be read in conjunction with the January 31, 2011 Consolidated Financial Statements of the Company and the accompanying notes and in conjunction with the Consolidated Financial Statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended October 31, 2010. References made to the Company or Quanex include Quanex Building Products Corporation and its subsidiaries and Quanex Corporation (Predecessor to Quanex Building Products Corporation) unless the context indicates otherwise.

Private Securities Litigation Reform Act

Certain of the statements contained in this document and in documents incorporated by reference herein, including those made under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations are forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. Generally, the words expect, believe, intend, estimate, anticipate, project, will and similar expressi forward-looking statements, which generally are not historical in nature. All statements which address future operating performance, events or developments that the Company expects or anticipates will occur in the future, including statements relating to volume, sales, operating income and earnings per share, and statements expressing general outlook about future operating results, are forward-looking statements. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from the Company s historical experience and the present projections or expectations. As and when made, management believes that these forward-looking statements are reasonable. However, caution should be taken not to place undue reliance on any such forward-looking statements since such statements speak only as of the date when made and there can be no assurance that such forward-looking statements will occur. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Factors exist that could cause the Company s actual results to differ materially from the expected results described in or underlying the Company s forward-looking statements. Such factors include domestic and international economic activity, prevailing prices of aluminum scrap and other raw material costs, the rate of change in prices for aluminum scrap, energy costs, interest rates, construction delays, market conditions, particularly in the home building and remodeling markets, any material changes in purchases by the Company s principal customers, labor supply and relations, environmental regulations, changes in estimates of costs for known environmental remediation projects and situations, world-wide political stability and economic growth, warranty obligations, the Company s successful implementation of its internal operating plans, acquisition strategies and integration, performance issues with key customers, suppliers and subcontractors, and regulatory changes and legal proceedings. Accordingly, there can be no assurance that the forward-looking statements contained herein will occur or that objectives will be achieved. All written and verbal forward-looking statements attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by such factors. For more information, see Part I, Item 1A, Risk Factors in the Company s Annual Report on Form 10-K, for the year ended October 31, 2010.

About Third-Party Information

In this report, the Company relies on and refers to information regarding industry data obtained from market research, publicly available information, industry publications, U.S. government sources and other third parties. Although the Company believes the information is reliable, it cannot guarantee the accuracy or completeness of the information and has not independently verified it.

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Description of Business

On December 12, 2007, Quanex Building Products Corporation was incorporated in the state of Delaware as a subsidiary of Quanex Corporation to facilitate the separation of Quanex Corporation s vehicular products and building products businesses. The separation occurred on April 23, 2008 through the spin-off of Quanex Corporation s building products business to its shareholders immediately followed by the merger of Quanex Corporation (consisting principally of the vehicular products business and all non-building products related corporate accounts) with a wholly-owned subsidiary of Gerdau S.A. (Gerdau).

The spin-off and subsequent merger is hereafter referred to as the Separation . For purposes of describing the events related to the Separation, as well as other events, transactions and financial results of Quanex Corporation and its subsidiaries related to periods prior to April 23, 2008, the term the Company refers to Quanex Building Products Corporation s accounting predecessor, Quanex Corporation.

In January 2010, management committed to a plan to close its start-up facility in China due to the contraction of demand and the Company s ability to serve the overseas thin film solar panel market from its North American operations. Accordingly, the China assets and liabilities, results of operation and cash flows are reported as discontinued operations for all periods presented. Unless otherwise noted, all discussions reflect only continuing operations.

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Consolidated Results of Operations

Summary Information

	Three Months Ended January 31,			
	2011	2010	Change	%
	(Dollars in millions)			
Net sales	$ 159.8	$ 151.4	$ 8.4	5.5
Cost of sales[1]	139.7	126.1	13.6	10.8
Selling, general and administrative	20.3	16.2	4.1	25.3
Depreciation and amortization	7.5	7.3	0.2	2.7
Operating income (loss)	(7.7)	1.8	(9.5)	(527.8)
Interest expense	(0.1)	(0.1)		
Other, net	0.1	0.1		
Income tax (expense) benefit	3.0	(0.7)	3.7	(528.6)
Income (loss) from continuing operations	$ (4.7)	$ 1.1	$ (5.8)	(527.3)

Overview

Net sales were up $8.4 million or 5.5% during the first fiscal quarter of 2011 compared to the year ago quarter despite the continued weak condition of the Company s primary end markets: U.S. residential remodeling activity and housing starts. The increase in net sales is primarily attributable to the addition of new customers, new products and customers building inventory to meet pre-buying demand ahead of the December 31, 2010 expiration of the $1,500 energy efficient window tax credit. November 2010 and December 2010 orders were stronger than the Company anticipated, but, as expected January 2011 orders were weaker. Despite the rise in net sales, operating income fell by $9.5 million during the first quarter of 2011 compared to the year ago quarter as a result of costs associated with rationalizing operations, higher raw material costs and warranty expense at Engineered Products, and lower shipped pounds at Aluminum Sheet Products.

The Company believes that consumer demand for more energy efficient products and its ability to provide innovative window and door systems, in addition to stand-alone components, along with its new sales and marketing efforts will help fuel organic growth. The Company works closely with customers in all phases of product development, which is critical to increasing revenue and a significant factor for its success in this otherwise difficult period. Efforts are also ongoing to increase business in the repair and remodel segment of the residential market. Demographics for long-term housing demand in the U.S. remain favorable when factoring the projected population increase and continuing immigration. Quanex began cross-selling initiatives in 2010 that combine the design, engineering and marketing talent within Engineered Products. The Company believes that taking a more disciplined approach to the way it seeks new business opportunities will make it a more successful company and a stronger competitor by offering a broader range of customers a more robust slate of systems, products and services. Additionally, the Company is elevating its programs to develop more energy efficient products. These programs and initiatives coupled with an eventual return to a more normal housing market will benefit Quanex over the long-term.

Business Segments

Quanex has two reportable segments: Engineered Products and Aluminum Sheet Products. The Engineered Products segment produces systems, finished products, and components serving the OEM residential window and door industry, while the Aluminum Sheet Products segment produces mill finished and coated aluminum sheet serving the home construction and remodeling markets and transportation market. The primary market drivers of both segments are residential remodeling activity and housing starts.

[1] Exclusive of items shown separately below.

For financial reporting purposes, three of the Company s four operating segments, Homeshield, Truseal and Mikron, have been aggregated into the Engineered Products reportable segment. The remaining operating segment, Aluminum Sheet Products (Nichols Aluminum), is reported as a separate reportable segment. Corporate & Other is comprised of corporate office expenses and certain inter-division eliminations. The sale of products between segments is recognized at market prices. The financial performance of the operations is based upon operating income. The segments follow the accounting principles described in Item 1, Note 1 to the consolidated financial statements of the Company s 2010 Form 10-K. The two reportable segments value inventory on a FIFO or weighted-average basis while the LIFO reserve relating to those operations accounted for under the LIFO method of inventory valuation is computed on a consolidated basis in a single pool and treated as a corporate item.

Three Months Ended January 31, 2011 Compared to Three Months Ended January 31, 2010

Engineered Products

	Three Months Ended January 31, 2011	2010	Change	%
	(Dollars in millions)			
Net sales	$ 84.0	$ 72.8	$ 11.2	15.4
Cost of sales[1]	68.5	54.6	13.9	25.5
Selling, general and administrative	10.8	8.9	1.9	21.3
Depreciation and amortization	5.4	5.2	0.2	3.8
Operating income (loss)	$ (0.7)	$ 4.1	$ (4.8)	(117.1)

The primary market drivers for the Engineered Products segment are U.S. residential remodeling activity (approx. 60% of sales) and housing starts (approx. 40% of sales). Engineered Products outperformed U.S. residential window shipments during the first fiscal quarter of 2011 with net sales up 15.4% over the year ago quarter. Comparatively, Ducker Worldwide, a nationally recognized business-to-business market research company, data indicated U.S. residential window shipments were down 5.0%. The expiration of the $1,500 window tax credit in December 2010 helped drive the volume growth during the first fiscal quarter of 2011, although volume in the month of January 2011 declined slightly compared to the previous two months from the hangover effect. Additionally, the increased sales in the first fiscal quarter of 2011 reflect the continuing progress we are making with the Company s sales initiatives with large and regional window and door customers. The Company believes it is gaining traction with its sales programs and new products.

Net sales less Cost of sales at Engineered Products for the three months ended January 31, 2011 compared to the same period last year declined by $2.7 million. Net sales less Cost of sales as a percent of Net sales for the three months ended January 31, 2011 is below the same 2010 period by 6.5%. Margins declined year over year from higher raw material costs and temporary increases in labor expense as the Company used overtime to meet a hike in orders in November and December; additionally, the first fiscal quarter of 2010 benefited from hourly labor savings associated with the strike at the segment s Barbourville, Kentucky facility in mid-December 2009. Further reducing margins during the three months ended January 31, 2011 was $3.1 million of costs associated with plant consolidations and closing as the Company rationalized production facilities. The Company finished the building consolidation project at its facility in Kent, Washington where four buildings have been consolidated to one, and the Company closed a facility in The Dalles, Oregon. Of the $3.1 million in plant consolidation costs, $1.3 million is recognized in Cost of sales. These building consolidations will reduce operating costs going forward. During the three months ended January 31, 2011, $2.1 million of expense was recognized in Cost of sales to increase the warranty reserve associated with a legacy product that was discontinued some years ago. Because the establishment of the warranty reserve is an inherently uncertain process involving estimates of the number of future claims and the cost to settle claims, the Company s ultimate losses may differ from the warranty reserve and future adjustments to the reserve may be necessary.

[1] Exclusive of items shown separately below.

The increase in Selling, general and administrative costs for the year were primarily attributable to $1.4 million (included in the total $3.1 million discussed above) of costs associated with the aforementioned plant consolidations and closing during the first fiscal quarter of 2011. The majority of the $1.4 million represents an estimated liability to terminate a facility operating lease; if the associated sublease differs from the sublease assumptions used to derive the reserve, additional expense or a recovery of expense could be recognized in future periods. Furthermore, the Company incurred $0.7 million of additional sales and marketing expenses in 2011 associated with the roll out of new products and programs. Benefiting the comparative 2011 results is $1.0 million of costs associated with the aforementioned strike in mid December 2009 (partially offset by the direct labor savings in Cost of sales).

Depreciation and amortization has increased in 2011 compared to 2010 primarily due to $0.3 million (included in the total $3.1 million discussed above) of accelerated depreciation related to the plant consolidations and closing.

The Company formally announced Project Nexus in February 2010, a long-term organic growth program focused on connecting the sales, marketing, and product development efforts of its Engineered Products operating divisions: Mikron, Truseal and Homeshield. The Company believes it will drive profitable growth at Engineered Products by furthering the goal of becoming the leading energy efficient expert in the market by offering customers state-of-the-art engineering, design and marketing support. The organic growth program is comprised of related initiatives to execute this strategy: The sales, marketing and engineering efforts of these three divisions operated independently in the past. Today, the Engineered Products sales and marketing employees have been organized into a single team to better utilize their combined capabilities to expand sales opportunities to the existing customer base. Additionally, the new sales and marketing structure is focused on developing and capturing more regional OEM opportunities. Regional OEMs, a customer class the Company has historically underserved, are believed to comprise about 60% of the market. The engineering resources across Engineered Products are also working together to develop products and systems that provide customers with the latest innovations in technology and energy efficiency. The Company is in the early stages of this long-term organic growth initiative but believes that it could have a valuable impact on the long-term growth and profitability of Engineered Products. The Company will be investing in additional resources in fiscal 2011 to support this organic growth effort. Annual incremental operating expenses and capital expenditures necessary associated with this initiative will be approximately $4.0 million and $3.0 million, respectively in fiscal 2011.

Aluminum Sheet Products

	Three Months Ended January 31, 2011	2010	Change	%
	(Dollars in millions)			
Net sales	$ 79.1	$ 81.6	$ (2.5)	(3.1)
Cost of sales[1]	74.4	74.3	0.1	0.1
Selling, general and administrative	2.0	1.6	0.4	25.0
Depreciation and amortization	2.1	2.1		
Operating income (loss)	$ 0.6	$ 3.6	$ (3.0)	(83.3)
Shipped pounds	52.2	61.1	(8.9)	(14.6)

The primary market drivers for the Aluminum Sheet Products segment are U.S. residential remodeling activity and housing starts (together approximately 70% of the segment s sales) and transportation (approximately 20% of the segment s sales) markets.

1 Exclusive of items shown separately below.

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The decrease in net sales at the Aluminum Sheet Products segment for the first quarter of fiscal 2011 was the result of a 15% decrease in shipped pounds during the period compared to the same period of 2010, partially offset by an increase in average selling price per pound of 14%. The Aluminum Association reported U.S. demand for the type of aluminum sheet the Company sells was up 10% from the year ago quarter while the segment s first quarter sheet shipments were down 15%. Part of the Company s underperformance can be attributed to relatively weak building and construction demand in the quarter, where Quanex has a sizable presence, compared to relatively strong distribution and transportation demand, where Quanex has a relatively small presence. Additionally, at this time last year, the Company s customers were aggressively restocking to meet pre-buying demand ahead of the expiration of the $8,000 first time home buyers tax credit compared to the first quarter of 2011 where they were destocking. The Company s facilities also had planned and unplanned outages in the first fiscal quarter of 2011, some of which were deferred from last year because of strong demand throughout much of fiscal 2010 and the Company s commitment to give its customers uninterrupted service during that time. Average selling price increased primarily due to higher London Metal Exchange (LME) aluminum prices. LME aluminum prices are the most commonly used index for correlating aluminum sheet prices.

Selling, general and administrative costs increased by $0.4 million for the three months ended January 31, 2011 compared to the same 2010 period primarily due to a reduction in estimated bad debt expense during the first quarter of 2010 as one customer s credit rating improved during that period.

Operating income decreased at the Aluminum Sheet Products segment for the three months ended January 31, 2011, compared to prior year primarily as a result of lower shipped pounds. This decline was partially offset by an increase in spreads (sales price less material costs). First quarter of fiscal 2011 spreads increased by 9% over the same 2010 period and up 11% over the sequential fourth quarter. The higher spread was generally a result of rising aluminum prices. The Aluminum Sheet Products operating income and margins are impacted by changes in LME aluminum prices as its material spread is correlated with aluminum prices over time. Declines in aluminum prices generally result in spread compression; however, as aluminum prices rebound, spread and profits generally expand.

On January 31, 2011, Quanex announced it signed a definitive agreement with Lauren International to acquire Edgetech for $107.0 million in an all cash transaction. Edgetech is headquartered in Cambridge, Ohio, and has three manufacturing facilities (U.S., U.K. and Germany) that produce and market a full line of warm edge insulating glass spacer systems for window and door customers in North America and abroad. Edgetech will be part of Quanex s Engineered Products Group. Quanex received the applicable governmental regulatory approval and now expects to close on or before April 1, 2011.

Corporate and Other

Other Regulatory Issues

As a United States entity operating through subsidiaries in foreign jurisdictions, we are subject to foreign exchange control, transfer pricing and custom laws that regulate the flow of funds between our subsidiaries and us for product purchases, management services and contractual obligations, such as the payment of member commissions. As is the case with most companies that operate in direct sales, we might receive inquiries from time to time from government regulatory authorities regarding the nature of our business and other issues, such as compliance with local direct selling, transfer pricing, customs, taxation, foreign exchange control, securities and other laws.

Product Warranties and Returns

Our refund policies and procedures closely follow industry and country-specific standards, which vary greatly by country. For example, in the United States, the Direct Selling Association recommends that direct sellers permit returns during the twelve-month period following the sale, while in Hong Kong the standard return policy is 14 days following the sale. Our return policies typically conform to local laws or the recommendation of the local direct selling association. In most cases, members who timely return unopened product that is in resalable condition may receive a refund. The amount of the refund may be dependent on the country in which the sale occurred, the timeliness of the return, and any applicable re-stocking fee. NHT Global must be notified of the return in writing and such written requests would be considered a termination notice of the membership. We may alter our return policy in response to special circumstances.

Significant Customers

Sales are made to our members and no single customer accounted for 10% or more of our net sales. However, our business model can result in a concentration of sales to several different members and their network of members. Although no single member accounted for 10% or more of net sales, the loss of a key member or that member’s network could have an adverse effect on our net sales and financial results.

Our Industry

We are engaged in the direct selling industry, selling wellness, herbal, beauty, lifestyle, home and baby products. More specifically, we are engaged in what is called network marketing or multi-level marketing. This type of organizational structure and approach to marketing and sales include companies selling lifestyle enhancement products, cosmetics and dietary supplements, or selling other types of consumer products. Generally, direct selling is based upon an organizational structure in which independent members purchasing a company’s products are compensated for sales made directly to consumers.

Our members are compensated based on sales generated by members they have enrolled and all subsequent members enrolled by their “down-line” network of members. The experience of the direct selling industry has been that once a sizeable network of members is established, new and alternative products and services can be offered to those members for sale to consumers and additional members.

Competition

The network marketing industry is very diverse, with giant multinational corporations as well as smaller, local operators. Big network marketing companies include Nu Skin Enterprises, Inc., USANA Health Sciences, Inc., and Herbalife, Ltd, which have much greater name recognition and financial resources than we do and also have many more members. They are publicly traded and therefore serve as informational benchmarks, but we don’t overlap with them in terms of marketplace or product range. On the other hand, many medium- and small-sized privately held Chinese, Taiwanese and Hong Kong companies are fierce competitors and are much closer to directly competing with us. Also, a number of our former employees and members now work for competitors, and sometimes try to use relationships and knowledge obtained to compete with us.

Our ability to compete with other network marketing companies depends, in significant part, on our success in attracting and retaining members. There can be no assurance that our programs for attracting and retaining members will be successful. The pool of individuals interested in network marketing is limited in each market and is reduced to the extent other network marketing companies successfully attract these individuals into their businesses. Although we believe that we offer an attractive opportunity for our members, there can be no assurance that other network marketing companies will not be able to recruit our existing members or deplete the pool of potential members in a given market.

The direct selling channel tends to sell products at a higher price compared to traditional retailers, which poses a degree of competitive risk. There is no assurance that we would continue to compete effectively against retail stores, internet-based retailers or other direct sellers.

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Item 1A. RISK FACTORS

We are exposed to a variety of risks that are present in our business and industry. The following are some of the more significant factors that could affect our business, results of operations and financial condition.

We could be adversely affected by management changes or an inability to attract and retain key management, directors and consultants.

We incur a low level of overhead and are run by a small number of executives, who rely on a small group of employees. Our future success depends to a significant degree on the skills, experience and efforts of our top management and directors. We also depend on the ability of our executive officers and other members of senior management to work effectively as a team. The loss of one or more of our executive officers, members of our senior management or directors could have a material adverse effect on our business, results of operations and financial condition. Moreover, as our business evolves, we may require additional or different management members, directors or consultants, and there can be no assurance that we will be able to locate, attract and retain them if and when they are needed.

Because our Hong Kong operations account for a substantial portion of our overall business, and substantially all of our Hong Kong business is derived from the sale of products to members in China, any material adverse change in our business relating to either Hong Kong or China would likely have a material adverse impact on our overall business.

In 2017, 2016 and 2015, approximately 89%, 92% and 93% of our revenue, respectively, was generated in Hong Kong. Substantially all of our Hong Kong revenues are derived from the sale of products that are delivered to members in China. This geographic concentration in our business means that events or conditions that could negatively impact this geographic region or our operations in this region would have a greater adverse impact upon our overall business and financial results than would be the case with a company having greater geographic diversification.

Our operations in China are subject to compliance with a myriad of applicable laws and regulations, and any actual or alleged violations of those laws or government actions otherwise directed at us could have a material adverse impact on our business and the value of our company.

In contrast to our operations in other parts of the world, we have not implemented a direct sales model in China. The Chinese government permits direct selling only by organizations that have a license, which we are in the process of applying for, and has also adopted anti-multilevel marketing legislation. We operate an e-commerce direct selling model in Hong Kong and recognize the revenue derived from sales to both Hong Kong and Chinese members as being generated in Hong Kong. Products purchased by members in China are delivered to third parties that act as the importers of record under agreements to pay applicable duties. In addition, through a Chinese entity, we sell products in China using an e-commerce retail model. The Chinese entity operates separately from the Hong Kong entity, and a Chinese member may elect to participate in either or both.

After consulting with outside professionals and certain Chinese authorities, and given the length of time we have been operating under our Hong Kong business model, we believe that our e-commerce direct selling model in Hong Kong does not violate any applicable laws in China, even though it is used for the internet purchase of our products by members in China. We also believe that our Chinese entity, including its e-commerce retail platform, is operating in compliance with applicable Chinese laws. However, there can be no assurance that the Chinese authorities will agree with our interpretations of applicable laws and regulations or that China will not adopt new laws or regulations. Should the Chinese government determine that our activities violate China's direct selling or anti-multilevel marketing legislation, or should new laws or regulations be adopted, there could be a material adverse effect on our business, financial condition and results of operations.

The Chinese government scrutinizes the activities of direct selling companies. Our business continues to be subject to regulations and examinations by municipal and provincial level regulators. At times, actions by government regulators have impacted our members' activities in certain locations and have resulted in a few cases of enforcement actions. In each of these cases, we helped our members with their defense of the legality of their conduct, and no material changes to our business model were required.

However, our business operations and the value of our company can be adversely affected by Chinese government scrutiny of our operations, even if that scrutiny does not result in investigations of our operations. For example, one or more parties encouraged the Beijing City governmental authorities to conduct an investigation of our business, which resulted in a meeting in January 2016 involving members of our Beijing office staff, Beijing City governmental officials, and two complainants. Even though the Beijing City governmental officials advised our staff and the complainants at that meeting that there was insufficient evidence to warrant an investigation of us, mischaracterizations of the meeting immediately appeared in several "news reports." Similarly, a subsequent meeting between several Guangzhou City government officials and members of our Guangzhou office staff that resulted in our providing routine information about our operations to the government officials was mischaracterized in an online posting made immediately following the meeting. Although we remain in regular contact with Chinese government officials and take other steps to address the risks posed by these events, our business and the value of our company remain vulnerable to Chinese government scrutiny of our operations, whether or not initiated by third parties.

Various other factors could harm our business in Hong Kong and China, such as worsening economic conditions in Hong Kong or China, adverse local publicity, geopolitical or trade tensions between the U.S. and China or other events that may be out of our control. For example, we were advised to voluntarily suspend marketing activities in China during the third quarter of 2007 when the Chinese government was expected to impose a more intense enforcement program against illegal pyramid scheme activities or "chain sales" activities in transliterated Chinese terms. We do not conduct such activities, but we did not want to run the risk of being inadvertently entangled in the government enforcement actions and voluntarily withdrew all marketing activities from China during that period. It may be necessary or advisable to repeat this or similar actions from time to time in the future, and such periods of reduced activity could have a material adverse effect on our business.

Although we attempt to work closely with both national and local Chinese governmental agencies in conducting our business, our efforts to comply with national and local laws may be harmed by a rapidly evolving regulatory climate, concerns about activities resembling violations of direct selling or anti-multi-level marketing legislation, subjective interpretations of laws and regulations, and activities by individual members that may violate laws notwithstanding our strict policies prohibiting such activities.

Any determination that our operations or activities, or the activities of our individual members, employee sales representatives, or importers of record are not in compliance with applicable laws and regulations could result in the imposition of substantial fines, extended interruptions of business, restrictions on our future ability to obtain business licenses or expand into new locations, changes to our business model, the termination of required licenses to conduct business, or other actions, any of which could materially harm our business, financial condition and results of operations.

Our failure to maintain and expand our member relationships could adversely affect our business.

We distribute our products through independent members, and we depend upon them directly for all of our sales in most of our markets. Accordingly, our success depends in significant part upon our ability to attract, retain and motivate a large base of members. Our direct selling organization is headed by a relatively small number of key members. The loss of a significant number of members, or the loss of one or more key members, could materially and adversely affect sales of our products and could impair our ability to attract new members. Moreover, the replacement of members could be difficult because, in our efforts to attract and retain members, we compete with other direct selling organizations, including but not limited to those in the personal care, cosmetic product and nutritional supplement industries. Our members may terminate their services with us at any time and, in fact, like most direct selling organizations, we have a high rate of attrition.

Our number of active members has recently declined and could in the future further decline. We cannot accurately predict any fluctuation in the number or the productivity of members because we primarily rely upon existing members to enroll and train new members and to motivate new and existing members. Operating results could be adversely affected if our existing and new business opportunities and products do not generate sufficient economic incentive or interest to retain existing members and to attract new members.

The number and productivity of our members could be harmed by several factors, including:

- adverse publicity or negative perceptions regarding us, our products, our method of distribution or our competitors;

- lack of interest in, or the technical failure of, existing or new products;

- lack of interest in our existing compensation plan for members or in enhancements or other changes to that compensation plan;

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- our actions to enforce our policies and procedures;
- regulatory actions or charges or private actions against us or others in our industry;
- general economic and business conditions;
- changes in management or the loss of one or more key member leaders;
- entry of new competitors, or new products or compensation plan enhancements by existing competitors, in our markets; and
- potential saturation or maturity levels in a given country or market which could negatively impact our ability to attract and retain members in such market.

We are currently being sued in three lawsuits alleging, among other things, that we made materially false and misleading statements regarding the legality of our business operations in China.

We, together with our executive officers, have been named as defendants in three complaints (one of which also names our directors as defendants) relating to running an alleged illegal multilevel marketing business in China and making alleged materially false and misleading statements regarding the legality of our business operations in China, among other things. These complaints seek an indeterminate amount of damages, and one of the complaints also seeks various equitable remedies. Notwithstanding potentially applicable insurance coverage, these complaints, or others filed alleging similar facts, could result in monetary or other penalties that may adversely affect our operating results and financial condition. Moreover, the negative publicity stemming from these complaints and the allegations they make could harm our business and operations. Accordingly, any adverse determination against us in these suits, or even the allegations contained in the suits regardless of whether they are ultimately found to be without merit, could harm our business, operations and financial condition.

We are currently involved in, and may in the future face, litigation claims and governmental proceedings and inquiries that could harm our business.

We are currently, and have in the past, been a party to lawsuits, claims and governmental proceedings and inquiries. Prosecuting and defending these matters may require significant expense and attention of our management. There can be no assurance that we will be able to successfully defend or resolve any such litigation, claims or governmental proceedings or inquiries, or that the significant money, time and effort spent in defending these matters will not adversely affect our business, financial condition and results of operations.

Although our members are independent contractors, improper member actions that violate laws or regulations could harm our business.

Our members are independent contractors and, accordingly, we are not in a position to directly provide the same direction, motivation and oversight as we would if members were our own employees. As a result, there can be no assurance that our members will participate in our marketing strategies or plans, accept our introduction of new products, or comply with our member policies and procedures. Extensive federal, state, local and foreign laws regulate our business, our products and our network marketing program. Because we have expanded into foreign countries, our policies and procedures for our members differ due to the different legal requirements of each country in which we do business. While we have implemented member policies and procedures designed to govern member conduct and to protect the goodwill associated with our trademarks and trade names, it can be difficult to enforce these policies and procedures because of the large number of members and their independent status.

Given the size and diversity of our member force, we experience problems with members from time to time, especially with respect to our members in foreign markets. For example, if our members engage in illegal activities in China, those actions could be attributed to us. Chinese laws regarding how and when members may assemble and the activities that they may conduct, or the conditions under which the activities may be conducted, are subject to interpretations and enforcement that sometimes vary from province to province, among different levels of government, and from time to time. Members can be accused of violating one or more of the laws regulating these activities, notwithstanding training that we attempt to provide. Enforcement measures regarding these violations, which can include arrests, raise the uncertainty and perceived risk associated with conducting this business, especially among those who are aware of the enforcement actions but not the specific activities leading to the enforcement action. We believe that this has led some existing members in China - who are signed up as members in Hong Kong - to leave the business or curtail their selling activities and has led some potential members to choose not to participate. Among other things, we are managing this risk with more training and public relations efforts that are designed, among other things, to distinguish our company from businesses that make no attempt to comply with the law. This environment creates uncertainty about the future of doing this type of business in China generally and under our business model, specifically.

In addition, members often desire to enter a market before we have received approval to do business in order to gain an advantage in the marketplace. Improper member activity in new geographic markets could result in adverse publicity and can be particularly harmful to our ability to ultimately enter these markets. Violations by our members of applicable law or of our policies and procedures in dealing with customers could reflect negatively on our products and operations, and harm our business reputation. In addition, it is possible that a judicial or administrative body could hold us civilly or criminally accountable based on vicarious liability because of the actions of our members. If any of the above or related events involving our members occur, our business, financial condition, or results of operations could be materially adversely affected.

Direct-selling laws and regulations may prohibit or severely restrict our direct sales efforts and cause our revenue and profitability to decline, and regulators could adopt new regulations that harm our business.

Our direct selling system is subject to extensive laws, governmental regulations, administrative determinations, court decisions and similar constraints. These laws and regulations are generally intended to prevent fraudulent or deceptive schemes, often referred to as “pyramid” schemes, which compensate participants for recruiting additional participants irrespective of product sales, use high pressure recruiting methods and/or do not involve legitimate products. They also seek to ensure that claims regarding the ability of participants to earn money are truthful and substantiated.

Complying with these widely varying and sometimes inconsistent rules and regulations can be difficult and may require the devotion of significant resources on our part. There can be no assurance that we or our members are in compliance with all of these regulations. Our failure or our members’ failure to comply with these regulations or new regulations could lead to the imposition of significant penalties or claims and could negatively impact our business. If we are unable to continue business in existing markets or commence operations in new markets because of these laws, our revenue and profitability may decline.

We are also subject to the risk that new laws or regulations might be implemented or that current laws or regulations might change, which could require us to change or modify the way we conduct our business in certain markets. This could be particularly detrimental to us if we have to change or modify the way we conduct business in markets that represent a significant percentage of our revenue.

The high level of competition in our industry could adversely affect our business.

The business of marketing personal care, cosmetic, nutritional supplements, and lifestyle enhancement products is highly competitive. This market segment includes numerous manufacturers, members, marketers, and retailers that actively compete for the business of consumers both in the United States and abroad. The market is highly sensitive to the introduction of new products, which may rapidly capture a significant share of the market. Sales of similar products by competitors may materially and adversely affect our business, financial condition and results of operations.

We are subject to significant competition for the recruitment of members from other direct selling organizations, including those that market similar products. Many of our competitors are substantially larger than we are, offer a wider array of products, have far greater financial resources and many more active members than we have. Even more numerous are those medium- and small-sized, all privately held Chinese, Taiwanese and Hong Kong companies that are fierce competitors and are much closer to directly competing with us. Our ability to remain competitive depends, in significant part, on our success in recruiting and retaining members with our products, attractive compensation plan and other incentives. We believe that we have an attractive product line and that our compensation and incentive programs provide our members with significant earning potential. However, we cannot be sure that our programs for recruitment and retention of members will be successful.

Some of our competitors have employed or otherwise contracted for the services of our former officers, employees, consultants, and members, who may try to use information and contacts obtained while under contract with us for competitive advantage. While we seek to protect our information through contractual and other means, there can be no assurance that we will timely learn of such activity, have the resources to attempt to stop it, or have adequate remedies available to us.

Challenges by third parties to the legality of our business operations could harm our business.

We are also subject to the risk of private party challenges to the legality of our operations, including our direct selling system. The regulatory requirements concerning direct selling systems generally do not include “bright line” rules and are inherently fact-based and subject to judicial or administrative interpretation. An adverse judicial or administrative determination against us with respect to our direct selling system, or in proceedings not involving us directly but which challenge the legality of other direct selling marketing systems, could have a material adverse effect on our business. There is also risk that challenges and settlements involving other parties could provide incentives for similar actions by members against us and other direct selling companies. Moreover, challenges to our business system and operations in important markets may come from short sellers, hedge funds, other investors, bloggers and reporters. Other companies in our industry have recently faced such challenges. Any challenges regarding us or others in our industry could harm our business if such challenges result in the imposition of any fines or damages on our business, create adverse publicity, increase scrutiny or investigations of us or our industry, detrimentally affect our efforts to recruit or motivate members and attract customers, or interpret laws in a manner inconsistent with our current business practices.

An increase in the amount of compensation paid to members would reduce profitability.

We incur significant expense in the payment of compensation to our members, which represented approximately 42%, 44% and 48% of net sales during 2017, 2016 and 2015, respectively. We compensate our members by paying commissions, bonuses, and certain awards and prizes. Factors impacting the overall commission payout include the growth and depth of the member network, the member retention rate, the level of promotions, local promotional programs and business development agreements. Any increase in compensation payments to members as a percentage of net sales will reduce our profitability.

Our compensation plan includes a cap that may be enforced on member compensation paid out on a weekly dollar limit or as a percentage of product sales. There can be no assurance that enforcement of this cap will ensure profitability (which depends on many other factors). Moreover, enforcement of this cap could cause key members affected by the cap to leave and join other companies.

Currency exchange rate fluctuations could lower our revenue and net income.

In 2017, 97% of our revenue was recorded by subsidiaries located outside of North America. Revenue transactions and related commission payments, as well as other incurred expenses, are typically denominated in the local currency. Accordingly, our international subsidiaries generally use the local currency as their functional currency. The results of operations of our international subsidiaries are exposed to foreign currency exchange rate fluctuations during consolidation since we translate into U.S. dollars using the average exchanges rates for the period. As exchange rates vary, revenue and other operating results may differ materially from our expectations. Additionally, we may record significant gains or losses related to foreign-denominated cash and cash equivalents and the re-measurement of inter-company balances.

Our most significant foreign exchange exposure, the Hong Kong dollar, is for now pegged to the U.S. dollar. We also purchase a significant majority of inventories in U.S. dollars. Our foreign currency exchange rate exposure to the South Korean won, Taiwan dollar, Japanese yen, Chinese yuan, Russian ruble, Kazakhstani tenge, Singaporean dollar, Malaysian ringgit, Vietnamese dong, Canadian dollar, Mexican peso, Peruvian sol and European euro collectively represented approximately 10%, 7% and 6% of our revenue in 2017, 2016 and 2015, respectively. Our foreign currency exchange rate exposure may increase in the near future as we develop opportunities in Southeast Asia, Canada, Central America, South America and Europe. Additionally, our foreign currency exchange rate exposure would significantly increase if the Hong Kong dollar were no longer pegged to the U.S. dollar. Finally, we also experience indirect exchange rate exposure due to the concentration of our sales to members residing in China and the impact of fluctuations in the value of the Chinese yuan on our members' purchasing power.

Given our inability to predict the degree of exchange rate fluctuations, we cannot estimate the effect these fluctuations may have upon future reported results, product pricing or our overall financial condition. Further, to date we have not attempted to reduce our exposure to short-term exchange rate fluctuations by using foreign currency exchange contracts.

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Changes in tax or duty laws, and unanticipated tax or duty liabilities, could adversely affect our net income.

In the course of doing business we may be subject to various taxes, such as sales and use, value-added, and franchise. We are also subject to income taxes in the United States and numerous foreign jurisdictions. We earn a substantial portion of our income in foreign jurisdictions. Economic and political conditions make tax rules in any jurisdiction, including the United States, subject to significant change. There have been recent changes in U.S. tax law that impact how U.S. multinational corporations are taxed on foreign earnings. There have also been proposals to reform foreign tax laws that could significantly affect the Company’s tax position. Although we cannot predict whether or in what form these proposals will pass, several of the proposals considered, if enacted into law, could have an adverse impact on our income tax expense and cash flows.

Our principal domicile is the United States. Under tax treaties, we are eligible to receive foreign tax credits in the United States for taxes paid abroad. Taxes paid to foreign taxing authorities may exceed the credits available to us, resulting in the payment of a higher overall effective tax rate on our worldwide operations.

Our effective income tax rate in the future could be adversely affected by a number of factors, including changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of deferred tax assets and liabilities, changes in tax laws, and the outcome of income tax audits in various jurisdictions around the world.

We may also be subject to examinations of our tax returns and other tax matters by the Internal Revenue Service and other tax authorities and governmental bodies. We regularly assess the likelihood of an adverse outcome resulting from these examinations to determine the adequacy of our provision for taxes, which is subject to significant discretion. There can be no assurance as to the outcome of these examinations. If our effective tax rates were to increase, particularly in the U.S., or if the ultimate determination of taxes owed is for an amount in excess of amounts previously accrued, our financial results or operations could be adversely affected.

In addition, our operations are subject to regulations designed to ensure that appropriate levels of customs duties are assessed on the importation of our products. The failure to properly calculate, report and pay such duties when we are subject to them could have a material adverse effect on our financial condition and results of operations. Any change in the laws or regulations regarding such duties, or any interpretation thereof, could result in an increase in the cost of doing business.

Transfer pricing regulations affect our business and results of operations.

In many countries, including the United States, we are subject to transfer pricing and other tax regulations designed to ensure that appropriate levels of income are reported as earned by our United States or local entities and are taxed accordingly. We have adopted transfer pricing agreements with our subsidiaries to regulate inter-company transfers, which agreements are subject to transfer pricing laws that regulate the flow of funds between the subsidiaries and the parent corporation for product purchases, management services, and contractual obligations, such as the payment of member compensation. We believe that we operate in compliance with all applicable transfer pricing laws, and we intend to continue to operate in compliance with such laws. However, there can be no assurance that we will continue to be found to be operating in compliance with transfer pricing laws, or that those laws would not be modified, which, as a result, may require changes in our operating procedures or otherwise may have a material adverse effect on our financial results or operations.

Our products and related activities are subject to extensive government regulation, which could delay, limit or prevent the sale of some of our products in some markets.

The formulation, manufacturing, packaging, labeling, importation, advertising, distribution, sale and storage of certain of our products are subject to extensive regulation by various federal agencies, including the Food and Drug Administration (the "FDA"), the FTC, the Consumer Product Safety Commission and the United States Department of Agriculture and by various agencies of the states, localities and foreign countries in which our products are manufactured, distributed and sold. For example, the FDA requires us and our suppliers to meet relevant current good manufacturing practice (cGMP) regulations for the preparation, packing and storage of foods and over-the-counter (OTC) drugs. We are also now required to report serious adverse events associated with consumer use of certain of our products. Other laws and regulations govern or restrict the claims that may be made about our products and the information that must be included and excluded on labels.

In markets outside the United States, prior to commencing operations or marketing new products, we may be required to obtain approvals, licenses, or certifications from a ministry of health or a comparable agency. Moreover, a foreign jurisdiction may pass laws that would prohibit the use of certain ingredients in their particular market. Compliance with these regulations can create delays and added expense in introducing new products to certain markets.

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Failure by our members or us to comply with those regulations could lead to the imposition of significant penalties or claims and could materially and adversely affect our business. If we are not able to satisfy the various regulations, then we would have to cease sales of that product in that market. In addition, the adoption of new regulations or changes in the interpretation of existing regulations may result in significant compliance costs or discontinuation of product sales and may adversely affect the marketing of our products, resulting in significant loss of revenues.

We cannot predict the nature of any future laws, regulations, interpretations, or applications, nor can we determine what effect additional governmental regulations or administrative orders, when and if promulgated, could have on our business. These potential effects could include, however, requirements for the reformulation of certain products to meet new standards, the recall or discontinuance of certain products, additional recordkeeping and reporting requirements, expanded documentation of the properties of certain products, expanded or different labeling, or additional scientific substantiation. Any or all of these requirements could have a material adverse effect on our business, financial condition, or results of operations.

Failure of new products to gain member and market acceptance could harm our business.

An important component of our business is our ability to develop new products that create enthusiasm among our member force. If we fail to introduce new products on a timely basis, our member productivity could be harmed. In addition, if any new products fail to gain market acceptance, are restricted by regulatory requirements, or have quality problems, this would harm our results of operations. Factors that could affect our ability to continue to introduce new products include, among others, limited capital and human resources, government regulations, proprietary protections of competitors that may limit our ability to offer comparable products and any failure to anticipate changes in consumer tastes and buying preferences.

New regulations governing the marketing and sale of nutritional supplements could harm our business.

There has been an increasing movement in the United States and other markets to increase the regulation of dietary supplements, which could impose additional restrictions or requirements in the future. In the United States, for example, some legislators and industry critics continue to push for increased regulatory authority by the FDA over nutritional supplements. Our business could be harmed if more restrictive legislation is successfully introduced and adopted in the future. In particular, the adoption of legislation requiring FDA approval of supplements or ingredients could delay or inhibit our ability to introduce new supplements. We face similar pressures in our other markets. In the United States the FTC Guides Concerning the Use of Endorsements and Testimonials in Advertising (“Guides”) require disclosure of material connections between an endorser and the company they are endorsing and require the disclosure of typical results when these are different from those reported by the endorser. The requirements and restrictions of the Guides may diminish the impact of our marketing efforts and negatively impact our sales results. If we or our members fail to comply with these Guides, the FTC could bring an enforcement action against us and we could be fined and/or forced to alter our operations. Our operations also could be harmed if new laws or regulations are enacted that restrict our ability to market or distribute nutritional supplements or impose additional burdens or requirements on nutritional supplement companies or require us to reformulate our products.

Regulations governing the production and marketing of our personal care products could harm our business.

Our personal care products are subject to various domestic and foreign laws and regulations that regulate cosmetic products and set forth regulations for determining whether a product can be marketed as a “cosmetic” or requires further approval as an over-the-counter drug. A determination that our cosmetic products impact the structure or function of the human body, or improper marketing claims by our members, may lead to a determination that such products require pre-market approval as a drug. Such regulations in any given market can limit our ability to import products and can delay product launches as we go through the registration and approval process for those products. Furthermore, if we fail to comply with these regulations, we could face enforcement action against us and we could be fined, forced to alter or stop selling our products and/or required to adjust our operations. Our operations also could be harmed if new laws or regulations are enacted that restrict our ability to market or distribute our personal care products or impose additional burdens or requirements on the contents of our personal care products or require us to reformulate our products.

If we are found not to be in compliance with good manufacturing practices our operations could be harmed.

Regulations on good manufacturing practices and adverse event reporting requirements for the nutritional supplement industry are in effect and require good manufacturing processes for us and our vendors, including stringent vendor qualifications, ingredient identification, manufacturing controls and record keeping. We are also required to report serious adverse events associated with consumer use of our products. Our operations could be harmed if regulatory authorities make determinations that we or our vendors are not in compliance with the regulations. A finding of noncompliance may result in administrative warnings, penalties or actions impacting our ability to continue selling certain of our products. In addition, compliance with these regulations has increased and may further increase the cost of manufacturing certain of our products as we work with our vendors to assure they are qualified and in compliance.

Failure to comply with domestic and foreign laws and regulations governing product claims and advertising could harm our business.

Our failure to comply with FTC or state regulations, or with regulations in foreign markets that cover our product claims and advertising, including direct claims and advertising by us, as well as claims and advertising by members for which we may be held responsible, may result in enforcement actions and imposition of penalties or otherwise materially and adversely affect the distribution and sale of our products. Member activities in our existing markets that violate applicable governmental laws or regulations could result in governmental or private actions against us in markets where we operate. Given the size of our member force, we cannot ensure that our members will comply with applicable legal requirements.

Adverse publicity associated with our products, ingredients or network marketing program, or those of similar companies, could harm our financial condition and operating results.

Adverse publicity concerning any actual or claimed failure by us or our members to comply with applicable laws and regulations regarding product claims and advertising, good manufacturing practices, the regulation of our network marketing program, the licensing of our products for sale in our target markets or other aspects of our business, whether or not resulting in enforcement actions or the imposition of penalties, could have an adverse effect on our goodwill and could negatively affect our ability to attract, motivate and retain members, which would negatively impact our ability to generate revenue. We cannot ensure that all members will comply with applicable legal requirements relating to the advertising, labeling, licensing or distribution of our products.

In addition, our members’ and consumers’ perception of the safety and quality of our products and ingredients, as well as similar products and ingredients distributed by other companies, can be significantly influenced by media attention, publicized scientific research or findings, widespread product liability claims and other publicity concerning our products or ingredients or similar products and ingredients distributed by other companies. Adverse publicity, whether or not accurate or resulting from consumers’ use or misuse of our products, that associates consumption of our products or ingredients or any similar products or ingredients with illness or other adverse effects, questions the benefits of our or similar products or claims that any such products are ineffective, inappropriately labeled or have inaccurate instructions as to their use, could negatively impact our reputation or the market demand for our products.

We are subject to risks relating to product concentration and lack of revenue diversification.

Although we have in recent years expanded our line of products, we derive more than 10% of our total revenue from each of our *Premium Noni Juice* and *Enhanced Essential Probiotics®* products. Further, we currently source each such product from a single supplier. If demand decreases significantly, government regulation restricts their sale, we are unable to adequately source or deliver the products, or we are unable to offer the products for any reason without suitable replacements, our business, financial condition and results of operations could be materially and adversely affected. Our future success will also depend on our ability to reduce our dependence on these few products by developing and introducing new products and product or feature enhancements in a timely manner. Even if we are able to develop and commercially introduce new products and enhancements, they may not achieve market acceptance and the revenue generated from these new products and enhancements may not offset the costs, which could substantially impair our business, financial condition and results of operations.

We rely on a limited number of independent third parties to manufacture and supply our products.

All of our products are manufactured by a limited number of independent third parties. There is no assurance that our current manufacturers will continue to reliably supply products to us at the level of quality we require. If a key manufacturer suffers liquidity problems or experiences operational or other problems assisting with our products, our results could suffer. In the event any of our third-party manufacturers become unable or unwilling to continue to provide the products in required volumes and quality levels at acceptable prices, we will be required to identify and obtain acceptable replacement manufacturing sources or replacement products. There is no assurance that we will be able to obtain alternative manufacturing sources or products or be able to do so on a timely basis. An extended interruption in the supply of certain of our products may result in a substantial loss of revenue. In addition, any actual or perceived degradation of product quality as a result of our reliance on third party manufacturers may have an adverse effect on revenue or result in increased product returns.

Growth may be impeded by the political and economic risks of entering and operating in foreign markets.

Our ability to achieve future growth is dependent, in part, on our ability to continue our international expansion efforts. However, there can be no assurance that we would be able to grow in our existing international markets, enter new international markets on a timely basis, or that new markets would be profitable. We must overcome significant regulatory and legal barriers before we can begin marketing in any foreign market.

Also, it is difficult to assess the extent to which our products and sales techniques would be accepted or successful in any given country. In addition to significant regulatory barriers, we may also encounter problems conducting operations in new markets with different cultures and legal systems from those elsewhere. We may be required to reformulate certain of our products before commencing sales in a given country. Once we have entered a market, we must adhere to the regulatory and legal requirements of that market. No assurance can be given that we would be able to successfully reformulate our products in any of our current or potential international markets to meet local regulatory requirements or attract local customers. The failure to do so could have a material adverse effect on our business, financial condition, and results of operations. There can be no assurance that we would be able to obtain and retain necessary permits and approvals.

In many markets, other direct selling companies already have significant market penetration, the effect of which could be to desensitize the local member population to a new opportunity or to make it more difficult for us to recruit qualified members. There can be no assurance that, even if we are able to commence operations in foreign countries, there would be a sufficiently large population of potential members inclined to participate in a direct selling system offered by us. We believe our future success could depend in part on our ability to seamlessly integrate our business methods, including member compensation plan, across all markets in which our products are sold. There can be no assurance that we would be able to further develop and maintain a seamless compensation program.

We may be held responsible for certain taxes or assessments relating to the activities of our members and service providers, which could harm our financial condition and operating results.

Our members and service providers are subject to taxation, and in some instances, legislation or governmental agencies impose an obligation on us to collect the taxes, such as value added taxes, and to maintain appropriate records. In addition, we are subject to the risk in some jurisdictions of being responsible for social security and similar taxes with respect to our members.

We may be unable to protect or use our intellectual property rights.

We rely on trade secret, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection of our confidential information and trademarks. Moreover, the laws of some countries in which we market our products may afford little or no effective protection of our intellectual property rights. The unauthorized copying, use or other misappropriation of our confidential information, trademarks and other intellectual property could enable third parties to benefit from such property without paying us for it. This could have a material adverse effect on our business, operating results and financial condition. If we resort to legal proceedings to enforce our intellectual property rights, the proceedings could be burdensome, expensive and result in inadequate remedies. It is also possible that our use of our intellectual property rights could be found to infringe on prior rights of others and, in that event, we could be compelled to stop or modify the infringing use, which could be burdensome and expensive.

We do not have a comprehensive product liability insurance program and product liability claims could hurt our business.

Currently, we do not have a comprehensive product liability insurance program, although the insurance carried by our suppliers may cover certain product liability claims against us. As a marketer of dietary supplements, cosmetics and other products that are ingested by consumers or applied to their bodies, we may become subjected to various product liability claims, including that:

•our products contain contaminants or unsafe ingredients;

•our products include inadequate instructions as to their uses; or

•our products include inadequate warnings concerning side effects and interactions with other substances.

If our suppliers' product liability insurance fails to cover product liability claims or other product liability claims, or any product liability claims exceeds the amount of coverage provided by such policies or if we are unsuccessful in any third party claim against the manufacturer or if we are unsuccessful in collecting any judgment that may be recovered by us against the manufacturer, we could be required to pay substantial monetary damages which could materially harm our business, financial condition and results of operations. As a result, we may become required to pay high premiums and accept high deductibles in order to secure adequate insurance coverage in the future. Especially since we do not have direct product liability insurance, it is possible that product liability claims and the resulting adverse publicity could negatively affect our business.

Our internal controls and accounting methods may require modification.

We continue to review and develop controls and procedures sufficient to accurately report our financial performance on a timely basis. If we do not develop and implement effective controls and procedures, we may not be able to report our financial performance on a timely basis and our business and stock price would be adversely affected.

We identified a material weakness in our internal control over financial reporting. If we do not adequately address this material weakness or if other material weaknesses or significant deficiencies in our internal control over financial reporting are discovered, our financial statements could contain material misstatements and our business, operations and stock price may be adversely affected.

As disclosed under "Item 9A. Controls and Procedures" of this report, our management has identified a material weakness in our internal control over financial reporting at December 31, 2017. Under standards established by the Public Company Accounting Oversight Board, a material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our financial statements will not be prevented or detected on a timely basis. Although no material misstatement of our historical financial statements was identified, the existence of this or one or more material weaknesses or significant deficiencies could result in material misstatements in our financial statements and we could be required to restate our financial statements. Further, significant costs and resources may be needed to remediate the identified material weakness or any other material weaknesses or internal control deficiencies. If we are unable to remediate, evaluate, and test our internal controls on a timely basis in the future, management will be unable to conclude that our internal controls are effective and our independent registered public accounting firm will be unable to express an unqualified opinion on the effectiveness of our internal controls. If we cannot produce reliable financial reports, investors may lose confidence in our financial reporting, the price of our common stock could be adversely impacted and we could be subject to sanctions or investigations by the SEC, NASDAQ or other regulatory authorities, which could negatively impact our business, financial condition and results of operations.

We rely on and are subject to risks associated with our reliance upon information technology systems.

Our success is dependent on the accuracy, reliability, and proper use of information processing systems and management information technology. Our information technology systems are designed and selected to facilitate order entry and customer billing, maintain member records, accurately track purchases and member compensation payments, manage accounting operations, generate reports, and provide customer service and technical support. Any interruption in these systems could have a material adverse effect on our business, financial condition, and results of operations.

There can be no assurance that there will not be delays or interruptions in our information technology services. An interruption or delay in availability of these services could, if it lasted long enough, prevent us from accepting orders, cause members to leave our business, or otherwise materially adversely affect our business.

System disruptions or failures, cybersecurity risks, and compromises of data could harm our business.

Because of our diverse geographic operations and our internationally applicable member compensation plans, our business is highly dependent on the secure and efficient functioning of our information technology systems, and the security of personal and sensitive business data. We collect certain personal information, including payment data, from members and consumers, as well as our employees. We also develop and maintain sensitive and proprietary business information. Any systems failure or interruption, breach in security, or loss of data, whatever the cause, could adversely affect our operations and financial results.

Systems disruptions and data breaches can derive from natural disasters, accidental technological events or human error, but can also result from fraud or malice on the part of external or internal parties. Our systems, networks and software, like those of other companies, have been and are likely to continue to be, the target of cybersecurity threats and attacks, which may range from isolated or random attempts to sophisticated and targeted measures directed specifically at us. The risk of a systems disruption or data breach, particularly through cyber-attack or cyber intrusion, has increased as the number, intensity and sophistication of attempted attacks and intrusions from around the world have increased. A material systems disruption or data breach affecting us could damage our reputation, deter members from purchasing our products, and result in cost and liability to us.

Although we have implemented technical and administrative safeguards to maintain the security and integrity of our information technology systems and data, there can be no assurance that our security efforts and measures will be effective in a continually evolving threat environment. In addition to the risks presented by malicious actors and natural disasters, many systems disruptions and data breaches are reportedly caused by human error. Therefore, despite our security policies and mandatory training, our systems and data are exposed to the risk that human error could either create a vulnerability that could be exploited by an attacker, or expose our systems and data to unintended risk of compromise. In addition, as described below, most of our information technology systems and data are hosted by third-party vendors over which we have limited control. We anticipate that we will be required to expend additional resources in order to continue to enhance our technical and administrative safeguards, and to investigate and remediate any vulnerabilities in our systems, networks and software.

In any case, a data breach or other significant disruption of our information systems or those related to our third party vendors, including as a result of cyber-attacks, could (1) disrupt the proper functioning of our systems and networks and therefore operations, (2) result in the unauthorized access to, and destruction, loss, theft, misappropriation or release of personal, confidential, sensitive or otherwise valuable data or other information, (3) result in a violation of applicable privacy, cybersecurity, data breach notification requirements under applicable laws, regulations and contractual provisions, subjecting us to additional regulatory scrutiny, and exposing us to possible fines, lawsuits and related financial liability, (4) require significant management attention and financial resources to investigate and remedy the breach or disruption, and (5) harm our reputation, cause a decrease in the number of our members and revenue, and otherwise damage our business. The occurrence of any of the foregoing could have a material adverse effect on our business, financial condition or results of operations.

Our systems, software and data reside on third-party servers, exposing us to risks that disruption or intrusion of those servers could temporarily or permanently interrupt our access and damage our business.

Beginning in 2012, most of our systems, software and data reside in the “cloud” on servers operated by third-party vendors to which we have limited access. We assess the risks presented by these third-party vendors, and our contracts with them contain representations, warranties and other provisions related to the security of our data, and of the systems and software on which we rely. We are, however, limited in our ability to mitigate the risks of a systems disruption or data breach affecting our third-party vendors. Moreover, any delay or failure in payment of the third-party vendors, disputes with such vendors, or business interruption or failure of the third-party vendors could result in loss of or interruption in access to our systems, software or data. It is possible that our systems, software and data could in the future be moved to servers of different third parties or to our own servers. Any such move could result in temporary or permanent loss of access to our systems, software or data. Any protracted loss of such access would materially and adversely affect our business, financial condition and results of operations.

Terrorist attacks, acts of war, epidemics or natural disasters may seriously harm our business.

Terrorist attacks, acts of war, epidemics or natural disasters may cause damage or disruption to us, our employees, our facilities and our members and customers, which could impact our revenues, expenses and financial condition. The potential for future terrorist attacks, the national and international responses to terrorist attacks, and other acts of war or hostility, such as challenges to Chinese sovereignty claims in the South China Sea or Chinese objection to the Taiwan independence movement and the resultant tension in the Taiwan Strait, could materially and adversely affect our business, results of operations, and financial condition in ways that we currently cannot predict. Additionally, epidemics such as outbreaks of avian influenza, or natural disasters, whether or not as severe as the Indian Ocean tsunami that occurred in December 2004, may adversely affect our business, financial condition and results of operations.

We may experience substantial negative cash flows, which may have a significant adverse effect on our business and could threaten our solvency.

We experienced substantial negative cash flows during the years ended December 31, 2009 and 2008, primarily due to declines in our revenues greater than the decreases in expenditures we could manage. If we again experience negative cash flows, any resulting decreasing cash balance could impair our ability to support our operations and, eventually, threaten our solvency, which would have a material adverse effect on our business, results of operations and financial condition, as well as our stock price. Negative cash flows and the related adverse market perception associated therewith may have negatively affected, and may in the future negatively affect, our ability to attract new members and/or sell our products. There can be no assurance that we will be successful in maintaining an adequate level of cash resources and we could be forced to act more aggressively in the area of expense reduction in order to conserve cash resources as we look for alternative solutions.

If we experience negative cash flows, we may need to seek additional debt or equity financing, which may not be available on acceptable terms or at all. If available, it could have a highly dilutive effect on the holdings of existing stockholders.

Unless we are able to maintain revenues, control expenses and achieve positive cash flows, our ability to support our obligations could be impaired and our liquidity could be adversely affected and our solvency and our ability to repay our debts when they come due could be threatened. We may need to seek additional debt or equity financing on acceptable terms in order to improve our liquidity. However, we may not be able to obtain additional debt or equity financing on satisfactory terms, or at all, and any new financing could have a dilutive effect to our existing stockholders.

Disappointing quarterly revenue or operating results could cause the price of our common stock to fall.

Our quarterly revenue and operating results are difficult to predict and may fluctuate significantly from quarter to quarter. If our quarterly revenue or operating results fall below the expectations of investors or securities analysts, the price of our common stock could fall substantially.

Our common stock is particularly subject to volatility because of the industry in which we operate.

The market prices of securities of direct selling companies have been extremely volatile, and have experienced fluctuations that have often been unrelated or disproportionate to the operating performance of such companies. These broad market fluctuations could adversely affect the market price of our common stock.

Our common stock continues to experience wide fluctuations in trading volumes and prices. This may make it more difficult for holders of our common stock to sell shares when they want and at prices they find attractive.

The public market for our common stock has historically been very volatile experiencing wide fluctuations in trading volumes and prices. There are a number of factors that may contribute to this volatility, including the following:

- active participation of speculative traders in our stock (including short sellers);
- market rumors regarding our business operations;

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- government scrutiny of our business;
- adverse publicity related to our business or industry; and
- fluctuations in our operating results.

This market volatility for our stock may make it more difficult for holders of our stock to sell shares when they want and at prices they find attractive. There can be no assurance that a larger or more liquid market will be developed or maintained for our common stock.

Future sales by us or our existing stockholders could depress the market price of our common stock.

If we or our existing stockholders sell a large number of shares of our common stock, the market price of our common stock could decline significantly. Further, even the perception in the public market that we or our existing stockholders might sell shares of common stock could depress the market price of our common stock.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

We lease 4,900 square feet of office space in Rolling Hills Estates, California for our corporate headquarters with a term expiring in September 2025. In August 2017, we entered into a lease for 2,000 square feet of retail space in Metuchen, New Jersey with a term expiring in November 2022, to help further develop the market for our products in North America. Similarly, we lease 2,400 and 1,600 square feet of retail space in Monterey Park, California and Richmond, British Columbia, respectively. The Monterey Park and Richmond locations have terms expiring in August 2020 and February 2021, respectively. We also maintain an office in Dallas, Texas.

Outside of North America, in February 2017, we entered into a lease for 9,000 square feet of office and retail space in Peru with a term expiring in July 2018. In November 2017, we renewed our lease for 7,300 square feet of office space in Hong Kong with a term expiring in February 2021, nine branch offices throughout China, and additional office space in Japan, Taiwan, South Korea, Singapore, Malaysia, Vietnam and the Cayman Islands. We also lease a multi-purpose facility and factory in Zhongshan, China and 11 service stations throughout the city of Guangzhou, China that serve or will in the future serve the needs of our Chinese consumers. We contract with third parties for fulfillment and distribution operations in all of our international markets. We believe that our existing office space is in good condition, and is suitable and adequate for the conduct of our business.

Item 3. LEGAL PROCEEDINGS

Securities Class Action

In January 2016, two putative securities class action complaints were filed against us and our top executives in the United States District Court for the Central District of California. On March 29, 2016, the Court consolidated these actions under the caption *Ford v. Natural Health Trends Corp.*, Case No. 2:16-cv-00255-TJH-AFMx, appointed two Lead Plaintiffs, Mahn Dao and Juan Wang, and appointed the Rosen Law Firm and Levi & Korsinsky LLP as co-Lead Counsel for the purported class. Plaintiffs filed a consolidated complaint on April 29, 2016. The consolidated complaint purports to assert claims on behalf of all persons who purchased or otherwise acquired our common stock between March 6, 2015 and March 15, 2016 under (i) Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder against Natural Health Trends Corp., and Chris T. Sharng, Timothy S. Davidson and George K. Broady (together, the “Individual Defendants”), and (ii) Section 20(a) of the Securities Exchange Act of 1934 against the Individual Defendants. The consolidated complaint alleges, among other things, that we have been running an allegedly illegal multilevel marketing business in China and that we have made materially false and misleading statements regarding the legality of our business operations in China. The consolidated complaint seeks an indeterminate amount of damages, plus interest and costs. On June 15, 2016, we filed a motion to dismiss the consolidated complaint, which was denied on December 5, 2016. On February 17, 2017, we filed an answer to the consolidated complaint. On July 10, 2017, the Court entered a stipulation between the parties, postponing all deadlines and staying the case to allow the parties to engage in settlement discussions. On July 17, 2017, the parties reached an agreement in principle to settle the action. The proposed class-wide settlement of $1.75 million was submitted to the Court on October 3, 2017. The Court entered an order preliminarily approving the settlement on November 17, 2017, which was amended on January 4, 2018. Plaintiffs have provided notice to the settlement class in accordance with the amended order, and a final approval hearing is currently set for April 2, 2018. If approved, the proposed settlement will be fully funded by our insurers. Defendants continue to believe that these claims are without merit and intend to vigorously defend against them if a settlement is not finalized and approved by the Court.

Shareholder Derivative Claims

In February 2016, a purported shareholder derivative complaint was filed in the Superior Court of the State of California, County of Los Angeles: *Zhou v. Sharng*. In March 2016, a purported shareholder derivative complaint was filed in the United States District Court for the Central District of California: *Kleinfeldt v. Sharng* (collectively the “Derivative Complaints”). The Derivative Complaints purport to assert claims for breach of fiduciary duties, unjust enrichment, abuse of control, gross mismanagement and corporate waste against certain of our officers and directors. The Derivative Complaints also purport to assert fiduciary duty claims based on alleged insider selling and conspiring to enter into several stock repurchase agreements, which allegedly harmed us and our assets. The Derivative Complaints allege, among other things, that we have been running an allegedly illegal multilevel marketing business in China, that we have made materially false and misleading statements regarding the legality of our business operations in China, and that certain officers and directors sold common stock on the basis of this allegedly material, adverse non-public information. The Derivative Complaints seek an indeterminate amount of damages, plus interest and costs, as well as various equitable remedies. On February 1, 2017, pursuant to a stipulation among the parties, the Los Angeles Superior Court entered a stay of the *Zhou* action pending conclusion of the related federal class action in the United States District Court for the Central District of California: *Ford v. Natural Health Trends Corp.* A nearly identical stipulated stay was entered in the *Kleinfeldt* case on February 28, 2017. On November 10, 2017, the parties to both the *Zhou* and *Kleinfeldt* actions entered into a Memorandum of Understanding (“MOU”) to resolve both actions, subject to the negotiation of a written settlement agreement and approval by the federal court in the *Kleinfeldt* matter. On November 15, 2017, the parties filed a joint status report and stipulation in the *Zhou* matter, alerting the court to the MOU and seeking to maintain the stay pending finalization and court approval of the parties’ tentative settlement. The *Zhou* court entered an order continuing the stay on November 17, 2017. On March 9, 2018, the parties filed a

Stipulation of Settlement and supporting papers in the *Kleinfeldt* action. On March 22, 2018, plaintiffs filed a motion for preliminary approval of the tentative settlement. The settlement is subject to both preliminary and final approval by the court. If approved, the proposed settlement will require certain corporate governance reforms and permit an award of up to $250,000 in attorneys' fees to plaintiffs' counsel, all of which will be fully funded by our insurers. Defendants continue to believe that these claims are without merit and intend to vigorously defend against them if the derivative settlement is not finalized and approved.

The consolidated class action (if the settlement is not approved by the Court) and the Derivative Complaints (if the tentative settlement is not finalized or approved), or other actions alleging similar facts, could result in monetary or other penalties that may materially affect our operating results and financial condition.

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Item 4. MINE SAFETY DISCLOSURES
Not applicable.

Part II
Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES
Market Information
Our common stock is currently traded on the NASDAQ Capital Market ("Nasdaq") under the symbol "NHTC." The following table sets forth the range of the high and low bid quotations of our common stock as reported by Nasdaq. The bid quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	2017		2016	
	High	Low	High	Low
First quarter	$29.66	$24.45	$36.19	$17.75
Second quarter	29.76	27.78	38.25	26.24
Third quarter	28.98	18.55	34.30	25.89
Fourth quarter	24.93	15.19	29.95	21.44

On March 21, 2018, the closing price of our common stock as reported by Nasdaq was $19.15 per share.

Holders of Record
At March 21, 2018, there were approximately 110 record holders of our common stock (although we believe that the number of beneficial owners of our common stock is substantially greater).

Dividends
The following tables summarize all cash dividend activity during 2017 and 2016 (in thousands, except per share data), all of which dividend payments were made to holders of our common stock:

Declaration Date	Per Share	Amount	Payment Date
October 30, 2017 (special)	$0.15	$1,701	November 24, 2017
October 30, 2017	0.12	1,360	November 24, 2017
July 31, 2017 (special)	0.25	2,833	August 31, 2017
July 31, 2017	0.11	1,246	August 31, 2017
April 24, 2017 (special)	0.35	3,964	May 19, 2017
April 24, 2017	0.10	1,133	May 19, 2017
January 24, 2017 (special)	0.35	3,962	March 3, 2017
January 24, 2017	0.09	1,019	March 3, 2017
	$1.52	$17,218	

Declaration Date	Per Share	Amount	Payment Date
October 23, 2016 (special)	$0.35	$3,941	November 25, 2016
October 23, 2016	0.08	901	November 25, 2016
July 19, 2016	0.07	787	August 26, 2016
April 21, 2016	0.06	686	May 20, 2016
March 1, 2016	0.05	576	March 24, 2016
Total	$0.61	$6,891	

Additionally, on February 6, 2018, the Board of Directors declared a cash dividend of $0.13 on each share of common stock outstanding. Such dividends were paid on March 9, 2018 to stockholders of record on February 27, 2018.
Declaration and payment of any future dividends on shares of common stock will be at the discretion of our Board of

Directors.

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Stock Performance Graph

Set forth below is a line graph and table comparing the performance of our common stock to the S&P 500 Index and to a market-weighted index of publicly traded peers from the period from December 31, 2012 through December 31, 2017. The graph assumes $100 was invested in our common stock, the S&P 500 Index and the index of publicly traded peers on December 31, 2012 and that all dividends were reinvested. The publicly traded companies in the peer group consist of Nature’s Sunshine Products, Nu Skin Enterprises Inc., USANA Health Sciences Inc., and Herbalife Ltd. The graph represents past performance and should not be considered to be an indication of future performance.

Period	NHTC	S&P 500	Peer Group
December 31, 2012	$ 100	$ 100	$ 100
December 31, 2013	317	132	302
December 31, 2014	1,137	151	182
December 31, 2015	3,342	153	226
December 31, 2016	2,538	171	219
December 31, 2017	1,707	208	302

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Item 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data, which have been derived from our audited consolidated financial statements, are not necessarily indicative of the results of future operations and should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations", and the consolidated financial statements and accompanying notes included elsewhere in this Annual Report on Form 10-K (in thousands, except per share data).

	Year Ended December 31				
	2017	2016	2015	2014	2013
Consolidated Statements of Operations Data:					
Net sales	$197,563	$287,728	$264,860	$124,590	$52,527
Cost of sales	38,645	54,903	54,098	26,981	12,551
Gross profit	158,918	232,825	210,762	97,609	39,976
Operating expenses:					
Commissions expense	83,638	125,050	126,598	56,997	24,053
Selling, general and administrative expenses	31,685	43,245	36,024	19,687	11,634
Depreciation and amortization	536	394	263	105	66
Total operating expenses	115,859	168,689	162,885	76,789	35,753
Income from operations	43,059	64,136	47,877	20,820	4,223
Other income (expense), net	367	(59)	(84)	(184)	(32)
Income before income taxes	43,426	64,077	47,793	20,636	4,191
Income tax provision	19,848	8,991	552	266	102
Net income	23,578	55,086	47,241	20,370	4,089
Preferred stock dividends	—	—	—	(10)	(15)
Net income available to common stockholders	$23,578	$55,086	$47,241	$20,360	$4,074
Net income per common share:					
Basic	$2.10	$4.84	$3.84	$1.67	$0.36
Diluted	$2.09	$4.83	$3.82	$1.61	$0.36
Weighted-average number of common shares outstanding:					
Basic	11,251	11,382	12,302	12,131	11,154
Diluted	11,267	11,407	12,372	12,600	11,331
Cash dividends declared per common share	$1.52	$0.61	$0.14	$0.03	$—
Consolidated Balance Sheets Data:					
Cash and cash equivalents	$135,311	$125,921	$104,914	$44,816	$14,550
Inventories	8,398	11,257	10,455	3,760	1,828
Working capital	109,322	84,090	56,199	25,253	3,598
Long-term incentive	7,904	8,190	5,770	1,665	—
Non-current income taxes payable	19,052	—	—	—	—
Total assets	159,554	148,051	124,152	52,540	19,827
Total stockholders' equity	90,621	82,439	56,809	26,450	6,077
Consolidated Statements of Cash Flows Data:					
Net cash provided by (used in):					
Operating activities	$26,605	$53,174	$81,326	$30,613	$10,686
Investing activities	(278)	(905)	(3,738)	(339)	(292)
Financing activities	(17,218)	(30,595)	(17,471)	(189)	(52)
Income taxes paid, net of refunds	6,772	8,791	707	60	71

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Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Business Overview

We are an international direct-selling and e-commerce company. Subsidiaries controlled by us sell personal care, wellness, and "quality of life" products under the "NHT Global" brand. Our wholly-owned subsidiaries have an active physical presence in the following markets: the Americas, which consists of the United States, Canada, Cayman Islands, Mexico and Peru; Greater China, which consists of Hong Kong, Taiwan and China; Southeast Asia, which consists of Singapore, Malaysia and Vietnam; South Korea; Japan; and Europe. We also operate in Russia and Kazakhstan through our engagement with a local service provider. See Note 10 of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data" of this report for further information about our net sales by geographic area.

As of December 31, 2017, we were conducting business through 95,670 active members, compared to 118,960 in 2016 and 109,360 in 2015. We consider a member "active" if they have placed at least one product order with us during the preceding year. Our priority is to focus our resources in our most promising markets, which we consider to be Greater China and countries where our existing members have the connections to recruit prospects and sell our products, such as Southeast Asia and Europe. We also invested some resources in Mexico and Peru during 2017.

We generate approximately 97% of our net sales from subsidiaries located outside the Americas, with sales of our Hong Kong subsidiary representing 89% of net sales in the latest fiscal year. Because of the size of our foreign operations, operating results can be impacted negatively or positively by factors such as foreign currency fluctuations, and economic, political and business conditions around the world. In addition, our business is subject to various laws and regulations, in particular, regulations related to direct selling activities that create uncertain risks for our business, including improper claims or activities by our members and potential inability to obtain necessary product registrations. For further information regarding some of the risks associated with the conduct of our business in China, see "Item 1A. Risk Factors," and more specifically under the captions "Risk Factors - Because our Hong Kong operations account for a substantial portion of our overall business..." and "Risk Factors - Our operations in China are subject to compliance with a myriad of applicable laws and regulations...".

China has been and continues to be our most important business development project. We operate an e-commerce direct selling model in Hong Kong that generates revenue derived from the sale of products to members in Hong Kong and elsewhere, including China. Substantially all of our Hong Kong revenues are derived from the sale of products that are delivered to members in China. Through a separate Chinese entity, we operate an e-commerce retail platform in China. We believe that neither of these activities require a direct selling license in China, which we do not currently hold. We have previously sought to obtain a direct selling license, and in August 2015 initiated the process for submitting a new preliminary application for a direct selling license in China. If we are able to obtain a direct selling license in China, we believe that the incentives inherent in the direct selling model in China would incrementally benefit our existing business. We do not expect that any increased sales in China derived from obtaining a direct selling license would initially be material and, in any event may be partially offset by the higher fixed costs associated with the establishment and maintenance of required service centers, branch offices, manufacturing facilities, certification programs and other legal requirements. We are unable to predict whether and when we will be successful in obtaining a direct selling license to operate in China, and if we are successful, when we will be permitted to conduct direct selling operations and whether such operations would be profitable.

Income Statement Presentation

We mainly derive revenue from sales of products. Substantially all of our product sales are to independent members at published wholesale prices. Product sales are recorded when the products are shipped and title passes to independent members, which generally is upon our delivery to the carrier that completes delivery to the members. We estimate and accrue a reserve for product returns based on our return policies and historical experience. Enrollment package revenue, including any nonrefundable set-up fees, is deferred and recognized over the term of the arrangement, generally twelve months. We bill members for shipping charges and recognize the freight revenue in net sales. Event and training revenue is deferred and recognized as the event or training occurs.

Cost of sales consists primarily of products purchased from third-party manufacturers, freight cost for transporting products to our foreign subsidiaries and shipping products to members, import duties, packing materials, product royalties, costs of promotional materials sold to our members at or near cost, and provisions for slow moving or obsolete inventories. Cost of sales also includes purchasing costs, receiving costs, inspection costs and warehousing costs.

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Member commissions are our most significant expense and are classified as an operating expense. Under our compensation plan, members are paid weekly commissions by our subsidiary in which they are enrolled, generally in their home country currency, for product purchases by their down-line member network across all geographic markets. Our China subsidiary maintains an e-commerce retail platform and does not pay commissions. This "seamless" compensation plan enables a member located in one country to enroll other members located in other countries where we are authorized to conduct our business. Currently, there are basically two ways in which our members can earn income:

- through commissions paid on the accumulated bonus volume from product purchases made by their down-line members and customers; and
- through retail profits on sales of products purchased by members at wholesale prices and resold at retail prices (in some markets, sales are for personal consumption only and income may not be earned through retail profits).

Each of our products is designated a specified number of bonus volume points. Commissions are based on total personal and group bonus volume points per weekly sales period. Bonus volume points are essentially a percentage of a product's wholesale price. As the member's business expands from successfully enrolling other members who in turn expand their own businesses by selling product to other members, the member receives higher commissions from purchases made by an expanding down-line network. In some of our markets, to be eligible to receive commissions, a member may be required to make nominal monthly or other periodic purchases of our products. Certain of our subsidiaries do not require these nominal purchases for a member to be eligible to receive commissions. In determining commissions, the number of levels of down-line members included within the member's commissionable group increases as the number of memberships directly below the member increases.

Under our current compensation plan, certain of our commission payouts may be limited to a hard cap dollar amount per week or a specific percentage of total product sales. In some markets, commissions may be further limited. In some markets, we also pay certain bonuses on purchases by up to three generations of personally enrolled members, as well as bonuses on commissions earned by up to three generations of personally enrolled members. Members can also earn additional income, trips and other prizes in specific time-limited promotions and contests we hold from time to time. Member commissions are dependent on the sales mix and, for each of fiscal 2017, 2016 and 2015 represented 42%, 44% and 48%, respectively, of net sales. Occasionally, we make modifications and enhancements to our compensation plan to help motivate members, which can have an impact on member commissions. We may also enter into performance-based agreements for business or market development, which can result in additional compensation to specific members.

Selling, general and administrative expenses consist of administrative compensation and benefits, travel, credit card fees and assessments, professional fees, certain occupancy costs, and other corporate administrative expenses (including stock-based compensation). In addition, this category includes selling, marketing, and promotion expenses (including the costs of member training events and conventions that are designed to increase both product awareness and member recruitment). Because our various member conventions are not always held at the same time each year, interim period comparisons will be impacted accordingly.

The functional currency of our international subsidiaries is generally their local currency. Local currency assets and liabilities are translated at the rates of exchange on the balance sheet date, and local currency revenues and expenses are translated at average rates of exchange during the period. Equity accounts are translated at historical rates. The resulting translation adjustments are recorded directly into accumulated other comprehensive income.

Sales by our foreign subsidiaries are generally transacted in the respective local currencies and are translated into U.S. dollars using average rates of exchange for each monthly accounting period to which they relate. Most of our product purchases from third-party manufacturers are transacted in U.S. dollars. Consequently, our sales and net earnings are affected by changes in currency exchange rates, with sales and earnings generally increasing with a weakening U.S. dollar and decreasing with a strengthening U.S. dollar, see “Item 7A. Quantitative and Qualitative Disclosures About Market Risk” and more specifically under the caption “Foreign Currency Exchange Risk” for further information.

Results of Operations

The following table sets forth our operating results as a percentage of net sales for the periods indicated:

	Year Ended December 31,		
	2017	2016	2015
Net sales	100.0%	100.0%	100.0%
Cost of sales	19.6	19.1	20.4
Gross profit	80.4	80.9	79.6
Operating expenses:			
Commissions expense	42.3	43.5	47.8
Selling, general and administrative expenses	16.0	15.0	13.6
Depreciation and amortization	0.3	0.1	0.1
Total operating expenses	58.6	58.6	61.5
Income from operations	21.8	22.3	18.1
Other income (expense), net	0.2	—	—
Income before income taxes	22.0	22.3	18.1
Income tax provision	10.0	3.1	0.2
Net income	12.0 %	19.2 %	17.9 %

The following table sets forth revenue by market for the periods indicated (in thousands):

	Year Ended December 31,					
	2017		2016		2015	
Americas[1]	$5,794	2.9 %	$5,909	2.0 %	$5,992	2.3 %
Hong Kong[2]	174,926	88.5	263,482	91.6	245,737	92.8
China	7,282	3.7	9,086	3.2	4,425	1.7
Taiwan	5,591	2.8	6,213	2.2	5,965	2.3
South Korea	466	0.2	691	0.2	1,128	0.4
Japan	129	0.1	86	—	92	—
Singapore	184	0.1	169	0.1	—	—
Russia, Kazakhstan and Ukraine[3]	913	0.5	858	0.3	1,139	0.4
Europe	2,278	1.2	1,234	0.4	382	0.1
Total	$197,563	100.0%	$287,728	100.0%	$264,860	100.0%

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[1] *United States, Canada, Mexico and Peru.*

[2] *Substantially all of our Hong Kong revenues are derived from the sale of products that are delivered to members in China. See "Item 1A. Risk Factors".*

[3] *We discontinued our Ukraine operations during the second quarter of 2015.*

Financial Results of 2017 Compared to 2016

Net Sales

Net sales were $197.6 million for the year ended December 31, 2017 compared with $287.7 million a year ago, a decrease of $90.1 million, or 31%. Hong Kong net sales, substantially all of which were shipped to members residing in China, decreased $88.6 million, or 34%, over the prior year. The sales decrease was primarily attributable to the slowdown we have been experiencing in our Asian markets since the third quarter of 2016. We believe much of this decrease could be traced to factors beyond our control, including the G20 Summit, the 20th Anniversary of Hong Kong's handover and the 19th National Congress of the Communist Party of China, which impaired our members' ability to conduct business and impacted the operations of our logistics partners. In addition, Hong Kong experienced a decrease of 26,400 active members, or 24%, during 2017, which contributed to the decrease in product sales volume.

Outside of our Hong Kong business, net sales decreased $1.6 million, or 7%, compared with the prior year, driven by a 20% decrease in our China e-commerce business and offset by an 85% increase in Europe. The $1.8 million net sales decrease in our China e-commerce business was primarily driven by decreased sales in our *Home* product line. The $1.0 million net sales increase in Europe was primarily driven by our *Wellness* product line.

As of December 31, 2017, deferred revenue was $4.5 million, which primarily consisted of $2.4 million in unshipped product orders, and $1.7 million and $379,000 pertaining to auto ship advances and unamortized enrollment package revenue, respectively.

Gross Profit

Gross profit was 80.4% of net sales for the year ended December 31, 2017 compared with 80.9% of net sales for the year ended December 31, 2016. The gross profit margin percentage decrease is primarily due to lower event revenue, offset by lower logistics costs.

Commissions

Commissions were 42.3% of net sales for the year ended December 31, 2017 compared with 43.5% of net sales for the year ended December 31, 2016. The decrease as a percentage of net sales was primarily due to less cost incurred for our third quarter incentive trip than expected and recognized during the qualification period in 2016. Excluding this benefit, commissions as a percentage of net sales for 2017 would have been relatively consistent with 2016.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $31.7 million for the year ended December 31, 2017 compared with $43.2 million for the year ended December 31, 2016. Selling, general and administrative expenses decreased by $11.6 million, or 27%, mainly due to a decrease in employee-related expenses, event costs, member training costs, and a decrease in credit card fees and assessments due to lower net sales, offset by an increase in professional fees, as compared to the year ended December 31, 2016.

Income Taxes

An income tax provision of $19.8 million was recognized for the year ended December 31, 2017 compared with $9.0 million for the year ended December 31, 2016. The increase is due to the enactment of the Tax Cuts and Jobs Act (the “Tax Act”) on December 22, 2017 by the U.S. government which is effective for taxable years beginning on or after January 1, 2018. Two major provisions of the Tax Act, however, increased our effective tax rate for the year ended December 31, 2017. The first of such provisions reduces the maximum U.S. federal corporate income tax rate from 35% to 21% effective January 1, 2018 (reducing the value of our net deferred tax asset by $1.0 million), and the second of which requires a one-time repatriation tax on certain un-repatriated earnings of foreign subsidiaries at a rate of 15.5% tax on post-1986 foreign earnings held in cash and an 8% rate on all other post-1986 earnings (resulting in a 2017 tax liability of $20.7 million). As a result of the repatriation tax, we reversed our deferred tax liability previously established for undistributed foreign earnings resulting in a tax benefit of $3.7 million, which partially offset the effect on tax expense of the repatriation tax.

Financial Results of 2016 Compared to 2015

Net Sales

Net sales were $287.7 million for the year ended December 31, 2016 compared with $264.9 million a year ago, an increase of $22.8 million, or 9%. Hong Kong net sales, substantially all of which were shipped to members residing in China, increased $17.7 million, or 7%, over the prior year. Hong Kong experienced an increase of 7,800 active members, or 8%, during 2016, which contributed to the increase in product sales volume. We also launched new *Wellness* products during 2016, which contributed approximately $11.2 million to our top-line growth. However, we believe our net sales increase was adversely impacted by the following:

- A primary factor was the special measures the Chinese government implemented in preparation of the G20 Summit in Hangzhou, one of our top markets, in which they relocated city residents, emptied entire districts, blocked urban traffic and shut down businesses in July, August and early September 2016.

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- Also, we did not offer a comparable incentive trip promotion in 2016 as the 2015 supplemental incentive trip promotion to the U.S., which proved to be appealing and contributed to increased sales in 2015.

- Finally, the devaluation of the Chinese yuan, which depreciated 7% against the Hong Kong dollar during 2016, indirectly affected our financial results by increasing the product pricing in the currency of our Chinese members.

Outside of our Hong Kong business, net sales increased $5.1 million, or 27%, compared with the prior year, driven by a 105% increase in our China e-commerce business and a 223% increase in Europe, offset by the performance of South Korea, which decreased 39% and our Commonwealth of Independent States ("CIS") market, which decreased 25%. The $4.7 million net sales increase in our China e-commerce business was primarily driven by increased sales in our *Home* product line, which was introduced during the fourth quarter of 2015. The $852,000 net sales increase in Europe was primarily driven by our *Wellness* product line.

As of December 31, 2016, deferred revenue was $4.9 million, which primarily consisted of $2.2 million in unshipped product orders, and $2.3 million and $430,000 pertaining to auto ship advances and unamortized enrollment package revenue, respectively.

Gross Profit

Gross profit was 80.9% of net sales for the year ended December 31, 2016 compared with 79.6% of net sales for the year ended December 31, 2015. The gross profit margin percentage increase is due to higher event and training revenue, higher product margins and lower logistics costs.

Commissions

Commissions were 43.5% of net sales for the year ended December 31, 2016 compared with 47.8% of net sales for the year ended December 31, 2015. The decrease as a percentage of net sales resulted primarily from the reduction in our on-going cash and other incentive programs which cost 3.0% of net sales for the year ended December 31, 2016 compared with 6.4% of net sales for the year ended December 31, 2015.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $43.2 million for the year ended December 31, 2016 compared with $36.0 million for the year ended December 31, 2015. Selling, general and administrative expenses increased by $7.2 million, or 20%, mainly due to an increase in event costs, member training costs, professional fees, and an increase in credit card fees and assessments due to higher net sales, offset by a decrease in our employee-related expenses, as compared to the year ended December 31, 2015.

Income Taxes

An income tax provision of $9.0 million was recognized for the year ended December 31, 2016 compared with $552,000 for the year ended December 31, 2015. The increase is due to greater profitability of our international operations, as well as the repatriation of foreign earnings back to the U.S. during the year. As a result of capital return activities approved by the Board of Directors during the first quarter of 2016 and anticipated future capital return activities, we then determined that a portion of our undistributed foreign earnings were no longer deemed reinvested indefinitely by our non-U.S. subsidiaries. We repatriated $19.8 million to the U.S. during the three months ended March 31, 2016, part of which was offset by U.S. net operating losses. Accordingly, the deferred tax liability previously established for undistributed foreign earnings up to existing U.S. net operating losses was reduced. The excess amount repatriated during the year ended December 31, 2016 was generated from current foreign earnings. In addition, during the three months ended December 31, 2016, we released our remaining valuation allowance against U.S. deferred tax assets as it was determined that it is more likely than not that we will realize the tax benefits of our deferred assets in future periods.

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Liquidity and Capital Resources

At December 31, 2017, our cash and cash equivalents totaled $135.3 million, of which $134.2 million is held in bank accounts overseas. Total cash and cash equivalents increased by $9.4 million and $21.0 million during 2017 and 2016, respectively. We consider all highly liquid investments with original maturities of three months or less, when purchased, to be cash equivalents. As of December 31, 2017, we had $73.6 million in available-for-sale investments classified as cash equivalents. In addition, cash and cash equivalents included $8.7 million held in banks located in China subject to foreign currency controls.

At December 31, 2017, the ratio of current assets to current liabilities was 3.61 to 1.00 and we had $109.3 million of working capital. Working capital as of December 31, 2017 increased $25.2 million compared to our working capital as of December 31, 2016, primarily due to our proactive expense management efforts designed to better align our cost structure with the challenging environment that we encountered during 2017.

Cash provided by operations during 2017 was $26.6 million compared to $53.2 million during 2016. The decrease in operating cash flows resulted primarily from the decrease in product orders and the impact of our members' increasing utilization of our eWallet functionality, offset by a reduction in inventories and inventory-related deposits during 2017.

Cash flows used in investing activities totaled $278,000 during 2017 and consisted primarily of capitalizable software development costs and buildout costs for our expansion into Peru and Vietnam. Cash flows used in investing activities totaled $905,000 during the year ended December 31, 2016 and consisted primarily of capitalized software development costs of $666,800 for our Oracle ERP upgrade and enhancement of our back office software platform.

Cash flows used in financing activities during 2017 consisted solely of the following cash dividend payments (in thousands, except per share amounts) to holders of our common stock:

Declaration Date	Per Share	Amount	Record Date	Payment Date
October 30, 2017 (special)	$ 0.15	$ 1,701	November 14, 2017	November 24, 2017
October 30, 2017	0.12	1,360	November 14, 2017	November 24, 2017
July 31, 2017 (special)	0.25	2,833	August 21, 2017	August 31, 2017
July 31, 2017	0.11	1,246	August 21, 2017	August 31, 2017
April 24, 2017 (special)	0.35	3,964	May 9, 2017	May 19, 2017
April 24, 2017	0.10	1,133	May 9, 2017	May 19, 2017
January 24, 2017 (special)	0.35	3,962	February 21, 2017	March 3, 2017
January 24, 2017	0.09	1,019	February 21, 2017	March 3, 2017
Total	$ 1.52	$ 17,218		

Subsequent to December 31, 2017, on February 6, 2018, the Board of Directors declared a cash dividend of $0.13 on each share of common stock outstanding. Such dividends were paid on March 9, 2018 to stockholders of record on February 27, 2018. Declaration and payment of any future dividends on shares of common stock will be at the discretion of our Board of Directors.

Cash flows used in financing activities during 2016 totaled $30.6 million. We used $23.7 million to repurchase shares of our common stock. On January 12, 2016, the Board of Directors authorized an increase to our stock repurchase program first approved on July 28, 2015 from $15.0 million to $70.0 million. Repurchases are expected to be executed to the extent that our earnings and cash-on-hand allow, and will be made in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Exchange Act. For all or a portion of the authorized repurchase amount, we may enter into one or more plans that are compliant with Rule 10b5-1 of the Exchange Act that are designed to facilitate these purchases. The stock repurchase program does not require us to acquire a specific number of shares, and may be suspended from time to time or discontinued. During February 2016, pursuant to the stock repurchase program, we authorized our broker to proceed with the purchase of shares of our common stock in the open market. During the year ended December 31, 2016, the stock repurchase program resulted in our purchasing a total of 903,031 shares of our common stock for an aggregate purchase price of $23.7 million, plus transaction costs. As of December 31, 2017, $32.0 million of the $70.0 million stock repurchase program approved on July 28, 2015 and increased on January 12, 2016 remained available for future purchases, inclusive of related estimated income tax. No shares were purchased under our stock repurchase program during 2017.

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We believe that our existing internal liquidity, supported by cash on hand and cash flows from operations should be adequate to fund normal business operations and address our financial commitments for the foreseeable future.

We do not have any significant unused sources of liquid assets. If necessary, we may attempt to generate more funding from the capital markets, but currently do not believe that will be necessary.

Our priority is to focus our resources on investing in our most important markets, which we consider to be Greater China and countries where our existing members may have the connections to recruit prospects and sell our products, such as Southeast Asia and Europe. We will continue to invest in our Mainland China entity for such purposes as establishing China-based manufacturing capabilities, increasing public awareness of our brand and our products, sourcing more Chinese-made products, building a chain of service stations, opening additional Healthy Lifestyle Centers or branch offices, adding local staffing and other requirements for a China direct selling license application. We also have invested some resources in Mexico and Peru.

Quarterly Results of Operations (Unaudited)

The following table sets forth unaudited quarterly operating results for each of the last eight fiscal quarters. The information for each of these quarters has been prepared on the same basis as the audited annual financial statements included elsewhere in this annual report and, in the opinion of management, includes all adjustments, which includes only normal recurring adjustments, necessary for the fair statement of the results of operations for these periods. This data should be read in conjunction with our audited consolidated financial statements and related notes included in "Item 8. Financial Statements and Supplementary Data" of this annual report. These quarterly operating results are not necessarily indicative of our operating results for any future period.

	2017				2016			
	4th Quarter[1]	3rd Quarter	2nd Quarter	1st Quarter	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
	(In Thousands, Except Per Share Data)							
Net sales	$46,092	$40,132	$51,465	$59,874	$62,312	$70,679	$80,391	$74,346
Gross profit	36,668	31,949	41,672	48,629	50,375	57,052	65,332	60,066
Income from operations	8,686	8,514	12,867	12,992	20,014	15,208	14,927	13,987
Net income	(4,488)	7,338	10,303	10,425	19,048	12,557	12,201	11,280
Net income per common share:								
Basic	(0.40)	0.65	0.92	0.93	1.70	1.12	1.08	0.96
Diluted	(0.40)	0.65	0.91	0.93	1.70	1.12	1.07	0.95

[1] Reflects the impact of the Tax Cuts and Jobs Act of 2017 enacted in December 2017.

Contractual Obligations

The following table summarizes our contractual obligations as of December 31, 2017 and the expected effect on our cash flow and liquidity in future periods (in thousands):

	Total	2018	2019-2020	2021-2022	Thereafter
Operating leases	$4,690	$1,586	$ 2,009	$ 582	$ 513
Purchase obligations	6,895	6,895	—	—	—
Long-term incentive compensation	9,742	1,838	1,397	4,338	2,169
Tax Cut & Jobs Act repatriation tax liability	20,708	1,657	3,313	3,313	12,425
Other commitments	250	93	140	17	—
Total	$42,285	$12,069	$ 6,859	$ 8,250	$ 15,107

We have entered into non-cancelable operating lease agreements for locations within the United States and for our international subsidiaries, with expirations through September 2025 totaling $4.7 million.

In May 2013, we entered into an exclusive distribution agreement with one of our suppliers to purchase their product through July 2016 which automatically renews annually unless terminated 90 days prior to the termination date. To maintain exclusivity, we are required to purchase a minimum of $40,000 of product per month until the termination date. As of December 31, 2017, we were in compliance with the exclusivity provision.

We have a supply agreement with one of our suppliers to maintain worldwide exclusivity in return for purchasing a minimum of $6.6 million of product in 2018, plus certain raw material guarantees. If we do not purchase the minimum product as required, then a Cure Payment, as defined, will be due to the supplier. The term of the agreement is one year commencing January 2018 and shall automatically renew for a successive one year term unless notice of termination is provided by either party.

Subsequent to December 31, 2017, we entered into an exclusive distribution, license and royalty agreement with a new supplier to purchase products through January 2021 and shall renew for successive one year terms unless notice of termination is provided by either party. To maintain exclusivity, we are required to purchase between $453,000 and $3.6 million of product, depending on the product mix and inclusive of royalties, per year until the termination date.

In recognition of the achievement of specified performance goals, financial rewards are awarded under our 2014 Long-Term Incentive Plan with cash payments through December 2023. See Note 1 of the Notes to Consolidated Financial Statements in “Item 8. Financial Statements and Supplementary Data” of this report for additional information.

On December 22, 2017, the U.S. Tax Cuts and Jobs Act (the “Tax Act”) was signed into law. The Tax Act significantly revised the U.S. corporate income tax regime by, among other things, lowering the U.S. corporate tax rate from 35% to 21% effective January 1, 2018, implementing a territorial tax system and imposing a one-time repatriation tax on deemed repatriated earnings of foreign subsidiaries. We are subject to this repatriation tax, resulting in a federal income tax liability as of December 31, 2017 in the amount of $20.7 million. An election is available to allow U.S. shareholders to spread the payment of the one-time repatriation tax liability over eight years. Under the election, 8% of the installment payments are due in each of the first five years, 15% in the sixth year, 20% in the seventh year, and the remaining 25% due in the eight year. As a result of the Tax Act adoption of a territorial tax regime, any foreign source portion of a qualified dividend received by a 10% U.S. corporate shareholder is exempt from U.S. tax, therefore resulting in any future repatriation having a minimal effect on our tax liability.

We have evaluated our tax positions and have determined that there are no uncertain tax positions for the current year or years prior.

We have employment agreements with certain members of our management team that can be terminated by either the employee or us upon four weeks’ notice. The employment agreements entered into with the management team contain provisions that guarantee the payments of specified amounts in the event of a change in control, as defined, or if the employee is terminated without cause, as defined, or terminates employment for good reason, as defined.

Critical Accounting Policies and Estimates

A summary of our significant accounting policies is provided in Note 1 of the Notes to Consolidated Financial Statements in “Item 8. Financial Statements and Supplementary Data” of this report. The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. The process of determining significant estimates is fact specific and takes into account historical experience and current and expected economic conditions. To the extent that there are material differences between the estimates and actual results, future results of operations will be affected.

Critical accounting policies and estimates are defined as both those that are material to the portrayal of our financial condition and results of operations and as those that require management's most subjective judgments. Management believes our critical accounting policies and estimates are those related to revenue recognition, as well as those used in the determination of liabilities related to sales returns, member commissions and income taxes.

Revenue Recognition. Product sales are recorded when the products are shipped and title passes to independent members. Product sales to members are made pursuant to a member agreement that provides for transfer of both title and risk of loss upon our delivery to the carrier that completes delivery to the members, which is commonly referred to as "F.O.B. Shipping Point." We primarily receive payment by credit card at the time members place orders. Our sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return. Amounts received for unshipped product are recorded as deferred revenue. Such amounts totaled $2.4 million and $2.2 million at December 31, 2017 and 2016, respectively. Shipping charges billed to members are included in net sales. Costs associated with shipments are included in cost of sales. Event and training revenue is deferred and recognized as the event or training occurs.

Enrollment package revenue, including any nonrefundable set-up fees, is deferred and recognized over the term of the arrangement, generally twelve months. Enrollment packages provide members access to both a personalized marketing website and a business management system. No upfront costs are deferred as the amount is nominal. At December 31, 2017 and 2016, enrollment package revenue totaling $379,000 and $430,000 was deferred, respectively. Although we have no immediate plans to significantly change the terms or conditions of enrollment packages, any changes in the future could result in additional revenue deferrals or could cause us to recognize the deferred revenue over a longer period of time. Additionally, deferred revenue includes advances for auto ship orders. In certain markets, when a member's cumulative commission income reaches a certain threshold, a percentage of the member's weekly commission is held back as an advance and applied to an auto ship order once the accumulated amount of the advances is sufficient to pay for the pre-selected auto ship package of the member. Such advances were $1.7 million and $2.3 million at December 31, 2017 and 2016, respectively.

Allowance for Sales Returns. An allowance for sales returns is provided during the period the product is shipped. The allowance is based upon the return policy of each country, which varies from 14 days to one year, and their historical return rates, which range from 1% to 7% of sales. Sales returns were 2% and 3% of sales for the years ended December 31, 2017 and 2016, respectively. The allowance for sales returns was $614,000 and $1.6 million at December 31, 2017 and 2016, respectively. No material changes in estimates have been recognized during the periods presented.

Commissions. Independent members earn commissions based on total personal and group bonus volume points per weekly sales period. Each of our products are designated a specified number of bonus volume points, which is essentially a percentage of the product's wholesale price. We accrue commissions when earned and as the related revenue is recognized and pay commissions on product sales generally two weeks following the end of the weekly sales period.

Independent members may also earn incentives based on meeting certain qualifications during a designated incentive period, which may range from several weeks to up to a year. For each individual incentive, we estimate the total number of qualifiers as well as the expected per qualifier cost and accrue all costs associated with incentives throughout the qualification period. We regularly review and update, if necessary, the estimates of both qualifiers and cost as more information is obtained during the qualification period. Any resulting change in total cost is recognized over the remaining qualification period. Accrued commissions, including the estimated cost of our international recognition incentive program and other supplemental programs, totaled $11.2 million and $13.6 million at December 31, 2017 and 2016, respectively.

Income Taxes. Deferred income taxes are recognized for differences between the financial reporting and tax bases of assets and liabilities at enacted statutory rates for the years in which the temporary differences are expected to be recovered or settled. We evaluate the probability of realizing the future benefits of any of our deferred tax assets and record a valuation allowance when we believe a portion or all of our deferred tax assets may not be realized. Deferred tax expense or benefit is a result of changes in deferred tax assets and liabilities. Based on the technical merits of our tax position, tax benefits may be recognized if we determine it is more likely than not that our position will be sustained on examination by tax authorities. The complex nature of these estimates requires us to anticipate the likely application of tax law and make judgments on the largest benefit that has a greater than fifty percent likelihood of being realized prior to the completion and filing of tax returns for such periods. As of December 31, 2017, we no longer have a valuation allowance against our U.S. deferred tax assets. We maintain a valuation allowance in certain foreign jurisdictions with an overall tax loss. The valuation allowance will be reduced at such time as management believes it is more likely than not that the deferred tax assets will be realized. Any reductions in the valuation allowance will reduce future income tax provision.

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Provision for income taxes depends on the statutory tax rates in each of the jurisdictions in which we operate. As a result of capital return activities, we determined that a portion of our current undistributed foreign earnings are no longer deemed reinvested indefinitely by our non-U.S. subsidiaries. For state income tax purposes, we will continue to periodically reassess the needs of our foreign subsidiaries and update our indefinite reinvestment assertion as necessary. The Tax Cuts and Jobs Act (the "Tax Act"), enacted on December 22, 2017 by the U.S. government requires a one-time repatriation tax on certain un-repatriated earnings of foreign subsidiaries at a rate of 15.5% tax on post-1986 foreign earnings held in cash and an 8% rate on all other post-1986 earnings. Due to the adoption of a territorial tax regime, any foreign source portion of a qualified dividend received by a 10% U.S. corporate shareholder is exempt from U.S. tax, therefore resulting in any future repatriation having a minimal effect on our effective tax rate. To the extent that additional foreign earnings are not deemed permanently reinvested, we expect to recognize additional income tax provision at the applicable U.S. state corporate tax rate(s). As of December 31, 2017, we have accrued tax liabilities for earnings that we plan to repatriate out of accumulated earnings in future periods for state purposes only. All undistributed earnings in excess of 50% of current earnings on an annual basis are intended to be reinvested indefinitely as of December 31, 2017.

We estimate what our effective tax rate will be for the full fiscal year at each interim reporting period and record a quarterly tax provision based on that estimated effective tax rate. Throughout the year that estimated rate may change based on variations in our business, changes in our corporate structure, changes in the geographic mix and amount of income, applicable tax laws and regulations, communications with tax authorities, as well as our estimated and actual level of annual pre-tax income. We adjust our income tax provision in the reporting period in which the change in our estimated rate occurs so that the year-to-date provision is consistent with the anticipated annual tax rate.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

y 10%, 7% and 6%

December 31, 2017 2016

We also

experience indirect exchange rate exposure to the Chinese yuan, due to the concentration of our sales to members residing in China and the impact of fluctuations in the value of the Chinese yuan on their purchasing power.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NATURAL HEALTH TRENDS CORP.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Natural Health Trends Corp.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheet of Natural Health Trends Corp. (the “Company”) as of December 31, 2017, the related consolidated statements of operations, comprehensive income, stockholders’ equity and cash flows for the year then ended, and the related notes (collectively referred to as the “financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 2017, based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 2013 and our report dated March 27, 2018, expressed an adverse opinion on the effectiveness of the Company’s internal control over financial reporting because of the existence of a material weakness.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

/s/ Marcum LLP

Marcum LLP

We have served as the Company’s auditor since 2017.

Chicago, IL
March 27, 2018

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Natural Health Trends Corp.
Rolling Hills Estates, California

We have audited the accompanying consolidated balance sheet of Natural Health Trends Corp. (the “Company”) as of December 31, 2016, and the related consolidated statements of operations, comprehensive income, stockholders’ equity, and cash flows for each of the years in the two-year period ended December 31, 2016. The Company’s management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Natural Health Trends Corp. as of December 31, 2016, and the consolidated results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

/s/ Lane Gorman Trubitt, LLC

Dallas, Texas
March 10, 2017

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NATURAL HEALTH TRENDS CORP.

CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

	December 31, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$135,311	$125,921
Inventories	8,398	11,257
Other current assets	7,534	4,066
Total current assets	151,243	141,244
Property and equipment, net	1,149	1,388
Goodwill	1,764	1,764
Restricted cash	3,167	2,963
Deferred tax asset	1,435	—
Other assets	796	692
Total assets	$159,554	$148,051
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,751	$2,145
Income taxes payable	309	663
Accrued commissions	11,170	13,611
Other accrued expenses	7,605	14,989
Deferred revenue	4,455	4,948
Amounts held in eWallets	15,152	19,165
Other current liabilities	1,479	1,633
Total current liabilities	41,921	57,154
Income taxes payable	19,052	—
Deferred tax liability	56	268
Long-term incentive	7,904	8,190
Total liabilities	68,933	65,612
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; no shares issued and outstanding at December 31, 2017 and 2016	—	—
Common stock, $0.001 par value; 50,000,000 shares authorized; 12,979,414 shares issued at December 31, 2017 and 2016	13	13
Additional paid-in capital	86,683	86,574
Retained earnings	44,908	38,548
Accumulated other comprehensive loss	(413)	(807)
Treasury stock, at cost; 1,637,524 and 1,692,218 shares at December 31, 2017 and 2016, respectively	(40,570)	(41,889)
Total stockholders' equity	90,621	82,439
Total liabilities and stockholders' equity	$159,554	$148,051

See accompanying notes to consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)

	Year Ended December 31,		
	2017	2016	2015
Net sales	$197,563	$287,728	$264,860
Cost of sales	38,645	54,903	54,098
Gross profit	158,918	232,825	210,762
Operating expenses:			
Commissions expense	83,638	125,050	126,598
Selling, general and administrative expenses	31,685	43,245	36,024
Depreciation and amortization	536	394	263
Total operating expenses	115,859	168,689	162,885
Income from operations	43,059	64,136	47,877
Other income (expense), net	367	(59)	(84)
Income before income taxes	43,426	64,077	47,793
Income tax provision	19,848	8,991	552
Net income	$23,578	$55,086	$47,241
Net income per common share:			
Basic	$2.10	$4.84	$3.84
Diluted	$2.09	$4.83	$3.82
Weighted-average number of common shares outstanding:			
Basic	11,251	11,382	12,302
Diluted	11,267	11,407	12,372
Cash dividends declared per common share	$1.52	$0.61	$0.14

See accompanying notes to consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In Thousands)

	Year Ended December 31,		
	2017	2016	2015
Net income	$23,578	$55,086	$47,241
Other comprehensive income (loss), net of tax:			
Foreign currency translation adjustments	677	(838)	(79)
Release of cumulative translation adjustment	(258)	132	(82)
Net change in foreign currency translation adjustment	419	(706)	(161)
Unrealized loss on available-for-sale securities	(25)	—	(2)
Comprehensive income	$23,972	$54,380	$47,078

See accompanying notes to consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS’ EQUITY
(In Thousands, Except Share Data)

	Preferred Stock		Common Stock		Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive (Loss) Income	Treasury Stock		Total
	Shares	Amount	Shares	Amount				Shares	Amount	
BALANCE, December 31, 2014	—	$ —	12,891,317	$ 13	$ 85,750	$ (54,799)	$ 62	(384,220)	$ (4,576)	$ 26,450
Net income	—	—	—	—	—	47,241	—	—	—	47,241
Exercise of warrants	—	—	88,097	—	309	—	—	—	—	309
Repurchase of common stock	—	—	—	—	—	—	—	(547,042)	(16,071)	(16,071)
Common stock issued	—	—	—	—	(182)	(380)	—	91,060	1,228	666
Dividends declared	—	—	—	—	—	(1,709)	—	—	—	(1,709)
Elimination of CTA upon dissolution	—	—	—	—	—	—	(82)	—	—	(82)
Foreign currency translation adjustments	—	—	—	—	—	—	(79)	—	—	(79)
Unrealized loss on available-for-sale securities	—	—	—	—	—	—	(2)	—	—	(2)
Stock-based compensation	—	—	—	—	86	—	—	—	—	86
BALANCE, December 31, 2015	—	—	12,979,414	13	85,963	(9,647)	(101)	(840,202)	(19,419)	56,809
Net income	—	—	—	—	—	55,086	—	—	—	55,086
Repurchase of common stock	—	—	—	—	—	—	—	(903,031)	(23,704)	(23,704)
Common stock issued	—	—	—	—	507	—	—	51,015	1,234	1,741
Dividends declared	—	—	—	—	—	(6,891)	—	—	—	(6,891)
Elimination of CTA upon dissolution	—	—	—	—	—	—	132	—	—	132
Foreign currency translation adjustments	—	—	—	—	—	—	(838)	—	—	(838)
Stock-based compensation	—	—	—	—	104	—	—	—	—	104
BALANCE, December 31, 2016	—	—	12,979,414	13	86,574	38,548	(807)	(1,692,218)	(41,889)	82,439
Net income	—	—	—	—	—	23,578	—	—	—	23,578
Restricted stock forfeiture	—	—	—	—	(5)	—	—	(1,566)	(33)	(38)
Common stock issued	—	—	—	—	79	—	—	56,260	1,352	1,431
Dividends declared	—	—	—	—	—	(17,218)	—	—	—	(17,218)
Elimination of CTA upon dissolution	—	—	—	—	—	—	(258)	—	—	(258)
Foreign currency translation adjustments	—	—	—	—	—	—	677	—	—	677
Unrealized loss on available-for-sale securities	—	—	—	—	—	—	(25)	—	—	(25)
Stock-based compensation	—	—	—	—	35	—	—	—	—	35
BALANCE, December 31, 2017	—	$ —	12,979,414	$ 13	$ 86,683	$ 44,908	$ (413)	(1,637,524)	$ (40,570)	$ 90,621

See accompanying notes to consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Year Ended December 31,		
	2017	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$23,578	$55,086	$47,241
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	536	394	263
Stock-based compensation	35	104	86
Cumulative translation adjustment realized in net income	(258)	132	(82)
Deferred income taxes	(1,644)	217	(15)
Changes in assets and liabilities:			
Inventories	2,843	(851)	(6,762)
Other current assets	(3,399)	(1,681)	(1,025)
Other assets	(61)	(90)	(267)
Accounts payable	(392)	(714)	637
Income taxes payable	18,676	303	(115)
Accrued commissions	(2,417)	(6,031)	10,840
Other accrued expenses	(6,033)	51	10,714
Deferred revenue	(481)	947	1,331
Amounts held in eWallets	(3,875)	2,752	14,350
Other current liabilities	(179)	135	25
Long-term incentive	(324)	2,420	4,105
Net cash provided by operating activities	26,605	53,174	81,326
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(278)	(905)	(710)
Increase in restricted cash	—	—	(3,028)
Net cash used in investing activities	(278)	(905)	(3,738)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from exercise of warrants	—	—	309
Repurchase of common stock	—	(23,704)	(16,071)
Dividends paid	(17,218)	(6,891)	(1,709)
Net cash used in financing activities	(17,218)	(30,595)	(17,471)
Effect of exchange rates on cash and cash equivalents	281	(667)	(19)
Net increase in cash and cash equivalents	9,390	21,007	60,098
CASH AND CASH EQUIVALENTS, beginning of period	125,921	104,914	44,816
CASH AND CASH EQUIVALENTS, end of period	$135,311	$125,921	$104,914
SUPPLEMENTAL CASH FLOW DISCLOSURE:			
Cash paid for income taxes, net	$6,772	$8,791	$707
Issuance of treasury stock for employee awards, net	$1,393	$1,741	$666

See accompanying notes to consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Natural Health Trends Corp., a Delaware corporation (whether or not including its subsidiaries, the "Company"), is an international direct-selling and e-commerce company headquartered in Rolling Hills Estates, California. Subsidiaries controlled by the Company sell personal care, wellness, and "quality of life" products under the "NHT Global" brand.

The Company's wholly-owned subsidiaries have an active physical presence in the following markets: the Americas, which consists of the United States, Canada, Cayman Islands, Mexico and Peru; Greater China, which consists of Hong Kong, Taiwan and China; Southeast Asia, which consists of Singapore, Malaysia and Vietnam; South Korea; Japan; and Europe. The Company also operates in Russia and Kazakhstan through an engagement with a local service provider.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and all of its wholly-owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period.

The most significant accounting estimates inherent in the preparation of the Company's financial statements include estimates associated with revenue recognition, as well as those used in the determination of liabilities related to sales returns, commissions and income taxes. Various assumptions and other factors prompt the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account historical experience and current and expected economic conditions. The actual results may differ materially and adversely from the Company's estimates. To the extent that there are material differences between the estimates and actual results, future results of operations will be affected.

Cash and Cash Equivalents

Cash and cash equivalents include the Company's investments in debt securities, comprising municipal notes, bonds and corporate debt, money market funds and time deposits. The Company considers all highly liquid investments with original maturities of three months or less, when purchased, to be cash equivalents. Debt securities classified as cash equivalents are required to be accounted for in accordance with ASC 320, *Investments - Debt and Equity Securities*. As such, the Company determined its investments in debt securities held at December 31, 2017 should be classified as available-for-sale and are carried at fair value with unrealized gains and losses reported in accumulated other comprehensive loss in stockholders' equity. The cost of debt securities is adjusted for amortization of premiums and discounts to maturity. This amortization is included in other income. Realized gains and losses, as well as interest income, are also included in other income. The fair values of securities are based on quoted market prices.

The Company includes credit card receivables due from certain of its credit card processors in its cash and cash equivalents as the cash proceeds are received within two to five days.

The Company maintains certain cash balances at several institutions located in the United States, Hong Kong and Malaysia which at times may exceed insured limits. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk.

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Restricted Cash

In June 2015, the Company funded a bank deposit account in the amount of CNY 20 million (USD 3.1 million at December 31, 2017) in anticipation of submitting a direct selling license application in China. Such deposit is required by Chinese laws to establish a consumer protection fund.

The Company periodically maintains a cash reserve with certain credit card processing companies to provide for potential uncollectible amounts and chargebacks. Those cash reserves held by credit card processing companies located in South Korea are reflected in noncurrent assets since they require the Company to provide 100% collateral before processing transactions, which must be maintained indefinitely.

Inventories

Inventories are stated at the lower of cost or net realizable value, using the first-in, first-out method. The Company reviews its inventory for obsolescence and any inventory identified as obsolete is reserved or written off. The Company's determination of obsolescence is based on assumptions about the demand for its products, product expiration dates, estimated future sales, and management's future plans.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally three to five years for office equipment, office software and capitalized internal-use software development costs and five to seven years for furniture and fixtures. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life of the assets. Expenditures for maintenance and repairs are charged to expense as incurred.

The Company reviews property and equipment for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of these assets is measured by comparison of its carrying amounts to future undiscounted cash flows the assets are expected to generate. If property and equipment are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair value.

Goodwill

The Company assesses qualitative factors in order to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, through this qualitative assessment, the conclusion is made that it is more likely than not that a reporting unit's fair value is less than its carrying amount, a two-step impairment test is performed. The Company's policy is to test for impairment annually during the fourth quarter. Considerable management judgment is necessary to measure fair value. The Company did not recognize any impairment charges for goodwill during the periods presented.

Income Taxes

The Company recognizes income taxes under the liability method of accounting for income taxes. Deferred income taxes are recognized for differences between the financial reporting and tax bases of assets and liabilities at enacted statutory tax rates in effect for the years in which the temporary differences are expected to be recovered or settled. Deferred tax expense or benefit is a result of changes in deferred tax assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be ultimately realized based on the more likely than not recognition criteria. The Company recognizes tax benefits from uncertain tax positions only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The Company has evaluated its tax positions and determined that there are no uncertain tax positions for the current year or years prior. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate resolution. The Company recognizes interest and penalties related to unrecognized tax benefits as a component of income tax expense. Deferred taxes are not provided for state income tax purposes on the portion of undistributed earnings of subsidiaries outside of the United States when these earnings are considered permanently reinvested.

Amounts Held in eWallets

Commencing in October 2014, the Company requires commission payments of certain members in Hong Kong to be first recorded into an electronic wallet (eWallet) account in lieu of being paid out directly to members. The eWallet functionality allows members to place new product orders utilizing eWallet available balance and/or request commission payout via multiple payment methods. Amounts held in eWallets are reflected on the balance sheet as a current liability.

Long-Term Incentive

Financial rewards earned under the 2014 Long-Term Incentive Plan (the "LTI Plan") are recognized over the performance period as specified performance or other goals are achieved or exceeded. In accordance with the LTI Plan, fifty percent of any cash payment earned is payable in thirty-five equal consecutive monthly installments commencing in February of the calendar year immediately following the conclusion of the performance period and the remaining fifty percent of the payment earned is payable in thirty-five equal consecutive monthly installments commencing in February 2021 and ending in December 2023. As such, certain installments to be paid are reflected on the balance sheet as a non-current liability, and the current portion of the installments is reflected in other accrued expenses.

At the sole discretion of the Compensation Committee of the Company's Board of Directors, distributions under the LTI Plan are made in cash, or alternatively awarded in the form of common stock or other common stock rights having an equivalent cash value under the terms of the Natural Health Trends Corp. 2016 Equity Incentive Plan. A determination of the form of distribution, if any, is made by the Compensation Committee subsequent to the end of each calendar year. As such, amounts earned are considered non-equity awards. See Note 6 for grant information of distributions settled in common stock.

Foreign Currency

The functional currency of the Company's international subsidiaries is generally their local currency. Local currency assets and liabilities are translated at the rates of exchange on the balance sheet date, and local currency revenues and expenses are translated at average rates of exchange during the period. Equity accounts are translated at historical rates. The resulting translation adjustments are recorded directly into accumulated other comprehensive income.

Aggregate transaction gains or losses, including gains or losses related to foreign-denominated cash and cash equivalents and the re-measurement of certain inter-company balances, are included in the statement of operations as other income and expense. Loss on foreign exchange totaling $451,000, $333,000 and $204,000 was recognized during 2017, 2016 and 2015, respectively.

Revenue Recognition

Product sales are recorded when the products are shipped and title passes to independent members. Product sales to members are made pursuant to a member agreement that provides for transfer of both title and risk of loss upon the Company's delivery to the carrier that completes delivery to the members, which is commonly referred to as "F.O.B. Shipping Point." The Company primarily receives payment by credit card at the time members place orders. Amounts received for unshipped product are recorded as deferred revenue. The Company's sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return.

Actual product returns are recorded as a reduction to net sales. The Company estimates and accrues a reserve for product returns based on its return policies and historical experience.

Enrollment package revenue, including any nonrefundable set-up fees, is deferred and recognized over the term of the arrangement, generally twelve months. Enrollment packages provide members access to both a personalized marketing website and a business management system. No upfront costs are deferred as the amount is nominal.

Shipping charges billed to members are included in net sales. Costs associated with shipments are included in cost of sales. Event and training revenue is deferred and recognized as the event or training occurs. Costs of events and member training are included within selling, general and administrative expenses.

Various taxes on the sale of products and enrollment packages to members are collected by the Company as an agent and remitted to the respective taxing authority. These taxes are presented on a net basis and recorded as a liability until remitted to the respective taxing authority.

Commissions

Independent members earn commissions based on total personal and group bonus volume points per weekly sales period. Each of the Company's products are designated a specified number of bonus volume points, which is essentially a percentage of the product's wholesale price. The Company accrues commissions when earned and pays commissions on product sales generally two weeks following the end of the weekly sales period.

In some markets, the Company also pays certain bonuses on purchases by up to three generations of personally enrolled members, as well as bonuses on commissions earned by up to three generations of personally enrolled members. Independent members may also earn incentives based on meeting certain qualifications during a designated incentive period, which may range from several weeks to up to a year. The Company estimates and accrues all costs associated with the incentives as the members meet the qualification requirements.

From time to time the Company makes modifications and enhancements to the Company's compensation plan to help motivate members, which can have an impact on member commissions. The Company also enters into performance-based agreements for business or market development, which may result in additional compensation to specific members.

Operating Leases

The Company leases its physical properties under operating leases. Certain lease agreements include rent holidays and incentives. The Company recognizes rent holiday periods on a straight-line basis over the lease term beginning when the Company has the right to the leased space.

Stock-Based Compensation

Stock-based compensation expense is determined based on the grant date fair value of each award, net of estimated forfeitures which are derived from historical experience, and is recognized on a straight-line basis over the requisite service period for the award.

Net Income Per Common Share

Diluted net income per common share is determined using the weighted-average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents. The dilutive effect of non-vested restricted stock and warrants is reflected by application of the treasury stock method. Under the treasury stock method, the amount of compensation cost for future service that the Company has not yet recognized and the amount of tax benefit that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares.

Certain Risks and Concentrations

A substantial portion of the Company's sales are generated in Hong Kong (see Note 10). Substantially all of the Company's Hong Kong revenues are derived from the sale of products that are delivered to members in China. In contrast to the Company's operations in other parts of the world, the Company has not implemented a direct sales model in China. The Chinese government permits direct selling only by organizations that have a license, which the Company has applied for, and has also adopted anti-multilevel marketing legislation. The Company operates an e-commerce direct selling model in Hong Kong and recognizes the revenue derived from sales to both Hong Kong and Chinese members as being generated in Hong Kong. Products purchased by members in China are delivered to third parties that act as the importers of record under agreements to pay applicable duties. In addition, through a

Chinese entity, the Company sells products in China using an e-commerce retail model. The Chinese entity operates separately from the Hong Kong entity, and a Chinese member may elect to participate separately or in both.

The Company believes that its e-commerce direct selling model in Hong Kong does not violate any applicable laws in China, even though it is used for the internet purchase of the Company’s products by members in China. The Company also believes that its Chinese entity, including its e-commerce retail platform, is operating in compliance with applicable Chinese laws. However, there can be no assurance that the Chinese authorities will agree with the Company’s interpretations of applicable laws and regulations or that China will not adopt new laws or regulations. Should the Chinese government determine that the Company’s activities violate China’s direct selling or anti-multilevel marketing legislation, or should new laws or regulations be adopted, there could be a material adverse effect on the Company’s business, financial condition and results of operations.

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Although the Company attempts to work closely with both national and local Chinese governmental agencies in conducting its business, the Company's efforts to comply with national and local laws may be harmed by a rapidly evolving regulatory climate, concerns about activities resembling violations of direct selling or anti-multi-level marketing legislation, subjective interpretations of laws and regulations, Chinese nationals collaborating with short traders to damage the Company's business and activities by individual members that may violate laws notwithstanding the Company's strict policies prohibiting such activities. Any determination that the Company's operations or activities, or the activities of its individual members or employee sales representatives, or importers of record are not in compliance with applicable laws and regulations could result in the imposition of substantial fines, extended interruptions of business, restrictions on the Company's future ability to obtain business licenses or expand into new locations, changes to its business model, the termination of required licenses to conduct business, or other actions, any of which could materially harm the Company's business, financial condition and results of operations.

The Company's *Premium Noni Juice* and *Enhanced Essential Probiotics®* products each account for more than 10% of the Company's total revenue. The Company currently sources each such product from a single supplier. If demand decreases significantly, government regulation restricts their sale, the Company is unable to adequately source or deliver the products, or the Company ceases offering the products for any reason without suitable replacements, the Company's business, financial condition and results of operations could be materially and adversely affected.

Sales are made to the Company's members and no single customer accounted for 10% or more of its net sales. However, the Company's business model can result in a concentration of sales to several different members and their network of members. Although no single member accounted for 10% or more of net sales, the loss of a key member or that member's network could have an adverse effect on the Company's net sales and financial results.

Fair Value of Financial Instruments

The carrying amounts of the Company's financial instruments, including cash and cash equivalents and accounts payable, approximate fair value because of their short maturities. The carrying amount of the noncurrent restricted cash approximates fair value since, absent the restrictions, the underlying assets would be included in cash and cash equivalents. The Company's cash equivalents are valued based on level 1 inputs which consist of quoted prices in active markets.

Accounting standards permit companies, at their option, to choose to measure many financial instruments and certain other items at fair value. The Company has elected to not fair value existing eligible items.

Recently Issued and Adopted Accounting Pronouncements

In November 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-18, *Statement of Cash Flows - Restricted Cash*, that requires amounts generally described as restricted cash or restricted cash equivalents be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The new standard will be effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, and early adoption is permitted. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation: Improvements to Employee Share-Based Payment Accounting*, that simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The new standard was effective for fiscal years beginning after December 15, 2016, including interim periods within those annual years, and early adoption was permitted. The

Company adopted this guidance as of the quarter ended March 31, 2017. The adoption of this guidance did not have a material effect on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*, that requires organizations that lease assets, referred to as "lessees", to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases with lease terms of more than 12 months. ASU 2016-02 will also require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases and will include qualitative and quantitative requirements. The new standard will be effective for fiscal years beginning after December 15, 2018, including interim periods within those annual years, and early application is permitted. The Company is currently assessing the impact that this standard will have on its consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, *Balance Sheet Classification of Deferred Taxes*. Under this guidance, entities are required to present deferred tax assets and deferred tax liabilities as noncurrent in a classified balance sheet. This guidance was effective for annual and interim periods beginning after December 15, 2016, with early adoption permitted. Entities were permitted to adopt this guidance either prospectively or retrospectively. The Company elected to early adopt this guidance prospectively as of the quarter ended December 31, 2016.

In July 2015, the FASB issued ASU No. 2015-11, *Inventory: Simplifying the Measurement of Inventory.* Under this guidance, inventory not measured using either the last in, first out (LIFO) or the retail inventory method are to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable cost of completion, disposal, and transportation. The new standard was effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years, with early adoption permitted. The Company adopted this guidance as of the quarter ended March 31, 2017. The adoption of this guidance did not have a material effect on the Company's consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue From Contracts With Customers*, that outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. ASU 2014-09 is based on the principle that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. It also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to fulfill a contract. Entities have the option of using either a full retrospective or a modified retrospective approach for the adoption of the new standard. In July 2015, the FASB approved the deferral of the effective date for annual reporting periods that begin after December 15, 2017, including interim reporting periods. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

Other recently issued accounting pronouncements did not or are not believed by management to have a material impact on the Company's present or future financial statements.

2. NET INCOME PER COMMON SHARE

The following table illustrates the computation of basic and diluted net income per common share for the periods indicated (in thousands, except per share data):

	Year Ended December 31,								
	2017			2016			2015		
	Income	Shares	Per Share	Income	Shares	Per Share	Income	Shares	Per Share
Basic net income per common share:									
Net income available to common stockholders	$23,578	11,251	$2.10	$55,086	11,382	$4.84	$47,241	12,302	$3.84
Effect of dilutive securities:									
Warrants to purchase common stock	—	—		—	—		—	21	
Non-vested restricted stock	—	16		—	25		—	49	
Diluted net income per common share:									
Net income available to common stockholders plus assumed conversions	$23,578	11,267	$2.09	$55,086	11,407	$4.83	$47,241	12,372	$3.82

Warrants to purchase 88,097 shares of common stock were exercised during April 2015.

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Certain non-vested restricted stock is anti-dilutive upon applying the treasury stock method since the amount of compensation cost for future service results in the hypothetical repurchase of shares exceeding the actual number of shares to be vested. Non-vested restricted stock totaling 2,232 and 345 shares were not included for the years ended December 31, 2017 and 2016, respectively, as their effect would have been anti-dilutive.

3. BALANCE SHEET COMPONENTS

The components of certain balance sheet amounts are as follows (in thousands):

	December 31,	
	2017	2016
Cash and cash equivalents:		
Cash	$61,703	$52,453
Cash equivalents	73,608	73,468
	$135,311	$125,921
Inventories:		
Finished goods	$7,779	$10,722
Raw materials	799	617
Inventory reserve for obsolescence	(180)	(82)
	$8,398	$11,257
Property and equipment:		
Office equipment	$530	$517
Office software	916	672
Machinery	30	28
Furniture and fixtures	276	241
Leasehold improvements	957	840
Construction in progress (including internal-use software development costs)	10	157
Property and equipment, at cost	2,719	2,455
Accumulated depreciation and amortization	(1,570)	(1,067)
	$1,149	$1,388
Other accrued expenses:		
Sales returns	$614	$1,632
Employee-related expense	5,568	10,541
Warehousing, inventory-related and other	1,423	2,816
	$7,605	$14,989
Deferred revenue:		
Unshipped product	$2,411	$2,191
Auto ship advances	1,665	2,327
Enrollment package revenue	379	430
	$4,455	$4,948

As of December 31, 2017, cash and cash equivalents include $8.7 million held in banks located within China subject to foreign currency controls.

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4. FAIR VALUE MEASUREMENTS

Available-for-sale investments included in cash equivalents at the end of each period were as follows (in thousands):

	December 31, 2017			December 31, 2016		
	Adjusted Cost	Gross Unrealized Gains/Losses	Fair Value	Adjusted Cost	Gross Unrealized Gains/Losses	Fair Value
Municipal bonds and notes	$13,320	$ (1)	$13,319	$43,490	$ —	$43,490
Corporate debt securities	49,432	(24)	49,408	1,673	(2)	1,671
Financial institution instruments	10,881	—	10,881	28,307	—	28,307
Total available-for-sale investments	$73,633	$ (25)	$73,608	$73,470	$ (2)	$73,468

Financial institution instruments include instruments issued or managed by financial institutions such as money market fund deposits and time deposits.

5. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company has entered into non-cancelable operating lease agreements for locations within the United States and for its international subsidiaries, with expirations through September 2025. Rent expense in connection with operating leases was $2.0 million, $1.8 million and $1.5 million during 2017, 2016 and 2015, respectively.

Future minimum lease obligations as of December 31, 2017 are as follows (in thousands):

2018	$1,586
2019	1,114
2020	895
2021	337
2022	245
Thereafter	513
Total minimum lease obligations	$4,690

Purchase Commitments

In May 2013, the Company entered into an exclusive distribution agreement with one of its suppliers to purchase its product through July 2016 which automatically renews annually unless terminated 90 days prior to the termination date. To maintain exclusivity, the Company is required to purchase a minimum of $40,000 of product per month until the termination date. As of December 31, 2017, the Company was in compliance with the exclusivity provision.

The Company has a supply agreement with one of its suppliers to maintain worldwide exclusivity in return for purchasing a minimum of $6.6 million of product in 2018, plus certain raw material guarantees. If the Company does not purchase the minimum product as required, then a Cure Payment, as defined, will be due to the supplier. The term of the agreement is one year commencing January 2018 and shall automatically renew for a successive one year term unless notice of termination is provided by either party.

Employment Agreements

The Company has employment agreements with certain members of its management team that can be terminated by either the employee or the Company upon four weeks' notice. The employment agreements entered into with the management team contain provisions that guarantee the payments of specified amounts in the event of a change in control, as defined, or if the employee is terminated without cause, as defined, or terminates employment for good reason, as defined.

Securities Class Action

In January 2016, two putative securities class action complaints were filed against the Company and its top executives in the United States District Court for the Central District of California. On March 29, 2016, the Court consolidated these actions under the caption *Ford v. Natural Health Trends Corp.*, Case No. 2:16-cv-00255-TJH-AFMx, appointed two Lead Plaintiffs, Mahn Dao and Juan Wang, and appointed the Rosen Law Firm and Levi & Korsinsky LLP as co-Lead Counsel for the purported class. Plaintiffs filed a consolidated complaint on April 29, 2016. The consolidated complaint purports to assert claims on behalf of all persons who purchased or otherwise acquired our common stock between March 6, 2015 and March 15, 2016 under (i) Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder against the Company and Chris T. Sharng, Timothy S. Davidson and George K. Broady (together, the "Individual Defendants"), and (ii) Section 20(a) of the Securities Exchange Act of 1934 against the Individual Defendants. The consolidated complaint alleges, among other things, that the Company has been running an allegedly illegal multilevel marketing business in China and that it has made materially false and misleading statements regarding the legality of its business operations in China. The consolidated complaint seeks an indeterminate amount of damages, plus interest and costs. On June 15, 2016, the Company filed a motion to dismiss the consolidated complaint, which was denied on December 5, 2016. On February 17, 2017, the Company filed an answer to the consolidated complaint. On July 10, 2017, the Court entered a stipulation between the parties, postponing all deadlines and staying the case to allow the parties to engage in settlement discussions. On July 17, 2017, the parties reached an agreement in principle to settle the action. The proposed class-wide settlement of $1.75 million was submitted to the Court on October 3, 2017. The Court entered an order preliminarily approving the settlement on November 17, 2017, which was amended on January 4, 2018. Plaintiffs have provided notice to the settlement class in accordance with the amended order, and a final approval hearing is currently set for April 2, 2018. If approved, the proposed settlement will be fully funded by the Company's insurers. Defendants continue to believe that these claims are without merit and intend to vigorously defend against them if a settlement is not finalized and approved by the Court.

Shareholder Derivative Claims

In February 2016, a purported shareholder derivative complaint was filed in the Superior Court of the State of California, County of Los Angeles: *Zhou v. Sharng*. In March 2016, a purported shareholder derivative complaint was filed in the United States District Court for the Central District of California: *Kleinfeldt v. Sharng* (collectively the "Derivative Complaints"). The Derivative Complaints purport to assert claims for breach of fiduciary duties, unjust enrichment, abuse of control, gross mismanagement and corporate waste against certain of the Company's officers and directors. The Derivative Complaints also purport to assert fiduciary duty claims based on alleged insider selling and conspiring to enter into several stock repurchase agreements, which allegedly harmed the Company and its assets. The Derivative Complaints allege, among other things, that the Company has been running an allegedly illegal multilevel marketing business in China, and it has made materially false and misleading statements regarding the legality of its business operations in China, and that certain officers and directors sold common stock on the basis of this allegedly material, adverse non-public information. The Derivative Complaints seek an indeterminate amount of damages, plus interest and costs, as well as various equitable remedies. On February 1, 2017, pursuant to a stipulation among the parties, the Los Angeles Superior Court entered a stay of the *Zhou* action pending conclusion of the related federal class action in the United States District Court for the Central District of California: *Ford v. Natural Health Trends Corp.* A nearly identical stipulated stay was entered in the *Kleinfeldt* case on February 28, 2017. On November 10, 2017, the parties to both the *Zhou* and *Kleinfeldt* actions entered into a Memorandum of Understanding ("MOU") to resolve both actions, subject to the negotiation of a written settlement agreement and approval by the federal court in the *Kleinfeldt* matter. On November 15, 2017, the parties filed a joint status report and stipulation in the *Zhou* matter, alerting the court to the MOU and seeking to maintain the stay pending finalization and court approval of the parties' tentative settlement. The *Zhou* court entered an order continuing the stay on November 17, 2017. On March 9, 2018, the parties filed a Stipulation of Settlement and supporting papers in the *Kleinfeldt* action. On March 22, 2018, plaintiffs filed a motion for preliminary approval of the tentative settlement. The settlement is subject to both preliminary and final approval by the court. If approved, the proposed settlement will require certain corporate governance reforms and permit an award of up to $250,000 in attorneys' fees to plaintiffs' counsel, all of which will be fully funded by the Company's insurers. Defendants continue to believe that these claims are without merit and intend to vigorously defend against them if the derivative settlement is not finalized and approved.

The consolidated class action (if the settlement is not approved by the Court) and the Derivative Complaints (if the tentative settlement is not finalized or approved), or other actions alleging similar facts, could result in monetary or other penalties that may materially affect the Company's operating results and financial condition.

Other Claims

The Company is currently involved in a legal matter with one of its vendors and an outside party. Per the royalty agreement with the vendor, the Company believes that it is fully indemnified in the event of an unfavorable outcome and any potential settlement costs related to the matter would be fully covered by the Company's vendor.

6. STOCKHOLDERS' EQUITY

Authorized Shares

The Company is authorized to issue two classes of capital stock consisting of up to shares of preferred stock, par value, and shares of common stock, par value.

Dividends

The following tables summarize the Company's cash dividend activity during 2017, 2016 and 2015 (in thousands, except per share data):

Declaration Date	Per Common Share	Amount	Payment Date
October 30, 2017 (special)	$ 0.15	$ 1,701	November 24, 2017
October 30, 2017	0.12	1,360	November 24, 2017
July 31, 2017 (special)	0.25	2,833	August 31, 2017
July 31, 2017	0.11	1,246	August 31, 2017
April 24, 2017 (special)	0.35	3,964	May 19, 2017
April 24, 2017	0.10	1,133	May 19, 2017
January 24, 2017 (special)	0.35	3,962	March 3, 2017
January 24, 2017	0.09	1,019	March 3, 2017
	$ 1.52	$ 17,218	

Declaration Date	Per Common Share	Amount	Payment Date
October 23, 2016 (special)	$ 0.35	$ 3,941	November 25, 2016
October 23, 2016	0.08	901	November 25, 2016
July 19, 2016	0.07	787	August 26, 2016
April 21, 2016	0.06	686	May 20, 2016
March 1, 2016	0.05	576	March 24, 2016
Total	$ 0.61	$ 6,891	

Declaration Date	Per Common Share	Amount	Payment Date
October 21, 2015	$ 0.05	$ 598	November 20, 2015
July 28, 2015	0.04	489	August 28, 2015
May 4, 2015	0.03	372	May 29, 2015
February 27, 2015	0.02	250	March 27, 2015
Total	$ 0.14	$ 1,709	

Declaration and payment of any future dividends on shares of common stock will be at the discretion of the Company’s Board of Directors.

Stock Repurchases

On January 12, 2016, the Board of Directors authorized an increase to the Company's stock repurchase program first approved on July 28, 2015 from $15.0 million to $70.0 million. Repurchases are expected to be executed to the extent that the Company's earnings and cash-on-hand allow, and will be made in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Exchange Act. For all or a portion of the authorized repurchase amount, the Company may enter into one or more plans that are compliant with Rule 10b5-1 of the Exchange Act that are designed to facilitate these purchases. The stock repurchase program does not require the Company to acquire a specific number of shares, and may be suspended from time to time or discontinued.

During February 2016, pursuant to the stock repurchase program, the Company authorized its broker to proceed with the purchase of shares of the Company's common stock in the open market. During the year ended December 31, 2016, the Company purchased a total of 903,031 shares of its common stock for an aggregate purchase price of $23.7 million, plus transaction costs. No shares of the Company's common stock were repurchased by the Company during the year ended December 31, 2017. As of December 31, 2017, $32.0 million of the $70.0 million stock repurchase program approved on July 28, 2015 and increased on January 12, 2016 remained available for future purchases, inclusive of related estimated income tax.

On July 28, 2015, the Board of Directors approved a stock repurchase program of up to $15.0 million of the Company's outstanding shares of common stock. Repurchases are expected to be executed to the extent that the Company's earnings and cash-on-hand allow, are anticipated to be conducted through December 2016, and will be made in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Exchange Act. For all or a portion of the authorized repurchase amount, the Company may enter into one or more plans that are compliant with Rule 10b5-1 of the Exchange Act that are designed to facilitate these purchases. The repurchase program does not require the Company to acquire a specific number of shares, and may be suspended from time to time or discontinued. In connection therewith, the Company was advised that George K. Broady, a director of the Company and owner of more than 5% of its outstanding shares of common stock, would participate in the stock repurchase program on a basis roughly proportional to his family's ownership interest.

During August 2015, pursuant to the foregoing stock repurchase program, the Company authorized its broker to proceed with the purchase of shares of the Company's common stock in the open market for a total purchase price of $3.5 million. The open market repurchases were completed on August 4, 2015. The stock repurchase program, which included both open market purchases and the purchase of shares from Mr. Broady, resulted in the Company purchasing a total of 162,442 shares of its common stock for an aggregate purchase price of $5.0 million, plus transaction costs. During October 2015, the Company authorized its broker to proceed with the purchase of shares of the Company's common stock in the open market for a total purchase price of $3.6 million. The open market repurchases were completed on October 30, 2015. The stock repurchase program, which included both open market purchases and the purchase of shares from Mr. Broady, resulted in the Company purchasing a total of 106,264 shares of its common stock for an aggregate purchase price of $5.0 million, plus transaction costs.

On May 4, 2015, the Board of Directors approved a separate, prior stock repurchase program of up to $5.0 million of the Company's outstanding shares of common stock. In connection therewith, the Company was advised by Mr. Broady that he would participate in the stock repurchase program on a basis roughly proportional to his family's ownership interest (see Note 8). As such, the Company authorized its broker to proceed with the purchase of shares of the Company's common stock in the open market for a total purchase price of $3.5 million in accordance with Rules 10b5-1 and 10b-18 under the Exchange Act. The stock repurchase program, which included both open market purchases and the purchase of shares from Mr. Broady, was completed on May 13, 2015, and resulted in the Company purchasing a total of 186,519 shares of its common stock for an aggregate purchase price of $5.0 million, plus transaction costs.

On January 22, 2015, the Company entered into a stock repurchase agreement with Mr. Broady that provided for the Company's purchase from Mr. Broady in off-the-market, private transactions of a total of 91,817 shares of the Company's common stock, which would be purchased at the rate of 5,000 shares each trading day following the date of the agreement until all of such shares were purchased (see Note 8). The shares were purchased at a per share price equal to the closing price per share of the Company's common stock on the preceding trading day, as reported on the primary market in which the Company's common stock is publicly traded. The Company's purchases concluded on February 19, 2015, and resulted in an aggregate purchase price of $1.1 million.

Restricted Stock

Stock-based compensation expense totaled approximately $35,000, $104,000 and $86,000 for 2017, 2016 and 2015, respectively. During March 2016, the Company modified the vesting feature of an award granted to a director who decided to not stand for re-election at the Company's 2016 annual meeting of stockholders. The modification of the award resulted in an additional $64,000 in stock-based compensation expense for the three months ended March 31, 2016.

At the Company's annual meeting of stockholders held on April 7, 2016, the Company's stockholders approved the Natural Health Trends Corp. 2016 Equity Incentive Plan (the "2016 Plan") to replace its 2007 Equity Incentive Plan. The 2016 Plan allows for the grant of various equity awards including incentive stock options, non-statutory options, stock, stock units stock appreciation rights and other similar equity-based awards to the Company's employees, officers, non-employee directors, contractors, consultants and advisors of the Company. Up to 2,500,000 shares of the Company's common stock (subject to adjustment under certain circumstances) may be issued pursuant to awards granted. As of December 31, 2017, 2,393,873 shares remained available for issuance under the 2016 Plan.

On January 24, 2017, the Company granted 56,260 shares of restricted common stock under the 2016 Plan to certain employees for the purpose of further aligning their interest with those of its stockholders and settling fiscal 2016 performance incentives totaling $1.4 million. The shares vest on a quarterly basis over three years and are subject to forfeiture in the event of the employee's termination of service to the Company under specified circumstances.

On April 8, 2016, the Company granted 51,015 shares of restricted common stock under the 2016 Plan to certain employees for the purpose of further aligning their interest with those of its stockholders and settling fiscal 2015 performance incentives totaling $1.7 million. The shares vest on a quarterly basis over three years and are subject to forfeiture in the event of the employee's termination of service to the Company under specified circumstances.

The following table summarizes the Company's restricted stock activity under the 2016 Plan:

	Shares	Wtd. Avg. Price at Date of Issuance
Nonvested at December 31, 2015	—	$ —
Granted	51,015	34.13
Vested	(12,759)	34.13
Nonvested at December 31, 2016	38,256	34.13
Granted	56,260	25.44
Vested	(35,336)	29.58
Forfeited	(1,148)	28.55
Nonvested at December 31, 2017	58,032	28.72

On January 20, 2015, the Company's Board of Directors granted 60,960 shares of restricted common stock to certain employees and its then-existing outside directors for the purpose of further aligning their interest with those of its stockholders and as to the employee shares, settling fiscal 2014 performance incentives. The shares vested on a quarterly basis over the next three years and were subject to forfeiture in the event of their termination of service to the Company under specified circumstances. On February 11, 2015, the Board of Directors granted an additional 6,116 shares of restricted common stock to its newly-elected outside directors subject to the same conditions.

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The following table summarizes the Company’s other restricted stock activity:

	Shares	Wtd. Avg. Price at Date of Issuance
Nonvested at December 31, 2014	—	$ —
Granted	67,076	12.15
Vested	(22,364)	12.15
Nonvested at December 31, 2015	44,712	12.15
Vested	(22,364)	12.15
Nonvested at December 31, 2016	22,348	12.15
Vested	(21,930)	12.15
Forfeited	(418)	12.28
Nonvested at December 31, 2017	—	12.15

On August 13, 2012, the Board of Directors authorized the Company, acting as trustee for certain of its non-officer, overseas employees, to execute a Rule 10b5-1 plan to purchase shares of its common stock in accordance with guidelines specified under Rule 10b5-1 of the Exchange Act and the Company’s policies regarding stock transactions. Pursuant to this authority, the Company, as Trustee, entered into a 10b5-1 plan and began purchasing in December 2012. The latest 10b5-1 plan terminated in November 2014, and the Company, as Trustee, did not enter into a new 10b5-1 plan. The employees received the stock as incentive compensation in quarterly increments over three years beginning March 15, 2013, provided that they were employees of the Company on the date of the distribution. Any common stock that was forfeited by an employee whose employment terminated was delivered to the Company and held as treasury stock.

	Shares	Wtd. Avg. Grant-Date Fair Value
Nonvested at December 31, 2014	23,984	1.37
Vested	(23,984)	1.37
Nonvested at December 31, 2015	—	—

7. INCOME TAXES

The components of income before income taxes consist of the following (in thousands):

	Year Ended December 31,		
	2017	2016	2015
Domestic	$(2,965)	$(3,106)	$(7,820)
Foreign	46,391	67,183	55,613
Income before income taxes	$43,426	$64,077	$47,793

The components of the income tax provision consist of the following (in thousands):

	Year Ended December 31,		
	2017	2016	2015
Current:			
Federal	$20,277	$7,151	$12

State	2	(81)	100
Foreign	1,216	1,648	456
Total current taxes	21,495	8,718	568
Deferred taxes	(1,647)	273	(16)
Income tax provision	$19,848	$8,991	$552

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A reconciliation of the reported income tax provision to the provision that would result from applying the domestic federal statutory tax rate to pretax income is as follows (in thousands):

	Year Ended December 31,		
	2017	2016	2015
Income tax at federal statutory rate	$15,200	$22,427	$16,250
Effect of permanent differences	459	12,496	370
Tax Cut & Jobs Act repatriation tax	20,792	—	—
Tax Cut & Jobs Act federal rate change	954	—	—
Change in valuation allowance	(43)	(3,877)	2,017
Foreign rate differential	(15,002)	(21,713)	(18,099)
Foreign tax credits	(2,105)	(261)	—
Other reconciling items	(407)	(81)	14
Income tax provision	$19,848	$8,991	$552

Income before income taxes and the statutory tax rate for each country that materially contributed to the foreign rate differential presented above is as follows (in thousands):

		Year Ended December 31,		
	Statutory Tax Rate	2017	2016	2015
Cayman Islands	— %	$39,954	$58,169	$50,993
Hong Kong	16.5 %	3,315	3,992	2,645
China	25.0 %	2,584	3,855	1,493

Deferred income taxes consist of the following (in thousands):

	December 31,	
	2017	2016
Deferred tax assets:		
Net operating losses	$192	$235
Stock-based compensation	270	623
Accrued expenses	1,374	3,174
Tax credits	—	—
Other	6	—
Total deferred tax assets	1,842	4,032
Valuation allowance	(192)	(235)
Net deferred tax assets	1,650	3,797
Deferred tax liabilities:		
Foreign earnings	(4)	(3,650)
Other	(267)	(415)
Total deferred tax liabilities	(271)	(4,065)
Net deferred tax asset (liability)	$1,379	$(268)

The effective income tax rate for the year ended December 31, 2017 was significantly impacted by recording the effect of the Tax Cuts and Jobs Act (the “Tax Act”), enacted on December 22, 2017 by the U.S. government. The Tax Act makes broad and complex changes to the Internal Revenue Code of 1986, as amended, which has affected the Company’s year ended December 31, 2017, including, but not limited to, reducing the maximum U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018, and requiring a one-time repatriation tax on certain un-repatriated earnings of foreign subsidiaries at a rate of 15.5% tax on post-1986 foreign earnings held in cash and an 8% rate on all other post-1986 earnings that is payable over eight years beginning with 8% of the liability due with the filing of the year ended December 31, 2017 federal tax return that will be due in 2018.

On December 22, 2017, the Securities and Exchange Commission staff issued Staff Accounting Bulletin No. 118 (“SAB 118”), which provides guidance on accounting for tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740, *Income Taxes*. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate to be included in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to apply ASC 740 on the basis of the provision of the tax laws that were in effect immediately before the enactment of the Tax Act. While the Company is able to make reasonable estimates of the impact of the reduction in the corporate income tax rate and the deemed repatriation transition tax, the final impact of the Tax Act may differ from these estimates, due to, among other things, changes in the Company’s interpretations and assumptions, additional guidance that may be issued by the Internal Revenue Service, and actions it may take. The Company is continuing to gather additional information to determine the final impact. Any adjustments recorded to the provisional amounts through the fourth quarter of 2018 will be included as an adjustment to income tax expense.

As a result of the Tax Act, the Company recorded additional income tax expense of $20.7 million due to the repatriation tax on deemed repatriation of deferred foreign income and of $1.0 million due to a re-measurement of deferred tax assets and liabilities, in the three months ended December 31, 2017. The Deemed Repatriation Transition Tax (the “Repatriation Tax”) is a tax on previously untaxed accumulated earnings and profits (“E&P”) of certain of its foreign subsidiaries. To determine the amount of the Repatriation Tax, the Company must determine, in addition to other factors, the amount of post-1986 E&P of the relevant subsidiaries, as well as the amount of non-U.S. income taxes paid on such earnings. The Company is able to make a reasonable estimate and recorded a provisional Repatriation Tax obligation of $20.7 million.

Because of the complexity of the new Global Intangible Low-Taxed Income (“GILTI”) tax rules, the Company continues to evaluate this provision of the Tax Act and the application of ASC 740. Under U.S. GAAP, the Company is allowed to make an accounting policy choice of either treating taxes due on future U.S. inclusions in taxable income related to GILTI as a current period expense when incurred (the “period cost method”) or factoring such amounts into the Company’s measurement of its deferred taxes (the “deferred method”). The Company is currently in the process of analyzing its structure and, as a result, is not yet able to reasonably estimate the effect of this provision of the Tax Act. Therefore, the Company has not made any adjustments related to potential GILTI tax in its financial statements and has not made a policy decision regarding whether to record deferred tax on GILTI.

As of December 31, 2017, the Company does not have a valuation allowance against its U.S. deferred tax assets. The Company analyzed all sources of available income and determined that they are more likely than not to realize the tax benefits of their deferred assets in future periods or carryback years.

As of December 31, 2017, the Company has a valuation allowance against certain foreign deferred tax assets. The Company is recording a valuation allowance in foreign jurisdictions with an overall deferred tax loss. The valuation allowance will be reduced at such time as management believes it is more likely than not that the deferred tax assets will be realized. Any reductions in the valuation allowance will reduce future income tax provision.

As of December 31, 2017, the Company has no U.S. federal net operating loss or credit carryforwards as any attributes are expected to be fully utilized to offset tax in the current year. At December 31, 2017, the Company has foreign net operating loss carryforwards of approximately $1.25 million in various jurisdictions with various expirations.

As a result of capital return activities approved by the Board of Directors during the first quarter of 2016 and anticipated future capital return activities, the Company determined that a portion of its current undistributed foreign earnings are no longer deemed reinvested indefinitely by its non-U.S. subsidiaries. The Company repatriated $19.8 million to the U.S. during the three months ended March 31, 2016, part of which was offset by U.S. net operating losses. Accordingly, the deferred tax liability previously established for undistributed foreign earnings up to its existing U.S. net operating losses was reduced. The excess amount repatriated during the year ended December 31, 2017 was generated from current foreign earnings. The Company will continue to periodically reassess the needs of its foreign subsidiaries and update its indefinite reinvestment assertion as necessary. To the extent that additional foreign earnings are not deemed permanently reinvested, the Company expects to recognize additional income tax provision at the applicable U.S. corporate income tax rate. As of December 31, 2017, the Company has recorded a state deferred tax liability for earnings that the Company plans to repatriate out of accumulated earnings in future periods. Due to the Tax Act, repatriation from foreign subsidiaries will be offset with a dividends received deduction, resulting in little to no impact on federal tax expense. All undistributed earnings in excess of 50% of current earnings on an annual basis are intended to be reinvested indefinitely as of December 31, 2017.

The Company and its subsidiaries file tax returns in the United States, California and Texas and various foreign jurisdictions. For federal income tax purposes, fiscal years 2007 through 2016 remain open for examination by tax authorities as a result of net operating loss carryovers from older years being used to offset income in recent tax years. The Company is no longer subject to state income tax examinations for years prior to 2011. No jurisdictions are currently examining any income tax returns of the Company or its subsidiaries except that the Taiwan Taxation Administration is currently examining the Taiwan subsidiary's 2016 tax return. No adjustments have been proposed at this time.

8. RELATED PARTY TRANSACTIONS

Product Royalties

On April 29, 2015, the Company entered into a Royalty Agreement and License with Broady Health Sciences, L.L.C., a Texas limited liability company, ("BHS") regarding the manufacture and sale of a product called *Soothe*™. The Company began selling this product in the fourth quarter of 2012 with the permission of BHS. Mr. Broady is owner of BHS. Under the agreement, the Company agreed to pay BHS a royalty of 2.5% of sales revenue in return for the right to manufacture (or have manufactured), market, import, export and sell this product worldwide. Further, the Company agreed to pay BHS $11,700 as royalties for the period it began selling the product in the fourth quarter of 2012 through 2014. The Company recognized royalties of $1,400, $3,400 and $7,000 during 2017, 2016 and 2015, respectively. The Company is not required to purchase any product under the agreement, and the agreement may be terminated at any time on 120 days' notice. Otherwise, the agreement terminates March 31, 2020.

In February 2013, the Company entered into a Royalty Agreement and License with BHS regarding the manufacture and sale of a product called *ReStor*™. Under this agreement, the Company agreed to pay BHS a royalty of   of sales revenue in return for the right to manufacture (or have manufactured), market, import, export and sell this product worldwide, with certain rights being exclusive outside the United States. On April 29, 2015, the Company and BHS amended the Royalty and Agreement and License to change the royalty to a price per unit instead of 2.5% of sales revenue. This provision was effective retroactive to January 1, 2015. The Company recognized royalties of $306,000,   and   during 2017, 2016 and 2015, respectively. The Company is not required to purchase any product under the agreement, and the agreement may be terminated at any time on   days' notice or, under certain circumstances, with no notice. Otherwise, the agreement terminates March 31, 2020.

Stock Repurchase Agreements

On October 28, 2015, the Company entered into a Stock Repurchase Agreement with Mr. Broady that provided for the Company's purchase of common stock from Mr. Broady in off-the-market, private transactions at a rate equal to 0.4066 times the number of shares purchased by the Company's broker in conjunction with the stock repurchase program authorized by the Company's Board of Directors on July 28, 2015. The Company's purchases from Mr. Broady concluded on November 2, 2015, were completed at a per share purchase price equal to the weighted average price per share paid by the Company's broker in its open-market purchases, and resulted in an aggregate purchase price of $1.4 million. See Note 6.

On July 31, 2015, the Company entered into a Stock Repurchase Agreement with Mr. Broady that provided for the Company's purchase of common stock from Mr. Broady in off-the-market, private transactions at a rate equal to 0.4085 times the number of shares purchased by the Company's broker in conjunction with the stock repurchase program authorized by the Company's Board of Directors on July 28, 2015. The Company's purchases from Mr. Broady concluded on August 6, 2015, were completed at a per share purchase price equal to the weighted average price per share paid by the Company's broker in its open-market purchases, and resulted in an aggregate purchase price of $1.5 million. See Note 6.

On May 7, 2015, the Company entered into a Stock Repurchase Agreement with Mr. Broady that provided for the Company's purchase of common stock from Mr. Broady in off-the-market, private transactions at a rate equal to 0.4286 times the number of shares purchased by the Company's broker in conjunction with the stock repurchase program authorized by the Company's Board of Directors on May 4, 2015. The Company's purchases from Mr. Broady concluded on May 13, 2015, were completed at a per share purchase price equal to the weighted average price per share paid by the Company's broker in its open-market purchases, and resulted in an aggregate purchase price of $1.5 million. See Note 6.

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On January 22, 2015, the Company entered into a Stock Repurchase Agreement with Mr. Broady that provided for the Company's purchase from Mr. Broady in off-the-market, private transactions of a total of 91,817 shares of the Company's common stock, which would be purchased at the rate of 5,000 shares each trading day following the date of the agreement until all of such shares were purchased. The shares were purchased at a per share price equal to the closing price per share of the Company's common stock on the preceding trading day, as reported on the primary market in which the Company's common stock was publicly traded. The Company's purchases concluded on February 19, 2015, and resulted in an aggregate purchase price of $1.1 million. See Note 6.

9. EMPLOYEE BENEFIT PLANS

The Company has a 401(k) defined contribution plan which permits participating employees in the United States to defer up to a maximum of 90% of their compensation, subject to limitations established by the Internal Revenue Service. Employees age 21 and older are eligible to contribute to the plan starting the first day of the following month of employment. Participating employees are eligible to receive discretionary matching contributions and profit sharing, subject to certain conditions, from the Company. In 2017, 2016 and 2015, the Company matched employee deferral contributions up to of salary, which vested immediately. No profit sharing has been paid under the plan. The Company recorded compensation expense of $171,000, $134,000 and $115,000 for 2017, 2016 and 2015, respectively, related to its matching contributions to the plan. Certain of the Company's employees located outside the United States participate in employee benefit plans that are statutory in nature.

10. SEGMENT INFORMATION

The Company sells products to a member network that operates in a seamless manner from market to market, except for the China market where it sells to consumers through an e-commerce platform, and the Russia and Kazakhstan market where the Company's engagement of a third-party service provider results in a different economic structure than its other markets. Otherwise, the Company believes that all of its other operating segments have similar economic characteristics and are similar in the nature of the products sold, the product acquisition process, the types of customers products are sold to, the methods used to distribute the products, and the nature of the regulatory environment.

There is no separate segment manager who is held accountable by the Company's chief operating decision-makers, or anyone else, for operations, operating results and planning for the China market or the Russia and Kazakhstan market on a stand-alone basis, and neither market is material for the periods presented. As such, the Company believes that all operating segments should be aggregated into a single reportable segment for disclosure purposes.

The Company's net sales by geographic area are as follows (in thousands):

	Year Ended December 31,		
	2017	2016	2015
Net sales from external customers:			
United States	$3,348	$4,100	$3,246
Canada	1,938	1,809	2,746
Peru	508	—	—
Hong Kong[1]	174,926	263,482	245,737
China	7,282	9,086	4,425
Taiwan	5,591	6,213	5,965
South Korea	466	691	1,129
Russia, Kazakhstan and Ukraine[2]	913	858	1,139
Europe	2,278	1,234	382
Other foreign countries	313	255	91

Total net sales	$197,563	$287,728	$264,860

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[1] *Substantially all of our Hong Kong revenues are derived from the sale of products that are delivered to members in China. See "Item 1A. Risk Factors".*
[2] *The Company discontinued its Ukraine operations during the second quarter of 2015.*

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The Company’s net sales by product and service are as follows (in thousands):

	Year Ended December 31,		
	2017	2016	2015
Net sales by product and service:			
Product sales	$187,591	$269,731	$253,041
Enrollment package revenue, freight and other	13,676	25,616	17,623
Less: sales returns	(3,704)	(7,619)	(5,804)
Total net sales	$197,563	$287,728	$264,860

Due to system constraints, it is impracticable for the Company to separately disclose sales by product category for the years presented.

The Company’s long-lived assets by geographic area are as follows (in thousands):

	December 31,	
	2017	2016
Long-lived assets:		
United States	$648	$763
Hong Kong	78	140
China	112	199
Other foreign countries	311	286
Total long-lived assets	$1,149	$1,388

11. SUBSEQUENT EVENTS

On February 6, 2018, the Board of Directors declared a cash dividend of $0.13 on each share of common stock outstanding. Such dividends were paid on March 9, 2018 to stockholders of record on February 27, 2018. Declaration and payment of any future dividends on shares of common stock will be at the discretion of the Company’s Board of Directors.

On February 1, 2018, the Company granted 34,202 shares of restricted common stock under the 2016 Plan to certain employees for the purpose of settling fiscal 2017 performance incentives. The shares vest on a quarterly basis over the next three years and are subject to forfeiture in the event of their termination of service to the Company under specified circumstances.

On January 26, 2018, the Company entered into an exclusive distribution, license and royalty agreement with a new supplier to purchase products through January 2021 and shall renew for successive one year terms unless notice of termination is provided by either party. To maintain exclusivity, the Company is required to purchase between $453,000 and $3.6 million of product, depending on the product mix and inclusive of royalties, per year until the termination date.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

Item 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Management, with the participation of our principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) as of December 31, 2017. Our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation and as disclosed in “Management’s Annual Report on Internal Control over Financial Reporting” below, the principal executive officer and principal financial officer concluded that due to a material weakness in internal control over financial reporting, our disclosure controls and procedures were not effective as of December 31, 2017.

The material weakness identified is related to information technology general controls (“ITGC”) related to our proprietary web-based system. No material financial statement misstatement was identified in relation to this material weakness in our internal control over financial reporting. Management, including our principal executive officer and principal financial officer, believes the consolidated financial statements included in this Annual Report on Form 10-K, fairly represent in all material respects our financial condition, results of operations and cash flows for the periods at and for the periods presented in accordance with U.S. GAAP.

Management’s Annual Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed by, or under the supervision of, our principal executive and principal financial officers and effected by our Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management evaluates the effectiveness of our internal control over financial reporting by using the criteria established in *Internal Control – Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this criteria, management concluded that our internal control over financial reporting as of December 31, 2017 was not effective due to the material weakness described below. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis.

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Management identified ITGC deficiencies related to user access controls for our proprietary web-based system, which is used to process orders, record bonus volume activity and calculate member commissions. The Company’s ITGC user access controls specific to our proprietary web-based system did not operate effectively to provide an adequate audit trail for system change management and for the periodic review and testing of user access rights and permissions. Although the control deficiencies identified resulted in no material misstatements to the consolidated financial statements, these ITGC deficiencies, combined with inadequate compensating review controls, create a reasonable possibility that a material misstatement to the consolidated financial statements will not be prevented or detected on a timely basis and represent a material weakness in the Company’s internal control over financial reporting. As a result, management concluded that our internal control over financial reporting was not effective at December 31, 2017.

Remediation Efforts to Address Material Weakness

Management, with oversight from the Audit Committee, has implemented a plan intended to remediate the material weakness related to our proprietary web-based system and strengthen our internal control environment. The remediation plan includes the following:

- Enhancement of controls to ensure that the system change management log is adequately backed up, secured and sufficiently maintained; and

- Initiation of periodic review and testing of user access rights and permissions.

During the first quarter of 2018, we began the process of revising our controls related to the backup of our proprietary web-based system change management logs and believe those controls are now providing the necessary audit trail. In addition, management has initiated the periodic reviews of user access rights and permissions; however, the required programming changes necessary to improve user access rights and permissions is on-going. We also continue to review and develop additional controls and procedures to improve our control environment, including compensating review controls for our proprietary web-based system. We expect that the remediation of this material weakness will be fully complete during 2018.

Changes in Internal Control over Financial Reporting

Other than with respect to the material weakness identified during the fourth quarter and described above, there were no changes in internal control over financial reporting that occurred during the quarter ended December 31, 2017 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Board of Directors and Stockholders
Natural Health Trends Corp.

Adverse Opinion on Internal Control over Financial Reporting

We have audited Natural Health Trends Corp.’s (the "Company") internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control-Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, because of the effect of the material weakness described in the following paragraph on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control-Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

A material weakness is a control deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in “Management's Annual Report on Internal Control Over Financial Reporting:”

Management identified Information Technology General Control (“ITGC”) deficiencies related to user access controls of its proprietary web-based system, which is used to process orders, record bonus volume activity and calculate member commissions. The Company’s ITGC user access controls specific to the proprietary web-based system did not operate effectively to provide an adequate audit trail for system change management and for the periodic review and testing of user access rights and permissions. These ITGC deficiencies, combined with inadequate compensating review controls, create a reasonable possibility that a material misstatement to the consolidated financial statements will not be prevented or detected on a timely basis and represent a material weakness in the Company’s internal control over financial reporting.

This material weakness was considered in determining the nature, timing and extent of audit tests applied in our audit of the fiscal December 31, 2017 consolidated financial statements, and this report does not affect our report dated March 27, 2018 on those consolidated financial statements.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the consolidated balance sheet as of December 31, 2017 and the related consolidated statements of operations, comprehensive income, stockholders’ equity, and cash flows for the year then ended of the Company and our report dated March 27, 2018 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Management Annual Report on Internal Control Over Financial Reporting." Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control over Financial Reporting

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

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that degree of compliance with the policies or procedures may deteriorate.

/s/ Marcum LLP
Marcum LLP

Chicago, IL
March 27, 2018

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Item 9B. OTHER INFORMATION

None.

Part III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated by reference from the definitive proxy statement to be filed with the SEC within 120 days after December 31, 2017.

Item 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference from the definitive proxy statement to be filed with the SEC within 120 days after December 31, 2017.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is incorporated by reference from the definitive proxy statement to be filed with the SEC within 120 days after December 31, 2017.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated by reference from the definitive proxy statement to be filed with the SEC within 120 days after December 31, 2017.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated by reference from the definitive proxy statement to be filed with the SEC within 120 days after December 31, 2017.

Part IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Documents filed as part of this Form 10-K:

1. Financial Statements. See Index to Consolidated Financial Statements under “Item 8. Financial Statements and Supplementary Data” of this report.
2. Financial Statement Schedules. Financial statement schedules have been omitted because they are not required, not applicable, or because the required information is shown in the financial statements or notes thereto.
3. Exhibits. The exhibits listed on the accompanying Exhibit Index are filed as a part of, and are incorporated by reference into, this report. We will furnish any of the exhibits referenced in the accompanying Exhibit Index to a requesting shareholder upon payment of a fee equal to our reasonable expenses in furnishing such exhibit(s).

Item 16. FORM 10-K SUMMARY

None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

	NATURAL HEALTH TRENDS CORP.
Date: March 27, 2018	/s/ Chris T. Sharng Chris T. Sharng President (Principal Executive Officer)

POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS that each of Natural Health Trends Corp., a Delaware corporation, and the undersigned directors and officers of Natural Health Trends Corp., hereby constitutes and appoints Chris T. Sharng and Timothy S. Davidson, or any one of them, its, his or her true and lawful attorney-in-fact and agent, for it, him or her and in its, his or her name, place and stead, in any and all capacities, with full power to act alone, to sign any and all amendments to this report, and to file each such amendment to the report, with all exhibits thereto, and any and all other documents in connection therewith, with the Securities and Exchange Commission, hereby granting unto said attorney-in-fact and agent full power and authority to do and perform any and all acts and things requisite and necessary to be done in and about the premises as fully to all intents and purposes as it, he or she might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	**Title**	**Date**
/s/ Chris T. Sharng Chris T. Sharng	President and Director (Principal Executive Officer)	March 27, 2018
/s/ Timothy S. Davidson Timothy S. Davidson	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 27, 2018
/s/ Randall A. Mason Randall A. Mason	Chairman of the Board and Director	March 27, 2018
/s/ George K. Broady George K. Broady	Director	March 27, 2018

/s/ Kin Y. Chung Kin Y. Chung	Director	March 27, 2018
/s/ Yiu T. Chan Yiu T. Chan	Director	March 27, 2018

EXHIBIT INDEX
(Pursuant to Item 601 of Regulation S-K)

Exhibit Number	Exhibit Description
3.1	Certificate of Incorporation of Natural Health Trends Corp. (incorporated by reference to Exhibit 3.01 to Current Report on Form 8-K filed on July 12, 2005).
3.3	By-Laws of Natural Health Trends Corp. (incorporated by reference to Exhibit 3.02 to Current Report on Form 8-K filed on July 12, 2005).
4.1	Specimen Certificate for shares of common stock, $.001 par value per share, of Natural Health Trends Corp. (incorporated by reference to Exhibit 4.01 to Annual Report on Form 10-K filed on May 8, 2006).
+10.1	Natural Health Trends Corp. 2016 Equity Incentive Plan (incorporated by reference to Appendix C to Definitive Proxy Statement filed on March 4, 2016).
+10.2	Form of Restricted Stock Award Agreement under the 2016 Equity Incentive Plan (incorporated by reference to Exhibit 10.2 to Annual Report on Form 10-K filed March 4, 2016).
+10.3	Natural Health Trends Corp. Annual Incentive Plan (Restated as of January 1, 2016) (incorporated by reference to Appendix A to Definitive Proxy Statement filed on March 4, 2016).
+10.4	Natural Health Trends Corp. 2014 Long-Term Incentive Plan (Restated as of January 1, 2016) (incorporated by reference to Appendix B to Definitive Proxy Statement filed on March 4, 2016).
+10.5	First Amendment to the Natural Health Trends Corp. 2014 Long-Term Incentive Plan (Restated as of January 1, 2016) (incorporated by reference to Exhibit 10.5 to Annual Report on Form 10-K filed on March 10, 2017).
+10.6	Employment Agreement (including form of Non-Competition and Proprietary Rights Assignment Agreement) for Chris T. Sharng, dated April 23, 2007 (incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K filed on April 26, 2007).
+10.7	Employment Agreement (including form of Non-Competition and Proprietary Rights Assignment Agreement) for Timothy S. Davidson dated April 23, 2007 (incorporated by reference to Exhibit 10.2 to Current Report on Form 8-K filed on April 26, 2007).
+10.8	Form of Restricted Stock Notice of Grant and Award Agreement for shares of restricted stock granted on (1) January 20, 2015 to each of Chris T. Sharng, Timothy S. Davidson, Randall A. Mason and George K. Broady, and (2) February 11, 2015 to each of Christopher R. O’Brien and Kin Y. Chung (incorporated by reference to Exhibit 10.9 to Annual Report on Form 10-K filed on March 6, 2015).
+10.9	Form of Indemnification Agreement dated February 11, 2015, between Natural Health Trends Corp. and each of its directors (incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K filed on February 12, 2015).
21.1	Subsidiaries of Natural Health Trends Corp. (filed herewith).
23.1	Consent of Marcum LLP (filed herewith).
23.2	Consent of Lane Gorman Trubitt, LLC (filed herewith).
24.1	Power of Attorney (see signature page).
31.1	Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certifications of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
101.INS	*Instance Document - the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document*
101.SCH	*XBRL Taxonomy Extension Schema*

101.CAL XBRL Taxonomy Extension Calculation
101.DEF XBRL Taxonomy Extension Definition
101.LAB XBRL Taxonomy Extension Labels
101.PRE XBRL Taxonomy Extension Presentation
+ Management contract or compensatory plan