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NATURAL HEALTH TRENDS CORP

Form 10-Q

October 25, 2016

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from _____ to _____

Commission File Number: 001-36849

NATURAL HEALTH TRENDS CORP.

(Exact name of registrant as specified in its charter)

Delaware 59-2705336

(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

609 Deep Valley Drive

Suite 395

Rolling Hills Estates, California 90274

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (310) 541-0888

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 Accelerated filer

Non-accelerated filer Smaller reporting company

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

At October 21, 2016, the number of shares outstanding of the registrant's common stock was 11,287,196 shares.

NATURAL HEALTH TRENDS CORP.
Quarterly Report on Form 10-Q
September 30, 2016

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FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, in particular “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operation,” includes “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). When used in this report, the words or phrases “will likely result,” “expect,” “intend,” “will continue,” “anticipate,” “estimate,” “project,” “believe” and similar expressions are intended to identify “forward-looking statements” within the meaning of the Exchange Act. These statements represent our expectations or beliefs concerning, among other things, future revenue, earnings, growth strategies, new products and initiatives, future operations and operating results, and future business and market opportunities.

Forward-looking statements in this report speak only as of the date hereof, and forward looking statements in documents incorporated by reference speak only as of the date of those documents. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as required by law. We caution and advise readers that these statements are based on certain assumptions that may not be realized and involve risks and uncertainties that could cause actual results to differ materially from the expectations and beliefs contained herein.

For a summary of certain risks related to our business, see “Item 1A. Risk Factors” in our most recent Annual Report on Form 10-K, which includes the following:

- We could be adversely affected by management changes or an inability to attract and retain key management, directors and consultants;
- 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; 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;
- Our failure to maintain and expand our member relationships could adversely affect our business;
- The high level of competition in our industry could adversely affect our business;
- Challenges by third parties to the legality of our business operations could harm our business;
 - 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;
- An increase in the amount of compensation paid to members would reduce profitability;
- Failure of new products to gain member and market acceptance could harm our business;
- 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 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;
- New regulations governing the marketing and sale of nutritional supplements could harm our business;
- Regulations governing the production and marketing of our personal care products could harm our business;
- If we are found not to be in compliance with good manufacturing practices our operations could be harmed;
- Failure to comply with domestic and foreign laws and regulations governing product claims and advertising could harm our business;
- Although our members are independent contractors, improper member actions that violate laws or regulations could harm our business;
 - Adverse publicity associated with our products, ingredients or network marketing program, or those of similar companies, could harm our financial condition and operating results;

❖ We have a limited product line;

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

- Growth may be impeded by the political and economic risks of entering and operating foreign markets;
- Currency exchange rate fluctuations could lower our revenue and net income;
- Changes in tax or duty laws, and unanticipated tax or duty liabilities, could adversely affect our net income;
- Transfer pricing regulations affect our business and results of operations;
- We may be held responsible for certain taxes or assessments relating to the activities of our members, which could harm our financial condition and operating results;
- We are currently involved in, and may in the future face, litigation that could harm our business;
- We may be unable to protect or use our intellectual property rights;
- We do not have a comprehensive product liability insurance program and product liability claims could hurt our business;
- Our internal controls and accounting methods may require modification;
- If we fail to achieve and maintain an effective system of internal controls in the future, we may not be able to accurately report our financial results or prevent fraud. As a result, investors may lose confidence in our financial reporting;
- We rely on and are subject to risks associated with our reliance upon information technology systems;
- System failures and attacks could harm our business;
- Terrorist attacks, cyber-attacks, acts of war, epidemics or other communicable diseases or any other natural disasters may seriously harm our business;
- Because our systems, software and data reside on third-party servers, our access could be temporarily or permanently interrupted;
- We may experience substantial negative cash flows, which may have a significant adverse effect on our business and could threaten our solvency;
- 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;
- Disappointing quarterly revenue or operating results could cause the price of our common stock to fall;
- Our common stock is particularly subject to volatility because of the industry in which we operate;
- 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; and
- Future sales by us or our existing stockholders could depress the market price of our common stock.

Additional factors that could cause actual results to differ materially from our forward-looking statements are set forth in this report, including under the headings “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and in our financial statements and the related notes.

PART I - FINANCIAL INFORMATION**Item 1. FINANCIAL STATEMENTS****NATURAL HEALTH TRENDS CORP.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)**

	September 30, 2016	December 31, 2015
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 114,500	\$ 104,914
Accounts receivable	98	57
Inventories, net	14,842	10,455
Other current assets	3,540	2,286
Total current assets	132,980	117,712
Property and equipment, net	1,297	894
Goodwill	1,764	1,764
Restricted cash	3,090	3,166
Other assets	723	616
Total assets	\$ 139,854	\$ 124,152
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 3,114	\$ 2,862
Income taxes payable	655	379
Accrued commissions	18,620	19,634
Other accrued expenses	18,443	16,703
Deferred revenue	4,236	4,011
Deferred tax liability	60	60
Amounts held in eWallets	19,510	16,414
Other current liabilities	1,543	1,510
Total current liabilities	66,181	61,573
Long-term incentive	4,945	5,770
Total liabilities	71,126	67,343
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, \$0.001 par value; 50,000,000 shares authorized; 12,979,414 shares issued at September 30, 2016 and December 31, 2015	13	13
Additional paid-in capital	86,564	85,963
Retained earnings (accumulated deficit)	24,342	(9,647)
Accumulated other comprehensive loss	(302)	(101)
Treasury stock, at cost; 1,692,218 and 840,202 shares at September 30, 2016 and December 31, 2015, respectively	(41,889)	(19,419)
Total stockholders' equity	68,728	56,809
Total liabilities and stockholders' equity	\$ 139,854	\$ 124,152

See accompanying notes to consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net sales	\$70,679	\$80,779	\$225,416	\$191,204
Cost of sales	13,627	16,001	42,966	39,025
Gross profit	57,052	64,778	182,450	152,179
Operating expenses:				
Commissions expense	30,578	40,036	103,547	93,443
Selling, general and administrative expenses (including stock-based compensation expense of \$10 and \$21 during the three months ended September 30, 2016 and 2015, respectively, and \$94 and \$56 during the nine months ended September 30, 2016 and 2015, respectively)	11,170	9,867	34,505	24,571
Depreciation and amortization	96	72	276	181
Total operating expenses	41,844	49,975	138,328	118,195
Income from operations	15,208	14,803	44,122	33,984
Other income (expense), net	48	(135)	40	(112)
Income before income taxes	15,256	14,668	44,162	33,872
Income tax provision	2,699	137	8,124	330
Net income	\$12,557	\$14,531	\$36,038	\$33,542
Income per common share:				
Basic	\$1.12	\$1.19	\$3.15	\$2.71
Diluted	\$1.12	\$1.18	\$3.14	\$2.70
Weighted-average number of common shares outstanding:				
Basic	11,209	12,239	11,437	12,364
Diluted	11,232	12,284	11,463	12,439
Cash dividends declared per common share	\$0.07	\$0.04	\$0.18	\$0.09

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(In thousands)

	Three Months		Nine Months	
	Ended September		Ended September	
	30,	30,	30,	30,
	2016	2015	2016	2015
Net income	\$12,557	\$14,531	\$36,038	\$33,542
Other comprehensive loss, net of tax:				
Foreign currency translation adjustment	(54)	(118)	(329)	35)
Release of cumulative translation adjustment	—	—	132	(82)
Net change in foreign currency translation adjustment	(54)	(118)	(197)	(47)
Unrealized (losses) gains on available-for-sale securities	(11)	—	(4)	2)
Comprehensive income	\$12,492	\$14,413	\$35,837	\$33,497

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

	Nine Months Ended September 30,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$36,038	\$33,542
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	276	181
Stock-based compensation	94	56
Cumulative translation adjustment realized in net income	132	(82)
Changes in assets and liabilities:		
Accounts receivable	(36)	(217)
Inventories, net	(4,382)	(2,904)
Other current assets	(1,208)	(736)
Other assets	(91)	(264)
Accounts payable	252	2,140
Income taxes payable	278	190
Accrued commissions	(1,045)	11,832
Other accrued expenses	3,459	8,397
Deferred revenue	222	1,844
Amounts held in eWallets	3,098	11,354
Other current liabilities	26	93
Long-term incentive	(825)	(229)
Net cash provided by operating activities	36,288	65,197
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment, net	(679)	(645)
Increase in restricted cash	—	(3,028)
Net cash used in investing activities	(679)	(3,673)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of warrants	—	309
Repurchase of common stock	(23,704)	(11,079)
Dividends paid	(2,049)	(1,111)
Net cash used in financing activities	(25,753)	(11,881)
Effect of exchange rates on cash and cash equivalents	(270)	106
Net increase in cash and cash equivalents	9,586	49,749
CASH AND CASH EQUIVALENTS, beginning of period	104,914	44,816
CASH AND CASH EQUIVALENTS, end of period	\$114,500	\$94,565
SUPPLEMENTAL DISCLOSURES OF OTHER CASH FLOW INFORMATION:		
Cash paid for income taxes, net of refunds	\$7,994	\$152
Issuance of treasury stock	\$1,741	\$666

See accompanying notes to consolidated financial statements.

**NATURAL HEALTH TRENDS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Nature of Operations

Natural Health Trends Corp. (the “Company”), a Delaware corporation, 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. In most markets, the Company sells its products to a network of members referred to the Company by other members.

The Company’s wholly-owned subsidiaries have an active physical presence in the following markets: North America; Greater China, which consists of Hong Kong, Taiwan and China; South Korea; Singapore; Japan; and Europe. The Company also operates within certain Commonwealth of Independent States (Russia and Kazakhstan) through an engagement with a local service provider.

Basis of Presentation

The unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. As a result, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the Company’s financial information for the interim periods presented. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. These consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company’s 2015 Annual Report on Form 10-K filed with the United States Securities and Exchange Commission (SEC) on March 4, 2016.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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 obsolete inventory, the fair value of goodwill, 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

As of September 30, 2016, cash and cash equivalents include \$5.8 million held in banks located within China subject to foreign currency controls.

Additionally, as of September 30, 2016, cash and cash equivalents include the Company's investments in debt securities, comprising municipal notes and 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 and have insignificant interest rate risk 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 September 30, 2016 should be classified as available-for-sale and are carried at fair value with unrealized gains and losses reported in accumulated other comprehensive income 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.

Cash and cash equivalents at the end of each period were as follows (in thousands):

	September 30, December 31,	
	2016	2015
Cash	\$ 57,130	\$ 47,431
Cash equivalents	57,370	57,483
Total cash and cash equivalents	\$ 114,500	\$ 104,914

Restricted Cash

In June 2015, the Company funded a bank deposit account in the amount of CNY 20 million (USD 3.0 million at September 30, 2016) in anticipation of submitting a direct selling license application in China. Such deposit is required by Chinese laws to establish a consumer protection fund.

Other Accrued Expenses

Other accrued expenses at the end of each period were as follows (in thousands):

	September 30, December 31,	
	2016	2015
Sales returns	\$ 1,215	\$ 1,552
Employee-related	14,140	11,064
Warehousing, inventory-related and other	3,088	4,087
Total other accrued expenses	\$ 18,443	\$ 16,703

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 differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be ultimately realized. 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 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 on the portion of undistributed earnings of subsidiaries outside of the United States when these earnings are considered permanently reinvested.

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 nine months ended September 30, 2016 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 tax rate.

The Company and its subsidiaries file income tax returns in the United States, various states, and foreign jurisdictions. The Company is no longer subject to U.S. federal income tax examinations for years prior to 2012, and 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.

Fair Value of Financial Instruments

The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, 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.

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

September 30, 2016		December 31, 2015	
Adjusted Cost	Gross Unrealized Losses	Fair Value	Adjusted Cost
			Gross Unrealized Gains (Losses)