WEIS MARKETS INC
Form 10-Q
May 01, 2015
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 28, 2015
or
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________to_________
Commission File Number 1-5039

WEIS MARKETS, INC.
(Exact name of registrant as specified in its charter)

PENNSYLVANIA (State or other jurisdiction of incorporation or organization)	24-0755415 (I.R.S. Employer Identification No.)
1000 S. Second Street P. O. Box 471 Sunbury, Pennsylvania (Address of principal executive offices)	17801-0471 (Zip Code)

Registrant's telephone number, including area code: (570) 286-4571Registrant's web address: www.weismarkets.com

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

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

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

As of May 1, 2015, there were issued and outstanding 26,898,443 shares of the registrant’s common stock.

WEIS MARKETS, INC.

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PART I – FINANCIAL INFORMATION

ITEM I – FINANCIAL STATEMENTS

WEIS MARKETS, INC.

CONSOLIDATED BALANCE SHEETS

	March 28, 2015	December 27, 2014
(dollars in thousands)	(unaudited)	
Assets		
Current:		
Cash and cash equivalents	$ 17,112	$ 22,986
Marketable securities	80,480	73,959
SERP investment	9,994	9,121
Accounts receivable, net	66,086	70,642
Inventories	236,548	239,641
Prepaid expenses and other current assets	17,423	17,432
Income taxes recoverable	-	612
Total current assets	427,643	434,393
Property and equipment, net	719,158	716,860
Goodwill	35,162	35,162
Intangible and other assets, net	5,300	4,704
Total assets	$ 1,187,263	$ 1,191,119
Liabilities		
Current:		
Accounts payable	$ 137,319	$ 144,812
Accrued expenses	30,875	34,590
Accrued self-insurance	19,597	18,695
Deferred revenue, net	4,628	6,720
Income taxes payable	5,666	-
Deferred income taxes	5,235	5,800
Total current liabilities	203,320	210,617
Postretirement benefit obligations	19,073	18,672
Deferred income taxes	97,451	100,756
Other	4,533	3,242
Total liabilities	324,377	333,287
Shareholders' Equity		
Common stock, no par value, 100,800,000 shares authorized, 33,047,807 shares issued,		
26,898,443 shares outstanding	9,949	9,949
Retained earnings	998,950	993,911
Accumulated other comprehensive income		
(Net of deferred taxes of $3,381 in 2015 and $3,371 in 2014)	4,844	4,829

	1,013,743	1,008,689
Treasury stock at cost, 6,149,364 shares	(150,857)	(150,857)
Total shareholders’ equity	862,886	857,832
Total liabilities and shareholders’ equity	$ 1,187,263	$ 1,191,119

See accompanying notes to consolidated financial statements.

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WEIS MARKETS, INC.

CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

	13 Weeks Ended	
(dollars in thousands, except shares and per share amounts)	March 28, 2015	March 29, 2014
Net sales	$ 712,426	$ 687,127
Cost of sales, including warehousing and distribution expenses	517,311	500,359
Gross profit on sales	195,115	186,768
Operating, general and administrative expenses	175,614	164,465
Income from operations	19,501	22,303
Investment income	532	753
Income before provision for income taxes	20,033	23,056
Provision for income taxes	6,924	8,290
Net income	$ 13,109	$ 14,766
Weighted-average shares outstanding, basic and diluted	26,898,443	26,898,443
Cash dividends per share	$ 0.30	$ 0.30
Basic and diluted earnings per share	$ 0.49	$ 0.55

See accompanying notes to consolidated financial statements

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WEIS MARKETS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

	13 Weeks Ended	
(dollars in thousands)	March 28, 2015	March 29, 2014
Net income	$ 13,109	$ 14,766
Other comprehensive income by component, net of tax:		
Available-for-sale marketable securities		
Unrealized holding gains arising during period		
(Net of deferred taxes of $13 and $658, respectively)	18	933
Reclassification adjustment for gains included in net income		
(Net of deferred taxes of $3 and $18, respectively)	(3)	(23)
Other comprehensive income, net of tax	15	910
Comprehensive income, net of tax	$ 13,124	$ 15,676

See accompanying notes to consolidated financial statements.

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WEIS MARKETS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(dollars in thousands)	13 Weeks Ended March 28, 2015	March 29, 2014
Cash flows from operating activities:		
Net income	$ 13,109	$ 14,766
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	15,303	14,173
Amortization	1,996	1,924
Loss (gain) on disposition of fixed assets	8	(1,809)
Gain on sale of marketable securities	(6)	(41)
Deferred income taxes	(3,880)	(1,308)
Changes in operating assets and liabilities:		
Inventories	3,093	9,775
Accounts receivable and prepaid expenses	4,608	(6,170)
Income taxes recoverable	612	-
Accounts payable and other liabilities	(9,666)	(1,298)
Income taxes payable	5,666	4,012
Other	183	168
Net cash provided by operating activities	31,026	34,192
Cash flows from investing activities:		
Purchase of property and equipment	(20,624)	(17,880)
Proceeds from the sale of property and equipment	27	2,042
Purchase of marketable securities	(9,907)	(603)
Proceeds from the sale of marketable securities	3,191	106
Purchase of intangible assets	(644)	(30)
Change in SERP investment	(873)	(807)
Net cash used in investing activities	(28,830)	(17,172)
Cash flows from financing activities:		
Dividends paid	(8,070)	(8,070)
Net cash used in financing activities	(8,070)	(8,070)
Net (decrease) increase in cash and cash equivalents	(5,874)	8,950
Cash and cash equivalents at beginning of year	22,986	17,965
Cash and cash equivalents at end of period	$ 17,112	$ 26,915

See accompanying notes to consolidated financial statements.

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WEIS MARKETS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(1) Significant Accounting Policies

Basis of Presentation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring deferrals and accruals) considered necessary for a fair presentation have been included. The operating results for the periods presented are not necessarily indicative of the results to be expected for the full year. The Company has evaluated subsequent events for disclosure through the date of issuance of the accompanying unaudited consolidated interim financial statements and there were no material subsequent events which require additional disclosure. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's latest Annual Report on Form 10-K.

(2) Current Relevant Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers (Topic 606), which amended the existing accounting standards for revenue recognition. ASU 2014-09 establishes principles for recognizing revenue upon the transfer of promised goods or services to customers, in an amount that reflects the expected consideration received in exchange for those goods or services. The standard is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. In April 2015, the FASB issued a one-year deferral of the effective date of this new guidance resulting in it now being effective for the Company beginning in fiscal year 2018. The amendments may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. The Company is currently in the process of evaluating the impact of adoption of the ASU on its consolidated financial statements.

In April 2014, the FASB issued ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. ASU 2014-08 amends guidance on reporting discontinued operations only if the disposal of a component of an entity or group of components of an entity represents a strategic shift that has (or will have) a major effect on an entity’s operations and financial results. It also allows companies to have significant continuing involvement and continuing cash flows with the discontinued operations. Additional disclosures are also required for discontinued operations and individually material disposal transactions that do not meet the definition of a discontinued operation. The standard should be applied prospectively for all disposals of components of an entity and for all businesses that, on acquisition, are classified as held for sale that occurred within annual periods beginning on or after December 15, 2014, including interim periods within that reporting period. Adoption of the ASU did not have an impact on the Company’s current consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40)(Topic 718): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. ASU 2014-15 provides guidance related to management's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern and to provide related footnote disclosures. The new requirements are effective for the annual periods ending after December 15, 2016, and for interim periods and annual periods thereafter. Early adoption is permitted. Adoption of the new ASU will not have an impact on the Company's consolidated financial statements.

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WEIS MARKETS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(3) Marketable Securities

The Company’s marketable securities are all classified as available-for-sale within Current Assets in the Company’s Consolidated Balance Sheets. FASB has established three levels of inputs that may be used to measure fair value:

Level 1 Observable inputs such as quoted prices in active markets for identical assets or liabilities;

Level 2 Observable inputs, other than Level 1 inputs in active markets, that are observable either directly

or indirectly; and

Level 3 Unobservable inputs for which there is little or no market data, which require the reporting entity

to develop its own assumptions.

The Company’s marketable securities valued using Level 1 inputs include highly liquid equity securities, for which quoted market prices are available. The Company’s bond portfolio is valued using Level 2 inputs. The Company’s bonds are valued using a combination of pricing for similar securities, recently executed transactions, cash flow models with yield curves and other pricing models utilizing observable inputs, which are considered Level 2 inputs.

For Level 2 investment valuation, the Company utilizes standard pricing procedures of its investment brokerage firm(s) which include various third party pricing services. These procedures also require specific price monitoring practices as well as pricing review reports, valuation oversight and pricing challenge procedures to maintain the most accurate representation of investment fair market value. In addition, the Company engaged an independent firm to value a sample of the Company’s municipal bond holdings in order to validate the investment’s assigned fair value.

The Company accrues interest on its bond portfolio throughout the life of each bond held. Dividends from the equity securities are recognized as received. Both interest and dividends are recognized in “Investment Income” on the Company’s Consolidated Statements of Income.

Marketable securities, as of March 28, 2015 and December 27, 2014, consisted of:

	Gross	Gross

(dollars in thousands)	Amortized	Unrealized	Unrealized	Fair
March 28, 2015	Cost	Holding Gains	Holding Losses	Value
Available-for-sale:				
Level 1				
Equity securities	$ 1,198	$ 6,485	$ -	$ 7,683
Level 2				
Municipal bonds	71,057	1,776	(36)	72,797
	$ 72,255	$ 8,261	$ (36)	$ 80,480

(dollars in thousands)	Amortized	Gross Unrealized	Gross Unrealized	Fair
December 27, 2014	Cost	Holding Gains	Holding Losses	Value
Available-for-sale:				
Level 1				
Equity securities	$ 1,198	$ 6,683	$ -	$ 7,881
Level 2				
Municipal bonds	64,561	1,613	(96)	66,078
	$ 65,759	$ 8,296	$ (96)	$ 73,959

Maturities of marketable securities classified as available-for-sale at March 28, 2015, were as follows:

(dollars in thousands)	Amortized Cost	Fair Value
Available-for-sale:		
Due within one year	$ 4,527	$ 4,567
Due after one year through five years	47,131	48,344
Due after five years through ten years	19,399	19,886
Equity securities	1,198	7,683
	$ 72,255	$ 80,480

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WEIS MARKETS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(4) Accumulated Other Comprehensive Income

All balances in accumulated other comprehensive income are related to available-for-sale marketable securities. The following table sets forth the balance of the Company's accumulated other comprehensive income, net of tax.

(dollars in thousands)	Unrealized Gains on Available-for-Sale Marketable Securities
Accumulated other comprehensive income balance as of December 27, 2014	$ 4,829
Other comprehensive income before reclassifications	18
Amounts reclassified from accumulated other comprehensive income	(3)
Net current period other comprehensive income	15
Accumulated other comprehensive income balance as of March 28, 2015	$ 4,844

The following table sets forth the effects on net income of the amounts reclassified out of accumulated other comprehensive income for the periods ended March 28, 2015 and March 29, 2014.

		Gains (Losses) Reclassified from Accumulated Other Comprehensive Income to the Consolidated Statements of Income 13 Weeks Ended	
(dollars in thousands)	Location	March 28, 2015	March 29, 2014
Unrealized gains on available-for-sale marketable securities			
	Investment income	$ 6	$ 41
	Provision for income taxes	(3)	(18)
Total amount reclassified, net of tax		$ 3	$ 23

(5) Income Taxes

Cash paid for federal income taxes was $4.5 million and $5.0 million in the first quarter of 2015 and 2014, respectively.

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WEIS MARKETS, INC.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of Weis Markets, Inc.'s (the "Company") financial condition and results of operations should be read in conjunction with the unaudited consolidated financial statements and related notes included in Item 1 of this Quarterly Report on Form 10-Q, the Company's audited consolidated financial statements and the related notes included in the Company's Annual Report on Form 10-K for the year ended December 27, 2014, filed with the U.S. Securities and Exchange Commission, as well as the cautionary statement captioned "Forward-Looking Statements" immediately following this analysis.

Overview

Weis Markets, Inc. was founded in 1912 by Harry and Sigmund Weis, in Sunbury, Pennsylvania. The Company currently ranks among the top 50 food and drug retailers in the United States in revenues generated. As of March 28, 2015, the Company operated 163 retail food stores in Pennsylvania and four surrounding states: Maryland, New Jersey, New York and West Virginia.

Company revenues are generated in its retail food stores from the sale of a wide variety of consumer products including groceries, dairy products, frozen foods, meats, seafood, fresh produce, floral, pharmacy services, deli products, prepared foods, bakery products, beer and wine, fuel, and general merchandise items, such as health and beauty care and household products. The Company supports its retail operations through a centrally located distribution facility, its own transportation fleet, three manufacturing facilities and its administrative offices. The Company's operations are reported as a single reportable segment.

Results of Operations

Analysis of Consolidated Statements of Income			Percent Changes 2015 vs. 2014
	13 Weeks Ended		
(dollars in thousands except per share amounts)	March 28, 2015	March 29, 2014	13 Weeks Ended
Net sales	$ 712,426	$ 687,127	3.7 %

Cost of sales, including warehousing and distribution expenses	517,311	500,359	3.4
Gross profit on sales	195,115	186,768	4.5
Gross profit margin	27.4 %	27.2 %	
Operating, general and administratives expenses	175,614	164,465	6.8
O, G & A, percent of net sales	24.7 %	23.9 %	
Income from operations	19,501	22,303	(12.6)
Operating margin	2.7 %	3.2 %	
Investment income	532	753	(29.3)
Investment income, percent of net sales	0.1 %	0.1 %	
Income before provision for income taxes	20,033	23,056	(13.1)
Provision for income taxes	6,924	8,290	(16.5)
Effective tax rate	34.6 %	36.0 %	
Net income	$ 13,109	$ 14,766	(11.2) %
Net income, percent of net sales	1.8 %	2.1 %	
Basic and diluted earnings per share	$ 0.49	$ 0.55	(10.9) %

Income is earned by selling merchandise at price levels that produce revenues in excess of cost of merchandise sold and operating and administrative expenses. Although the Company may experience short term fluctuations in its earnings due to unforeseen short-term operating cost increases, it historically has been able to increase revenues and maintain stable earnings from year to year.

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WEIS MARKETS, INC.
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(continued)

Results of Operations (continued)

Net Sales
The Company's revenues are earned and cash is generated as merchandise is sold to customers at the point of sale. Discounts provided to customers by the Company at the point of sale are recognized as a reduction in sales as products are sold or over the life of a promotional program if redeemable in the future. Discounts provided by vendors, usually in the form of paper coupons, are not recognized as a reduction in sales provided the coupons are redeemable at any retailer that accepts coupons.

Total store sales increased 3.7% in the first quarter of 2015 compared to the same period in 2014. Excluding fuel sales, total store sales increased 4.8%.

When calculating the percentage change in comparable store sales, the Company defines a new store to be comparable when it has been in operation for five full quarters. Relocated stores and stores with expanded square footage are included in comparable store sales since these units are located in existing markets and are open during construction. Planned store dispositions are excluded from the calculation. The Company only includes retail food stores in the calculation.

Comparable store sales increased 3.4% in the first quarter of 2015 compared to the same quarter in 2014. Excluding fuel sales, comparable store sales increased 4.7% in first quarter of 2015 compared to the same period in 2014. The Company attributes the sales increase to its continued investments in lower pricing and disciplined sales building programs.

The Company continues to make progress in a market impacted by a slowly recovering economy. It attributes the increased sales to its continued investments in lower pricing and disciplined sales building programs. This includes targeted promotional activity in key regional markets and its Everyday Lower Prices (EDLP) and Lowest Price Guarantee promotional programs. The EDLP program lowered prices on more than 1,000 regularly purchased items. The Lowest Price Guarantee program offers discounts on four items every week that the Company guarantees to be the lowest compared to local competitors. Compared to the first quarter of 2014, the Company generated a 1.2% increase in average sales per customer transaction in the first quarter of 2015, while identical customer store visits increased by 2.6%.

The Company’s results also benefited from increased operational efficiencies and improved in-stock conditions at store level. In addition, the Company’s Gold Card program, an extension of its existing Preferred Club Shopper program, continues to target the Company’s best shoppers with personalized offers and strong values to help them save money. The Company also continues to offer its "Gas Rewards" program in most markets. The "Gas Rewards" program allows Weis Preferred Shoppers club card members to earn gas discounts resulting from their in-store purchases. Customers can redeem these gas discounts at Sheetz convenience stores, located in most of the Company's markets, at Manley's Mighty Mart Valero locations, in the Binghamton, NY market or at any of the twenty-seven Weis Gas-n-Go locations.

Comparable center store sales increased 2.2% in the first quarter of 2015 compared to the same quarter in 2014. Comparable dairy sales increased 4.0% in the first quarter of 2015 as compared to the same quarter in 2014, despite significant milk deflation. This increase is mainly attributed to strong unit sales throughout the dairy category, primarily related to cheese, butter, eggs and yogurt. The Company also continues to benefit from the promotion of its dairy products in the EDLP and Lowest Price Guarantee programs.

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WEIS MARKETS, INC.
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(continued)

Results of Operations (continued)

Comparable fresh sales increased 7.8% in the first quarter compared to the same quarter in 2014. Comparable meat sales increased 8.7% in the first quarter of 2015 compared to 2014. The Company continues to build the base business in our meat department through our “Great Meals Start Here” program, which focuses on superior customer service, educating our customers about our quality and our ability to cut fresh meat within the stores. This program coupled with price inflation; more strategic meat advertising; and a focus on freshness, variety and service has contributed to the increase in meat sales.

Comparable pharmacy sales increased 7.7% in the first quarter of 2015 compared to the same period in 2014 and increased 4.7% in the first quarter of 2014 compared to the same quarter in 2013. The 2015 sales increase was driven by an increased number of filled prescriptions, partially due to the Company’s medication synchronization program and expanded pharmacy hours at some stores. There were also more individuals eligible for healthcare benefits under the Affordable Care Act. While pharmacy sales experienced significant price inflation in 2014, they were negatively affected in 2013 due to the conversion of brand to generic drugs.

Comparable fuel sales decreased 33.8% in the first quarter of 2015 compared to the same quarter in 2014. The fuel sales decrease is mainly due to decreasing retail fuel prices. According to the U.S. Department of Energy, the thirteen week average price of gasoline in the Central Atlantic States decreased 30.4% or $1.12 per gallon in the first quarter of 2015 compared to the same quarter in 2014.

Management remains confident in its ability to generate sales growth in a highly competitive environment, but also understands some competitors have greater financial resources and could use these resources to take measures which could adversely affect the Company's competitive position.

Cost of Sales and Gross Profit
Cost of sales consists of direct product costs (net of discounts and allowances), distribution center and transportation costs, as well as manufacturing facility operations.

According to the latest U.S. Bureau of Labor Statistics' report, the annual Seasonally Adjusted Food-at-Home Consumer Price Index increased 2.9% compared to an increase of 0.8% for the same period last year. Even though the U.S. Bureau of Labor Statistics' index rates may be reflective of a trend, it will not necessarily be indicative of the Company's actual results. Despite the fluctuation of retail and wholesale prices, the Company has achieved a gross profit rate of 27.4% and 27.2% in the first quarter 2015 and 2014, respectively. The increase in gross profit rate was driven by a shift in our sales mix from fuel to grocery sales which carry a higher profit margin.

The Company's profitability is impacted by the cost of oil. Fluctuating fuel prices affect the delivered cost of product and the cost of other petroleum-based supplies. As a percentage of sales, the cost of diesel fuel used by the Company to deliver goods from its distribution center to its stores decreased 0.07% in the first quarter of 2015 compared to the first quarter of 2014. Although the Company experienced a decrease in these costs, the decline was minimized due to higher fuel usage resulting from more store deliveries to meet the higher sales demand. According to the U.S. Department of Energy, the thirteen week average diesel fuel price for the Central Atlantic States in the first quarter of 2015 was $3.20 per gallon compared to $4.23 per gallon in the same period in 2014, for an average decrease of $1.03 per gallon. Based upon the U.S. Energy Information Administration's current projections, the Company is expecting diesel fuel prices to remain fairly steady through the second quarter of 2015.

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WEIS MARKETS, INC.
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(continued)

Results of Operations (continued)

Although the Company experienced product cost inflation and deflation in various commodities for both quarters presented, management cannot accurately measure the full impact of inflation or deflation on retail pricing due to changes in the types of merchandise sold between periods, shifts in customer buying patterns and the fluctuation of competitive factors.

Operating, General and Administrative Expenses
Business operating costs including expenses generated from administration and purchasing functions, are recorded in "Operating, general and administrative expenses." Business operating costs include items such as wages, benefits, utilities, repairs and maintenance, advertising costs and credits, rent, insurance, equipment depreciation, leasehold amortization and costs for outside provided services.

The Company may not be able to recover rising expenses through increased prices charged to its customers. Any delay in the Company's response to unforeseen cost increases or competitive pressures that prevent its ability to raise prices may cause earnings to suffer. A majority of our associates are paid hourly rates related to federal and state minimum wage laws. Although we have and will continue to attempt to pass along any increased labor costs through food price increases, there can be no assurance that all such increased labor costs can be reflected in our prices or that increased prices will be absorbed by consumers without diminishing consumer spending to some degree. However, to date, we have not experienced a significant reduction in profit margins as a result of changes in such laws, and management does not anticipate any significant related future reductions in gross profit margins.

Employee-related costs such as wages, employer paid taxes, health care benefits and retirement plans, comprise approximately 60% of the total “Operating, general and administrative expenses.” Employee-related costs increased $7.7 million or 7.9% in the first quarter of 2015 compared to the same quarter last year. As a percent of sales, employee-related costs increased 0.6% in the first quarter of 2015 compared to the same period in 2014. The Company’s self-insured health care benefit expenses increased $3.1 million or 94.9% in the first quarter of 2015 compared to the same quarter last year. This variance is mainly attributed to higher dollar value self-insured healthcare claims and an increase in the prescription plan costs. The Company remains concerned about the impact that The Patient Protection and Affordable Care Act will have on its future operating expenses. As a percent of sales, direct store labor decreased 0.3% compared to the first quarter of 2014.

Depreciation and amortization expense was $17.3 million, or 2.4% of net sales for the first quarter of

Total members
8,523,300

8,153,000

7,860,000

Average cost per acquisition of a new member
$
2.89

$
2.85

$
3.43

Revenue per member (2)
$
4.13

$
4.69

$
5.41

Revenue per employee (3)
$
222

$
249

$
277

Mobile application downloads
1,738,481

1,595,000

1,419,000

Social media followers
791,000

637,000

595,000

North America

Total members
17,375,600

17,223,000

17,184,000

Average cost per acquisition of a new member
$
1.87

$
2.15

$
2.16

Revenue per member (2)
$
3.79

$
3.94

$

4.35

Revenue per employee (3)
$
322

$
332

$
314

Mobile application downloads
3,015,700

3,049,000

2,734,000

Social media followers
2,866,000

2,507,000

2,250,000

Consolidated

Total members (1)
29,388,200

28,838,000

28,390,000

Average cost per acquisition of a new member
$
2.34

$
2.51

$
2.62

Revenue per member (2)
$
3.69

$
4.02

$
4.48

Revenue per employee (3)
$
241

$
258

$
266

Mobile application downloads
5,482,481

5,306,000

4,716,000

Social media followers
4,216,000

3,675,000

3,228,000

(1) Members represent individuals who are signed up to receive one or more of our free email publications that present our travel, entertainment and local deals.
(2) Annual revenue divided by number of members at the beginning of the year.
(3) Annual revenue divided by number of employees at the end of the year (in thousands).

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Revenues

The following table sets forth the breakdown of revenues (in thousands) by category and segment. Travel revenue includes travel publications (Top 20, Website, Newsflash, Travelzoo Network), Getaway vouchers and hotel platform. Local revenue includes Local Deals vouchers and entertainment offers (vouchers and direct bookings).

	Year Ended December 31,		
	2017	2016	2015
Asia Pacific			
Travel	$6,992	$8,845	$9,355
Local	527	853	1,294
Total Asia Pacific revenues	$7,519	$9,698	$10,649
Europe			
Travel	$29,180	$31,087	$33,603
Local	4,501	5,820	6,133
Total Europe revenues	$33,681	$36,907	$39,736
North America			
Travel	$53,880	$54,248	$56,156
Local	11,444	13,410	17,420
Total North America revenues	$65,324	$67,658	$73,576
Consolidated			
Travel	$90,052	$94,180	$99,114
Local	16,472	20,083	24,847
Total revenues	$106,524	$114,263	$123,961

Asia Pacific

Asia Pacific revenues decreased $2.2 million or 22% in 2017 compared to 2016. This decrease was primarily due to the decrease in Travel revenues, the decrease in Local revenues and a $341,000 negative impact from foreign currency movements relative to the U.S. dollar. The decrease in Travel revenues of $1.5 million was primarily due to the decreased number of e-mails sent. The decrease in Local revenues of $301,000 was primarily due to the decreased number of Local Deals vouchers sold.

Asia Pacific revenues decreased $951,000 or 9% in 2016 compared to 2015. This decrease was primarily due to the decrease in Travel revenues and the decrease in Local revenues offset partially by a $207,000 positive impact from foreign currency movements relative to the U.S. dollar. The decrease in Travel revenues of $718,000 was primarily due to the decreased number of e-mails sent. The decrease in Local revenues of $441,000 was primarily due to the decreased number of Local Deals vouchers sold.

Europe

Europe revenues decreased $3.2 million or 9% in 2017 compared to 2016. This decrease was primarily due to the decrease in Travel revenues, the decrease in Local revenues and a $766,000 negative impact from foreign currency movements relative to the U.S. dollar. The decrease in Travel revenue of $1.3 million was primarily due to the decrease in the average take rate earned from travel publications and the decrease in vouchers sold in getaway voucher revenues. The decrease in Local revenues of $1.2 million was primarily due to the decreased number of Local Deals vouchers sold.

Europe revenues decreased $2.8 million or 7% in 2016 compared to 2015. This decrease was primarily due to the $2.8 million negative impact from foreign currency movements relative to the U.S. dollar and the decrease in Travel revenues, offset partially by the increase in Local revenues. The decrease in Travel revenue of $360,000 was primarily due to the decreased number of emails sent and paid clicks. The increase in Local revenues of $312,000 was primarily due to the increased number of Local Deals vouchers sold.

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North America
North America revenues decreased $2.3 million or 3% in 2017 compared to 2016. This decrease was primarily due to the decrease in Local and Travel revenues. The decrease in Local revenues of $2.0 million was primarily due to the decreased number of Local Deals vouchers sold. The decrease in Travel revenue of $371,000 was primarily due to the decreased number of Getaway vouchers sold, offset partially by the increased travel publications revenues.
North America revenues decreased $5.9 million or 8% in 2016 compared to 2015. The decrease in Travel revenues of $1.8 million was primarily due to the decreased number of emails sent. The decrease in Local revenues of $4.0 million was primarily due to the decreased number of Local Deals vouchers sold.
For 2017, 2016 and 2015, none of our customers accounted for 10% or more of our revenue.
Cost of Revenues
Cost of revenues consists primarily of network expenses, including fees we pay for co-location services and depreciation and maintenance of network equipment, payments made to third-party partners of the Travelzoo Network, amortization of capitalized website development costs, credit card fees, certain estimated refunds to members and customer service costs associated with vouchers we sell and hotel bookings, and salary expenses associated with network operations and customer service staff. Cost of revenues was $12.9 million, $13.9 million and $18.1 million for the years ended December 31, 2017, 2016 and 2015, respectively.
Cost of revenue decreased $946,000 in 2017 compared to 2016. This decrease was primarily due to a $837,000 decrease in payments made to third-party partners of the Travelzoo Network.
Cost of revenue decreased $4.3 million in 2016 compared to 2015. This decrease was primarily due to a $2.9 million decrease in payments made to third-party partners of the Travelzoo Network, a $771,000 decrease in Local Deals and Getaway costs and a $585,000 decrease in employee compensation and benefits.
Operating Expenses
Sales and Marketing
Sales and marketing expenses consist primarily of advertising and promotional expenses, salary expenses associated with sales, marketing and production staff, expenses related to our participation in industry conferences, and public relations expenses. Sales and marketing expenses were $57.3 million, $58.4 million and $65.6 million for 2017, 2016 and 2015, respectively. Advertising expenses accounted for 15%, 18% and 21%, respectively, of total sales and marketing expenses and consisted primarily of online advertising, which we refer to as traffic acquisition cost and member acquisition costs. The goal of our advertising was to acquire new members for our e-mail products, increase the traffic to our websites and increase brand awareness.
Sales and marketing expenses decreased $1.1 million in 2017 compared to 2016. The decrease was primarily due to a $1.2 million decrease in member acquisition costs and a $0.4 million decrease in salary and employee related expenses, offset partially by a $0.3 million increase in facility costs and $0.3 million increase in marketing costs.
Sales and marketing expenses decreased $7.2 million in 2016 compared to 2015. The decrease was primarily due to a $4.0 million decrease in salary and employee related expenses due in part to a decrease in headcount, a $1.9 million decrease in trade and brand marketing expenses, $0.7 million decrease in member acquisition costs and a $0.4 million decrease in professional service expenses.
Product Development
Product development expenses consist primarily of compensation for software development staff, fees for professional services, software maintenance and amortization and facilities costs. Product development expenses were $9.2 million, $9.1 million and $12.2 million for 2017, 2016 and 2015, respectively.
Product development expenses increased $128,000 in 2017 compared to 2016. The increase was primarily due to an increase in professional services related in part to our continuous enhancement to our website.
Product development expenses decreased $3.1 million in 2016 compared to 2015. The decrease was primarily due to a $1.5 million decrease in salary and employee related expenses, a $1.0 million decrease in professional service expenses and a $0.3 million decrease in contractor expenses.

General and Administrative
General and administrative expenses consist primarily of compensation for administrative, executive, fees for professional services, rent, bad debt expense, amortization of intangible assets, and general office expense. General and administrative expenses were $22.6 million, $22.7 million and $24.2 million for 2017, 2016 and 2015, respectively.
General and administrative expenses decreased $139,000 in 2017 compared to 2016. The decrease was primarily due to a $548,000 decrease in professional services expenses related to various outside services, offset partially by a $435,000 increase in salary and employee related expenses.
General and administrative expenses decreased $1.5 million in 2016 compared to 2015. The decrease was primarily due to a $2.2 million decrease in salary and employee related expenses due in part to a decrease in headcount, offset partially by a $0.5 million increase in professional services expenses.
Other Income (loss)
Other income (loss) consisted primarily of foreign exchange transactions gains and losses, interest income earned on cash, cash equivalents and restricted cash as well as interest expense. Other income (loss) was $173,000, $(187,000) and $(1.2) million for 2017, 2016 and 2015, respectively. Other income (loss) increased $360,000 from 2016 to 2017 primarily due to foreign exchange transaction gains in 2017. Other income (loss) decreased $1.1 million from 2015 to 2016 primarily due to foreign exchange transaction losses in 2015.
Income Taxes
On December 22, 2017, the U.S. government enacted the Tax Cuts and Jobs Act (the “Tax Act”). The Tax Act includes significant changes to the U.S. corporate income tax system including: a federal corporate rate reduction from 35% to 21%; limitations on the deductibility of interest expense and executive compensation; creation of new minimum taxes such as the base erosion anti-abuse tax (“BEAT”) and Global Intangible Low Taxed Income (“GILTI”) tax; and the transition of U.S. international taxation from a worldwide tax system to a modified territorial tax system, which will result in a one time U.S. tax liability on those earnings which have not previously been repatriated to the U.S. (the “Transition Tax”).
In connection with the Company's initial analysis of the impact of the Tax Act, the Company has recorded a provisional estimate of discrete net tax expense of $508,000 for the period ended December 31, 2017. This discrete expense consists of provisional estimates of zero net expense for the Transition Tax, $173,000 net benefit for the decrease in the Company's deferred tax liability on unremitted foreign earnings, and $681,000 net expense for remeasurement of the Company's deferred tax assets/liabilities for the corporate rate reduction.
We have not completed our accounting for the income tax effects of certain elements of the Tax Act, including the new GILTI and BEAT taxes. Due to the complexity of these new tax rules, we are continuing to evaluate these provisions of the Tax Act and whether such taxes are recorded as a current-period expense when incurred or whether such amounts should be factored into a company’s measurement of its deferred taxes. As a result, we have not included an estimate of the tax expense/benefit related to these items for the period ended December 31, 2017.
Our income is generally taxed in the U.S., Canada and U.K. Our income tax provision reflects federal, state and country statutory rates applicable to our worldwide income, adjusted to take into account expenses that are treated as having no recognizable tax benefit. Income tax expense (benefit) was $3.1 million, $4.0 million and $(5.9) million for 2017, 2016 and 2015, respectively. Our effective tax rate was 66%, 40% and (231)% for 2017, 2016 and 2015, respectively.
Our effective tax rate increased for the year ended December 31,2017 compared to the year ended December 31, 2016, primarily due to unfavorable change in our geographic mix of our worldwide taxable income including foreign net operating losses from Asia Pacific that are not benefited. In addition, the effective tax rate decreased by $907,000 due primarily to the recognition of certain previously unrecognized tax benefits related to uncertain tax positions as a result of the settlement of certain tax examinations offset by the provisional estimated net tax expense of $508,000 resulting from our initial analysis of the impact of the U.S. tax reform passed in December 2017. Our effective tax rate increased for the year ended December 31, 2016 compared to the year ended December 31, 2015, primarily due to the recognition of an $8.4 million tax benefit related to the unexchanged promotional shares after a lapse of certain statute of limitations in 2015. We expect that our effective tax rate in future periods may fluctuate depending on the geographic mix of our worldwide taxable income, total amount of expenses representing payments to former

stockholders, income or losses incurred by our operations in Asia Pacific, Canada and Europe, statutory tax rate changes that may occur and the need for valuation allowances on certain tax assets, if any. See Note 5 to the accompanying consolidated financial statements for more information on our effective tax rate.

Segment Information

Asia Pacific

	Year Ended December 31,		
	2017	2016	2015
	(In thousands)		
Revenues	$7,519	$9,698	$10,649
(Loss) from operations	$(5,967)	$(3,890)	$(2,469)
(Loss) from operations as a % of revenues	(79)%	(40)%	(23)%

Asia Pacific net revenues decreased $2.2 million in 2017 compared to 2016 (see “Revenues” above). Asia Pacific expenses decreased $102,000 from 2016 to 2017. This decrease was primarily due to a $470,000 decrease in member acquisition costs, offset partially by a $188,000 increase of salary expense and a $130,000 increase in rent expense.

Asia Pacific net revenues decreased $951,000 in 2016 compared to 2015 (see “Revenues” above). Asia Pacific expenses increased $470,000 from 2015 to 2016. This increase was primarily due to a $666,000 increase in member acquisition costs, a $251,000 increase in trade and brand marketing expenses, offset partially by a $620,000 decrease of salary and employee related expense due primarily to a decrease in headcount.

Foreign currency movements relative to the U.S. dollar positively impacted our local currency loss from our operations in Asia Pacific by approximately $35,000 for fiscal years 2017. Foreign currency movements relative to the U.S. dollar negatively impacted our local currency loss from our operations in Asia Pacific by approximately $191,000 and $16,000 for fiscal years 2016 and 2015, respectively.

Europe

	Year Ended December 31,		
	2017	2016	2015
	(In thousands)		
Revenues	$33,681	$36,907	$39,736
Income from operations	$2,290	$5,604	$2,472
Income from operations as a % of revenues	7 %	15 %	6 %

Europe net revenues decreased $3.2 million in 2017 compared to 2016 (see “Revenues” above). Europe expenses increased $88,000 from 2016 to 2017. The increase was primarily due to a $176,000 increase in customer retention costs, a $173,000 increase in trade and brand marketing expenses, a $136,000 increase in office and facility expenses and a $130,000 increase in professional services expenses, offset partially by a $496,000 decrease in salary and employee related expenses.

Europe net revenues decreased $2.8 million in 2016 compared to 2015 (see “Revenues” above). Europe expenses decreased $6.0 million from 2015 to 2016. The decrease was primarily due to a $1.8 million decrease in salary and employee related expenses, a $1.5 million decrease in trade and brand marketing expenses, a $1.0 million decrease in member acquisition costs.

Foreign currency movements relative to the U.S. dollar negatively impacted our local currency income from our operations in Europe by approximately $116,000, $633,000 and $101,000 for 2017, 2016 and 2015, respectively.

North America

	Year Ended December 31,		
	2017	2016	2015
	(In thousands)		
Revenues	$65,324	$67,658	$73,576
Income from operations	$8,222	$8,472	$3,817
Income from operations as a % of revenues	13 %	13 %	5 %

North America net revenues decreased $2.3 million in 2017 compared to 2016 (see “Revenues” above). North America expenses decreased $2.1 million from 2016 to 2017. This decrease was primarily due to a $1.0 million decrease in professional services expenses, a $0.8 million decrease in member acquisition costs and a $0.6 million decrease in payments made to third-party partners of the Travelzoo Network, offset partially by a $0.5 million increase in customer refund in Local Deals and Getaway products.

North America net revenues decreased $5.9 million in 2016 compared to 2015 (see “Revenues” above). North America expenses decreased $10.6 million from 2015 to 2016. This decrease was primarily due to a $6.3 million decrease in salary and employee related expense due in part to a decrease in headcount, a $2.8 million decrease in payments made to third-party partners of the Travelzoo Network and a $0.9 million decrease in member acquisition costs.

Liquidity and Capital Resources

As of December 31, 2017, we had $22.6 million in cash and cash equivalents, of which $16.4 million was held outside the U.S. in certain of our foreign operations. If these assets are distributed to the U.S., we may be subject to additional U.S. taxes in certain circumstances. Cash and cash equivalents decreased from $26.8 million as of December 31, 2016 primarily as a result of cash used for repurchases of our common stock. We expect that cash on hand will be sufficient to provide for working capital needs for at least the next twelve months.

	Year Ended December 31,		
	2017	2016	2015
	(In thousands)		
Net cash provided by operating activities	$2,076	$8,722	$4,192
Net cash provided by (used in) investing activities	2,152	(909)	(1,218)
Net cash used in financing activities	(9,712)	(15,262)	(20,012)
Effect of exchange rate changes on cash and cash equivalents	1,199	(841)	(3,251)
Net decrease in cash and cash equivalents	$(4,285)	$(8,290)	$(20,289)

Net cash provided by operating activities is net income adjusted for certain non-cash items and changes in assets and liabilities. Net cash provided by operating activities was $2.1 million for 2017, which consisted of a net income of $3.5 million, adjustments for non-cash items of $265,000, offset partially a $1.7 million decrease in cash from changes in operating assets and liabilities. Adjustments for non-cash items primarily consisted of the $2.9 million discontinued operations gain on the sale of the Fly.com domain name, offset by $2.1 million of depreciation and amortization expense on property and equipment and $1.0 million of stock-based compensation expense. The decrease in cash from changes in operating assets and liabilities primarily consisted of $2.5 million decrease in other non-current liabilities primarily associated with the resolution of 2009 IRS audit related to the sale of our Asia Pacific business segment and $1.6 million decrease in accounts payable, offset partially by $3.1 million decrease in accounts receivable.

Net cash provided by operating activities was $8.7 million for 2016, which consisted of a net income of $6.6 million, adjustments for non-cash items of $3.0 million and a $958,000 decrease in cash from changes in operating assets and liabilities. Adjustments for non-cash items primarily consisted of $2.5 million of depreciation and amortization expense on property and equipment and $933,000 of stock-based compensation expense. The decrease in cash from changes in operating assets and liabilities primarily consisted of $2.5 million decrease in accounts payable offset partially by $1.3 million decrease in accounts receivable.

Net cash provided by operating activities was $4.2 million for 2015, which consisted of a net income of $10.9 million, adjustments for non-cash items of $3.4 million and a $10.1 million decrease in cash from changes in operating assets and liabilities. Adjustments for non-cash items primarily consisted of $2.8 million of depreciation and amortization expense on property and equipment and $401,000 of stock-based compensation expense. In addition, the decrease in cash from changes in operating assets and liabilities primarily consisted of $7.9 million in other non-current liabilities, $1.4 million in accrued expenses for unexchanged promotional shares, $2.8 million in accounts payable and accrued expenses offset by $2.4 million in income tax receivable.

Cash paid for income tax net of refunds received in 2017, 2016 and 2015 was $6.2 million, $3.3 million and $801,000, respectively.

Net cash provided by investing activities for 2017 was $2.2 million. Net cash used in investing activities for 2016 and 2015 was $909,000 and $1.2 million, respectively. The cash provided by investing activities in 2017 was primarily due to $2.9 million proceeds from sale the Fly.com domain name, offset partially by $738,000 in purchases of property and equipment. The cash used in investing activities in 2016 was due primarily to $909,000 in purchases of property and equipment. The cash used in investing activities in 2015 was due primarily to $1.3 million in purchases of property and equipment offset by $64,000 release of restricted cash.

Net cash used in financing activities for 2017, 2016 and 2015 was $9.7 million, $15.3 million and $20.0 million, respectively. Net cash used in financing activities for the year ended December 31, 2017 was primarily due to $9.7 million cash used in repurchases of our common stock. Net cash used in financing activities for the year ended December 31, 2016 was primarily due to $5.7 million payment of related party loan and $9.7 million cash used in repurchases of our common stock. Net cash used in financing activities for the year ended December 31, 2015 was primarily due to cash used in acquiring the Travelzoo Asia Pacific business and repurchases of our common stock. See Note 4 to the accompanying consolidated financial statements for information on the unexchanged promotional share settlements and related cash program.

Although the Company has settled the states unclaimed property claims with all states, the Company may still receive inquiries from certain potential Netsurfer promotional stockholders that had not provided their state of residence to the Company by April 25, 2004. Therefore, the Company is continuing its voluntary program under which it makes cash payments to individuals related to the promotional shares for individuals whose residence was unknown by the Company and
who establish that they satisfied the conditions to receive shares of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo within the required time period. This voluntary program is not available for individuals whose promotional shares have been escheated to a state by the Company.

Our capital requirements depend on a number of factors, including market acceptance of our products and services, the amount of our resources we devote to the development of new products, cash payments related to former stockholders of Travelzoo.com Corporation, expansion of our operations, and the amount of resources we devote to promoting awareness of our Travelzoo brands. Since the inception of the program under which we make cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo within the required time period, we have incurred expenses of $2.9 million. While future payments for this program are expected to decrease, the total cost of this program is still undeterminable because it is dependent on our stock price and on the number of valid requests ultimately received.

Consistent with our growth, we have experienced fluctuations in our cost of revenues, sales and marketing expenses and our general and administrative expenses, including increases in product development costs, and we anticipate that these increases will continue for the foreseeable future. We believe cash on hand will be sufficient to pay such costs for at least the next twelve months. In addition, we will continue to evaluate possible investments in businesses, products and technologies, the consummation of any of which would increase our capital requirements.

Although we currently believe that we have sufficient capital resources to meet our anticipated working capital and capital expenditure requirements for at least the next twelve months, unanticipated events and opportunities or a less favorable than expected development of our business with one or more of advertising formats may require us to sell additional equity or debt securities or establish new credit facilities to raise capital in order to meet our capital requirements.

If we sell additional equity or convertible debt securities, the sale could dilute the ownership of our existing stockholders. If we issue debt securities or establish a new credit facility, our fixed obligations could increase, and we may be required to agree to operating covenants that would restrict our operations. We cannot be sure that any such financing will be available in amounts or on terms acceptable to us.

If the development of our business is less favorable than expected, we may decide to significantly reduce the size of our operations and marketing expenses in certain markets with the objective of reducing cash outflow.

The information set forth under “Note 4 — Commitments and Contingencies” to the accompanying consolidated financial statements included in Part II, Item 8 of this report is incorporated herein by reference. Litigation and claims against

the Company may result in legal defense costs, settlements or judgments that could have a material impact on our financial condition.
The following summarizes our principal contractual commitments as of December 31, 2017 (in thousands):

	2018	2019	2020	2021	2022	Thereafter	Total
Operating leases	$5,320	$4,505	$3,833	$3,205	$2,370	$ 3,258	$22,491
Purchase obligations	1,446	17	11	—	—	—	1,474
Total commitments	$6,766	$4,522	$3,844	$3,205	$2,370	$ 3,258	$23,965

We also have contingencies related to net unrecognized tax benefits, including interest, of approximately $1.2 million as of December 31, 2017. See Note 5 to the accompanying consolidated financial statements for further information.

Critical Accounting Policies and Estimates

We believe that there are a number of accounting policies that are critical to understanding our historical and future performance, as these policies affect the reported amounts of revenue and the more significant areas involving management’s judgments and estimates. These significant accounting policies relate to revenue recognition, reserve for member refunds, allowance for doubtful accounts, income taxes and loss contingencies. These policies, and our procedures related to these policies, are described in detail below.

Revenue Recognition

We recognize advertising revenues in the period in which the advertisement is displayed, or the voucher sale has been completed, provided that evidence of an arrangement exists, the fees are fixed or determinable and collection of the resulting receivable is reasonably assured. If fixed-fee advertising is displayed over a term greater than one month, revenues are recognized ratably over the period as described below. The majority of insertion orders have terms that begin and end in a quarterly reporting period. In the cases where at the end of a quarterly reporting period the term of an insertion order is not complete, the Company allocates the total arrangement fee to each element based on the relative estimated selling price of each element. The Company uses prices stated on its internal rate card, which represents stand-alone sales prices, to establish estimated selling prices. The stand-alone price is the price that would be charged if the advertiser purchased only the individual insertion. Fees for variable-fee advertising arrangements are recognized based on the number of impressions displayed, number of clicks delivered, or number of referrals generated during the period.

Under these policies, the Company evaluates each of these criteria as follows:

- Evidence of an arrangement. We consider an insertion order signed by the advertiser or its agency to be evidence of an arrangement.
- Delivery. Delivery is considered to occur when the advertising has been displayed, the click-throughs have been delivered, the voucher sale has been completed and cancelable hotel booking reservation stays have occurred or non-cancelable hotel booking reservations have been booked, as applicable.
- Fixed or determinable fee. Our arrangements with our customers specifies the price paid for advertising services.
- Collection is deemed reasonably assured. We conduct a credit review for all advertising transactions at the time of the arrangement to determine the creditworthiness of the advertiser. Collection is deemed reasonably assured if we expect that the advertiser will be able to pay amounts under the arrangement as payments become due. Collection is deemed not reasonably assured when an advertiser is perceived to be in financial distress, which may be evidenced by weak industry conditions, a bankruptcy filing, or previously billed amounts that are past due. If we determine that collection is not reasonably assured, then we defer the revenue and recognize the revenue upon cash collection. Collection is deemed reasonably assured for our voucher sales to consumers as these transactions require the use of credit cards subject to authorization.

Revenues from advertising sold to advertisers through agencies are reported at the amount billed to the agency.

For Local Deals and Getaway products, the Company earns a fee for acting as an agent in these transactions which is recorded on a net basis and is included in revenue upon completion of the voucher sale. Certain merchant contracts in foreign locations allow us to retain fees related to vouchers sold that are not redeemed by purchasers upon expiration, which we recognize as revenue after the expiration of the redemption period and after there are no further obligations to provide funds to merchants, members or others.

Commission revenues generated through provision of hotel booking reservations to hotels are recognized upon the estimated date the stay occurs at the hotel, which includes estimates of cancellations of the hotel bookings based upon historical patterns. If the hotel booking cannot be canceled or the hotel advertiser has agreed to pay for booking regardless of potential future cancellations then revenue is recognized upon booking.

Reserve for Member Refunds

We record an estimated reserve for member refunds based on our historical experience at the time revenue is recorded for Local Deals and Getaway voucher sales. We accrue costs associated with refunds in accrued expenses on the consolidated balance sheets. We consider many key factors such as the historical refunds based upon the time lag since the sale, historical reasons for refunds, time period that remains until the deal expiration date, any changes in refund procedures and estimates of redemptions and breakage. Should any of these factors change, the estimates made by management will also change, which could impact the level of our future reserves for member refunds. Specifically, if the financial condition of our advertisers, the businesses that are providing the vouchered services, were to deteriorate, affecting their ability to provide the services to our members, additional reserves for member refunds may be required.

Estimated member refunds that are determined to be recoverable from the merchant and the portion of which represents our fee from the merchant are recorded in the consolidated statements of operations as a reduction to revenue. Estimated member refunds that are determined not to be recoverable from the merchant are presented as a cost of revenue. If our judgments regarding estimated member refunds are inaccurate, reported results of operations could differ from the amount we previously accrued.

Allowance for Doubtful Accounts

We record a provision for doubtful accounts based on our historical experience of write-offs and a detailed assessment of our accounts receivable and allowance for doubtful accounts. In estimating the provision for doubtful accounts, management considers the age of the accounts receivable, our historical write-offs, the creditworthiness of the advertiser, the economic conditions of the advertiser’s industry, and general economic conditions, among other factors. Should any of these factors change, the estimates made by management will also change, which could impact the level of our future provision for doubtful accounts. Specifically, if the financial condition of our advertisers were to deteriorate, affecting their ability to make payments, additional provision for doubtful accounts may be required.

Income Taxes

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. We adjust these reserves in light of changing facts and circumstances, such as the progress or closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest. In addition to local country tax laws and regulations, our income tax rate depends on the extent that our foreign earnings are taxed by the U.S. through new provisions under the Tax Act such as the new GILTI tax and BEAT or as a result of our indefinite reinvestment assertion. Indefinite reinvestment is determined by management’s judgment about and intentions concerning our future operations.

Our effective tax rates have differed from the statutory rate primarily due to the tax impact of foreign operations, state taxes, certain benefits realized related to stock option activities, credits, the extent that our earnings are indefinitely reinvested outside the U.S. and tax asset valuation allowance determinations, including on certain loss carryforwards. For the years ended December 31, 2017, 2016 and 2015, our effective tax rates were 66%, 40% and (231)%, respectively. Our future effective tax rates could be materially impacted by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, changes in the deferred tax assets or liabilities, existing or new uncertain tax matters that may arise and require changes in tax reserves, changes in tax asset valuation allowance determinations, changes in our judgment about whether certain foreign earnings are indefinitely reinvested outside the U.S., or changes in tax laws, regulations, and accounting principles. In addition, we are subject to the continuous examination of our income tax returns by the IRS and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. See Note 5 to the accompanying consolidated financial statements for further information.

Loss Contingencies

We are involved in claims, suits, and proceedings arising from the ordinary course of our business. We record a provision for a liability when we believe that it is both probable that a liability has been incurred, and the amount can be reasonably estimated. Significant judgment is required to determine both probability and the estimated amount. Such claim proceedings are inherently unpredictable and subject to significant uncertainties, some of which are beyond our control. Should any of these estimates and assumptions change or prove to have been incorrect, it could have a material impact on our results of operations, financial position and cash flows. Please refer to Note 4 to the accompanying consolidated financial statements for further information regarding our loss contingencies.

Recent Accounting Pronouncements

See “Note 1 — Summary of Significant Accounting Policies” to the accompanying consolidated financial statements included in this report, regarding our significant accounting policies and any impact of certain recent accounting pronouncements on our consolidated financial statements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We believe that our potential exposure to changes in market interest rates is not material. The Company is not a party to any derivative transactions. We invest in highly liquid investments with short maturities. Accordingly, we do not expect any material loss from these investments.

Our operations in Canada expose us to foreign currency risk associated with agreements being denominated in Canadian Dollars. Our operations in Europe expose us to foreign currency risk associated with agreements being denominated in British Pound Sterling and Euros. Our operations in Asia Pacific expose us to foreign currency risk associated with agreements being denominated in Australian dollars, Chinese Yuan, Hong Kong dollar, Japanese Yen and Taiwanese Yuan. We are exposed to foreign currency risk associated with fluctuations of these currencies as the financial position and operating results of our operations in Asia Pacific, Canada and Europe are translated into U.S. dollars for consolidation purposes. We do not use derivative instruments to hedge these exposures. We have performed a sensitivity analysis as of December 31, 2017, using a modeling technique that measures the change in the fair values arising from a hypothetical 10% adverse movement in the levels of foreign currency exchange rates relative to the U.S. dollar with all other variables held constant. The foreign currency exchange rates we used were based on market rates in effect at December 31, 2017. The sensitivity analysis indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in an incremental $185,000 foreign exchange loss for the year ended December 31, 2017.

Item 8. Financial Statements and Supplementary Data
TRAVELZOO
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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Travelzoo

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Travelzoo and its subsidiaries as of December 31, 2017 and December 31, 2016, and the related consolidated statements of operations, comprehensive income, stockholders' equity and cash flows for each of the two years in the period ended December 31, 2017, including the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Company's 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 (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and December 31, 2016, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2017 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the COSO.

Change in Accounting Principle

As discussed in Note 1 to the consolidated financial statements, the Company changed the manner in which it accounts for certain elements of its deferred income taxes in 2017.

Basis for Opinions

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on the Company's consolidated financial statements and on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("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 audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated 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 consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. 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 audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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 (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) 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 (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

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

/s/ PricewaterhouseCoopers LLP

San Jose, California
March 15, 2018

We have served as the Company’s auditor since 2016.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
The Board of Directors and Stockholders
Travelzoo:

We have audited the accompanying consolidated statements of operations, comprehensive income, stockholders' equity, and cash flows of Travelzoo and subsidiaries (Travelzoo) for the year ended December 31, 2015. These consolidated financial statements are the responsibility of Travelzoo's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.
We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit of the consolidated financial statements included 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, and evaluating the overall financial statement presentation. We believe that our audit provide a reasonable basis for our opinion.
In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations and cash flows of Travelzoo for the year ended December 31, 2015, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP
Santa Clara, California
March 11, 2016, except for Note 11, as to which the date is March 15, 2018

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TRAVELZOO
CONSOLIDATED BALANCE SHEETS
(In thousands, except par value)

	December 31, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$ 22,553	$ 26,838
Accounts receivable, less allowance for doubtful accounts of $315 and $295 as of December 31, 2017 and 2016, respectively	11,769	14,415
Income tax receivable	517	542
Deferred tax assets	—	793
Deposits	259	105
Prepaid expenses and other	2,141	1,773
Total current assets	37,239	44,466
Deposits and other	548	702
Deferred tax assets	1,516	1,052
Restricted cash	1,448	1,152
Property and equipment, net	4,921	6,158
Total assets	$ 45,672	$ 53,530
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 19,105	$ 19,714
Accrued expenses and other	8,702	8,699
Deferred revenue	825	719
Income tax payable	961	691
Total current liabilities	29,593	29,823
Long-term tax liabilities	373	2,879
Long-term deferred rent and other	2,628	2,764
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.01 par value per share (5,000 shares authorized; none issued)	—	—
Common stock, $0.01 par value (40,000 shares authorized; 12,462 shares issued and outstanding as of December 31, 2017 and 13,462 shares issued and outstanding as of December 31, 2016)	125	135
Additional paid-in capital	—	—
Retained earnings	16,550	21,716
Accumulated other comprehensive loss	(3,597)	(3,787)
Total stockholders' equity	13,078	18,064
Total liabilities and stockholders' equity	$ 45,672	$ 53,530

See accompanying notes to consolidated financial statements.

TRAVELZOO
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Year Ended December 31,		
	2017	2016	2015
Revenues	$106,524	$114,263	$123,961
Cost of revenues	12,909	13,855	18,148
Gross profit	93,615	100,408	105,813
Operating expenses:			
Sales and marketing	57,288	58,429	65,609
Product development	9,224	9,096	12,214
General and administrative	22,558	22,697	24,170
Total operating expenses	89,070	90,222	101,993
Income from continuing operations	4,545	10,186	3,820
Other income (loss), net	173	(187)	(1,242)
Income from continuing operations before income taxes	4,718	9,999	2,578
Income tax expense (benefit)	3,126	3,992	(5,945)
Income from continuing operations	$1,592	$6,007	$8,523
Income from discontinued operations, net of income taxes	1,938	624	2,341
Net income	$3,530	$6,631	$10,864
Income per share—basic:			
Continuing operations	$0.12	$0.43	$0.58
Discontinued operations	0.15	0.04	0.16
Net income per share—basic	$0.27	$0.47	$0.74
Income per share—diluted:			
Continuing operations	$0.12	$0.43	$0.58
Discontinued operations	0.15	0.04	0.16
Net income per share—diluted	$0.27	$0.47	$0.74
Shares used in computing basic net income per share	12,882	13,997	14,722
Shares used in computing diluted net income per share	12,894	13,997	14,722

See accompanying notes to consolidated financial statements.

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TRAVELZOO
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Year Ended December 31,		
	2017	2016	2015
Net income	$3,530	$6,631	$10,864
Other comprehensive income (loss):			
Foreign currency translation adjustment	190	121	(1,306)
Total comprehensive income	$3,720	$6,752	$9,558

See accompanying notes to consolidated financial statements.

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TRAVELZOO
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)

	Common Stock Shares	Common Stock Amount	Treasury Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balances, January 1, 2015	14,730	$ 163	$ (21,517)	$ 30,586	$ 29,197	$ (2,602)	$ 35,827
Stock-based compensation expense	—	—	—	401	—	—	401
Retirement of treasury stock	—	(13)	23,241	(23,228)	—	—	—
Repurchase and retirement of common stock, net	(212)	—	(1,724)	—	—	—	(1,724)
Proceeds from sale of shares fractionalized from reverse/forward stock split, including transaction costs	—	—	—	—	(102)	—	(102)
Acquisition of Asia Pacific Business	—	—	—	—	(22,573)	—	(22,573)
Foreign currency translation adjustment	—	—	—	—	—	(1,306)	(1,306)
Net income	—	—	—	—	10,864	—	10,864
Balances, December 31, 2015	14,518	150	—	7,759	17,386	(3,908)	21,387
Stock-based compensation expense	—	—	—	933	—	—	933
Repurchase and retirement of common stock, net	(1,056)	(15)	—	(7,189)	(2,301)	—	(9,505)
Tax benefit shortfall from forfeiture/cancellation of stock options	—	—	—	(1,503)	—	—	(1,503)
Foreign currency translation adjustment	—	—	—	—	—	121	121
Net income	—	—	—	—	6,631	—	6,631
Balances, December 31, 2016	13,462	135	—	—	21,716	(3,787)	18,064
Stock-based compensation expense	—	—	—	1,006	—	—	1,006
Repurchase and retirement of common stock, net	(1,000)	(10)	—	(1,006)	(8,696)	—	(9,712)
Foreign currency translation adjustment	—	—	—	—	—	190	190
Net income	—	—	—	—	3,530	—	3,530
Balances, December 31, 2017	12,462	$ 125	$—	$—	$ 16,550	$ (3,597)	$ 13,078

See accompanying notes to consolidated financial statements.

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TRAVELZOO
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended December 31,		
	2017	2016	2015
Cash flows from operating activities:			
Net income	$3,530	$6,631	$10,864
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,075	2,530	2,788
Discontinued operations gain on sale of Fly.com domain name	(2,890)	—	—
Stock-based compensation	1,006	933	401
Deferred income tax	309	(199)	(269)
Net foreign currency effect	(354)	(315)	480
Other	118	100	(20)
Changes in operating assets and liabilities:			
Accounts receivable	3,065	1,313	(789)
Income tax receivable	28	816	2,371
Prepaid expenses and other	(487)	957	675
Accounts payable	(1,588)	(2,463)	(1,139)
Reserve for unexchanged promotional shares	—	—	(1,393)
Accrued expenses and other	(475)	(1,747)	(1,681)
Income tax payable	261	287	(161)
Other non-current liabilities	(2,522)	(121)	(7,935)
Net cash provided by operating activities	2,076	8,722	4,192
Cash flows from investing activities:			
Purchases of property and equipment	(738)	(909)	(1,282)
Proceeds from sale of Fly.com domain name	2,890	—	—
Release of restricted cash	—	—	64
Net cash provided by (used in) investing activities	2,152	(909)	(1,218)
Cash flows from financing activities:			
Acquisition of the Asia Pacific business	—	58	(16,974)
Payment of loan to related party	—	(5,658)	(3,250)
Proceeds from loan from related party	—	—	2,224
Increase in bank overdraft	—	—	44
Decrease in bank overdraft	—	—	