NAUTILUS, INC.
Form 10-K
March 07, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2012

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number: 001-31321

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

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

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, no par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [x]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [x]

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [x]

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

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the last sales price ($2.67) as reported on the New York Stock Exchange as of the last business day of the registrant's most recently completed second fiscal quarter (June 30, 2012) was $82,456,947.

The number of shares outstanding of the registrant's common stock as of February 28, 2013 was 30,935,316 shares.

Documents Incorporated by Reference

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The registrant has incorporated by reference into Part III of this Form 10-K portions of its Proxy Statement for its 2013 Annual Meeting of Shareholders.

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NAUTILUS, INC.
2012 FORM 10-K ANNUAL REPORT

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PART I

Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "plan," "expect," "aim," "believe," "project," "intend," "estimate," "will," "should," "could," and other terms of similar meaning typically identify forward-looking statements. The forward-looking statements in this report include, without limitation, the anticipated opportunity for growth in sales of cardio products; plans to continue to be a large direct marketer of strength products; potential continuance of or improvement in consumer credit financing approval rates; the continuance of certain advertising strategies and the impact of such programs on product sales; our new product development strategies; expectations for increased research and development expenses and our plans and expectations regarding borrowing agreements. Forward-looking statements also include any statements related to our expectations regarding future business and financial performance or conditions, anticipated sales growth across markets, distribution channels and product categories, expenses and gross margins, profits or losses, losses from discontinued operation, settlements of warranty obligations, new product introductions, financing and working capital requirements and resources. These forward-looking statements, and others we make from time-to-time, are subject to a number of risks and uncertainties. Many factors could cause actual results to differ materially from those projected in forward-looking statements, including the risks described in Part I, Item 1A of this report. We do not undertake any duty to update forward-looking statements after the date they are made or conform them to actual results or to changes in circumstances or expectations.

Item 1. Business

Unless the context otherwise requires, “Nautilus,” “Company,” “we,” “us,” and “our” refer to Nautilus, Inc. and its subsidiaries. All references to 2012, 2011 and 2010 in this report refer to our fiscal years ended on December 31, 2012, 2011 and 2010, respectively.

OVERVIEW

Founded in 1986, Nautilus is a consumer fitness products company headquartered in Vancouver, Washington and incorporated in the State of Washington in January 1993. We are committed to providing innovative, quality solutions to help people achieve a fit and healthy lifestyle. Our principal business activities include designing, developing, sourcing and marketing high-quality cardio and strength fitness products and related accessories for consumer use, primarily in the United States and Canada. Our products are sold under some of the most-recognized brand names in the fitness industry: Nautilus®, Bowflex®, Schwinn®, Schwinn Fitness™ and Universal®.

We market our products through two distinct distribution channels, Direct and Retail, which we consider to be separate business segments. Our Direct business offers products directly to consumers through television advertising, catalogs and the Internet. Our Retail business offers our products through a network of independent retail companies with stores and websites located in the United States and internationally. We also derive a portion of our revenue from the licensing of our brands and intellectual property.

During the third quarter of 2009, we committed to a plan for the complete divestiture of our Commercial business with the expectation that the plan's successful completion would improve our overall operating results. Our former Commercial business, now classified as a discontinued operation, offered products to health clubs, schools, hospitals and other organizations. We completed the disposal of the assets held for sale of our former Commercial business in April 2011 and we substantially completed the liquidation of our investment in foreign subsidiaries related to the discontinued operation in the fourth quarter of 2012.

BUSINESS STRATEGY

We are focused on developing and marketing consumer fitness equipment and related products to help people enjoy healthier lives. Our products are targeted to meet the needs of a broad range of consumers, including fitness enthusiasts and individuals who are seeking the benefits of regular exercise. We have diversified our business by expanding our portfolio of high-quality fitness equipment into multiple product lines utilizing our well-recognized brand names. Our business strategy focuses exclusively on consumer products, markets and distribution channels.

Our strategies incorporate the individual characteristics of our Direct and Retail businesses. Our Direct business focuses on (i) the development of, or acquisition of rights to, unique products; (ii) the application of creative, cost-effective ways to communicate the benefits of their use; and (iii) making various payment options available to our customers. We are particularly attentive to Direct business metrics that provide feedback regarding the effectiveness of our media marketing programs and attractiveness of third-party consumer financing programs.

In our Retail business, we strive to develop long-term relationships with key retailers of sports or fitness equipment. The primary objectives of our Retail business are (i) to offer a selection of products at key price-points; and (ii) to utilize the strength of our brands and long-standing customer relationships to secure more floor space with our Retail customers for our products.

Our long-term strategy involves:

- creatively marketing our equipment, both directly to consumers and through our Retail customers, while leveraging our well-known brand names;
- enhancing our product lines by designing fitness equipment that meets or exceeds the high expectations of our customers;
- utilizing our strengths in product engineering to reduce product costs;
- continuing our investment in research and development activities aimed at acquiring or creating new technologies;
- increasing our international Retail sales and distribution; and
- increasing royalty revenues from the licensing of our brands and intellectual property.

PRODUCTS

We market quality cardiovascular and strength fitness products that cover a broad range of price points and features. Our products are designed for home use by individuals with varying exercise needs. From the person who works out occasionally to the serious athlete, we have products that will help them achieve their fitness objectives.

- Our Nautilus brand includes a complete line of cardio equipment, including treadmills, specialized cardio, exercise bikes and ellipticals.

- Our Bowflex brand represents a highly-regarded line of fitness equipment comprised of both cardio and strength products, including TreadClimber® specialized cardio machines, treadmills, PowerRod® and Revolution® home gyms, and SelectTech® dumbbells.

- Our Schwinn brand is known for its popular line of exercise bikes, including the Airdyne®, ellipticals and treadmills.

- Our Universal brand, one of the oldest and most recognized names in the fitness industry, currently offers a line of kettlebell weights and weight benches.

While we offer our full product assortment to our Direct customers through our Internet websites and our catalogs, we generally differentiate the product models offered in our Direct and Retail sales channels. Currently, our Bowflex TreadClimber product line is offered for sale primarily through our Direct sales channel.

Approximately 71% of our revenue in 2012 was derived from sales of consumer cardio products. While we continue to be a leader in the consumer strength product category, we believe the much larger market for cardio products offers us greater opportunity for growth.

BUSINESS SEGMENTS

We conduct our business in two segments, Direct and Retail. For further information, see Note 14, Segment Information, to our consolidated financial statements in Part II, Item 8 of this report.

SALES AND MARKETING

Direct

In our Direct business, we market and sell our products, principally Bowflex cardio and strength products, directly to consumers. While we are, and plan to continue to be, a large direct marketer of strength products in the United States, our advertising emphasis has shifted toward cardio products, especially the Bowflex TreadClimber, as cardio products represent the largest component of the fitness equipment market and a growing part of our business. Sales of cardio products represented 81% of our Direct channel revenues in 2012, compared to 71% in 2011 and 56% in 2010.

Our marketing efforts are based on an integrated combination of media and direct consumer contact. In addition to television advertising, which ranges in length from 30 seconds to as long as five minutes, we utilize extended 30-minute television infomercials, Internet advertising, product websites, inquiry-response mailings, catalogs and inbound/outbound call centers. Marketing and media effectiveness is measured continuously based on sales inquiries generated, cost-per-lead, conversion rates, return on investment and other performance metrics. Almost all of our Direct customer orders are received either on our Internet websites or through company-owned and third-party call centers.

In September 2010, we completed our transition to a new consumer credit program with a new primary third-party financing provider, GE Capital Retail Bank, formerly GE Money Bank ("GE"). The relationship with GE has expanded the ability of our customers to obtain third-party consumer financing for purchases of our products. In addition, we added one secondary third-party consumer credit financing provider during the third quarter of 2010 and another in early 2011, both of which offer credit to certain qualified consumers whose credit applications have been declined by GE. As a result, combined consumer credit approvals by our primary and secondary U.S. third-party financing providers increased to 32% in 2012 from 25% in 2011 and 15% in 2010.

Retail

In our Retail business, we market and sell a comprehensive line of consumer fitness equipment under the Nautilus, Schwinn, Universal and Bowflex brands. Our products are marketed through a network of retail companies, consisting of sporting goods stores, Internet retailers, large-format and warehouse stores, and, to a lesser extent, smaller specialty retailers and independent bike dealers.

We offer programs that provide price discounts to our Retail customers for ordering container-sized shipments or placing orders early enough in the season to allow for more efficient manufacturing by our Asian suppliers. These programs are designed to reduce our shipping and handling costs, with much of the savings being passed on to our customers. In addition, our Retail customers generally are eligible for other types of sales incentives, including volume discounts and various forms of rebates or allowances, which generally are intended to increase product exposure and availability for consumers, reduce transportation costs, and encourage marketing and promotion of our brands or specific products.

PRODUCT DESIGN AND INNOVATION

Innovation is a vital part of our business, and we continue to expand and diversify our product offerings by leveraging our research and development capabilities. We constantly search for new technologies and innovations that will help us grow our business, either through higher sales or increased production efficiencies. To accomplish this objective, we seek out ideas and concepts both within our company and from outside inventors.

We rely on financial and engineering models to assist us in assessing the potential operational and economic impacts of adopting new technologies and innovations. If we determine that a third-party technology or innovation concept meets certain technical and financial criteria, we may enter into a licensing arrangement to utilize the technology or, in certain circumstances, purchase the technology for our own use. Our product design and engineering teams also invest considerable effort to improve product design and quality. As a consumer-driven company, we invest from time-to-time in qualitative and quantitative consumer research to help us assess new product concepts, optimal features and anticipated consumer adoption.

Our research and development expenses were $4.2 million, $3.2 million and $2.9 million in 2012, 2011 and 2010, respectively, as we increased our investment in new product development resources and capabilities. We expect our research and development expenses to increase in 2013 as we continue to increase our investment in new product development.

SEASONALITY

We expect our sales to vary seasonally. Sales are typically strongest in the first and fourth quarters, followed by the third quarter, and are generally weakest in the second quarter. We believe that various factors, such as the broadcast of network season finales and seasonal weather patterns, influence television viewers and cause our advertising on cable television stations to be less effective in the second quarter than in other periods. In addition, during the spring and summer months, consumers tend to be involved in outdoor activities, including outdoor exercise, which impacts sales of indoor fitness equipment. This seasonality can have a significant effect on our inventory levels, working capital needs and resource utilization.

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MERCHANDISE SOURCING

All of our products are produced by third-party manufacturers, most of whom are the sole source for particular products and substantially all of whom are located in Asia. Lead times for inventory purchases from our Asian suppliers, from order placement to receipt of goods, generally range from approximately two to three months, of which transit time represents three-to-four weeks. The length of our lead times requires us to place advance manufacturing orders based on management forecasts of future demand for our products. We attempt to compensate for our long replenishment lead times by maintaining adequate levels of inventory at our warehousing facilities.

We monitor our suppliers' ability to meet our product needs and we participate in quality assurance activities to reinforce adherence to our quality standards. Our third-party manufacturing contracts are generally of annual or shorter duration, or manufactured products are sourced on the basis of individual purchase orders. Our manufacturing relationships are non-exclusive, and we are permitted to procure our products from other sources at our discretion. None of our manufacturing contracts include production volume or purchase commitments on the part of either party. Our third-party manufacturers are responsible for the sourcing of raw materials.

LOGISTICS

Our warehousing and distribution facilities are located in Portland, Oregon and Winnipeg, Manitoba. In our Direct business, we strive to maintain inventory levels that will allow us to ship our products shortly after receiving a customer's order. We use common carriers for substantially all of our merchandise shipments to Direct customers.

In our Retail business, we manage our inventory levels to accommodate anticipated seasonal changes in demand. Generally, we maintain higher inventory levels at the end of the third and fourth quarters to satisfy relatively higher consumer demand in the fourth and first quarters of each year. Many of our Retail customers place orders well in advance of peak periods of consumer demand to ensure an adequate supply for the anticipated selling season. We use various commercial truck lines for our merchandise shipments to Retail customers.

In 2012 approximately 40% of our Retail inventory replenishment orders were shipped by our contract manufacturers in Asia directly to our Retail customer locations, typically in container loads. The use of such direct shipments allows us to maintain lower levels of inventory in our warehouses, resulting in lower storage, handling, freight, insurance and other costs.

COMPETITION

The markets for all of our products are highly competitive. We believe the principal competitive factors affecting our business are quality, brand recognition, innovation and pricing. We believe we are well-positioned to compete in markets in which we can take advantage of our strong brand names.

Our products compete directly with those offered by a large number of companies that market consumer fitness equipment and fitness programs. As the use of Internet websites for product sales by traditional retailers has increased, our competitors have become increasingly similar across our Direct and Retail sales channels. Our principal competitors include: Fitness Quest, marketer of Total Fitness®-branded products; ICON Health & Fitness, marketer of ProForm®- and NordicTrack®-branded products; Johnson Health Tech, marketer of Horizon®-branded products; Beach Body, marketer of the P90X® fitness program; and American Telecast, marketer of Total Gym®-branded products. Among our other competitors are marketers of computer- based physical activity products, such as the Nintendo Wii® and Microsoft Xbox® Kinect®, and weight management companies, such as Weight Watchers, each of which offers alternative solutions for a fit and healthy lifestyle.

EMPLOYEES

As of February 28, 2013, we had approximately 310 employees, substantially all of whom were full-time. None of our employees are subject to collective bargaining agreements. We have not experienced a material interruption of our operations due to labor disputes.

INTELLECTUAL PROPERTY

Trademarks, patents and other forms of intellectual property are vital to the success of our business and are an essential factor in maintaining our competitive position in the health and fitness industry.

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Trademarks

We own many trademarks including Nautilus®, Bowflex®, PowerRod®, Revolution®, TreadClimber®, SelectTech®, Trimline®, Airdyne®, CoreBody Reformer™ and Universal®. Nautilus is the exclusive licensee under the mark Schwinn® for indoor fitness products. We believe that having distinctive trademarks that are readily identifiable by consumers is an important factor in creating a market for our products, maintaining a strong company identity and developing brand loyalty among our customers. In addition, we have granted licenses to certain third-parties to use the Nautilus, Schwinn and TreadClimber tradenames on commercial fitness products, for which we receive royalty income and expanded consumer awareness of our brands.

Each federally registered trademark is renewable indefinitely if the trademark is still in use at the time of renewal. We are not aware of any material claims of infringement or other challenges to our trademark rights in our major markets.

Patents

Building our intellectual property portfolio is an important factor in maintaining our competitive position in the health and fitness equipment industry. We have followed a policy of filing applications for U.S. and non-U.S. patents on utility and design inventions that we deem valuable to our business.

We maintain a portfolio of patents related to our Bowflex® TreadClimber® specialized cardio machines. The portfolio is comprised of approximately 24 issued U.S. patents covering various product features and other technologies associated with our TreadClimber® products. Expiration dates for individual patents within this portfolio range from 2013 to 2025.

Additionally, we own or license patents covering a variety of technologies, some of which are utilized in our variable stride ellipticals, selectorized dumbbells and recumbent exercise bikes. Nautilus is also the exclusive licensee of patents that cover the Bowflex Revolution home gyms. Patent protection for these technologies extends as far as 2020.

We protect our proprietary rights vigorously and take prompt, reasonable actions to prevent counterfeit products and other infringement on our intellectual property. Expiration or invalidity of these or other patents could trigger the introduction of similar products by our competitors.

BACKLOG

Historically, our backlog has not been a significant factor in our business. Our customer order backlog as of December 31, 2012 and 2011 was approximately $0.1 million and $0.6 million, respectively.

SIGNIFICANT CUSTOMERS

In 2012 and 2011, Amazon.com accounted for more than 10 percent, but less than 15 percent, of our consolidated net sales. No individual customer accounted for 10 percent or more of our consolidated net sales in 2010.
ENVIRONMENTAL AND OTHER REGULATORY MATTERS

Our operations are subject to various laws and regulations both domestically and abroad. In the United States, federal, state and local regulations impose standards on our workplace and our relationship with the environment. For example, the U.S. Environmental Protection Agency, Occupational Safety and Health Administration and other federal agencies have the authority to promulgate regulations that may impact our operations. In particular, we are subject to legislation placing restrictions on our generation, emission, treatment, storage and disposal of materials, substances and wastes. Such legislation includes: the Toxic Substances Control Act; the Resource Conservation and

Recovery Act; the Clean Air Act; the Clean Water Act; the Safe Drinking Water Act; and the Comprehensive Environmental Response and the Compensation and Liability Act (also known as Superfund). We are also subject to the requirements of the Consumer Product Safety Commission and the Federal Trade Commission, in addition to regulations concerning employee health and safety matters.

Our operations and certain disposed components of our former Commercial business expose us to claims related to environmental matters. Although compliance with federal, state, local and international environmental legislation has not had a material adverse effect on our financial condition or results of operations in the past, there can be no assurance that material costs or liabilities will not be incurred in connection with such environmental matters in the future.

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AVAILABLE INFORMATION

Our common stock is listed on the New York Stock Exchange and trades under the symbol “NLS.” Our principal executive offices are located at 17750 SE 6th Way, Vancouver, Washington 98683, and our telephone number is (360) 859-2900. The Internet address of our corporate website is http://www.nautilusinc.com.

We file annual reports, quarterly reports, current reports, proxy statements and other information with the Securities and Exchange Commission (the “SEC”) under the Securities Exchange Act of 1934, as amended. You can inspect and obtain a copy of our reports, proxy statements and other information filed with the SEC at the offices of the SEC's Public Reference Room at 100 F Street N.E., Washington, D.C. 20549, on official business days during the hours of 10 a.m. to 3 p.m. EST. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. The SEC maintains an Internet website at http://www.sec.gov where you can access copies of most of our SEC filings.

We make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, available free of charge on our corporate website. In addition, our Code of Business Conduct and Ethics, corporate governance policies, and the charters of our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee are available on our corporate website. The information presented on our corporate website is not part of this report.

Item 1A. Risk Factors

Nautilus operates in an environment that involves a number of risks and uncertainties. The risks and uncertainties described in this Annual Report on Form 10-K are not the only risks and uncertainties that we face. Additional risks and uncertainties that presently are not considered material or are not known to us, and therefore are not mentioned herein, may impair our business operations. If any of the risks described in this Annual Report on Form 10-K actually occur, our business, operating results and financial position could be adversely affected.

Our revenues and profitability can fluctuate from period to period and are often difficult to predict due to factors beyond our control.

Our results of operations in any particular period may not be indicative of results to be expected in future periods, and have historically been, and are expected to continue to be, subject to periodic fluctuations arising from a number of factors, including:

- Introduction and market acceptance of new products and sales trends affecting specific existing products;
- Variations in product selling prices and costs and the mix of products sold;
- Size and timing of Retail customer orders, which, in turn, often depend upon the success of our customers' businesses or specific products;
- Changes in the market conditions for consumer fitness equipment;
- Changes in macroeconomic factors;
- Availability of consumer credit;
- Timing and availability of products coming from our offshore contract manufacturing suppliers;
- Seasonality of markets, which vary from quarter-to-quarter and are influenced by outside factors such as overall consumer confidence and the availability and cost of television advertising time;
- Effectiveness of our media and advertising programs;
- Customer consolidation in our Retail segment, or the bankruptcy of any of our larger Retail customers;
- Restructuring charges;
- Goodwill and other intangible asset impairment charges; and
- Legal and contract settlement charges.

These trends and factors could adversely affect our business, operating results, financial position and cash flows in any particular period.

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Intense competition or loss of one or more of our large Retail customers could negatively impact our sales and operating results.

Our products are sold in highly competitive markets with limited barriers to entry. As a result, introduction by competitors of lower-priced or more innovative products could result in a significant decline in our revenues and have a material adverse effect on our operating results, financial position and cash flows.

Additionally, we derive a significant portion of our revenue from a small number of Retail customers. A loss of business from one or more of these large customers, if not replaced with new business, could negatively affect our operating results and cash flow.

A decline in sales of TreadClimber products without a corresponding increase in sales of other products would negatively affect our future revenues and operating results.

Sales of cardio products, especially Bowflex® TreadClimber® products, represent a substantial portion of our Direct segment revenues. Introduction by competitors of comparable products at lower price-points, a maturing product lifecycle or other factors could result in a decline in our revenues derived from these products. A significant decline in our sales of these products would have a material adverse effect on our operating results, financial position and cash flows.

Portions of our operating expenses and costs of goods sold are relatively fixed, and we may have limited ability to reduce expenses sufficiently in response to any revenue shortfalls.

Many of our operating expenses are relatively fixed. We may not be able to adjust our operating expenses or other costs sufficiently to adequately respond to any revenue shortfalls. If we are unable to reduce operating expenses or other costs quickly in response to any declines in revenue, it would negatively impact our operating results, financial condition and cash flows.

If we are unable to anticipate consumer preferences or to effectively develop, market and sell future products, our future revenues and operating results could be adversely affected.

Our future success depends on our ability to effectively develop, market and sell new products that respond to new and evolving consumer preferences. Accordingly, our revenues and operating results may be adversely affected if we are unable to develop or acquire rights to new products that satisfy consumer preferences. In addition, any new products that we market may not generate sufficient revenues to recoup their acquisition, development, production, marketing, selling and other costs.

Further decline or weaker than expected recovery in consumer spending likely would negatively affect our product revenues and earnings.

Success of each of our products depends substantially on the amount of discretionary funds available to our customers. Global credit and financial markets have experienced extreme disruptions in the recent past, including severely diminished liquidity and credit availability, declines in consumer confidence, declines in economic growth, increases in unemployment rates and uncertainty about economic stability. There can be no assurance that there will not be further deterioration in these conditions. Further decline or weaker than expected recovery in general economic conditions could further depress consumer spending, especially spending for discretionary consumer products such as ours. Poor economic conditions could in turn lead to substantial decreases in our net sales or have a material adverse effect on our operating results, financial position and cash flows.

Our business is affected by seasonality which results in fluctuations in our operating results.

We experience moderate fluctuations in aggregate sales volume during the year. Sales are typically strongest in the first and fourth quarters, followed by the third quarter, and are generally weakest in the second quarter. However, the mix of product sales may vary considerably from time to time as a result of changes in seasonal and geographic demand for particular types of fitness equipment. In addition, our customers may cancel orders, change delivery schedules or change the mix of products ordered with minimal notice. As a result, we may not be able to accurately predict our quarterly sales. Accordingly, our results of operations are likely to fluctuate significantly from period to period.

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Government regulatory actions could disrupt our marketing efforts and product sales.

Various international and U.S. federal, state and local governmental authorities, including the Federal Trade Commission, the Consumer Product Safety Commission, the Securities and Exchange Commission and the Consumer Financial Protection Bureau, regulate our product and marketing efforts. Our sales and profitability could be significantly harmed if any of these authorities commence a regulatory enforcement action that interrupts our marketing efforts, results in a product recall or negative publicity, or requires changes in product design.

Substantially higher advertising rates or a significant decline in availability of media time may hinder our ability to effectively market our products and may reduce profitability.

We depend on television advertising to market certain products sold directly to consumers. Consequently, a marked increase in the price we must pay for our preferred media time and/or a reduction in its availability may adversely impact our financial performance.

We may be unable to adapt to significant changes in media consumption habits, which could diminish the effectiveness or efficiency of our advertising.

New television technologies and services, such as video-on-demand, digital video recorders and Internet streaming services are changing traditional patterns of television viewing. Additionally, consumer attention is increasingly fragmented across a variety of games, apps, the Internet and other digital media. If we are unable to successfully adapt our media strategies to new television viewing and media consumption habits, the effectiveness and efficiency of our media placements could be adversely affected, and our operating results may be harmed.

Our revenues could decline due to changes in credit markets and decisions made by credit providers.

Historically, a significant portion of our Direct sales have been financed for our customers under various programs offered by third-party consumer credit financing sources. Reductions in consumer lending and the availability of consumer credit could limit the number of customers with the financial means to purchase our products. Higher interest rates could increase monthly payments for consumer products financed through one of our monthly payment plans or through other sources of consumer financing. In the past, we have partnered with financial service companies to assist our customers in obtaining financing to purchase our products. Our present agreements with our third party consumer credit financing providers enable certain customers to obtain financing if they qualify for the provider's private label revolving credit card. We cannot be assured that our third party financing providers will continue to provide consumers with access to credit or that credit limits under such arrangements will not be reduced. Such restrictions or reductions in the availability of consumer credit could have a material adverse impact on our results of operations, financial position and cash flows.

If our contract manufacturers experience any delay, disruption or quality control problems in their operations, we could lose revenues, and our reputation and market share may be harmed.

We have outsourced the production of all of our products to third-party manufacturers. We rely on our contract manufacturers to procure components and provide spare parts in support of our warranty and customer service obligations. We generally commit the manufacturing of each product to a single contract manufacturer.

Our reliance on contract manufacturers exposes us to the following risks over which we may have limited control:
- Unexpected increases in manufacturing and repair costs;
- Interruptions in shipments if our contract manufacturer is unable to complete production;
- Inability to completely control the quality of finished products;

- Inability to completely control delivery schedules;
- Changes in our contract manufacturer's business models or operations;
- Potential increases in our negotiated product costs as a result of fluctuations in currency exchange rates;
- Impact of the global market and economic conditions on the financial stability of our contract manufacturers and their ability to operate without requesting earlier payment terms or letters of credit;
- Potential lack of adequate capacity to manufacture all or a part of the products we require; and
- Potential unauthorized reproduction or counterfeiting of our products.

Substantially all of our contract manufacturers are located in Asia, primarily China, and may be subject to disruption by natural disasters, as well as political, social or economic instability. The temporary or permanent loss of the services of any of our

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primary contract manufacturers could cause a significant disruption in our product supply chain and operations and delays in product shipments.

Our third-party manufacturing contracts are generally of annual or shorter duration, or manufactured products are sourced on the basis of individual purchase orders. There is no assurance that we will be able to maintain our current relationships with these parties or, if necessary, establish future arrangements with other third-party manufacturers on commercially reasonable terms. Further, we cannot assure that their manufacturing and quality control processes will be maintained at a level sufficient to meet our inventory needs or prevent the inadvertent sale of substandard products. While we believe that products manufactured by our current third-party manufacturers could generally be procured from alternative sources, temporary or permanent loss of services from a significant manufacturer could cause disruption in our supply chain and operations.

Our inventory purchases are subject to long lead times, which could negatively impact our sales, cash flows and liquidity.

All of our products are produced by third-party manufacturers, substantially all of which are located in Asia, primarily China. Lead times for inventory purchases from our Asian suppliers, from order placement to receipt of goods, generally range from approximately two to three months, of which transit time represents three-to-four weeks. The length of our lead times requires us to place advance manufacturing orders based on management forecasts of future demand for our products. Due to the length of our lead times, our sales and cash flows may be negatively impacted if we do not have sufficient inventory on hand to meet customer demand for such items. In addition, our liquidity and cash flows may be negatively affected, and inventory obsolescence may increase, if the quantity of products we order exceeds customer demand for such items.

A delay in getting non-U.S.-sourced products through port operations and customs in a timely manner could result in reduced sales, canceled sales orders and unanticipated inventory accumulation.

Most of our imported products are subject to duties or tariffs that affect the cost and quantity of various types of goods imported into the U.S. or our other markets. The countries in which our products are produced or sold may adjust or impose new quotas, duties, tariffs or other restrictions. Further, our business depends on our ability to source and distribute products in a timely manner. As a result, we rely on the free flow of goods through open and operational ports worldwide. Labor disputes at various ports create significant risks for our business, particularly if these disputes result in work slowdowns, lockouts, strikes or other disruptions during our peak importing seasons. Any of these factors could result in reduced sales, canceled sales orders and unanticipated inventory accumulation and have a material adverse effect on our operating results, financial position and cash flows.

Unpredictable events and circumstances relating to our international operations, including our use of non-U.S. manufacturers, could have a material adverse effect on our business.

Substantially all of our products are manufactured outside of the U.S. and a portion of our revenue is derived from sales outside the U.S., primarily in Canada. Accordingly, our future results could be materially adversely affected by a variety of factors pertaining to international trade, including: changes in a specific country's or region's political or economic conditions; trade restrictions; import and export licensing requirements; changes in regulatory requirements; additional efforts to comply with a variety of foreign laws and regulations; and longer payment cycles in certain countries, thus requiring us to finance customer purchases over a longer period than those made in the U.S. In addition, we rely on the performance of our employees located in foreign countries. Our ability to control the actions of these employees may be limited by the laws and regulations in effect in each country. Changes in any of the above factors could have a material adverse effect on our operating results, financial position and cash flows.

Currency exchange rate fluctuations could result in higher costs and reduced margins.

Substantially all of our products are manufactured outside of the U.S. and, therefore, currency exchange rate fluctuations could result in higher costs for our products, or could disrupt the business of independent manufacturers that produce our products, by making their purchases of raw materials more expensive and more difficult to finance. Our future financial results could be significantly affected by the value of the U.S. dollar in relation to the foreign currencies in which we, our customers or our suppliers conduct business. Recent fluctuations in the Chinese Renminbi exchange rate have caused our costs for certain products to increase, reducing our margins and cash flows. Similar fluctuations and cost increases may occur in the future. If we are unable to increase our selling prices to offset such cost increases, or if such increases have a negative impact on sales of our products, our revenues and margins would be reduced and our operating results and cash flows would be negatively impacted. In addition, a portion of our revenue is derived from sales outside the U.S., primarily in Canada. Currency rate

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fluctuations could make our products more expensive for foreign consumers and reduce our sales, which would negatively affect our operating results and cash flows.

Failure or inability to protect our intellectual property could significantly harm our competitive position.

Protecting our intellectual property is an essential factor in maintaining our competitive position in the health and fitness industry. If we do not, or are unable to, adequately protect our intellectual property, we may face difficulty in differentiating our products from those of our competitors and our sales and profitability may be adversely affected. We own numerous patents and trademarks worldwide. However, our efforts to protect our proprietary rights may be inadequate, and applicable laws provide only limited protection.

Trademark infringement or other intellectual property claims relating to our products could increase our costs.

Our industry is susceptible to litigation regarding trademark and patent infringement and other intellectual property rights. We could become a plaintiff or defendant in litigation involving trademark or patent infringement claims or claims of breach of license. The prosecution or defense of intellectual property litigation is both costly and disruptive of the time and resources of our management, even if the claim or defense against us is without merit. We could also be required to pay substantial damages or settlement costs to resolve intellectual property litigation or related matters.

We also may not be able to successfully acquire intellectual property rights, protect existing rights, or potentially prevent others from claiming that we have violated their proprietary rights when we launch new products. We could incur substantial costs in defending against such claims even if they are without basis, and we could become subject to judgments or settlements requiring us to pay substantial damages, royalties or other charges.

Future impairments of intangible assets could negatively impact our operating results.

We had goodwill of $2.9 million and other intangible assets of $14.7 million as of December 31, 2012. Any future impairment charges, if significant, could materially and adversely affect our operating results. An unexpected decline in revenue, changes in market conditions, changes in competitive products or technologies or a change in management's intentions regarding utilization of intangible assets could lead to future impairment charges.

We are subject to periodic litigation, product liability risk and other regulatory proceedings which could result in unexpected expense of time and resources.

From time to time, we may be a defendant in lawsuits and regulatory actions relating to our business or the former operations of our discontinued Commercial business segment. Due to the inherent uncertainties of litigation and regulatory proceedings, we cannot accurately predict the ultimate outcome of any such proceedings. An unfavorable outcome could have a material adverse impact on our business, financial condition and results of operations. In addition, any significant litigation in the future, regardless of its merits, could divert management's attention from our operations and may result in substantial legal costs.

We are subject to warranty claims for our products which could result in unexpected expense.

Many of our products carry limited warranties for defects in quality and workmanship. We may experience significant expense as the result of product quality issues, product recalls or product liability claims which may have a material adverse effect on our business. We maintain a warranty reserve for estimated future warranty claims. However, the actual costs of servicing future warranty claims may exceed the reserve and have a material adverse effect on our results of operations, financial condition and cash flows. In addition, we remain contingently liable for product warranty obligations which were transferred to buyers of our Commercial business product lines, if the buyer is unable to fulfill such obligations.

Disruption to our information and communication systems could result in interruptions to our business and the planned implementation of new systems for critical business functions heightens the risk of disruption.

Our business is reliant on information and communication technology, and a substantial portion of our revenues are generated with the support of information and communication systems. The success of our Direct business is heavily dependent on our ability to respond to customer sales inquiries and process sales transactions using our call center communication systems, Internet websites and similar data monitoring and communication systems provided and supported by third-parties. If such systems were to fail, or experience significant or lengthy interruptions in availability or service, our revenues could be materially affected. We also rely on information systems in all stages of our product cycle, from design to distribution, and we use such systems as a method of communication between employees, suppliers and customers. In addition, we use information

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systems to maintain our accounting records, assist in trade receivables collection and customer service efforts, and forecast operating results and cash flows.

System failures or service interruptions may occur as the result of a number of factors, including: computer viruses; hacking or other unlawful activities by third parties; disasters; equipment, hardware or software failures; ineffective implementation of new systems or systems upgrades; cable outages, extended power failures, or our inability or failure to properly protect, repair or maintain our communication and information systems. To mitigate the risk of business interruption, we have in place a disaster recovery program that targets our most critical operational systems. If our disaster recovery system is ineffective, in whole or in part, or efforts conducted by us or third-parties to prevent or respond to system interruptions in a timely manner are ineffective, our ability to conduct operations would be significantly affected. If we do not consider the potential impact of critical decisions related to systems or process design and implementation, this could lead to operational challenges and increased costs. Any of the aforementioned factors could have a material adverse affect on our operating results, financial position and cash flows.
Our current primary enterprise resource planning system is highly customized to our business and we may experience difficulties as we transition to new systems during 2013. Difficulties or delays in implementing our new information systems or significant system failures could disrupt our operations and have a material adverse effect on our operating results, financial position and cash flows.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Following is a summary of our principal properties as of December 31, 2012:

Location	Primary Function(s)	Owned or Leased
Washington	Corporate headquarters and customer call center	Leased
Oregon	Warehouse and distribution	Leased
Canada	Warehouse, distribution and showroom	Leased
China	Quality assurance office	Leased

Each of our principal properties is used by both our Direct segment and our Retail segment. Our properties generally are well-maintained, adequate and suitable for their intended purposes and we believe our existing properties will meet our operational needs for the foreseeable future. If we require additional warehouse or office space in the future, we believe we will be able to obtain such space on commercially reasonable terms.

Item 3. Legal Proceedings

We are party to various legal proceedings and claims arising from normal business activities. In addition, our tax filings are subject to audit by authorities in the jurisdictions where we conduct business, which may result in assessments of additional taxes. Management believes the Company has adequately provided for obligations that would result from these legal and tax proceedings where it is probable the Company will pay some amounts and the amounts can be reasonably estimated. In some cases, however, it is too early to predict a final outcome. Management believes that the ultimate resolution of these matters will not have a material effect on the Company's financial position, results of operations or cash flows.

Item 4. Mine Safety Disclosures

Not applicable.

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PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market for our Common Stock

Our common stock is listed on the New York Stock Exchange (the “NYSE”) and trades under the symbol “NLS.” On February 28, 2013, the closing sale price of our common stock was $5.72 per share, as reported on the NYSE. As of February 28, 2013, there were 46 holders of record of our common stock and approximately 24,000 beneficial shareholders. The following table sets forth the high and low sales prices and dividends paid per common share for each period presented:

	High	Low	Dividends Paid
2012:			
Quarter 1	$3.04	$1.74	—
Quarter 2	3.50	2.20	—
Quarter 3	3.64	2.28	—
Quarter 4	4.00	2.58	—
2011:			
Quarter 1	3.30	1.81	—
Quarter 2	3.45	1.58	—
Quarter 3	2.24	1.32	—
Quarter 4	2.20	1.39	—

Currently, we have no plans to pay dividends on our common stock. Payment of any future dividends, when permitted under our borrowing arrangements, is at the discretion of our Board of Directors, which considers various factors such as our financial condition, operating results, current and anticipated cash needs and future expansion plans.

Equity Compensation Plans

The following table provides information about our equity compensation plans as of December 31, 2012:

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,729,000	$ 6.92	3,844,000
Equity compensation plans not approved by security holders	—	—	—
Total	1,729,000	6.92	3,844,000

For further information regarding our equity compensation plans, refer to Note 12, Stockholders' Equity, to our consolidated financial statements in Part II, Item 8 of this report.

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The following table provides information about issuer repurchases of equity securities during the fourth quarter ended December 31, 2012:

Period	(a) Total Number of Shares (or Units) Purchased [1]	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
October 1 to October 31, 2012	1,634	$2.81	—	—
November 1 to November 30, 2012	1,634	3.40	—	—
December 1 to December 31, 2012	1,634	3.51	—	—
Total	4,902	3.24	—	—

[1] Consists of shares withheld from delivery upon settlement of the vesting portion of a restricted stock unit award granted to Bruce M. Cazenave, our Chief Executive Officer. We will withhold from the settlement of each monthly vesting portion of the award the number of shares sufficient to satisfy Mr. Cazenave's tax withholding obligation incident to such vesting, unless Mr. Cazenave should first elect to satisfy the tax obligation by cash payment to us. We do not have any publicly announced equity securities repurchase plans or programs.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

The following discussion and analysis is based upon our financial statements as of the dates and for the periods presented in this section. You should read this discussion and analysis in conjunction with the financial statements and notes thereto found in Part II, Item 8 of this report. All references to the years 2012, 2011 and 2010 mean the twelve-month periods ended December 31, 2012, 2011 and 2010, respectively. Unless the context otherwise requires, “Nautilus,” “we,” “us” and “our” refer to Nautilus, Inc. and its subsidiaries. Unless indicated otherwise, all information regarding our operating results pertains to our continuing operations.

Our results of operations may vary significantly from period-to-period. Our revenues typically fluctuate due to the seasonality of our industry, customer buying patterns, product innovation, the nature and level of competition for health and fitness products, our ability to procure products to meet customer demand, the level of spending on, and effectiveness of, our media and advertising programs and our ability to attract new customers and maintain existing sales relationships. In addition, our revenues are highly susceptible to economic factors, including, among other things, the overall condition of the economy and the availability of consumer credit in both the United States and Canada. Our profit margins may vary in response to the aforementioned factors and our ability to manage product costs. Profit margins may also be affected by fluctuations in the costs or availability of materials used to manufacture our products, product warranty costs, higher or lower fuel prices, and changes in costs of other distribution or manufacturing-related services. Our operating profits or losses may also be affected by the efficiency and effectiveness of our organization. Historically, our operating expenses have been influenced by media costs to produce and air television advertisements of our products, facility costs, operating costs of our information and communications systems, product supply chain management, customer support and new product development activities. In addition, our operating expenses have been affected from time-to-time by asset impairment charges, restructuring charges and other significant unusual or infrequent expenses.

As a result of the above and other factors, our period-to-period operating results may not be indicative of future performance. You should not place undue reliance on our operating results and should consider our prospects in light of the risks, expenses and difficulties typically encountered by us and other companies, both within and outside our industry. We may not be able to successfully address these risks and difficulties and, consequently, we cannot assure you of any future growth or profitability. For more information, see our discussion of Risk Factors located at Part I, Item 1A of this report.

OVERVIEW

We are committed to providing innovative, quality solutions to help people achieve a fit and healthy lifestyle. Our principal business activities include designing, developing, sourcing and marketing high-quality cardiovascular and strength fitness products and related accessories for consumer home use, primarily in the United States and Canada. Our products are sold under some of the most recognized brand names in the fitness industry: Nautilus®, Bowflex®, Schwinn®, Schwinn Fitness™ and Universal®

We market our products through two distinct distribution channels, Direct and Retail, which we consider to be separate business segments. Our Direct business offers products directly to consumers through television advertising, the Internet and catalogs. Our Retail business offers our products through a network of third-party retailers with stores and websites located in the United States and internationally. We also derive a portion of our revenues from the licensing of our brands and intellectual property.

Our net sales in 2012 were $193.9 million, an increase of $13.5 million, or 7.5%, compared to net sales of $180.4 million in 2011, largely due to higher sales of cardio products, especially the Bowflex TreadClimber, which we believe was driven by increased advertising effectiveness, improved call center effectiveness and higher U.S.

consumer credit approval rates.

Income from continuing operations was $10.6 million in 2012, compared to $2.5 million for 2011. Income from continuing operations was $0.34 per diluted share in 2012, compared to $0.08 per diluted share in 2011. The significant improvement in our results from continuing operations was primarily attributable to increased sales and higher gross margin in our Direct business, compared to 2011.

RESULTS OF OPERATIONS

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements. An accounting estimate is considered to be critical if it meets both of the following criteria: (i) the estimate requires assumptions about matters that are highly uncertain at the time the accounting estimate is made, and (ii) different estimates reasonably could have been used, or changes in the estimate that are reasonably likely to occur from period to period may have a material impact on the presentation of our financial condition, changes in financial condition or results of operations.

Our critical accounting policies and estimates are discussed below. We have not made any material changes in the methodologies we use in our critical accounting estimates during the past three fiscal years. If our assumptions or estimates change in future periods, the impact on our financial position and operating results could be material.

Sales Discounts and Allowances

Product sales and shipping revenues are reported net of promotional discounts and return allowances. We estimate the revenue impact of retail sales incentive programs based on the planned duration of the program and historical experience. If the amount of our retail sales incentives can be reasonably estimated, we record the impact of such incentives at the later of the time we notify our customer of the sales incentive, or the time of the sale. If actual amounts differ from our estimates, revenue is adjusted.

Our calculation of amounts owed for sales discounts and allowances contains uncertainties because it requires management to make assumptions in interim periods and to apply judgment regarding a number of factors, including estimated future customer inventory purchases and returns.

Goodwill and Intangible Asset Valuation
We evaluate our indefinite-lived intangible assets and goodwill for potential impairment annually or when events or circumstances indicate their carrying value may be impaired. Finite-lived intangible assets, including patents and patent rights, are evaluated for impairment when events or circumstances indicate the carrying value may be impaired. No goodwill or intangible asset impairment charges were recognized in 2012 or 2011.

Our impairment loss calculations contain uncertainties because they require management to make assumptions and to apply judgment in order to estimate future cash flows and asset fair values. Our judgments regarding potential impairment are based on a number of factors including: the timing and amount of anticipated cash flows; market conditions; relative levels of risk; the cost of capital; terminal values; royalty rates; and the allocation of revenues, expenses and assets and liabilities to business segments. Each of these factors can significantly affect the value of our goodwill or indefinite-lived intangible assets and, thereby, could have a material adverse affect on our financial position and results of operations.

Product Warranty Obligations
Our products carry limited defined warranties for defects in materials or workmanship. Our product warranties generally obligate us to pay for the cost of replacement parts, cost of shipping the parts to our customers and, in certain instances, service labor costs. At the time of sale, we record a liability for the estimated costs of fulfilling future warranty claims. The estimated warranty costs are recorded as a component of cost of sales, based on historical warranty claim experience and available product quality data. If necessary, we adjust our liability for specific warranty matters when they become known and are reasonably estimable. Our estimates of warranty expenses are based on significant judgment, and the frequency and cost of warranty claims are subject to variation. Warranty expenses are affected by the performance of new products, significant manufacturing or design defects not discovered until after the product is delivered to the customer, product failure rates and variances in expected repair costs.

Litigation and Loss Contingencies

From time to time, we may be involved in claims, lawsuits and other proceedings. Such matters involve uncertainty as to the eventual outcomes and any losses or gains we may ultimately realize when one or more future events occur or fail to occur. We record expenses for litigation and loss contingencies when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We estimate the probability of such losses based on the advice of internal and external counsel, outcomes from similar litigation, status of the lawsuits (including settlement initiatives), legislative developments and other factors.

Due to the numerous variables associated with these judgments and assumptions, both the precision and reliability of the resulting estimates of the related loss contingencies are subject to substantial uncertainties. We regularly monitor our estimated exposure to these contingencies and, as additional information becomes known, we may change our estimates accordingly.

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Deferred Tax Assets - Valuation Allowance

We account for income taxes based on the asset and liability method, whereby deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. Deferred tax assets and liabilities are measured using the enacted tax rates that are expected to be in effect when the temporary differences are expected to be included, as income or expense, in the applicable tax return. The effect of a change in tax rates on our deferred tax assets and liabilities is recognized in the period of the enactment. A tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained based on the technical merits of the position upon examination, including resolutions of any related appeals or litigation.

We have recorded a valuation allowance to reduce our deferred tax assets to the amount we believe is more likely than not to be realized. As we determined, based on reviewing all the positive and negative evidence, that it is more likely than not that the benefit from our deferred tax assets will not be realized, we have a valuation allowance against net deferred tax assets of $57.2 million. If our assumptions change and we determine we will be able to realize these deferred tax assets, the tax benefits related to any reversal of the valuation allowance will be accounted for in the period in which we make such determination. Likewise, should we determine that we would be able to realize our deferred tax assets in the future in excess of our recorded amount, an adjustment to the deferred tax assets would increase income in the period such determination was made.

Significant judgments are required in determining tax provisions and evaluating tax positions. Such judgments require us to interpret existing tax law and other published guidance as applied to our circumstances. In particular, our valuation allowance contains uncertainties because management is required to make assumptions and to apply judgment to estimate the future realization of net deferred tax assets. If our financial results or other relevant facts change, thereby impacting the likelihood of realizing the tax benefit of an uncertain tax position, significant judgment would be applied in determining the effect of the change on our valuation allowance.

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COMPARISON OF THE YEARS ENDED DECEMBER 31, 2012 AND 2011

The discussion that follows should be read in conjunction with our consolidated financial statements and the related notes in this report. All comparisons to prior year results are in reference to continuing operations only in each period, unless otherwise indicated.

The following table compares selected financial information in our consolidated statements of operations for the years ended December 31, 2012 and 2011 (in thousands):

	Year Ended December 31,			
	2012	2011	Change	% Change
Net sales	$193,926	$180,412	$13,514	7.5 %
Cost of sales	102,889	101,953	936	0.9 %
Gross profit	91,037	78,459	12,578	16.0 %
Operating expenses:				
Selling and marketing	58,617	54,494	4,123	7.6 %
General and administrative	17,669	17,143	526	3.1 %
Research and development	4,163	3,223	940	29.2 %
Total operating expenses	80,449	74,860	5,589	7.5 %
Operating income	10,588	3,599	6,989	
Other income (expense):				
Interest income	18	65	(47)	
Interest expense	56	(466)	522	
Other	(246)	(11)	(235)	
Total other expense	(172)	(412)	240	
Income before income taxes	10,416	3,187	7,229	
Income tax (benefit) expense	(226)	686	(912)	
Income from continuing operations	10,642	2,501	8,141	
Income (loss) from discontinued operation, net of income taxes	6,241	(1,081)	7,322	
Net income	$16,883	$1,420	$15,463	

The following table compares the net sales and gross margins of our business segments for the years ended December 31, 2012 and 2011 (in thousands):

	Year Ended December 31,			
	2012	2011	Change	% Change
Net sales:				
Direct	$124,978	$107,061	$17,917	16.7 %
Retail	63,891	68,591	(4,700)	(6.9)%
Royalty income	5,057	4,760	297	6.2 %
Total net sales	$193,926	$180,412	$13,514	7.5 %
Gross profit:				
Direct	$71,629	$57,655	$13,974	24.2 %
Retail	14,351	16,044	(1,693)	(10.6)%
Royalty income	5,057	4,760	297	6.2 %
Total gross profit	$91,037	$78,459	$12,578	16.0 %
Gross margin:				
Direct	57.3 %	53.9 %	340	basis points

Retail	22.5 %	23.4 %	(90) basis points

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The following table compares the net sales of our major product lines within each business segment for the years ended December 31, 2012 and 2011 (in thousands):

	Year Ended December 31,			
	2012	2011	Change	% Change
Direct net sales:				
Cardio products(1)	$ 100,677	$ 75,982	$ 24,695	32.5 %
Strength products(2)	24,301	31,079	(6,778)	(21.8)%
Total Direct net sales	124,978	107,061	17,917	16.7 %
Retail net sales:				
Cardio products(1)	36,209	43,718	(7,509)	(17.2)%
Strength products(2)	27,682	24,873	2,809	11.3 %
Total Retail net sales	63,891	68,591	(4,700)	(6.9)%
Royalty income	5,057	4,760	297	6.2 %
Total net sales	$ 193,926	$ 180,412	$ 13,514	7.5 %

(1) Cardio products include treadclimbers, treadmills, exercise bikes, ellipticals and CoreBody Reformer.
(2) Strength products include home gyms, selectorized dumbbells, kettlebell weights and weight benches.

Direct

Net sales of our Direct business were $125.0 million in 2012, an increase of $17.9 million, or 16.7%, compared to Direct net sales of $107.1 million in 2011. Revenues of cardio products in our Direct channel increased by 32.5% in 2012, compared to 2011, reflecting strong consumer demand for our cardio products, especially the Bowflex TreadClimber, which we believe was driven by increased advertising effectiveness, improved call center effectiveness and higher U.S. consumer credit approval rates. Combined consumer credit approvals by our primary and secondary U.S. third-party financing providers increased to 32% in 2012 from 25% in 2011. We expect U.S. consumer credit financing approval rates in 2013 approximately consistent with the 2012 level.

The increase in Direct sales of cardio products was partially offset by a 21.8% decline in Direct sales of strength products, primarily rod-based home gyms. The decline in sales of rod-based home gyms is attributable in part to the cessation of television advertising for these products, as management determined that television ad spending on this mature product category was generating unsatisfactory returns. We have marketed rod-based home gyms through more cost efficient online media since early 2011.

Cost of sales of our Direct business increased by 8.0% to $53.4 million in 2012, compared to $49.4 million in 2011. Of this $4.0 million increase in cost of sales, approximately $7.3 million was due to higher sales volume, partially offset by a $2.9 million decrease in cost of sales primarily attributable to a shift in product sales mix and a $0.4 million reduction in supply chain costs, including freight.

Gross margin of our Direct business was 57.3% in 2012, an increase of 340 basis points compared to 2011. Gross margin of our Direct business in 2012 benefited from greater absorption of fixed supply chain costs due to higher sales volume, compared to 2011.

Retail

Net sales of our Retail business were $63.9 million in 2012, a decrease of $4.7 million, or 6.9%, compared to Retail net sales of $68.6 million in 2011, primarily due to lower sales of certain cardio products, including indoor bikes and ellipticals. Total Retail sales of cardio products decreased by 17.2%, compared to 2011. In 2012, Retail sales of strength products increased by 11.3%, primarily due to higher sales of selectorized dumbbells, compared to 2011.

Cost of sales of our Retail business declined by $3.0 million, or 5.7%, to $49.5 million in 2012, compared to $52.5 million in 2011, almost entirely due to the decline in Retail sales volume.

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Gross margin of our Retail business was 22.5% in 2012, a decrease of 90 basis points compared to 2011, as the Retail price increase we implemented in the third quarter of 2012 was more than offset by less absorption of fixed supply chain costs due to lower sales volume, compared to 2011.

Operating Expenses

Operating expenses were $80.4 million in 2012, an increase of $5.6 million, or 7.5%, compared to operating expenses of $74.9 million in 2011. As a percent of revenue, operating expenses remained unchanged at 41.5% of net sales. The increase in operating expenses was largely due to an increase of $4.1 million in selling and marketing expense and a $0.9 million increase in research and development expense. In addition, general and administrative expenses increased by $0.5 million in 2012, compared to 2011.

Selling and Marketing

Selling and marketing expenses were $58.6 million in 2012, an increase of $4.1 million, or 7.6%, compared to 2011, mainly due to higher advertising expense of our Direct business. Advertising expense of our Direct business, a component of selling and marketing expenses, was $30.9 million in 2012, an increase of $2.3 million, or 8.0%, compared to 2011, reflecting management's effort to increase Direct revenues in 2012 by increasing advertising levels of existing products and promoting new products.

General and Administrative

General and administrative expenses were $17.7 million in 2012, an increase of $0.5 million, or 3.1%, compared to 2011, primarily due to increases in information technology and legal expenses totaling $1.0 million, partially offset by reductions of $0.3 million in depreciation and amortization expenses and $0.2 million in personnel costs.

Research and Development

Research and development expenses were $4.2 million in 2012, an increase of $0.9 million, or 29.2%, compared to 2011, as we increased our investment in new product development resources and capabilities.

Other Income and Expense

Interest Expense

Negative interest expense of $0.1 million in 2012 arose from the prepayment in March 2012 of our Increasing Rate Senior Discount Notes. Early repayment of the notes resulted in a lower average effective interest rate over the term of the notes than would have applied if the notes had been held to maturity. In periods preceding the repayment date, we used the average effective interest rate as if the notes were held to maturity in determining the amount of interest expense incurred. Interest expense was $0.5 million in 2011. We have not borrowed under our current financing agreement with Bank of the West, other than to fund our outstanding letters of credit. For more information, see "LIQUIDITY AND CAPITAL RESOURCES - Financing Arrangements."

Other Expense

Other expense was $0.2 million in 2012, compared to less than $0.1 million in 2011, primarily due to changes in foreign currency exchange gains and losses.

Income Tax Expense

Income tax benefit was $0.2 million in 2012, compared to income tax expense of $0.7 million in 2011. Income tax benefit in 2012 primarily relates to the expiration of statutes of limitation applicable to our liabilities for uncertain tax positions in certain jurisdictions. Income tax expense in 2011 was attributable to the taxable income generated in Canada and the result of the Company's uncertain tax positions.

Generally we did not recognize U.S. income tax expense associated with our income from continuing operations for 2012 and 2011 due to the valuation allowance against the net deferred tax asset.

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Discontinued Operation

Income from discontinued operation, net of income taxes, was $6.2 million in 2012, compared to a loss of $1.1 million in 2011. In the fourth quarter of 2012, we substantially completed the liquidation of our investment in foreign subsidiaries formerly associated with the Commercial business. As a result, an accumulated translation adjustment of $6.2 million was removed as a separate component of equity and recognized as a gain of the discontinued operation. Loss from discontinued operation in 2011 was net of a reduction of $0.9 million in the amount of pre-tax disposal loss previously estimated in connection with the divestiture of our Commercial business. Some expenses may be incurred in 2013 in connection with the settlement of contingencies arising from and directly related to our Commercial business prior to its disposal.

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COMPARISON OF THE YEARS ENDED DECEMBER 31, 2011 AND 2010

The discussion that follows should be read in conjunction with our consolidated financial statements and the related notes in this report. All comparisons to prior year results are in reference to continuing operations only in each period, unless otherwise indicated.

The following table compares selected financial information in our consolidated statements of operations for the years ended December 31, 2011 and 2010 (in thousands):

	Year Ended December 31,			
	2011	2010	Change	% Change
Net sales	$180,412	$168,450	$11,962	7.1 %
Cost of sales	101,953	91,704	10,249	11.2 %
Gross profit	78,459	76,746	1,713	2.2 %
Operating expenses:				
Selling and marketing	54,494	64,039	(9,545)	(14.9)%
General and administrative	17,143	19,371	(2,228)	(11.5)%
Research and development	3,223	2,905	318	10.9 %
Total operating expenses	74,860	86,315	(11,455)	(13.3)%
Operating income (loss)	3,599	(9,569)	13,168	
Other income (expense):				
Interest income	65	15	50	
Interest expense	(466)	(140)	(326)	
Other	(11)	464	(475)	
Total other income (expense)	(412)	339	(751)	
Income (loss) before income taxes	3,187	(9,230)	12,417	
Income tax expense	686	588	98	
Income (loss) from continuing operations	2,501	(9,818)	12,319	
Loss from discontinued operation, net of income taxes	(1,081)	(13,023)	11,942	
Net income (loss)	$1,420	$(22,841)	$24,261	

The following table compares the net sales and gross margins of our business segments for the years ended December 31, 2011 and 2010 (in thousands):

	Year Ended December 31,			
	2011	2010	Change	% Change
Net sales:				
Direct	$107,061	$96,668	$10,393	10.8 %
Retail	68,591	67,789	802	1.2 %
Royalty income	4,760	3,993	767	19.2 %
Total net sales	$180,412	$168,450	$11,962	7.1 %
Gross profit:				
Direct	$57,655	$54,041	$3,614	6.7 %
Retail	16,044	18,711	(2,667)	(14.3)%
Royalty income	4,760	3,994	766	19.2 %
Total gross profit	$78,459	$76,746	$1,713	2.2 %
Gross margin:				

Direct	53.9 %	55.9 %	(200) basis points
Retail	23.4 %	27.6 %	(420) basis points

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The following table compares the net sales of our major product lines within each business segment for the years ended December 31, 2011 and 2010 (in thousands):

	Year Ended December 31,			
	2011	2010	Change	% Change
Direct net sales:				
Cardio products[1]	$ 75,982	$ 54,409	$ 21,573	39.6 %
Strength products[2]	31,079	42,259	(11,180)	(26.5)%
Total Direct net sales	107,061	96,668	10,393	10.8 %
Retail net sales:				
Cardio products[1]	43,718	43,628	90	0.2 %
Strength products[2]	24,873	24,161	712	2.9 %
Total Retail net sales	68,591	67,789	802	1.2 %
Royalty income	4,760	3,993	767	19.2 %
Total net sales	$ 180,412	$ 168,450	$ 11,962	7.1 %

[1] Cardio products include treadclimbers, treadmills, exercise bikes and ellipticals and CoreBody Reformer.
[2] Strength products include home gyms, selectorized dumbbells, kettlebell weights and weight benches.

Direct

Net sales of our Direct business were $107.1 million in 2011, an increase of $10.4 million, or 10.8%, compared to Direct net sales of $96.7 million in 2010. Revenues of cardio products in our Direct channel increased by 39.6% in 2011, compared to 2010, primarily due to higher sales of Bowflex TreadClimber products. The increase in Direct sales of cardio products was partially offset by a 26.5% decline in Direct sales of strength products, primarily rod-based home gyms. The decline in sales of rod-based home gyms is attributable in part to the cessation of television advertising for these products, as television ad spending on this mature product category was generating unsatisfactory returns. We have marketed rod-based home gyms through more cost efficient online media since early 2011.

In September 2010, we completed our transition to a new consumer credit program with a new primary third-party financing provider, GE Capital Retail Bank, formerly GE Money Bank ("GE"). The relationship with GE has expanded the ability of our customers to obtain third-party consumer financing for buying our products. In addition, we added one secondary third-party consumer credit financing provider during the third quarter of 2010 and another in early 2011, both of which offer credit to certain qualified consumers whose credit applications have been declined by GE. As a result, combined consumer credit approvals by our primary and secondary U.S. third-party financing providers increased from 15% in 2010 to 25% in 2011.
Cost of sales of our Direct business increased by 15.9% to $49.4 million, compared to $42.6 million in 2010. Of this increase of $6.8 million, approximately $3.9 million was due to higher sales volume, $1.1 million was due to comparatively higher delivery costs, including in-home assembly expense, $0.5 million was due to higher supply chain costs, $0.5 million was attributable to higher warranty expenses associated with increased sales of cardio products and $0.8 million was due to higher product costs, largely arising from changes in foreign currency exchange rates between the U.S. and China, and various other factors.
Gross margin of our Direct business was 53.9% in 2011, a decrease of 200 basis points compared to 2010, primarily due to higher outbound freight costs, reflecting increased sales of in-home assembly services, which are sold to customers at relatively low margins.

Retail

Net sales of our Retail business were $68.6 million in 2011, an increase of $0.8 million, or 1.2%, compared to Retail net sales of $67.8 million in 2010, primarily driven by growth among our e-commerce Retail customers. In 2011, Retail sales of strength products increased by 2.9%, primarily due to higher sales of home gyms, and sales of cardio products increased by 0.2%, compared to 2010.

Cost of sales of our Retail business increased by 7.1% to $52.5 million, compared to $49.1 million in 2010. Of this increase of $3.4 million, approximately $0.5 million was due to higher sales volume, $1.6 million was due to higher product costs,

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primarily arising from changes in foreign currency exchange rates between the U.S. and China, and $1.3 million was attributable to higher supply chain costs, including outbound freight.

Gross margin of our Retail business was 23.4% in 2011, a decrease of 420 basis points compared to 2010, of which approximately 280 basis points was due to increased costs of certain products, largely arising from changes in foreign currency exchange rates, and approximately 140 basis points was due to higher supply chain costs, including freight.

Operating Expenses

Operating expenses were $74.9 million in 2011, a decrease of $11.5 million, or 13.3%, compared to operating expenses of $86.3 million in 2010. This reduction was achieved primarily through more effective media advertising, which enabled more efficient spending. In addition, general and administrative expenses decreased by $2.2 million in 2011, compared to 2010.

Selling and Marketing

Selling and marketing expenses were $54.5 million in 2011, a decrease of $9.5 million, or 14.9%, compared to 2010. Advertising expense of our Direct business, a component of selling and marketing expenses, in 2011 was $28.6 million, a decrease of $12.0 million, or 29.6%, compared to 2010. The comparative decrease in Direct advertising expenses was primarily attributable to management's decision in early 2011 to shift advertising away from the mature home-gym category and to increase the media investment in our TreadClimber product line. Beginning in early 2011, we shifted the marketing of home gyms from television advertising to more cost efficient online media. Lower comparable Direct advertising expenses were offset in part by higher consumer credit financing costs, as a result of sequentially improving consumer credit approval rates, and the availability of additional secondary consumer financing providers in 2011, as compared to 2010.

General and Administrative

General and administrative expenses were $17.1 million in 2011, a decrease of $2.2 million, or 11.5%, compared to 2010, primarily due to lower depreciation expense.

Research and Development

Research and development expenses were $3.2 million in 2011, an increase of $0.3 million, or 10.9%, compared to 2010, as we increased our investment in new product development resources and capabilities.

Other Income and Expense

Interest Expense

We incurred interest expense of $0.5 million in 2011 in connection with our long-term note payable, compared to $0.1 million in 2010. We have not borrowed under our current financing agreement with Bank of the West, other than to fund our outstanding letters of credit.

Other Expense

Other expense was less than $0.1 million in 2011, compared to $0.5 million in 2010, primarily due to changes in foreign currency exchange gains and losses.

Income Tax Expense

Income tax expense was $0.7 million in 2011, compared to income tax expense of $0.6 million in 2010, and primarily relates to taxable income generated in Canada.

We increased our valuation allowances in 2010 to reduce U.S. deferred income tax assets generated during the respective years to the amounts expected, more likely than not, to be realized. As a result, generally we did not recognize U.S. income tax benefits associated with our operating loss in 2010.

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Discontinued Operation

Loss from discontinued operation, net of income taxes, was $1.1 million in 2011, compared to a loss of $13.0 million in 2010, as we completed the disposal of assets held for sale of our former Commercial business in April 2011. Loss from discontinued operation in 2011 and 2010 was net of reductions of $0.9 million and $3.7 million, respectively, in the amount of pre-tax disposal loss previously estimated in connection with the divestiture of our Commercial business.

LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2012, we had $23.2 million of cash and cash equivalents, compared to $17.4 million as of December 31, 2011. The principal source of this increase in liquidity was cash provided by operating activities of $12.8 million in 2012, compared to $4.6 million in 2011. Management believes that sufficient funds will be available to meet our expected cash needs for at least the next twelve months, based on cash currently on hand and anticipated cash flows from operations.

Cash provided by operating activities of $12.8 million in 2012 consisted primarily of income from continuing operations of $10.6 million. Income from discontinued operation of $6.2 million consisted almost entirely of a non-cash gain related to the substantial liquidation of foreign entities. An increase in trade payables provided cash of $4.2 million and a decrease in trade receivables provided cash of $1.9 million in 2012. These increases in liquidity were partially offset by $7.6 million of cash used for an increase in inventories in 2012 aimed at supporting the anticipated level of sales growth of our business.

Cash provided by operating activities of $4.6 million in 2011 consisted primarily of income from continuing operations, partially offset by loss from discontinued operation, as adjusted for non-cash items. Cash provided by a $4.0 million increase in trade payables was more than offset by a $4.6 million increase in trade receivables and a $1.3 million increase in inventories.

The following table presents comparative cash flows related to trade receivables and inventories for the years ended December 31, 2012, 2011 and 2010 (in thousands):

	2012	2011	2010
Trade receivables:			
Collections	$195,854	$175,832	$188,290
Sales on account	(193,926)	(180,412)	(181,043)
Net cash (used in)/provided by trade receivables	$1,928	$(4,580)	$7,247
Inventories:			
Shipments	$77,580	$78,139	$81,980
Purchases	(85,153)	(79,426)	(75,637)
Net cash (used in)/provided by inventories	$(7,573)	$(1,287)	$6,343

Cash used in investing activities in 2012 of $2.0 million consisted of $2.4 million used to purchase computer software and production tooling, partially offset by $0.4 million in previously deferred proceeds from the sale of portions of our discontinued Commercial business.

Cash used in investing activities in 2011 of $0.9 million consisted of $2.5 million used to purchase computer software and production tooling, partially offset by $1.3 million in proceeds from the sale of portions of our discontinued Commercial business and $0.4 million from a decrease in the amount of restricted cash collateralizing our outstanding letters of credit.

Cash used in financing activities in 2012 of $4.9 million consisted of $5.0 million used to repay our Increasing Rate Senior Discount Notes, partially offset by $0.1 million provided by the exercise of stock options.

Cash used in financing activities in 2011 was less than $0.1 million for payment of bank financing costs.

Financing Arrangements

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We have a Credit Agreement (the "Loan Agreement") with Bank of the West that, as amended and restated on March 30, 2012, provides for a $15,750,000 maximum revolving secured credit line. The line of credit is available through March 31, 2015 for working capital, standby letters of credit and general corporate purposes. Borrowing availability under the Loan Agreement is subject to our compliance with certain financial and operating covenants at the time borrowings are requested. Standby letters of credit under the Loan Agreement are treated as a reduction of the available borrowing amount and are subject to covenant testing.

The interest rate applicable to borrowings under the Loan Agreement is based on either, at our discretion, Bank of the West's base rate, a floating rate or LIBOR, plus an applicable margin based on certain Company financial performance metrics. Our borrowing rate was 2.00% as of December 31, 2012. The Loan Agreement contains customary covenants, including minimum fixed charge coverage ratio and leverage ratio, and limitations on capital expenditures, mergers and acquisitions, indebtedness, liens, dispositions, dividends and investments. The Loan Agreement also contains customary events of default. Upon an event of default, the lender has the option of terminating its credit commitment and accelerating all obligations under the Loan Agreement. Borrowings under the Loan Agreement are collateralized by substantially all of our assets, including intellectual property assets.

As of December 31, 2012, we had no outstanding borrowings and $1.0 million in standby letters of credit issued under the Loan Agreement. As of December 31, 2012, we were in compliance with the financial covenants of the Loan Agreement and approximately $14.8 million was available for borrowing.
On September 3, 2010, we entered into a Note Purchase Agreement (the “Purchase Agreement”) with certain entities (collectively, the “Sherborne Purchasers”) under common control of Sherborne Investors GP, LLC and its affiliates (collectively “Sherborne”). Sherborne was formerly our largest shareholder and is controlled by Edward J. Bramson, the Company's former Chairman and Chief Executive Officer, and Craig L. McKibben, a former member of our Board of Directors.

Pursuant to the Purchase Agreement, we issued to the Sherborne Purchasers $6,096,996 in aggregate principal amount at maturity of Increasing Rate Senior Discount Notes due December 31, 2012 (the “Notes”). The Notes had an original principal amount totaling $5,000,000 and an original maturity date of December 31, 2012. On March 12, 2012, the maturity date of the Notes was automatically extended under certain terms of the Purchase Agreement to May 2, 2013.

On July 19, 2011, beneficial interest in the Notes was assigned by the Sherborne Purchasers pro-rata to their respective investors in the manner permitted by the Purchase Agreement. Such assignment was made in connection with the resignation of Messrs. Bramson and McKibben from their respective positions with Nautilus on May 26, 2011, and the subsequent pro-rata distribution by certain Sherborne-affiliated entities to their respective investors of the common stock of Nautilus owned by such entities.
We repaid all amounts outstanding under the Notes on March 30, 2012. If all of the Notes were paid on the original maturity date, the effective rate of interest over the term of the Purchase Agreement would have been approximately 8.7% per annum, which was the rate at which interest expense was accrued in periods preceding the repayment date. The actual effective rate of interest through the repayment date was approximately 6.4% per annum.

Non-Cancelable Contractual Obligations

Our operating cash flows include the effect of certain non-cancelable, contractual obligations. A summary of such obligations as of December 31, 2012, including those related to our discontinued Commercial operation, is as follows (in thousands):

	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years

Operating lease obligations	$16,835	$3,369	$6,437	$5,379	$1,650
Purchase obligations[1]	1,323	1,323	—	—	—
Minimum royalty obligations	250	250	—	—	—
Total	$18,408	$4,942	$6,437	$5,379	$1,650

(1) Our purchase obligations are comprised primarily of inventory purchase commitments. Because substantially all of our inventory is sourced from Asia, we have long lead times and therefore need to secure factory capacity from our vendors in advance.

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Due to uncertainty with respect to the timing of future cash flows associated with our unrecognized tax benefits at December 31, 2012, we are unable to make reasonably reliable estimates of the timing of any cash settlements with the respective taxing authorities. Therefore, approximately $4.1 million of unrecognized tax benefits, including interest and penalties on uncertain tax positions, have been excluded from the contractual table above. For further information, refer to Note 11, Income Taxes, to our consolidated financial statements in Part II, Item 8 of this report.

Off-Balance Sheet Arrangements

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

The nature and terms of these indemnifications vary from contract to contract, and generally a maximum obligation is not stated. We hold insurance policies that mitigate potential losses arising from certain types of indemnifications. Because we are unable to estimate our potential obligation, and because management does not expect these obligations to have a material adverse effect on our consolidated financial position, results of operations or cash flows, no liabilities are recorded at December 31, 2012.

Seasonality

We expect our sales from fitness equipment products to vary seasonally. Sales are typically strongest in the first and fourth quarters, followed by the third quarter, and are generally weakest in the second quarter. We believe that various factors, such as the broadcast of network season finales and seasonal weather patterns, influence television viewers and cause our advertising on cable television stations to be less effective in the second quarter than in other periods. In addition, during the spring and summer months, consumers tend to be involved in outdoor activities, including outdoor exercise, which impacts sales of indoor fitness equipment. This seasonality can have a significant effect on our inventory levels, working capital needs and resource utilization.

NEW ACCOUNTING PRONOUNCEMENTS

In the first quarter of 2012, we adopted Accounting Standards Update No. 2011-5, Presentation of Comprehensive Income ("ASU 2011-05"), which revises the manner in which entities present comprehensive income in their financial statements. ASU 2011-05 amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of ASU 2011-05 did not have any effect on our financial position, results of operations or cash flows.

In July 2012, the Financial Accounting Standards Board ("FASB") issued ASU 2012-02, Testing Indefinite-Lived Intangible Assets for Impairment ("ASU 2012-02"), which amends the guidance in Accounting Standards Topic 350-30, Intangibles - Goodwill and Other, on testing indefinite-lived intangible assets, other than goodwill, for impairment. Under ASU 2012-02, entities testing indefinite-lived intangible assets for impairment would have the option of performing a qualitative assessment before calculating the fair value of the asset. If an entity determines, on the basis of qualitative factors, that the indefinite-lived intangible asset is not more likely than not impaired, a quantitative fair value calculation would not be needed. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, although early adoption is permitted.

The adoption of ASU 2012-02 will not affect our financial position, results of operations or cash flows.

In February 2013, the FASB issued ASU No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income ("ASU 2013-02"). This ASU requires an entity to disclose additional information with respect to changes in accumulated other comprehensive income (AOCI) balances by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. This ASU is effective for interim and annual periods beginning after December 15, 2012. Since ASU 2013-02 relates entirely to disclosure, the adoption of this standard will not have any effect on our financial position, results of operations or cash flows.

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Item 8. Financial Statements and Supplementary Data

Index to Consolidated Financial Statements

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Nautilus, Inc.
Vancouver, Washington

We have audited the accompanying consolidated balance sheets of Nautilus, Inc. and subsidiaries (the "Company") as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Nautilus, Inc. and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2012, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 7, 2013, expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP

Portland, Oregon
March 7, 2013

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NAUTILUS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands)

	As of December 31,	
	2012	2011
ASSETS		
Cash and cash equivalents	$23,207	$17,427
Trade receivables, net of allowances of $93 in 2012 and $300 in 2011	21,767	23,780
Inventories	18,787	11,601
Prepaids and other current assets	5,750	4,433
Income taxes receivable	101	454
Short-term notes receivable	82	317
Deferred income tax assets	193	75
Total current assets	69,887	58,087
Property, plant and equipment, net	6,138	4,405
Goodwill	2,940	2,873
Other intangible assets, net	14,666	16,716
Other assets	680	732
Total assets	$94,311	$82,813
LIABILITIES AND STOCKHOLDERS' EQUITY		
Trade payables	$32,753	$28,563
Accrued liabilities	8,171	7,218
Warranty obligations, current portion	2,278	1,803
Deferred income tax liabilities	1,275	1,064
Total current liabilities	44,477	38,648
Long-term notes payable	—	5,598
Warranty obligations, non-current	214	214
Income taxes payable, non-current	2,812	3,658
Deferred income tax liabilities, non-current	1,484	1,434
Other long-term liabilities	1,998	1,308
Total liabilities	50,985	50,860
Commitments and contingencies (Note 15)		
Stockholders' equity:		
Common stock - no par value, 75,000 shares authorized, 30,924 and 30,747 shares issued and outstanding as of December 31, 2012 and 2011, respectively	6,103	5,360
Retained earnings	36,598	19,715
Accumulated other comprehensive income	625	6,878
Total stockholders' equity	43,326	31,953
Total liabilities and stockholders' equity	$94,311	$82,813

See accompanying notes to consolidated financial statements.

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NAUTILUS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Year Ended December 31,		
	2012	2011	2010
Net sales	$193,926	$180,412	$168,450
Cost of sales	102,889	101,953	91,704
Gross profit	91,037	78,459	76,746
Operating expenses:			
Selling and marketing	58,617	54,494	64,039
General and administrative	17,669	17,143	19,371
Research and development	4,163	3,223	2,905
Total operating expenses	80,449	74,860	86,315
Operating income (loss)	10,588	3,599	(9,569)
Other income (expense):			
Interest income	18	65	15
Interest expense	56	(466)	(140)
Other	(246)	(11)	464
Total other (expense) income	(172)	(412)	339
Income (loss) from continuing operations before income taxes	10,416	3,187	(9,230)
Income tax (benefit) expense	(226)	686	588
Income (loss) from continuing operations	10,642	2,501	(9,818)
Discontinued operation:			
Income (loss) from discontinued operation before income taxes	6,007	(1,065)	(12,924)
Income tax (benefit) expense of discontinued operation	(234)	16	99
Income (loss) from discontinued operation	6,241	(1,081)	(13,023)
Net income (loss)	$16,883	$1,420	$(22,841)
Income (loss) per share from continuing operations:			
Basic	$0.34	$0.08	$(0.32)
Diluted	0.34	0.08	(0.32)
Income (loss) per share from discontinued operation:			
Basic	$0.21	$(0.03)	$(0.42)
Diluted	0.21	(0.03)	(0.42)
Net income (loss) per share:			
Basic	$0.55	$0.05	$(0.74)
Diluted	0.55	0.05	(0.74)
Weighted average shares outstanding:			
Basic	30,851	30,746	30,744
Diluted	30,974	30,776	30,744

See accompanying notes to consolidated financial statements

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NAUTILUS, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands)

	Year Ended December 31,		
	2012	2011	2010
Net income (loss)	$16,883	$1,420	$(22,841)
Other comprehensive income (loss), net of tax:			
Foreign currency translation, net of income tax (benefit) expense of ($9), $8 and ($15)	(83)	(575)	520
Total comprehensive income (loss)	$16,800	$845	$(22,321)

See accompanying notes to consolidated financial statements.

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NAUTILUS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)

	Common Stock	Retained Earnings	Accumulated Other