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, 2009

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.)**

16400 S.E. Nautilus Drive

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 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. ¨

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 ¨ No ¨

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company x

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 ($1.13) 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, 2009) was $34,594,200.

The number of shares outstanding of the registrant s common stock as of January 31, 2010 was 30,744,336 shares.

Documents Incorporated by Reference

The registrant has incorporated by reference into Part III of this Form 10-K portions of its Proxy Statement for its 2010 Annual Meeting of Shareholders.

Table of Contents

NAUTILUS, INC.

2009 FORM 10-K ANNUAL REPORT

PART I

PART II

PART III

PART IV

Table of Contents

PART I

Item 1. Business

OVERVIEW

Nautilus is a fitness products company headquartered in Vancouver, Washington. 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, including Nautilus, Bowflex, Universal and Schwinn Fitness.

We market our products through two business segments: Direct and Retail, each representing a distinct marketing distribution channel. Our direct business offers products directly to consumers through direct advertising, catalogs and the Internet. Our retail business offers our products through a network of independent retail companies located in the United States and Canada, as well as Internet-based merchants. Our commercial business, formerly an operating segment and reported as a discontinued operation beginning in 2009, offered products to health clubs, schools, hospitals and other organizations, which typically require fitness products specifically designed for higher usage.

Founded in 1986, Nautilus developed and introduced the Bowflex rod-based home gym and, through the use of infomercials, became a leading direct marketer of fitness equipment. The direct marketing model of selling directly to the consumer grew quickly, allowing the Company to invest its earnings in a series of strategic acquisitions of well-recognized brands including: Nautilus® in 1999; Schwinn Fitness in 2001; StairMaster in 2002; and Universal in 2006. In the third quarter of 2009, the Company adopted a plan for the complete divestiture of its commercial business, including the StairMaster trademark and StairMaster, Schwinn Fitness and Nautilus product lines sold in the commercial sales channel. Nautilus plans to retain, however, ownership of the Schwinn and Nautilus trademarks, and its strong presence in the consumer fitness equipment market through its direct and retail sales channels.

Our company was incorporated in the state of Washington in January 1993. Unless the context otherwise requires, Nautilus , Company , we , us and our refer to Nautilus, Inc. and its subsidiaries. All references to 2009 and 2008 in this report refer to our fiscal years ended on December 31, 2009 and 2008, respectively.

BUSINESS STRATEGY

We are focused on developing and marketing 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 well-recognized brands. More recently, our business strategy has focused exclusively on consumer products, markets and distribution channels, which we believe will provide the greatest long-term value to our shareholders. Implementation of this strategy includes the sale of our fitness apparel business in 2008 and the divestiture of our commercial fitness products business, which we began in late 2009 and expect to complete in 2010.

Product innovation is a vital part of our business. A unique or new product can often provide a significant competitive advantage, as consumers are looking for ways to improve the effectiveness of their workouts. We continually evaluate new product concepts, generated by both internal and external resources, and seek feedback from users on how to enhance our current product offerings.

Our strategies incorporate the specific characteristics of our direct and retail business segments. Our *direct* business segment focuses on (i) the development of, or acquisition of rights to, unique products, and (ii) the

Table of Contents

application of creative, cost-effective ways to communicate the benefits of their use. We are very attentive to direct business metrics, particularly those that provide feedback regarding the effectiveness of our media marketing programs. In our *retail* business segment, we strive to enter into business 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 in order to maintain lasting relationships with our customers, and (ii) to utilize such relationships and the strength of our brands to obtain more floor space for our products.

As a result of recent economic challenges, we are in the process of restructuring certain aspects of our operations to (i) improve our cost structure and operating efficiency, and (ii) provide us with greater flexibility to respond to future market opportunities. In addition, we plan to place additional emphasis on our direct business, as the high margin and low working capital requirements of that business model make it favorable both in difficult economic times and when growth accelerates. We will continue to assess the health of the economy and, if appropriate, will re-evaluate our business strategies and prioritize our use of resources accordingly.

Our long-term strategy involves: continued investment in research and development activities aimed at creating or acquiring new technologies; 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; and creatively marketing our equipment, both directly to consumers and through our retail partners, using our popular brand names.

RECENT DEVELOPMENTS

On September 25, 2009, our Board of Directors approved management s plan for the complete divestiture of our commercial business. On December 29, 2009, we completed the sale of certain assets of our StairMaster and Schwinn Fitness product lines. On February 19, 2010, we completed an agreement for the sale of certain assets of our Nautilus strength equipment product lines. The buyer also acquired rights to certain patents, technologies and other intellectual property, assumed certain outstanding warranty obligations related to our North American commercial products and entered into a short-term lease of our Independence, Virginia manufacturing and warehousing facilities with an option to purchase such facilities. For further information, see Note 2, Discontinued Operations, in our consolidated financial statements.

Table of Contents

Management currently expects to complete the sale of the remaining assets of the commercial business in 2010. The following table shows portions of the commercial business divestiture for which asset disposals have been completed, and those portions for which asset disposals are not completed:

	Asset Disposals Completed as of December 31, 2009	Asset Disposals Completed as of March 8, 2010	Asset Disposals Not Completed
StairMaster Commercial Product Lines			
Finished goods and spare parts inventories	X		
Raw materials and work-in-process inventories		X	
Production equipment and other fixed assets	X		
Trademark intangible asset	X		
Schwinn Fitness Commercial Product Lines			
Finished goods and spare parts inventories on hand	X		
Finished goods inventories in-transit		X	
Accounts receivable	X		
Production equipment and other fixed assets	X		
Nautilus Commercial Product Lines			
Raw materials, work-in-process and North America spare parts inventories		X	
Finished goods inventories			X
Manufacturing equipment and related fixed assets		X	
Independence, Virginia land and buildings			X
Europe distribution operations, including finished goods and spare parts inventories			X
China finished goods and spare parts inventories			X

In December 2009, the President signed into U.S. federal law a provision allowing taxpayers to carry back applicable net operating losses for a period of up to five years. This new law allowed us to carry-back a portion of our 2008 net operating loss to prior years in which we had paid federal taxes and, as a result, we received a U.S. income tax refund of approximately $12.1 million in January 2010.

On March 8, 2010, we entered into a new loan agreement with Bank of the West (the New Loan Agreement), providing for a $15.0 million revolving secured credit line, available for a thirty-month term. The New Loan Agreement is available for working capital, standby letters of credit and general corporate purposes, assuming we are able to satisfy certain terms and conditions at the time the borrowings are requested.

PRODUCTS

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

Our **Nautilus** brand includes: a complete line of cardio equipment, including specialized products and treadmills, ellipticals and exercise bikes. In early 2009, we introduced new lower priced treadmills specifically designed for the retail business. In December 2009, we introduced the Mobia, a specialized cardio machine that utilizes dual treads and burns twice the calories of an equivalent standard treadmill.

Our **Bowflex** brand represents a line of fitness equipment comprised of both strength and cardio products. Our Bowflex product line includes our PowerRod home gyms, the Revolution home gym, SelectTech dumbbells, weight benches, treadmills, and TreadClimber specialized cardio machines, specifically designed for home use.

Table of Contents

Our **Schwinn Fitness** brand is known for its popular line of indoor cycling equipment, exercise bikes, including the Airdyne, and ellipticals. In 2009, we introduced treadmills specifically designed for the retail business.

Our **Universal** brand is one of the oldest and most recognized names in the fitness industry. In 2009, we introduced a limited product line of kettlebell weights and benches.

We differentiate the product lines offered in our direct and retail sales channels, as indicated in the table below:

	Direct Channel	Retail Channel
Bowflex		
Rod-based home gyms	X	X
Spiroflex home gyms	X	X
Specialized cardio	X	
Treadmills		X
Selectorized dumbbells	X	X
Nautilus		
Specialized cardio	X	
Upright and recumbent exercise bikes		X
Ellipticals		X
Treadmills		X
Schwinn Fitness		
Upright and recumbent exercise bikes		X
Indoor cycling bikes		X
Ellipticals		X
Treadmills		X
Universal		
Kettlebell weights and benches		X

While our marketing efforts are focused as indicated in the chart above, we offer our full product assortment to our direct customers through our websites.

BUSINESS SEGMENTS

We conduct our business in two segments, Direct and Retail. For further information, see Note 15, Segment Information, in our consolidated financial statements.

SALES AND MARKETING

Direct

In our *direct* business, we market and sell our products, principally Bowflex strength and cardiovascular products, directly to end-consumers. Historically, almost all of our direct business sales were in strength-related products and accessories, including our Bowflex rod-based home gyms and the Revolution home gym. We have been, and plan to continue to be, the largest direct marketer of strength products in the United States. We have also taken measures to diversify our product mix by increasing advertising for the Bowflex TreadClimber, a unique cardio fitness product, and by launching the Nautilus Mobia, a specialized cardio fitness machine.

Our marketing efforts are based on an integrated combination of media and direct consumer contact. We utilize television advertising, which ranges in length from 30 seconds to as long as five minutes, in addition to 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 key metrics. The majority of our direct sales activity occurs through our call center and Internet websites.

Table of Contents

For the year ended December 31, 2009, approximately half of our U.S. customers took advantage of a financing program offered by HSBC Bank Nevada, N.A. (HSBC) to purchase our products using the private label Bowflex revolving credit card, as compared to approximately two-thirds of our U.S. customers in 2008, reflecting the application of more stringent credit approval standards by HSBC. We expect that HSBC will continue to apply these more stringent credit approval standards to our customers in 2010. Accordingly, we are investigating other consumer financing options and developing marketing strategies that do not rely on access to consumer credit as a principal factor in the customer s purchase decision. Our current agreement with HSBC expires in 2013.

Retail

In our *retail* business, we market and sell a comprehensive line of consumer fitness equipment under the Nautilus, Schwinn Fitness, Universal and Bowflex brands. Our products are marketed through a network of retail locations, consisting of sporting goods stores, department stores, governmental agencies and, to a lesser extent, smaller specialty retailers and independent bike dealers.

Retail business sales have historically been led by our strength products, including the Bowflex rod-based home gym and SelectTech dumbbells. However, we believe the fitness equipment market for cardio products is much larger and provides greater opportunity for growth. As a result we have focused our retail business product development efforts on the introduction of new cardio products, including a line of Schwinn Fitness branded indoor bikes and ellipticals. We plan to continue to invest in the development of cardio products for the retail business, anticipating that such investments will help us achieve greater market share.

We have implemented sales programs which provide discounts to our customers for ordering container sized shipments and/or placing orders early enough in the season to allow for efficient manufacturing by our Asian suppliers. These sales programs are designed to reduce our shipping and handling costs, with much of the savings being passed on to our customers. Many of our retail customers are also eligible for other types of sales incentives, including volume discounts and various forms of rebates or allowances, which primarily are intended to increase product availability, offset transportation costs and encourage marketing of our brands.

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 to 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 third-party technology or innovation concepts meet 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.

Our research and development expenses were approximately $5.2 million and $6.6 million for the years ended December 31, 2009 and 2008, respectively.

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 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.

MANUFACTURING AND DISTRIBUTION

Manufacturing

All our products are produced by third party manufacturers, substantially all of which are located in Asia. We monitor our suppliers ability to meet our product needs and participate in quality assurance activities to reduce the risk of marketing substandard products. Other than our contract with Land America Health & Fitness Co., LTD. (Land America), which expires in December 2010, our third-party manufacturing contracts are terminable by either party on relatively short notice.

Distribution

Our warehousing and distribution facilities are located in Portland, Oregon and Winnipeg, Manitoba. In our direct business, we strive to maintain inventory levels which will allow us to ship our products shortly after receiving a customer s order. Because our direct business products are manufactured in Asia, we have long merchandise replenishment lead times, for which we compensate by maintaining adequate levels of safety stock.

We manage our retail inventory levels to accommodate seasonal changes in anticipated demand. We generally maintain higher inventory levels at the ends of the third and fourth quarters, to satisfy 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 they have an adequate supply for the anticipated selling season. If consumer demand exceeds store forecasts, many of our retail customers will place additional orders during the season, provided the product can be delivered in a short period of time. Approximately one-third of our retail inventory replenishment orders are shipped by our contract manufacturers directly to customer locations, typically in large containers. The use of these drop ships allows us to maintain lower levels of inventory, resulting in lower storage, handling, insurance and other carrying costs. We also distribute our products to retail customers using various commercial truck lines. We use FedEx Corp. for the delivery of substantially all of our direct business products in the U.S. and Canada.

BACKLOG

Historically, backlog has not been a significant factor in our business.

COMPETITION

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

Direct

In our direct business, our products compete directly with those offered by a large number of companies that market home fitness equipment. Our principal competitors in this segment are *Fitness Quest* and *ICON Health & Fitness*. Other competitors in this segment include weight-loss companies, such as Jenny Craig and NutriSystems, each of which offers alternative solutions to a fit and healthy lifestyle.

Retail

In our retail business, our products compete with those of other retail fitness equipment companies, such as *Johnson Health Tech* and *ICON Health & Fitness.*

Table of Contents

EMPLOYEES

As of January 31, 2010, we had approximately 640 employees, substantially all of which were full-time, and approximately 280 of which were employed in connection with our commercial business discontinued operation. None of our employees are subject to collective bargaining agreements. We have not experienced a material interruption of our operations due to labor disputes.

SIGNIFICANT CUSTOMERS

No individual customer accounted for 10 percent or more of our consolidated net sales in the past two fiscal years.

INTELLECTUAL PROPERTY

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

Trademarks

We own many trademarks including Nautilus, Bowflex, PowerRod, Revolution, Mobia, TreadClimber, Schwinn Fitness, SelectTech, Trimline and Universal. The vast majority of our trademarks are either registered or protected by common law rights. We believe that having distinctive trademarks, which are readily identifiable by consumers, is an important factor in creating a market for our products, creating a strong company identity and developing brand loyalty among our customers.

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

We own a broad array of patents and patent rights, both issued and pending, covering our fitness equipment. These patents cover a variety of technologies, some of which are utilized in the following products: TreadClimber; variable stride ellipticals; selectorized weights; recumbent bicycles; and the Bowflex Revolution. Patent protection for these technologies extends as far as 2020, with none expiring prior to 2011. Expiration of these and other patents could trigger the introduction of similar products by our competitors. Patent protection has ended for our rod-based home gyms.

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 foreign patents on inventions, new designs and improvements that we deem valuable to our business. We protect our proprietary rights vigorously and take prompt, reasonable actions to prevent counterfeit reproductions or other infringement on our intellectual property.

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 (EPA), Occupational Safety and Health Administration (OSHA) and other federal agencies have the authority to promulgate regulations which 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 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.

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 16400 SE Nautilus Drive, Vancouver, Washington 98683, and our telephone number is (360) 859-2900. The Internet address of our corporate website is http://www.nautilus.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. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. The SEC maintains an Internet site 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 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 also available on our corporate website. The information found on our website is not part of this Form 10-K.

Item 1A. Risk Factors

Special Note Regarding Forward-Looking Statements

This Form 10-K, including Item 1 of Part I and Item 7 of Part II, contains forward-looking statements. Forward-looking statements include any statements related to our expectations regarding future performance or conditions, including any statements regarding anticipated sales growth across markets, distribution channels, and product categories, expenses and gross margins, expense as a percentage of revenue, anticipated earnings, new product introductions, manufacturing plans and activities, future capital expenditures, our turnaround plan, 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 herein. We do not undertake any duty to update forward-looking statements after the date they are made or to conform them to actual results or to changes in circumstances or expectations.

A continued decline 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 consumers. 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. A continued decline in general economic conditions could further depress consumer spending, especially spending for discretionary consumer products such as ours. Higher interest rates could increase monthly payments for consumer products financed through one

Table of Contents

of our monthly payment plans or through other sources of consumer financing. These poor economic conditions could in turn lead to substantial further decreases in our net sales or have a material adverse effect on our operating results, financial condition and cash flows.

We may need to raise additional financing if our financial results do not improve.

We sustained significant operating losses during 2009 and 2008, and if we continue to experience significant operating losses, we will need to obtain additional debt or equity financing to continue operating. There is no guarantee that we will be able to raise additional funds on favorable terms, if at all, or that any amount raised will be sufficient to meet our cash requirements. If we are not able to raise additional needed capital, we would be forced to sharply curtail our operations.

Failure to successfully implement our turnaround strategies may adversely affect revenues and expenses.

To implement our business strategy, we must effectively manage our turnaround in each of our business segments. We expect to continue to change various aspects of our business, enhance our operations, and attract, retain and manage qualified personnel. Our turnaround efforts could place an increasing strain on management, financial, product design, marketing, manufacturing, distribution and other resources, and we could experience operating difficulties in association with our turnaround and restructuring plans. As a result of these and other pressures, our turnaround strategies involve many risks and uncertainties that could have a material adverse effect on our results of operations, financial condition and cash flows.

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

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

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

Reductions in consumer lending and the availability of consumer credit could limit the number of customers with the financial means to purchase our products. In the past, we have partnered with financial service companies, including HSBC, to assist our customers in obtaining financing to purchase our products. Our present agreement with HSBC helps certain customers obtain financing if they qualify for HSBC s private label Bowflex revolving credit card. We cannot be assured that HSBC, or others, 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 condition and cash flows.

Failure to collect accounts receivable from our customers could adversely affect our ability to operate our business.

Our trade receivables reflect a large and diverse customer base, domestically and internationally. Our trade receivables are generally unsecured and therefore collection is affected by the economic conditions in each of our principal markets. Collection of receivables due from customers outside the U.S. may also be negatively impacted by the nature, and extent of our business presence in a particular country and any rights or protections afforded to our customers under a country s legal system. We cannot predict, with certainty, future changes in the financial stability of our customers or in the general economy. We periodically review the credit worthiness of our customers to help gauge collectability and increase our allowance for doubtful accounts when collection is at risk. However, our actual future losses from uncollectible accounts may differ from our estimates. Our ability to collect the amounts due from our customers could be impacted by various factors including: a deterioration in the financial condition of a key customer, inability of customers to obtain bank credit lines, a significant slow-down

Table of Contents

in the economy, our efforts to pursue collections, product quality matters or other customer disputes. If our estimates of uncollectible amounts are inaccurate or change significantly or we are unable to collect amounts due from our customers, it could have a material adverse affect on our operating results, financial condition and cash flows.

If our contract manufacturers experience any delay, disruption or quality control problems in their operations, we could lose market share and revenues, and our reputation 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 platform 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;
- The 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 of our products.

Our contract manufacturers primarily are located in Asia 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 primary contract manufacturers could cause a significant disruption in our product supply chain and operations and delays in product shipments. In addition, other than our contract with Land America, which expires in December 2010, our third-party manufacturing contracts are terminable by either party on relatively short notice.

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.

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 continuing 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:

- The introduction and market acceptance of new products;
- Variations in product selling prices and costs and the mix of products sold;
- The size and timing of customer orders, which, in turn, often depend upon the success of our customers businesses or specific products;

Table of Contents

- Changes in the market conditions for consumer fitness equipment;
- Changes in macroeconomic factors;
- The availability of consumer credit;
- The timing and availability of products coming from our offshore contract manufacturing partners;
- 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;
- The 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 harm our business, operating results, financial condition and cash flows in any particular period.

Our operating expenses and portions of our costs of revenues 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 revenue shortfall, 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 earnings could be adversely affected.

Our future success depends on our ability to develop, or acquire the rights to, and effectively produce, market, and sell new products that create and/or respond to new and evolving consumer demands. Accordingly, our net sales and profitability may be harmed if we are unable to develop, or acquire the rights to new or different products that satisfy consumers preferences. In addition, any new products that we market may not generate sufficient net sales to recoup their development, acquisition, production, marketing, selling and other costs.

A delay in getting foreign sourced products through customs in a timely manner could result in cancelled orders and unanticipated inventory accumulation.

Most of our imported products are subject to duties, tariffs or quotas 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 have a material adverse effect on our business, potentially resulting in reduced revenues and earnings, cancelled orders by customers and/or unanticipated inventory accumulation.

Unpredictable events and circumstances relating to our international operations, including our use of foreign manufacturers, could result in cancelled orders, unanticipated inventory accumulation, and reduced revenues and earnings.

A portion of our revenue is derived from sales outside the U.S. International sales represented approximately 10% of our consolidated net sales from continuing operations in 2009. In addition, substantially all of our products are manufactured outside of the U.S. 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 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 business, operating results, financial condition 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, our sales and profitability may be adversely affected. We currently hold approximately 200 patents and trademarks and have approximately 40 patent and trademark applications pending in the United States. 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 trademark and 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.

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

We had goodwill of $2.8 million and other intangible assets of $20.8 million at December 31, 2009. We recognized impairment charges of $5.9 million in 2009 for intangible assets related to continuing operations, and an impairment charge of $29.8 million in 2008 for goodwill of our continuing operations. Any future impairment charges, if significant, could materially and adversely affect our reported operating results. A decline in revenue, a change in market conditions, a change in competitive products or technologies or a change in management s intentions to utilize our intangible assets may lead to further impairment charges.

Intense competition may have a negative impact on our net sales and operating results.

Our products are sold in highly competitive markets with limited barriers to entry. As a result, introduction of lower priced or more innovative products could result in a significant decline in our net sales, operating results, financial condition and cash flows.

Inability to effectively manage our distribution facilities may harm our business and financial results.

Our ability to meet customer expectations, manage inventory, complete sales and achieve objectives for operating efficiencies depends on the proper operation of our existing distribution facilities and the timely performance of services by third parties, including those involved in shipping product to and from our distribution facilities. Our distribution facilities are located in Oregon in the United States, and Manitoba in Canada.

Operations at our distribution facilities could be interrupted by disasters such as earthquakes or fires. We maintain business interruption insurance, but it may not adequately protect us from the adverse effect that could be caused by significant disruptions in our distribution network.

Our or others failure to maintain information and communication systems could result in interruptions to our business.

Our business is increasingly 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 production cycle, from design to distribution, and we use such systems as a method of communication between employees, as well as our customers. In addition, we use information systems to maintain our accounting records, assist in collection and customer service efforts, and to 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; 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. Any of the aforementioned factors could have a material adverse affect on our operating results, financial condition and cash flows.

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

We have significant sales outside of the United States. As a result, we conduct transactions in various currencies which increase our exposure to fluctuations in foreign currency exchange rates relative to the U.S. dollar. Our international revenues and expenses generally are derived from sales and operations in non-U.S. currencies, and these revenues and expenses could be affected by currency fluctuations. Currency exchange rate fluctuations could also 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. Therefore, our future financial results could be significantly affected by the value of the U.S. dollar in relation to the non-U.S. currencies in which we, our customers or our suppliers conduct business.

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.

Table of Contents

We may be adversely affected by the financial health of our customers.

We extend credit to our customers, generally without requiring collateral, based on our assessment of a customer s financial circumstances. To assist in the scheduling of production and the shipping of seasonal products, we offer customers financial incentives to place orders four to six months ahead of delivery. These advance orders may be cancelled, and the risk of cancellation may increase when dealing with financially challenged customers struggling with economic uncertainty. In the past, some customers have experienced financial difficulties which in turn have had an adverse effect on our business. More recently, customers have been cautious in placing orders as a result of weakness in the economy. A depressed global economy may continue to negatively affect the financial health of our customers and have an adverse effect on our results of operations, financial condition and cash flows.

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, Environmental Protection Agency, and the Consumer Product Safety Commission, regulate our marketing efforts and the manufacturing of products. Our sales and profitability could be significantly harmed if any of these authorities commence a regulatory enforcement action that interrupts our marketing or manufacturing efforts, results in a product recall or negative publicity, or requires changes in product design.

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. 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 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 and/or other sums.

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 have been transferred to buyers of our commercial business product lines, if the buyer is unable to fulfill such obligations.

In order to be successful, we must attract, retain and motivate key employees, and failure to do so may have an adverse impact on our business.

Our future success depends on our ability to attract and retain key executives, managers, product development engineers, sales personnel and others. We face intense competition for such individuals worldwide. Not being able to attract or retain these employees may have a significant adverse effect on our results of operations and financial condition.

Table of Contents

Our plan to divest the remaining portions of our commercial business may not be successful and may involve substantial additional charges.

In September 2009, management committed to a plan for the complete divestiture of our commercial business. In December 2009, we completed the sale of certain assets of our StairMaster and Schwinn Fitness product lines and, in February 2010, we completed an agreement for the sale of certain assets of our Nautilus commercial equipment product line. We may be unable to successfully divest the remaining portions of our commercial business on favorable terms, or at all. The amount of estimated loss recorded in connection with the planned sale of the commercial business may be adjusted in future periods, depending on changes that may occur in the underlying facts and circumstances, and these adjustments may be material. Additionally, we may incur material costs, fees, expenses and charges relating to our planned divestiture of the commercial business, including employee termination severance payments and costs related to the termination of lease agreements and other contractual obligations. Our results of operations and liquidity may be negatively impacted by such charges or by a failure to successfully complete the planned divestiture within a reasonable time period. We currently expect to incur additional costs related to our planned divestiture, including employee termination severance payments of approximately $1.6 million and termination charges for leases and other commercial contract obligations of approximately $1.8 million, which are not reflected in our 2009 operating results in accordance with generally accepted accounting principles. The estimated amounts of additional costs may be adjusted in future periods, depending on changes that may occur in the underlying facts and circumstances, and the amount of adjustment may be material.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Following is a summary of our principal properties as of December 31, 2009:

Reportable Segment	Location	Primary Function(s)	Owned or Leased
Unallocated	Washington	World headquarters and call center	Leased
Unallocated	Oregon	Warehouse and distribution	Leased
Unallocated	China	Quality assurance and supplier relationships	Leased
Direct	Canada	Warehouse, distribution and showroom	Leased
*	Colorado	Testing and engineering	Leased
*	Virginia	Three properties for manufacturing, warehousing and support services	Owned
*	Oklahoma	Manufacturing	Leased
*	Switzerland	Administrative	Leased
*	Germany	Administrative, showroom and warehouse	Leased
*	United Kingdom	Administrative, showroom and warehouse	Leased

* These facilities are related to our commercial business which is classified as a discontinued operation, and are scheduled for sale or closure in 2010. In each case, we are seeking to either sell the property or terminate the underlying lease or sub-lease the property.

In general, our properties are well maintained, adequate and suitable for their purposes, and we believe these properties will meet our operational needs for the foreseeable future. If we require additional warehouse or office space, we believe we will be able to obtain such space on commercially reasonable terms.

Table of Contents

Item 3. Legal Proceedings

We are party to various legal proceedings and claims arising from normal business activities. Based on the facts currently available, we do not believe that the disposition of matters that are pending or asserted, individually or in the aggregate, will have a material adverse effect on our future financial results. However, an adverse judgment by a court, administrative or regulatory agency, arbitrator or a settlement could adversely impact our financial position, results of operations and cash flows.

Item 4. [Reserved]

Table of Contents

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. As of January 31, 2010, there were 73 holders of record of our common stock and approximately 32,000 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
2009:			
Quarter 1	$ 2.57	$ 0.45	
Quarter 2	2.35	0.59	
Quarter 3	2.96	0.96	
Quarter 4	2.47	1.59	
2008:			
Quarter 1	$ 5.50	$ 3.00	
Quarter 2	6.85	3.15	
Quarter 3	6.37	4.09	
Quarter 4	4.55	1.66	

Payment of any future dividends 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, 2009:

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	1,413,709	$ 10.50	4,608,000
Equity compensation plans not approved by security holders			
Total	1,413,709	$ 10.50	4,608,000

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

Table of Contents

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

Our Management s Discussion and Analysis of Financial Condition and Results of Operation (the MD&A) should be read in conjunction with our consolidated financial statements and related notes, in Item 8.

OVERVIEW

Nautilus, Inc., a fitness products company headquartered in Vancouver, Washington, is 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, including Nautilus, Bowflex, Universal and Schwinn Fitness.

We market our products through two business segments: Direct and Retail, each representing a distinct marketing distribution channel. Our direct business offers products directly to consumers through direct advertising, catalogs and the Internet. Our retail business offers our products through a network of independent retail companies located in the United States and Canada, as well as Internet-based merchants.

Economic and market conditions have been, and continue to be, disruptive and volatile. These conditions, including reduced business and consumer confidence, disruptions in the residential housing market, materially reduced consumer credit availability for our customers and increased unemployment, all of which have contributed to reductions in consumer spending, particularly on discretionary products such as our home fitness equipment.

During 2008, we implemented cost reduction efforts to adjust for the decline in revenue, and in early 2009 we announced plans to initiate additional cost reductions aimed at further reducing operating costs and improving the overall alignment of spending and anticipated revenue. During the third quarter of 2009, in order to focus exclusively on the development of our direct and retail businesses, management committed to a plan for the complete divestiture of our commercial business. Consequently, our commercial business has been classified as a discontinued operation. Management s actions to reduce costs in our continuing and discontinued operations and focus on the development of our direct and retail businesses are summarized as follows:

During 2009:

- We restructured our workforce and reduced the number of employees in our corporate headquarters and our manufacturing and distribution functions to better match the requirements of our business;
- We conducted a thorough review of our information technology costs to better align computer systems and support services to our restructured business model, resulting in significant savings related to software purchases, maintenance agreements and licensing fees;
- We terminated our lease for our corporate headquarters facility in Vancouver, Washington, and entered into a new lease for substantially less space and substantially lower rent payments in the same building;
- We terminated a third-party warehouse distribution service agreement for our U.S. service parts inventory, which now will be distributed from our company facility; and
- We committed to a plan for the complete divestiture of our commercial business, and completed the sale of certain assets of our StairMaster and Schwinn Fitness commercial product lines. In February 2010, we completed an agreement for the sale of certain assets of our Nautilus commercial fitness product lines.

During 2008:

We restructured our workforce to better match the requirements of our redefined business segment organization;

Table of Contents

- We closed our Tulsa commercial manufacturing facility and transferred operations to third party manufacturers in Asia and our owned manufacturing facility in Independence, Virginia;
- We consolidated our U.S. distribution centers and aligned the products by segment to allow for more efficient product handling;
- We ceased direct business sales through our Australian subsidiary and closed those operations;
- We sold our apparel division, Dash America, Inc. d/b/a Pearl iZumi;
- We closed our Canadian call center and consolidated our call center operations in Vancouver, Washington to achieve better economies of scale;
- We terminated a number of marketing arrangements to better align our spending with our revised operating plans;
- We reduced our revolving line of credit to a level better suited for our anticipated borrowing; and
- We exercised our right to terminate agreements to acquire a manufacturing operation located in China.

Substantially all of our revenues are generated from product sales. Our net sales for the year ended December 31, 2009, were $189.3 million, a decrease of $94.4 million, or 33.3%, as compared to net sales of $283.7 million in the prior year. The decline in net sales primarily was due to a general decline in consumer spending on discretionary products and reduced availability of consumer financing.

Gross profit margin increased to 51.0% for the year ended December 31, 2009, compared to 47.9% in the prior year, primarily due to reduced distribution costs resulting from the consolidation of our distribution centers, a decrease in shipping costs arising from a change in our primary outbound freight carrier and a decrease in warranty costs.

Operating expenses for the year ended December 31, 2009 were $125.7 million, a decrease of $67.6 million, or 35.0%, as compared to operating expenses of $193.3 million in the prior year. The decrease in operating expenses reflects the impact of management s efforts to better align spending with current and anticipated revenue levels through significant reductions in advertising expenses, employment costs and other expenses. For the years ended December 31, 2009 and 2008, we incurred $14.2 million and $13.9 million, respectively, in expenses associated with our restructuring initiatives. Operating expenses for the year ended December 31, 2009 include intangible asset impairment charges of $5.9 million. Operating expenses for the year ended December 31, 2008 include a goodwill impairment charge of $29.8 million.

We reported an income tax benefit from continuing operations of $10.9 million for the year ended December 31, 2009, compared to a benefit of $5.9 million in the prior year.

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.

Revenue Recognition

Product sales and shipping revenues, net of promotional discounts, rebates and return allowances, are recorded when products are shipped and title passes to customers. Retail sales to customers are made pursuant to a sales contract that provides for transfer of both title and risk of loss upon our delivery to the carrier.

We record taxes collected from customers and remitted to governmental authorities on a net basis, excluded from revenue. Shipping and handling fees billed to customers are recorded gross, meaning they are included in both revenue and cost of sales. Many of our direct business customers finance their purchases through a third-party credit provider, for which we pay a commission or customer financing fee to the credit provider. We record sales for these transactions based on the sales prices charged to our customers and record the commission or financing fee as a component of selling and marketing expense.

Revenue is recognized net of applicable sales incentives, such as promotional discounts, rebates and return allowances. We estimate the revenue impact of our incentive programs based on the planned duration of the program and historical experience. If the amount of our 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.

We estimate our liability for product returns based on historical experience and record the expected obligation as a reduction in revenue. If actual return costs differ from our estimates, the recorded amount of the liability and corresponding revenue are adjusted.

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. 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 and indefinite-lived intangible assets and, thereby, could have a material adverse affect on our financial position and results of operations. Events could cause us to conclude that goodwill or other intangible assets are impaired, resulting in the recognition of an impairment charge.

In 2009, we recognized $5.9 million in impairment charges related to intangible assets used in our continuing operations. In 2008 we recognized a $29.8 million impairment charge on goodwill of our retail business. Impairment charges of $1.7 million and $1.1 million related to intangible assets of discontinued operations were recognized in 2009 and 2008, respectively.

Accounts Receivable Valuation

We evaluate the collectability of our accounts receivable based on a combination of factors including: an aging of receivable balances, historical collection experience, our understanding of the current financial status of key customers and overall economic conditions. We periodically review the credit worthiness of our customers to help gauge collectability and increase our allowance for doubtful accounts when collection is at risk. We believe that by analyzing historical trends and monitoring potential collection problems, we have sufficient information to establish a reasonable estimate of the portion of our receivable balances that will not be collected. However, since we cannot predict, with certainty, future changes in the financial stability of our customers or in the general economy, our actual future losses from uncollectible accounts may differ from our estimates. Our ability to collect the amounts due from our customers could be impacted by various factors including: a deterioration in the financial condition of a key customer, inability of customers to obtain bank credit lines, a significant slow-down in the economy, our efforts to pursue collections, product quality matters or other customer disputes. Even

Table of Contents

though portions of our accounts receivable are protected by a security interest in products held by customers, any of the factors noted above may affect our ability to collect all, or a portion of, our receivable balances and could have a material impact on our financial position, results of operations and cash flows.

Inventory Valuation

Our inventory is reported at the lower of cost or market, with cost determined based on the first-in, first-out method. We establish provisions for excess, slow moving and obsolete inventory based on inventory levels, expected product life and forecasted sales demand. In assessing the ultimate realization of inventory values, we are required to make judgments regarding the salability of our products, including an assessment of future demand compared with existing inventory levels, competitive factors, and changes in technology and product life cycles. A significant change in any of the aforementioned factors could have a material impact on our financial position, results of operation and cash flows. It is also possible that an increase in our inventory provisions may be required in the future if there is a significant decline in demand for our products and we do not adjust our purchases from manufacturers accordingly.

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. If warranty costs differ from our previous estimates, or if circumstances change such that the assumptions inherent in our previous estimates are no longer valid, we adjust our warranty reserve amount accordingly. Changes in the aforementioned factors or other warranty-related assumptions could have a significant impact on our results of operations, financial position and cash flows.

Stock-Based Compensation

We recognize stock-based compensation on a straight-line basis over the applicable vesting period, based on the grant-date fair value of our awards. We estimate the fair value of our stock options using the Black-Scholes-Merton option valuation model and determine the fair value of our restricted stock awards based on the closing market price on the day preceding the grant.

Estimating the fair value of our stock-based awards involves inherent uncertainties and the application of management judgment. The valuation of our stock options requires us to make assumptions regarding the expected term of our options, expected future volatility in the market price of our common stock, future risk-free interest rates and future dividends, if any, expected to be approved by our Board of Directors.

We estimate future forfeitures, at the time of grant and in subsequent periods, based on historical experience, and recognize compensation expense only for those awards that are expected to vest. We reevaluate our estimate of forfeitures each quarter and, if applicable, recognize a cumulative effect adjustment in the period of the change if the revised estimate of forfeitures differs significantly from the previous estimate.

To the extent a stock-based award is subject to performance conditions, the amount of expense we record in a given period, if any, may fluctuate depending upon our assessment of the probability of achieving the performance targets.

Table of Contents

Our stock-based compensation expense may also change over time, as we review and adjust our compensation practices.

If factors, such as those discussed above, were to change and we used different assumptions, our stock-based compensation expense in the future could be materially different from that reported in previous periods.

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 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, may change our estimates accordingly. A significant change in our estimates, or an outcome that differs from the assumptions incorporated in our estimates, may have a material impact on our financial position, results of operations and cash flows.

Income Tax Provisions

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 bases 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.

Significant judgments are required in determining tax provisions, evaluating tax positions and, when necessary, establishing or making adjustments to our valuation allowance. Such judgments require us to interpret existing tax law and other published guidance as applied to our circumstances. To the extent that it is more likely than not that all or some portion of deferred tax assets will not be realized, a valuation allowance must be established for that amount. 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.

Risks and Uncertainties

Our results of operations may vary significantly from period-to-period. Our revenues will 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 manufacture or 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 renew existing sales relationships. In addition, our revenues are highly susceptible to economic factors, including, among other things, the overall condition of the U.S. economy and economies of other countries where we market our products and the availability of consumer credit, both in the U.S. and abroad. 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

Table of Contents

services. Our operating profits or losses may also be affected by the relative success of strategies we employ to improve the efficiency and effectiveness of our organization. Historically, our operating expenses have been influenced by media costs to produce and air advertisements, facility costs, operating costs of our information and communications systems, costs to develop and maintain our Internet websites, bad debt costs and costs related to attracting and retaining key personnel. In addition, our operating expenses have been impacted 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.

Table of Contents

COMPARISON OF THE YEARS ENDED DECEMBER 31, 2009 AND 2008

The tables below set forth selected financial information derived from our consolidated financial statements. The discussion that follows should be read in conjunction with our consolidated financial statements and the related notes. All comparisons to prior year results are in reference to continuing operations only in each period, unless otherwise indicated.

	Year Ended December 31,			
(In thousands)	**2009**	**2008**	**Change**	**% Change**
Net sales	$ 189,260	$ 283,712	$ (94,452)	-33.3%
Cost of sales	92,745	147,930	(55,185)	-37.3%
Gross profit	96,515	135,782	(39,267)	-28.9%
Operating expenses:				
Selling and marketing	75,827	107,613	(31,786)	-29.5%
General and administrative	24,616	35,353	(10,737)	-30.4%
Research and development	5,222	6,615	(1,393)	-21.1%
Restructuring	14,151	13,938	213	1.5%
Intangible asset impairments	5,904		5,904	n/a
Goodwill impairment		29,755	(29,755)	n/a
Total operating expenses	125,720	193,274	(67,554)	-35.0%
Operating loss	(29,205)	(57,492)	28,287	49.2%
Other income (expense):				
Interest income	77	229	(152)	-66.4%
Interest expense	(168)	(1,753)	1,585	90.4%
Other income (expense), net	(194)	501	(695)	-138.7%
Total other expense	(285)	(1,023)	738	72.1%
Loss before income taxes	(29,490)	(58,515)	29,025	49.6%
Income tax benefit	(10,880)	(5,918)	(4,962)	-83.8%
Loss from continuing operations	(18,610)	(52,597)	33,987	64.6%
Loss from discontinued operations, net of tax	(34,687)	(37,991)	3,304	8.7%
Net loss	$ (53,297)	$ (90,588)	$ 37,291	41.2%

	Year Ended December 31,			
(In thousands)	**2009**	**2008**	**Change**	**% Change**
Net sales:				
Direct business	$ 123,045	$ 185,704	$ (62,659)	-33.7%
Retail business	63,597	94,498	(30,901)	-32.7%
Corporate (royalty income)	2,618	3,510	(892)	-25.4%
Total net sales	$ 189,260	$ 283,712	$ (94,452)	-33.3%
Gross profit:				
Direct business	$ 75,541	$ 111,505	$ (35,964)	-32.3%

Retail business	19,310	23,163	(3,853)	-16.6%
Corporate	1,664	1,114	550	49.4%
Total gross profit	$ 96,515	$ 135,782	$ (39,267)	-28.9%
Gross profit margin (% of net sales):				
Direct business	61.4%	60.0%	1.4	
Retail business	30.4%	24.5%	5.9	
Total gross profit margin	51.0%	47.9%	3.1	

Table of Contents

Direct business

Net sales of our direct business were $123.0 million in 2009, a decrease of $62.7 million, or 33.7%, as compared to 2008. The comparative decrease in net sales was primarily due to a substantial decrease in customer credit approvals in 2009 through HSBC, our third-party financing company, as well as a reduction in advertising media spending, compared to the prior year. Economic weakness was cited by HSBC as the reason for the lower approval rates. Additionally, in 2008 we had a secondary financing program available which was not available for direct customers in 2009.

Gross profit margin of our direct business was 61.4% in 2009, compared to 60.0% in 2008, an increase of 140 basis points. The comparative increase in gross profit margin primarily was attributable to a decrease in outbound freight expenses and a decrease in warranty costs, each of which represented approximately 230 basis points of gross margin improvement, partially offset by reduced supplier rebates due to lower-volume purchases in 2009, as compared to 2008, representing approximately 180 basis points.

Retail business

Net sales of our retail business were $63.6 million in 2009, a decrease of $30.9 million, or 32.7%, as compared to 2008. We believe the comparative decrease in retail net sales primarily was due to the reluctance by retailers to replenish inventories, in response to reduced consumer demand, as well as our tighter credit controls in the challenging economic environment. In addition, net sales declined in 2009 due to management s decision to reduce the number of rod-based home gym products offered in our retail business, so as not to conflict with our direct business, as well as a reduction of product placement with certain customers, partially offset by new business growth.

Gross profit margin of our retail business was 30.4% in 2009, compared to 24.5% in 2008, an increase of 590 basis points. The comparative increase in gross profit margin primarily was attributable to a decrease in warranty costs, representing approximately 280 basis points, as well as lower sales of clearance and end-of-life products in 2009, as compared to the prior year.

Operating Expenses

Operating expenses in 2009 were $125.7 million, a decrease of $67.6 million, or 35.0%, as compared to operating expenses of $193.3 million in 2008.

Selling and Marketing

Selling and marketing expenses were $75.8 million in 2009, a decrease of $31.8 million, or 29.5%, as compared to the prior year. In response to the tighter credit approval environment, we reduced our advertising expenditures to better align with our expected revenue levels. Advertising expenses of our direct business in 2009 decreased by approximately $18.7 million, or 27.9%, as compared to the prior year. Our selling and marketing expenses reflect our improved advertising efficiencies, including better alignment of our expenditures with anticipated revenue, optimized advertising placement and improved creative content. In addition, third-party financing commission fees decreased by approximately $5.8 million, primarily due to lower credit approval rates and reduced use of financing promotions. Other selling and marketing expenses declined by approximately $7.7 million, compared to the prior year, primarily due to the impact of cost savings initiatives.

General and Administrative

General and administrative expenses were $24.6 million in 2009, a decrease of $10.7 million, or 30.4%, as compared to the prior year. The decrease in general and administrative expenses primarily was due to a reduction in employment costs, facilities costs, legal expenses and various other expenses in connection with our cost-savings initiatives. General and administrative expenses in 2009 also decreased due to the resolution of legal matters, which were settled for $1.0 million less than the amount previously estimated and accrued in 2008. In addition, general and administrative expenses in 2008 included $2.0 million for legal and contract settlement costs; $1.1 million for the writeoff of deferred financing costs from amending our loan agreement; and $0.6 million for reimbursement obligations related to a shareholder action.

Research and Development

Research and development expenses were $5.2 million in 2009, a decrease of $1.4 million, or 21.1%, as compared to the prior year, primarily due to lower employee costs and reduced third-party intellectual property costs.

Restructuring

Our restructuring expenses primarily relate to the reorganization or termination of business activities and initiatives and include: contract termination fees, costs associated with abandoned purchase agreements, and severance.

Restructuring expenses in 2009 were $14.2 million, and included: $8.0 million in impairment charges for abandoned leasehold improvements in space we are no longer using at our Vancouver, Washington headquarters facility; $2.8 million in lease termination costs and accrued lease obligations associated with the reduction of leased space at our headquarters facility; $1.8 million in charges due to our abandonment of information technology software; a $0.9 million fee to terminate a third-party service agreement for distribution of repair and replacement parts in the U.S.; and employee termination severance costs of $0.6 million.

Restructuring expenses in 2008 were $13.9 million, and included: $8.0 million in charges related to the termination of an agreement to acquire a manufacturing operation in China; $4.8 million in employee termination benefits and other employee costs; $0.6 million in other contract termination costs; and $0.5 million for the disposal of unused creative media assets related to a change in our marketing strategies.

Intangible asset impairments

In 2009, in light of changes in long-term product strategies, we recognized impairment charges of $5.9 million for intangible assets of our retail business segment.

Goodwill Impairment

In 2008, in connection with our annual impairment review, we determined that goodwill was impaired and recognized a $29.8 million non-cash impairment charge.

Interest Income

Interest income was $0.1 million in 2009, compared to $0.2 million in 2008, a decrease of $0.1 million, primarily due to a reduction in interest earned on income tax refunds.

Interest Expense

Interest expense was $0.2 million in 2009, compared to $1.8 million in 2008, a decrease of $1.6 million, primarily due to lower average short-term borrowings in 2009.

Other Income (Expense)

Other expense was $0.2 million in 2009, compared to income of $0.5 million in 2008, primarily due to fluctuations in currency exchange rates.

Table of Contents

Income Tax Benefit

The provision for income tax benefit from continuing operations was $10.9 million in 2009, compared to a tax benefit from continuing operations of $5.9 million in 2008. Our effective tax benefit rate in 2009 was 36.9%, compared to a benefit rate of 10.1% in the prior year. The change in our effective tax rate primarily reflects the impact of 2009 legislation allowing us to carry back net operating losses for a period of five years. As a result, in January 2010 we received an income tax refund of $12.1 million in connection with a net operating loss carryback. In 2008, we provided a valuation reserve against deferred income tax assets as we determined it was more likely than not that such assets would not be realized.

Discontinued Operations

On September 25, 2009 management committed to a plan for the complete divestiture of our commercial business. The results of our commercial business have been classified as discontinued operations in all periods presented. Loss from our commercial business discontinued operation, net of income taxes, was $34.3 million in 2009, including an estimated after-tax disposal loss of $9.0 million. Loss from our commercial business discontinued operation, net of income taxes, was $40.4 million in 2008.

We currently expect to incur additional costs related to our planned divestiture, including employee termination severance payments of approximately $1.8 million and termination charges for leases and other commercial contract obligations of approximately $2.2 million, which charges will be included in results of discontinued operations in the respective periods when such liabilities are incurred. The estimated amounts of additional costs may be adjusted in future periods, depending on changes that may occur in the underlying facts and circumstances, and the amount of adjustment may be material.

Our former fitness apparel business (Pearl iZumi) was sold in 2008 and reported as a discontinued operation. We reported an after-tax loss related to Pearl iZumi of $0.4 million in 2009, compared to after-tax income of $2.4 million in 2008.

LIQUIDITY AND CAPITAL RESOURCES

In November 2009, the President signed into U.S. federal law a provision allowing taxpayers to carry back an applicable net operating loss for a period of up to five years. We elected to carry-back our 2008 net operating loss and, as a result, we received a U.S. income tax refund of approximately $12.1 million in January 2010. On March 8, 2010 we entered into a new bank borrowing agreement, providing for a $15.0 million revolving secured credit line. Based on the amount of cash currently on hand and expected future cash flows from operations, management believes that sufficient funds will be available to meet our expected cash needs for at least the next twelve months.

Operating activities provided cash of $14.8 million in 2009, compared to $5.6 million in the prior year. Cash from operating activities in 2009 was primarily provided by the collection of accounts receivable, reductions in inventory levels and the receipt of a $10.7 million U.S. federal income tax refund. Cash provided by operating activities in 2008 was primarily related to the collection of accounts receivable.

Net cash provided by investing activities was $4.7 million in 2009, compared to $62.4 million in the prior year. Cash provided by investing activities in 2009 included $7.4 million from the sale of assets of our discontinued operations, $4.0 million from the release of Pearl iZumi escrow funds and $0.2 million in proceeds from the sale of equipment. Cash used in investing activities in 2009 included $4.9 million for restricted cash accounts, as collateral for our outstanding letters of credit, and $2.0 million for capital expenditures. We do not expect capital expenditures to increase substantially in 2010. Cash provided by investing activities in 2008 included $58.4 million in proceeds from the sale of Pearl iZumi, a $5.0 million refund of an escrow deposit, $2.4 million in payments on a note receivable and $1.4 million in proceeds from the sale of equipment. Capital expenditures in 2008 were $4.8 million.

Net cash used in financing activities was $18.0 million in 2009, compared to $69.1 million in the prior year. Cash used in financing activities included $17.9 million to repay all of our bank borrowings in 2009, compared to a $61.2 million reduction in bank borrowings in 2008. The 2008 reduction in bank borrowings primarily was funded with proceeds received from the sale of our former fitness apparel business. In 2008, we paid $5.3 million for the repurchase of Nautilus common stock and paid approximately $2.0 million in debt issuance costs associated with a former financing agreement.

Financing Arrangement

During 2009 and 2008, we had a Loan and Security Agreement (the Loan Agreement) with Bank of America N.A., which provided a revolving secured credit line to fund our letters of credit and for working capital needs and other general business purposes. On December 29, 2009, pursuant to the sale of certain assets of our Stairmaster and Schwinn Fitness commercial product lines, we satisfied all outstanding obligations under the Loan Agreement and it was terminated.

On December 29, 2009, we entered into a Credit Agreement (the Letter of Credit Agreement) with Bank of America, N.A, (BofA). The Letter of Credit Agreement provides us with up to $6.0 million in standby letters of credit, and expires on December 31, 2010 (Expiration Date). During this period, BofA will issue standby letters of credit with a maximum maturity not to exceed more than 365 days beyond the Expiration Date. Letters of credit are secured by a cash collateral account held by BofA in an amount not less than 105% of the amount of the outstanding letters of credit, plus $0.3 million.

As of December 31, 2009, we had $4.3 million in standby letters of credit. The balance in our cash collateral account, reported as restricted cash in our consolidated balance sheet, was $4.9 million as of December 31, 2009.

On March 8, 2010, we entered into the New Loan Agreement with Bank of the West, providing for a $15.0 million revolving secured credit line. The New Loan Agreement is available for working capital, standby letters of credit and general corporate purposes through September 2012, assuming we satisfy certain terms and conditions at the time borrowings are requested.

The interest rate on any future borrowings under the New Loan Agreement will be based on the bank s prime rate or LIBOR, based on our financial condition at the time we elect to borrow. The New Loan Agreement includes a fee for the unused portion of the credit facility, which fee will vary depending on our borrowing base availability.

Borrowings under the New Loan Agreement are collateralized by a lien on substantially all of our assets. The New Loan Agreement contains customary covenants, including, but not limited to, covenants relating to minimum current ratio, minimum liquidity, minimum EBITDA and limitations on capital expenditures, mergers and acquisitions, indebtedness, liens, dispositions, dividends, and investments. The New Loan Agreement also contains customary events of default.

Table of Contents

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, 2009, including those related to our discontinued operations, is as follows:

		Payments due by period			
(In thousands)	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Operating lease obligations	$ 20,298	$ 4,828	$ 7,788	$ 5,610	$ 2,072
Purchase obligations (1)	18,029	18,029			
Minimum royalty obligations	296	296			
Total	$ 38,623	$ 23,153	$ 7,788	$ 5,610	$ 2,072

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

Due to uncertainty with respect to the timing of future cash flows associated with our unrecognized tax benefits at December 31, 2009, 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, have been excluded from the contractual table above. For further information, see Note 11, Income Taxes, in Notes to Consolidated Financial Statements.

Issues Arising from China Sales Operation

In 2008, we recognized a $3.8 million charge, included in discontinued operations, due to uncertainties regarding access to, and future recovery of, certain assets of our China sales operation. In 2009, we recovered a portion of these assets and, as a result of this and other changes in circumstances, we reduced the previously accrued loss amount by $2.3 million. At December 31, 2009 we have an allowance of $1.5 million due to uncertainties regarding the future recovery of our China trade receivables.

Off-Balance Sheet Arrangements

At times, we become involved in third-party lease and financing arrangements which assist our customers in obtaining funds to purchase our products. While most of these financings are without recourse, in certain cases we may offer a guarantee or other recourse provisions. Our financing partner reviews consumer credit information in evaluating the risk of default prior to extending credit to our customers. We rely on the quality of our partner s review and our own risk assessment in determining whether to proceed with a recourse transaction. At December 31, 2009 and 2008, the maximum contingent liability under all recourse provisions was approximately $1.4 million and $1.6 million, respectively. Refer to Note 1 of our consolidated financial statements for further discussion of this arrangement.

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

Table of Contents

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, 2009.

Seasonality

We expect our sales from fitness equipment products to vary seasonally. Sales are typically strongest in the first and fourth quarters, and are generally weakest in the second quarter. We believe the broadcast of national network season finales and seasonal weather patterns influence television viewership and cause our television commercials on national cable television to be less effective in the second quarter than in other periods of the year. In addition, during the spring and summer months, consumers tend to be involved in outdoor activities, including exercise, which impacts sales of fitness equipment used indoors. This seasonality can have a significant affect on our operating results, inventory levels and working capital needs.

NEW ACCOUNTING PRONOUNCEMENTS

No new accounting pronouncements had, or are reasonably likely to have, a material impact on our consolidated financial position, results of operations or cash flows.

Table of Contents

Item 8. Financial Statements and Supplementary Data

Index to Consolidated Financial Statements

Table of Contents

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, 2009 and 2008, and the related consolidated statements of operations, stockholders equity and comprehensive loss, and cash flows for the years then ended. 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. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Nautilus Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

Portland, Oregon

March 8, 2010

Table of Contents

NAUTILUS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands)

	December 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,289	$ 5,547
Trade receivables, net of allowances of $4,160 in 2009 and $6,602 in 2008	27,799	53,770
Inventories	13,119	43,802
Prepaids and other current assets	5,043	11,362
Income taxes receivable	13,178	11,954
Assets of discontinued operation held-for-sale	10,781	
Deferred income tax assets	54	266
Total current assets	77,263	126,701
Restricted cash	4,933	
Property, plant and equipment, net	8,042	32,883
Goodwill	2,794	2,398
Other intangible assets, net	20,838	34,403
Other assets	1,302	1,134
Total assets	$ 115,172	$ 197,519
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Trade payables	$ 37,107	$ 38,198
Accrued liabilities	10,744	15,128
Accrued warranty obligations	7,129	15,344
Short-term borrowings		17,944
Deferred income tax liabilities	1,220	919
Total current liabilities	56,200	87,533
Other long-term liabilities	2,869	3,203
Long-term deferred income tax liabilities	754	1,037
Income taxes payable	2,866	2,061
Total liabilities	62,689	93,834
Commitments and contingencies (Note 16)		
Stockholders equity:		
Common stock no par value, 75,000 shares authorized, 30,744 and 30,614 shares issued and outstanding at December 31, 2009 and 2008, respectively	4,414	3,207
Retained earnings	41,136	94,433
Accumulated other comprehensive income	6,933	6,045
Total stockholders equity	52,483	103,685
Total liabilities and stockholders equity	$ 115,172	$ 197,519

See accompanying notes to consolidated financial statements.

Table of Contents

NAUTILUS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

	2009	2008
Net sales	$ 189,260	$ 283,712
Cost of sales	92,745	147,930
Gross profit	96,515	135,782
Operating expenses:		
Selling and marketing	75,827	107,613
General and administrative	24,616	35,353
Research and development	5,222	6,615
Restructuring	14,151	13,938
Intangible asset impairments	5,904	
Goodwill impairment		29,755
Total operating expenses	125,720	193,274
Operating loss	(29,205)	(57,492)
Other income (expense):		
Interest income	77	229
Interest expense	(168)	(1,753)
Other income (expense), net	(194)	501
Total other expense, net	(285)	(1,023)
Loss from continuing operations before income taxes	(29,490)	(58,515)
Income tax benefit	(10,880)	(5,918)
Loss from continuing operations	(18,610)	(52,597)
Discontinued operations:		
Loss from discontinued operations, including estimated disposal loss of $9,491 in 2009	(34,777)	(27,178)
Income tax expense (benefit) from discontinued operations	(90)	10,813
Loss from discontinued operations, net of tax	(34,687)	(37,991)
Net loss	$ (53,297)	$ (90,588)
Loss per share from continuing operations:		
Basic and diluted	$ (0.61)	$ (1.69)
Loss per share from discontinued operations:		
Basic and diluted	$ (1.13)	$ (1.22)
Loss per share:		
Basic and diluted	$ (1.74)	$ (2.91)
Weighted average shares outstanding:		
Basic and diluted	30,664	31,117

See accompanying notes to consolidated financial statements.

Table of Contents

NAUTILUS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

AND COMPREHENSIVE LOSS

(In thousands)

	Common Stock			Accumulated Other	Total
	Shares	Amount	Retained Earnings	Comprehensive Income (1)	Stockholders Equity
Balances at January 1, 2008	31,557	$ 4,346	$ 185,021	$ 7,087	$ 196,454
Net loss			(90,588)		(90,588)
Foreign currency translation adjustment				(1,042)	(1,042)
Comprehensive loss					(91,630)
Stock-based compensation expense		4,792			4,792
Stock options exercised	90	563			563
Stock repurchased	(1,033)	(5,320)			(5,320)
Stock option income tax deficiencies		(1,174)			(1,174)
Balances at December 31, 2008	30,614	3,207	94,433	6,045	103,685
Net loss			(53,297)		(53,297)
Foreign currency translation adjustment, net of income taxes of $43				888	888
Comprehensive loss					(52,409)
Stock-based compensation expense		1,207			1,207
Shares issued for vested stock awards	130				
Balances at December 31, 2009	30,744	$ 4,414	$ 41,136	$ 6,933	$ 52,483

(1) Foreign currency translation adjustments are the sole component of Accumulated Other Comprehensive Income.

See accompanying notes to consolidated financial statements.

Table of Contents

NAUTILUS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	2009	2008
Cash flows from operating activities:		
Loss from continuing operations	$ (18,610)	$ (52,597)
Loss from discontinued operations	(34,687)	(37,991)
Net loss	(53,297)	(90,588)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	10,739	16,832
Allowance for doubtful accounts	1,315	4,761
Inventory lower-of-cost-or-market adjustments	1,562	5,952
Stock-based compensation expense	1,207	4,792
Loss on asset disposals	10,250	755
Asset impairments	9,067	30,855
Writeoff of abandoned leasehold improvements and other assets	9,922	
Deferred income taxes, net of valuation allowances	1,025	14,106
Other		816
Changes in operating assets and liabilities:		
Trade receivables	23,458	22,475
Inventories	11,003	10,917
Prepaids and other current assets	2,299	4,971
Income taxes	(1,018)	(2,137)
Trade payables	(1,252)	(10,277)
Accrued liabilities, including warranty obligations	(11,498)	(8,660)
Net cash provided by operating activities	14,782	5,570
Cash flows from investing activities:		
Proceeds from sale of discontinued operations	7,397	58,435
Proceeds from other asset sales	211	1,379
Refunds of escrow deposits	4,024	5,000
Purchases of equipment and intangible assets	(2,000)	(4,824)
Net increase in restricted cash	(4,933)	
Payments received on note receivable		2,364
Net cash provided by investing activities	4,699	62,354
Cash flows from financing activities:		
Decrease in short-term borrowings	(17,944)	(61,230)
Debt issuance costs	(75)	(1,954)
Stock repurchases		(5,320)
Proceeds from exercises of stock options		563
Other		(1,174)
Net cash used in financing activities	(18,019)	(69,115)
Net effect of currency exchange rate changes	280	(1,173)

Net increase (decrease) in cash and cash equivalents	1,742	(2,364)
Cash and cash equivalents, beginning of year	5,547	7,911
Cash and cash equivalents, end of year	$ 7,289	$ 5,547
Supplemental disclosure of cash flow information:		
Cash refunded for income taxes	$ 11,105	$ 9,025
Cash paid for interest	$ 227	$ 2,677

See accompanying notes to consolidated financial statements.

Table of Contents

NAUTILUS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) SIGNIFICANT ACCOUNTING POLICIES

Organization and Business Nautilus is a leading designer, developer and marketer of fitness products sold under such well-known brand names as Nautilus, Bowflex, Schwinn Fitness and Universal. As used herein, the term Nautilus or Company refers to Nautilus, Inc. and subsidiaries, unless the context indicates otherwise. The Company s goal is to develop and market fitness equipment and related products to help people enjoy healthier lives. Nautilus was founded in 1986 and incorporated in the state of Washington in 1993. The Company s headquarters are located in Vancouver, Washington.

We market our products through two business segments: Direct and Retail, each representing a distinct marketing distribution channel. Our direct business offers products directly to consumers through direct advertising, catalogs and the Internet. Our retail business offers our products through a network of independent retail companies located in the United States and Canada, as well as Internet-based merchants. Our commercial business, formerly an operating segment and reported as a discontinued operation beginning in 2009, offered products to health clubs, schools, hospitals and other organizations.

On April 18, 2008, the Company completed the sale of its former fitness apparel business, DashAmerica, Inc. d/b/a Pearl Izumi (Pearl Izumi). Accordingly, results of operations associated with the fitness apparel business have been presented in the consolidated financial statements as discontinued operations for all periods presented.

On September 25, 2009 the Company committed to a plan for the complete divestiture of its commercial business. Accordingly, results of operations and certain assets associated with the commercial business have been presented in the consolidated financial statements as discontinued operations for all periods presented.

Basis of presentation The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) and relate to Nautilus, Inc. and its subsidiaries, all of which are wholly-owned, directly or indirectly. Intercompany transactions and balances have been eliminated in consolidation.

Year-end The Company s fiscal year ends on December 31.

Reclassifications The Company has reclassified certain 2008 amounts related to the cash flows of its fitness apparel division discontinued operation, as permitted by accounting guidance, which previously were reported separately, to conform to the current period presentation. Net cash flows were not impacted by this reclassification.

The results of the commercial business, including related costs previously included in restructuring expense, have been reclassified as discontinued operations in the Company s financial statements for all periods presented.

Accrued warranty obligations, previously included in accrued liabilities, have been reclassified as a separate component of current liabilities in the Company s consolidated balance sheets.

Use of estimates The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses and the disclosure of contingent assets and liabilities in the financial statements. Actual results could differ from those estimates.

Concentrations of risk Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash held in bank accounts that exceed federally insured limits and trade receivables.

Table of Contents

Trade receivables are generally unsecured and therefore collection is affected by the economic conditions in each of our principal markets. Collection of receivables due from customers outside the U.S. may also be negatively impacted by the nature and extent of our business presence in a particular country and any rights or protections afforded to our customers under a country s legal system.

Nautilus relies on third-party contract manufacturers in Asia for substantially all of its products and for certain product engineering support. Business operations could be disrupted by natural disasters, difficulties in transporting our products from foreign suppliers, as well as political, social or economic instability in the countries where our contract manufacturers or their vendors and customers conduct business. While any of the Company s manufacturing arrangements could be replaced over time, the temporary loss of the services of any primary contract manufacturer could cause a significant disruption in operations and delay product shipments.

Cash, cash equivalents and restricted cash All highly liquid investments with remaining maturities of three months or less at purchase are considered to be cash equivalents. Restricted cash consists of bank accounts pledged as collateral for outstanding letters of credit, which are long-term.

Inventories Inventories are stated at the lower of cost or market, with cost determined based on the first-in, first-out method. Any abnormal amounts of freight, handling costs and spoilage are recognized as current period charges. The Company establishes inventory allowances for excess, slow-moving and obsolete inventory based on inventory levels, expected product life cycles and forecasted sales demand. Inventories are written down to market value, based on historical demand, competitive factors, changes in technology and product lifecycles.

Property, plant and equipment Property, plant and equipment is stated at cost, net of accumulated depreciation. Improvements or betterments which add new functionality or significantly extend the life of an asset are capitalized. Expenditures for maintenance and repairs are expensed as incurred. The cost of assets retired, or otherwise disposed of, and the related accumulated depreciation, are removed from the accounts in the year of disposal. Gains and losses resulting from asset sales and dispositions are recognized in our consolidated statement of operations in the period in which assets are disposed.

Depreciation is recognized, using the straight-line method, over the lesser of the estimated useful lives of the assets or, in the case of leasehold improvements, the lease term including renewal periods if the Company expects to exercise its renewal options. Depreciation on furniture, equipment and information systems is determined based on estimated useful lives, which generally range from three to five years.

Goodwill and intangible assets Goodwill consists of the excess of acquisition costs over the fair values of net assets acquired in business combinations. Indefinite-life intangible assets consist of acquired trademarks. Goodwill and other indefinite-life intangible assets are stated at cost and are not amortized; instead, they are tested for impairment at least annually.

Nautilus reviews goodwill and other indefinite-life intangible assets for impairment in the fourth quarter of each year, or more frequently when events or changes in circumstances indicate that the assets may be impaired. With respect to goodwill, the Company compares the carrying value of the related reporting unit to an estimate of the reporting unit s fair value. If the carrying value of the reporting unit exceeds its estimated fair value, the estimated fair values of all of the reporting unit s assets and liabilities are determined to establish the amount of the impairment, if any. For further information regarding goodwill, refer to Note 7, Goodwill. For further information regarding other intangible assets, refer to Note 8, Other Intangible Assets.

In 2009, in connection with its annual impairment review, Nautilus determined that an indefinite-life trademark was impaired and recognized an impairment charge of $2.3 million. In 2008, in connection with its annual impairment review, Nautilus determined that goodwill of its retail segment was impaired and recognized an impairment charge of $29.8 million.

Finite-lived intangible assets, primarily acquired patents and patent rights, are stated at cost, net of accumulated amortization. The Company recognizes amortization expense for its finite-lived intangible assets on a straight-line basis over the estimated useful lives, which generally range from one to 16 years.

Impairment of long-lived assets Long-lived assets, including property, plant and equipment, and finite-lived intangible assets, including patents and patent rights, are evaluated for impairment when events or circumstances indicate the carrying value may be impaired. When such an event or condition occurs, Nautilus estimates the future undiscounted cash flows to be derived from the use and eventual disposition of the asset to determine whether a potential impairment exists. If the carrying value exceeds estimated future undiscounted cash flows, the Company records impairment expense to reduce the carrying value of the asset to its estimated fair value.

In connection with changes in long-term product development plans resulting from strategic decisions made by management in the fourth quarter, Nautilus recognized an impairment charge of $3.6 million in 2009 related to certain patent rights which the Company previously expected to be utilized in its retail products.

Revenue recognition Product sales and shipping revenues, net of promotional discounts, rebates and return allowances, are recorded when products are shipped and title passes to customers. Retail sales to customers are made pursuant to a sales contract that provides for transfer of both title and risk of loss upon our delivery to the carrier.

Taxes collected from customers and remitted to governmental authorities are recorded on a net basis, and excluded from revenue. Shipping and handling fees billed to customers are recorded gross and included in both revenue and cost of sales. Many direct business customers finance their purchases through a third-party credit provider, for which Nautilus pays a commission or financing fee to the credit provider. Revenue for these transactions is recognized based on the sales prices charged to the customer and the commission or financing fee is included in selling and marketing expense.

Revenue is recognized net of applicable sales incentives, such as promotional discounts, rebates and return allowances. Nautilus estimates the revenue impact of incentive programs, based on the planned duration of the program and historical experience. If the amount of sales incentives is reasonably estimable, the impact of such incentives is recorded at the later of the time the customer is notified of the sales incentive or the time of the sale.

Nautilus estimates liability for product returns based on historical experience and records the expected obligation as a reduction in revenue. If actual return costs differ from previous estimates, the amount of the liability and corresponding revenue are adjusted in the period such costs occur.

Cost of sales Cost of sales is primarily comprised of: inventory purchase costs; royalties; salaries, wages and other employee-related costs; occupancy charges, including depreciation of warehouse and distribution facility improvements and equipment; transportation expenses; costs of product warranties and related services; distribution information systems costs; and allocated expenses for shared administrative functions.

Product warranty obligations The Company s products carry limited defined warranties for defects in materials or workmanship, which require Nautilus to pay for replacement parts, costs for shipping the parts to customers and, in certain instances, service labor costs. Nautilus records a liability, at the time of sale, for the estimated costs of responding to future warranty claims. 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, Nautilus adjusts its liability for specific warranty matters when they become known and are reasonably estimable. 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 higher or lower than expected repair costs. If warranty costs differ from previous estimates, or if circumstances change such that the assumptions inherent in our previous estimates are no longer valid, the amount of warranty reserve is adjusted accordingly.

Table of Contents

The following reflects the activity related to our reserves for warranty obligations for the two-year period ended December 31, 2009:

(In thousands)	Balance at Beginning of Year	Charged to Costs and Expenses	Deductions*	Balance at End of Year
Warranty reserves:				
2009	$ 17,837	$ 3,073	$ (12,531)	$ 8,379
2008	25,185	9,122	(16,470)	17,837

* Deductions represent warranty claims paid out in the form of service costs and/or product replacements.

Warranty reserves at December 31, 2009 and 2008 include $1.3 million and $2.5 million, respectively, in estimated long-term obligations.

Litigation and Loss Contingencies From time to time, the Company may be involved in various claims, lawsuits and other proceedings. Such litigation involves uncertainty as to the eventual outcomes and losses which may be realized when one or more future events occur or fail to occur. Nautilus records 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. The Company estimates the probability of such losses based on the advice of internal and external counsel, the outcomes from similar litigation, the 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. The Company regularly monitors its estimated exposure to these contingencies and, as additional information becomes known, may change its estimates accordingly.

Advertising and promotion Nautilus expenses its advertising and promotion costs as incurred. Production costs of television advertising commercials are recorded as prepaid expenses until the initial broadcast, at which time such costs are expensed. Advertising and promotion costs are included in selling and marketing expenses.

Total advertising and promotion expenses were $48.3 million and $67.0 million for the years ended December 31, 2009 and 2008, respectively. Prepaid advertising and promotion costs totaled $0.9 million at December 31, 2009 and December 31, 2008.

Research and development Internal research and development costs, which primarily consist of salaries and wages, employee benefits, expenditures for materials, and fees to use licensed technologies, are expensed as incurred. Third party research and development costs for products under development or being researched, if any, are expensed as the contracted work is performed.

Income taxes Nautilus accounts 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 of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates 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 deferred tax assets and liabilities is recognized in the period of the enactment. Valuation allowances are provided against deferred income tax assets if we determine it is more likely than not that such assets will not be realized.

The Company recognizes a tax benefit from an uncertain tax position 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.

Table of Contents

Foreign currency translation Nautilus translates the accounts of its foreign subsidiaries into U.S. dollars, using the current rate method, whereby: revenues, expenses, gains and losses are translated at weighted-average exchange rates during the year; and assets and liabilities are translated at the exchange rate on the balance sheet date. Translation gains and losses are reported in the Company s consolidated balance sheets as a component of accumulated other comprehensive income (loss) in stockholders equity.

Gains and losses arising from foreign currency transactions, including transactions between the Company and its foreign subsidiaries, are recorded as a component of other income (expense) in our consolidated statements of operations.

Fair value of financial instruments Financial instruments include cash, cash equivalents, restricted cash, trade receivables, short-term borrowings, accounts payable, letters of credit and guarantees entered into in the ordinary course of our business. The carrying amounts reflected in our consolidated balance sheets approximate fair value due to their market rates of interest and/or short-term maturities.

Stock-based compensation Nautilus recognizes stock-based compensation, on a straight-line basis, over the applicable vesting period, based on the grant-date fair value of the award. To the extent a stock-based award is subject to performance conditions, the amount of expense recorded in a given period, if any, reflects our assessment of the probability of achieving the performance targets.

Fair value of stock options is estimated using the Black-Scholes-Merton option valuation model; fair value of restricted stock awards is based on the closing market price on the day preceding the grant. Assumptions used in calculating the fair value of stock-option grants are as follows:

	2009	**2008**
Dividend yield	0.0%	0.0%
Risk-free interest rate	2.5%	3.2%
Expected life (years)	4.75	4.59
Expected volatility	88%	52%

Expected dividend yield is based on our current expectation that no dividend payments will be made in future periods.

Risk-free interest rate is based on the implied yield available on U.S. Treasury zero coupon issues with a remaining term approximating the expected life of the options.

Expected life is calculated using the simplified method, equal to the sum of the vesting term and the original contractual term, divided by two.

Expected volatility is determined based on the daily historical volatility of the Company s common stock over a period commensurate with the expected life of the stock option.

The Company estimates future forfeitures, at the time of grant and in subsequent periods, based on historical turnover rates, previous forfeiture experience and changes in the business or key personnel that would suggest future forfeitures may differ from historical data. The Company recognizes compensation expense for only those stock options and stock-based awards that are expected to vest. The Company reevaluates estimated forfeitures each quarter and, if applicable, recognizes a cumulative effect adjustment in the period of the change if the revised estimate of the impact of forfeitures differs significantly from the previous estimate.

Related party transactions The Company s largest shareholder, Sherborne Investors LP (Sherborne) undertook a successful action to replace four of the Company s directors with Sherborne nominees in a December 2007 special meeting of shareholders. In May 2008, shareholders approved the reimbursement of up to $0.6 million of expenses incurred by Sherborne in connection with the shareholder action. Payment requires the approval of the disinterested members of the Company s Board and is not anticipated until some time after the Company returns to profitability. The obligation to reimburse Sherborne s expenses is included as a long-term liability in the Company s consolidated balance sheets at December 31, 2009 and 2008.

In February 2009, the disinterested members of the Company s Board of Directors approved a separate agreement with Sherborne Investors Management (Sherborne Investors) under which the Company is obligated to reimburse Sherborne Investors, $20,000 per month, for the use of Sherborne s New York office space and administrative, information technology and communications services to support the Company s Chief Executive Officer. In 2009, Nautilus paid Sherborne Investors $220,000 in reimbursements under this agreement.

New accounting pronouncements No new accounting pronouncements had, or are reasonably likely to have, a material impact on the Company s consolidated financial position, results of operations or cash flows.

(2) DISCONTINUED OPERATIONS

Discontinued operations consist of the Company s commercial business and its former fitness apparel business.

Commercial Business

In light of continuing operating losses in its commercial business and in order to focus exclusively on management of its direct and retail consumer businesses, on September 25, 2009 the Company committed to a plan for the complete divestiture of its commercial business segment. As a result of this action, the Company reported its commercial business as a discontinued operation, which qualified for held-for-sale accounting treatment, in the third quarter of 2009. The results of the commercial business have been reclassified as discontinued operations in the Company s financial statements for all periods presented.

In 2009, in light of continuing declines in commercial real property values and changes in management s expectations regarding revenue, the Company tested the long-lived assets of its commercial business segment for impairment. As a result, the Company recognized pre-tax impairment charges in the third quarter of 2009 related to real property and other intangible assets of $1.4 million and $1.6 million, respectively. In addition, the Company recognized an estimated pre-tax disposal loss of $18.3 million in the third quarter of 2009 in connection with its planned sale of the commercial business.

Subsequently, in the fourth quarter of 2009, management determined that the Company might realize greater value by selling its commercial business in multiple asset groups involving several buyers, rather than as a single disposal group as originally was planned. In the quarter ended December 31, 2009 the Company completed the sale of its StairMaster and Schwinn Fitness commercial product lines and recorded an $8.8 million adjustment to reduce the estimated pre-tax disposal loss related to the commercial business.

Following is the adjustment to previously reported amount of estimated pre-tax disposal loss, reflecting management s decision in the fourth quarter of 2009 to dispose of the business in multiple asset groups involving several buyers, rather than as a single disposal group as originally was planned:

(In thousands, before income taxes)	**2009**
Estimated loss on sale of commercial discontinued operation, as of September 30, 2009	$ (18,331)
Adjustment to expected proceeds	8,840
Estimated loss on sale of commercial discontinued operation, as of December 31, 2009	$ (9,491)

The amount of estimated loss recognized by the Company in connection with the disposal of commercial business assets reflects the carrying values of the assets expected to be sold in excess of the estimated amount of

Table of Contents

anticipated cash proceeds, net of sale transaction costs. The estimated loss amount may be adjusted in future periods, depending on changes that may occur in the underlying facts and circumstances and finalization of the related sale transactions, and the amount of the adjustment may be material.

Operating results of the commercial business discontinued operation are as follows:

	Year ended December 31,	
(In thousands)	**2009**	**2008**
Revenue	$ 74,644	$ 127,466
Loss before income taxes	$ (24,909)	$ (30,194)
Estimated loss on sale of commercial discontinued operation	(9,491)	
Income tax expense (benefit)	(90)	10,208
Loss from discontinued operation commercial business	$ (34,310)	$ (40,402)

The income tax expense in 2008 results from valuation allowances provided against certain deferred income tax assets related to the commercial business discontinued operation. Commercial business discontinued operation assets held-for-sale and related disposal loss impairments as of December 31, 2009 are as follows:

(In thousands)	**Inventories**	**Property, Plant & Equipment**	**Totals**
Assets of discontinued operation held-for-sale, before impairment adjustments	$ 14,164	$ 6,883	$ 21,047
Impairment adjustments included in loss from discontinued operations:			
Estimated loss on remaining commercial business assets held-for-sale at December 31, 2009	(3,897)	(6,369)	(10,266)
Assets of discontinued operation held-for-sale, as adjusted	$ 10,267	$ 514	$ 10,781

Currently, the Company expects to incur additional cash charges related to its planned divestiture, including estimated employee termination severance payments of approximately $1.6 million and estimated termination charges for leases and other commercial contract obligations of approximately $1.8 million, which are not reflected in 2009 operating results because such liabilities were not incurred as of year-end. The estimated amounts of additional costs may be adjusted in future periods, depending on changes that may occur in the underlying facts and circumstances, and the amount of adjustment may be material.

Cash flows of the commercial business after completion of the sale transactions may include settlements of then outstanding accounts receivable, trade payables and contractual obligations, settlements of sales agreement contingencies and receipts of passive royalties, all of which, according to accounting guidance, are not considered to be direct cash flows of the disposed segment.

In 2008, the Company recognized a $3.8 million charge, included in discontinued operations, due to uncertainties regarding access to, and future recovery of, certain assets of its China sales operation. In 2009, the Company recovered a portion of these assets and, as a result of this and other changes in circumstances, reduced the previously accrued loss amount by $2.3 million. At December 31, 2009 the Company had an allowance of $1.5 million due to uncertainties regarding the future recovery of China trade receivables.

Table of Contents

Fitness Apparel Business

On April 18, 2008 the Company completed the sale of its fitness apparel business, Pearl iZumi. Operating results for Pearl iZumi, included in loss from discontinued operations, are as follows:

(In thousands)	**2009**	**2008**		
Revenue				
June 30, 2018				
Commercial	$ 2,631	$90,724	$91,220	$8,594,305
Personal Banking	919	18,172	64,762	5,250,910
Total	$ 3,550	$108,896	$155,982	$13,845,215
December 31, 2017				
Commercial	$ 3,067	$92,613	$90,637	$8,532,213
Personal Banking	1,176	22,182	64,652	5,336,666
Total	$ 4,243	$114,795	$155,289	$13,868,879

Impaired loans

The table below shows the Company’s investment in impaired loans at June 30, 2018 and December 31, 2017. These loans consist of all loans on non-accrual status and other restructured loans whose terms have been modified and classified as troubled debt restructurings. These restructured loans are performing in accordance with their modified terms, and because the Company believes it probable that all amounts due under the modified terms of the agreements will be collected, interest on these loans is being recognized on an accrual basis. They are discussed further in the "Troubled debt restructurings" section on page 15.

(In thousands)	June 30, 2018	Dec. 31, 2017
Non-accrual loans	$9,472	$11,983
Restructured loans (accruing)	99,424	102,812
Total impaired loans	$108,896	$114,795

Table of contents

The following table provides additional information about impaired loans held by the Company at June 30, 2018 and December 31, 2017, segregated between loans for which an allowance for credit losses has been provided and loans for which no allowance has been provided.

(In thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
June 30, 2018			
With no related allowance recorded:			
Business	$ 4,946	$8,936	$ —
Real estate – business	1,210	1,300	—
	$ 6,156	$10,236	$ —
With an allowance recorded:			
Business	$ 70,871	$71,157	$ 2,090
Real estate – construction and land	1,342	1,346	39
Real estate – business	12,355	12,928	502
Real estate – personal	5,707	8,134	295
Consumer	5,464	5,464	52
Revolving home equity	114	114	11
Consumer credit card	6,887	6,887	561
	$ 102,740	$106,030	$ 3,550
Total	$ 108,896	$116,266	$ 3,550
December 31, 2017			
With no related allowance recorded:			
Business	$ 5,356	$9,000	$ —
Real estate – business	1,299	1,303	—
Consumer	779	817	—
	$ 7,434	$11,120	$ —
With an allowance recorded:			
Business	$ 72,589	$73,168	$ 2,455
Real estate – construction and land	837	841	27
Real estate – business	12,532	13,071	585
Real estate – personal	9,126	11,914	532
Consumer	5,388	5,426	67
Revolving home equity	204	204	11
Consumer credit card	6,685	6,685	566
	$ 107,361	$111,309	$ 4,243
Total	$ 114,795	$122,429	$ 4,243

Table of contents

Total average impaired loans for the three and six month periods ended June 30, 2018 and 2017, respectively, are shown in the table below.

(In thousands)	Commercial	Personal Banking	Total
Average Impaired Loans:			
For the three months ended June 30, 2018			
Non-accrual loans	$ 7,676	$ 2,005	$ 9,681
Restructured loans (accruing)	81,832	17,122	98,954
Total	$ 89,508	$ 19,127	$ 108,635
For the six months ended June 30, 2018			
Non-accrual loans	$ 8,097	$ 2,464	$ 10,561
Restructured loans (accruing)	80,552	17,943	98,495
Total	$ 88,649	$ 20,407	$ 109,056
For the three months ended June 30, 2017			
Non-accrual loans	$ 9,867	$ 4,539	$ 14,406
Restructured loans (accruing)	34,765	15,780	50,545
Total	$ 44,632	$ 20,319	$ 64,951
For the six months ended June 30, 2017			
Non-accrual loans	$ 10,238	$ 4,027	$ 14,265
Restructured loans (accruing)	33,333	15,991	49,324
Total	$ 43,571	$ 20,018	$ 63,589

The table below shows interest income recognized during the three and six month periods ended June 30, 2018 and 2017, respectively, for impaired loans held at the end of each period. This interest all relates to accruing restructured loans, as discussed in the "Troubled debt restructurings" section on page 15.

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(In thousands)	2018	2017	2018	2017
Interest income recognized on impaired loans:				
Business	$ 821	$ 319	$ 1,641	$ 637
Real estate – construction and land	22	1	44	2
Real estate – business	147	88	294	175
Real estate – personal	52	36	103	71
Consumer	82	80	164	159
Revolving home equity	1	6	2	12
Consumer credit card	159	145	317	289
Total	$ 1,284	$ 675	$ 2,565	$ 1,345

Table of contents

Delinquent and non-accrual loans

The following table provides aging information on the Company's past due and accruing loans, in addition to the balances of loans on non-accrual status, at June 30, 2018 and December 31, 2017.

(In thousands)	Current or Less Than 30 Days Past Due	30 – 89 Days Past Due	90 Days Past Due and Still Accruing	Non-accrual	Total
June 30, 2018					
Commercial:					
Business	$4,983,337	$1,404	$443	$ 5,114	$4,990,298
Real estate – construction and land	963,654	3,492	—	5	967,151
Real estate – business	2,718,888	6,227	—	2,465	2,727,580
Personal Banking:					
Real estate – personal	2,092,350	7,155	1,193	1,888	2,102,586
Consumer	1,985,195	25,096	2,353	—	2,012,644
Revolving home equity	372,865	708	984	—	374,557
Consumer credit card	758,230	8,504	8,480	—	775,214
Overdrafts	3,731	350	—	—	4,081
Total	$13,878,250	$52,936	$ 13,453	$ 9,472	$13,954,111
December 31, 2017					
Commercial:					
Business	$4,949,148	$3,085	$374	$ 5,947	$4,958,554
Real estate – construction and land	967,321	1,473	21	5	968,820
Real estate – business	2,694,234	482	—	2,736	2,697,452
Personal Banking:					
Real estate – personal	2,050,787	6,218	3,321	2,461	2,062,787
Consumer	2,067,025	32,674	3,954	834	2,104,487
Revolving home equity	397,349	1,962	1,276	—	400,587
Consumer credit card	764,568	10,115	9,181	—	783,864
Overdrafts	6,840	283	—	—	7,123
Total	$13,897,272	$56,292	$ 18,127	$ 11,983	$13,983,674

Credit quality

The following table provides information about the credit quality of the Commercial loan portfolio, using the Company's internal rating system as an indicator. The internal rating system is a series of grades reflecting management's risk assessment, based on its analysis of the borrower's financial condition. The "pass" category consists of a range of loan grades that reflect increasing, though still acceptable, risk. Movement of risk through the various grade levels in the "pass" category is monitored for early identification of credit deterioration. The "special mention" rating is applied to loans where the borrower exhibits negative financial trends due to borrower specific or systemic conditions that, if left uncorrected, threaten its capacity to meet its debt obligations. The borrower is believed to have sufficient financial flexibility to react to and resolve its negative financial situation. It is a transitional grade that is closely monitored for improvement or deterioration. The "substandard" rating is applied to loans where the borrower exhibits well-defined weaknesses that jeopardize its continued performance and are of a severity that the distinct possibility of default exists. Loans are placed on "non-accrual" when management does not expect to collect payments consistent with acceptable and agreed upon terms of repayment.

Table of contents

Commercial Loans

(In thousands)	Business	Real Estate-Construction	Real Estate-Business	Total
June 30, 2018				
Pass	$4,771,613	$ 954,492	$2,648,144	$8,374,249
Special mention	58,771	10,501	33,791	103,063
Substandard	154,800	2,153	43,180	200,133
Non-accrual	5,114	5	2,465	7,584
Total	$4,990,298	$ 967,151	$2,727,580	$8,685,029
December 31, 2017				
Pass	$4,740,013	$ 955,499	$2,593,005	$8,288,517
Special mention	59,177	10,614	50,577	120,368
Substandard	153,417	2,702	51,134	207,253
Non-accrual	5,947	5	2,736	8,688
Total	$4,958,554	$ 968,820	$2,697,452	$8,624,826

The credit quality of Personal Banking loans is monitored primarily on the basis of aging/delinquency, and this information is provided in the table in the above "Delinquent and non-accrual loans" section. In addition, FICO scores are obtained and updated on a quarterly basis for most of the loans in the Personal Banking portfolio. This is a published credit score designed to measure the risk of default by taking into account various factors from a borrower's financial history. The Bank normally obtains a FICO score at the loan's origination and renewal dates, and updates are obtained on a quarterly basis. Excluded from the table below are certain personal real estate loans for which FICO scores are not obtained because they generally pertain to commercial customer activities and are often underwritten with other collateral considerations. These loans totaled $211.1 million at June 30, 2018 and $219.2 million at December 31, 2017. The table also excludes consumer loans related to the Company's patient healthcare loan program, which totaled $161.8 million at June 30, 2018 and $145.0 million at December 31, 2017. As the healthcare loans are guaranteed by the hospital, FICO scores are not considered relevant for this program. The personal real estate loans and consumer loans excluded below totaled less than 8% of the Personal Banking portfolio. For the remainder of loans in the Personal Banking portfolio, the table below shows the percentage of balances outstanding at June 30, 2018 and December 31, 2017 by FICO score.

Personal Banking Loans

	% of Loan Category			
	Real Estate - Personal	Consumer	Revolving Home Equity	Consumer Credit Card
June 30, 2018				
FICO score:				
Under 600	1.1 %	3.2 %	.8 %	4.6 %
600 - 659	2.0	5.1	1.6	14.1
660 - 719	10.0	18.0	9.2	35.3
720 - 779	23.6	23.6	22.1	26.4
780 and over	63.3	50.1	66.3	19.6
Total	100.0 %	100.0 %	100.0 %	100.0 %
December 31, 2017				
FICO score:				
Under 600	1.3 %	3.3 %	1.1 %	4.7 %
600 - 659	2.1	5.5	1.7	14.4
660 - 719	10.5	17.3	9.5	34.4

720 - 779	25.6	26.8	21.4	26.0
780 and over	60.5	47.1	66.3	20.5
Total	100.0 %	100.0 %	100.0 %	100.0 %

14

Table of contents

Troubled debt restructurings

As mentioned previously, the Company's impaired loans include loans which have been classified as troubled debt restructurings, as shown in the table below. Restructured loans are those extended to borrowers who are experiencing financial difficulty and who have been granted a concession. Restructured loans are placed on non-accrual status if the Company does not believe it probable that amounts due under the contractual terms will be collected. Other performing restructured loans are comprised of certain business, construction and business real estate loans classified as substandard. Upon maturity, the loans renewed at interest rates judged not to be market rates for new debt with similar risk and as a result were classified as troubled debt restructurings. These loans are performing in accordance with their modified terms, and because the Company believes it probable that all amounts due under the modified terms of the agreements will be collected, interest on these loans is being recognized on an accrual basis. Troubled debt restructurings also include certain credit card loans under various debt management and assistance programs. Modifications to credit card loans generally involve removing the available line of credit, placing loans on amortizing status, and lowering the contractual interest rate. The Company also classified certain loans as troubled debt restructings because they were not reaffirmed by the borrower in bankruptcy proceedings. These loans are comprised of personal real estate, revolving home equity and consumer loans. Interest on these loans is being recognized on an accrual basis, as the borrowers are continuing to make payments.

(In thousands)	June 30, 2018	December 31, 2017
Accruing loans:		
Non-market interest rates	$86,906	$ 88,588
Assistance programs	6,887	6,685
Bankruptcy non-affirmation	5,335	7,283
Other	296	256
Non-accrual loans	7,156	7,796
Total troubled debt restructurings	$106,580	$ 110,608

The table below shows the balance of troubled debt restructurings by loan classification at June 30, 2018, in addition to the outstanding balances of these restructured loans which the Company considers to have been in default at any time during the past twelve months. For purposes of this disclosure, the Company considers "default" to mean 90 days or more past due as to interest or principal.

(In thousands)	June 30, 2018	Balance 90 days past due at any time during previous 12 months
Commercial:		
Business	$75,680	$ 32
Real estate - construction and land	1,337	—
Real estate - business	12,311	—
Personal Banking:		
Real estate - personal	4,787	303
Consumer	5,464	115
Revolving home equity	114	42
Consumer credit card	6,887	577

Total troubled debt restructurings	$106,580	$ 1,069

For those loans on non-accrual status also classified as restructured, the modification did not create any further financial effect on the Company as those loans were already recorded at net realizable value. For those performing commercial loans classified as restructured, there were no concessions involving forgiveness of principal or interest and, therefore, there was no financial impact to the Company as a result of modification to these loans. No financial impact resulted from those performing loans where the debt was not reaffirmed in bankruptcy, as no changes to loan terms occurred in that process. The effects of modifications to consumer credit card loans were estimated to decrease interest income by approximately $925 thousand on an annual, pre-tax basis, compared to amounts contractually owed.

The allowance for loan losses related to troubled debt restructurings on non-accrual status is determined by individual evaluation, including collateral adequacy, using the same process as loans on non-accrual status which are not classified as troubled debt restructurings. Those performing loans classified as troubled debt restructurings are accruing loans which management expects to collect under contractual terms. Performing commercial loans have had no other concessions granted other than being renewed at an interest rate judged not to be market. As such, they have similar risk characteristics as non-troubled debt commercial loans and are collectively evaluated based on internal risk rating, loan type, delinquency, historical experience and current economic factors. Performing personal banking loans classified as troubled debt restructurings resulted from the borrower not reaffirming the debt during bankruptcy and have had no other concession granted, other than the Bank's future limitations on collecting payment deficiencies or in pursuing foreclosure actions. As such, they have similar risk characteristics as non-troubled debt personal banking loans and are evaluated collectively based on loan type, delinquency, historical experience and current economic factors.

If a troubled debt restructuring defaults and is already on non-accrual status, the allowance for loan losses continues to be based on individual evaluation, using discounted expected cash flows or the fair value of collateral. If an accruing troubled debt restructuring defaults, the loan's risk rating is downgraded to non-accrual status and the loan's related allowance for loan losses is determined based on individual evaluation, or if necessary, the loan is charged off and collection efforts begun.

The Company had commitments of $6.1 million at June 30, 2018 to lend additional funds to borrowers with restructured loans.

Loans held for sale
The Company designates certain long-term fixed rate personal real estate loans as held for sale, and the Company has elected the fair value option for these loans. The election of the fair value option aligns the accounting for these loans with the related economic hedges discussed in Note 10. The loans are primarily sold to FNMA, FHLMC, and GNMA. At June 30, 2018, the fair value of these loans was $10.8 million, and the unpaid principal balance was $10.4 million.

The Company also designates student loan originations as held for sale. The borrowers are credit-worthy students who are attending colleges and universities. The loans are intended to be sold in the secondary market, and the Company maintains contracts with Sallie Mae to sell the loans within 210 days after the last disbursement to the student. These loans are carried at lower of cost or fair value, which at June 30, 2018 totaled $9.6 million.

At June 30, 2018, none of the loans held for sale were on non-accrual status or 90 days past due and still accruing.

Foreclosed real estate/repossessed assets
The Company’s holdings of foreclosed real estate totaled $1.0 million and $681 thousand at June 30, 2018 and December 31, 2017, respectively. Personal property acquired in repossession, generally autos and marine and recreational vehicles, totaled $2.3 million and $2.7 million at June 30, 2018 and December 31, 2017, respectively. Upon acquisition, these assets are recorded at fair value less estimated selling costs at the date of foreclosure, establishing a new cost basis. They are subsequently carried at the lower of this cost basis or fair value less estimated selling costs.

3. Investment Securities
Investment securities as shown in this report reflect revised categories as required by the Company’s adoption of ASU 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities”, on January 1, 2018. That new guidance refined the definition of equity securities and required their segregation from available for sale debt securities. For comparability purposes, prior period disclosures in this report have been revised to show the new categorization.

(In thousands)	June 30, 2018	December 31, 2017
Available for sale debt securities	$8,412,376	$8,725,442
Trading debt securities	31,156	18,269

Equity securities:		
Readily determinable fair value	2,741	48,838
No readily determinable fair value	1,703	1,753
Other:		
Federal Reserve Bank stock	33,369	33,253
Federal Home Loan Bank stock	10,000	10,000
Private equity investments	68,940	55,752
Total investment securities	$8,560,285	$8,893,307

While changes in the fair value of available for sale debt securities continue to be recorded in the equity category of accumulated other comprehensive income, the new guidance requires changes in the fair value of equity securities to be recorded in current earnings. As required by the new guidance, the unrealized gain in fair value on equity securities (recorded in accumulated other

16

Table of contents

comprehensive income at December 31, 2017) was reclassified to retained earnings on January 1, 2018. The amount of the reclassification was $33.3 million, net of tax.

Equity securities include common and preferred stock with readily determinable fair values that totaled $2.5 million at cost and $2.7 million at fair value at June 30, 2018. The decline in these balances from prior periods was due to a third party merger transaction in June 2018, in which the majority of these securities were redeemed for cash of $39.9 million. During the first six months of 2018, unrealized net losses of $176 thousand were recognized in current earnings on equity securities still held at June 30, 2018.

Equity securities also include securities with a carrying value of $1.7 million that do not have readily determinable fair values. The Company has elected, under the ASU, to measure these at cost minus impairment, if any, plus or minus changes resulting from observable price changes for the identical or similar investment of the same issuer. The Company did not record any impairment or other adjustments to the carrying amount of these investments during the period.

Other investment securities whose accounting is not addressed in the ASU include Federal Reserve Bank (FRB) stock, Federal Home Loan Bank (FHLB) stock, and investments in portfolio concerns held by the Company's private equity subsidiaries. FRB stock and FHLB stock are held for debt and regulatory purposes. Investment in FRB stock is based on the capital structure of the investing bank, and investment in FHLB stock is tied to the level of borrowings from the FHLB. These holdings are carried at cost. The private equity investments, in the absence of readily ascertainable market values, are carried at estimated fair value.

The majority of the Company’s investment portfolio is comprised of available for sale debt securities, which are carried at fair value with changes in fair value reported in accumulated other comprehensive income (AOCI). A summary of the available for sale debt securities by maturity groupings as of June 30, 2018 is shown below. The investment portfolio includes agency mortgage-backed securities, which are guaranteed by agencies such as the FHLMC, FNMA, GNMA and FDIC, in addition to non-agency mortgage-backed securities, which have no guarantee but are collateralized by commercial and residential mortgages. Also included are certain other asset-backed securities, which are primarily collateralized by credit cards, automobiles, student loans, and commercial loans. These securities differ from traditional debt securities primarily in that they may have uncertain maturity dates and are priced based on estimated prepayment rates on the underlying collateral.

Table of contents

(In thousands)	Amortized Cost	Fair Value
U.S. government and federal agency obligations:		
Within 1 year	$52,660	$52,603
After 1 but within 5 years	645,431	634,819
After 5 but within 10 years	157,967	155,108
After 10 years	69,202	68,562
Total U.S. government and federal agency obligations	925,260	911,092
Government-sponsored enterprise obligations:		
Within 1 year	117,562	117,444
After 1 but within 5 years	121,584	119,743
After 5 but within 10 years	34,984	33,946
After 10 years	42,852	40,228
Total government-sponsored enterprise obligations	316,982	311,361
State and municipal obligations:		
Within 1 year	147,325	147,668
After 1 but within 5 years	598,663	600,688
After 5 but within 10 years	591,819	590,950
After 10 years	40,963	39,858
Total state and municipal obligations	1,378,770	1,379,164
Mortgage and asset-backed securities:		
Agency mortgage-backed securities	3,194,764	3,131,025
Non-agency mortgage-backed securities	1,019,545	1,010,331
Asset-backed securities	1,351,461	1,338,542
Total mortgage and asset-backed securities	5,565,770	5,479,898
Other debt securities:		
Within 1 year	9,003	8,971
After 1 but within 5 years	257,704	252,151
After 5 but within 10 years	73,283	69,739
Total other debt securities	339,990	330,861
Total available for sale debt securities	$8,526,772	$8,412,376

Investments in U.S. government and federal agency obligations include U.S. Treasury inflation-protected securities, which totaled $443.8 million, at fair value, at June 30, 2018. Interest paid on these securities increases with inflation and decreases with deflation, as measured by the Consumer Price Index. Included in state and municipal obligations are $15.1 million, at fair value, of auction rate securities, which were purchased from bank customers in 2008. Interest on these bonds is currently being paid at the maximum failed auction rates.

Table of contents

For debt securities classified as available for sale, the following table shows the unrealized gains and losses (pre-tax) in AOCI, by security type.

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2018				
U.S. government and federal agency obligations	$925,260	$ 503	$(14,671)	$911,092
Government-sponsored enterprise obligations	316,982	—	(5,621)	311,361
State and municipal obligations	1,378,770	8,105	(7,711)	1,379,164
Mortgage and asset-backed securities:				
Agency mortgage-backed securities	3,194,764	5,995	(69,734)	3,131,025
Non-agency mortgage-backed securities	1,019,545	6,232	(15,446)	1,010,331
Asset-backed securities	1,351,461	2,343	(15,262)	1,338,542
Total mortgage and asset-backed securities	5,565,770	14,570	(100,442)	5,479,898
Other debt securities	339,990	—	(9,129)	330,861
Total	$8,526,772	$ 23,178	$(137,574)	$8,412,376
December 31, 2017				
U.S. government and federal agency obligations	$917,494	$ 4,096	$(4,443)	$917,147
Government-sponsored enterprise obligations	408,266	26	(1,929)	406,363
State and municipal obligations	1,592,707	21,413	(2,754)	1,611,366
Mortgage and asset-backed securities:				
Agency mortgage-backed securities	3,046,701	17,956	(23,744)	3,040,913
Non-agency mortgage-backed securities	903,920	6,710	(4,837)	905,793
Asset-backed securities	1,495,380	2,657	(5,237)	1,492,800
Total mortgage and asset-backed securities	5,446,001	27,323	(33,818)	5,439,506
Other debt securities	350,988	1,250	(1,178)	351,060
Total	$8,715,456	$ 54,108	$(44,122)	$8,725,442

The Company's impairment policy requires a review of all securities for which fair value is less than amortized cost. Special emphasis and analysis is placed on securities whose credit rating has fallen below A3 (Moody's) or A- (Standard & Poor's), whose fair values have fallen more than 20% below purchase price for an extended period of time, or who have been identified based on management's judgment. These securities are placed on a watch list, and for all such securities, cash flow analyses are prepared. For more complex analyses, detailed cash flow models are prepared which use inputs specific to each security. Inputs to these models include factors such as cash flow received, contractual payments required, and various other information related to the underlying collateral (including current delinquencies), collateral loss severity rates (including loan to values), expected delinquency rates, credit support from other tranches, and prepayment speeds. Stress tests are performed at varying levels of delinquency rates, prepayment speeds and loss severities in order to gauge probable ranges of credit loss. At June 30, 2018, the fair value of securities on this watch list was $57.3 million compared to $68.0 million at December 31, 2017.

As of June 30, 2018, the Company had recorded other-than-temporary impairment (OTTI) on certain non-agency mortgage-backed securities, part of the watch list mentioned above, which had an aggregate fair value of $22.4 million. The cumulative credit-related portion of the impairment on these securities, which was recorded in earnings, totaled $14.2 million. The Company does not intend to sell these securities and believes it is not likely that it will be required to sell the securities before the recovery of their amortized cost.

The credit-related portion of the loss on these securities was based on the cash flows projected to be received over the estimated life of the securities, discounted to present value, and compared to the current amortized cost bases of the securities. Significant inputs to the cash flow models used to calculate the credit losses on these securities at June 30, 2018 included the following:

Significant Inputs	Range
Prepayment CPR	0% - 25%
Projected cumulative default	13% - 52%
Credit support	0% - 20%
Loss severity	14% - 63%

Table of contents

The following table presents a rollforward of the cumulative OTTI credit losses recognized in earnings on all available for sale debt securities.

(In thousands)	For the Six Months Ended June 30 2018	2017
Cumulative OTTI credit losses at January 1	$14,199	$14,080
Credit losses on debt securities for which impairment was not previously recognized	58	46
Credit losses on debt securities for which impairment was previously recognized	10	274
Increase in expected cash flows that are recognized over remaining life of security	(104)	(146)
Cumulative OTTI credit losses at June 30	$14,163	$14,254

Debt securities with unrealized losses recorded in AOCI are shown in the table below, along with the length of the impairment period.

(In thousands)	Less than 12 months Fair Value	Unrealized Losses	12 months or longer Fair Value	Unrealized Losses	Total Fair Value	Unrealized Losses
June 30, 2018						
U.S. government and federal agency obligations	$707,018	$ 12,156	$90,340	$ 2,515	$797,358	$ 14,671
Government-sponsored enterprise obligations	261,378	5,605	49,983	16	311,361	5,621
State and municipal obligations	458,880	5,700	51,863	2,011	510,743	7,711
Mortgage and asset-backed securities:						
Agency mortgage-backed securities	2,029,957	45,267	566,986	24,467	2,596,943	69,734
Non-agency mortgage-backed securities	773,890	12,076	134,679	3,370	908,569	15,446
Asset-backed securities	862,416	13,296	173,895	1,966	1,036,311	15,262
Total mortgage and asset-backed securities	3,666,263	70,639	875,560	29,803	4,541,823	100,442
Other debt securities	311,714	8,033	19,147	1,096	330,861	9,129
Total	$5,405,253	$ 102,133	$1,086,893	$ 35,441	$6,492,146	$ 137,574
December 31, 2017						
U.S. government and federal agency obligations	$618,617	$ 4,443	$—	$ —	$618,617	$ 4,443
Government-sponsored enterprise obligations	286,393	1,712	49,766	217	336,159	1,929
State and municipal obligations	282,843	1,752	49,339	1,002	332,182	2,754
Mortgage and asset-backed securities:						
Agency mortgage-backed securities	1,320,689	9,433	619,300	14,311	1,939,989	23,744
Non-agency mortgage-backed securities	577,017	2,966	153,813	1,871	730,830	4,837
Asset-backed securities	786,048	3,168	264,295	2,069	1,050,343	5,237
Total mortgage and asset-backed securities	2,683,754	15,567	1,037,408	18,251	3,721,162	33,818
Other debt securities	144,090	727	20,202	451	164,292	1,178
Total	$4,015,697	$ 24,201	$1,156,715	$ 19,921	$5,172,412	$ 44,122

The available for sale debt portfolio included $6.5 billion of securities that were in a loss position at June 30, 2018, compared to $5.2 billion at December 31, 2017. The total amount of unrealized loss on these securities was $137.6 million at June 30, 2018, an increase of $93.5 million compared to the loss at December 31, 2017. This increase in losses was mainly due to a rising rate environment.

Table of contents

The following tables present proceeds from sales of securities and the components of investment securities gains and losses which have been recognized in earnings.

	For the Six Months Ended June 30	
(In thousands)	2018	2017
Proceeds from sales of securities:		
Available for sale debt securities	$152,541	$4,972
Equity securities	39,981	584
Other	—	996
Total proceeds	$192,522	$6,552
Investment securities gains (losses), net:		
Available for sale debt securities:		
Losses realized on called bonds	$—	$(254)
Gains realized on sales	423	—
Losses realized on sales	—	(22)
Other-than-temporary impairment recognized on debt securities	(68)	(320)
Equity securities:		
Gains realized on donations of securities	—	4,315
Gains realized on sales	102	584
Losses realized on sales	(8,917)	—
Fair value adjustments, net	2,699	—
Other:		
Gains realized on sales	—	58
Losses realized on sales	—	(652)
Fair value adjustments, net	8,096	(2,830)
Total investment securities gains, net	$2,335	$879

Securities gains for the six months ended June 30, 2018 included gains in fair value of $8.1 million on private equity investments and $2.7 million on equity securities. These were offset by an $8.9 million adjustment to recognize dividend income on a equity security liquidated during the second quarter of 2018.

At June 30, 2018, securities totaling $3.8 billion in fair value were pledged to secure public fund deposits, securities sold under agreements to repurchase, trust funds, and borrowings at the FRB and FHLB. Securities pledged under agreements pursuant to which the collateral may be sold or re-pledged by the secured parties approximated $557.7 million, while the remaining securities were pledged under agreements pursuant to which the secured parties may not sell or re-pledge the collateral. Except for obligations of various government-sponsored enterprises such as FNMA, FHLB and FHLMC, no investment in a single issuer exceeded 10% of stockholders’ equity.

Table of contents

4. Goodwill and Other Intangible Assets

The following table presents information about the Company's intangible assets which have estimable useful lives.

(In thousands)	June 30, 2018 Gross Carrying Amount	Accumulated Amortization	Valuation Allowance	Net Amount	December 31, 2017 Gross Carrying Amount	Accumulated Amortization	Valuation Allowance	Net Amount
Amortizable intangible assets:								
Core deposit premium	$31,270	$ (28,650)	$ —	$ 2,620	$31,270	$ (28,305)	$ —	$ 2,965
Mortgage servicing rights	8,996	(3,533)	—	5,463	7,906	(3,244)	(9)	4,653
Total	$40,266	$ (32,183)	$ —	$ 8,083	$39,176	$ (31,549)	$ (9)	$ 7,618

Aggregate amortization expense on intangible assets was $313 thousand and $330 thousand for the three month periods ended June 30, 2018 and 2017, respectively, and $634 thousand and $678 thousand for the six month periods ended June 30, 2018 and 2017, respectively. The following table shows the estimated annual amortization expense for the next five fiscal years. This expense is based on existing asset balances and the interest rate environment as of June 30, 2018. The Company’s actual amortization expense in any given period may be different from the estimated amounts depending upon the acquisition of intangible assets, changes in mortgage interest rates, prepayment rates and other market conditions.

(In thousands)	
2018	$1,232
2019	1,094
2020	937
2021	816
2022	720

Changes in the carrying amount of goodwill and net other intangible assets for the six month period ended June 30, 2018 are as follows:

(In thousands)	Goodwill	Core Deposit Premium	Mortgage Servicing Rights
Balance January 1, 2018	$138,921	$ 2,965	$ 4,653
Originations	—	—	1,090
Amortization	—	(345)	(289)
Impairment reversal	—	—	9
Balance June 30, 2018	$138,921	$ 2,620	$ 5,463

Goodwill allocated to the Company’s operating segments at June 30, 2018 and December 31, 2017 is shown below.

(In thousands)	
Consumer segment	$70,721
Commercial segment	67,454
Wealth segment	746
Total goodwill	$138,921

5. Guarantees

The Company, as a provider of financial services, routinely issues financial guarantees in the form of financial and performance standby letters of credit. Standby letters of credit are contingent commitments issued by the Company generally to guarantee the payment or performance obligation of a customer to a third party. While these represent a potential outlay by the Company, a significant amount of the commitments may expire without being drawn upon. The Company has recourse against the customer for any amount it is required to pay to a third party under a standby letter of credit. The letters of credit are subject to the same credit policies, underwriting standards and approval process as loans made by the Company. Most of the standby letters of credit are secured, and in the event of nonperformance by customers, the Company has rights to the underlying collateral, which could include commercial real estate, physical plant and property, inventory, receivables, cash and marketable securities.

Upon issuance of standby letters of credit, the Company recognizes a liability for the fair value of the obligation undertaken, which is estimated to be equivalent to the amount of fees received from the customer over the life of the agreement. At June 30, 2018, that net liability was $2.2 million, which will be accreted into income over the remaining life of the respective commitments.

Table of contents

The contractual amount of these letters of credit, which represents the maximum potential future payments guaranteed by the Company, was $377.5 million at June 30, 2018.

The Company periodically enters into credit risk participation agreements (RPAs) as a guarantor to other financial institutions, in order to mitigate those institutions' credit risk associated with interest rate swaps with third parties. The RPA stipulates that, in the event of default by the third party on the interest rate swap, the Company will reimburse a portion of the loss borne by the financial institution. These interest rate swaps are normally collateralized (generally with real property, inventories and equipment) by the third party, which limits the credit risk associated with the Company's RPAs. The third parties usually have other borrowing relationships with the Company. The Company monitors overall borrower collateral and at June 30, 2018, believes sufficient collateral is available to cover potential swap losses. The RPAs are carried at fair value throughout their term with all changes in fair value, including those due to a change in the third party's creditworthiness, recorded in current earnings. The terms of the RPAs, which correspond to the terms of the underlying swaps, range from 2 to 11 years. At June 30, 2018, the fair value of the Company's guarantee liabilities for RPAs was $67 thousand, and the notional amount of the underlying swaps was $103.2 million. The maximum potential future payment guaranteed by the Company cannot be readily estimated but is dependent upon the fair value of the interest rate swaps at the time of default.

6. Pension

The amount of net pension cost is shown in the table below:

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(In thousands)	2018	2017	2018	2017
Service cost - benefits earned during the period	$152	$128	$305	$257
Interest cost on projected benefit obligation	951	973	1,901	1,946
Expected return on plan assets	(1,438)	(1,438)	(2,875)	(2,876)
Amortization of prior service cost	(67)	(68)	(135)	(136)
Amortization of unrecognized net loss	592	617	1,184	1,234
Net periodic pension cost	$190	$212	$380	$425

Substantially all benefits accrued under the Company's defined benefit pension plan were frozen effective January 1, 2005, and the remaining benefits were frozen effective January 1, 2011. During the first six months of 2018, the Company made no funding contributions to its defined benefit pension plan and made minimal funding contributions to a supplemental executive retirement plan (the CERP), which carries no segregated assets.

The Company adopted ASU 2017-07, "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost", on January 1, 2018. This guidance requires that the service cost component of net periodic pension cost be reported in the same income statement line item as other compensation costs, while other components of net periodic pension cost be reported separately from the service cost component. Historically, the Company has reported all components of pension cost in salaries and employee benefits. Beginning in 2018, only the service cost component has been included in this category, and the other components have been recorded in other non-interest expense. Prior period financial statements have not been revised because the amount of the reclassification was not significant.

Table of contents

7. Common Stock *

Presented below is a summary of the components used to calculate basic and diluted income per share. The Company applies the two-class method of computing income per share, as nonvested share-based awards that contain nonforfeitable rights to dividends are considered securities which participate in undistributed earnings with common stock. The two-class method requires the calculation of separate income per share amounts for the nonvested share-based awards and for common stock. Income per share attributable to common stock is shown in the table below. Nonvested share-based awards are further discussed in Note 12.

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(In thousands, except per share data)	2018	2017	2018	2017
Basic income per common share:				
Net income attributable to Commerce Bancshares, Inc.	$110,330	$78,960	$211,314	$150,464
Less preferred stock dividends	2,250	2,250	4,500	4,500
Net income available to common shareholders	108,080	76,710	206,814	145,964
Less income allocated to nonvested restricted stock	1,139	943	2,260	1,888
Net income allocated to common stock	$106,941	$75,767	$204,554	$144,076
Weighted average common shares outstanding	105,686	105,583	105,660	105,486
Basic income per common share	$1.02	$.71	$1.94	$1.36
Diluted income per common share:				
Net income available to common shareholders	$108,080	$76,710	$206,814	$145,964
Less income allocated to nonvested restricted stock	1,136	941	2,254	1,883
Net income allocated to common stock	$106,944	$75,769	$204,560	$144,081
Weighted average common shares outstanding	105,686	105,583	105,660	105,486
Net effect of the assumed exercise of stock-based awards - based on the treasury stock method using the average market price for the respective periods	343	360	338	389
Weighted average diluted common shares outstanding	106,029	105,943	105,998	105,875
Diluted income per common share	$1.01	$.71	$1.93	$1.36

Unexercised stock appreciation rights of 295 thousand and 132 thousand were excluded in the computation of diluted income per common share for the six month periods ended June 30, 2018 and 2017, respectively, because their inclusion would have been anti-dilutive.

* All prior year share and per share amounts in this note have been restated for the 5% common stock dividend distributed in December 2017.

24

Table of contents

8. Accumulated Other Comprehensive Income

The table below shows the activity and accumulated balances for components of other comprehensive income. The largest component is the unrealized holding gains and losses on available for sale debt securities. Unrealized gains and losses on debt securities for which an other-than-temporary impairment (OTTI) has been recorded in current earnings are shown separately below. The other component is the amortization from other comprehensive income of losses associated with pension benefits, which occurs as the losses are included in current net periodic pension cost.

	Unrealized Gains (Losses) on Securities (1)		Pension Loss	Total Accumulated Other Comprehensive Income (Loss)
(In thousands)	OTTI	Other		
Balance January 1, 2018	$3,411	$30,326	$(19,629)	$ 14,108
ASU 2018-02 Reclassification of tax rate change	715	6,359	(4,142)	2,932
ASU 2016-01 Reclassification of unrealized gain on equity securities	—	(33,320)	—	(33,320)
Other comprehensive loss before reclassifications to current earnings	(173)	(123,854)	—	(124,027)
Amounts reclassified to current earnings from accumulated other comprehensive income	68	(424)	1,049	693
Current period other comprehensive income (loss), before tax	(105)	(124,278)	1,049	(123,334)
Income tax (expense) benefit	27	31,068	(262)	30,833
Current period other comprehensive income (loss), net of tax	(78)	(93,210)	787	(92,501)
Transfer of unrealized gain on securities for which impairment was not previously recognized	12	(12)	—	—
Balance June 30, 2018	$4,060	$(89,857)	$(22,984)	$ (108,781)
Balance January 1, 2017	$2,975	$27,328	$(19,328)	$ 10,975
Other comprehensive income (loss) before reclassifications to current earnings	(44)	53,072	—	53,028
Amounts reclassified to current earnings from accumulated other comprehensive income	320	(4,293)	1,098	(2,875)
Current period other comprehensive income, before tax	276	48,779	1,098	50,153
Income tax expense	(105)	(18,536)	(417)	(19,058)
Current period other comprehensive income, net of tax	171	30,243	681	31,095
Transfer of unrealized gain on securities for which impairment was not previously recognized	24	(24)	—	—
Balance June 30, 2017	$3,170	$57,547	$(18,647)	$ 42,070

(1) The pre-tax amounts reclassified from accumulated other comprehensive income to current earnings are included in "investment securities gains (losses), net" in the consolidated statements of income.

The requirement to revalue deferred tax assets and liabilities in the period of enactment stranded the effects of the tax rate change, mandated by the Tax Cuts and Jobs Act, in accumulated other comprehensive income. In response, the FASB issued ASU 2018-02, “Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income”, which the Company adopted on January 1, 2018. This ASU allowed the reclassification of the stranded tax effects from accumulated other comprehensive income (as shown in the table above) to retained earnings.

As mentioned in Note 3, additional new accounting guidance, which was effective January 1, 2018, required the reclassification of unrealized gains on equity securities from accumulated other comprehensive income to retained earnings (also shown above).

9. Segments

The Company segregates financial information for use in assessing its performance and allocating resources among three operating segments: Consumer, Commercial and Wealth. The Consumer segment consists of various consumer loan and deposit products offered through its retail branch network of approximately 180 locations. This segment also includes indirect and other consumer loan financing businesses, along with debit and credit card loan and fee businesses. Residential mortgage origination, sales and servicing functions are included in this Consumer segment, but residential mortgage loans retained by the Company are not considered part of this segment. The Commercial segment provides corporate lending, leasing, and international services, along with business and governmental deposit products and commercial cash management services. This segment includes both merchant and commercial bank card products. It also includes the Capital Markets Group which sells fixed income securities and provides safekeeping and accounting services to its business and correspondent bank customers. The Wealth segment provides traditional trust and estate planning, advisory and discretionary investment management, and brokerage services. This segment also provides various loan and deposit related services to its private banking customers.

Table of contents

The following table presents selected financial information by segment and reconciliations of combined segment totals to consolidated totals. There were no material intersegment revenues among the three segments. Management periodically makes changes to methods of assigning costs and income to its business segments to better reflect operating results. If appropriate, these changes are reflected in prior year information presented below.

(In thousands)	Consumer	Commercial	Wealth	Segment Totals	Other/Elimination	Consolidated Totals
Three Months Ended June 30, 2018						
Net interest income	$73,471	$85,721	$11,857	$171,049	$39,910	$210,959
Provision for loan losses	(10,409)	308	16	(10,085)	42	(10,043)
Non-interest income	32,116	51,651	42,896	126,663	(1,813)	124,850
Investment securities losses, net	—	—	—	—	(3,075)	(3,075)
Non-interest expense	(72,095)	(75,360)	(30,254)	(177,709)	(4,151)	(181,860)
Income before income taxes	$23,083	$62,320	$24,515	$109,918	$30,913	$140,831
Six Months Ended June 30, 2018						
Net interest income	$144,908	$167,816	$23,302	$336,026	$67,825	$403,851
Provision for loan losses	(20,924)	488	(48)	(20,484)	45	(20,439)
Non-interest income	62,332	100,862	84,997	248,191	(3,651)	244,540
Investment securities gains, net	—	—	—	—	2,335	2,335
Non-interest expense	(142,266)	(148,158)	(62,113)	(352,537)	(11,600)	(364,137)
Income before income taxes	$44,050	$121,008	$46,138	$211,196	$54,954	$266,150
Three Months Ended June 30, 2017						
Net interest income	$69,274	$82,137	$11,934	$163,345	$19,462	$182,807
Provision for loan losses	(10,802)	111	24	(10,667)	(91)	(10,758)
Non-interest income	29,617	46,088	38,852	114,557	823	115,380
Investment securities gains, net	—	—	—	—	1,651	1,651
Non-interest expense	(68,374)	(72,134)	(29,494)	(170,002)	(6,888)	(176,890)
Income before income taxes	$19,715	$56,202	$21,316	$97,233	$14,957	$112,190
Six Months Ended June 30, 2017						
Net interest income	$136,628	$162,007	$23,778	$322,413	$38,667	$361,080
Provision for loan losses	(20,464)	624	1	(19,839)	(2,047)	(21,886)
Non-interest income	56,780	90,998	76,558	224,336	657	224,993
Investment securities gains, net	—	—	—	—	879	879
Non-interest expense	(135,791)	(142,499)	(59,813)	(338,103)	(18,164)	(356,267)
Income before income taxes	$37,153	$111,130	$40,524	$188,807	$19,992	$208,799

The information presented above was derived from the internal profitability reporting system used by management to monitor and manage the financial performance of the Company. This information is based on internal management accounting procedures and methods, which have been developed to reflect the underlying economics of the businesses. The methodologies are applied in connection with funds transfer pricing and assignment of overhead costs among segments. Funds transfer pricing was used in the determination of net interest income by assigning a standard cost (credit) for funds used (provided) by assets and liabilities based on their maturity, prepayment and/or repricing characteristics.

The segment activity, as shown above, includes both direct and allocated items. Amounts in the "Other/Elimination" column include activity not related to the segments, such as that relating to administrative functions, the investment securities portfolio, and the effect of certain expense allocations to the segments. The provision for loan losses in this category contains the difference between net loan charge-offs assigned directly to the segments and the recorded provision for loan loss expense. Included in this category's net interest income are earnings of the investment portfolio, which are not allocated to a segment.

The performance measurement of the operating segments is based on the management structure of the Company and is not necessarily comparable with similar information for any other financial institution. The information is also not necessarily indicative of the segments' financial condition and results of operations if they were independent entities.

Table of contents

10. Derivative Instruments

The notional amounts of the Company’s derivative instruments are shown in the table below. These contractual amounts, along with other terms of the derivative, are used to determine amounts to be exchanged between counterparties and are not a measure of loss exposure. At June 30, 2018, the Company’s derivative instruments are accounted for as free-standing derivatives, and changes in their fair value are recorded in current earnings.

(In thousands)	June 30, 2018	December 31, 2017
Interest rate swaps	$1,891,877	$ 1,741,412
Interest rate caps	31,483	31,776
Credit risk participation agreements	152,402	133,488
Foreign exchange contracts	8,737	11,826
Mortgage loan commitments	21,653	17,110
Mortgage loan forward sale contracts	2,848	2,566
Forward TBA contracts	25,000	25,000
Total notional amount	$2,134,000	$ 1,963,178

The largest group of notional amounts relate to interest rate swap contracts sold to commercial customers who wish to modify their interest rate sensitivity. These swaps are offset by matching contracts purchased by the Company from other financial dealer institutions. Contracts with dealers that require central clearing are novated to a regulated clearinghouse who becomes the Company's legal counterparty. Because of the matching terms of the offsetting contracts, in addition to collateral provisions which mitigate the impact of non-performance risk, changes in fair value subsequent to initial recognition have a minimal effect on earnings.

Many of the Company’s interest rate swap contracts with large financial institutions contain contingent features relating to debt ratings or capitalization levels. Under these provisions, if the Company’s debt rating falls below investment grade or if the Company ceases to be “well-capitalized” under risk-based capital guidelines, certain counterparties can require immediate and ongoing collateralization on interest rate swaps in net liability positions or instant settlement of the contracts. The Company maintains debt ratings and capital well above these minimum requirements.

The Company also contracts with other financial institutions, as a guarantor or beneficiary, to share credit risk associated with certain interest rate swaps through risk participation agreements. The Company’s risks and responsibilities as guarantor are further discussed in Note 5 on Guarantees. In addition, the Company enters into foreign exchange contracts, which are mainly comprised of contracts to purchase or deliver foreign currencies for customers at specific future dates.

Under its program to sell residential mortgage loans in the secondary market, the Company designates certain newly-originated residential mortgage loans as held for sale. Derivative instruments arising from this activity include mortgage loan commitments and forward loan sale commitments. Changes in the fair values of the loan commitments and funded loans prior to sale that are due to changes in interest rates are economically hedged with forward contracts to sell residential mortgage-backed securities in the to-be-announced (TBA) market. These forward TBA contracts are also considered to be derivatives and are settled in cash at the security settlement date.

Table of contents

The fair values of the Company's derivative instruments, whose notional amounts are listed above, are shown in the table below. Information about the valuation methods used to determine fair value is provided in Note 15 on Fair Value Measurements in the 2017 Annual Report on Form 10-K.

The Company's policy is to present its derivative assets and derivative liabilities on a gross basis in its consolidated balance sheets, and these are reported in other assets and other liabilities. However, in January 2017, a clearinghouse rule change required that variation margin on centrally cleared derivatives, formerly treated as collateral, be treated as settlements of derivative exposure. As a result, the fair values of the respective derivative contracts must be reduced by variation margin payments and reported as a single, net amount. Accordingly, at June 30, 2018 in the table below, the positive fair values of cleared swaps were reduced by $15.9 million and the negative fair values of cleared swaps were reduced by $1.5 million. At December 31, 2017, the positive fair values of cleared swaps were reduced by $4.5 million and the negative fair values of cleared swaps were reduced by $4.3 million.

	Asset Derivatives		Liability Derivatives	
	June 30, 2018	Dec. 31, 2017	June 30, 2018	Dec. 31, 2017
(In thousands)	Fair Value		Fair Value	
Derivative instruments:				
Interest rate swaps	$5,265	$7,674	$(19,616)	$(7,857)
Interest rate caps	20	16	(20)	(16)
Credit risk participation agreements	21	46	(67)	(123)
Foreign exchange contracts	194	21	(31)	(40)
Mortgage loan commitments	730	580	—	—
Mortgage loan forward sale contracts	8	8	(1)	(7)
Forward TBA contracts	1	4	(111)	(31)
Total	$6,239	$8,349	$(19,846)	$(8,074)

The effects of derivative instruments on the consolidated statements of income are shown in the table below.

	Location of Gain or (Loss) Recognized in Income on Derivatives	Amount of Gain or (Loss) Recognized in Income on Derivatives			
		For the Three Months Ended June 30		For the Six Months Ended June 30	
(In thousands)		2018	2017	2018	2017
Derivative instruments:					
Interest rate swaps	Other non-interest income	$1,727	$456	$2,232	$599
Credit risk participation agreements	Other non-interest income	16	1	180	11
Foreign exchange contracts	Other non-interest income	173	(55)	182	(75)
Mortgage loan commitments	Loan fees and sales	148	(32)	149	522
Mortgage loan forward sale contracts	Loan fees and sales	6	(4)	6	62
Forward TBA contracts	Loan fees and sales	(9)	(160)	533	(258)
Total		$2,061	$206	$3,282	$861

The following table shows the extent to which assets and liabilities relating to derivative instruments have been offset in the consolidated balance sheets. It also provides information about these instruments which are subject to an enforceable master netting arrangement, irrespective of whether they are offset, and the extent to which the instruments could potentially be offset. Also shown is collateral received or pledged in the form of other financial instruments, which is generally cash or marketable securities. The collateral amounts in this table are limited to the outstanding balances of the related asset or liability (after netting is applied); thus amounts of excess collateral are not shown. Most of the derivatives in the following table were transacted under master netting arrangements that contain a conditional right of offset, such as close-out netting, upon default.

Table of contents

Collateral exchanged between the Company and dealer bank counterparties is generally subject to thresholds and transfer minimums, and usually consists of marketable securities. By contract, these may be sold or re-pledged by the secured party until recalled at a subsequent valuation date by the pledging party. For those swap transactions requiring central clearing, the Company posts cash or securities to its clearing agent. Collateral positions are valued daily, and adjustments to amounts received and pledged by the Company are made as appropriate to maintain proper collateralization for these transactions. Swap derivative transactions with customers are generally secured by rights to non-financial collateral, such as real and personal property, which is not shown in the table below.

				Gross Amounts Not Offset in the Balance Sheet		
(In thousands)	Gross Amount Recognized	Gross Amounts Offset in the Balance Sheet	Net Amounts Presented in the Balance Sheet	Financial Instruments Available for Offset	Collateral Received/Pledged	Net Amount
June 30, 2018						
Assets:						
Derivatives subject to master netting agreements	$ 5,338	$ —	$ 5,338	$ (491)	$ (2,114)	$ 2,733
Derivatives not subject to master netting agreements	901	—	901			
Total derivatives	6,239	—	6,239			
Liabilities:						
Derivatives subject to master netting agreements	$ 19,777	$ —	$ 19,777	$ (491)	$ (354)	$ 18,932
Derivatives not subject to master netting agreements	69	—	69			
Total derivatives	19,846	—	19,846			
December 31, 2017						
Assets:						
Derivatives subject to master netting agreements	$ 7,726	$ —	$ 7,726	$ (233)	$ (824)	$ 6,669
Derivatives not subject to master netting agreements	623	—	623			
Total derivatives	8,349	—	8,349			
Liabilities:						
Derivatives subject to master netting agreements	$ 7,935	$ —	$ 7,935	$ (233)	$ (1,570)	$ 6,132
Derivatives not subject to master netting agreements	139	—	139			
Total derivatives	8,074	—	8,074			

11. Resale and Repurchase Agreements

The following table shows the extent to which assets and liabilities relating to securities purchased under agreements to resell (resale agreements) and securities sold under agreements to repurchase (repurchase agreements) have been offset in the consolidated balance sheets, in addition to the extent to which they could potentially be offset. Also shown is collateral received or pledged, which consists of marketable securities. The collateral amounts in the table are limited to the outstanding balances of the related asset or liability (after netting is applied); thus amounts of excess collateral are not shown. The agreements in the following table were transacted under master netting arrangements that contain a conditional right of offset, such as close-out netting, upon default.

Resale and repurchase agreements are agreements to purchase/sell securities subject to an obligation to resell/repurchase the same or similar securities. They are accounted for as collateralized financing transactions, not as sales and purchases of the securities portfolio. The securities collateral accepted or pledged in resale and repurchase agreements with other financial institutions also may be sold or re-pledged by the secured party, but is usually delivered to and held by third party trustees. The Company generally retains custody of securities pledged for repurchase agreements with customers.

Table of contents

The Company is party to several agreements commonly known as collateral swaps. These agreements involve the exchange of collateral under simultaneous repurchase and resale agreements with the same financial institution counterparty. These repurchase and resale agreements have the same principal amounts, inception dates, and maturity dates and have been offset against each other in the consolidated balance sheets, as permitted under the netting provisions of ASC 210-20-45. The collateral swaps totaled $550.0 million at June 30, 2018 and $650.0 million at December 31, 2017. At June 30, 2018, the Company had posted collateral of $557.0 million in marketable securities, consisting of agency mortgage-backed bonds and treasuries, and had accepted $556.0 million in investment grade asset-backed, commercial mortgage-backed, and corporate bonds.

(In thousands)	Gross Amount Recognized	Gross Amounts Offset in the Balance Sheet	Net Amounts Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet: Financial Instruments Available for Offset	Gross Amounts Not Offset in the Balance Sheet: Securities Collateral Received/Pledged	Net Amount
June 30, 2018						
Total resale agreements, subject to master netting arrangements	$ 1,250,000	$ (550,000)	$ 700,000	$ —	$ (698,414)	$ 1,586
Total repurchase agreements, subject to master netting arrangements	1,585,074	(550,000)	1,035,074	—	(1,035,074)	—
December 31, 2017						
Total resale agreements, subject to master netting arrangements	$ 1,350,000	$ (650,000)	$ 700,000	$ —	$ (700,000)	$ —
Total repurchase agreements, subject to master netting arrangements	1,954,768	(650,000)	1,304,768	—	(1,304,768)	—

The table below shows the remaining contractual maturities of repurchase agreements outstanding at June 30, 2018 and December 31, 2017, in addition to the various types of marketable securities that have been pledged as collateral for these borrowings.

(In thousands)	Remaining Contractual Maturity of the Agreements: Overnight and continuous	Up to 90 days	Greater than 90 days	Total
June 30, 2018				
Repurchase agreements, secured by:				
U.S. government and federal agency obligations	$ 253,662	$ —	$ 350,000	$ 603,662
Government-sponsored enterprise obligations	63,916	—	—	63,916
Agency mortgage-backed securities	518,375	22,850	202,750	743,975
Non-agency mortgage-backed securities	10,591	—	—	10,591
Asset-backed securities	56,335	75,000	—	131,335
Other debt securities	31,595	—	—	31,595
Total repurchase agreements, gross amount recognized	$ 934,474	$ 97,850	$ 552,750	$ 1,585,074
December 31, 2017				
Repurchase agreements, secured by:				
U.S. government and federal agency obligations	$ 271,820	$ 1,731	$ 450,000	$ 723,551

Government-sponsored enterprise obligations	149,111	—	—	149,111
Agency mortgage-backed securities	737,975	9,750	200,000	947,725
Asset-backed securities	89,601	30,000	—	119,601
Other debt securities	14,780	—	—	14,780
Total repurchase agreements, gross amount recognized	$1,263,287	$41,481	$650,000	$1,954,768

Table of contents

12. Stock-Based Compensation
The Company issues stock-based compensation in the form of nonvested restricted stock and stock appreciation rights (SARs). Most of the awards are issued during the first quarter of each year. The stock-based compensation expense that has been charged against income was $3.1 million in both the three months ended June 30, 2018 and 2017, and $6.4 million and $6.2 million in the six months ended June 30, 2018 and 2017, respectively.

Nonvested stock awards generally vest in 4 to 7 years and contain restrictions as to transferability, sale, pledging, or assigning, among others, prior to the end of the vesting period. Dividend and voting rights are conferred upon grant. A summary of the status of the Company's nonvested share awards as of June 30, 2018, and changes during the six month period then ended, is presented below.

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2018	1,254,518	$38.67
Granted	225,764	59.23
Vested	(344,830)	32.27
Forfeited	(15,049)	45.88
Nonvested at June 30, 2018	1,120,403	$44.69

SARs are granted with exercise prices equal to the market price of the Company's stock at the date of grant. SARs vest ratably over 4 years of continuous service and have 10-year contractual terms. All SARs must be settled in stock under provisions of the plan. In determining compensation cost, the Black-Scholes option-pricing model is used to estimate the fair value of SARs on date of grant. The current year per share average fair value and the model assumptions are shown in the table below.

Weighted per share average fair value at grant date	$12.44	
Assumptions:		
Dividend yield	1.6	%
Volatility	20.6	%
Risk-free interest rate	2.7	%
Expected term	6.6 years	

A summary of SAR activity during the first six months of 2018 is presented below.

(Dollars in thousands, except per share data)	Rights	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2018	1,179,286	$37.13		
Granted	168,716	58.42		
Forfeited	(8,856)	46.86		
Expired	(276)	43.52		
Exercised	(226,488)	29.82		
Outstanding at June 30, 2018	1,112,382	$41.77	7.1 years	$ 25,584

13. Revenue from Contracts with Customers

The Company adopted ASU 2014-09, "Revenue from Contracts with Customers", and its related amendments on January 1, 2018. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. For the six months ended June 30, 2018, approximately 62% of the Company's total revenue was comprised of net interest income, which is not within the scope of this guidance. Of the remaining revenue, those items that were subject to this guidance mainly included fees for bank card, trust, deposit account services and consumer brokerage services.

The Company has concluded that the new guidance did not require any significant change to its revenue recognition processes. However, application of the new guidance resulted in a reclassification of certain bank card related network and rewards costs, previously classified as non-interest expense, to a reduction to non-interest income in the Company's consolidated statements of

Table of contents

income. The reclassification had no effect on prior period net income or net income per share. The Company adopted ASU 2014-09 on a full retrospective basis, in which each prior reporting period has been presented in accordance with the new guidance.

The table below shows the effect of this reclassification on bank card fee income and non-interest expense for the three and six months ended June 30, 2017.

(In thousands)	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
	As Previously Reported	Adoption of ASU 2014-09	As Adjusted	As Previously Reported	Adoption of ASU 2014-09	As Adjusted
Non-interest income:						
Bank card transaction fees	$44,999	$(7,704)	$37,295	$88,203	$(15,157)	$73,046
Total non-interest income	123,084	(7,704)	115,380	240,150	(15,157)	224,993
Non-interest expense:						
Data processing and software	$23,356	$(3,321)	$20,035	$46,453	$(6,513)	$39,940
Other	19,761	(4,383)	15,378	39,725	(8,644)	31,081
Total non-interest expense	184,594	(7,704)	176,890	371,424	(15,157)	356,267

The following table disaggregates non-interest income subject to ASU 2014-09 by major product line.

(In thousands)	Three Months Ended June 30		Six Months Ended June 30	
	2018	2017	2018	2017
Bank card transaction fees	$43,215	$37,295	$84,668	$73,046
Trust fees	37,036	33,120	73,098	65,134
Deposit account charges and other fees	23,893	22,861	46,875	44,803
Consumer brokerage services	3,971	3,726	7,739	7,375
Other non-interest income	6,852	8,570	14,163	16,167
Total non-interest income from contracts with customers	114,967	105,572	226,543	206,525
Other non-interest income [(a)]	9,883	9,808	17,997	18,468
Total non-interest income	$124,850	$115,380	$244,540	$224,993

(a) This revenue is not within the scope of ASU 2014-09, and includes fees relating to capital market activities, loan fees and sales, derivative instruments, standby letters of credit and various other transactions.

The following table presents the opening and closing receivable balances for the six month periods ended June 30, 2018 and 2017 for the Company's significant revenue categories subject to ASU 2014-09.

(In thousands)	June 30, 2018	December 31, 2017	June 30, 2017	December 31, 2016
Bank card transaction fees	$11,104	$ 13,315	$10,878	$ 14,686
Trust fees	2,893	2,802	3,227	2,681
Deposit account charges and other fees	5,773	5,597	5,471	5,735
Consumer brokerage services	924	380	345	309

For these revenue categories, none of the transaction price has been allocated to performance obligations that are unsatisfied as of the end of a reporting period.

A description of these revenue categories follows.

32

Table of contents

Bank Card Transaction Fees

The following table presents the components of bank card fee income.

	Three Months Ended June 30		Six Months Ended June 30	
(In thousands)	2018	2017	2018	2017
Debit card:				
Fee income	$10,582	$10,325	$20,344	$19,966
Expense for network charges	(375)	(1,921)	(746)	(3,571)
Net debit card fees	10,207	8,404	19,598	16,395
Credit card:				
Fee income	6,800	6,483	12,845	12,223
Expense for network charges and rewards	(3,304)	(2,923)	(6,248)	(5,669)
Net credit card fees	3,496	3,560	6,597	6,554
Corporate card:				
Fee income	49,141	43,261	97,017	85,680
Expense for network charges and rewards	(24,521)	(23,365)	(48,229)	(45,820)
Net corporate card fees	24,620	19,896	48,788	39,860
Merchant:				
Fee income	7,606	8,350	14,907	16,289
Fees to cardholder banks	(1,878)	(2,080)	(3,603)	(4,169)
Expense for network charges	(836)	(835)	(1,619)	(1,883)
Net merchant fees	4,892	5,435	9,685	10,237
Total bank card transaction fees	$43,215	$37,295	$84,668	$73,046

The majority of debit and credit card fees are reported in the Consumer segment, while corporate card and merchant fees are reported in the Commercial segment.

Debit and Credit Card Fees

The Company issues debit and credit cards to its retail and commercial banking customers who use the cards to purchase goods and services from merchants through an electronic payment system. As a card issuer, the Company earns fees, including interchange income, for processing the cardholder’s purchase transaction with a merchant through a settlement network. Purchases are charged directly to a customer’s checking account (in the case of a debit card), or are posted to a customer’s credit card account. The fees earned are established by the settlement network and are dependent on the type of transaction processed but are typically based on a per unit charge. Interchange income, the largest component of debit and credit card fees, is settled daily through the networks. The services provided to the cardholders include issuing and maintaining cards, settling purchases with merchants, and maintaining memberships in various card networks to facilitate processing. These services are considered one performance obligation as one of the services would not be performed without the others. The performance obligation is satisfied as services are rendered for each purchase transaction, and income is immediately recognized.

In order to participate in the settlement network process, the Company must pay various transaction-related costs, established by the networks, including membership fees and a per unit charge for each transaction. These expenses are recorded net of the card fees earned.

Consumer credit card products offer cardholders rewards that can be later redeemed for cash or goods or services to encourage card usage. Reward programs must meet network requirements based on the type of card issued. The expense associated with the rewards granted are recorded net of the credit card fees earned.

Commercial card products offer cash rewards to corporate cardholders to encourage card usage in facilitating corporate payments. The Company pays cash rewards based on contractually agreed upon amounts, normally as a percent of each sales transaction. The expense associated with the cash rewards program is recorded net of the corporate card fees earned.

Table of contents

Merchant Fees
The Company offers merchant processing services to its business customers to enable them to accept credit and debit card payments. Merchant processing activities include gathering merchant sales information, authorizing sales transactions and collecting the funds from card issuers using the networks. The merchant is charged a merchant discount fee for the services based on agreed upon pricing between the merchant and the Company. Merchant fees are recorded net of outgoing interchange costs paid to the card issuing banks and net of other network costs as show in the table above.

Merchant services provided are considered one performance obligation as one of the services would not be performed without the others. The performance obligation is satisfied as services are rendered for each settlement transaction and income is immediately recognized. Income earned from merchant fees settles with the customer according to terms negotiated in individual customer contracts. The majority of customers settle with the Company at least monthly.

Trust Fees
The following table shows the components of revenue within trust fees.

	Three Months Ended June 30		Six Months Ended June 30	
(In thousands)	2018	2017	2018	2017
Private client	$27,987	$24,701	$54,855	$48,463
Institutional	7,271	6,751	14,682	13,245
Other	1,778	1,668	3,561	3,426
Total trust fees	$37,036	$33,120	$73,098	$65,134

This revenue is reported in the Wealth segment.

The Company provides trust and asset management services to both private client and institutional trust customers including asset custody, investment advice, and reporting and administrative services. Other specialized services such as tax preparation, financial planning, representation and other related services are provided as needed. Trust fees are generally earned monthly and billed based on a rate multiplied by the fair value of the customer trust assets. The majority of customer trust accounts are billed monthly. However, some accounts are billed quarterly, and a small number of accounts are billed semi-annually or annually, in accordance with agreements in place with the customer. The Company accrues trust fees monthly based on an estimate of fees due and either directly charges the customer's account the following month or invoices the customer for fees due.

The Company maintains written product pricing information which is used to bill each trust customer based on the services provided. Providing trust services is considered to be a single performance obligation that is satisfied on a monthly basis, involving the monthly custody of customer assets, statement rendering, periodic investment advice where applicable, and other specialized services as needed. As such, performance obligations are considered to be satisfied at the conclusion of each month while trust fee income is also recorded monthly.

Deposit Account Charges and Other Fees
The following table shows the components of revenue within deposit account charges and other fees.

	Three Months Ended June 30		Six Months Ended June 30	
(In thousands)	2018	2017	2018	2017
Corporate cash management fees	$10,095	$9,477	$19,492	$18,388
Overdraft and return item fees	7,656	7,448	15,168	14,628
Other service charges on deposit accounts	6,142	5,936	12,215	11,787
Total deposit account charges and other fees	$23,893	$22,861	$46,875	$44,803

Approximately half of this revenue is reported in the Consumer segment, while the remainder is reported in the Commercial segment.

The Company provides corporate cash management services to its business and non-profit customers to meet their various transaction processing needs. Such services include deposit and check processing, lockbox, remote deposit, reconciliation, on-line banking and other similar transaction processing services. The Company maintains unit prices for each type of service, and the customer is billed based on transaction volumes processed monthly. The customer is usually billed either monthly or quarterly,

34

however, some customers may be billed semi-annually or annually. The customer may pay for the cash management services provided either by paying in cash or using the value of deposit balances (formula provided to the customer) held at the Company. The Company's performance obligation for corporate cash management services is the processing of items over a monthly term, and the obligations are satisfied at the conclusion of each month.

Overdraft fees are charged to customers when daily checks and other withdrawals to customers' accounts exceed balances on hand. Fees are based on a unit price multiplied by the number of items processed whose total amounts exceed the available account balance. The daily overdraft charge is calculated and the fee is posted to the customer's account each day. The Company's performance obligations for overdraft transactions is based on the daily transaction processed and the obligation is satisfied as each day's transaction processing is concluded.

Other deposit fees include numerous smaller fees such as monthly statement fees, foreign ATM processing fees, identification restoration fees, and stop payment fees. Such fees are mostly billed to customers directly on their monthly deposit account statements, or in the case of ATM fees, the fee is charged to the customer on the day that transactions are processed. Performance obligations for all of these various services are satisfied at the time that the service is rendered.

Consumer Brokerage Services

The following shows the components of revenue within consumer brokerage services.

	Three Months Ended June 30		Six Months Ended June 30	
(In thousands)	2018	2017	2018	2017
Commission income	$2,269	$2,193	$4,361	$4,423
Managed account services	1,702	1,533	3,378	2,952
Total consumer brokerage services	$3,971	$3,726	$7,739	$7,375

Nearly all of this revenue is reported in the Company's Wealth segment.

Consumer brokerage services revenue is comprised of commissions received upon the execution of purchases and sales of mutual fund shares and equity securities, in addition to sales of annuities and certain limited insurance products in an agency capacity. Also, fees are earned on professionally managed advisory programs through arrangements with sub-advisors. Payment from the customer is due upon settlement date for purchases and sales of securities, at the purchase date for annuities and insurance products, and upon inception of the service period for advisory programs.

Most of the contracts (except advisory contracts) encompass two types of performance obligations. The first is an obligation to provide account maintenance, record keeping and custodial services throughout the contract term. The second is the obligation to provide trade execution services for the customers' purchases and sales of products mentioned above. The first obligation is satisfied over time as the service period elapses, while the second type of obligation is satisfied upon the execution of each purchase/sale transaction. Contracts for advisory services contain a single performance obligation comprised of providing the management services and related reporting/administrative services over the contract term.

The transaction price of the contracts (except advisory contracts) is a commission charged at the time of trade execution. The commission varies across different security types, insurance products and mutual funds. It is generally determined by standardized price lists published by the Company and its mutual fund and insurance vendors. Because the transaction price relates specifically to the trade execution, it has been allocated to that performance obligation and is recorded at the time of execution. The fee for advisory services is charged to the customer in advance of the quarterly service period, based on the account balance at the beginning of the period. Revenue is recognized ratably over the service period.

Other Non-Interest Income from Contracts with Customers

Other non-interest income consists mainly of various customer deposit related fees such as ATM fees and gains on sales of tax credits, foreclosed assets, and bank premises and equipment. Performance obligations for these services consist mainly of the execution of transactions for sales of various properties or providing specific deposit related transactions. Fees from these revenue sources are recognized when the performance obligation is completed, at which time cash is received by the Company.

Table of contents

14. Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain financial and nonfinancial assets and liabilities and to determine fair value disclosures. Various financial instruments such as available for sale debt securities, equity securities, trading debt securities, certain investments relating to private equity activities, and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets and liabilities on a nonrecurring basis, such as mortgage servicing rights and certain other investment securities. These nonrecurring fair value adjustments typically involve lower of cost or fair value accounting or write-downs of individual assets.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Depending on the nature of the asset or liability, the Company uses various valuation techniques and assumptions when estimating fair value. For accounting disclosure purposes, a three-level valuation hierarchy of fair value measurements has been established. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 – inputs to the valuation methodology are quoted prices for identical assets or liabilities in active markets.
- Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, and inputs that are observable for the assets or liabilities, either directly or indirectly (such as interest rates, yield curves, and prepayment speeds).
- Level 3 – inputs to the valuation methodology are unobservable and significant to the fair value. These may be internally developed, using the Company’s best information and assumptions that a market participant would consider.

The valuation methodologies for assets and liabilities measured at fair value on a recurring and non-recurring basis are described in the Fair Value Measurements note in the Company's 2017 Annual Report on Form 10-K. There have been no significant changes in these methodologies since then.

Table of contents

Instruments Measured at Fair Value on a Recurring Basis

The table below presents the June 30, 2018 and December 31, 2017 carrying values of assets and liabilities measured at fair value on a recurring basis. There were no transfers among levels during the first six months of 2018 or the year ended December 31, 2017.

		Fair Value Measurements Using		
(In thousands)	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
June 30, 2018				
Assets:				
Residential mortgage loans held for sale	$ 10,750	$—	$ 10,750	$ —
Available for sale debt securities:				
U.S. government and federal agency obligations	911,092	911,092	—	—
Government-sponsored enterprise obligations	311,361	—	311,361	—
State and municipal obligations	1,379,164	—	1,364,091	15,073
Agency mortgage-backed securities	3,131,025	—	3,131,025	—
Non-agency mortgage-backed securities	1,010,331	—	1,010,331	—
Asset-backed securities	1,338,542	—	1,338,542	—
Other debt securities	330,861	—	330,861	—
Trading debt securities	31,156	—	31,156	—
Equity securities	2,741	2,741	—	—
Private equity investments	68,940	—	—	68,940
Derivatives *	6,239	—	5,488	751
Assets held in trust for deferred compensation plan	13,790	13,790	—	—
Total assets	8,545,992	927,623	7,533,605	84,764
Liabilities:				
Derivatives *	19,846	—	19,779	67
Liabilities held in trust for deferred compensation plan	13,790	13,790	—	—
Total liabilities	$ 33,636	$ 13,790	$ 19,779	$ 67
December 31, 2017				
Assets:				
Residential mortgage loans held for sale	$ 15,327	$—	$ 15,327	$ —
Available for sale debt securities:				
U.S. government and federal agency obligations	917,147	917,147	—	—
Government-sponsored enterprise obligations	406,363	—	406,363	—
State and municipal obligations	1,611,366	—	1,594,350	17,016
Agency mortgage-backed securities	3,040,913	—	3,040,913	—
Non-agency mortgage-backed securities	905,793	—	905,793	—
Asset-backed securities	1,492,800	—	1,492,800	—
Other debt securities	351,060	—	351,060	—
Trading debt securities	18,269	—	18,269	—

Equity securities	48,838	19,864	28,974	—
Private equity investments	55,752	—	—	55,752
Derivatives *	8,349	—	7,723	626
Assets held in trust for deferred compensation plan	12,843	12,843	—	—
Total assets	8,884,820	949,854	7,861,572	73,394
Liabilities:				
Derivatives *	8,074	—	7,951	123
Liabilities held in trust for deferred compensation plan	12,843	12,843	—	—
Total liabilities	$ 20,917	$ 12,843	$ 7,951	$ 123

* The fair value of each class of derivative is shown in Note 10.

37

Table of contents

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized as follows:

(In thousands)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) State and Municipal Obligations	Private Equity Investments	Derivatives	Total
For the three months ended June 30, 2018				
Balance March 31, 2018	$17,158	$ 64,951	$ 520	$82,629
Total gains or losses (realized/unrealized):				
Included in earnings	—	3,791	164	3,955
Included in other comprehensive income *	(379)	—	—	(379)
Investment securities sold	(1,715)	—	—	(1,715)
Discount accretion	9	—	—	9
Purchases of private equity investments	—	364	—	364
Sale/pay down of private equity investments	—	(166)	—	(166)
Balance June 30, 2018	$15,073	$ 68,940	$ 684	$84,697
Total gains or losses for the three months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2018	$—	$ 3,791	$ 747	$4,538
For the six months ended June 30, 2018				
Balance January 1, 2018	$17,016	$ 55,752	$ 503	$73,271
Total gains or losses (realized/unrealized):				
Included in earnings	—	8,096	329	8,425
Included in other comprehensive income *	(246)	—	—	(246)
Investment securities sold	(1,715)	—	—	(1,715)
Discount accretion	18	—	—	18
Purchases of private equity investments	—	5,243	—	5,243
Sale/pay down of private equity investments	—	(186)	—	(186)
Capitalized interest/dividends	—	35	—	35
Sale of risk participation agreement	—	—	(148)	(148)
Balance June 30, 2018	$15,073	$ 68,940	$ 684	$84,697
Total gains or losses for the six months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2018	$—	$ 8,096	$ 910	$9,006
For the three months ended June 30, 2017				
Balance March 31, 2017	$17,083	$ 52,800	$ 822	$70,705
Total gains or losses (realized/unrealized):				
Included in earnings	—	48	(31)	17
Included in other comprehensive income *	319	—	—	319
Investment securities called	(600)	—	—	(600)
Discount accretion	23	—	—	23
Purchases of private equity investments	—	2,259	—	2,259
Sale/pay down of private equity investments	—	(1,550)	—	(1,550)
Balance June 30, 2017	$16,825	$ 53,557	$ 791	$71,173
Total gains or losses for the three months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2017	$—	$ 48	$ 872	$920

For the six months ended June 30, 2017				
Balance January 1, 2017	$16,682	$ 50,820	$ 258	$67,760
Total gains or losses (realized/unrealized):				
Included in earnings	—	(2,830)	533	(2,297)
Included in other comprehensive income *	710	—	—	710
Investment securities called	(600)	—	—	(600)
Discount accretion	33	—	—	33
Purchases of private equity investments	—	7,084	—	7,084
Sale/pay down of private equity investments	—	(1,550)	—	(1,550)
Capitalized interest/dividends	—	33	—	33
Balance June 30, 2017	$16,825	$ 53,557	$ 791	$71,173
Total gains or losses for the six months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2017	$—	$ (2,655)	$ 882	$(1,773)

* Included in "net unrealized gains (losses) on other securities" in the consolidated statements of comprehensive income.

38

Gains and losses included in earnings for the Level 3 assets and liabilities in the previous table are reported in the following line items in the consolidated statements of income:

(In thousands)	Loan Fees and Sales	Other Non-Interest Income	Investment Securities Gains (Losses), Net	Total
For the three months ended June 30, 2018				
Total gains or losses included in earnings	$147	$ 17	$ 3,791	$3,955
Change in unrealized gains or losses relating to assets still held at June 30, 2018	$730	$ 17	$ 3,791	$4,538
For the six months ended June 30, 2018				
Total gains or losses included in earnings	$149	$ 180	$ 8,096	$8,425
Change in unrealized gains or losses relating to assets still held at June 30, 2018	$730	$ 180	$ 8,096	$9,006
For the three months ended June 30, 2017				
Total gains or losses included in earnings	$(32)	$ 1	$ 48	$17
Change in unrealized gains or losses relating to assets still held at June 30, 2017	$871	$ 1	$ 48	$920
For the six months ended June 30, 2017				
Total gains or losses included in earnings	$522	$ 11	$ (2,830)	$(2,297)
Change in unrealized gains or losses relating to assets still held at June 30, 2017	$871	$ 11	$ (2,655)	$(1,773)

Level 3 Inputs

The Company's significant Level 3 measurements which employ unobservable inputs that are readily quantifiable pertain to auction rate securities (ARS) held by the Bank, investments in portfolio concerns held by the Company's private equity subsidiaries, and held for sale residential mortgage loan commitments. ARS are included in state and municipal securities and totaled $15.1 million at June 30, 2018, while private equity investments, included in other securities, totaled $68.9 million.
Information about these inputs is presented in the table and discussions below.

Quantitative Information about Level 3 Fair Value Measurements

	Valuation Technique	Unobservable Input	Range		Weighted Average
Auction rate securities	Discounted cash flow	Estimated market recovery period		5 years	
		Estimated market rate	3.7%	-5.9%	
Private equity investments	Market comparable companies	EBITDA multiple	4.0	-6.0	
Mortgage loan commitments	Discounted cash flow	Probability of funding	50.5%	-98.8%	80.4%
		Embedded servicing value	.5%	-2.4%	1.3%

39

Table of contents

Instruments Measured at Fair Value on a Nonrecurring Basis

For assets measured at fair value on a nonrecurring basis during the first six months of 2018 and 2017, and still held as of June 30, 2018 and 2017, the following table provides the adjustments to fair value recognized during the respective periods, the level of valuation inputs used to determine each adjustment, and the carrying value of the related individual assets or portfolios at June 30, 2018 and 2017.

		Fair Value Measurements Using			
(In thousands)	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses) Recognized During the Six Months Ended June 30
June 30, 2018					
Collateral dependent impaired loans	$175	$ —	$ —	$ 175	$ (118)
Mortgage servicing rights	5,463	—	—	5,463	9
Foreclosed assets	47	—	—	47	(47)
Long-lived assets	914	—	—	914	(552)
June 30, 2017					
Collateral dependent impaired loans	$2,044	$ —	$ —	$ 2,044	$ (550)
Mortgage servicing rights	3,646	—	—	3,646	6
Foreclosed assets	75	—	—	75	(58)
Long-lived assets	1,834	—	—	1,834	(343)

15. Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments held by the Company are set forth below. Fair value estimates are made at a specific point in time based on relevant market information. They do not reflect any premium or discount that could result from offering for sale at one time the Company’s entire holdings of a particular financial instrument. Because no market exists for many of the Company’s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, risk characteristics and economic conditions. These estimates are subjective, involve uncertainties, and cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

As mentioned in Note 3, the Company prospectively adopted ASU 2016-01 on January 1, 2018. In accordance with its requirements, the fair value of loans as of June 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

Table of contents

The estimated fair values of the Company’s financial instruments and the classification of their fair value measurement within the valuation hierarchy are as follows at June 30, 2018 and December 31, 2017:

	Carrying Amount	Estimated Fair Value at June 30, 2018			
(In thousands)		Level 1	Level 2	Level 3	Total
Financial Assets					
Loans:					
Business	$4,990,298	$—	$—	$4,890,517	$4,890,517
Real estate - construction and land	967,151	—	—	962,276	962,276
Real estate - business	2,727,580	—	—	2,689,312	2,689,312
Real estate - personal	2,102,586	—	—	2,038,381	2,038,381
Consumer	2,012,644	—	—	1,976,911	1,976,911
Revolving home equity	374,557	—	—	367,886	367,886
Consumer credit card	775,214	—	—	720,044	720,044
Overdrafts	4,081	—	—	3,018	3,018
Total loans	13,954,111	—	—	13,648,345	13,648,345
Loans held for sale	20,352	—	20,352	—	20,352
Investment securities	8,560,285	913,833	7,517,367	129,085	8,560,285
Federal funds sold	31,500	31,500	—	—	31,500
Securities purchased under agreements to resell	700,000	—	—	680,830	680,830
Interest earning deposits with banks	114,947	114,947	—	—	114,947
Cash and due from banks	386,339	386,339	—	—	386,339
Derivative instruments	6,239	—	5,488	751	6,239
Assets held in trust for deferred compensation plan	13,790	13,790	—	—	13,790
Total	$23,787,563	$1,460,409	$7,543,207	$14,459,011	$23,462,627
Financial Liabilities					
Non-interest bearing deposits	$6,876,756	$6,876,756	$—	$—	$6,876,756
Savings, interest checking and money market deposits	11,761,832	11,761,832	—	—	11,761,832
Time open and certificates of deposit	1,682,969	—	—	1,682,894	1,682,894
Federal funds purchased	131,685	131,685	—	—	131,685
Securities sold under agreements to repurchase	1,035,074	—	—	1,035,558	1,035,558
Other borrowings	9,291	—	7,682	1,609	9,291
Derivative instruments	19,846	—	19,779	67	19,846
Liabilities held in trust for deferred compensation plan	13,790	13,790	—	—	13,790
Total	$21,531,243	$18,784,063	$27,461	$2,720,128	$21,531,652

Table of contents

(In thousands)	Carrying Amount	Estimated Fair Value at December 31, 2017 Level 1	Level 2	Level 3	Total
Financial Assets					
Loans:					
Business	$4,958,554	$—	$—	$4,971,401	$4,971,401
Real estate - construction and land	968,820	—	—	979,389	979,389
Real estate - business	2,697,452	—	—	2,702,598	2,702,598
Real estate - personal	2,062,787	—	—	2,060,443	2,060,443
Consumer	2,104,487	—	—	2,074,129	2,074,129
Revolving home equity	400,587	—	—	400,333	400,333
Consumer credit card	783,864	—	—	798,093	798,093
Overdrafts	7,123	—	—	7,123	7,123
Total loans	13,983,674	—	—	13,993,509	13,993,509
Loans held for sale	21,398	—	21,398	—	21,398
Investment securities	8,893,307	937,011	7,838,522	117,774	8,893,307
Federal funds sold	42,775	42,775	—	—	42,775
Securities purchased under agreements to resell	700,000	—	—	695,194	695,194
Interest earning deposits with banks	30,631	30,631	—	—	30,631
Cash and due from banks	438,439	438,439	—	—	438,439
Derivative instruments	8,349	—	7,723	626	8,349
Assets held in trust for deferred compensation plan	12,843	12,843	—	—	12,843
Total	$24,131,416	$1,461,699	$7,867,643	$14,807,103	$24,136,445
Financial Liabilities					
Non-interest bearing deposits	$7,158,962	$7,158,962	$—	$—	$7,158,962
Savings, interest checking and money market deposits	11,499,620	11,499,620	—	—	11,499,620
Time open and certificates of deposit	1,766,864	—	—	1,768,780	1,768,780
Federal funds purchased	202,370	202,370	—	—	202,370
Securities sold under agreements to repurchase	1,304,768	—	—	1,305,375	1,305,375
Other borrowings	1,758	—	—	1,758	1,758
Derivative instruments	8,074	—	7,951	123	8,074
Liabilities held in trust for deferred compensation plan	12,843	12,843	—	—	12,843
Total	$21,955,259	$18,873,795	$7,951	$3,076,036	$21,957,782

16. Legal and Regulatory Proceedings

The Company has various legal proceedings pending at June 30, 2018, arising in the normal course of business. While some matters pending against the Company specify damages claimed by plaintiffs, others do not seek a specified amount of damages or are at very early stages of the legal process. The Company records a loss accrual for all legal and regulatory matters for which it deems a loss is probable and can be reasonably estimated. Some matters, which are in the early stages, have not yet progressed to the point where a loss amount can be determined to be probable and estimable.

Table of contents

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

The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes and with the statistical information and financial data appearing in this report as well as the Company's 2017 Annual Report on Form 10-K. Results of operations for the three and six month periods ended June 30, 2018 are not necessarily indicative of results to be attained for any other period.

Forward-Looking Information

This report may contain "forward-looking statements" that are subject to risks and uncertainties and include information about possible or assumed future results of operations. Many possible events or factors could affect the future financial results and performance of the Company. This could cause results or performance to differ materially from those expressed in the forward-looking statements. Words such as "expects", "anticipates", "believes", "estimates", variations of such words and other similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in, or implied by, such forward-looking statements. Readers should not rely solely on the forward-looking statements and should consider all uncertainties and risks discussed throughout this report. Forward-looking statements speak only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events. Such possible events or factors include: changes in economic conditions in the Company's market area, changes in policies by regulatory agencies, governmental legislation and regulation, fluctuations in interest rates, changes in liquidity requirements, demand for loans in the Company's market area, changes in accounting and tax principles, estimates made on income taxes, competition with other entities that offer financial services, cybersecurity threats, and such other factors as discussed in Part I Item 1A - "Risk Factors" and Part II Item 7 - "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's 2017 Annual Report on Form 10-K.

Critical Accounting Policies

The Company has identified several policies as being critical because they require management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. These policies relate to the allowance for loan losses, the valuation of certain investment securities, and accounting for income taxes. A discussion of these policies can be found in the sections captioned "Critical Accounting Policies" and "Allowance for Loan Losses" in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's 2017 Annual Report on Form 10-K. There have been no changes in the Company's application of critical accounting policies since December 31, 2017.

Table of contents

Selected Financial Data

	Three Months Ended June 30		Six Months Ended June 30	
	2018	2017	2018	2017
Per Share Data				
Net income per common share — basic	$1.02	$.71 *	$1.94	$1.36 *
Net income per common share — diluted	1.01	.71 *	1.93	1.36 *
Cash dividends on common stock	.235	.214 *	.470	.429 *
Book value per common share			24.64	23.28 *
Market price			64.71	54.12 *
Selected Ratios				
(Based on average balance sheets)				
Loans to deposits (1)	68.85 %	65.25 %	68.97 %	64.82 %
Non-interest bearing deposits to total deposits	33.37	34.03	33.61	34.25
Equity to loans (1)	19.59	19.26	19.54	19.00
Equity to deposits	13.49	12.57	13.48	12.32
Equity to total assets	11.12	10.42	11.07	10.23
Return on total assets	1.80	1.26	1.73	1.21
Return on common equity	16.78	12.48	16.19	12.12
(Based on end-of-period data)				
Non-interest income to revenue (2)	37.18	38.69	37.71	38.39
Efficiency ratio (3)	54.06	59.21	56.06	60.67
Tier I common risk-based capital ratio			13.71	12.28
Tier I risk-based capital ratio			14.48	13.05
Total risk-based capital ratio			15.33	14.00
Tangible common equity to tangible assets ratio (4)			10.18	9.37
Tier I leverage ratio			11.18	9.87

* Restated for the 5% stock dividend distributed in December 2017.
(1) Includes loans held for sale.
(2) Revenue includes net interest income and non-interest income.
(3) The efficiency ratio is calculated as non-interest expense (excluding intangibles amortization) as a percent of revenue.
(4) The tangible common equity to tangible assets ratio is a measurement which management believes is a useful indicator of capital adequacy and utilization. It provides a meaningful basis for period to period and company to company comparisons, and also assists regulators, investors and analysts in analyzing the financial position of the Company. Tangible common equity and tangible assets are non-GAAP measures and should not be viewed as substitutes for, or superior to, data prepared in accordance with GAAP.

The following table is a reconciliation of the GAAP financial measures of total equity and total assets to the non-GAAP measures of total tangible common equity and total tangible assets.

	June 30	
(Dollars in thousands)	2018	2017
Total equity	$2,771,383	$2,628,207
Less non-controlling interest	3,396	4,324
Less preferred stock	144,784	144,784
Less goodwill	138,921	138,921
Less core deposit premium	2,620	3,356
Total tangible common equity (a)	$2,481,662	$2,336,822

Total assets	$24,524,742	$25,078,843
Less goodwill	138,921	138,921
Less core deposit premium	2,620	3,356
Total tangible assets (b)	$24,383,201	$24,936,566
Tangible common equity to tangible assets ratio (a)/(b)	10.18 %	9.37 %

44

Table of contents

Results of Operations

Summary

(Dollars in thousands)	Three Months Ended June 30 2018	2017	% change	Six Months Ended June 30 2018	2017	% change
Net interest income	$210,959	$182,807	15.4 %	$403,851	$361,080	11.8 %
Provision for loan losses	(10,043)	(10,758)	(6.6)	(20,439)	(21,886)	(6.6)
Non-interest income	124,850	115,380	8.2	244,540	224,993	8.7
Investment securities gains (losses), net	(3,075)	1,651	N.M.	2,335	879	N.M.
Non-interest expense	(181,860)	(176,890)	2.8	(364,137)	(356,267)	2.2
Income taxes	(29,507)	(33,201)	(11.1)	(52,765)	(58,108)	(9.2)
Non-controlling interest expense	(994)	(29)	N.M.	(2,071)	(227)	N.M.
Net income attributable to Commerce Bancshares, Inc.	110,330	78,960	39.7	211,314	150,464	40.4
Preferred stock dividends	(2,250)	(2,250)	—	(4,500)	(4,500)	—
Net income available to common shareholders	$108,080	$76,710	40.9 %	$206,814	$145,964	41.7 %

N.M. - Not meaningful.

For the quarter ended June 30, 2018, net income attributable to Commerce Bancshares, Inc. (net income) amounted to $110.3 million, an increase of $31.4 million, or 39.7%, compared to the second quarter of the previous year. For the current quarter, the annualized return on average assets was 1.80%, the annualized return on average common equity was 16.78% and the efficiency ratio was 54.06%. Diluted earnings per common share was $1.01, an increase of 42.3% compared to $.71 per share in the second quarter of 2017 and an increase of 9.8% compared to $.92 per share in the previous quarter.

Compared to the second quarter of last year, net interest income increased $28.2 million, or 15.4%, mainly due to growth of $20.0 million in interest income on loans coupled with an increase of $10.6 million in interest income on investment securities, partly offset by an increase of $3.9 million in interest expense on deposits and borrowings. The provision for loan losses totaled $10.0 million for the current quarter, representing a decrease of $715 thousand from the second quarter of 2017. Non-interest income increased $9.5 million, or 8.2%, compared to the second quarter of 2017, mainly due to combined growth of $10.9 million in trust, deposit and bank card fee income. Non-interest expense increased $5.0 million, or 2.8%, over the second quarter of 2017 primarily due to increases in salaries and employee benefits, data processing, and marketing expense. Although taxable income was higher in the second quarter of 2018 compared to the prior year, income tax expense declined due to new tax legislation lowering the corporate tax rate in 2018.

Net investment securities losses totaled $3.1 million in the current quarter compared to gains of $1.7 million in the same quarter last year. Current quarter losses were primarily comprised of an adjustment of $8.9 million to recognize dividend income on a liquidated equity security, partly offset by unrealized gains in fair value on the Company’s holdings of private equity investments. The dividend income adjustment was entirely offset this quarter by a comparable adjustment increasing interest on investment securities.

Net income for the first six months of 2018 was $211.3 million, an increase of $60.9 million, or 40.4%, over the same period last year. Diluted earnings per common share was $1.93, an increase of 41.9% compared to $1.36 per share in the same period last year. For the first six months of 2018, the annualized return on average assets was 1.73%, the annualized return on average common equity was 16.19%, and the efficiency ratio was 56.06%. Net interest income increased $42.8 million, or 11.8%, over the same period last year. This growth was largely due to increases of $38.8 million in loan interest income and $8.6 million in investment securities interest income, offset by a $7.3 million increase in interest expense on deposits and borrowings. The provision for loan losses was $20.4 million for the first six months of 2018, down $1.4 million from the same period last year. Non-interest income increased $19.5 million, or 8.7%, over the first six months of last year due to growth in bank card, trust, and deposit fees. Non-interest expense increased $7.9 million, or 2.2%, due to higher salaries and benefits expense of $10.3 million, partly offset by a $4.5 million decrease in community service expense.

45

Table of contents

Net Interest Income

The following table summarizes the changes in net interest income on a fully taxable equivalent basis, by major category of interest earning assets and interest bearing liabilities, identifying changes related to volumes and rates. Changes not solely due to volume or rate changes are allocated to rate.

Analysis of Changes in Net Interest Income

	Three Months Ended June 30, 2018 vs. 2017			Six Months Ended June 30, 2018 vs. 2017		
	Change due to			Change due to		
(In thousands)	Average Volume	Average Rate	Total	Average Volume	Average Rate	Total
Interest income, fully taxable equivalent basis:						
Loans:						
Business	$1,099	$5,909	$7,008	$1,284	$11,433	$12,717
Real estate - construction and land	1,173	1,825	2,998	2,365	3,777	6,142
Real estate - business	238	3,249	3,487	1,038	6,137	7,175
Real estate - personal	695	619	1,314	1,154	929	2,083
Consumer	273	2,294	2,567	1,209	4,159	5,368
Revolving home equity	(205)	635	430	(316)	1,223	907
Consumer credit card	674	282	956	955	1,037	1,992
Overdrafts	—	—	—	—	—	—
Total interest on loans	3,947	14,813	18,760	7,689	28,695	36,384
Loans held for sale	7	102	109	93	124	217
Investment securities:						
U.S. government and federal agency securities	78	1,519	1,597	89	1,582	1,671
Government-sponsored enterprise obligations	(381)	260	(121)	(557)	513	(44)
State and municipal obligations	(3,388)	(1,902)	(5,290)	(5,826)	(4,125)	(9,951)
Mortgage-backed securities	2,103	2,580	4,683	3,089	4,891	7,980
Asset-backed securities	(3,980)	2,077	(1,903)	(7,575)	3,835	(3,740)
Other securities	334	9,149	9,483	556	5,719	6,275
Total interest on investment securities	(5,234)	13,683	8,449	(10,224)	12,415	2,191
Federal funds sold and short-term securities purchased under agreements to resell	67	73	140	150	147	297
Long-term securities purchased under agreements to resell	190	(89)	101	52	370	422
Interest earning deposits with banks	556	672	1,228	614	1,357	1,971
Total interest income	(467)	29,254	28,787	(1,626)	43,108	41,482
Interest expense:						
Deposits:						
Savings	15	(16)	(1)	28	(30)	(2)
Interest checking and money market	43	2,135	2,178	28	3,850	3,878
Time open & C.D.'s of less than $100,000	(73)	93	20	(144)	182	38
Time open & C.D.'s of $100,000 and over	(738)	1,399	661	(1,648)	2,385	737
Total interest on deposits	(753)	3,611	2,858	(1,736)	6,387	4,651
Federal funds purchased and securities sold under agreements to repurchase	(232)	2,150	1,918	(32)	4,412	4,380
Other borrowings	(900)	1	(899)	(1,776)	1	(1,775)
Total interest expense	(1,885)	5,762	3,877	(3,544)	10,800	7,256
Net interest income, tax equivalent basis	$1,418	$23,492	$24,910	$1,918	$32,308	$34,226

Net interest income in the second quarter of 2018 was $211.0 million, an increase of $28.2 million over the second quarter of 2017. On a tax equivalent (T/E) basis, net interest income totaled $215.8 million in the second quarter of 2018, up $24.9 million over the same period last year and up $19.1 million over the previous quarter. The increase in net interest income compared to the second quarter of 2017 was mainly due to higher interest income on loans (T/E) of $18.9 million. The increase in interest on loans was a result of higher yields on all loan products, especially commercial loans, many of which have variable rates. Total interest

46

Table of contents

income on investment securities (T/E) increased $8.4 million over the second quarter of 2017, which included dividend income of $8.9 million related to a liquidated equity security which was carried at fair value. Also, inflation income on the Company's treasury inflation-protected securities (TIPS) increased $1.7 million over the same period last year. This increase was partly offset by a $1.0 billion decrease in average investment securities balances, resulting in a decline in interest income of $5.2 million. Excluding the dividend mentioned above, the Company's net yield on earning assets (T/E) was 3.50% in the current quarter compared to 3.18% in the second quarter of 2017.

Total interest income (T/E) increased $28.8 million over the second quarter of 2017. Interest income on loans (T/E) was $156.0 million during the second quarter of 2018, and increased $18.9 million, or 13.8%, over the same quarter last year. The increase was due to growth of $377.7 million, or 2.8%, in average loan balances, and an increase of 43 basis points in average rates earned. Most of the increase in interest income occurred in the business, construction and business real estate loan categories. The largest increase to interest income occurred in business loan interest, which grew $7.0 million due to a 48 basis point increase in the average rate earned, coupled with higher average balances of $134.7 million. Construction loan interest grew $3.0 million, as average balances increased $109.4 million, or 12.7%, and the average rate earned increased 76 basis points. Business real estate loan interest increased $3.5 million due to an increase of 48 basis points in the average rate earned and an increase in average balances of $25.6 million. Personal real estate loan interest increased $1.3 million due to an increase of $75.0 million in average balances, or 3.7%, and an increase of 12 basis points in the average rate earned. Interest on consumer loans increased $2.6 million over the same period last year as the average rate increased 45 basis points, coupled with a $27.8 million increase in average balances. This increase was mainly due to growth of $57.2 million in patient health care loans. During the quarter, auto loans totaling $25.9 million were sold to another financial institution, and contributed to an average decline of $6.7 million in auto loan balances, while average marine and recreational vehicle (RV) loans declined $26.1 million from the same quarter last year. In addition, interest on consumer credit card loans grew $956 thousand over the same period last year, as average balances increased $22.7 million and the average rate earned increased 15 basis points.

Interest income on investment securities (T/E) was $68.9 million during the second quarter of 2018, which was an increase of $8.4 million over the same quarter last year. The increase was mainly due to the receipt of $8.9 million in dividend income on the equity security mentioned above. In addition, interest income earned on mortgage-backed securities grew $4.7 million and resulted from an increase of $359.0 million in average balances and a 25 basis point increase in the average rate earned. Adjustments to premium amortization expense, due to slowing prepayment speeds on various mortgage-backed and asset-backed securities, increased interest income $1.5 million in the current quarter, compared to minor adjustments in the same quarter last year. Interest income related to TIPS increased $1.7 million in the second quarter of 2018 compared to the same period in 2017 and totaled $4.5 million in the current quarter and $2.9 million in the second quarter of 2017. The largest decline in interest income occurred in state and municipal obligations, which declined $5.3 million and was impacted by a decline in average balances of $376.9 million and a lower tax equivalent adjustment. Interest income on asset-backed securities declined $1.9 million due to lower average balances of $928.0 million, partly offset by an increase in the average rate earned of 60 basis points. The average balance of the total investment portfolio (excluding unrealized fair value adjustments on available for sale debt securities) was $8.7 billion in the second quarter of 2018, compared to $9.7 billion in the second quarter of 2017.

Interest income on balances at the Federal Reserve increased $1.2 million due to a 76 basis point increase in the average rate earned and a $214.5 million increase in the average balance invested.

The average tax equivalent yield on total interest earning assets was 3.90% in the second quarter of 2018, up from 3.36% in the second quarter of 2017.

Total interest expense increased $3.9 million compared to the second quarter of 2017 due to a $2.9 million increase in interest expense on interest bearing deposits and a $1.0 million increase in interest expense on borrowings. The increase in deposit expense resulted mainly from a nine basis point increase in the overall average rate paid on deposits. Interest expense on interest checking and money market accounts increased $2.2 million due to higher rates paid. Interest expense on certificates of deposit rose $681 thousand, as the effect of higher rates paid was mostly offset by lower average balances. Interest expense on borrowings increased due to higher rates paid on customer repurchase agreements, partly offset by lower average FHLB borrowings. The overall average rate incurred on all interest bearing liabilities was .40% and .29% in the second quarters of 2018 and 2017, respectively.

Net interest income (T/E) for the first six months of 2018 was $412.4 million compared to $378.2 million for the same period in 2017. For the first six months of 2018, the net interest margin was 3.51% compared to 3.16% for the first six months of 2017.

Total interest income (T/E) for the first six months of 2018 increased $41.5 million over the same period last year mainly due to higher interest income on loans. Loan interest income (T/E) rose $36.6 million due to a $384.7 million, or 2.8%, increase in total average loan balances and a 42 basis point increase in the average rate earned. Most of the increase in loan interest occurred in business, business real estate, construction and consumer loan categories. Interest income on investment securities (T/E) grew

Table of contents

$2.2 million mainly due to a 34 basis point increase in the average rate earned, partly offset by a $1.0 billion decrease in average balances. Increased earnings were recorded for equity securities due to the receipt of $8.9 million in dividend income mentioned previously, while interest earned on mortgage-backed securities grew $8.0 million on higher average rates earned and higher average balances. Interest earned on U.S government and federal agency securities rose due to higher TIPS interest of $1.8 million. These increases were partly offset by lower interest earned on state and municipal obligations of $10.0 million, which saw declines in average balances and rates earned. Also, interest income on asset-backed securities declined $3.7 million due to lower average balances, partly offset by higher rates earned.

Total interest expense for the first six months of 2018 increased $7.3 million compared to last year. Interest expense on interest bearing deposits increased $4.7 million, mainly due to an eight basis point increase in the overall rate paid. Interest expense on interest checking and money market account balances increased $3.9 million due to a seven basis point increase in the rates paid. Interest expense on certificates of deposit rose $775 thousand and as noted above, the effect of higher rates paid were largely offset by a decline in average balances. Interest expense on borrowings increased $2.6 million, mainly due to higher rates paid on customer repurchase agreements, which were partly offset by lower FHLB borrowings. The overall cost of total interest bearing liabilities increased to .38% compared to .27% in the same period last year.

Summaries of average assets and liabilities and the corresponding average rates earned/paid appear on the last page of this discussion.

Non-Interest Income

	Three Months Ended June 30			Six Months Ended June 30		
(Dollars in thousands)	2018	2017	% change	2018	2017	% change
Bank card transaction fees	$43,215	$37,295	15.9 %	$84,668	$73,046	15.9 %
Trust fees	37,036	33,120	11.8	73,098	65,134	12.2
Deposit account charges and other fees	23,893	22,861	4.5	46,875	44,803	4.6
Capital market fees	1,992	2,156	(7.6)	4,283	4,498	(4.8)
Consumer brokerage services	3,971	3,726	6.6	7,739	7,375	4.9
Loan fees and sales	3,229	4,091	(21.1)	6,091	7,259	(16.1)
Other	11,514	12,131	(5.1)	21,786	22,878	(4.8)
Total non-interest income	$124,850	$115,380	8.2 %	$244,540	$224,993	8.7 %
Non-interest income as a % of total revenue*	37.2 %	38.7 %		37.7 %	38.4 %	

* Total revenue includes net interest income and non-interest income.

For the second quarter of 2018, total non-interest income amounted to $124.9 million compared with $115.4 million in the same quarter last year, which was an increase of $9.5 million, or 8.2%. The increase was mainly due to growth in bank card, trust, deposit and swap fee income, partly offset by lower loan fees and sales.

Bank card transaction fees for the current quarter increased $5.9 million, or 15.9%, over the same quarter last year and were comprised of fees on corporate card ($24.6 million), debit card ($10.2 million), merchant ($4.9 million) and credit card ($3.5 million) transactions. Corporate card fees grew $4.7 million over the same period last year due to growth in interchange income of 14.2%, coupled with lower network costs, but higher rewards costs. Debit card fees grew $1.8 million mostly because of lower network processing costs, which declined $1.5 million. Overall merchant income was down 10.0% compared to the same period last year due to lower merchant fees, while credit card fees declined 1.8% on higher rewards expense, partly offset by higher interchange income and lower network costs.

Trust fees for the quarter increased $3.9 million, or 11.8%, over the same quarter last year, resulting mainly from growth in private client trust fees, which were up $3.3 million, or 13.3%, and institutional trust fees, which were up $520 thousand, or 7.7%. Deposit account fees increased $1.0 million, or 4.5%, over the same quarter last year, as corporate cash management fees increased $618 thousand, or 6.5%, overdraft and return item fees increased $208 thousand, or 2.8%, and deposit account service charges increased $206 thousand, or 3.5%. Consumer brokerage fees grew $245 thousand, or 6.6%, on higher fixed annuity and advisory fees, while capital market fees declined $164 thousand. Loan fees and sales decreased $862 thousand, or 21.1%, this quarter mainly due to lower mortgage banking revenue related to the Company's fixed rate residential mortgage sale program. Other non-interest income decreased $617 thousand compared to the same quarter of last year, mainly due to lower gains on sales of leased assets to customers upon lease termination, write downs on software costs, and lower gains on sales of branch properties. These decreases were partly offset by higher fees from sales of interest rate swaps and tax credits.

Non-interest income for the first six month of 2018 was $244.5 million compared to $225.0 million in the first six months of

48

Table of contents

2017, resulting in an increase of $19.5 million, or 8.7%. Bank card fees increased $11.6 million, or 15.9%, as a result of growth in corporate card fees of $8.9 million, or 22.4%, and debit card fees of $3.2 million, or 19.5%, partly offset by a decline of $552 thousand, or 5.4%, in merchant fees. Trust fee income increased $8.0 million, or 12.2%, as a result of growth in private client and institutional trust fees. Deposit account fees increased $2.1 million, or 4.6%, mainly due to growth of $1.1 million in corporate cash management fees, $540 thousand in overdraft and return item fees and $428 thousand in deposit account service charges. Loan fees and sales decreased $1.2 million, or 16.1%, due to lower mortgage banking revenue. Consumer brokerage fees rose $364 thousand due to higher annuity and advisory fee income, while capital market fees decreased $215 thousand, or 4.8%. Other non-interest income decreased $1.1 million, or 4.8%, mainly due to lower gains on sales of branch properties, lower gains on sales of leased assets, and software write downs. These declines were partly offset by higher fees from interest rate swap sales and cash sweep commissions.

Investment Securities Gains (Losses), Net

	Three Months Ended June 30		Six Months Ended June 30	
(In thousands)	2018	2017	2018	2017
Net gains (losses) on sales and fair value adjustments of private equity investments	$3,791	$(604)	$8,096	$(3,424)
Adjustment for dividend income on a liquidated equity investment	(8,917)	—	(8,917)	—
Donations of equity securities	—	2,158	—	4,315
Fair value adjustments on equity securities	1,752	—	2,699	—
Other	299	97	457	(12)
Total investment securities gains (losses), net	$(3,075)	$1,651	$2,335	$879

Net gains and losses on investment securities which were recognized in earnings during the three and six months ended June 30, 2018 and 2017 are shown in the table above. Net securities losses of $3.1 million were reported in the second quarter of 2018, compared to net gains of $1.7 million in the same period last year. The net losses in the second quarter of 2018 were mainly comprised of an adjustment to recognize dividend income on a liquidated equity security, partly offset by unrealized gains in fair value on the Company's holdings of private equity investments. The net gains for the same quarter last year resulted from a gain recorded on the donation of appreciated equity securities to a charitable foundation, offset by losses on the disposition of certain private equity securities.

Included in gains and losses are credit-related impairment losses on certain non-agency guaranteed mortgage-backed securities which have been identified as other-than-temporarily impaired. Impairment losses on these securities totaled $68 thousand in the first six months of 2018, compared to $320 thousand in the same period last year. Private equity investment activity generated net gains of $8.1 million in the first six months of 2018 compared to net losses of $3.4 million in the same period in 2017. These included fair value adjustments, in addition to gains and losses realized upon disposition. The portion of private equity activity attributable to minority interests is reported as non-controlling interest in the consolidated statements of income, and resulted in expense of $1.6 million during the first six months of 2018 and income of $654 thousand during the first six months of 2017.

Non-Interest Expense

	Three Months Ended June 30			Six Months Ended June 30		
(Dollars in thousands)	2018	2017	% change	2018	2017	% change
Salaries and employee benefits	$115,589	$108,829	6.2 %	$231,483	$221,198	4.6 %
Net occupancy	11,118	11,430	(2.7)	22,702	22,873	(.7)
Equipment	4,594	4,776	(3.8)	9,025	9,385	(3.8)

Supplies and communication	5,126	5,446	(5.9)	10,439	11,155	(6.4)
Data processing and software	21,016	20,035	4.9	41,706	39,940	4.4
Marketing	5,142	4,488	14.6	9,947	7,712	29.0
Deposit insurance	3,126	3,592	(13.0)	6,583	7,063	(6.8)
Community service	656	2,916	(77.5)	1,385	5,860	(76.4)
Other	15,493	15,378	.7	30,867	31,081	(.7)
Total non-interest expense	$181,860	$176,890	2.8 %	$364,137	$356,267	2.2 %

Non-interest expense for the second quarter of 2018 amounted to $181.9 million, an increase of $5.0 million, or 2.8%, compared with $176.9 million in the second quarter of last year. The increase in expense over the same period last year was mainly due to

49

Table of contents

higher costs for salaries, employee benefits, data processing and marketing, partly offset by lower occupancy, supplies and communication, community service, and deposit insurance expense. Salaries expense increased $5.8 million, or 6.2%, mainly due to higher full-time salary costs and incentive compensation. Employee benefits expense totaled $16.8 million, reflecting growth of $1.0 million, or 6.4%, as a result higher medical costs. Full-time equivalent employees totaled 4,797 at June 30, 2018 compared to 4,805 at June 30, 2017. Occupancy costs decreased $312 thousand, or 2.7%, partly due to lower repair and maintenance costs, while equipment expense declined $182 thousand, or 3.8%, due to lower depreciation expense. Supplies and communication expense declined $320 thousand, or 5.9%, mainly due to lower data network expense. Data processing expense increased $981 thousand, or 4.9%, mainly due to higher processing and software costs, while marketing expense increased $654 thousand partly due to new bank card initiatives which are being funded by reduced bank card network costs. Deposit insurance expense decreased $466 thousand, or 13.0%, from the second quarter of last year due to decreases in average assets and the assessment rate. Community service expense declined $2.3 million due to the donation of $2.3 million in appreciated securities to a charitable foundation in the previous year.

For the first six months of 2018, non-interest expense amounted to $364.1 million, an increase of $7.9 million, or 2.2%, compared with $356.3 million in the same period last year. Salaries and benefits increased $10.3 million, or 4.6%, mainly due to higher full-time salaries, incentives and medical expense. Equipment expense declined $360 thousand, or 3.8%, while supplies and communication expense was down $716 thousand, or 6.4%, both due to the trends mentioned above. Data processing and software expense increased $1.8 million, or 4.4%, mostly due to higher processing costs. Marketing expense increased $2.2 million, or 29.0%, mainly due to new bank card initiatives in 2018 and lower spending in the first quarter of 2017. Community service expense decreased due to the donation of $4.5 million in appreciated securities in the previous year, while deposit insurance expense decreased $480 thousand, or 6.8%. Other non-interest expense decreased $214 thousand mainly due to lower operating and bank card fraud losses in addition to lower professional fees, partly offset by higher directors fees and employee education expense.

Provision and Allowance for Loan Losses

	Three Months Ended			Six Months Ended June 30	
(In thousands)	June 30, 2018	Mar. 31, 2018	June 30, 2017	2018	2017
Provision for loan losses	$10,043	$10,396	$10,758	$20,439	$21,886
Net loan charge-offs (recoveries):					
Commercial:					
Business	36	(14)	318	22	415
Real estate-construction and land	(297)	(36)	(207)	(333)	(742)
Real estate-business	(40)	(205)	(10)	(245)	(49)
Commercial net loan charge-offs (recoveries)	(301)	(255)	101	(556)	(376)
Personal Banking:					
Real estate-personal	(95)	57	(131)	(38)	(112)
Consumer	1,862	2,528	2,642	4,390	4,738
Revolving home equity	—	56	104	56	111
Consumer credit card	8,251	7,566	7,750	15,817	14,898
Overdrafts	326	444	292	770	727
Personal banking net loan charge-offs	10,344	10,651	10,657	20,995	20,362
Total net loan charge-offs	$10,043	$10,396	$10,758	$20,439	$19,986

50

Table of contents

	Three Months Ended			Six Months Ended June 30	
	June 30, 2018	Mar. 31, 2018	June 30, 2017	2018	2017
Annualized net loan charge-offs (recoveries)*:					
Commercial:					
Business	— %	— %	.03 %	— %	.02 %
Real estate-construction and land	(.12)	(.02)	(.10)	(.07)	(.18)
Real estate-business	(.01)	(.03)	—	(.02)	—
Commercial net loan charge-offs (recoveries)	(.01)	(.01)	—	(.01)	(.01)
Personal Banking:					
Real estate-personal	(.02)	.01	(.03)	—	(.01)
Consumer	.37	.49	.53	.43	.48
Revolving home equity	—	.06	.10	.03	.06
Consumer credit card	4.39	4.05	4.25	4.22	4.06
Overdrafts	29.08	38.91	26.00	34.04	33.73
Personal banking net loan charge-offs	.79	.82	.83	.80	.80
Total annualized net loan charge-offs	.29 %	.30 %	.32 %	.30 %	.30 %

* as a percentage of average loans (excluding loans held for sale)

The Company has an established process to determine the amount of the allowance for loan losses, which assesses the risks and losses inherent in its portfolio. This process provides an allowance consisting of a specific allowance component based on certain individually evaluated loans and a general component based on estimates of allowances for pools of loans. The Company's policies and processes for determining the allowance for loan losses are discussed in Note 1 to the consolidated financial statements and in the Allowance for Loan Losses discussion in Item 7 of the 2017 Annual Report on Form 10-K.

Net loan charge-offs in the second quarter of 2018 amounted to $10.0 million, compared with $10.4 million in the prior quarter and $10.8 million in the second quarter of last year. During the second quarter of 2018, the Company recorded net recoveries on construction loans of $297 thousand, compared to net recoveries of $36 thousand in the prior quarter. Additionally, net loan charge-offs on consumer loans declined $666 thousand in the second quarter of 2018 compared to the prior quarter, and the Company also recorded lower net charge-offs on personal real estate, overdraft, and revolving home equity loans. These decreases in net loan charge-offs were partially offset by $685 thousand of higher net charge-offs on consumer credit card loans in the second quarter of 2018 compared to the prior quarter, as well as higher net charge-offs on business real-estate loans.

For the three months ended June 30, 2018, annualized net charge-offs on average consumer credit card loans totaled 4.39%, compared to 4.05% in the previous quarter and 4.25% in the same period last year. Consumer loan annualized net charge-offs in the current quarter amounted to .37%, compared to .49% in the prior quarter and .53% in the same period last year. Annualized net charge-offs on personal real estate loans also remained low this quarter. In the second quarter of 2018, total annualized net loan charge-offs were .29%, compared to .30% in the previous quarter and .32% in the same period last year.

In the current quarter, the provision for loan losses totaled $10.0 million, a decrease of $353 thousand from $10.4 million in the prior quarter. The provision for loan losses in both the current and prior quarters matched net loan charge-offs. During the second quarter of 2017, the provision for loan losses totaled $10.8 million and matched net loan charge-offs for the period.

For the six months ended June 30, 2018, net loan charge-offs amounted to $20.4 million, compared to $20.0 million in the same period last year. During the first six months of 2018, the Company recorded net recoveries of $556 thousand on commercial loans, compared to net recoveries of $376 thousand in the first six months of 2017. Additionally, consumer loan net charge-offs declined $348 thousand in the first six months of 2018 compared to the first six months of the prior year, but the decrease was offset by $919 thousand of higher net charge-offs on consumer credit card loans. The provision expense for the first six months of 2018 was $20.4 million and matched net loan charge-offs. The provision expense for the first six months of 2017 was $21.9 million and exceeded net loan charge-offs for the period by $1.9 million.

At June 30, 2018, the allowance for loan losses amounted to $159.5 million, unchanged from December 31, 2017, and was 1.14% of total loans. The Company considers the allowance for loan losses adequate to cover losses inherent in the loan portfolio at June 30, 2018.

Table of contents

Risk Elements of Loan Portfolio

The following table presents non-performing assets and loans which are past due 90 days and still accruing interest. Non-performing assets include non-accruing loans and foreclosed real estate. Loans are placed on non-accrual status when management does not expect to collect payments consistent with acceptable and agreed upon terms of repayment. Loans that are 90 days past due as to principal and/or interest payments are generally placed on non-accrual, unless they are both well-secured and in the process of collection, or they are personal banking loans that are exempt under regulatory rules from being classified as non-accrual.

(Dollars in thousands)	June 30, 2018	December 31, 2017
Non-accrual loans	$9,472	$ 11,983
Foreclosed real estate	1,039	681
Total non-performing assets	$10,511	$ 12,664
Non-performing assets as a percentage of total loans	.08 %	.09 %
Non-performing assets as a percentage of total assets	.04 %	.05 %
Total loans past due 90 days and still accruing interest	$13,453	$ 18,127

Non-accrual loans, which are also classified as impaired, totaled $9.5 million at June 30, 2018, and decreased $2.5 million from balances at December 31, 2017. The decrease occurred mainly in consumer and business loans, which decreased $834 thousand and $833 thousand, respectively. At June 30, 2018, non-accrual loans were comprised mainly of business (54.0%), business real estate (26.0%), and personal real estate (19.9%) loans. Foreclosed real estate totaled $1.0 million at June 30, 2018, an increase of $358 thousand when compared to December 31, 2017. Total loans past due 90 days or more and still accruing interest were $13.5 million as of June 30, 2018, a decrease of $4.7 million when compared to December 31, 2017. Balances by class for non-accrual loans and loans past due 90 days and still accruing interest are shown in the "Delinquent and non-accrual loans" section in Note 2 to the consolidated financial statements.

In addition to the non-performing and past due loans mentioned above, the Company also has identified loans for which management has concerns about the ability of the borrowers to meet existing repayment terms. They are classified as substandard under the Company's internal rating system. The loans are generally secured by either real estate or other borrower assets, reducing the potential for loss should they become non-performing. Although these loans are generally identified as potential problem loans, they may never become non-performing. Such loans totaled $202.4 million at June 30, 2018 compared with $213.4 million at December 31, 2017, resulting in a decrease of $11.0 million, or 5.1%.

(In thousands)	June 30, 2018	December 31, 2017
Potential problem loans:		
Business	$154,797	$ 153,417
Real estate – construction and land	2,153	2,702
Real estate – business	43,180	51,134
Real estate – personal	2,280	6,121
Total potential problem loans	$202,410	$ 213,374

At June 30, 2018, the Company had $106.6 million of loans whose terms have been modified or restructured under a troubled debt restructuring. These loans have been extended to borrowers who are experiencing financial difficulty and who have been granted a concession, as defined by accounting guidance, and are further discussed in the "Troubled debt restructurings" section in Note 2 to the consolidated financial statements. This balance includes certain commercial loans totaling $86.9 million which are classified as substandard and included in the table above because of this classification.

Loans with Special Risk Characteristics
Management relies primarily on an internal risk rating system, in addition to delinquency status, to assess risk in the loan portfolio, and these statistics are presented in Note 2 to the consolidated financial statements. However, certain types of loans are considered at high risk of loss due to their terms, location, or special conditions. Additional information about the major types of loans in these categories and their risk features are provided below. Information based on loan-to-value (LTV) ratios was generally calculated with valuations at loan origination date. The Company normally obtains an updated appraisal or valuation at the time a loan is renewed or modified, or if the loan becomes significantly delinquent or is in the process of being foreclosed upon.

Table of contents

Real Estate – Construction and Land Loans

The Company's portfolio of construction and land loans, as shown in the table below, amounted to 6.9% of total loans outstanding at June 30, 2018. The largest component of construction and land loans was commercial construction, which decreased $2.2 million during the six months ended June 30, 2018. At June 30, 2018, multi-family residential construction loans totaled approximately $226.2 million, or 31.6% of the commercial construction loan portfolio, compared to $252.8 million, or 35.2%, at December 31, 2017.

(Dollars in thousands)	June 30, 2018	% of Total	% of Total Loans	December 31, 2017	% of Total	% of Total Loans
Residential land and land development	$78,899	8.2 %	.6 %	$ 81,859	8.5 %	.6 %
Residential construction	124,394	12.9	.9	121,138	12.5	.9
Commercial land and land development	48,756	5.0	.3	48,474	5.0	.3
Commercial construction	715,102	73.9	5.1	717,349	74.0	5.1
Total real estate - construction and land loans	$967,151	100.0 %	6.9 %	$ 968,820	100.0 %	6.9 %

Real Estate – Business Loans

Total business real estate loans were $2.7 billion at June 30, 2018 and comprised 19.5% of the Company's total loan portfolio. These loans include properties such as manufacturing and warehouse buildings, small office and medical buildings, churches, hotels and motels, shopping centers, and other commercial properties. At June 30, 2018, 37.6% of business real estate loans were for owner-occupied real estate properties, which present lower risk profiles.

(Dollars in thousands)	June 30, 2018	% of Total	% of Total Loans	December 31, 2017	% of Total	% of Total Loans
Owner-occupied	$1,024,291	37.6 %	7.3 %	$ 1,010,786	37.5 %	7.2 %
Multi-family	356,044	13.1	2.6	298,605	11.1	2.1
Office	354,704	13.0	2.5	373,301	13.8	2.7
Retail	298,277	10.9	2.0	338,937	12.6	2.4
Hotels	202,488	7.4	1.5	181,704	6.7	1.3
Farm	163,273	6.0	1.2	161,972	6.0	1.2
Industrial	69,056	2.5	.5	73,078	2.7	.5
Other	259,447	9.5	1.9	259,069	9.6	1.9
Total real estate - business loans	$2,727,580	100.0 %	19.5 %	$ 2,697,452	100.0 %	19.3 %

Real Estate – Personal Loans

The Company's $2.1 billion personal real estate loan portfolio is composed mainly of residential first mortgage real estate loans. As shown on page 51, recent loss rates have remained low. At June 30, 2018, loans past due over 30 days decreased $1.2 million, and non-accrual loans decreased $573 thousand compared to December 31, 2017. Also, as shown in Note 2, only 3.1% of this portfolio has FICO scores of less than 660. Approximately $30.8 million, or 1.5%, of personal real estate loans were structured with interest only payments. These loans are typically made to high net-worth borrowers and generally have low LTV ratios at origination or have additional collateral pledged to secure the loan. Therefore, they are not perceived to represent above normal credit risk. Loans originated with interest only payments were not made to "qualify" the borrower for a lower payment amount. At June 30, 2018, loans with no mortgage insurance and an original LTV higher than 80% totaled $182.9 million compared to $183.6 million at December 31, 2017.

Revolving Home Equity Loans

The Company had $374.6 million in revolving home equity loans at June 30, 2018 that were generally collateralized by residential real estate. Most of these loans (92.2%) are written with terms requiring interest only monthly payments. These loans are offered in three main product lines: LTV up to 80%, 80% to 90%, and 90% to 100%. As of June 30, 2018, the outstanding principal of loans with an original LTV higher than 80% was $46.3 million, or 12.4% of the portfolio, compared to $51.3 million as of December 31, 2017. Total revolving home equity loan balances over 30 days past due or on non-accrual status were $1.7 million at June 30, 2018 compared to $3.2 million at December 31, 2017. The weighted average FICO score for the total current portfolio balance is 794. At maturity, the accounts are re-underwritten, and if they qualify under the Company's credit, collateral and capacity policies, the borrower is given the option to renew the line of credit or convert the outstanding balance to an amortizing loan. If criteria are not met, amortization is required, or the borrower may pay off the loan. During the remainder of 2018 through 2020, approximately 10% of the Company's current outstanding balances are expected to mature. Of these balances, approximately

Table of contents

94% have a FICO score of 700 or higher. The Company does not expect a significant increase in losses as these loans mature, due to their high FICO scores, low LTVs, and low historical loss levels.

Other Consumer Loans
Within the consumer loan portfolio are several direct and indirect product lines, which include loans for the purchase of automobiles, motorcycles, marine and RVs. Outstanding balances for auto loans were $952.1 million and $1.0 billion at June 30, 2018 and December 31, 2017, respectively. The balances over 30 days past due amounted to $13.1 million at June 30, 2018 compared to $18.4 million at the end of 2017, and comprised 1.4% and 1.8% of the outstanding balances of these loans at June 30, 2018 and December 31, 2017, respectively. For the six months ended June 30, 2018, $199.1 million of new auto loans were originated, compared to $239.7 million during the first six months of 2017. At June 30, 2018, the automobile loan portfolio had a weighted average FICO score of 756.

Outstanding balances for motorcycle loans were $110.3 million at June 30, 2018, compared to $129.5 million at December 31, 2017. The balances over 30 days past due amounted to $1.6 million and $2.5 million at June 30, 2018 and December 31, 2017, respectively, and comprised 1.5% of the outstanding balance of these loans at June 30, 2018, compared to 1.9% at December 31, 2017. During the first six months of 2018, new motorcycle loan originations totaled $10.0 million compared to $55.3 million during the full year of 2017.

The Company's balance of marine and RV loans totaled $60.9 million at June 30, 2018, compared to $71.8 million at December 31, 2017, and the balances over 30 days past due amounted to $2.6 million at both June 30, 2018 and December 31, 2017. The net charge-offs on marine and RV loans decreased from $741 thousand in the first six months of 2017 to $198 thousand in the first six months of the current year.

Additionally, the Company offers low promotional rates on selected consumer credit card products. Out of a portfolio at June 30, 2018 of $775.2 million in consumer credit card loans outstanding, approximately $177.1 million, or 23%, carried a low promotional rate. Within the next six months, $57.4 million of these loans are scheduled to convert to the ongoing higher contractual rate. To mitigate some of the risk involved with this credit card product, the Company performs credit checks and detailed analysis of the customer borrowing profile before approving the loan application. Management believes that the risks in the consumer loan portfolio are reasonable and the anticipated loss ratios are within acceptable parameters.

Energy Lending
The Company's energy lending portfolio is comprised of lending to the petroleum and natural gas sectors and totaled $134.3 million at June 30, 2018, as shown in the table below.

(In thousands)	June 30, 2018	December 31, 2017	Unfunded commitments at June 30, 2018
Extraction	$97,049	$ 86,040	$ 47,442
Mid-stream shipping and storage	4,796	9,310	50,700
Downstream distribution and refining	19,415	25,329	20,976
Support activities	13,021	13,811	13,953
Total energy lending portfolio	$134,281	$ 134,490	$ 133,071

Shared National Credits
The Company participates in credits of large, publicly traded companies which are defined by regulation as shared national credits, or SNCs. Regulations define SNCs as loans exceeding $100 million that are shared by three or more financial institutions. The Company typically participates in these loans when business operations are maintained in

the local communities or regional markets and opportunities to provide other banking services are present. The balance of SNC loans totaled $870.3 million at June 30, 2018, compared to $1.1 billion at December 31, 2017. Additional unfunded commitments at June 30, 2018 totaled $1.1 billion.

Income Taxes

Income tax expense was $29.5 million in the second quarter of 2018, compared to $23.3 million in the first quarter of 2018 and $33.2 million in the second quarter of 2017. The Company's effective tax rate, including the effect of non-controlling interest, was 21.1% in the second quarter of 2018, compared to 18.7% in the first quarter of 2018 and 29.6% in the second quarter of 2017. For the six months ended June 30, 2018, income tax expense was $52.8 million, compared to $58.1 million in the first six months ended June 30 2017. The Company's effective tax rate, including the effect of non-controlling interest, was 20.0% in the first six months of 2018, compared to 27.9% in the first six months of the prior year. Beginning in 2018, new tax reform legislation lowered the federal tax rate from 35% to 21%, which resulted in the lower effective tax rate in the first and second quarters of 2018. The effective tax rate in the first quarter is also typically lower than in other quarters due to the recognition of share-based excess tax benefits as a reduction to income tax expense. These benefits result from transactions relating to equity award vesting, most of which occur in the first quarter of each year.

Financial Condition

Balance Sheet

Total assets of the Company were $24.5 billion at June 30, 2018 and $24.8 billion at December 31, 2017. Earning assets (excluding the allowance for loan losses and fair value adjustments on debt securities) amounted to $23.5 billion at June 30, 2018 and $23.7 billion at December 31, 2017, and consisted of 59% in loans and 37% in investment securities.

At June 30, 2018, total loans decreased $30.6 million, or .2%, compared with balances at December 31, 2017. This decrease was mainly due to decline in consumer loans, which decreased $91.8 million. Consumer loans, which includes automobile, marine and RV, fixed rate home equity, and other consumer loans, decreased largely because of declines in automobile lending activity. Lower demand for auto loans, coupled with the sale of $25.9 million of loans to another financial institution in the second quarter of 2018, decreased auto loan balances $57.7 million at June 30, 2018 compared to balances at December 31, 2017. Marine and RV loans continued to run off during the period, decreasing $11.0 million, and lower demand for fixed home equity loans decreased balances $15.5 million. However, patient health care loans increased $16.9 million. Business loans increased $31.7 million during the first six months of the year, primarily due to higher commercial and industrial lending activity, partly offset by lower tax-free lending. Business real estate loans grew by $30.1 million over year end balances due to growth in multi-family residential projects, while personal real estate loan balances increased $39.8 million during the first six months of 2018. The Company sold $87.7 million of longer-term fixed rate loans during the first six months of both 2018 and 2017. Consumer credit card loans and revolving home equity loans declined $8.7 million and $26.0 million, respectively.

Available for sale investment securities, excluding fair value adjustments, decreased $188.7 million at June 30, 2018 compared to December 31, 2017. Purchases of securities during this period totaled $787.9 million, offset by sales, maturities, and pay downs of $964.8 million. The largest decreases in outstanding balances occurred in asset-backed securities, state and municipal obligations, and government-sponsored enterprise obligations, which decreased $143.9 million, $213.9 million, and $91.3 million, respectively. These decreases were partially offset by increases in agency mortgage-backed and non-agency mortgage-backed securities of $148.1 million and $115.6 million, respectively. At June 30, 2018, the duration of the investment portfolio was 3.2 years, and maturities and pay downs of approximately $1.2 billion are expected to occur during the next 12 months.

Equity securities decreased $46.1 million at June 30, 2018 compared to December 31, 2017. The decline in equity securities during the first six months of 2018 was due to a third party merger transaction in June 2018, in which the majority of these securities were redeemed for cash of $39.9 million.

Total deposits at June 30, 2018 amounted to $20.3 billion and decreased $103.9 million compared to December 31, 2017. The decrease in deposits resulted mainly from a decline in business demand (decrease of $262.8 million), but was partly offset by growth in savings, interest checking, and money market accounts (increase of $262.2 million). The Company’s borrowings totaled $1.2 billion at June 30, 2018, a decline of $332.8 million from balances at December 31, 2017, mainly due to fewer customer repurchase agreements.

Table of contents

Liquidity and Capital Resources

Liquidity Management

The Company’s most liquid assets are comprised of available for sale debt securities, federal funds sold, securities purchased under agreements to resell (resale agreements), and balances at the Federal Reserve Bank, as follows:

(In thousands)	June 30, 2018	March 31, 2018	December 31, 2017
Liquid assets:			
Available for sale debt securities	$8,412,376	$8,432,180	$ 8,725,442
Federal funds sold	31,500	17,000	42,775
Long-term securities purchased under agreements to resell	700,000	700,000	700,000
Balances at the Federal Reserve Bank	114,947	134,697	30,631
Total	$9,258,823	$9,283,877	$ 9,498,848

Federal funds sold, which are funds lent to the Company's correspondent bank customers with overnight maturities, totaled $31.5 million as of June 30, 2018. Long-term resale agreements, maturing through 2021, totaled $700.0 million at June 30, 2018. Under these agreements, the Company lends funds to upstream financial institutions and holds marketable securities, safe-kept by a third-party custodian, as collateral. This collateral totaled $713.1 million in fair value at June 30, 2018. Interest earning balances at the Federal Reserve Bank, which have overnight maturities and are used for general liquidity purposes, totaled $114.9 million at June 30, 2018. The fair value of the available for sale debt portfolio was $8.4 billion at June 30, 2018 and included an unrealized net loss in fair value of $114.4 million. The total net unrealized loss included net losses of $85.9 million on mortgage-backed and asset-backed securities, $14.2 million on U.S. government and federal agency obligations, $5.6 million on government-sponsored enterprise obligations, and $9.1 million on other debt securities.

Approximately $1.2 billion of the available for sale debt portfolio is expected to mature or pay down during the next 12 months, and these funds offer substantial resources to meet new loan demand or help offset reductions in the Company's deposit funding base. The Company pledges portions of its investment securities portfolio to secure public fund deposits, securities sold under agreements to repurchase, trust funds, letters of credit issued by the FHLB, and borrowing capacity at the Federal Reserve Bank. Total investment securities pledged for these purposes were as follows:

(In thousands)	June 30, 2018	March 31, 2018	December 31, 2017
Investment securities pledged for the purpose of securing:			
Federal Reserve Bank borrowings	$75,583	$81,419	$ 84,946
FHLB borrowings and letters of credit	11,360	12,247	13,332
Securities sold under agreements to repurchase *	1,623,193	1,719,583	2,001,401
Other deposits and swaps	2,043,502	1,856,778	1,679,024
Total pledged securities	3,753,638	3,670,027	3,778,703
Unpledged and available for pledging	3,249,559	3,332,768	3,346,826
Ineligible for pledging	1,409,179	1,429,385	1,599,913
Total available for sale debt securities, at fair value	$8,412,376	$8,432,180	$ 8,725,442

* Includes securities pledged for collateral swaps, as discussed in Note 11 to the consolidated financial statements.

Liquidity is also available from the Company's large base of core customer deposits, defined as non-interest bearing, interest checking, savings, and money market deposit accounts. At June 30, 2018, such deposits totaled $18.6 billion and represented 91.7% of total deposits. These core deposits are normally less volatile, as they are often with customer relationships tied to other products offered by the Company, promoting long lasting relationships and stable funding sources. Time open and certificates of deposit of $100,000 and over totaled $1.1 billion at June 30, 2018. These accounts are normally considered more volatile and higher costing and comprised 5.3% of total deposits at June 30, 2018.

(In thousands)	June 30, 2018	March 31, 2018	December 31, 2017
Core deposit base:			
Non-interest bearing	$6,876,756	$6,953,430	$7,158,962
Interest checking	1,592,848	1,447,556	1,533,904
Savings and money market	10,168,984	10,380,582	9,965,716
Total	$18,638,588	$18,781,568	$18,658,582

Table of contents

Other important components of liquidity are the level of borrowings from third party sources and the availability of future credit. The Company's outside borrowings are mainly comprised of federal funds purchased, securities sold under agreements to repurchase, and advances from the FHLB, as follows:

(In thousands)	June 30, 2018	March 31, 2018	December 31, 2017
Borrowings:			
Federal funds purchased	$131,685	$104,940	$ 202,370
Securities sold under agreements to repurchase	1,035,074	1,027,389	1,304,768
FHLB advances	—	—	—
Other debt	9,291	9,214	1,758
Total	$1,176,050	$1,141,543	$ 1,508,896

Federal funds purchased are unsecured overnight borrowings obtained mainly from upstream correspondent banks with which the Company maintains approved lines of credit. Securities sold under agreements to repurchase are secured by a portion of the Company's investment portfolio and are comprised of non-insured customer funds totaling $1.2 billion, which generally mature overnight.

The Company pledges certain assets, including loans and investment securities, to both the Federal Reserve Bank and the FHLB as security to establish lines of credit and borrow from these entities. Based on the amount and type of collateral pledged, the FHLB establishes a collateral value from which the Company may draw advances against the collateral. Also, this collateral is used to enable the FHLB to issue letters of credit in favor of public fund depositors of the Company. The Federal Reserve Bank also establishes a collateral value of assets pledged to support borrowings from the discount window. The following table reflects the collateral value of assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to the Company at June 30, 2018.

(In thousands)	June 30, 2018 FHLB	Federal Reserve	Total
Collateral value pledged	$2,454,301	$1,318,514	$3,772,815
Advances outstanding	—	—	—
Letters of credit issued	(215,423)	—	(215,423)
Available for future advances	$2,238,878	$1,318,514	$3,557,392

In addition to those mentioned above, several other sources of liquidity are available. No commercial paper has been issued or outstanding during the past ten years. The Company has no subordinated debt or hybrid instruments which could affect future borrowing capacity. Because of its lack of significant long-term debt, the Company believes that it could generate additional liquidity through its Capital Markets Group from sources such as jumbo certificates of deposit or privately placed corporate debt. The Company receives strong outside rankings from both Standard & Poor's and Moody's on both the consolidated company level and its subsidiary bank, Commerce Bank, which would support future financing efforts, should the need arise. These ratings are as follows:

	Standard & Poor’s	Moody’s
Commerce Bancshares, Inc.		
Issuer rating	A-	
Rating outlook	Stable	Stable
Preferred stock	BBB-	Baa1
Commerce Bank		
Issuer rating	A	A2
Rating outlook	Stable	Stable
Baseline credit assessment		a1
Short-term rating	A-1	P-1

The cash flows from the operating, investing and financing activities of the Company resulted in a net increase in cash and cash equivalents of $23.2 million during the first six months of 2018, as reported in the consolidated statements of cash flows in this report. Operating activities, consisting mainly of net income adjusted for certain non-cash items, provided cash flow of $288.1 million and has historically been a stable source of funds. Investing activities, which occur mainly in the loan and investment

57

securities portfolios, provided cash of $252.9 million. Activity in the investment securities portfolio provided cash of $256.8 million from sales, maturities and pay downs (net of purchases). Financing activities used cash of $517.7 million, largely resulting from a decrease of $340.4 million in federal funds purchased and securities sold under agreements to repurchase and dividend payments of $54.7 million on common and preferred stock. A net decrease in deposit balances resulted in a cash outflow of $111.1 million. Future short-term liquidity needs arising from daily operations are not expected to vary significantly, and the Company believes it will be able to meet these cash flow needs.

Capital Management

The Company met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well-capitalized institutions at June 30, 2018 and December 31, 2017, as shown in the following table.

(Dollars in thousands)	June 30, 2018	December 31, 2017	Minimum Ratios under Capital Adequacy Guidelines *	Minimum Ratios for Well-Capitalized Banks **
Risk-adjusted assets	$18,932,765	$19,149,949		
Tier I common risk-based capital	2,596,487	2,422,480		
Tier I risk-based capital	2,741,271	2,567,264		
Total risk-based capital	2,901,878	2,747,863		
Tier I common risk-based capital ratio	13.71 %	12.65 %	7.00 %	6.50 %
Tier I risk-based capital ratio	14.48 %	13.41 %	8.50 %	8.00 %
Total risk-based capital ratio	15.33 %	14.35 %	10.50 %	10.00 %
Tier I leverage ratio	11.18 %	10.39 %	4.00 %	5.00 %

* as of the fully phased-in date of Jan. 1, 2019, including capital conservation buffer
**under Prompt Corrective Action requirements

The Company maintains a treasury stock buyback program under authorizations by its Board of Directors and normally purchases stock in the open market. The Company purchased 322,448 shares at an average price of $59.14 during the six months ended June 30, 2018, which were related to both open market purchases and stock-based compensation transactions. At June 30, 2018, 3,121,075 shares remained available for purchase under the current Board authorization.

The Company's common stock dividend policy reflects its earnings outlook, desired payout ratios, the need to maintain adequate capital and liquidity levels, and alternative investment options. The Company paid a $.235 per share cash dividend on its common stock in both the first and second quarters of 2018, which was a 9.8% increase compared to its 2017 quarterly dividend.

Commitments, Off-Balance Sheet Arrangements and Contingencies

In the normal course of business, various commitments and contingent liabilities arise which are not required to be recorded on the balance sheet. The most significant of these are loan commitments, which at June 30, 2018 totaled $10.8 billion (including approximately $5.2 billion in unused approved credit card lines). In addition, the Company enters into standby and commercial letters of credit. These contracts totaled $377.5 million and $4.3 million, respectively, at June 30, 2018. As many commitments expire unused or only partially used, these totals do not necessarily reflect future cash requirements. The carrying value of the guarantee obligations associated with the standby letters of credit, which has been recorded as a liability on the consolidated balance sheet, amounted to $2.2

million at June 30, 2018.

The Company regularly purchases various state tax credits arising from third-party property redevelopment. These credits are either resold to third parties at a profit or retained for use by the Company. During the first six months of 2018, purchases and sales of tax credits amounted to $37.6 million and $41.2 million, respectively. Fees from sales of tax credits were $2.3 million for six months ended June 30, 2018, compared to $1.9 million in the same period last year. At June 30, 2018, the Company expected to fund outstanding purchase commitments of $87.7 million during the remainder of 2018.

Table of contents

Segment Results

The table below is a summary of segment pre-tax income results for the first six months of 2018 and 2017.

(Dollars in thousands)	Consumer	Commercial	Wealth	Segment Totals	Other/ Elimination	Consolidated Totals
Six Months Ended June 30, 2018						
Net interest income	$144,908	$167,816	$23,302	$336,026	$67,825	$403,851
Provision for loan losses	(20,924)	488	(48)	(20,484)	45	(20,439)
Non-interest income	62,332	100,862	84,997	248,191	(3,651)	244,540
Investment securities gains, net	—	—	—	—	2,335	2,335
Non-interest expense	(142,266)	(148,158)	(62,113)	(352,537)	(11,600)	(364,137)
Income before income taxes	$44,050	$121,008	$46,138	$211,196	$54,954	$266,150
Six Months Ended June 30, 2017						
Net interest income	$136,628	$162,007	$23,778	$322,413	$38,667	$361,080
Provision for loan losses	(20,464)	624	1	(19,839)	(2,047)	(21,886)
Non-interest income	56,780	90,998	76,558	224,336	657	224,993
Investment securities gains, net	—	—	—	—	879	879
Non-interest expense	(135,791)	(142,499)	(59,813)	(338,103)	(18,164)	(356,267)
Income before income taxes	$37,153	$111,130	$40,524	$188,807	$19,992	$208,799
Increase in income before income taxes:						
Amount	$6,897	$9,878	$5,614	$22,389	$34,962	$57,351
Percent	18.6 %	8.9 %	13.9 %	11.9 %	174.9 %	27.5 %

Consumer
For the six months ended June 30, 2018, income before income taxes for the Consumer segment increased $6.9 million, or 18.6%, compared to the first six months of 2017. This increase in income before taxes was mainly due to growth in net interest income of $8.3 million, or 6.1%, and non-interest income of $5.6 million, or 9.8%. These increases to income were partly offset by higher non-interest expense of $6.5 million, or 4.8%, and an increase in the provision for loan losses of $460 thousand, or 2.2%. Net interest income increased due to a $6.0 million increase in net allocated funding credits assigned to the Consumer segment's loan and deposit portfolios and growth of $2.6 million in loan interest income. Non-interest income increased mainly due to growth in debit card fees and deposit fees (mainly deposit account service fees and overdraft and return item fees). Non-interest expense increased over the same period in the previous year due to higher allocated servicing and support costs, mainly marketing, online banking and information technology. The provision for loan losses totaled $20.9 million, a $460 thousand increase over the first six months of 2017, which was mainly due to higher consumer credit card loan and personal loan net charge-offs, partly offset by lower marine and RV loan net charge-offs.

Commercial
For the six months ended June 30, 2018, income before income taxes for the Commercial segment increased $9.9 million, or 8.9%, compared to the same period in the previous year. This increase was mainly due to higher net interest income and non-interest income. These increases to income were partly offset by higher non-interest expense. Net interest income increased $5.8 million, or 3.6%, due to a $32.6 million increase in loan interest income, partly offset by a decline of $17.6 million in net allocated funding credits and higher interest expense of $9.2 million on deposits and customer repurchase agreements. Non-interest income increased $9.9 million, or 10.8%, over the previous year due to higher corporate card fees, swap fees, and deposit account fees (mainly corporate cash management fees). These increases were partly offset by lower gains on sales of leased assets to customers upon lease termination. Non-interest expense increased $5.7 million, or 4.0%, mainly due to increases in allocated service and support costs (mainly deposit operations, information technology, and commercial sales and product support fees). In addition, salaries expense and data processing expense increased over the prior year. The provision for loan losses

increased $136 thousand over the same period last year, due to lower net recoveries on construction loans. This increase was partly offset by lower net charge-offs on commercial card loans and higher net recoveries on business real estate loans.

Table of contents

Wealth
Wealth segment pre-tax profitability for the six months ended June 30, 2018 increased $5.6 million, or 13.9%, over the same period in the previous year. Net interest income decreased $476 thousand, or 2.0%, mainly due to a decline in net allocated funding credits, partly offset by an increase in loan interest income. Non-interest income increased $8.4 million, or 11.0%, over the prior year largely due to higher private client and institutional trust fees and cash sweep commissions. These increases were partly offset by write downs on software costs. Non-interest expense increased $2.3 million, or 3.8%, mainly due to higher salary and benefit costs, trust losses, and allocated support and corporate management fee costs, partly offset by lower professional fees expense. The provision for loan losses increased $49 thousand, mainly due to higher personal real estate loan net charge-offs.

The Other/Elimination category in the preceding table includes the activity of various support and overhead operating units of the Company, in addition to the investment securities portfolio and other items not allocated to the segments. In accordance with the Company's transfer pricing procedures, the difference between the total provision and total net charge-offs/recoveries is not allocated to a business segment and is included in this category. The pre-tax profitability of this category was higher than in the same period last year by $35.0 million. This increase was mainly due to higher unallocated net interest income of $29.2 million and lower non-interest expense of $6.6 million, partly offset by lower non-interest income of $4.3 million. Unallocated securities gains were $2.3 million in the first six months of 2018 compared to gains of $879 thousand in 2017. Also, the unallocated loan loss provision decreased $2.1 million, as the provision was $1.9 million in excess of charge-offs in the first six months of 2017, while the provision equaled charge-offs during the first six months of 2018.

Impact of Recently Issued Accounting Standards

Derivatives The FASB issued ASU 2017-12, "Targeted Improvements to Accounting for Hedging Activities", in August 2017. The ASU improves the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. These improvements allow the hedging of risk components, ease restrictions on the measurement of the change in fair value of the hedged item, aligns the recognition and presentation of the effects of the hedging instrument and the hedged item, and otherwise simplify hedge accounting guidance. The amendments are effective January 1, 2019 but may be adopted early in any interim period. The Company adopted the ASU on January 1, 2018, but as the Company did not utilize hedge accounting on that date, the Company's consolidated financial statements were not affected by the adoption.

Revenue from Contracts with Customers The FASB issued ASU 2014-09, "Revenue from Contracts with Customers", in May 2014, which has been followed by additional clarifying guidance on specified implementation issues. The ASU supersedes revenue recognition requirements in Topic 605, Revenue Recognition, including most industry specific revenue recognition guidance in the FASB Accounting Standards Codification. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance was adopted on January 1, 2018 under the full retrospective method with a restatement of prior periods. The impact of the adoption and required disclosures are discussed in Note 13 to the consolidated financial statements.

Liabilities The FASB issued ASU 2016-04, "Recognition of Breakage for Certain Prepaid Stored-Value Products", in March 2016, in order to address current and potential future diversity in practice related to the derecognition of a prepaid stored-value product liability. Such products include prepaid gift cards issued on a specific payment network and redeemable at network-accepting merchant locations, prepaid telecommunication cards, and traveler's checks. The amendments require that the portion of the dollar value of prepaid stored-value products that is ultimately unredeemed (that is, the breakage) be accounted for consistent with the breakage guidance for stored-value product transactions provided in ASC Topic 606 - Revenue from Contracts with Customers. These amendments were effective for interim and annual periods beginning January 1, 2018 and did not have a significant effect on the Company's consolidated financial statements.

Income Taxes The FASB issued ASU 2016-16, "Intra-Entity Transfers of Assets Other Than Inventory", in October 2016. Current GAAP prohibits the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold to an outside party. The amendments require the recognition of income tax consequences of an intra-entity transfer of an asset (other than inventory) when the transfer occurs. This change removes the current exception to the principal of comprehensive recognition of current and deferred income taxes in GAAP (except for inventory). These amendments were effective for reporting periods beginning January 1, 2018 and did not have a significant effect on the Company's consolidated financial statements.

Financial Instruments The FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities", in January 2016. The amendments require all equity investments to be measured at fair value with changes in the fair value recognized through net income, other than those accounted for under the equity method of accounting or those that result in the consolidation of the investee. The amendments also require use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes. These amendments were adopted on January 1, 2018 and are further discussed in Notes 3 and 15 to the consolidated financial statements.

Statement of Cash Flows The FASB issued ASU 2016-15, "Classification of Certain Cash Receipts and Cash Payments", in August 2016. The ASU addresses the presentation and classification in the Statement of Cash Flows of several specific cash flow issues. These include cash payments for debt prepayment or extinguishment costs, settlement of zero-coupon debt instruments, distributions received from equity method investees, and separately identifiable cash flows and application of the predominance principle. The amendments were effective January 1, 2018 and did not have a significant effect on the Company's consolidated financial statements.

The FASB issued ASU 2016-18, "Restricted Cash", in November 2016. The ASU requires that amounts described as restricted cash and restricted cash equivalents be included with cash and cash equivalents when reconciling the beginning and end of period amounts shown on the statement of cash flows. Disclosures are to be provided on the amounts reported as restricted and the nature of the restrictions on cash and cash equivalents. The amendments, which were applied on a retrospective basis, were effective January 1, 2018 and did not have a significant effect on the Company's consolidated financial statements.

Retirement Benefits The FASB issued ASU 2017-07, "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost", in March 2017. Under current guidance, the different components comprising net benefit cost are aggregated for reporting in the financial statements. Because these components are heterogeneous, the current presentation reduces the transparency and usefulness of the financial statements. The ASU requires that an employer report the service cost component of net benefit cost in the same line item as other compensation costs arising from services rendered during the period. The other components of net benefit cost are required to be presented separately from the servicing cost component. Only service cost is eligible for capitalization when applicable. The amendments were effective January 1, 2018 and as noted in Note 6 to the consolidated financial statements, did not have a significant effect on the Company's consolidated financial statements.

Leases In February 2016, the FASB issued ASU 2016-02, "Leases", in order to increase transparency and comparability by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The ASU primarily affects lessee accounting, which requires the lessee to recognize a right-of-use asset and a liability to make lease payments for those leases classified as operating leases under previous GAAP. For leases with a term of 12 months or less, an election by class of underlying asset not to recognize lease assets and lease liabilities is permitted. The ASU also provides additional guidance as to the definition of a lease, identification of lease components, and sale and leaseback transactions. The amendments in the ASU are effective for interim and annual periods beginning January 1, 2019. The Company is the lessee in approximately 200 lease agreements. At December 31, 2017, future minimum lease payments for operating leases totaled $34 million. The Company is in the process of installing new lease accounting software to comply with the new accounting requirements and has reviewed all existing lease agreements for which the new accounting standard is to be applied. Also, the Company is developing methodologies and processes to estimate and account for right-of-use assets and lease liabilities, which are based on the present value of future lease payments.

Premium Amortization The FASB issued ASU 2017-08, "Premium Amortization on Purchased Callable Debt Securities", in March 2017. Under current guidance, many entities amortize the premium on purchased callable debt securities over the contractual life of the instrument. As a result, upon the exercise of a call on a callable debt security held at a premium, the unamortized premium is recorded as a loss in earnings. The amendments in this ASU shorten the amortization period for certain callable debt securities held at a premium to the earliest call date, and more closely align the amortization period to expectations incorporated in market pricing of the instrument. The amendments are effective January 1, 2019 and are not expected to have a significant effect on the Company's consolidated financial statements.

Financial Instruments ASU 2016-13, "Measurement of Credit Losses on Financial Instruments", was issued in June 2016. Its implementation will result in a new loan loss accounting framework, also known as the current expected credit loss (CECL) model. CECL requires credit losses expected throughout the life of the asset portfolio on loans and held-to-maturity securities to be recorded at the time of origination. Under the current incurred loss model, losses are recorded when it is probable that a loss event has occurred. The new standard will require significant operational changes, especially in data collection and analysis. The ASU is effective for interim and annual periods beginning January 1, 2020, and is expected to increase the allowance upon adoption. In the second quarter of 2017, the Company formed a working group and contracted with a software supplier to assist in the data collection and calculation of the allowance for loan losses under the new model. Historical loan data has been collected in this software system and a CECL working group is actively working with outside professionals to select various model inputs such as loans segments, modeling methods and other data as required under the CECL model, which would allow for proforma calculations to occur later this year.

Table of contents

Intangible Assets The FASB issued ASU 2017-04, "Simplifying the Test for Goodwill Impairment", in January 2017. Under current guidance, a goodwill impairment loss is measured by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill by following procedures that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Under the new amendments, the goodwill impairment test compares the fair value of a reporting unit with its carrying amount and an impairment charge is measured as the amount by which the carrying amount exceeds the reporting unit's fair value. The amendments are effective for impairment tests beginning January 1, 2020 and are not expected to have a significant effect on the Company's consolidated financial statements.

Comprehensive Income The FASB issued ASU 2018-02, "Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income", in February 2018. The guidance allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. The amendments are effective for all entities effective January 1, 2019, but early adoption is permitted in certain circumstances. The Company adopted the ASU effective January 1, 2018 and recorded a reclassification which increased accumulated other comprehensive income and reduced retained earnings by $2.9 million. As these are both categories within equity, total equity was unchanged. The adoption did not have a significant effect on the Company's consolidated financial statements.

Table of contents

AVERAGE BALANCE SHEETS — AVERAGE RATES AND YIELDS
Three Months Ended June 30, 2018 and 2017

(Dollars in thousands)	Second Quarter 2018 Average Balance	Interest Income/Expense	Avg. Rates Earned/Paid	Second Quarter 2017 Average Balance	Interest Income/Expense	Avg. Rates Earned/Paid
ASSETS:						
Loans:						
Business[(A)]	$4,962,171	$ 45,614	3.69 %	$4,827,439	$ 38,606	3.21 %
Real estate — construction and land	971,854	12,254	5.06	862,479	9,256	4.30
Real estate — business	2,726,697	28,706	4.22	2,701,144	25,219	3.74
Real estate — personal	2,078,972	19,916	3.84	2,003,997	18,602	3.72
Consumer	2,025,585	22,181	4.39	1,997,761	19,614	3.94
Revolving home equity	378,366	4,252	4.51	399,730	3,822	3.84
Consumer credit card	754,199	22,661	12.05	731,471	21,705	11.90
Overdrafts	4,497	—	—	4,505	—	—
Total loans	13,902,341	155,584	4.49	13,528,526	136,824	4.06
Loans held for sale	22,202	372	6.72	18,341	263	5.75
Investment securities:						
U.S. government and federal agency obligations	923,183	7,328	3.18	910,821	5,731	2.52
Government-sponsored enterprise obligations	354,156	1,661	1.88	450,362	1,782	1.59
State and municipal obligations[(A)]	1,394,766	10,634	3.06	1,771,674	15,924	3.61
Mortgage-backed securities	4,067,152	26,385	2.60	3,708,124	21,702	2.35
Asset-backed securities	1,407,300	8,134	2.32	2,335,344	10,037	1.72
Other debt securities	340,246	2,229	2.63	320,869	2,033	2.54
Trading debt securities[(A)]	26,101	205	3.15	21,062	142	2.70
Equity securities[(A)]	47,179	10,548	89.68	53,162	526	3.97
Other securities[(A)]	108,563	1,807	6.68	99,545	2,605	10.50
Total investment securities	8,668,646	68,931	3.19	9,670,963	60,482	2.50
Federal funds sold and short-term securities purchased under agreements to resell	36,791	177	1.93	13,115	37	1.13
Long-term securities purchased under agreements to resell	700,000	3,785	2.17	665,655	3,684	2.22
Interest earning deposits with banks	353,607	1,590	1.80	139,061	362	1.04
Total interest earning assets	23,683,587	230,439	3.90	24,035,661	201,652	3.36
Allowance for loan losses	(158,664)			(157,003)		
Unrealized gain (loss) on debt securities	(122,114)			57,547		
Cash and due from banks	357,074			349,132		
Land, buildings and equipment, net	342,778			344,310		
Other assets	419,602			413,086		
Total assets	$24,522,263			$25,042,733		
LIABILITIES AND EQUITY:						
Interest bearing deposits:						
Savings	$881,045	239	.11	$831,038	240	.12
Interest checking and money market	10,850,123	6,280	.23	10,667,042	4,102	.15

Time open & C.D.'s of less than $100,000	609,011	694	.46		688,047	674	.39	
Time open & C.D.'s of $100,000 and over	1,134,900	3,483	1.23		1,510,001	2,822	.75	
Total interest bearing deposits	13,475,079	10,696	.32		13,696,128	7,838	.23	
Borrowings:								
Federal funds purchased and securities sold								
under agreements to repurchase	1,339,278	3,956	1.18		1,363,031	2,038	.60	
Other borrowings	1,913	12	2.52		105,311	911	3.47	
Total borrowings	1,341,191	3,968	1.19		1,468,342	2,949	.81	
Total interest bearing liabilities	14,816,270	14,664	.40	%	15,164,470	10,787	.29	%
Non-interest bearing deposits	6,749,104				7,065,849			
Other liabilities	229,080				203,139			
Equity	2,727,809				2,609,275			
Total liabilities and equity	$24,522,263				$25,042,733			
Net interest margin (T/E)		$ 215,775				$ 190,865		
Net yield on interest earning assets			3.65	%			3.18	%

(A) Stated on a tax equivalent basis using a federal income tax rate of 21% in 2018 and 35% in prior periods.

63

Table of contents

AVERAGE BALANCE SHEETS — AVERAGE RATES AND YIELDS
Six Months Ended June 30, 2018 and 2017

(Dollars in thousands)	Six Months 2018 Average Balance	Six Months 2018 Interest Income/Expense	Six Months 2018 Avg. Rates Earned/Paid		Six Months 2017 Average Balance	Six Months 2017 Interest Income/Expense	Six Months 2017 Avg. Rates Earned/Paid	
ASSETS:								
Loans:								
Business(A)	$4,948,472	$ 87,909	3.58	%	$4,866,837	$ 75,192	3.12	%
Real estate — construction and land	961,947	23,268	4.88		845,343	17,126	4.09	
Real estate — business	2,730,235	56,090	4.14		2,673,491	48,915	3.69	
Real estate — personal	2,070,574	39,258	3.82		2,008,203	37,175	3.73	
Consumer	2,048,748	43,913	4.32		1,986,391	38,545	3.91	
Revolving home equity	385,507	8,371	4.38		402,565	7,464	3.74	
Consumer credit card	755,936	45,200	12.06		739,582	43,208	11.78	
Overdrafts	4,562	—	—		4,346	—	—	
Total loans	13,905,981	304,009	4.41		13,526,758	267,625	3.99	
Loans held for sale	20,667	676	6.60		15,174	459	6.10	
Investment securities:								
U.S. government and federal agency obligations	919,937	12,116	2.66		912,140	10,445	2.31	
Government-sponsored enterprise obligations	379,776	3,497	1.86		450,425	3,541	1.59	
State and municipal obligations(A)	1,453,677	22,040	3.06		1,777,357	31,991	3.63	
Mortgage-backed securities	3,996,918	51,780	2.61		3,734,065	43,800	2.37	
Asset-backed securities	1,438,222	15,777	2.21		2,347,427	19,517	1.68	
Other debt securities	341,029	4,461	2.64		323,921	4,099	2.55	
Trading debt securities(A)	24,045	353	2.96		23,102	314	2.74	
Equity securities(A)	48,834	11,002	45.43		54,634	1,078	3.98	
Other securities(A)	104,799	3,483	6.70		99,004	7,533	15.34	
Total investment securities	8,707,237	124,509	2.88		9,722,075	122,318	2.54	
Federal funds sold and short-term securities purchased under agreements to resell	40,544	357	1.78		11,510	60	1.05	
Long-term securities purchased under agreements to resell	700,000	7,899	2.28		695,164	7,477	2.17	
Interest earning deposits with banks	314,012	2,730	1.75		173,263	759	.88	
Total interest earning assets	23,688,441	440,180	3.75		24,143,944	398,698	3.33	
Allowance for loan losses	(158,721)				(156,170)			
Unrealized gain (loss) on debt securities	(82,894)				36,283			
Cash and due from banks	360,279				362,723			
Land, buildings and equipment, net	343,859				345,115			
Other assets	428,118				415,036			
Total assets	$24,579,082				$25,146,931			
LIABILITIES AND EQUITY:								
Interest bearing deposits:								
Savings	$860,089	484	.11		$813,464	486	.12	
Interest checking and money market	10,794,286	11,624	.22		10,635,689	7,746	.15	

Time open & C.D.'s of less than $100,000	617,120	1,356	.44		696,544	1,318	.38	
Time open & C.D.'s of $100,000 and over	1,134,549	6,322	1.12		1,590,118	5,585	.71	
Total interest bearing deposits	13,406,044	19,786	.30		13,735,815	15,135	.22	
Borrowings:								
Federal funds purchased and securities sold								
under agreements to repurchase	1,449,314	7,957	1.11		1,359,692	3,577	.53	
Other borrowings	1,913	24	2.53		103,670	1,799	3.50	
Total borrowings	1,451,227	7,981	1.11		1,463,362	5,376	.74	
Total interest bearing liabilities	14,857,271	27,767	.38	%	15,199,177	20,511	.27	%
Non-interest bearing deposits	6,786,693				7,155,774			
Other liabilities	213,824				218,556			
Equity	2,721,294				2,573,424			
Total liabilities and equity	$24,579,082				$25,146,931			
Net interest margin (T/E)		$ 412,413				$ 378,187		
Net yield on interest earning assets			3.51	%			3.16	%

(A) Stated on a tax equivalent basis using a federal income tax rate of 21% in 2018 and 35% in prior periods.

Table of contents

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate risk management focuses on maintaining consistent growth in net interest income within Board-approved policy limits. The Company primarily uses earnings simulation models to analyze net interest income sensitivity to movement in interest rates. The Company performs monthly simulations which model interest rate movements and risk in accordance with changes to its balance sheet composition. For further discussion of the Company's market risk, see the Interest Rate Sensitivity section of Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's 2017 Annual Report on Form 10-K.

The tables below compute the effects of gradual shifts in interest rates over a twelve month period on the Company's net interest income, assuming a static balance sheet with the exception of deposit attrition. The difference between the two simulations is the amount of deposit attrition incorporated, which is shown in the tables below. In both simulations, three rising rate scenarios and one falling rates scenario were selected as shown in the tables, and net interest income was calculated and compared to a base scenario in which assets, liabilities and rates remained constant over a twelve month period. For each of the simulations, interest rates applicable to each interest earning asset or interest bearing liability were ratably increased or decreased during the year (by either 100, 200 or 300 basis points). The balances contained in the balance sheet were assumed not to change over the twelve month period, except that as presented in the tables below, it was assumed certain non-maturity type deposit attrition would occur, as a result of higher interest rates, and would be replaced with short-term federal funds borrowings.

The simulations reflect two different assumptions related to deposit attrition. The Company utilizes these simulations both for monitoring interest rate risk and for liquidity planning purposes. While the future effects of rising rates on deposit balances cannot be known, the Company maintains a practice of running multiple rate scenarios to better understand interest rate risk and its effect on the Company's performance. The Company believes that its approach to interest rate risk has appropriately considered its susceptibility to both rising rates and falling rates and has adopted strategies which minimize impacts to overall interest rate risk.

Simulation A	June 30, 2018			March 31, 2018		
(Dollars in millions)	$ Change in Net Interest Income	% Change in Net Interest Income	Assumed Deposit Attrition	$ Change in Net Interest Income	% Change in Net Interest Income	Assumed Deposit Attrition
300 basis points rising	$(.2)	(.02)%	$(339.6)	$(2.3)	(.30)%	$(329.7)
200 basis points rising	2.0	.24	(234.1)	1.9	.23	(230.4)
100 basis points rising	2.5	.31	(120.3)	3.0	.38	(121.5)
100 basis points falling	(18.7)	(2.32)	131.8	(28.5)	(3.96)	122.7

Simulation B	June 30, 2018			March 31, 2018		
(Dollars in millions)	$ Change in Net Interest Income	% Change in Net Interest Income	Assumed Deposit Attrition	$ Change in Net Interest Income	% Change in Net Interest Income	Assumed Deposit Attrition
300 basis points rising	$(21.4)	(2.65)%	$(933.9)	$(23.3)	(3.01)%	$(966.1)
200 basis points rising	(16.8)	(2.09)	(830.0)	(16.7)	(2.15)	(867.1)
100 basis points rising	(13.9)	(1.72)	(717.9)	(13.0)	(1.68)	(759.1)

The difference in these two simulations is the degree in which deposits are modeled to decline in a rising rate environment, as noted in the above table. Both simulations assume that a decline in deposits would be offset by increased short-term borrowings, which are more rate sensitive and can result in higher interest costs in a rising rate environment. Simulation B assumes a much larger deposit attrition factor with deposits declining $933.9 million in the 300 basis points scenario compared with a decline of $339.6 million in deposits under Simulation A. The 100 basis points falling rate scenario is used in both Simulation A and B and the scenario assumes that deposits would increase by $131.8 million due to greater customer deposit liquidity.

Under Simulation A, a gradual increase in interest rates of 100 basis points is expected to increase net interest income from the base calculation by $2.5 million, while a gradual increase in rates of 200 basis points would increase net interest income by $2.0 million. An increase in rates of 300 basis points would result in a decrease in net interest income of $197 thousand, while a decrease in rates of 100 basis points would result in a decrease in net interest income of $18.7 million. The change in net interest income from the base calculation at June 30, 2018 was higher than projections made in the prior quarter for both the 200 and 300 basis points rising scenarios mainly due to lower deposits and borrowings balances in the current quarter, which kept funding costs lower in a rising rate environment than in previous projections. Under the 100 basis point rising rate scenario, deposit attrition was lower, and higher rates on deposits provided a greater increase in funding costs than in the prior quarter’s projection. As a result, increased deposit expense resulted in a smaller increase in net interest income this quarter than the previous quarter for the 100 basis point rising rate scenario. Under the 100 basis point falling rate scenario, net income is reduced by $18.7 million mainly due to the fact that rates on loans declined faster than rates paid on deposits. Furthermore, under this scenario, deposits are projected to grow $131.8 million, with these proceeds invested in lower-earning assets.

Simulation B utilizes similar assumptions to Simulation A but assumes greater deposit attrition under rising rate scenarios. Doing so provides greater stress on projected net interest income to enable better analysis on interest rate risk. Under the rising rate scenarios in Simulation B, net interest income declines more than in Simulation A as more expensive short-term borrowings are assumed to replace the declining deposit balances. The results under Simulation B were only slightly different than in the prior quarter mainly due to higher loan balances and lower deposit balances in the current quarter. The falling rate scenario in Simulation B would approximate the results in Simulation A, as the same assumptions are utilized in both simulations.

Projecting deposit activity in a period of historically low interest rates is difficult, and the Company cannot predict how deposits will actually react to rising rates. The simulations above provide insight into potential effects of changes in rates and deposit levels on net interest income. The Company believes that its approach to interest rate risk has appropriately considered its susceptibility to both rising and falling rates and has adopted strategies which minimize the impact of interest rate risk.

Item 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of June 30, 2018. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective. There were no changes in the Company's internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of contents

PART II: OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

The information required by this item is set forth in Part I, Item 1 under Note 16, Legal and Regulatory Proceedings.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table sets forth information about the Company's purchases of its $5 par value common stock, its only class of common stock registered pursuant to Section 12 of the Securities Exchange Act of 1934, as amended.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as part of Publicly Announced Program	Maximum Number that May Yet Be Purchased Under the Program
April 1 — 30, 2018	28,515	$ 62.79	28,515	3,124,324
May 1 — 31, 2018	2,144	$ 64.25	2,144	3,122,180
June 1 — 30, 2018	1,105	$ 66.53	1,105	3,121,075
Total	31,764	$ 63.02	31,764	3,121,075

The Company's stock purchases shown above were made under authorizations by the Board of Directors. Under the most recent authorization in October 2015 of 5,000,000 shares, 3,121,075 shares remained available for purchase at June 30, 2018.

Item 6. EXHIBITS

31.1 — Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 — Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 — Certifications of CEO and CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101 — Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Equity, (v) the Consolidated Statements of Cash Flows and (vi) the Notes to Consolidated Financial Statements, tagged as blocks of text and in detail

Table of contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

COMMERCE
BANCSHARES, INC.

By /s/ THOMAS J. NOACK
Thomas J. Noack
Vice President & Secretary

Date: August 6, 2018
By /s/ JEFFERY D. ABERDEEN
Jeffery D. Aberdeen
Controller
(Chief Accounting Officer)

Date: August 6, 2018