

WINMARK CORP
Form 10-Q
October 24, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

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: 000-22012

WINMARK CORPORATION

(Exact name of registrant as specified in its charter)

Minnesota
(State or other jurisdiction of incorporation or organization) 41-1622691
(I.R.S. Employer Identification No.)

605 Highway 169 North, Suite 400, Minneapolis, MN 55441

(Address of principal executive offices) (Zip Code)

(763) 520-8500

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated
Non-accelerated filer filer
(Do not
check if a

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smaller Smaller
reporting reporting
company) company

Emerging
growth
company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Common stock, no par value, 3,821,528 shares outstanding as of October 17, 2017.

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WINMARK CORPORATION AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1: Financial Statements

WINMARK CORPORATION AND SUBSIDIARIES

CONSOLIDATED CONDENSED BALANCE SHEETS

(Unaudited)

	September 30, 2017	December 31, 2016
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 1,060,700	\$ 1,252,900
Marketable securities	—	199,900
Receivables, less allowance for doubtful accounts of \$1,700 and \$2,100	1,708,100	1,479,200
Restricted cash	40,000	40,000
Net investment in leases - current	16,311,000	17,004,800
Income tax receivable	1,721,500	1,678,800
Inventories	67,000	87,500
Prepaid expenses	865,400	1,050,700
Total current assets	21,773,700	22,793,800
Net investment in leases - long-term	24,249,500	24,410,700
Property and equipment, net	547,700	769,600
Goodwill	607,500	607,500
	\$ 47,178,400	\$ 48,581,600
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current Liabilities:		
Notes payable, net of unamortized debt issuance costs of \$13,900 and \$10,000	\$ 3,236,100	\$ 1,990,000
Accounts payable	1,474,600	1,692,000
Accrued liabilities	2,906,100	1,811,100
Deferred revenue	1,649,300	1,864,700
Total current liabilities	9,266,100	7,357,800
Long-Term Liabilities:		
Line of credit	41,900,000	23,400,000
Notes payable, net of unamortized debt issuance costs of \$99,900 and \$73,500	29,650,100	19,926,500
Deferred revenue	1,458,200	1,423,800
Other liabilities	808,400	993,600
Deferred income taxes	3,485,300	3,331,900
Total long-term liabilities	77,302,000	49,075,800

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Shareholders' Equity (Deficit):

Common stock, no par value, 10,000,000 shares authorized, 3,821,528 and 4,165,769 shares issued and outstanding	—	2,976,100
Accumulated other comprehensive income (loss)	—	(9,900)
Retained earnings (accumulated deficit)	(39,389,700)	(10,818,200)
Total shareholders' equity (deficit)	(39,389,700)	(7,852,000)
	\$ 47,178,400	\$ 48,581,600

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

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WINMARK CORPORATION AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 24, 2016	September 30, 2017	September 24, 2016
REVENUE:				
Royalties	\$ 12,316,700	\$ 11,311,000	\$ 33,865,100	\$ 32,140,800
Leasing income	3,915,800	4,174,000	13,722,000	12,839,000
Merchandise sales	773,100	520,000	2,058,500	1,882,400
Franchise fees	317,800	501,800	1,262,500	1,367,800
Other	244,500	227,500	1,033,100	984,400
Total revenue	17,567,900	16,734,300	51,941,200	49,214,400
COST OF MERCHANDISE SOLD	728,300	499,100	1,942,400	1,784,800
LEASING EXPENSE	792,000	646,200	2,724,000	2,010,400
PROVISION FOR CREDIT LOSSES	(13,300)	(29,700)	(26,200)	(52,000)
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	6,208,900	5,180,700	19,179,400	17,671,500
Income from operations	9,852,000	10,438,000	28,121,600	27,799,700
INTEREST EXPENSE	(613,900)	(552,300)	(1,559,300)	(1,786,800)
INTEREST AND OTHER INCOME (EXPENSE)	28,000	(6,300)	29,900	(7,300)
Income before income taxes	9,266,100	9,879,400	26,592,200	26,005,600
PROVISION FOR INCOME TAXES	(3,547,100)	(3,785,200)	(9,683,600)	(9,954,200)
NET INCOME	\$ 5,719,000	\$ 6,094,200	\$ 16,908,600	\$ 16,051,400
EARNINGS PER SHARE - BASIC	\$ 1.42	\$ 1.48	\$ 4.09	\$ 3.90
EARNINGS PER SHARE - DILUTED	\$ 1.33	\$ 1.41	\$ 3.83	\$ 3.72
WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC	4,024,692	4,116,957	4,131,269	4,113,819
WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED	4,314,412	4,328,168	4,416,185	4,320,284

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

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WINMARK CORPORATION AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 24, 2016	September 30, 2017	September 24, 2016
NET INCOME	\$ 5,719,000	\$ 6,094,200	\$ 16,908,600	\$ 16,051,400
OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX:				
Unrealized holding net gains (losses) arising during period	(700)	6,800	15,900	41,100
OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX	(700)	6,800	15,900	41,100
INCOME TAX (EXPENSE) BENEFIT RELATED TO ITEMS OF OTHER COMPREHENSIVE INCOME:				
Unrealized holding net gains/losses arising during period	300	(2,600)	(6,000)	(15,500)
INCOME TAX (EXPENSE) BENEFIT RELATED TO ITEMS OF OTHER COMPREHENSIVE INCOME	300	(2,600)	(6,000)	(15,500)
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX	(400)	4,200	9,900	25,600
COMPREHENSIVE INCOME	\$ 5,718,600	\$ 6,098,400	\$ 16,918,500	\$ 16,077,000

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

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WINMARK CORPORATION AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended	
	September 30, 2017	September 24, 2016
OPERATING ACTIVITIES:		
Net income	\$ 16,908,600	\$ 16,051,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	275,700	320,600
Provision for credit losses	(26,200)	(52,000)
Compensation expense related to stock options	1,462,500	1,324,400
Deferred income taxes	153,400	62,100
(Gain) Loss on sale of marketable securities	(1,400)	12,600
Deferred initial direct costs	(369,200)	(421,300)
Amortization of deferred initial direct costs	345,300	356,200
Tax benefits on exercised stock options	592,800	69,700
Change in operating assets and liabilities:		
Receivables	(228,900)	(138,400)
Restricted cash	—	(15,000)
Income tax receivable/payable	(641,500)	2,505,700
Inventories	20,500	(50,400)
Prepaid expenses	185,300	(243,200)
Accounts payable	(217,400)	(524,400)
Accrued and other liabilities	867,000	617,600
Rents received in advance and security deposits	92,800	392,300
Deferred revenue	(181,000)	(261,900)
Net cash provided by operating activities	19,238,300	20,006,000
INVESTING ACTIVITIES:		
Proceeds from sale of marketable securities	217,200	52,200
Purchase of property and equipment	(53,800)	(46,800)
Purchase of equipment for lease contracts	(19,253,300)	(16,432,200)
Principal collections on lease receivables	20,078,100	17,749,900
Net cash provided by investing activities	988,200	1,323,100
FINANCING ACTIVITIES:		
Proceeds from borrowings on line of credit	46,900,000	10,600,000
Payments on line of credit	(28,400,000)	(27,800,000)
Proceeds from borrowings on notes payable	12,500,000	—
Payments on notes payable	(1,500,000)	(1,500,000)
Repurchases of common stock	(49,904,100)	(1,573,900)
Proceeds from exercises of stock options	1,329,200	170,900
Dividends paid	(1,343,800)	(1,111,900)

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Net cash used for financing activities	(20,418,700)	(21,214,900)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(192,200)	114,200
Cash and cash equivalents, beginning of period	1,252,900	1,006,700
Cash and cash equivalents, end of period	\$ 1,060,700	\$ 1,120,900
SUPPLEMENTAL DISCLOSURES:		
Cash paid for interest	\$ 1,349,500	\$ 1,778,400
Cash paid for income taxes	\$ 9,514,800	\$ 7,316,700

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

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WINMARK CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

1. Management's Interim Financial Statement Representation:

The accompanying consolidated condensed financial statements have been prepared by Winmark Corporation and subsidiaries (the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. The Company has a 52/53 week year which ends on the last Saturday in December. The information in the consolidated condensed financial statements includes normal recurring adjustments and reflects all adjustments which are, in the opinion of management, necessary for a fair presentation of such financial statements. The consolidated condensed financial statements and notes are presented in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions for Form 10-Q, and therefore do not contain certain information included in the Company's annual consolidated financial statements and notes. This report should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's latest Annual Report on Form 10-K.

Revenues and operating results for the nine months ended September 30, 2017 are not necessarily indicative of the results to be expected for the full year.

Reclassifications

Certain reclassifications of previously reported amounts have been made to conform to the current year presentation. Such reclassifications did not impact net income or shareholders' equity (deficit) as previously reported.

2. Organization and Business:

The Company offers licenses to operate franchises using the service marks Plato's Closet®, Once Upon A Child®, Play It Again Sports®, Style Encore® and Music Go Round®. The company uses its Winmark Franchise Partners™ mark in connection with its strategic consulting and corporate development activities. The Company also operates both middle market and small-ticket equipment leasing businesses under the Winmark Capital® and Wirth Business Credit® marks.

3. Fair Value Measurements:

The Company defines fair value as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Company uses three levels of inputs to measure fair value:

- Level 1 – quoted prices in active markets for identical assets and liabilities.
- Level 2 – observable inputs other than quoted prices in active markets for identical assets and liabilities.
- Level 3 – unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions.

The Company's marketable securities were valued based on Level 1 inputs using quoted prices.

Due to their nature, the carrying value of cash equivalents, receivables, payables and debt obligations approximates fair value.

4. Investments:

Marketable Securities

The following is a summary of marketable securities classified as available-for-sale securities:

	September 30, 2017		December 31, 2016	
	Cost	Fair Value	Cost	Fair Value
Equity securities	\$ —	\$ —	\$ 215,800	\$ 199,900

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The Company's unrealized gains and losses for marketable securities classified as available-for-sale securities in accumulated other comprehensive loss are as follows:

	September 30, 2017	December 31, 2016
Unrealized gains	\$ —	\$ —
Unrealized losses	—	(15,900)
Net unrealized gains (losses)	\$ —	\$ (15,900)

The Company's realized gains and losses recognized on sales of available-for-sale marketable securities are as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 24, 2016	September 30, 2017	September 24, 2016
Realized gains	\$ 10,300	\$ —	\$ 10,300	\$ —
Realized losses	(8,900)	—	(8,900)	(12,600)
Net realized gains (losses)	\$ 1,400	\$ —	\$ 1,400	\$ (12,600)

Amounts reclassified out of accumulated other comprehensive loss into earnings is determined by using the average cost of the security when sold. Gross realized gains (losses) reclassified out of accumulated other comprehensive loss into earnings are included in Interest and Other Income (Expense) and the related tax benefits (expenses) are included in the Provision for Income Taxes lines of the Consolidated Condensed Statements of Operations.

5. Investment in Leasing Operations:

Investment in leasing operations consists of the following:

September 30, 2017	December 31, 2016
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Direct financing and sales-type leases:		
Minimum lease payments receivable	\$ 39,565,600	\$ 37,839,800
Estimated residual value of equipment	4,797,600	4,754,200
Unearned lease income net of initial direct costs deferred	(5,734,900)	(5,844,500)
Security deposits	(4,504,700)	(4,424,400)
Equipment installed on leases not yet commenced	7,113,000	9,961,600
Total investment in direct financing and sales-type leases	41,236,600	42,286,700
Allowance for credit losses	(883,600)	(896,000)
Net investment in direct financing and sales-type leases	40,353,000	41,390,700
Operating leases:		
Operating lease assets	1,494,000	800,700
Less accumulated depreciation and amortization	(1,286,500)	(775,900)
Net investment in operating leases	207,500	24,800
Total net investment in leasing operations	\$ 40,560,500	\$ 41,415,500

As of September 30, 2017, the \$40.6 million total net investment in leases consists of \$16.3 million classified as current and \$24.3 million classified as long-term. As of December 31, 2016, the \$41.4 million total net investment in leases consists of \$17.0 million classified as current and \$24.4 million classified as long-term.

As of September 30, 2017, leased assets with two customers approximated 26% and 10%, respectively, of the Company's total assets.

As of September 30, 2017, the Company had no future minimum lease payments receivable for operating leases. Future minimum lease payments receivable under lease contracts and the amortization of unearned lease income, net of initial

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direct costs deferred, is as follows for the remainder of fiscal 2017 and the full fiscal years thereafter as of September 30, 2017:

Fiscal Year	Direct Financing and Sales-Type Leases	
	Minimum Lease Payments Receivable	Income Amortization
2017	\$ 6,461,600	\$ 1,341,400
2018	19,175,400	3,300,600
2019	11,561,600	1,017,200
2020	2,343,000	74,000
2021	12,800	1,200
Thereafter	11,200	500
	\$ 39,565,600	\$ 5,734,900

The activity in the allowance for credit losses for leasing operations during the first nine months of 2017 and 2016, respectively, is as follows:

	September 30, 2017	September 24, 2016
Balance at beginning of period	\$ 896,000	\$ 859,100
Provisions charged to expense	(26,200)	(52,000)
Recoveries	13,800	39,800
Deductions for amounts written-off	—	(29,200)
Balance at end of period	\$ 883,600	\$ 817,700

The Company's investment in direct financing and sales-type leases ("Investment In Leases") and allowance for credit losses by loss evaluation methodology are as follows:

	September 30, 2017		December 31, 2016	
	Investment In Leases	Allowance for Credit Losses	Investment In Leases	Allowance for Credit Losses
Collectively evaluated for loss potential	\$ 41,236,600	\$ 883,600	\$ 42,286,700	\$ 896,000
Individually evaluated for loss potential	—	—	—	—
Total	\$ 41,236,600	\$ 883,600	\$ 42,286,700	\$ 896,000

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The Company's key credit quality indicator for its investment in direct financing and sales-type leases is the status of the lease, defined as accruing or non-accrual. Leases that are accruing income are considered to have a lower risk of loss. Non-accrual leases are those that the Company believes have a higher risk of loss. The following table sets forth information regarding the Company's accruing and non-accrual leases. Delinquent balances are determined based on the contractual terms of the lease.

	September 30, 2017				
	0-60 Days Delinquent and Accruing	61-90 Days Delinquent and Accruing	Over 90 Days Delinquent and Accruing	Non-Accrual	Total
Middle-Market	\$ 40,058,900	\$ 93,200	\$ —	\$ —	\$ 40,152,100
Small-Ticket	1,084,500	—	—	—	1,084,500
Total Investment in Leases	\$ 41,143,400	\$ 93,200	\$ —	\$ —	\$ 41,236,600

	December 31, 2016				
	0-60 Days Delinquent and Accruing	61-90 Days Delinquent and Accruing	Over 90 Days Delinquent and Accruing	Non-Accrual	Total
Middle-Market	\$ 41,299,600	\$ —	\$ —	\$ —	\$ 41,299,600
Small-Ticket	987,100	—	—	—	987,100
Total Investment in Leases	\$ 42,286,700	\$ —	\$ —	\$ —	\$ 42,286,700

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6. Recent Accounting Pronouncements:

Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, Revenue from Contracts with Customers, which provides guidance for revenue recognition that supersedes existing revenue recognition guidance (but does not apply to nor supersede accounting guidance for lease contracts). The ASU’s core principle is that an entity will recognize revenue when it transfers 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 ASU also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The ASU should be applied retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the ASU recognized at the date of initial application. The new standard will become effective for the Company beginning with the first quarter of fiscal 2018. During 2016, the FASB issued four clarifications on specific topics within the new revenue recognition guidance that did not change the core principles of the guidance originally issued in May 2014. The Company is continuing to evaluate the impact of the adoption of this ASU on the Company’s consolidated financial statements, information technology systems, processes, internal controls and the expected method of adoption. Based on a preliminary assessment, the adoption of this guidance is not expected to impact the Company’s recognition of leasing revenues or revenue from royalties that are based on a percentage of franchisee sales. Upon adoption, initial franchise fees, which are currently recognized upon the opening of a franchise, are expected to be deferred and recognized over the term of the underlying franchise agreement. The effect of the required deferral of initial franchise fees received in a given year will be mitigated by the recognition of revenue from fees retrospectively deferred from prior years.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which provides guidance on accounting for leases that supersedes existing lease accounting guidance. The ASU’s core principle is that a lessee should recognize lease assets and lease liabilities for those leases classified as operating leases under existing lease accounting guidance. The new standard also makes targeted changes to lessor accounting. This guidance is effective for reporting periods beginning after December 15, 2018, with early adoption permitted. The provisions of this guidance are to be applied using a modified retrospective approach, with elective reliefs, which requires application of the guidance for all periods presented. The Company is currently in the process of evaluating the impact of the adoption of this ASU on the Company’s consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses of Financial Instruments, which changes the methodology for measuring credit losses on financial instruments and the timing of when such losses are recorded. This guidance will be effective for reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is currently in the process of evaluating the impact of the adoption of this ASU on the Company’s consolidated financial statements.

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Recently Adopted Accounting Pronouncements

In March 2016, the FASB issued ASU 2016-09, Compensation-Stock Compensation: Improvements to Employee Share-Based Payment Accounting, which simplifies several aspects of accounting for stock based compensation, including excess tax benefits and deficiencies, forfeiture estimates and classification in the statements of cash flows. Upon adoption, any future excess tax benefits or deficiencies are recorded to the provision for income taxes in the consolidated statements of operations instead of recorded to equity in the consolidated balance sheets. This reclassification can have a material impact on the Company's provision for income taxes and effective tax rate, depending in part on whether significant stock option exercises occur. In addition, when applying the treasury stock method for computing diluted weighted average common shares, the assumed proceeds available for hypothetical repurchase of shares do not include any windfall tax benefits under the new ASU. As a result, outstanding option awards have a more dilutive effect on earnings per share. The Company adopted ASU 2016-09 in the first quarter of 2017, using a prospective approach. As a result of adopting the ASU, for the three months and nine months ended September 30, 2017, the Company recognized \$74,800 and \$592,800, respectively, of excess tax benefits as a discrete tax benefit. The treatment of forfeitures has not changed as the Company will continue to estimate the number of forfeitures at the time of the option grant; therefore, there is no cumulative effect on retained earnings. The Company has elected to present the cash flows on a retrospective transition method with prior periods adjusted, which resulted in a reclassification of excess tax benefits for the nine months ended September 24, 2016 of \$69,700 from cash flows from financing activities to cash flows from operating activities.

7. Earnings Per Share:

The following table sets forth the presentation of shares outstanding used in the calculation of basic and diluted earnings per share ("EPS"):

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 24, 2016	September 30, 2017	September 24, 2016
Denominator for basic EPS — weighted average common shares	4,024,692	4,116,957	4,131,269	4,113,819
Dilutive shares associated with option plans	289,720	211,211	284,916	206,465
Denominator for diluted EPS — weighted average common shares and dilutive potential common shares	4,314,412	4,328,168	4,416,185	4,320,284
Options excluded from EPS calculation — anti-dilutive	10,753	12,868	16,057	18,348

8. Shareholders' Equity (Deficit):

Dividends

On January 25, 2017, the Company's Board of Directors approved the payment of a \$0.10 per share quarterly cash dividend to shareholders of record at the close of business on February 8, 2017, which was paid on March 1, 2017.

On April 26, 2017, the Company's Board of Directors approved the payment of a \$0.11 per share quarterly cash dividend to shareholders of record at the close of business on May 10, 2017, which was paid on June 1, 2017.

On July 26, 2017, the Company's Board of Directors approved the payment of a \$0.11 per share quarterly cash dividend to shareholders of record at the close of business on August 9, 2017, which was paid on September 1, 2017.

Repurchase of Common Stock

In July 2017, the Company's Board of Directors authorized the repurchase of up to 400,000 shares of our common stock for a price of \$124.48 per share through a tender offer (the "Tender Offer"). The Tender Offer began on the date of the announcement, July 19, 2017 and expired on August 16, 2017. Upon expiration, the Company accepted for payment

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400,000 shares for a total purchase price of approximately \$49.9 million, including fees and expenses related to the Tender Offer.

Under a previous Board of Directors' authorization, as of September 30, 2017, the Company has the ability to repurchase an additional 142,988 shares of its common stock. Repurchases may be made from time to time at prevailing prices, subject to certain restrictions on volume, pricing and timing.

Stock Option Plans and Stock-Based Compensation

The Company had authorized up to 750,000 shares of common stock be reserved for granting either nonqualified or incentive stock options to officers and key employees under the Company's 2001 Stock Option Plan (the "2001 Plan"). The 2001 Plan expired on February 20, 2011. At the April 26, 2017 Annual Shareholders meeting, the Company's shareholders approved an increase in the shares of common stock available for granting either nonqualified or incentive stock options to officers and key employees under the Company's 2010 Stock Option Plan (the "2010 Plan") by 200,000 shares, from 500,000 to 700,000.

The Company also sponsors a Stock Option Plan for Nonemployee Directors (the "Nonemployee Directors Plan") and has reserved a total of 350,000 shares for issuance to directors of the Company who are not employees.

Stock option activity under the 2001 Plan, 2010 Plan and Nonemployee Directors Plan (collectively, the "Option Plans") as of September 30, 2017 was as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Intrinsic Value
Outstanding, December 31, 2016	673,670	\$ 62.11	6.11	\$ 43,139,100
Granted	36,000	122.19		
Exercised	(58,686)	28.96		
Forfeited	(4,750)	95.28		
Outstanding, September 30, 2017	646,234	\$ 68.23	5.84	\$ 41,050,600
Exercisable, September 30, 2017	456,953	\$ 54.68	4.82	\$ 35,215,600

The fair value of options granted under the Option Plans during the first nine months of 2017 and 2016 were estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions and results:

	Nine Months Ended	
	September 30, 2017	September 24, 2016
Risk free interest rate	1.90 %	1.52 %
Expected life (years)	6	6
Expected volatility	26.93 %	27.10 %
Dividend yield	1.14 %	1.38 %
Option fair value	\$ 31.38	\$ 23.78

During the nine months ended September 30, 2017, options holders surrendered 2,927 shares of previously owned common shares as payment for option shares exercised as provided for by the Option Plans. All unexercised options at September 30, 2017 have an exercise price equal to the fair market value on the date of the grant.

Compensation expense of \$1,462,500 and \$1,324,400 relating to the vested portion of the fair value of stock options granted was expensed to "Selling, General and Administrative Expenses" in the first nine months of 2017 and 2016, respectively. As of September 30, 2017, the Company had \$3.8 million of total unrecognized compensation expense related to stock options that is expected to be recognized over the remaining weighted average vesting period of approximately 2.3 years.

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A reconciliation of common shares outstanding and total equity (deficit) from December 31, 2016 to September 30, 2017 is as follows:

	Common Shares	Total Equity (Deficit)
BALANCE, December 31, 2016	4,165,769	\$ (7,852,000)
Repurchase of common stock	(400,000)	(49,904,100)
Stock options exercised, net of shares surrendered	55,759	1,329,200
Compensation expense relating to stock options	—	1,462,500
Cash dividends	—	(1,343,800)
Comprehensive income	—	16,918,500
BALANCE, September 30, 2017	3,821,528	\$ (39,389,700)

9. Debt:

Line of Credit

In July 2017, the Company's Line of Credit with CIBC Bank USA (as successor by merger to the PrivateBank and Trust Company) and BMO Harris Bank N.A. was amended to, among other things:

- Provide the consent of the lenders for the Tender Offer;
- Extend the termination date from April 14, 2019 to July 19, 2021;
- Amend the tangible net worth covenant calculation to remove the effect of the Tender Offer;
- Reduce the applicable margin on interest rate options in connection with LIBOR loans under the Line of Credit;
- Permit the Company to sell up to \$15.0 million in term notes to one or more affiliates or managed accounts of Prudential to partially fund the Tender Offer.

During the first nine months of 2017, the Line of Credit was used to finance in part the Tender Offer and has been and will continue to be used for general corporate purposes. The Line of Credit is secured by a lien against substantially all of the Company's assets, contains customary financial conditions and covenants, and requires maintenance of minimum levels of debt service coverage and tangible net worth and maximum levels of leverage (all as defined within the Line of Credit). As of September 30, 2017, the Company was in compliance with all of its financial covenants. There were \$41.9 million in borrowings outstanding under the line of credit bearing interest ranging from 3.23% to 4.25%, leaving \$8.1 million available for additional borrowings.

Notes Payable

In July 2017, the Note Agreement with Prudential Investment Management, Inc., its affiliates and managed accounts (“Prudential”) was amended to, among other things:

- Provide the consent of Prudential for the Tender Offer;
- Amend the tangible net worth covenant calculation to remove the effect of the Tender Offer;
- Provide for a new \$12.5 million term loan to partially fund the Tender Offer.

In August 2017, the Company issued \$12.5 million of Series B notes to finance in part the Tender Offer. As of September 30, 2017, with the \$20.5 million in principal outstanding from the \$25.0 million of Series A notes issued in May 2015, the aggregate principal outstanding under the Note Agreement was \$33.0 million.

The final maturity of the Series A and Series B notes is 10 years from the issuance date. For the Series A notes, interest at a rate of 5.50% per annum on the outstanding principal balance is payable quarterly, along with required prepayments of the principal of \$500,000 quarterly for the first five years, and \$750,000 quarterly thereafter until the principal is paid in full. For the Series B notes, interest at a rate of 5.10% per annum on the outstanding principal balance is payable quarterly, along with required prepayments of the principal of \$312,500 quarterly until the principal is paid in full. The Series A and Series B notes may be prepaid, at the option of the Company, in whole or in part (in a minimum amount of \$1.0 million), but prepayments require payment of a Yield Maintenance Amount, as defined in the Note Agreement.

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The Company's obligations under the Note Agreement are secured by a lien against substantially all of the Company's assets (as the notes rank pari passu with the Line of Credit), and the Note Agreement contains customary financial conditions and covenants, and requires maintenance of minimum levels of fixed charge coverage and tangible net worth and maximum levels of leverage (all as defined within the Note Agreement). As of September 30, 2017, the Company was in compliance with all of its financial covenants.

In connection with the Note Agreement, the Company incurred debt issuance costs, of which unamortized amounts are presented as a direct deduction from the carrying amount of the related liability.

10. Segment Reporting:

The Company currently has two reportable business segments, franchising and leasing. The franchising segment franchises value-oriented retail store concepts that buy, sell, trade and consign merchandise as well as provides strategic consulting services related to franchising. The leasing segment includes (i) Winmark Capital Corporation, a middle-market equipment leasing business and (ii) Wirth Business Credit, Inc., a small ticket financing business. Segment reporting is intended to give financial statement users a better view of how the Company manages and evaluates its businesses. The Company's internal management reporting is the basis for the information disclosed for its business segments and includes allocation of shared-service costs. Segment assets are those that are directly used in or identified with segment operations, including cash, accounts receivable, prepaid expenses, inventory, property and equipment and investment in leasing operations. Unallocated assets include corporate cash and cash equivalents, marketable securities, current and deferred tax amounts and other corporate assets. Inter-segment balances and transactions have been eliminated. The following tables summarize financial information by segment and provide a reconciliation of segment contribution to operating income:

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 24, 2016	September 30, 2017	September 24, 2016
Revenue:				
Franchising	\$ 13,652,100	\$ 12,560,300	\$ 38,219,200	\$ 36,375,400
Leasing	3,915,800	4,174,000	13,722,000	12,839,000
Total revenue	\$ 17,567,900	\$ 16,734,300	\$ 51,941,200	\$ 49,214,400
Reconciliation to operating income:				
Franchising segment contribution	\$ 8,145,400	\$ 8,058,800	\$ 21,500,200	\$ 20,833,600
Leasing segment contribution	1,706,600	2,379,200	6,621,400	6,966,100
Total operating income	\$ 9,852,000	\$ 10,438,000	\$ 28,121,600	\$ 27,799,700
Depreciation and amortization:				
Franchising	\$ 66,300	\$ 79,700	\$ 211,200	\$ 248,200
Leasing	20,700	23,600	64,500	72,400

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Total depreciation and amortization	\$ 87,000	\$ 103,300	\$ 275,700	\$ 320,600
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	As of September 30, 2017	December 31, 2016
Identifiable assets:		
Franchising	\$ 3,473,100	\$ 3,141,300
Leasing	41,444,100	42,735,600
Unallocated	2,261,200	2,704,700
Total	\$ 47,178,400	\$ 48,581,600

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ITEM 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

As of September 30, 2017, we had 1,210 franchises operating under the Plato's Closet, Once Upon A Child, Play It Again Sports, Style Encore and Music Go Round brands and had a leasing portfolio of \$40.6 million. Management closely tracks the following financial criteria to evaluate current business operations and future prospects: royalties, leasing activity, and selling, general and administrative expenses.

Our most significant source of franchising revenue is royalties received from our franchisees. During the first nine months of 2017, our royalties increased \$1.7 million or 5.4% compared to the first nine months of 2016.

Leasing income net of leasing expense during the first nine months of 2017 was \$11.0 million compared to \$10.8 million in the same period last year. Fluctuations in period-to-period leasing income and leasing expense result primarily from the manner and timing in which leasing income and leasing expense is recognized over the term of each particular lease in accordance with accounting guidance applicable to leasing. For this reason, we believe that more meaningful levels of leasing activity are the purchases of equipment for lease customers and the medium- to long-term trend in the size of the leasing portfolio. During the first nine months of 2017, we purchased \$19.3 million in equipment for lease customers compared to \$16.4 million in the nine months of 2016. Our leasing portfolio (net investment in leases — current and long-term) decreased to \$40.6 million at September 30, 2017 from \$41.4 million at December 31, 2016.

Management continually monitors the level and timing of selling, general and administrative expenses. The major components of selling, general and administrative expenses include salaries, wages and benefits, advertising, travel, occupancy, legal and professional fees. During the first nine months of 2017, selling, general and administrative expenses increased \$1.5 million, or 8.5%, compared to the first nine months of 2016.

Management also monitors several nonfinancial factors in evaluating the current business operations and future prospects including franchise openings and closings and franchise renewals. The following is a summary of our franchising activity for the first nine months ended September 30, 2017:

	TOTAL 12/31/2016	OPENED	CLOSED	TOTAL 9/30/2017	AVAILABLE FOR RENEWAL	COMPLETED RENEWALS
Plato's Closet	468	12	(5)	475	13	13

Franchises - US and Canada						
Once Upon A Child Franchises - US and Canada	348	15	(2)	361	18	18
Play It Again Sports Franchises - US and Canada	283	4	(5)	282	13	13
Style Encore Franchises - US and Canada	52	9	(2)	59	—	—
Music Go Round Franchises - US	35	0	(2)	33	3	3
Total Franchised Stores	1,186	40	(16)	1,210	47	47

Renewal activity is a key focus area for management. Our franchisees sign 10-year agreements with us. The renewal of existing franchise agreements as they approach their expiration is an indicator that management monitors to determine the health of our business and the preservation of future royalties. During the nine months of 2017, we renewed 47 of the 47 franchise agreements available for renewal.

Our ability to grow our operating income is dependent on our ability to: (i) effectively support our franchise partners so that they produce higher revenues, (ii) open new franchises, (iii) increase lease originations and minimize write-offs in our leasing portfolio, and (iv) control our selling, general and administrative expenses.

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Results of Operations

The following table sets forth selected information from our Consolidated Condensed Statements of Operations expressed as a percentage of total revenue:

	Three Months Ended		Nine Months Ended		
	September 30, 2017	September 24, 2016	September 30, 2017	September 24, 2016	
Revenue:					
Royalties	70.1	% 67.6	% 65.2	% 65.3	%
Leasing income	22.3	24.9	26.4	26.1	
Merchandise sales	4.4	3.1	4.0	3.8	
Franchise fees	1.8	3.0	2.4	2.8	
Other	1.4	1.4	2.0	2.0	
Total revenue	100.0	100.0	100.0	100.0	
Cost of merchandise sold	(4.1)	(3.0)	(3.7)	(3.6)	
Leasing expense	(4.5)	(3.9)	(5.2)	(4.1)	
Provision for credit losses	—	0.2	—	0.1	
Selling, general and administrative expenses	(35.3)	(31.0)	(36.9)	(35.9)	
Income from operations	56.1	62.3	54.2	56.5	
Interest expense	(3.5)	(3.3)	(3.0)	(3.7)	
Interest and other income (expense)	0.2	—	—	—	
Income before income taxes	52.8	59.0	51.2	52.8	
Provision for income taxes	(20.2)	(22.6)	(18.6)	(20.2)	
Net income	32.6	% 36.4	% 32.6	% 32.6	%

Comparison of Three Months Ended September 30, 2017 to Three Months Ended September 24, 2016

Revenue

Revenues for the quarter ended September 30, 2017 totaled \$17.6 million compared to \$16.7 million for the comparable period in 2016.

Royalties and Franchise Fees

Royalties increased to \$12.3 million for the third quarter of 2017 from \$11.3 million for the third quarter of 2016, an 8.9% increase. The increase was due to higher Plato's Closet, Once Upon A Child and Style Encore royalties of \$0.4 million and \$0.4 million and \$0.1 million, respectively. The increase in royalties for these brands is primarily from higher franchisee retail sales as well as having additional franchise stores in the third quarter of 2017 compared to the same period last year.

Franchise fees were \$0.3 million for the third quarter of 2017 compared to \$0.5 million for the third quarter of 2016.

Leasing Income

Leasing income decreased to \$3.9 million for the third quarter of 2017 compared to \$4.2 million for the same period in 2016. The decrease was primarily due to the classification of certain leases in the 2016 period as sales-type leases in accordance with accounting guidance applicable to lessors.

Merchandise Sales

Merchandise sales include the sale of product to franchisees either through our Computer Support Center or through the Play It Again Sports buying group (together, "Direct Franchisee Sales"). Direct Franchisee Sales were \$0.8 million for the third quarter of 2017 compared to \$0.5 million in the same period of 2016. The increase is primarily due to an increase in technology purchases by our franchisees.

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Cost of Merchandise Sold

Cost of merchandise sold includes in-bound freight and the cost of merchandise associated with Direct Franchisee Sales. Cost of merchandise sold was \$0.7 million for the third quarter of 2017 compared to \$0.5 million in the same period of 2016. The increase was primarily due to an increase in Direct Franchisee Sales discussed above. Cost of merchandise sold as a percentage of Direct Franchisee Sales for the third quarter of 2017 and 2016 was 94.2% and 96.0%, respectively.

Leasing Expense

Leasing expense was \$0.8 million for the third quarter of 2017 compared to \$0.6 million for the third quarter of 2016.

Provision for Credit Losses

Provision for credit losses was \$(13,300) for the third quarter of 2017 compared to \$(29,700) for the third quarter of 2016.

Selling, General and Administrative

Selling, general and administrative expenses increased 19.8% to \$6.2 million in the third quarter of 2017 from \$5.2 million in the same period of 2016. The increase was primarily due to increases in compensation and benefits expenses, advertising production and outside services, inclusive of amounts related to our launch of Winmark Franchise Partners.

Interest Expense

Interest expense of \$0.6 million for the third quarter of 2017 was comparable to \$0.6 million for the third quarter of 2016.

Interest and Other Income (Expense)

During the third quarter of 2017, we had interest and other income of \$28,000 compared to \$(6,300) of interest and other expense in the third quarter of 2016.

Income Taxes

The provision for income taxes was calculated at an effective rate of 38.3% and 38.3% for the third quarter of 2017 and 2016, respectively.

Comparison of Nine Months Ended September 30, 2017 to Nine Months Ended September 24, 2016

Revenue

Revenues for the first nine months of 2017 totaled \$51.9 million compared to \$49.2 million for the comparable period in 2016.

Royalties and Franchise Fees

Royalties increased to \$33.9 million for the first nine months of 2017 from \$32.1 million for the first nine months of 2016, a 5.4% increase. The increase was due to higher Plato's Closet, Once Upon A Child and Style Encore royalties of \$0.7 million, \$0.6 million and \$0.4 million, respectively. The increase in royalties for these brands is primarily from higher franchisee retail sales as well as having additional franchise stores in the first nine months of 2017 compared to the same period last year.

Franchise fees of \$1.3 million for the first nine months of 2017 were comparable to \$1.4 million for the first nine months of 2016.

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Leasing Income

Leasing income increased to \$13.7 million for the first nine months of 2017 compared to \$12.8 million for the same period in 2016. The increase is primarily due to a higher level of equipment sales to customers.

Merchandise Sales

Merchandise sales include the sale of product to franchisees either through our Computer Support Center or through the Play It Again Sports buying group (together, "Direct Franchisee Sales"). Direct Franchisee Sales were \$2.1 million for the first nine months of 2017 compared to \$1.9 million in the same period of 2016. The increase is primarily due to an increase in technology purchases by our franchisees.

Cost of Merchandise Sold

Cost of merchandise sold includes in-bound freight and the cost of merchandise associated with Direct Franchisee Sales. Cost of merchandise sold was \$1.9 million for the first nine months of 2017 compared to \$1.8 million in the same period of 2016. The increase was due to an increase in Direct Franchisee Sales discussed above. Cost of merchandise sold as a percentage of Direct Franchisee Sales for the first nine months of 2017 and 2016 was 94.4% and 94.8%, respectively.

Leasing Expense

Leasing expense increased to \$2.7 million for the first nine months of 2017 compared to \$2.0 million for the first nine months of 2016. The increase is primarily due to an increase in the associated cost of equipment sales to customers discussed above.

Provision for Credit Losses

Provision for credit losses was \$(26,200) for the first nine months of 2017 compared to \$(52,000) for the first nine months of 2016.

Selling, General and Administrative

Selling, general and administrative expenses increased to \$19.2 million in the first nine months of 2017 compared to \$17.7 million in the same period of 2016. The increase was primarily due to increases in compensation and benefits expenses, advertising production and outside services, inclusive of amounts related to our launch of Winmark Franchise Partners.

Interest Expense

Interest expense decreased to \$1.6 million for the first nine months of 2017 compared to \$1.8 million for the first nine months of 2016. The decrease is primarily due to lower average corporate borrowings when compared to the same period last year.

Interest and Other Income (Expense)

During the first nine months of 2017, we had interest and other income of \$29,900 compared to \$(7,300) of interest and other expense in the first nine months of 2016.

Income Taxes

The provision for income taxes was calculated at an effective rate of 36.4% and 38.3% for the first nine months of 2017 and 2016, respectively. The decrease is primarily due to a tax benefit on the exercise of non-qualified stock options as a result of our adoption of a new accounting standard (ASU 2016-09) in the first quarter of 2017. (See Note 6 – “Recent Accounting Pronouncements”).

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Segment Comparison of Three Months Ended September 30, 2017 to Three Months Ended September 24, 2016

Franchising Segment Operating Income

The franchising segment's operating income for the third quarter of 2017 was \$8.1 million compared to \$8.1 million for the third quarter of 2016.

Leasing Segment Operating Income

The leasing segment's operating income for the third quarter of 2017 decreased by \$0.7 million to \$1.7 million from \$2.4 million for the third quarter of 2016. The decrease in segment contribution was primarily due to a decrease in leasing income net of leasing expense as well as an increase in selling, general and administrative expenses.

Segment Comparison of Nine Months Ended September 30, 2017 to Nine Months Ended September 24, 2016

Franchising Segment Operating Income

The franchising segment's operating income for the first nine months of 2017 increased by \$0.7 million to \$21.5 million from \$20.8 million for the first nine months of 2016. The increase in segment contribution was primarily due to increased royalty revenue; partially offset by an increase in selling, general and administrative expenses.

Leasing Segment Operating Income

The leasing segment's operating income for the first nine months of 2017 decreased by \$0.4 million to \$6.6 million from \$7.0 million for the first nine months of 2016. The decrease in segment contribution was primarily due to an increase in selling, general and administrative expenses.

Liquidity and Capital Resources

Our primary sources of liquidity have historically been cash flow from operations and borrowings. The components of the consolidated condensed statements of operations that reduce our net income but do not affect our liquidity include non-cash items for depreciation and compensation expense related to stock options.

We ended the third quarter of 2017 with \$1.1 million in cash and cash equivalents compared to \$1.1 million in cash and cash equivalents at the end of the third quarter of 2016.

Operating activities provided \$19.2 million of cash during the first nine months of 2017 compared to \$20.0 million provided during the same period last year. The decrease in cash provided by operating activities in the first nine months of 2017 compared to 2016 was primarily due to an increase in cash paid for income taxes.

Investing activities provided \$1.0 million of cash during the first nine months of 2017. The 2017 activities consisted primarily of the purchase of equipment for lease customers of \$19.3 million and principal collections on lease receivables of \$20.1 million.

Financing activities used \$20.4 million of cash during the first nine months of 2017. Our most significant financing activities during the first nine months of 2017 consisted of \$49.9 million to repurchase 400,000 shares of our common stock in the Tender Offer (including fees and expenses) and net borrowings on our line of credit and notes payable of \$29.5 million with such borrowings incurred primarily to fund in part the Tender Offer. (See Note 8 — “Shareholders’ Equity (Deficit)” and Note 9 — “Debt”).

As of September 30, 2017, we had no off balance sheet arrangements.

In July 2017, our \$50.0 million Line of Credit with CIBC Bank USA (as successor by merger to the PrivateBank and Trust Company) and BMO Harris Bank N.A. was amended to, among other things:

- Provide the consent of the lenders for the Tender Offer;
- Extend the termination date from April 14, 2019 to July 19, 2021;

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- Amend the tangible net worth covenant calculation to remove the effect of the Tender Offer;
- Reduce the applicable margin on interest rate options in connection with LIBOR loans under the Line of Credit;
- Permit us to sell up to \$15.0 million in term notes to one or more affiliates or managed accounts of Prudential to partially fund the Tender Offer.

During the first nine months of 2017, the Line of Credit was used to finance in part the Tender Offer and has been and will continue to be used for general corporate purposes. In July 2019 and each subsequent July thereafter through the term of the facility, the aggregate commitments under the Line of Credit automatically reduce by \$5.0 million. The Line of Credit is secured by a lien against substantially all of our assets, contains customary financial conditions and covenants, and requires maintenance of minimum levels of debt service coverage and tangible net worth and maximum levels of leverage (all as defined within the Line of Credit). As of September 30, 2017, there were \$41.9 million in borrowings outstanding under the line of credit bearing interest ranging from 3.23% to 4.25%, leaving \$8.1 million available for additional borrowings.

In July 2017, our Note Agreement with Prudential Investment Management, Inc., its affiliates and managed accounts (“Prudential”) was amended to, among other things:

- Provide the consent of Prudential for the Tender Offer;
- Amend the tangible net worth covenant calculation to remove the effect of the Tender Offer;
- Provide for a new \$12.5 million term loan to partially fund the Tender Offer.

In August 2017, we issued \$12.5 million of Series B notes to finance in part the Tender Offer. As of September 30, 2017, with the \$20.5 million in principal outstanding from the \$25.0 million of Series A notes issued in May 2015, the aggregate principal outstanding under the Note Agreement was \$33.0 million.

The final maturity of the Series A and Series B notes is 10 years from the issuance date. For the Series A notes, interest at a rate of 5.50% per annum on the outstanding principal balance is payable quarterly, along with required prepayments of the principal of \$500,000 quarterly for the first five years, and \$750,000 quarterly thereafter until the principal is paid in full. For the Series B notes, interest at a rate of 5.10% per annum on the outstanding principal balance is payable quarterly, along with required prepayments of the principal of \$312,500 quarterly until the principal is paid in full. The Series A and Series B notes may be prepaid, at our option, in whole or in part (in a minimum amount of \$1.0 million), but prepayments require payment of a Yield Maintenance Amount, as defined in the Note Agreement.

Our obligations under the Note Agreement are secured by a lien against substantially all of our assets, and the Note Agreement contains customary financial conditions and covenants, and requires maintenance of minimum levels of fixed charge coverage and tangible net worth and maximum levels of leverage (all as defined within the Note Agreement).

As of September 30, 2017, we were in compliance with all of the financial covenants under the Line of Credit and Note Agreement.

We incurred increased indebtedness in connection with the purchase of shares in the Tender Offer and, as a result, are more leveraged. We expect to generate the cash necessary to pay our expenses, finance our leasing business and to pay the principal and interest on all of our outstanding debt from cash flows provided by operating activities and by opportunistically using other means to repay or refinance our obligations as we determine appropriate. Our ability to pay our expenses, finance our leasing business and meet our debt service obligations depends on our future performance, which may be affected by financial, business, economic, and other factors including the risk factors described under Item 1A of our Form 10-K for the fiscal year ended December 31, 2016. If we do not have enough money to pay our debt service obligations, we may be required to refinance all or part of our existing debt, sell assets, borrow more money or raise equity. In such an event, we may not be able to refinance our debt, sell assets, borrow more money or raise equity on terms acceptable to us or at all. Also, our ability to carry out any of these activities on favorable terms, if at all, may be further impacted by any financial or credit crisis which may limit access to the credit markets and increase our cost of capital.

We may utilize discounted lease financing to provide funds for a portion of our leasing activities. Rates for discounted lease financing reflect prevailing market interest rates and the credit standing of the lessees for which the payment stream of the leases are discounted. We believe that discounted lease financing will continue to be available to us at competitive rates of interest through the relationships we have established with financial institutions.

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We believe that the combination of our cash on hand, the cash generated from our franchising business, cash generated from discounting sources, our Line of Credit and proceeds from the sale of term notes will be adequate to fund our planned operations through 2018.

Critical Accounting Policies

The Company prepares the consolidated condensed financial statements of Winmark Corporation and Subsidiaries in conformity with accounting principles generally accepted in the United States of America. As such, the Company is required to make certain estimates, judgments and assumptions that it believes are reasonable based on information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the periods presented. There can be no assurance that actual results will not differ from these estimates. The critical accounting policies that the Company believes are most important to aid in fully understanding and evaluating the reported financial results include the following:

Revenue Recognition — Royalty Revenue and Franchise Fees

The Company collects royalties from each retail franchise based on a percentage of retail store gross sales. The Company recognizes royalties as revenue when earned. At the end of each accounting period, estimates of royalty amounts due are made based on applying historical weekly sales information to the number of weeks of unreported franchisee sales. If there are significant changes in the actual performance of franchisees versus the Company's estimates, its royalty revenue would be impacted. During the first nine months of 2017, the Company collected \$52,200 less than it estimated at December 31, 2016. As of September 30, 2017, the Company's royalty receivable was \$1,411,300.

The Company collects initial franchise fees when franchise agreements are signed and recognizes the initial franchise fees as revenue when the franchise is opened, which is when the Company has performed substantially all initial services required by the franchise agreement. Franchise fees collected from franchisees but not yet recognized as income are recorded as deferred revenue in the liability section of the consolidated condensed balance sheet. As of September 30, 2017, deferred franchise fees were \$1,239,700.

Leasing Income Recognition

Leasing income for direct financing leases is recognized under the effective interest method. The effective interest method of income recognition applies a constant rate of interest equal to the internal rate of return on the lease. Generally, when a lease is more than 90 days delinquent (where more than three monthly payments are owed), the lease is classified as being on non-accrual and the Company stops recognizing leasing income on that date. Payments received on leases in non-accrual status generally reduce the lease receivable. Leases on non-accrual status remain classified as such until there is sustained payment performance that, in the Company's judgment, would indicate that all contractual amounts will be collected in full.

In certain circumstances, the Company may re-lease equipment in its existing portfolio. As this equipment may have a fair value greater than its carrying amount when re-leased, the Company may be required to account for the lease as a sales-type lease. At inception of a sales-type lease, revenue is recorded that consists of the present value of the future minimum lease payments discounted at the rate implicit in the lease. In subsequent periods, the recording of income is consistent with the accounting for a direct financing lease.

For leases that are accounted for as operating leases, income is recognized on a straight-line basis when payments under the lease contract are due.

Allowance for Credit Losses

The Company maintains an allowance for credit losses at an amount that it believes to be sufficient to absorb losses inherent in its existing lease portfolio as of the reporting dates. Leases are collectively evaluated for potential loss. The Company's methodology for determining the allowance for credit losses includes consideration of the level of delinquencies and non-accrual leases, historical net charge-off amounts and review of any significant concentrations.

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A provision is charged against earnings to maintain the allowance for credit losses at the appropriate level. If the actual results are different from the Company's estimates, results could be different. The Company's policy is to charge-off against the allowance the estimated unrecoverable portion of accounts once they reach 121 days delinquent. (See Note 5 — "Investment in Leasing Operations").

Stock-Based Compensation

The Company currently uses the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of the awards on the date of grant using an option-pricing model is affected by stock price as well as assumptions regarding a number of complex and subjective variables. These variables include implied volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends.

The Company evaluates the assumptions used to value awards on an annual basis. If factors change and the Company employs different assumptions for estimating stock-based compensation expense in future periods or if the Company decides to use a different valuation model, the future periods may differ significantly from what it has recorded in the current period and could materially affect operating income, net income and earnings per share.

Forward Looking Statements

The statements contained in this Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" that are not strictly historical fact, including without limitation, the Company's belief that it will have adequate capital and reserves to meet its current and contingent obligations and operating needs, as well as its disclosures regarding market rate risk are forward looking statements made under the safe harbor provision of the Private Securities Litigation Reform Act. Such statements are based on management's current expectations as of the date of this Report, but involve risks, uncertainties and other factors that may cause actual results to differ materially from those contemplated by such forward looking statements. Investors are cautioned to consider these forward looking statements in light of important factors which may result in material variations between results contemplated by such forward looking statements and actual results and conditions. See the section appearing in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016 entitled "Risk Factors" and Part II, Item 1A in this Report for a more complete discussion of certain factors that may cause the Company's actual results to differ from those in its forward looking statements. You should not place undue reliance on these forward-looking statements, which speak only as of the date they were made. The Company undertakes no obligation to revise or update publicly any forward-looking statements for any reason.

ITEM 3: Quantitative and Qualitative Disclosures About Market Risk

The Company incurs financial market risk in the form of interest rate risk. Risk can be quantified by measuring the financial impact of a near-term adverse increase in short-term interest rates. At September 30, 2017, the Company had available a \$50.0 million line of credit with CIBC Bank USA and BMO Harris Bank, N.A. The interest rates applicable to this agreement are based on either the bank's base rate or LIBOR for short-term borrowings (twelve months or less). The Company had \$41.9 million of debt outstanding at September 30, 2017 under this line of credit, all of which was in the form of short-term borrowings subject to daily changes in the bank's base rate or LIBOR. The Company's earnings would be affected by changes in these short-term interest rates. With the Company's borrowings at September 30, 2017, a one percent increase in short-term rates would reduce annual pretax earnings by \$419,000. The Company had no interest rate derivatives in place at September 30, 2017.

None of the Company's cash and cash equivalents at September 30, 2017 was invested in money market mutual funds, which are subject to the effects of market fluctuations in interest rates.

Foreign currency transaction gains and losses were not material to the Company's results of operations for the nine months ended September 30, 2017. During fiscal 2016, less than 5% of the Company's total revenues and 1% of expenses were denominated in a foreign currency. Based upon these revenues and expenses, a 10% increase or decrease in the foreign currency exchange rates would impact annual pretax earnings by approximately \$420,000. To date, the Company has not entered into any foreign currency forward exchange contracts or other derivative financial instruments to hedge the effects of adverse fluctuations in foreign currency exchange rates.

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ITEM 4: Controls and Procedures

As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of its disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”). Based upon, and as of the date of that evaluation, the principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company’s management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure. There was no change in the Company’s internal control over financial reporting during its most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, its internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1: Legal Proceedings

We are not a party to any material litigation and are not aware of any threatened litigation that would have a material adverse effect on our business.

ITEM 1A: Risk Factors

In addition to the other information set forth in this report, including the important information in “Forward-Looking Statements,” you should carefully consider the “Risk Factors” discussed in our Annual Report on Form 10-K for the year ended December 31, 2016. If any of those factors were to occur, they could materially adversely affect our financial condition or future results, and could cause our actual results to differ materially from those expressed in its forward-looking statements in this report. We are aware of no material changes to the Risk Factors discussed in our Annual Report on Form 10-K for the year ended December 31, 2016, other than the following:

We incurred increased indebtedness in connection with the purchase of shares in the Tender Offer (see Note 8 – “Shareholders’ Equity (Deficit)” and Note 9 – “Debt”) and, as a result, are more leveraged. We expect to generate the cash necessary to pay our expenses, finance our leasing business and to pay the principal and interest on all of our outstanding debt from cash flows provided by operating activities and by opportunistically using other means to repay or refinance our obligations as we determine appropriate. Our ability to pay our expenses, finance our leasing business and meet our debt service obligations depends on our future performance, which may be affected by financial, business, economic, and other factors including the risk factors described under Item 1A of our Form 10-K for the fiscal year ended December 31, 2016. If we do not have enough money to pay our debt service obligations, we may be required to refinance all or part of our existing debt, sell assets, borrow more money or raise equity. In such an event, we may not be able to refinance our debt, sell assets, borrow more money or raise equity on terms acceptable to us or at all. Also, our ability to carry out any of these activities on favorable terms, if at all, may be further impacted by any financial or credit crisis which may limit access to the credit markets and increase our cost of capital.

ITEM 2: Unregistered Sales of Equity Securities and Use of Proceeds

Purchase of Equity Securities by the Issuer and Affiliated Purchasers

On July 19, 2017 the Company announced a self-tender (the “Tender Offer”) to purchase up to 400,000 shares of its outstanding common stock for a price of \$124.48 per share. The Tender Offer expired on August 16, 2017, and upon expiration, the company accepted for purchase a total of 400,000 shares for a total purchase price of \$49.9 million, including fees and expenses.

The following table summarized the Company’s common stock repurchase during the third quarter of 2017. No shares were purchased during the quarter other than through the Tender Offer described above.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of a Publicly Announced Plan(1)	Maximum Number of Shares that may yet be Purchased Under the Plan
July 2, 2017 to August 5, 2017	—	\$ —	—	142,988
August 6, 2017 to September 2, 2017	400,000	\$ 124.48	400,000	142,988
September 3, 2017 to September 30, 2017	—	\$ —	—	142,988

(1) The Board of Directors’ authorization for the repurchase of shares of the Company’s common stock was originally approved in 1995 with no expiration date. The total shares approved for repurchase has been increased by additional Board of Directors’ approvals and is currently limited to 5,000,000 shares, of which 142,988 may still be repurchased

ITEM 3: Defaults Upon Senior Securities

None.

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ITEM 4: Mine Safety Disclosures

Not applicable.

ITEM 5: Other Information

All information required to be reported in a report on Form 8-K during the period covered by this Form 10-Q has been reported.

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ITEM 6: Exhibits

- 3.1 Articles of Incorporation, as amended (Exhibit 3.1)(1)
- 3.2 By-laws, as amended and restated to date (Exhibit 3.2)(2)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
- 101 Interactive Data Files Pursuant to Rule 405 of Regulation S-T: Financial statements from the quarterly report on Form 10-Q of Winmark Corporation and Subsidiaries for the quarter ended September 30, 2017, formatted in XBRL: (i) Consolidated Condensed Balance Sheets, (ii) Consolidated Condensed Statements of Operations, (iii) Consolidated Condensed Statements of Comprehensive Income, (iv) Consolidated Condensed Statements of Cash Flows, and (v) Notes to Consolidated Condensed Financial Statements.
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*Filed Herewith

- (1) Incorporated by reference to the specified exhibit to the Registration Statement on Form S-1, effective August 24, 1993 (Reg. No. 333-65108).
- (2) Incorporated by reference to the specified exhibit to the Annual Report on Form 10-K for the fiscal year ended December 30, 2006.

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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.

October 24

WINMARK CORPORATION

Date: October 24, 2017 By: /s/ Brett D. Heffes
Brett D. Heffes
Chief Executive Officer and Director
(principal executive officer)

Date: October 24, 2017 By: /s/ Anthony D. Ishaug
Anthony D. Ishaug

Executive Vice President,
Chief Financial Officer and Treasurer
(principal financial and accounting officer)