Atrion

# 2016

**ATRION CORPORATION** develops and manufactures products primarily for medical applications. Our products advance the standard of care by increasing safety for patients and providers. We target niche markets, with particular emphasis on fluid delivery, cardiovascular and ophthalmology applications. Headquartered in Allen, Texas, Atrion has design and manufacturing facilities in Alabama, Florida and Texas.

## Contents


Letter to Stockholders .......... 2
Financial Statements .......... 4
Management's Discussion .......... 22
Selected Financial Data .......... 27
Corporate Information .......... 29

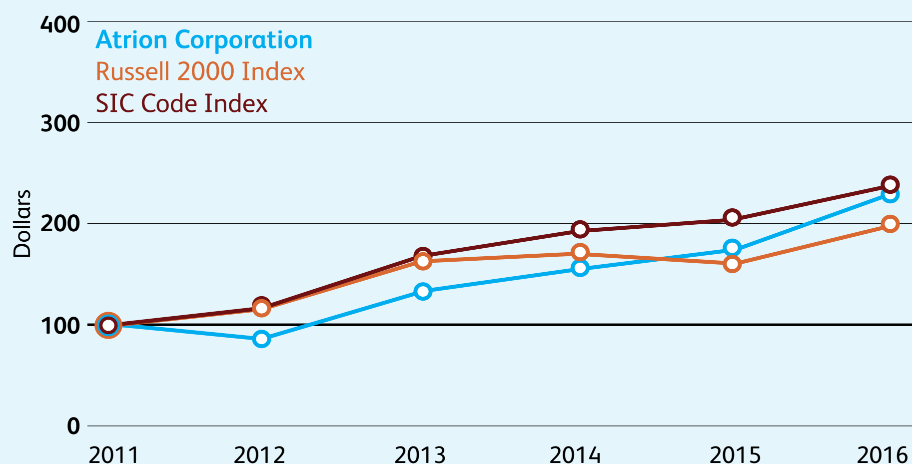
# Financial Highlights

| For the Year Ended December 31 | 2016 | 2015 |
|---|---|---|
| Revenues | $ 143,487,000 | $ 145,733,000 |
| Operating Income | 39,126,000 | 42,510,000 |
| Net Income | 27,581,000 | 28,925,000 |
| Income per Diluted Share | $ 14.85 | $ 15.47 |
| Weighted Average Diluted Shares Outstanding | 1,857,000 | 1,870,000 |

| As of December 31 | 2016 | 2015 |
|---|---|---|
| Total Assets | $ 182,593,000 | $ 164,336,000 |
| Cash and Investments | 54,047,000 | 38,256,000 |
| Long-term Debt | — | — |
| Stockholders' Equity | $ 162,988,000 | $ 144,098,000 |

## Comparison of 5-year cumulative total return

Among Atrion Corporation, Russell 2000 Index and SIC Code Index




*The graph set forth at left compares the total cumulative return for the five-year period ended December 31, 2016 on the Company's common stock, the Russell 2000 Index and SIC Code 3841 Index--Surgical and Medical Instruments (compiled by Zacks Investment Research, Inc.), assuming $100 was invested on December 31, 2011 in our common stock, the Russell 2000 Index and the SIC Code Index and dividends were reinvested*

| Company/Index | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| Atrion Corporation | $100.00 | $86.56 | $132.20 | $153.07 | $173.12 | $232.44 |
| Russell 2000 Index | $100.00 | $116.35 | $161.52 | $169.42 | $161.95 | $196.45 |
| SIC Code Index | $100.00 | $118.75 | $166.81 | $192.53 | $206.24 | $239.63 |

# To our stockholders,

We finished 2016 with an after-tax return on equity of 18%, almost 50% higher than the S&P 500. This return is even stronger if you consider that about 30% of our equity was comprised of cash and investments that did not generate significant income in this low-interest environment. If we exclude these assets and the income they generated, our after-tax return on equity for the year jumps to 25%. Once again, Atrion provided double-digit increases in the dividend to our stockholders—17% in 2016. We also finished the year debt-free and with $54 million in cash and investments—40% higher than at the end of 2015.

That we achieved these results despite the significant headwinds I described in last year's letter reveals some critical insights about Atrion.

We proudly own and operate our manufacturing facilities, all of which are in the United States. We do this to ensure the highest levels of quality, as well as out of mutual loyalty to our employees—many have more than 20 years with us, and more than a few have given us an incredible 30 or more years of their expertise. But, like other U.S.-based manufacturers that export a substantial portion of their products, the strong dollar impacted our revenues and operating income. Even though product volumes actually grew in 2016, we saw a 2% decline in revenues and an 8% decline in operating income.

We nevertheless generated strong returns for our investors because we manage the ups and downs of business cycles sensibly. This does not mean we happily accept, let alone excuse, any sort of negative year-over-year comparisons—quite the opposite, in fact. In 2016, we redoubled our efforts to expand our sales. We went back and questioned our processes and production methods to further improve our efficiencies. But we also remained focused on our commitment to long-term growth for our stockholders, employees, and customers. This means that making smart investments in people, manufacturing technologies, and future products took precedence over adding a little more to the 2016 year-end numbers.

This is how we intend to continue to grow and remain highly profitable over the next decade.

## Well-prepared for what's next

While 2016 brought us significant headwinds in the form of pricing pressure, we are still proud that our products are increasing their share of the marketplace. Our unwavering commitment to consistency, our laser focus on quality, our unfailing dedication to customer service, and our careful attention to hiring and retaining the right people: these are the factors that have long shored up our foundation, and that we are confident we can rely on going forward.

Since last year's report, global volatility has only increased and it might well continue in that direction. We don't know what 2017 will bring in terms of macroeconomic factors, but we do recognize that any changes that come our way—for example, corporate tax reform, trade policies, and regulatory requirements —could impact us in ways that might be positive or negative.

In the face of this, it is critical that we remain prepared and able to maintain a steady course. Guided by solid business planning, our philosophy has long been to prepare for, and protect against, factors that are beyond our control. Over the years, we have done this by focusing on maintaining a solid financial condition, and on growth that is steady and sustainable.

A solid financial foundation is what allows us to continue investing in what matters. We have no plans to slow the pace of investment in our manufacturing, technology, and people. Of particular focus has been investing in research and development, an area where we hold a significant competitive advantage. In 2017, we will maintain the pace of these investments; they have served us well.

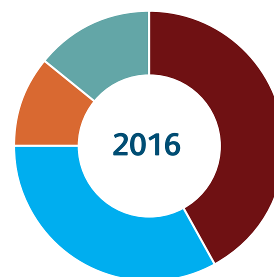
Atrion's stability and growth are firmly rooted in the capabilities of our facilities and equipment, the intellectual property we own, and the people driving our advancements.

Our priority is ensuring Atrion's long-term stability and growth, rather than realizing the kind of short-term outcomes achieved when we react too quickly to events or expectations. You can continue to count on us to focus on the long term, just as you can count on my continued appreciation of your belief in us. I am grateful to all of our investors, and to the many people at Atrion responsible for our steady, strong performance.

Respectfully,

David Battat

David A. Battat
President and CEO




**2016 REVENUES BY PRODUCT LINE**

| Product Line | Share |
|---|---|
| **Fluid Delivery**<br>$ 60,889,000 | **42%** |
| **Cardiovascular**<br>$ 47,064,000 | **33%** |
| **Ophthalmology**<br>$ 15,427,000 | **11%** |
| **Other**<br>$ 20,107,000 | **14%** |

# CONSOLIDATED BALANCE SHEETS

As of December 31, 2016 and 2015

| Assets: | 2016 | 2015 |
|---|---|---|
| | (in thousands) | |
| Current Assets: | | |
| Cash and cash equivalents | **$ 20,022** | $ 28,346 |
| Short-term investments | **24,080** | 44 |
| Accounts receivable, net of allowance for doubtful accounts of $71 and $50 in 2016 and 2015, respectively | **17,166** | 16,620 |
| Inventories | **29,015** | 29,771 |
| Prepaid expenses and other current assets | **3,181** | 2,934 |
| Deferred income taxes | **651** | 580 |
| Total Current Assets | **94,115** | 78,295 |
| Long-term investments | **9,945** | 9,866 |
| Property, Plant and Equipment | **160,413** | 150,807 |
| Less accumulated depreciation and amortization | **95,148** | 87,493 |
| | **65,265** | 63,314 |
| Other Assets and Deferred Charges: | | |
| Patents and licenses, net of accumulated amortization of $11,911 and $11,647 in 2016 and 2015, respectively | **1,929** | 2,193 |
| Goodwill | **9,730** | 9,730 |
| Other | **1,609** | 938 |
| | **13,268** | 12,861 |
| Total Assets | **$ 182,593** | $ 164,336 |

The accompanying notes are an integral part of these statements.

| Liabilities and Stockholders' Equity: | 2016 | 2015 |
| --- | --- | --- |
| | (in thousands) | |
| Current Liabilities: | | |
| Accounts payable | **$ 4,028** | $ 3,926 |
| Accrued liabilities | **4,635** | 5,061 |
| Accrued income and other taxes | **410** | 329 |
| Total Current Liabilities | **9,073** | 9,316 |
| Line of credit | **—** | — |
| Other Liabilities and Deferred Credits: | | |
| Deferred income taxes | **9,404** | 9,989 |
| Other | **1,128** | 933 |
| | **10,532** | 10,922 |
| Total Liabilities | **19,605** | 20,238 |
| Commitments and Contingencies | | |
| Stockholders' Equity: | | |
| Common stock, par value $.10 per share, authorized 10,000 shares, issued 3,420 shares | **342** | 342 |
| Additional paid-in capital | **37,448** | 35,945 |
| Accumulated other comprehensive income (loss) | **(474)** | 283 |
| Retained earnings | **239,946** | 219,516 |
| Treasury shares, 1,596 shares in both 2016 and 2015, at cost | **(114,274)** | (111,988) |
| Total Stockholders' Equity | **162,988** | 144,098 |
| Total Liabilities and Stockholders' Equity | **$ 182,593** | $ 164,336 |

The accompanying notes are an integral part of these statements.

# CONSOLIDATED STATEMENTS OF INCOME

For the year ended December 31, 2016, 2015 and 2014

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| | (in thousands, except per share amounts) | | |
| Revenues | **$ 143,487** | $ 145,733 | $ 140,762 |
| Cost of Goods Sold | **75,857** | 74,752 | 72,244 |
| Gross Profit | **67,630** | 70,981 | 68,518 |
| Operating Expenses: | | | |
| Selling | **6,611** | 6,043 | 6,210 |
| General and administrative | **15,319** | 16,082 | 16,205 |
| Research and development | **6,574** | 6,346 | 5,286 |
| | **28,504** | 28,471 | 27,701 |
| Operating Income | **39,126** | 42,510 | 40,817 |
| Interest Income | **448** | 771 | 1,191 |
| Other Income (Expense), net | **(308)** | (2,411) | 13 |
| Income before Provision for Income Taxes | **39,266** | 40,870 | 42,021 |
| Provision for Income Taxes | **(11,685)** | (11,945) | (14,213) |
| Net Income | **$ 27,581** | $ 28,925 | $ 27,808 |
| Net Income Per Basic Share | **$ 15.12** | $ 15.67 | $ 14.20 |
| Weighted Average Basic Shares Outstanding | **1,824** | 1,846 | 1,958 |
| Net Income Per Diluted Share | **$ 14.85** | $ 15.47 | $ 14.08 |
| Weighted Average Diluted Shares Outstanding | **1,857** | 1,870 | 1,975 |
| Dividends Per Common Share | **$ 3.90** | $ 3.30 | $ 2.78 |

The accompanying notes are an integral part of these statements.

# CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the year ended December 31, 2016, 2015 and 2014

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| | | (in thousands) | |
| Net Income | **$ 27,581** | $ 28,925 | $ 27,808 |
| Other Comprehensive Income (Loss), net of tax: Unrealized Gain (Loss) on investments, net of tax benefit of $408 in 2016, net of tax expense of $283 in 2015 and net of tax benefit of $131 in 2014 | **(757)** | 528 | (245) |
| Comprehensive Income | **$ 26,824** | $ 29,453 | $ 27,563 |

The accompanying notes are an integral part of these statements.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

For the year ended December 31, 2016, 2015 and 2014

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| | | (in thousands) | |
| **Cash Flows From Operating Activities:** | | | |
| Net income | **$ 27,581** | $ 28,925 | $ 27,808 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | **8,953** | 8,823 | 8,723 |
| Deferred income taxes | **(247)** | (1,431) | 2 |
| Stock-based compensation | **1,566** | 1,841 | 2,209 |
| Impairment of investment | **345** | 2,413 | — |
| Net change in accrued interest, premiums, and discounts on investments | **(37)** | 100 | 340 |
| Other | **—** | 17 | 29 |
| | **38,161** | 40,688 | 39,111 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | **(546)** | 371 | (2,798) |
| Inventories | **756** | (1,749) | (1,756) |
| Prepaid expenses and other current assets | **(247)** | 1,786 | (3,117) |
| Other non-current assets | **(673)** | (103) | (22) |
| Accounts payable and accrued liabilities | **(324)** | (492) | 968 |
| Accrued income and other taxes | **81** | (128) | (396) |
| Other non-current liabilities | **195** | 54 | (767) |
| | **37,403** | 40,427 | 31,223 |
| **Cash Flows From Investing Activities:** | | | |
| Property, plant and equipment additions | **(10,639)** | (9,323) | (12,671) |
| Purchase of investments | **(30,799)** | (168) | (33,115) |
| Proceeds from sale of investments | **210** | — | — |
| Proceeds from maturities of investments | **5,000** | 13,400 | 35,975 |
| | **(36,228)** | 3,909 | (9,811) |
| **Cash Flows From Financing Activities:** | | | |
| Shares tendered for employees' withholding taxes on stock-based compensation | **(1,112)** | (154) | (376) |
| Tax benefit related to stock-based compensation | **—** | 156 | 168 |
| Purchase of treasury stock | **(1,276)** | (30,698) | (23,556) |
| Dividends paid | **(7,111)** | (6,069) | (5,432) |
| | **(9,499)** | (36,765) | (29,196) |
| **Net change in cash and cash equivalents** | **(8,324)** | 7,571 | (7,784) |
| **Cash and cash equivalents, beginning of year** | **28,346** | 20,775 | 28,559 |
| **Cash and cash equivalents, end of year** | **$ 20,022** | $ 28,346 | $ 20,775 |
| **Cash paid for:** | | | |
| Income taxes | **$ 10,750** | $ 12,900 | $ 17,475 |

The accompanying notes are an integral part of these statements.

# CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

For the year ended December 31, 2016, 2015 and 2014 (in thousands)

| | Common Stock | | Treasury Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive Income (loss) | Retained Earnings | Total |
|---|---|---|---|---|---|---|---|---|
| | Shares Outstanding | Amount | Shares | Amount | | | | |
| **Balances, January 1, 2014** | **1,985** | **$ 342** | **1,435** | **$ (57,302)** | **$ 31,592** | **$ —** | **$ 174,362** | **$ 148,994** |
| Net income | | | | | | | 27,808 | **27,808** |
| Other comprehensive income | | | | | | (245) | | **(245)** |
| Tax benefit from stock-based compensation | | | | | 168 | | | **168** |
| Stock-based compensation transactions | 3 | | (3) | 61 | 2,180 | | | **2,241** |
| Shares surrendered in stock transactions | (1) | | 1 | (376) | | | | **(376)** |
| Purchase of treasury stock | (74) | | 74 | (23,556) | | | | **(23,556)** |
| Dividends | | | | | | | (5,464) | **(5,464)** |
| **Balances, December 31, 2014** | **1,913** | **342** | **1,507** | **(81,173)** | **33,940** | **(245)** | **196,706** | **149,570** |
| Net income | | | | | | | 28,925 | **28,925** |
| Other comprehensive income | | | | | | 528 | | **528** |
| Tax benefit from stock-based compensation | | | | | 156 | | | **156** |
| Stock-based compensation transactions | 1 | | (1) | 37 | 1,849 | | | **1,886** |
| Shares surrendered in stock transactions | (1) | | 1 | (154) | | | | **(154)** |
| Purchase of treasury stock | (89) | | 89 | (30,698) | | | | **(30,698)** |
| Dividends | | | | | | | (6,115) | **(6,115)** |
| **Balances, December 31, 2015** | **1,824** | **342** | **1,596** | **(111,988)** | **35,945** | **283** | **219,516** | **144,098** |
| Net income | | | | | | | 27,581 | **27,581** |
| Other comprehensive income | | | | | | (757) | | **(757)** |
| Stock-based compensation transactions | 7 | | (7) | 102 | 1,503 | | | **1,605** |
| Shares surrendered in stock transactions | (3) | | 3 | (1,112) | | | | **(1,112)** |
| Purchase of treasury stock | (4) | | 4 | (1,276) | | | | **(1,276)** |
| Dividends | | | | | | | (7,151) | **(7,151)** |
| **Balances, December 31, 2016** | **1,824** | **$ 342** | **1,596** | **$ (114,274)** | **$ 37,448** | **$ (474)** | **$ 239,946** | **$ 162,988** |

The accompanying notes are an integral part of this statement.

# ATRION CORPORATION
# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## (1) Summary of Significant Accounting Policies

Atrion Corporation and its subsidiaries ("we," "our," "us," "Atrion" or the "Company") develop and manufacture products primarily for medical applications. We market our products throughout the United States and internationally. Our customers include physicians, hospitals, distributors, and other manufacturers. Atrion Corporation's principal subsidiaries through which these operations are conducted are Atrion Medical Products, Inc., Halkey-Roberts Corporation and Quest Medical, Inc.

### Principles of Consolidation

The consolidated financial statements include the accounts of Atrion Corporation and its subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.

### Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements and the reported amount of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

### Cash and Cash Equivalents and Investments

Cash and cash equivalents include cash on hand and in the bank as well as money market accounts and debt securities with maturities at the time of purchase of 90 days or less.

Our investments consist of taxable corporate bonds, certificates of deposit and equity securities. We classify our investment securities in one of two categories: held-to-maturity or available-for-sale. Securities that we have the positive intent and ability to hold to maturity are reported at amortized cost and classified as held-to-maturity securities. If we do not have the intent and ability to hold a security to maturity, we report the investment as available-for-sale securities. We report available-for-sale securities at fair value, based on quoted market prices, with unrealized gains and, to the extent deemed temporary, unrealized losses recorded in stockholders' equity as accumulated other comprehensive income (loss). We consider investments which will mature in the next 12 months as current assets. The remaining investments are considered non-current assets including our investment in equity securities which we intend to hold longer than 12 months. We periodically evaluate our investments for impairment.

The components of the Company's cash and cash equivalents and our short and long-term investments as of December 31, 2016 and 2015 are as follows (in thousands):

| | December 31, 2016 | December 31, 2015 |
|---|---|---|
| **Cash and Cash Equivalents:** | | |
| Cash deposits | **$ 10,724** | $ 16,015 |
| Money market funds | **9,298** | 12,331 |
| Total cash and cash equivalents | **$ 20,022** | $ 28,346 |
| **Short-term investments:** | | |
| Certificates of deposit (held-to-maturity) | **$ 24,000** | — |
| Corporate bonds (held-to-maturity) | **80** | 44 |
| Total short-term investments | **$ 24,080** | $ 44 |
| **Long-term investments:** | | |
| Corporate bonds (held-to-maturity) | **$ 5,000** | $ 5,555 |
| Equity securities (available-for-sale) | **4,945** | 4,311 |
| Total long-term investments | **$ 9,945** | $ 9,866 |
| **Total cash, cash equivalents and short and long-term investments** | **$ 54,047** | $ 38,256 |

### Trade Receivables

Trade accounts receivable are recorded at the original sales price to the customer. We maintain an allowance for doubtful accounts to reflect estimated losses resulting from the failure of customers to make required payments. On an ongoing basis, the collectability of accounts receivable is assessed based upon historical collection trends, current economic factors and the assessment of the collectability of specific accounts. We evaluate the collectability of specific accounts and determine when to grant credit to our customers using a combination of factors, including the age of the outstanding balances, evaluation of customers' current and past financial condition, recent payment history, current economic environment, and discussions with appropriate Company personnel and with the customers directly. Accounts are written off when we determine the receivable will not be collected.

### Inventories

Inventories are stated at the lower of cost (including materials, direct labor and applicable overhead) or market. Cost is determined by using the first-in, first-out method. The following table details the major components of inventory (in thousands):

| | December 31, | | | |
|---|---|---|---|---|
| | 2016 | | 2015 | |
| Raw materials | $ | 12,984 | $ | 12,775 |
| Work in process | | 6,230 | | 6,557 |
| Finished goods | | 9,801 | | 10,439 |
| Total inventories | $ | 29,015 | $ | 29,771 |

### Accounts Payable

We reflect disbursements as trade accounts payable until such time as payments are presented to our bank for payment. At December 31, 2016 and 2015, disbursements totaling approximately $624,000 and $636,000, respectively, had not been presented for payment to our bank.

### Income Taxes

We account for income taxes utilizing Accounting Standards Codification (ASC 740), *Income Taxes*, or ASC 740. ASC 740 requires the asset and liability method for the recording of deferred income taxes, whereby deferred tax assets and liabilities are recognized based on the tax effects of temporary differences between the financial statement and the tax bases of assets and liabilities, as measured at current enacted tax rates. When appropriate, we evaluate the need for a valuation allowance to reduce deferred tax assets.

ASC 740 also requires the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement attributes of income tax positions taken or expected to be taken on a tax return. Under ASC 740, the impact of an uncertain tax position taken or expected to be taken on an income tax return must be recognized in the financial statements at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized in the financial statements unless it is more-likely-than-not of being sustained.

Our uncertain tax positions are recorded as "Other non-current liabilities." We classify interest expense on underpayments of income taxes and accrued penalties related to unrecognized tax benefits in the income tax provision.

During the years ended December 31, 2016 and 2015, we made quarterly payments in excess of federal income taxes due of approximately $920,000 and $1.2 million, respectively. These amounts are recorded in Prepaid expenses and other current assets on our Consolidated Balance Sheets.

### Property, Plant and Equipment

Property, plant and equipment is stated at cost and depreciated using the straight-line method over the estimated useful lives of the related assets. Additions and improvements are capitalized, including all material, labor and engineering costs to design, install or improve the asset. Expenditures for repairs and maintenance are charged to expense as incurred. The following table represents a summary of property, plant and equipment at original cost (in thousands):

| | December 31, | | | | |
|---|---|---|---|---|---|
| | 2016 | | 2015 | | Useful Lives |
| Land | $ | 5,260 | $ | 5,260 | — |
| Buildings | | 32,321 | | 31,914 | 30-40 yrs |
| Machinery and equipment | | 122,832 | | 113,633 | 3-15 yrs |
| Total property, plant and equipment | $ | 160,413 | $ | 150,807 | |

Depreciation expense of $8,689,000, $8,478,000 and $8,454,000 was recorded for the years ended December 31, 2016, 2015 and 2014, respectively. Depreciation expense is recorded in either cost of goods sold or operating expenses based on the associated assets' usage.

### Patents and Licenses

Costs for patents and licenses acquired are determined at acquisition date. Patents and licenses are amortized over the useful lives of the individual patents and licenses, which are from seven to 20 years. Patents and licenses are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

### Goodwill

Goodwill represents the excess of cost over the fair value of tangible and identifiable intangible net assets acquired. Annual impairment testing for goodwill is done using a qualitative assessment on goodwill impairment to determine whether it is necessary to perform the two-step goodwill impairment test. Goodwill is also reviewed whenever events or changes in circumstances indicate a change in value may have occurred. We have identified three reporting units where goodwill was recorded for purposes of testing goodwill impairment annually: (1) Atrion Medical Products, Inc., (2) Halkey-Roberts Corporation and (3) Quest Medical, Inc. The total carrying amount of goodwill in each of the years ended December 31, 2016 and 2015 was $9,730,000. Our evaluation of goodwill during each year resulted in no impairment losses.

### Current Accrued Liabilities

The items comprising current accrued liabilities are as follows (in thousands):

| | December 31, | |
|---|---|---|
| | 2016 | 2015 |
| Accrued payroll and related expenses | **$ 3,661** | $ 4,206 |
| Accrued vacation | **265** | 245 |
| Other accrued liabilities | **709** | 610 |
| Total accrued liabilities | **$ 4,635** | $ 5,061 |

### Revenues

We recognize revenue when our products are shipped to our customers, provided an arrangement exists, the fee is fixed and determinable and collectability is reasonably assured. All risks and rewards of ownership pass to the customer upon shipment. Net sales represent gross sales invoiced to customers, less certain related charges, including discounts, returns and other allowances. Revenues are recorded exclusive of sales and similar taxes. Returns, discounts and other allowances have been insignificant historically.

### Shipping and Handling Policy

Shipping and handling fees charged to customers are reported as revenue and all shipping and handling costs incurred related to products sold are reported as cost of goods sold.

### Research and Development Costs

R&D costs relating to the development of new products and improvements of existing products are expensed as incurred.

### Stock-Based Compensation

We have stock-based compensation plans covering certain of our officers, directors and key employees. As explained in detail in Note 8, we account for stock-based compensation utilizing the fair value recognition provisions of ASC 718, *Compensation-Stock Compensation*, or ASC 718.

### New Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-09, *Stock Compensation* (Topic 718): *Improvements to Employee Share-Based Payment Accounting* (ASU 2016-09). This amendment simplifies the accounting for some aspects of share-based payment transactions, including the income tax treatment of excess tax benefits and deficiencies, forfeitures, classification of share-based awards as either equity or liabilities, and classification in the statement of cash flows for certain share-based transactions related to tax benefits and payments. Under this guidance all excess tax benefits ("windfalls") and deficiencies ("shortfalls") related to employee stock compensation are recognized within income tax expense. Under prior guidance windfalls were recognized in paid-in capital and shortfalls were only recognized to the extent they exceeded the pool of windfall tax benefits. ASU 2016-09 also requires companies to classify cash flows resulting from excess tax benefits and deficiencies from employee share-based payments as cash flows from operating activities. These items were previously included as cash flows from financing activities. ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted. The Company early adopted this guidance in the second quarter of 2016 effective January 1, 2016. The Company elected to account for forfeitures as they occur and to use a prospective transition method for the presentation of excess tax benefits on the statement of cash flows. As a result of the adoption, a tax benefit of $687,000 was recorded in 2016 reflecting the excess tax benefits resulting from the vesting of restricted stock and restricted stock units. Prior to adoption, this amount would have been recorded as additional paid-in capital. This change could create future volatility in our effective tax rate depending upon the amount of exercise or vesting activity from our stock based awards. This adoption also impacted the computation of diluted shares outstanding for all 2016 reporting periods as we excluded the excess tax benefits from the assumed proceeds available to repurchase shares in the computation of our diluted earnings per share. The effect of this change on our diluted earnings per share was not significant. The excess tax benefit recorded in 2016 was included in our consolidated statements of cash flows as an operating activity rather than as a financing activity as was done in prior years. There were no restatements of cash flows from operating activities or cash flows from financing activities for the years 2015 and 2014 because we elected to adopt this change on a prospective basis. ASU 2016-09 also requires the presentation of employee taxes paid by the Company through the withholding of shares as a financing activity on the statement of cash flows, which is how we had previously reflected these items.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments - Overall* (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*. The main objective of this update is to enhance the reporting model for financial instruments in order to provide users of financial statements with more decision-useful information. The new guidance addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. This ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. We are currently evaluating the new guidance to determine the impact it may have on our consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, *Balance Sheet Classification of Deferred Taxes* (ASU 2015-17) which requires that deferred tax liabilities and assets be classified as noncurrent on the balance sheet. The current requirement that deferred tax liabilities and assets of a tax-paying component of an entity be offset and presented as a single amount is not affected by this guidance. ASU 2015-17 is effective for annual

and interim periods beginning after December 15, 2016 but early application is permitted and the guidance may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company does not anticipate a material impact on its consolidated financial statements at the time of adoption of this new standard.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). ASU 2014-09 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in United States Generally Accepted Accounting Principles when it becomes effective. In July 2015, the FASB voted to delay the effective date of ASU 2014-09 by one year, making it effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, with early adoption permitted as of the original effective date. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We plan on adopting the ASU in the first quarter of the year ended December 31, 2018. The Company has not yet selected a transition method and is currently evaluating the effect that our pending adoption for the guidance will have on our consolidated financial statements and related disclosures. We anticipate our assessment to be completed by December 31, 2017. Based on our existing evaluation process, we have not identified any revenue stream that would be impacted.

From time to time, new accounting pronouncements applicable to us are issued by the FASB, or other standards setting bodies, which we will adopt as of the specified effective date. Unless otherwise discussed, we believe the impact of recently issued standards that are not yet effective will not have a material impact on our consolidated financial statements upon adoption.

### Fair Value Measurements

Accounting standards use a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value. These tiers are: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists therefore requiring an entity to develop its own assumptions.

As of December 31, 2016 and 2015, we held certain investments in corporate and government debt securities, certificates of deposit, and certain equity securities. These investments are all considered Level 2 assets and the fair value of our investments were estimated using recently executed transactions and market price quotations (see Note 2).

The carrying values of our other financial instruments including cash and cash equivalents, money market accounts, accounts receivable, accounts payable, accrued liabilities, and accrued income and other taxes approximated fair value due to their liquid and short-term nature.

### Concentration of Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, certificates of deposit, investments and accounts receivable.

Our cash and cash equivalents and certificates of deposit are held in accounts with financial institutions that we believe are creditworthy. Certain of these amounts at times may exceed federally-insured limits. At December 31, 2016, approximately 89 percent of our cash and cash equivalents and all of our certificates of deposit were uninsured. We have not experienced any credit losses in such accounts and do not believe we are exposed to any significant credit risk on these funds.

We have investments in corporate bonds. As a result, we are exposed to potential loss from market risks that may occur as a result of changes in interest rates, changes in credit quality of the issuer and otherwise. These securities have a higher degree of credit or default risk and a greater exposure to credit risk and may be less liquid in times of economic weakness or market disruptions.

For accounts receivable, we perform ongoing credit evaluations of our customers' financial condition and generally do not require collateral. We maintain reserves for possible credit losses. As of December 31, 2016 and 2015, we had allowances for doubtful accounts of approximately $71,000 and $50,000, respectively. The carrying amount of the receivables approximates their fair value. No customer exceeded 10 percent of our accounts receivable as of December 31, 2016 or 2015.

## (2) Investments

As of December 31, 2016 and 2015, we held certain investments that were required to be measured for disclosure purposes at fair value on a recurring basis. These investments were considered Level 2 investments. We consider as current assets those investments which will mature in the next 12 months including interest receivable on long-term bonds. The remaining investments are considered non-current assets including our investment in equity securities which we intend to hold longer than 12 months.

The amortized cost and fair value of our investments and the related gross unrealized gains and losses, were as follows as of the dates shown below (in thousands):

| | Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| As of December 31, 2016 | | | | |
| **Short-term Investments:** | | | | |
| Certificates of deposit | **$ 24,000** | **$ 9** | **$ —** | **$ 24,009** |
| Corporate bonds | **$ 80** | **$ —** | **$ —** | **$ 80** |
| **Long-term Investments:** | | | | |
| Corporate bonds | **$ 5,000** | **$ —** | **($287)** | **$ 4,713** |
| Equity Investments | **$ 5,675** | **$ —** | **($730)** | **$ 4,945** |
| As of December 31, 2015 | | | | |
| **Short-term Investments:** | | | | |
| Corporate bonds | $ 44 | $ — | $ — | $ 44 |
| **Long-term Investments:** | | | | |
| Corporate and government bonds | $ 5,555 | $ — | ($30) | $ 5,525 |
| Equity Investments | $ 3,876 | $ 435 | $ — | $ 4,311 |

The above long-term corporate bonds represent an investment in one issuer at December 31, 2016. The unrealized loss for this investment relates to a rise in interest rates which resulted in a lower market price for that security. This investment has not been in a loss position for more than 12 months. In 2015, one of our bonds experienced a significant decline in market value over a 12-month period due to a changed outlook for the issuer resulting from a major economic decline in its industry. In the fourth quarter of 2015, we determined based upon disclosures by the issuer, that more likely than not, we would be required to sell or exchange the bond before recovery of its amortized cost. Therefore, we recorded an impairment loss on this bond of $2.4 million in 2015, reducing the carrying value of the bond to its market value at December 31, 2015. In 2016 after the issuer declared bankruptcy, we sold this bond that was previously intended to be held to maturity. We recorded an additional net loss of $311,000 on this bond in 2016 prior to and including its sale. These losses in 2015 and 2016 are reported as other income (loss) on our Consolidated Statements of Income.

The carrying value of our investments is reviewed quarterly for changes in circumstance or the occurrence of events that suggest an investment may not be recoverable. At December 31, 2016, the length of time until maturity of the corporate bond we currently own is 53.5 months and the length of time until maturity of the certificates of deposit ranged from 1.5 to 9.7 months.

Our accumulated other comprehensive income (loss) is comprised solely of unrealized losses on our above equity investments, net of tax. These equity securities are treated as available-for-sale securities.

## (3) Patents and Licenses

Purchased patents and licenses paid for the use of other entities' patents are amortized over the useful life of the patent or license. The following tables provide information regarding patents and licenses (dollars in thousands):

| December 31, 2016 | | |
|---|---|---|
| Weighted Average Original Life (years) | Gross Carrying Amount | Accumulated Amortization |
| **15.67** | **$ 13,840** | **$ 11,911** |

| December 31, 2015 | | |
|---|---|---|
| Weighted Average Original Life (years) | Gross Carrying Amount | Accumulated Amortization |
| 15.67 | $ 13,840 | $ 11,647 |

Aggregate amortization expense for patents and licenses was $264,000, $345,000 and $269,000 for 2016, 2015 and 2014, respectively. Estimated future amortization expense for each of the years set forth below ending December 31 is as follows (in thousands):

| | |
|---|---|
| **2017** | $ 151 |
| **2018** | $ 119 |
| **2019** | $ 119 |
| **2020** | $ 119 |
| **2021** | $ 119 |

## (4) Line of Credit

As of December 31, 2016 we had a $40.0 million revolving credit facility with a money center bank pursuant to which the lender was obligated to make advances until October 1, 2021. The credit facility was secured by substantially all our inventories, equipment and accounts receivable. Interest under the credit facility was assessed at 30-day, 60-day or 90-day LIBOR, as selected by us, plus one percent (1.76 percent at December 31, 2016) and was payable monthly. We had no outstanding borrowings under the credit facility at December 31, 2016 or 2015. Our ability to borrow funds under the credit facility from time to time was contingent on meeting certain covenants in the loan agreement, the most restrictive of which was the ratio of total debt to earnings before interest, income tax, depreciation and amortization. At December 31, 2016, we were in compliance with all of those covenants.

On February 28, 2017 we replaced the revolving credit facility with a new $75.0 million revolving credit facility with the same bank. The new credit facility has similar operational, covenant and collateral characteristics as the prior facility. Interest under the new credit facility is assessed at one, two, three or six-month LIBOR, as selected by us, plus .875 percent. The new credit facility provides for advances until February 28, 2022.

## (5) Income Taxes

The items comprising income tax expense are as follows (in thousands):

| | | Year ended December 31, | | |
|---|---|---|---|---|
| | | 2016 | 2015 | 2014 |
| Current | — Federal | $ 10,706 | $ 11,848 | $ 12,626 |
| | — State | 1,226 | 1,528 | 1,585 |
| | | 11,932 | 13,376 | 14,211 |
| Deferred | — Federal | (92) | (1,364) | 31 |
| | — State | (155) | (67) | (29) |
| | | (247) | (1,431) | 2 |
| Provision for Income Taxes | | $ 11,685 | $ 11,945 | $ 14,213 |

Temporary differences and carryforwards which have given rise to deferred income tax assets and liabilities as of December 31, 2016 and 2015 are as follows (in thousands):

| | 2016 | 2015 |
|---|---|---|
| **Deferred tax assets:** | | |
| Benefit plans | $ 1,819 | $ 1,958 |
| Inventories | 519 | 473 |
| Other | 1,292 | 733 |
| Total deferred tax assets | $ 3,630 | $ 3,164 |
| **Deferred tax liabilities:** | | |
| Property, plant and equipment | $ 9,550 | $ 9,585 |
| Patents and goodwill | 2,833 | 2,897 |
| Other | — | 91 |
| Total deferred tax liabilities | $ 12,383 | $ 12,573 |
| Net deferred tax liability | $ 8,753 | $ 9,409 |
| **Balance Sheet classification:** | | |
| Non-current deferred income tax liability | $ 9,404 | $ 9,989 |
| Current deferred income tax asset | 651 | 580 |
| Net deferred tax liability | $ 8,753 | $ 9,409 |

Total income tax expense differs from the amount that would be provided by applying the statutory federal income tax rate to pretax earnings as illustrated below (in thousands):

| | Year ended December 31, | | |
|---|---|---|---|
| | 2016 | 2015 | 2014 |
| Income tax expense at the statutory federal income tax rate | $ 13,743 | $ 14,304 | $ 14,707 |
| Increase (decrease) resulting from: | | | |
| State income taxes | 730 | 882 | 934 |
| Section 199 manufacturing deduction | (1,165) | (1,383) | (1,290) |
| R&D tax credits | (1,070) | (2,254) | (393) |
| Excess tax benefit from stock compensation | (687) | — | — |
| Other, net | 134 | 396 | 255 |
| Provision for Income Taxes | $ 11,685 | $ 11,945 | $ 14,213 |

An excess tax benefit is the realized tax benefit related to the amount of deductible compensation cost reported on an employer's tax return for equity instruments in excess of the compensation cost for those instruments recognized for financial reporting purposes. The Company adopted ASU-2016-09 (see Note 1) effective January 1, 2016 eliminating the requirement for excess tax benefits to be recorded as additional paid-in capital when realized. Excess tax benefits in the amount of $156,000 and $168,000 were recognized as additional paid-in capital during 2015 and 2014, respectively, resulting from the vesting of restricted stock and restricted stock units. With the adoption of ASU 2016-09, excess tax benefits of $687,000 were recognized as a component of income tax expense in 2016 for these types of transactions.

We recorded tax credits for our R&D expenditures totaling $2.3 million in 2015. This amount included an adjustment for recalculation of our R&D tax credits from prior years resulting from a new regulation issued by the Treasury Department which favorably impacted the benefits provided to the Company under these rules.

A reconciliation of the beginning and ending balances of the total amounts of gross unrecognized tax benefits as required by ASC 740 is as follows (in thousands):

| | |
|---|---|
| Gross unrecognized tax benefits at January 1, 2014 | $ 346 |
| Increase in tax positions for prior years | 6 |
| Increase in tax positions for current year | 0 |
| Lapse in statutes of limitation | (223) |
| Gross unrecognized tax benefits at December 31, 2014 | $ 129 |
| Increase in tax positions for prior years | 122 |
| Increase in tax positions for current year | 0 |
| Lapse in statutes of limitation | (131) |
| Gross unrecognized tax benefits at December 31, 2015 | $ 120 |
| Decrease in tax positions for prior years | (120) |
| Increase in tax positions for current year | 0 |
| Lapse in statutes of limitation | 0 |
| Gross unrecognized tax benefits at December 31, 2016 | $ 0 |

We are subject to United States federal income tax as well as to income tax of multiple state jurisdictions. We have concluded all United States federal income tax matters for years through 2011. The audit of our federal income tax returns for 2011, 2012 and 2013 was completed in 2016 with no changes. All material state and local income tax matters have been concluded for years through 2012.

We recognize interest and penalties, if any, related to unrecognized tax benefits in income tax expense. Tax expense for the year ended December 31, 2016, 2015 and 2014 included a net interest benefit of $0, $9,000 and $12,000, respectively.

## (6) Stockholders' Equity

Our Board of Directors has at various times authorized repurchases of our stock in open-market or privately-negotiated transactions at such times and at such prices as management may from time to time determine. On August 16, 2011, our Board of Directors adopted a stock repurchase program pursuant to which we repurchased 200,000 shares of our common stock from time to time in open market or privately-negotiated transactions, which was the maximum number of shares that could be repurchased. On May 21, 2015 our Board of Directors adopted a new stock repurchase program pursuant to which we can repurchase up to 250,000 shares of our common stock from time to time in open market or privately-negotiated transactions. This program has no expiration date but may be terminated by the Board of Directors at any time. As of December 31, 2016, 231,765 shares remained available for repurchase under this program. We repurchased 3,427, 89,452 and 73,379 shares during 2016, 2015 and 2014, respectively.

We increased our quarterly cash dividend payments in September of each of the past three years. The quarterly dividend was increased to $.75 per share in September 2014, to $.90 per share in September 2015 and to $1.05 per share in September 2016. Holders of our stock units earned non-cash dividend equivalents of $40,000 in 2016, $46,000 in 2015 and $33,000 in 2014.

## (7) Income Per Share

The following is the computation of basic and diluted income per share:

| | Year ended December 31, | | |
|---|---|---|---|
| | **2016** | **2015** | **2014** |
| | (in thousands, except per share amounts) | | |
| Net Income | **$ 27,581** | $ 28,925 | $ 27,808 |
| Weighted average basic shares outstanding | **1,824** | 1,846 | 1,958 |
| Add: Effect of dilutive securities | **33** | 24 | 17 |
| Weighted average diluted shares outstanding | **1,857** | 1,870 | 1,975 |
| Net Income Per Share | | | |
| Basic | **$ 15.12** | $ 15.67 | $ 14.20 |
| Diluted | **$ 14.85** | $ 15.47 | $ 14.08 |

As required by ASC 260, *Earnings per Share*, unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are considered participating securities and, therefore, are included in the computation of basic income per share pursuant to the two-class method.

Incremental shares from stock options and restricted stock units were included in the calculation of weighted average diluted shares outstanding using the treasury stock method. Dilutive securities representing eight shares of common stock for the year ended December 31, 2014 were excluded from the computation of weighted average diluted shares outstanding because their effect would have been anti-dilutive.

## (8) Stock Plans

At December 31, 2016, we had three stock-based compensation plans which are described more fully below. We account for our plans under ASC 718, and the disclosures that follow are based on applying ASC 718.

Our Amended and Restated 2006 Equity Incentive Plan, or 2006 Plan, provides for awards to key employees, non-employee directors and consultants of incentive and nonqualified stock options, restricted stock, restricted stock units, deferred stock units, stock appreciation rights, performance shares and other stock-based awards. Under the 2006 Plan, 200,000 shares, in the aggregate, of common stock have been reserved for awards. The purchase price of shares issued on the exercise of options must be at least equal to the fair market value of such shares on the date of grant. The options granted become exercisable and expire as determined by the Compensation Committee. As of December 31, 2016, there remained 52,248 shares reserved for future stock-based awards under the 2006 Plan.

In May 2007, we adopted our Deferred Compensation Plan for Non-Employee Directors (as amended, the "Deferred Compensation Plan"), and 2,500 shares of our common stock were initially reserved for issuance thereunder. This plan allows our non-employee directors to elect to receive stock units in lieu of all or part of the cash fees they are receiving for their services as directors. On the first business day of each calendar year, each participating non-employee director is credited with a number of stock units determined on the basis of the foregone cash fees and the closing price of our common stock on the next preceding date on which shares of our stock were traded. The stock units are converted to shares of our common stock on a one-for-one basis at a future date as elected in advance by the director, but no later than the January following the year in which the director ceases to serve on the Board of Directors, and the shares are delivered to the director. As of December 31, 2016, there remained 1,559 shares of common stock reserved for issuance upon the conversion of stock units which may be credited in the future to non-employee directors.

In May 2007, we also adopted our Non-Employee Director Stock Purchase Plan, (as amended, the "Director Stock Purchase Plan"), and 2,500 shares of our common stock were initially reserved for issuance thereunder. Under this plan, our non-employee directors may elect to receive on the first business day of the calendar year fully-vested stock and restricted stock in lieu of some or all of their fees payable to them during such year. The foregone fees are converted into shares of fully-vested stock and restricted stock on the first business day of such calendar year based on the closing price of our common stock on the

next preceding date on which shares of our stock were traded. The restricted stock vests in equal amounts on the first day of the next three succeeding calendar quarters provided the non-employee director is then serving on our Board of Directors. As of December 31, 2016, there remained 1,126 shares reserved for issuance under such plan.

A summary of stock option transactions for the year ended December 31, 2016 is presented below:

| Options | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term |
|---|---|---|---|
| Outstanding at December 31, 2015 | 50,000 | $ 204.76 | |
| Granted | — | — | |
| Exercised | — | — | |
| Outstanding at December 31, 2016 | 50,000 | $ 204.76 | 1.9 years |
| Exercisable at December 31, 2016 | 45,000 | $ 202.17 | 1.8 years |

All nonvested options outstanding at December 31, 2016 are expected to vest. We estimate the fair value of stock options granted using the Black-Scholes option-pricing formula and a single option award approach. None of our grants includes performance-based or market-based vesting conditions. The expected life represents the period that our stock-based awards are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The fair value of stock-based payments, funded with options, is valued using the Black-Scholes valuation method with a volatility factor based on our historical stock trading history. We base the risk-free interest rate using the Black-Scholes valuation method on the implied yield currently available on U.S. Treasury securities with an equivalent term. We base the dividend yield used in the Black-Scholes valuation method on our dividend history.

There were no options granted in 2016, 2015 or 2014. There were no options exercised in 2016 or 2015. The total intrinsic values of options outstanding and options currently exercisable at December 31, 2016, were $15.1 million and $13.7 million, respectively.

During 2016, no shares of restricted stock were awarded under the 2006 Plan. Under the terms of our restricted stock awards, the restrictions usually lapse over a five-year period. During the vesting period, holders of restricted stock have voting rights and earn dividends, but the shares may not be sold, assigned, transferred, pledged or otherwise encumbered. Nonvested shares are generally forfeited on termination of employment unless otherwise provided in the participant's employment agreement or the termination is in connection with a change in control. A summary of changes in nonvested restricted stock for the year ended December 31, 2016 is presented below:

| Nonvested Shares | Shares | Weighted Average Award Date Fair Value Per Share |
|---|---|---|
| Restricted stock at December 31, 2015 | 4,500 | $ 212.53 |
| Granted in 2016 | — | $ — |
| Vested in 2016 | (3,000) | $ 204.76 |
| Restricted stock at December 31, 2016 | 1,500 | $ 228.08 |

All shares of nonvested restricted stock outstanding at December 31, 2016 are expected to vest. The total fair value of restricted stock vested during 2016, 2015 and 2014 was $1,177,000, $1,086,000 and $1,372,000, respectively.

During 2016 there were no restricted stock units awarded under the 2006 Plan. All of our restricted stock units are convertible to shares of stock on a one-for-one basis when the restrictions lapse, which is generally after a five-year period. Nonvested stock units are generally forfeited on termination of employment unless the termination is in connection with a change in control. During the vesting period, holders of all restricted stock units earn dividends in the form of additional units. During 2016, one non-employee director elected to receive stock units in lieu of a portion of his cash fees for his services as a member of the Board of Directors.

A summary of changes in stock units for the year ended December 31, 2016, is presented below:

| Nonvested Stock Units | Restricted Stock Units | Weighted Average Award Date Fair Value Per Unit | Director's Stock Units | Weighted Average Award Date Fair Value Per Unit |
|---|---|---|---|---|
| Nonvested at December 31, 2015 | 15,428 | $ 229.02 | — | |
| Granted | 88 | $ 431.74 | 25 | $ 390.43 |
| Vested | (6,128) | $ 186.49 | (25) | $ 390.43 |
| Nonvested at December 31, 2016 | 9,388 | $ 258.69 | — | |

All nonvested restricted stock units at December 31, 2016 are expected to vest. The total intrinsic value of all outstanding stock units which were not convertible at December 31, 2016, including 457 stock units held for the accounts of non-employee directors, was $4,994,000. The total fair value of directors' stock units that vested was $10,000 during 2016, $5,000 during 2015 and $8,000 during 2014.

Stock awards that vested immediately were awarded under the 2006 Plan to non-employee directors totaling $240,000 in value in each of 2016, 2015 and 2014. Compensation related to stock awards, restricted stock and stock units is based on the fair market value of the stock on the date of the award. These fair values are then amortized on a straight-line basis over the requisite service periods of the entire awards, which is generally the vesting period. Compensation related to stock options is based on the fair value of stock options granted using the Black-Scholes option-pricing formula and a single option award approach.

For the years ended December 31, 2016, 2015 and 2014, we recorded stock-based compensation expense as a G&A expense in the amount of $1,566,000, $1,841,000 and $2,209,000, respectively, for all of the above mentioned stock-based compensation arrangements. The total tax benefit recognized in the income statement from stock-based compensation arrangements for the years ended December 31, 2016, 2015 and 2014, was $1,235,000, $644,000 and $773,000, respectively. The 2016 tax benefit amount includes $687,000 of excess tax benefits within income tax expense as a result of the adoption of ASU 2016-09. Excess tax benefits of $156,000 and $168,000 were recognized during 2015 and 2014, respectively, as additional paid-in capital and are shown as a financing activity in our consolidated statements of cash flows for such years.

Unrecognized compensation cost information for our various stock-based compensation types is shown below as of December 31, 2016:

| | Unrecognized Compensation Cost | Weighted Average Remaining Years in Amortization Period |
|---|---|---|
| Stock options | $ 76,000 | 0.4 |
| Restricted stock | 128,000 | 0.4 |
| Restricted stock units | 622,000 | 2.5 |
| Total | $ 826,000 | |

We have a policy of utilizing treasury shares to satisfy stock option exercises, stock unit conversions and restricted stock awards.

## (9) Industry Segment and Geographic Information

We operate in one reportable industry segment: developing and manufacturing products primarily for medical applications and have no foreign operating subsidiaries. We have other product lines which include pressure relief valves and inflation systems, which are sold primarily to the aviation and marine industries. Due to the similarities in product technologies and manufacturing processes, these products are managed as part of our medical products segment. Our revenues from sales to customers outside the United States totaled approximately 37, 35 and 42 percent of our net revenues in 2016, 2015 and 2014, respectively. In 2015, we saw a shift in the percentage of our international sales that was driven in large part by a customer's decision to build a new facility in the United States. We have no assets located outside the United States.

A summary of revenues by geographic area, based on shipping destination, for 2016, 2015 and 2014 is as follows (in thousands):

| | Year ended December 31, | | |
|---|---|---|---|
| | **2016** | **2015** | **2014** |
| United States | **$ 91,092** | $ 94,840 | $ 81,971 |
| Canada | **2,041** | 2,062 | 11,655 |
| Other countries less than 10% of revenues | **50,354** | 48,830 | 47,136 |
| Total | **$ 143,487** | $ 145,733 | $ 140,762 |

A summary of revenues by product line for 2016, 2015 and 2014 is as follows (in thousands):

| | **2016** | **2015** | **2014** |
|---|---|---|---|
| Fluid Delivery | **$ 60,889** | $ 60,630 | $ 57,905 |
| Cardiovascular | **47,064** | 46,463 | 43,001 |
| Ophthalmology | **15,427** | 18,253 | 19,329 |
| Other | **20,107** | 20,387 | 20,527 |
| Total | **$ 143,487** | $ 145,733 | $ 140,762 |

## (10) Employee Retirement and Benefit Plans

We sponsor a defined contribution 401(k) plan for all employees. Each participant may contribute certain amounts of eligible compensation. We make a matching contribution to the plan. Our contributions under this plan were $667,000, $645,000 and $600,000 in 2016, 2015 and 2014, respectively.

## (11) Commitments and Contingencies

From time to time and in the ordinary course of business, we may be subject to various claims, charges and litigation. In some cases, the claimants may seek damages, as well as other relief, which, if granted, could require significant expenditures. We accrue the estimated costs of settlement or damages when a loss is deemed probable and such costs are estimable, and accrue for legal costs associated with a loss contingency when a loss is probable and such amounts are estimable. Otherwise, these costs are expensed as incurred. If the estimate of a probable loss or defense costs is a range and no amount within the range is more likely, we accrue the minimum amount of the range. As of December 31, 2016, the Company had no ongoing litigation or arbitration for such matters.

We had a dispute which was favorably settled in the third quarter of 2007. This settlement was amended in December 2008. The amended settlement agreement provides that we may receive annual payments from 2009 through 2024. We have not recorded $4.0 million in potential future payments under this settlement as of December 31, 2016 due to the uncertainty of payment.

We have arrangements with three of our executive officers pursuant to which the termination of their employment under certain circumstances would result in lump sum payments to them. Termination under such circumstances at December 31, 2016 could have resulted in payments aggregating $6.0 million.

## (12) Quarterly Financial Data (Unaudited)

| Quarter Ended | Operating Revenue | Operating Income | Net Income | Income Per Basic Share | Income Per Diluted Share |
|---|---|---|---|---|---|
| | (in thousands, except per share amounts) | | | | |
| 03/31/16 | $ 36,215 | $ 10,465 | $ 6,945 | $ 3.81 | $ 3.76 |
| 06/30/16 | 36,143 | 10,074 | 7,450 | 4.09 | 4.02 |
| 09/30/16 | 37,835 | 10,976 | 7,614 | 4.17 | 4.10 |
| 12/31/16 | 33,294 | 7,611 | 5,571 | 3.05 | 3.00 |
| | | | | | |
| 03/31/15 | $ 38,324 | $ 11,486 | $ 7,602 | $ 4.05 | $ 4.01 |
| 06/30/15 | 37,655 | 11,120 | 7,474 | 4.04 | 3.99 |
| 09/30/15 | 37,381 | 11,573 | 7,799 | 4.25 | 4.19 |
| 12/31/15 | 32,372 | 8,330 | 6,050 | 3.32 | 3.27 |

The quarterly information presented above reflects, in the opinion of management, all adjustments necessary for a fair presentation of the results for the interim periods presented.

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

## Board of Directors and Stockholders
## Atrion Corporation

We have audited the accompanying consolidated balance sheets of Atrion Corporation and subsidiaries (the "Company") as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2016. Our audits of the basic consolidated financial statements included the financial statement schedule (not presented separately herein) listed in the index appearing under Item 15, *Exhibits and Financial Statement Schedules*. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Atrion Corporation and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2016, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 14, 2017 expressed an unqualified opinion.

Grant Thornton LLP
Dallas, Texas
March 14, 2017

# MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management, including our Chief Executive Officer and Chief Financial Officer, is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended. Our internal control system is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. All internal control systems, no matter how well designed, have inherent limitations. A system of internal control may become inadequate over time because of changes in conditions or deterioration in the degree of compliance with the policies or procedures. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2016 using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in the 2013 *Internal Control–Integrated Framework*. Based on this assessment, our management concluded that, as of December 31, 2016, our internal control over financial reporting was effective.

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

**Board of Directors and Stockholders**
**Atrion Corporation**

We have audited the internal control over financial reporting of Atrion Corporation and subsidiaries (the "Company") as of December 31, 2016, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by COSO.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of the Company as of and for the year ended December 31, 2016, and our report dated March 14, 2017, expressed an unqualified opinion on those financial statements.

Grant Thornton LLP
Dallas, Texas

March 14, 2017

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## Overview

We develop and manufacture products primarily for medical applications. We market components to other equipment manufacturers for incorporation in their products and sell finished devices to physicians, hospitals, clinics and other treatment centers. Our medical products primarily serve the fluid delivery, cardiovascular, and ophthalmology markets. Our other medical and non-medical products include valves and inflation devices used in marine and aviation safety products. In 2016, approximately 37 percent of our sales were outside the United States.

Our products are used in a wide variety of applications by numerous customers. We encounter competition in all of our markets and compete primarily on the basis of product quality, price, engineering, customer service and delivery time.

Our strategy is to provide a broad selection of products in the areas of our expertise. R&D efforts are focused on improving current products and developing highly-engineered products that meet customer needs and serve niche markets with meaningful sales potential. Proposed new products may be subject to regulatory clearance or approval prior to commercialization and the time period for introducing a new product to the marketplace can be unpredictable. We also focus on controlling costs by investing in modern manufacturing technologies and controlling purchasing processes. We have been successful in consistently generating cash from operations and have used that cash to reduce or eliminate indebtedness, to fund capital expenditures, to make investments, to repurchase stock and to pay dividends.

Our strategic objective is to further enhance our position in our served markets by:

- Focusing on customer needs;
- Expanding existing product lines and developing new products;
- Maintaining a culture of controlling cost; and
- Preserving and fostering a collaborative, entrepreneurial management structure.

For the year ended December 31, 2016, we reported revenues of $143.5 million, operating income of $39.1 million and net income of $27.6 million.

## Results of Operations

Our net income was $27.6 million, or $15.12 per basic and $14.85 per diluted share, in 2016 compared to $28.9 million, or $15.67 per basic and $15.47 per diluted share, in 2015 and net income of $27.8 million, or $14.20 per basic and $14.08 per diluted share, in 2014. Revenues were $143.5 million in 2016 compared with $145.7 million in 2015 and $140.8 million in 2014. Our 2016 revenues were negatively impacted by the strong U. S. dollar in our international markets and lower sales prices in certain markets. The four percent revenue increase in 2015 over 2014 was generally attributable to higher sales volumes.

Annual revenues by product lines were as follows (in thousands):

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| Fluid Delivery | **$ 60,889** | $ 60,630 | $ 57,905 |
| Cardiovascular | **47,064** | 46,463 | 43,001 |
| Ophthalmology | **15,427** | 18,253 | 19,329 |
| Other | **20,107** | 20,387 | 20,527 |
| Total | **$ 143,487** | $ 145,733 | $ 140,762 |

Our cost of goods sold was $75.9 million in 2016, $74.8 million in 2015 and $72.2 million in 2014. Increased compensation costs, depreciation and repair costs partially offset by reduced utilities and reduced supplies were the primary contributors to the increase in cost of goods sold in 2016 over 2015. Higher sales volume along with increased compensation costs, supplies and utilities partially offset by improved manufacturing efficiencies were the primary contributors to the increase in cost of goods sold in 2015 over 2014.

Gross profit in 2016 was $67.6 million compared with $71.0 million in 2015 and $68.5 million in 2014. Our gross profit was 47 percent of revenues in 2016 and 49 percent of revenues in both 2015 and 2014. The decrease in gross profit percentage in 2016 from 2015 was primarily related to reduced sales, lower sales prices and increased manufacturing costs.

Operating expenses were $28.5 million in both 2016 and 2015 and $27.7 million in 2014. R&D expenses increased $228,000 in 2016 as compared to 2015 primarily as a result of increased costs for supplies and travel partially offset by reduced outside services. R&D expenses consist primarily of salaries and other related expenses of our R&D personnel as well as costs associated with regulatory matters. In 2016, selling expenses increased $568,000 as compared with 2015 primarily as a result of increased travel, outside services, compensation and trade shows. Selling expenses consist primarily of salaries, commissions and other related expenses for sales and marketing personnel, marketing, advertising and promotional expenses. General and administrative, or G&A, expenses decreased $763,000 in 2016 as compared to 2015 primarily as a result of reduced compensation and benefits. G&A expenses consist primarily of salaries and other related expenses of administrative, executive and financial personnel and outside professional fees.

R&D expenses increased $1.1 million in 2015 as compared to 2014 primarily as a result of increased costs for outside services and supplies. In 2015, selling expenses decreased $167,000 as compared with 2014 primarily as a result of decreased promotional costs partially offset by increased commissions. G&A expenses decreased $123,000 in 2015 as compared to 2014 primarily as a result of reduced outside services partially offset by increased amortization.

Our operating income for 2016 was $39.1 million compared with $42.5 million in 2015 and $40.8 million in 2014. Operating income was 27 percent of revenues for 2016 and 29 percent of revenues for both 2015 and 2014. Decreases in 2016 gross profit was the major contributor to the decrease in operating income for 2016 as compared to the previous year. Increases in gross profit partially offset by increases in operating expenses described above were the major contributors to the operating income increase in 2015 as compared to the previous year. We expect modest growth in our operating income during 2017 as compared to 2016, reflecting the volatility of our ophthalmic sales as well as the significant impact of the strong U. S. dollar on sales to our international markets.

Interest income for 2016 was $448,000, compared with $771,000 in 2015 and $1.2 million in 2014. Lower interest rates were the primary reason for the reductions in 2016. Reduced levels of investments and lower interest rates were the primary reasons for the reductions in 2015.

Other income (expense) in 2015 is primarily related to an impairment loss on one of our long-term corporate bonds which experienced a significant decline in market value due to a changed outlook for the issuer resulting from a major economic decline in its industry. In the fourth quarter of 2015, we determined, based upon disclosures by the issuer, that more likely than not we would be required to sell or exchange the bond before recovery of its amortized cost. Therefore, we recorded an impairment loss on this bond of $2.4 million reducing the carrying value of the bond to its market value at December 31, 2015. In 2016 after the issuer declared bankruptcy, we sold this bond that was previously intended to be held to maturity. We recorded an additional net loss of $311,000 on this bond in 2016 prior to and including its sale.

Income tax expense in 2016 totaled $11.7 million, compared with $11.9 million in 2015 and $14.2 million in 2014. The effective tax rates for 2016, 2015 and 2014 were 29.8 percent, 29.2 percent and 33.8 percent, respectively. The effective tax rate for 2016 benefitted by $687,000 from the early adoption of ASU 2016-09 regarding the accounting for employee share-based compensation. The adoption was on a prospective basis and therefore had no impact on prior years. The effective tax rate for 2015 benefitted from tax credits totaling $2.3 million for our R&D expenditures. These credits reflected amounts for the full year 2015 following the extension of the R&D tax credit in December 2015. This amount also included an adjustment for recalculation of these tax credits from prior years resulting from a new regulation issued by the Treasury Department which favorably impacted the benefits provided to the Company under these rules. Benefits from R&D tax credits totaled $1.1 million in 2016, $2.3 million in 2015 and $393,000 in 2014. Benefits from tax incentives for domestic production totaled $1.2 million in 2016, $1.4 million in 2015 and $1.3 million in 2014. Benefits from changes in uncertain tax positions totaled $120,000 in 2016, $9,000 in 2015 and $217,000 in 2014. We expect our effective tax rate for 2017 to be approximately 33.0 percent. Accounting for stock based awards could create volatility in our effective tax rate depending upon the amount of exercise or vesting activity from these activities.

## Liquidity and Capital Resources

At December 31, 2016, we had a $40.0 million revolving credit facility with a money center bank that could be utilized for the funding of operations and for major capital projects or acquisitions, subject to certain limitations and restrictions. Interest under the credit facility was assessed at 30-day, 60-day or 90-day LIBOR, as selected by us, plus one percent and was payable monthly. We had no outstanding borrowings under our credit facility at December 31, 2016 or 2015. The credit facility contained various restrictive covenants, none of which was expected to impact our liquidity or capital resources. At December 31, 2016, we were in compliance with all financial covenants.

On February 28, 2017 we replaced the revolving credit facility with a new $75.0 million revolving credit facility with the same bank. The new credit facility has similar operational, covenant and collateral characteristics as the prior facility. Interest under the new credit facility is assessed at one, two, three or six-month LIBOR, as selected by us, plus .875 percent. The new credit facility allows us to make advances until February 28, 2022. We believe the bank providing the credit facility is highly-rated and that the entire $75.0 million under the credit facility is currently available to us.

At December 31, 2016, we had a total of $54.0 million in cash and cash equivalents, short-term investments and long-term investments, an increase of $15.8 million from December 31, 2015. The principal contributor to this increase was operational results.

Cash flows provided by operations of $37.4 million in 2016 were primarily comprised of net income plus the net effect of non-cash expenses. At December 31, 2016, we had working capital of $85.0 million, including $20.0 million in cash and cash equivalents and $24.1 million in short-term investments. The $16.1 million increase in working capital during 2016 was primarily related to increases in short-term investments. This increase was partially offset by decreases in cash and cash equivalents. The increase in short-term investments was primarily a result of operational results partially offset by purchases of treasury stock under our stock repurchase program, purchases of property, plant and equipment and payment of dividends. Working capital items consisted primarily of cash, accounts receivable, short-term investments, inventories and other current assets minus accounts payable and other current liabilities.

Capital expenditures for property, plant and equipment totaled $10.6 million in 2016, compared with $9.3 million in 2015 and $12.7 million in 2014. These expenditures were primarily for machinery and equipment. We expect 2017 capital expenditures, primarily machinery and equipment, to be greater than the average of the levels expended during each of the past three years.

We paid cash dividends totaling $7.1 million, $6.1 million and $5.4 million during 2016, 2015 and 2014, respectively. We expect to fund future dividend payments with cash flows from operations. We purchased treasury stock totaling $1.3 million, $30.7 million and $23.6 million during 2016, 2015 and 2014, respectively

The table below summarizes debt, lease and other contractual obligations outstanding at December 31, 2016:

| | Payments Due by Period | | | |
|---|---|---|---|---|
| **Contractual Obligations** | **Total** | **2017** | **2018–2019** | **2020 and thereafter** |
| | (in thousands) | | | |
| Purchase Obligations | $ 11,863 | $ 11,643 | $ 220 | $ — |
| Total | $ 11,863 | $ 11,643 | $ 220 | $ — |

We believe our cash, cash equivalents, short-term investments and long-term investments, cash flows from operations and available borrowings of up to $75.0 million under our credit facility will be sufficient to fund our cash requirements for at least the foreseeable future. We believe our strong financial position would allow us to access equity or debt financing should that be necessary. Additionally, we expect our cash and cash equivalents and investments, as a whole, will continue to increase in 2017.

## Off-Balance Sheet Arrangements

We have no off-balance sheet financing arrangements.

## Impact of Inflation

We experience the effects of inflation primarily in the prices we pay for labor, materials and services. Over the last three years, we have experienced the effects of moderate inflation in these costs. At times, we have been able to offset a portion of these increased costs by increasing the sales prices of our products. However, competitive pressures have not allowed for full recovery of these cost increases.

## New Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-09, *Stock Compensation (Topic718): Improvements to Employee Share-Based Payment Accounting* (ASU 2016-09). This amendment simplifies the accounting for some aspects of share-based payment transactions, including the income tax treatment of excess tax benefits and deficiencies, forfeitures, classification of share-based awards as either equity or liabilities, and classification in the statement of cash flows for certain share-based transactions related to tax benefits and payments. Under this guidance all excess tax benefits ("windfalls") and deficiencies ("shortfalls") related to employee stock compensation are recognized within income tax expense.

Under prior guidance windfalls were recognized in paid-in capital and shortfalls were only recognized to the extent they exceeded the pool of windfall tax benefits. ASU 2016-09 also requires companies to classify cash flows resulting from excess tax benefits and deficiencies from employee share-based payments as cash flows from operating activities. These items were previously included as cash flows from financing activities. ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted. The Company early adopted this guidance in the second quarter of 2016 effective January 1, 2016. The Company elected to account for forfeitures as they occur and to use a prospective transition method for the presentation of excess tax benefits on the statement of cash flows. As a result of the adoption, a tax benefit of $687,000 was recorded in 2016 reflecting the excess tax benefits resulting from the vesting of restricted stock and restricted stock units. Prior to adoption, this amount would have been recorded as additional paid-in capital. This change could create future volatility in our effective tax rate depending upon the amount of exercise or vesting activity from our stock based awards. This adoption also impacted the computation of diluted shares outstanding for all 2016 reporting periods as we excluded the excess tax benefits from the assumed proceeds available to repurchase shares in the computation of our diluted earnings per share. The effect of this change on our diluted earnings per share was not significant. The excess tax benefit recorded in 2016 was included in our consolidated statements of cash flows as an operating activity rather than as a financing activity as was done in prior years. There were no restatements of cash flows from operating activities or cash flows from financing activities for the years 2015 and 2014 because we elected to adopt this change on a prospective basis. ASU 2016-09 also requires the presentation of employee taxes paid by the Company through the withholding of shares as a financing activity on the statement of cash flows, which is how we had previously reflected these items.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.* The main objective of this update is to enhance the reporting model for financial instruments in order to provide users of financial statements with more decision-useful information. The new guidance addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. This ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. We are currently evaluating the new guidance to determine the impact it may have on our consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, Balance Sheet Classification of Deferred Taxes (ASU 2015-17) which requires that deferred tax liabilities and assets be classified as noncurrent on the balance sheet. The current requirement that deferred tax liabilities and assets of a tax-paying component of an entity be offset and presented as a single amount is not affected by this guidance. ASU 2015-17 is effective for annual and interim periods beginning after December 15, 2016 but early application is permitted and the guidance may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company does not anticipate a material impact on its consolidated financial statements at the time of adoption of this new standard.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). ASU 2014-09 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in United States Generally Accepted Accounting Principles when it becomes effective. In July 2015, the FASB voted to delay the effective date of ASU 2014-09 by one year, making it effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, with early adoption permitted as of the original effective date. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We plan on adopting the ASU in the first quarter of the year ended December 31, 2018. The Company has not yet selected a transition method and is currently evaluating the effect that our pending adoption of this guidance will have on our consolidated financial statements and related disclosures. We anticipate our assessment to be completed by December 31, 2017. Based on our existing evaluation process, we have not identified any revenue stream that would be materially impacted.

From time to time, new accounting standards updates applicable to us are issued by the FASB which we will adopt as of the specified effective date. Unless otherwise discussed, we believe the impact of recently issued standards updates that are not yet effective will not have a material impact on our consolidated financial statements upon adoption.

## Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In the preparation of these financial statements, we make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. We believe the following discussion addresses our most critical accounting policies and estimates, which are those that are most important to the portrayal of our financial condition and results and require management's most difficult, subjective and complex judgments, often as a result of the need to make estimates

about the effect of matters that are inherently uncertain. Actual results could differ significantly from those estimates under different assumptions and conditions.

From time to time, we accrue legal costs associated with certain litigation. In making determinations of likely outcomes of litigation matters, we consider the evaluation of legal counsel knowledgeable about each matter, case law and other case-specific issues. We believe these accruals are adequate to cover the legal fees and expenses associated with litigating these matters. However, the time and cost required to litigate these matters as well as the outcomes of the proceedings may vary significantly from what we have projected.

We maintain an allowance for doubtful accounts to reflect estimated losses resulting from the failure of customers to make required payments.  On an ongoing basis, the collectability of accounts receivable is assessed based upon historical collection trends, current economic factors and the assessment of the collectability of specific accounts.  We evaluate the collectability of specific accounts and determine when to grant credit to our customers using a combination of factors, including the age of the outstanding balances, evaluation of customers' current and past financial condition, recent payment history, current economic environment, and discussions with our personnel and with the customers directly. Accounts are written off when it is determined the receivable will not be collected. If circumstances change, our estimates of the collectability of amounts could be changed by a material amount.

We are required to estimate our provision for income taxes and uncertain tax positions in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure, including assessing the risks associated with tax audits, together with assessing temporary differences resulting from the different treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the balance sheet. We assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is more likely than not, do not establish a valuation allowance. In the event that actual results differ from these estimates, the provision for income taxes could be materially impacted.

We assess the impairment of our long-lived identifiable assets, excluding goodwill which is tested for impairment as explained below, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. This review is based upon projections of anticipated future cash flows. Although we believe that our estimates of future cash flows are reasonable, different assumptions regarding such cash flows or changes in our business plan could materially affect our evaluations. No such changes are anticipated at this time.

We assess goodwill for impairment pursuant to Accounting Standards Codification, or ASC, 350, I*ntangibles—Goodwill and Other*, which requires that goodwill be assessed whenever events or changes in circumstances indicate that the carrying value may not be recoverable, or, at a minimum, on an annual basis by applying a qualitative assessment on goodwill impairment to determine whether it is necessary to perform the two-step goodwill impairment test.

We assess the total carrying value for each of our investments on a quarterly basis for changes in circumstance or the occurrence of events that suggest our investment may not be recoverable. If an investment is considered impaired, we must determine whether the impairment is other than temporary. If it is determined to be other than temporary, the impairment must be recognized in our financial statements.

During 2016, 2015 and 2014, none of our critical accounting policy estimates, with the exception of the previously mentioned impairment loss on one of our long-term corporate bonds, required significant adjustments. We did not note any material events or changes in circumstances indicating that the carrying value of long-lived assets were not recoverable.

## Quantitative and Qualitative Disclosures About Market Risks

### *Foreign Exchange Risk*

We are not exposed to material fluctuations in currency exchange rates because the payments from our international customers are received primarily in United States dollars.

However, fluctuations in exchange rates may affect the prices that our international customers are willing to pay and may put us at a price disadvantage compared to other customers. Increases in the value of the United States dollar relative to foreign currencies could make our products less competitive or less affordable and therefore adversely affect our sales in international markets.

### *Market Risk and Credit Risk*

The Company's cash and cash equivalents are held in accounts with financial institutions that we believe are creditworthy. Certain of these accounts at times may exceed federally-insured limits. We have not experienced any credit losses in such accounts and do not believe we are exposed to any significant credit risk on these funds.

We have investments in taxable corporate bonds, certificates of deposit and equity securities. As a result, we are exposed to potential loss from market risks that may occur as a result of changes in interest rates, changes in credit quality of the issuer and otherwise. These securities have a higher degree of credit or default risk and a greater exposure to credit risk and may be less liquid in times of economic weakness or market disruptions. We have also invested a portion of our available funds in common

stock. The value of these securities fluctuates due to changes in the equity and credit markets along with other factors. In times of economic weakness, the market value and liquidity of these assets may decline and may negatively impact our financial condition.

### Forward-looking Statements

Statements in this Management's Discussion and Analysis and elsewhere in this Annual Report to Stockholders that are forward looking are based upon current expectations, and actual results or future events may differ materially. Therefore, the inclusion of such forward-looking information should not be regarded as a representation by us that our objectives or plans will be achieved. Such statements include, but are not limited to, our growth in operating income in 2017, our 2017 effective tax rate, the impact of the restrictive covenants in our credit facility on our liquidity and capital resources, our earnings in 2017, our 2017 capital expenditures, funding future dividend payments with cash flows from operations, availability of equity and debt financing, our ability to meet our cash requirements for the foreseeable future, the impact on our consolidated financial statement of recently issued accounting standards when we adopt those standards, the pace of investments in manufacturing, technology, people, and R&D in 2017, and increases in 2017 in cash, cash equivalents and investments. Words such as "expects," "believes," "anticipates," "intends," "should," "plans," and variations of such words and similar expressions are intended to identify such forward-looking statements. Forward-looking statements contained herein involve numerous risks and uncertainties, and there are a number of factors that could cause actual results or future events to differ materially, including, but not limited to, the following: changing economic, market and business conditions; acts of war or terrorism; the effects of governmental regulation; the impact of competition and new technologies; slower-than-anticipated introduction of new products or implementation of marketing strategies; implementation of new manufacturing processes or implementation of new information systems; our ability to protect our intellectual property; changes in the prices of raw materials; changes in product mix; intellectual property and product liability claims and product recalls; the ability to attract and retain qualified personnel and the loss of any significant customers. In addition, assumptions relating to budgeting, marketing, product development and other management decisions are subjective in many respects and thus susceptible to interpretations and periodic review which may cause us to alter our marketing, capital expenditures or other budgets, which in turn may affect our results of operations and financial condition.

## SELECTED FINANCIAL DATA

(in thousands, except per share amounts)

| | 2016 | 2015 | 2014 | 2013 | 2012 |
|---|---|---|---|---|---|
| **Operating Results for the Year ended December 31,** | | | | | |
| Revenues | **$ 143,487** | $ 145,733 | $ 140,762 | $ 131,993 | $ 119,062 |
| Operating income | **39,126** | 42,510 | 40,817 | 37,944 | 33,626 |
| Net income | **27,581** | 28,925 | 27,808 | 26,582 | 23,629 |
| Depreciation and amortization | **8,953** | 8,823 | 8,723 | 8,592 | 7,610 |
| **Per Share Data:** | | | | | |
| Net income per diluted share | **$ 14.85** | $ 15.47 | $ 14.08 | $ 13.18 | $ 11.66 |
| Cash dividends per common share | **$ 3.90** | $ 3.30 | $ 2.78 | $ 2.40 | $ 12.10 |
| Average diluted shares outstanding | **1,857** | 1,870 | 1,975 | 2,017 | 2,027 |
| **Financial Position at December 31,** | | | | | |
| Total assets | **$ 182,593** | $ 164,336 | $ 171,514 | $ 172,066 | $ 155,810 |
| Long-term debt | **—** | — | — | — | — |

# NON-GAAP FINANCIAL MEASURES RECONCILIATION

(Dollars in thousands)

Included in our Annual Report is a non-GAAP financial measure that is calculated by excluding certain income and assets that are included in financial measures determined in accordance with GAAP. We have provided this non-GAAP measure as an additional tool for investors to evaluate the Company's performance. This measure should be considered in addition to, rather than as a substitute for, GAAP measures of the Company's performance. The table below provides a reconciliation of this non-GAAP financial measure with the most directly comparable GAAP financial measure.

| | GAAP | Adjustments | Non-GAAP |
|---|---|---|---|
| 2016 net income [A] | $ 27,581 | $ 291 [1] | $ 27,290 |
| Equity at December 31, 2015 | $ 144,098 | $ 38,256 [2] | $ 105,842 |
| Equity at December 31, 2016 | $ 162,988 | $ 54,047 [3] | $ 108,941 |
| Average equity [B] | $ 153,543 [4] | | $ 107,392 [5] |
| Return on equity (A/B) | 18 % | | 25 % |

1) 2016 after tax interest income.

2) Cash, cash equivalents and investments at December 31, 2015.

3) Cash, cash equivalents and investments at December 31, 2016.

4) GAAP equity at December 31, 2015 plus GAAP equity at December 31, 2016 divided by 2.

5) Adjusted equity at December 31, 2015 plus adjusted equity at December 31, 2016 divided by 2.

# Leadership

## Board of Directors

**Emile A Battat**
Chairman of the Board
Atrion Corporation

**Preston G. Athey**
Private Investor
Former Portfolio Manager
T. Rowe Price Small Cap Value Fund
T. Rowe Price Associates, Inc.
Baltimore, Maryland

**Hugh J. Morgan, Jr.**
Private Investor
Former Chairman of the Board
National Bank of Commerce
of Birmingham
Morganton, North Carolina

**Ronald N. Spaulding**
Private Investor
Former President of
Worldwide Commercial Operations
Abbott Vascular
Miami, Florida

**Roger F. Stebbing**
President and Chief Executive Officer
Stebbing and Associates, Inc.
Signal Mountain, Tennessee

**John P. Stupp, Jr.**
President and Chief Executive Officer
Stupp Bros., Inc.
St. Louis, Missouri

## Executive Officers

**Emile A Battat**
Chairman of the Board

**David A. Battat**
President and Chief Executive Officer

**Jeffery Strickland**
Vice President and Chief Financial Officer, Secretary and Treasurer

# Corporate Information

**Corporate Office**
Atrion Corporation
One Allentown Parkway
Allen, Texas 75002
(972) 390-9800
www.atrioncorp.com

**Registrar and Transfer Agent**
American Stock Transfer and
Trust Company, LLC
Attn: Shareholder Services
6201 15th Avenue
Brooklyn, NY 11219

**Form 10-K**
**A copy of the Company's 2016 Annual Report on Form 10-K/A, as filed with the Securities and Exchange Commission, may be obtained by any stockholder without charge by written request to:**

**Corporate Secretary**
**Atrion Corporation**
**One Allentown Parkway**
**Allen, Texas 75002**

## Stock Information

The Company's common stock is traded on the NASDAQ Global Select Market (Symbol: ATRI). As of February 21, 2017, we had 262 record holders, and approximately 4,500 beneficial owners, of our common stock. The table below sets forth the high and low sales prices as reported by NASDAQ and the quarterly dividends per share declared by the Company for each quarter of 2015 and 2016.

| 2015 Quarter Ended | High | Low | Dividends |
|---|---|---|---|
| March 31 | $ 355.62 | $ 315.01 | $ 0.75 |
| June 30 | 396.00 | 316.25 | 0.75 |
| September 30 | 428.85 | 365.00 | 0.90 |
| December 31 | 423.00 | 343.50 | 0.90 |
| **2016 Quarter Ended** | **High** | **Low** | **Dividends** |
| March 31 | $ 415.00 | $ 350.00 | $ 0.90 |
| June 30 | 442.50 | 385.00 | 0.90 |
| September 30 | 490.45 | 393.96 | 1.05 |
| December 31 | 522.05 | 418.00 | 1.05 |

The Company presently plans to pay quarterly cash dividends in the future.

**ATRION CORPORATION**
One Allentown Parkway
Allen, Texas 75002
972.390.9800

www.atrioncorp.com