

Health Fitness Corp /MN/  
Form 10-Q  
August 14, 2007

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
FORM 10-Q  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2007  
Commission File No. 000-25064**

**HEALTH FITNESS CORPORATION  
(Exact name of registrant as specified in its charter)**

<b>Minnesota</b>	<b>No. 41-1580506</b>
<b>(State or Other Jurisdiction of Incorporation or Organization)</b>	<b>(IRS Employer Identification No.)</b>
<b>3600 American Boulevard West, Bloomington, Minnesota 55431</b>	
<b>(Address of Principal Executive Offices)</b>	
<b>Registrant's telephone number (952) 831-6830</b>	

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
YES  NO

The number of shares outstanding of the registrant's common stock as of August 13, 2007 was: Common Stock, \$0.01 par value, 19,875,098 shares

---

**Health Fitness Corporation**  
**Consolidated Financial Statements**  
**Table of Contents**

	PAGE
<u>PART I. FINANCIAL INFORMATION</u>	3
<u>ITEM 1. Consolidated Financial Statements (unaudited)</u>	3
<u>Consolidated Balance Sheets as of June 30, 2007 and December 31, 2006</u>	3
<u>Consolidated Statements of Operations for the three and six months ended June 30, 2007 and 2006</u>	4
<u>Consolidated Statements of Cash Flows for the six months ended June 30, 2007 and 2006</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
<u>ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
<u>ITEM 3. Quantitative and Qualitative Disclosures About Market Risk</u>	22
<u>ITEM 4. Controls and Procedures</u>	22
<u>PART II. OTHER INFORMATION</u>	23
<u>ITEM 1. Legal Proceedings</u>	23
<u>ITEM 1A. Risk Factors</u>	23
<u>ITEMS 2-3. Not Applicable</u>	23
<u>ITEM 4. Submission of Matters to a Vote of Security Holders</u>	23
<u>ITEM 5. Other Information</u>	24
<u>ITEM 6. Exhibits</u>	24
<u>Signatures</u>	25
<u>Exhibit Index</u>	26
<u>Lease Agreement dated as of May 2, 2007</u>	
<u>Office Lease dated as of September 29, 2003</u>	
<u>First Amendment to Lease dated April 29, 2005</u>	
<u>Second Amendment to Lease dated January 31, 2006</u>	
<u>Third Amendment to Lease dated May 9, 2007</u>	
<u>Statement re: Computation of Earnings per Share</u>	
<u>Certification of President and Chief Executive Officer Pursuant to Section 302</u>	
<u>Certification of Chief Financial Officer Pursuant to Section 302</u>	
<u>Certification of President and Chief Executive Officer Pursuant to Section 906</u>	
<u>Certification of Chief Financial Officer Pursuant to Section 906</u>	

**Table of Contents**

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**HEALTH FITNESS CORPORATION**  
**CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

	June 30, 2007	December 31, 2006
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 131,753	\$ 987,465
Trade and other accounts receivable, less allowances of \$210,500 and \$283,100	12,427,703	12,404,856
Inventories	809,400	326,065
Prepaid expenses and other	601,315	375,824
Deferred tax assets	217,476	217,476
Total current assets	14,187,647	14,311,686
PROPERTY AND EQUIPMENT, net	1,123,325	767,675
<b>OTHER ASSETS</b>		
Goodwill	14,529,674	14,509,469
Software technology, less accumulated amortization of \$577,900 and \$370,200	1,614,815	1,658,575
Trademark, less accumulated amortization of \$295,900 and \$246,300	197,185	246,809
Other intangible assets, less accumulated amortization of \$205,800 and \$166,500	323,250	362,528
Deferred tax assets	437,010	437,010
Other	17,927	24,597
	\$ 32,430,833	\$ 32,318,349

**LIABILITIES AND STOCKHOLDERS EQUITY**

<b>CURRENT LIABILITIES</b>		
Trade accounts payable	\$ 1,229,617	\$ 1,811,939
Accrued salaries, wages, and payroll taxes	3,577,563	3,249,424
Accrued acquisition earnout		1,475,000
Other accrued liabilities	177,049	120,044
Accrued self funded insurance	196,956	201,053
Line of credit	274,491	
Deferred revenue	1,210,020	1,663,121
Total current liabilities	6,665,696	8,520,581

**LONG-TERM OBLIGATIONS**

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS EQUITY

Common stock, \$0.01 par value; 50,000,000 shares authorized; 19,803,177 and 19,220,217 shares issued and outstanding	197,823	192,202
Additional paid-in capital	27,282,030	25,989,447
Accumulated comprehensive income	(50,692)	(35,186)
Accumulated deficit	(1,664,024)	(2,348,695)
	25,765,137	23,797,768
	\$ 32,430,833	\$ 32,318,349

See notes to consolidated financial statements.

**Table of Contents****HEALTH FITNESS CORPORATION  
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
REVENUE	\$ 16,979,167	\$ 15,575,130	\$ 33,569,200	\$ 30,142,391
COSTS OF REVENUE	12,223,734	11,415,116	24,003,873	22,377,897
GROSS PROFIT	4,755,433	4,160,014	9,565,327	7,764,494
OPERATING EXPENSES				
Salaries	2,645,073	2,146,470	5,043,875	4,142,369
Other selling, general and administrative	1,691,109	1,219,161	3,173,634	2,338,337
Amortization of acquired intangible assets	42,770	107,610	85,540	216,072
Total operating expenses	4,378,952	3,473,241	8,303,049	6,696,778
OPERATING INCOME	376,481	686,773	1,262,278	1,067,716
OTHER INCOME (EXPENSE)				
Interest expense	(4,591)	(2,470)	(6,690)	(4,150)
Change in fair value of warrants		406,694		841,215
Other, net	4,090	14,071	2,576	10,061
EARNINGS BEFORE INCOME TAXES	375,980	1,105,068	1,258,164	1,914,842
INCOME TAX EXPENSE	202,976	377,594	573,493	527,695
NET EARNINGS	173,004	727,474	684,671	1,387,147
Dividend to preferred shareholders				96,410
NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS	\$ 173,004	\$ 727,474	\$ 684,671	\$ 1,290,737
NET EARNINGS PER SHARE:				
Basic	\$ 0.01	\$ 0.04	\$ 0.04	\$ 0.08
Diluted	0.01	0.02	0.03	0.03

**WEIGHTED AVERAGE COMMON  
SHARES:**

Edgar Filing: Health Fitness Corp /MN/ - Form 10-Q

Basic	19,702,693	18,831,169	19,508,107	17,005,769
Diluted	20,558,007	20,310,830	20,415,501	20,305,674

See notes to consolidated financial statements.

4

---

**Table of Contents****HEALTH FITNESS CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

	Six Months Ended June 30,	
	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net earnings	\$ 684,671	\$ 1,290,737
Adjustments to reconcile net earnings to net cash used in operating activities:		
Depreciation	368,708	241,033
Amortization	88,901	219,434
Warrant valuation		(841,215)
Stock-based compensation	386,338	238,404
Deferred taxes		(1,701)
Loss on disposal of assets		158
Change in assets and liabilities:		
Trade and other accounts receivable	(22,847)	(431,789)
Inventories	(482,223)	(115,406)
Prepaid expenses and other	(226,603)	(19,828)
Other assets	6,671	11,671
Trade accounts payable	(603,508)	(122,572)
Accrued liabilities and other	381,047	(69,927)
Deferred revenue	(453,101)	(115,583)
Net cash provided by operating activities	128,054	283,416
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property and equipment	(674,918)	(301,748)
Business acquisition, net of cash acquired	(20,205)	
Accrued acquisition earnout	(737,500)	
Other		(85,807)
Net cash used in investing activities	(1,432,623)	(387,555)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Costs from issuance of preferred stock	(17,415)	(161,725)
Proceeds from the issuance of common stock	21,249	85,698
Proceeds from the exercise of stock options	170,532	3,706
Borrowings under line of credit	7,229,742	
Repayments under line of credit	(6,955,251)	
Net cash provided by (used in) financing activities	448,857	(72,321)
<b>NET DECREASE IN CASH</b>	<b>(855,712)</b>	<b>(176,460)</b>
<b>CASH AT BEGINNING OF PERIOD</b>	<b>987,465</b>	<b>1,471,505</b>



Edgar Filing: Health Fitness Corp /MN/ - Form 10-Q

CASH AT END OF PERIOD	\$ 131,753	\$ 1,295,045
Supplemental cash flow information:		
Cash paid for interest	\$ 3,153	\$ 788
Cash paid for taxes	101,364	475,817
Non-cash investing and financing activities affecting cash flows:		
Common stock issued for accrued acquisition earnout	737,500	
Conversion of warrant liability to additional paid in capital		1,369,674
See notes to consolidated financial statements.		

5

---

**Table of Contents**

HEALTH FITNESS CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

**NOTE 1. ORGANIZATION**

Health Fitness Corporation, a Minnesota corporation (also referred to as we, us, our, the Company, or Health Fitness Corporation) is a leading provider of population health improvement services and programs to corporations, hospitals, communities and universities located in the United States and Canada. We currently manage 257 corporate fitness center sites and 162 corporate health improvement programs.

We provide staffing services as well as a comprehensive menu of programs, products and consulting services within our Health Management and Fitness Management business segments. Our broad suite of services enables our clients employees to live healthier lives, and our clients to control rising healthcare costs, through participation in our assessment, education, coaching, physical activity, weight management and wellness program services, which can be offered as follows: (i) through on-site fitness centers we manage; (ii) remotely via the web and; (iii) through telephonic health coaching.

**NOTE 2. BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements for the three and six months ended June 30, 2007 have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Financial information as of December 31, 2006 has been derived from our audited consolidated financial statements. In accordance with the rules and regulations of the United States Securities and Exchange Commission, the Company has omitted footnote disclosures that would substantially duplicate the disclosures contained in the audited financial statements of the Company. The unaudited consolidated financial statements should be read together with the financial statements for the year ended December 31, 2006, and the footnotes thereto included in the Company's Form 10-K as filed with the United States Securities and Exchange Commission on March 30, 2007.

In the opinion of management, the interim consolidated financial statements include all adjustments (consisting of normal recurring accruals) necessary for the fair presentation of the results for interim periods presented. These financial statements include some amounts that are based on management's best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of earnings in the period in which the change in estimate is identified. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of the operating results that may be expected for the year ended December 31, 2007.

**NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Consolidation* The consolidated financial statements include the accounts of our Company and our wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

*Reclassifications* Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications had no net effect on assets, liabilities, shareholders' equity or results of operations as previously reported.

*Cash* We maintain cash balances at several financial institutions, and at times, such balances exceed insured limits. We have not experienced any losses in such accounts and we believe we are not exposed to any significant credit risk on cash. At June 30, 2007 and December 31, 2006, we had cash of approximately \$73,900 and \$36,900 (U.S. Dollars) in a Canadian bank account.

**Table of Contents**

*Trade and Other Accounts Receivable* Trade and other accounts receivable represent amounts due from companies and individuals for services and products. We grant credit to customers in the ordinary course of business, but generally do not require collateral or any other security to support amounts due. Management performs ongoing credit evaluations of customers. Accounts receivable from sales of services are typically due from customers within 30 to 90 days. Accounts outstanding longer than contractual payment terms are considered past due. We determine our allowance for discounts and doubtful accounts by considering a number of factors, including the length of time trade accounts receivable are past due, our previous loss history, the customer's current ability to pay its obligation to us, and the condition of the general economy and the industry as a whole. We write off accounts receivable when they become uncollectible, and payments subsequently received on such receivable are credited to the allowance. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers and their geographic dispersion.

*Property and Equipment* Property and equipment are stated at cost. Depreciation and amortization are computed using both straight-line and accelerated methods over the useful lives of the assets.

*Software Development Costs* - Software development costs are accounted for in accordance with Statement SFAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed. Accordingly, software development costs incurred subsequent to the determination of technological feasibility and marketability of a software product are capitalized. Capitalization of costs ceases and amortization of capitalized software development costs commences when the products are available for general release. Amortization is determined on a product by product basis using the greater of a ratio of current product revenues to projected current and future product revenues or an amount calculated using the straight-line method over the estimated economic life of the product, which is generally three to five years.

Capitalized software development costs are stated at the lower of amortized cost or net realizable value.

Recoverability of these capitalized costs is determined by comparing the forecasted future revenues from the related products, based on management's best estimates using appropriate assumptions and projections at the time, to the carrying amount of the capitalized software development costs. If the carrying value is determined not to be recoverable from future revenues, an impairment loss is recognized equal to the amount by which the carrying amount exceeds the future revenues.

During the three and six months ended June 30, 2007, we capitalized \$38,500 and \$164,000, respectively, of software development costs related to enhancements we made to our eHealth platform, a system we acquired through our acquisition of HealthCalc. Capitalized software development costs are captured within Software Technology. These software development costs will be amortized over the remaining economic life of the eHealth platform, or five years. We expect to recover our capitalized software development costs due to the growth of our Health Management segment.

*Goodwill* Goodwill represents the excess of the purchase price and related costs over the fair value of net assets of businesses acquired. The carrying value of goodwill is tested for impairment on an annual basis or when factors indicating impairment are present. Projected discounted cash flows are used in assessing these assets. We elected to complete the annual impairment test of goodwill on December 31 each year and determined that our goodwill relates to two reporting units for purposes of impairment testing.

*Intangible Assets* Our intangible assets include trademarks and tradenames, software and other intangible assets, all of which are amortized on a straight-line basis. Trademarks and tradenames represent the value assigned to acquired trademarks and tradenames, and are amortized over a period of five years. Software represents the value assigned to an acquired web-based software program and is amortized over a period of five years. Other intangible assets include the value assigned to acquired customer lists, which is amortized over a period of six years, as well as deferred financing costs, which are amortized over the term of the related credit agreement.

**Table of Contents**

*Revenue Recognition* Revenue is recognized at the time the service is provided to the customer. We determine our allowance for discounts by considering historical discount history and current payment practices of our customers. For annual contracts, monthly amounts are recognized ratably over the term of the contract. Certain services provided to the customer may vary on a periodic basis and are invoiced to the customer in arrears. The revenues relating to these services are estimated in the month that the service is performed.

We also provide services to companies located in Canada. Although we invoice these customers in their local currency, we do not believe there is a risk of material loss due to foreign currency translation.

Amounts received from customers in advance of providing contracted services are treated as deferred revenue and recognized when the services are provided.

We have contracts with third-parties to provide ancillary services in connection with their fitness and wellness management services and programs. Under such arrangements, the third-parties invoice and receive payments from us based on transactions with our customer. We do not recognize revenues related to such transactions as our customer assumes the risk and rewards of the contract and the amounts billed to the customer are either at cost or with a fixed markup.

*Net Earnings Per Common Share* Basic net earnings per common share is computed by dividing net earnings applicable to common shareholders by the number of basic weighted average common shares outstanding. Diluted net earnings per share is computed by dividing net earnings applicable to common shareholders, plus dividends to preferred shareholders (net earnings), less the non-cash benefit related to a change in fair value of warrants by the number of diluted weighted average common shares outstanding, and common share equivalents relating to stock options, unearned restricted stock and stock warrants, if dilutive. Refer to Exhibit 11.0 attached hereto for a detailed computation of earnings per share.

*Stock-Based Compensation* We maintain a stock option plan for the benefit of certain eligible employees and directors of the Company. Commencing January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123R, Share Based Payment ( SFAS 123R ), using the modified prospective method of adoption, which requires all share-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair values over the requisite service period. The compensation cost we record for these awards is based on their fair value on the date of grant. The Company continues to use the Black Scholes option-pricing model as its method for valuing stock options. The key assumptions for this valuation method include the expected term of the option, stock price volatility, risk-free interest rate and dividend yield. Many of these assumptions are judgmental and highly sensitive in the determination of compensation expense. Further information on our share-based payments can be found in Note 7 in the Notes to the Consolidated Financial Statements under Part I, Item 1.

*Fair Values of Financial Instruments* Due to their short-term nature, the carrying value of our current financial assets and liabilities approximates their fair values. The fair value of long-term obligations, if recalculated based on current interest rates, would not significantly differ from the recorded amounts.

*Valuation of Derivative Instruments* In accordance with the interpretive guidance in EITF Issue No. 05-4, The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, we valued warrants we issued in November 2005 in our financing transaction as a derivative liability. We were required to make certain periodic assumptions and estimates to value the derivative liability. Factors affecting the amount of this liability include changes in our stock price, the computed volatility of our stock price and other assumptions. The change in value is reflected in our statements of operations as non-cash income or expense, and the changes in the carrying value of derivatives can have a material impact on our financial statements.

*Income Taxes* The Company records income taxes in accordance with the liability method of accounting. Deferred income taxes are provided for temporary differences between the financial reporting and tax basis of

**Table of Contents**

assets and liabilities and federal operating loss carryforwards. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of the enactment. We do not record a tax liability or benefit in connection with the change in fair value of certain of our warrants. Income taxes are calculated based on management's estimate of the Company's effective tax rate, which takes into consideration a federal tax rate of 34% and a net effective state tax rate of 4%. This total effective tax rate of 38% is less than the tax rate resulting from income tax expense we recognized during the three and six months ended June 30, 2007, due to the tax rate effects related to compensation expense for incentive stock options.

*Use of Estimates* Preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**NOTE 4. SEGMENT REPORTING**

The Company discloses segment information in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, which defines an operating segment as a component of a company for which operating results are reviewed regularly by the chief operating decision-makers to determine resource allocation and assess performance. The Company has two reportable segments, Fitness Management and Health Management. Total assets are not allocated to the segments for internal reporting purposes.

Financial information by segment is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<b>REVENUE:</b>				
Fitness Management Revenue				
Staffing Services	\$ 9,848,487	\$ 9,952,698	\$ 19,841,171	\$ 19,652,222
Program and Consulting Services	667,347	633,926	1,363,581	1,199,999
	10,515,834	10,586,624	21,204,752	20,852,221
Health Management Revenue				
Staffing Services	3,893,275	3,345,243	7,560,613	6,415,255
Program and Consulting Services	2,570,058	1,643,263	4,803,835	2,874,915
	6,463,333	4,988,506	12,364,448	9,290,170
Total Revenue				
Staffing Services	13,741,762	13,297,941	27,401,784	26,067,477
Program and Consulting Services	3,237,405	2,277,189	6,167,416	4,074,914
	\$ 16,979,167	\$ 15,575,130	\$ 33,569,200	\$ 30,142,391

**Table of Contents**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<b>GROSS PROFIT:</b>				
Fitness Management Revenue				
Staffing Services	\$ 2,012,802	\$ 2,007,950	\$ 4,121,983	\$ 4,002,530
Program and Consulting Services	246,668	282,342	611,519	582,869
	2,259,470	2,290,292	4,733,502	4,585,399
Health Management Revenue				
Staffing Services	999,876	884,922	1,907,113	1,540,998
Program and Consulting Services	1,496,087	984,800	2,924,712	1,638,097
	2,495,963	1,869,722	4,831,825	3,179,095
Total Gross Profit				
Staffing Services	3,012,678	2,892,872	6,029,096	5,543,528
Program and Consulting Services	1,742,755	1,267,142	3,536,231	2,220,966
	\$ 4,755,433	\$ 4,160,014	\$ 9,565,327	\$ 7,764,494

**NOTE 5. RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FIN No. 48, "Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes. ( SFAS 109 ) FIN 48 clarifies the application of SFAS No. 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements. Additionally, FIN 48 provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 was effective for us on January 1, 2007. Previously, the Company had accounted for tax contingencies in accordance with SFAS No. 5, "Accounting for Contingencies. As required by FIN 48, the Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, the Company applied FIN 48 to all tax positions for which the statute of limitations remained open. At January 1, 2007, the Company's existing reserve for income tax uncertainties was not material. The Company recognized no additional liabilities for unrecognized tax benefits as a result of the implementation of FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, ( SFAS 157 ). SFAS 157 does not address what to measure at fair value; instead, it addresses how to measure fair value. SFAS 157 applies (with limited exceptions) to existing standards that require assets or liabilities to be measured at fair value. SFAS 157 establishes a fair value hierarchy, giving the highest priority to quoted prices in active markets and the lowest priority to unobservable data and requires new disclosures for assets and liabilities measured at fair value based on their level in the hierarchy. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We do not believe that the adoption of SFAS 157 will have a material effect on our financial position or results of operation.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, ( SFAS 159 ) which permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact, if any, the adoption of SFAS 159 will have on our financial statements.

NOTE 6. FINANCING

On November 14, 2005 (the Effective Date ), in a Private Investment in Public Equity transaction (the PIPE Transaction ), we issued an aggregate of 1,000 shares of Series B Convertible Preferred Stock (the Series B

**Table of Contents**

Stock ), together with warrants to purchase 1,530,000 shares of common stock at \$2.40 per share, to a limited number of accredited investors for aggregate gross proceeds of \$10.2 million. After selling commissions and expenses, we received net proceeds of approximately \$9.4 million. The Series B Stock automatically converted into 5,100,000 shares of our common stock on March 10, 2006, the date the Securities and Exchange Commission (the SEC ) first declared effective a registration statement covering these shares. We used the proceeds from this PIPE Transaction to redeem our Series A Convertible Preferred Stock and to fund the acquisition of HealthCalc.Net, Inc.

In accordance with the terms of the PIPE Transaction, we were required to file with the SEC, within sixty (60) days from the Effective Date, a registration statement covering the common shares issued and issuable in the PIPE Transaction. We were also required to cause the registration statement to be declared effective on or before the expiration of one hundred twenty (120) days from the Effective Date. We would have been subject to liquidated damages of one percent (1%) per month of the aggregate gross proceeds (\$10,200,000), if we failed to meet these date requirements. On March 10, 2006, the SEC declared effective our registration statement and, as a result, we did not pay any liquidated damages for failure to meet the filing and effectiveness date requirements. We could nevertheless be subject to the foregoing liquidated damages if we fail (subject to certain permitted circumstances) to maintain the effectiveness of the registration statement. On June 15, 2006, we entered into an agreement with the accredited investors to amend the Registration Rights Agreement to cap the amount of liquidated damages we could pay at 9% of the aggregate purchase price paid by each accredited investor.

The warrants, which were issued together with the Series B Stock, have a term of five years, and give the investors the option to require us to repurchase the warrants for a purchase price, payable in cash within five (5) business days after such request, equal to the Black Scholes value of any unexercised warrant shares, only if, while the warrants are outstanding, any of the following change in control transactions occur: (i) we effect any merger or consolidation, (ii) we effect any sale of all or substantially all of our assets, (iii) any tender offer or exchange offer is completed whereby holders of our common stock are permitted to tender or exchange their shares for other securities, cash or property, or (iv) we effect any reclassification of our common stock whereby it is effectively converted into or exchanged for other securities, cash or property. On June 15, 2006, we entered into an agreement with the accredited investors to amend the Warrant Agreement to give us the ability to repurchase the warrants, in the case of a change in control transaction, using shares of stock, securities or assets, including cash.

Under EITF 00-19 Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock ( EITF 00-19 ), the fair value of the warrants issued under the PIPE Transaction have been reported as a liability due to the requirement to net-cash settle the transaction. There are two reasons for this treatment: (i) there are liquidated damages, payable in cash, of 1% of the gross proceeds per month (\$102,000) should we fail to maintain effectiveness of the registration statement in accordance with the PIPE Transaction; and (ii) our investors may put their warrants back to us for cash if we initiate a change in control that meets the definition previously discussed. As a result of the amendments we structured with the accredited investors on June 15, 2006, we were allowed to account for the warrants as equity. As a result of this accounting change, we made a final valuation of our warrant liability on June 15, 2006, which resulted in non-cash income of \$406,694 for our second quarter in 2006, and the remaining warrant liability of \$1,369,674 was reclassified to additional paid in capital. We are no longer required to revalue these warrants on a prospective basis.



**Table of Contents****NOTE 7. EQUITY**

*Stock Options* We maintain a stock option plan for the benefit of certain eligible employees and our directors. We have authorized 4,000,000 shares for grant under our Amended and Restated 2005 Stock Option Plan (the 2005 Stock Option Plan), and a total of 927,150 shares of common stock are reserved for additional grants of options at June 30, 2007. Generally, the options outstanding are granted at prices equal to the market value of our stock on the date of grant, generally vest over four years and expire over a period of six or ten years from the date of grant.

Commencing January 1, 2006, we adopted Statement of Financial Accounting Standard No. 123R, Share Based Payment (SFAS 123R), which requires all share-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair values over the requisite service period. Prior to 2006, the compensation cost we recorded for option awards was based on their grant date fair value as calculated for the proforma disclosures required by Statement 123.

For the three and six months ended June 30, 2007, we recorded stock-based compensation expense of \$196,600 and \$292,900, respectively, compared to \$162,900 and \$238,400, respectively, for the three and six months ended June 30, 2006. The compensation expense reduced diluted earnings per share by approximately \$0.01 for the three months ended June 30, 2007 and three and six months ended June 30, 2006, and \$0.02 for the six months ended June 30, 2007.

As of June 30, 2007, approximately \$1,041,400 of total unrecognized compensation costs related to non-vested awards is expected to be recognized over a weighted average period of approximately 2.94 years.

The following table summarizes information about stock options at June 30, 2007:

Range of Exercise Prices	Number Outstanding	Options Outstanding			Options Exercisable	
		Weighted Average Remaining Contractual Life In Years	Weighted Average Exercise Price	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$0.30 - \$0.39	147,900	1.12	\$0.39	\$0.39	147,900	\$0.39
0.47 - 0.69	362,900	1.03	0.52	0.52	362,900	0.52
0.95 - 1.25	239,000	2.76	1.15	1.15	179,250	1.16
1.26 - 2.27	451,100	4.08	1.85	1.85	374,575	1.84
2.28 - 3.00	1,169,250	4.42	2.73	2.73	377,375	2.68
	2,370,150	3.47	\$1.92	\$1.92	1,442,000	\$1.49

We use the Black-Scholes option pricing model to determine the weighted average fair value of options. The assumptions utilized to determine fair value of options at the date of grant are indicated in the following table:

	Three Months Ended June 30,	
	2007	2006
Risk-free interest rate	4.72%	4.97%
Expected volatility	40.0%	52.6%
Expected life (in years)	3.0	3.0
Dividend yield		

**Table of Contents**

Option transactions under the 2005 Stock Option Plan during the second quarter ended June 30, 2007 are summarized as follows:

	Options	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Term
Outstanding at March 31, 2007	2,630,650	\$ 1.90		
Granted	105,000	2.83		
Forfeited	(30,625)	2.76		
Exercised	(144,875)	0.63		
Expired	(190,000)	3.00		
Outstanding at June 30, 2007	2,370,150	\$ 1.92	\$ 2,937,434	3.77
Exercisable at June 30, 2007	1,442,000	\$ 1.49	\$ 2,402,248	3.06

Option transactions under the 2005 Stock Option Plan during the six months ended June 30, 2007 are summarized as follows:

	Options	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Term
Outstanding at December 31, 2006	2,250,900	\$ 1.64		
Granted	610,500	2.81		
Forfeited	(34,375)	2.75		
Exercised	(266,875)	0.69		
Expired	(190,000)	3.00		
Outstanding at June 30, 2007	2,370,150	\$ 1.92	\$ 2,937,434	3.77
Exercisable at June 30, 2007	1,442,000	\$ 1.49	\$ 2,402,248	3.06

*Restricted Stock* - In connection with our employment agreement dated as of December 1, 2006 with Gregg O. Lehman, Ph.D., our President and Chief Executive Officer, on January 1, 2007 we granted an award of 50,000 shares of restricted common stock to Mr. Lehman. This restricted common stock vests in three equal installments on the first of the year for each of 2007, 2008 and 2009. For the three and six months ended June 30, 2007, we recorded \$16,600 and \$77,300, respectively, of stock-based compensation related to this grant, which was valued using a price of \$2.65 per share, which was the market value of our common stock on the date of grant. As of June 30, 2007, \$55,200 of unrecognized compensation costs related to the non-vested portion of this award will be recognized through December 31, 2008.

*Equity Incentive Plan* At our Annual Meeting of Shareholders on May 21, 2007, our shareholders approved the implementation of our 2007 Equity Incentive Plan (the "Equity Plan"). The Equity Plan was developed to provide our executives with restricted stock incentives if certain financial targets are achieved for calendar years 2007 through 2009. In lieu of selecting restricted stock, executives can choose to receive a cash bonus under our 2007 Cash Incentive Plan (the "Cash Plan"). The performance objectives, and monetary potential of the Cash Plan would be the same as those under the Equity Plan and participants would receive their cash bonuses at the same time as the restricted stock vests under the Equity Plan. Restricted stock granted under the Equity Plan is earned on an annual basis upon achievement of certain financial objectives for each of 2007, 2008 and 2009. All shares earned during these years will vest upon completion of our 2009 annual audit. For the three and six months ended June 30, 2007, we recorded \$16,160 of stock-based compensation related to this program, which was valued using a price of \$2.78 per share, which was the market value of our common stock on the date our shareholders approved the program. As of

June 30, 2007, \$1,778,337 of unrecognized compensation costs related to the non-vested portion of this program will be recognized through March 2010.

**Table of Contents**

*Accrued Acquisition Earnout* - In accordance with the Stock Purchase Agreement executed in connection with our acquisition of HealthCalc.Net, Inc. on December 23, 2005, we agreed to pay the shareholders of HealthCalc a contingent earnout payment based upon the achievement of specific 2006 revenue objectives. In accordance with this Stock Purchase Agreement, the contingent earnout payment could be made by us in cash, stock or a combination thereof. At December 31, 2006, we recorded a liability of \$1,475,000 in favor of the former shareholders of HealthCalc representing the contingent earnout payment, with the offset reflected as an increase to goodwill. On March 27, 2007, our Board of Directors determined that this earnout payment would be made by a cash payment of \$737,500 and the issuance of 262,590 shares of common stock, which was determined using an average closing share price of \$2.81 for the twenty-one trading days preceding the date of payment. We made the cash payment on March 28, 2007 and issued the common stock effective on March 27, 2007.

**NOTE 8. CONTINGENCIES**

In March, 2007, we received a letter inquiring about our interest in negotiating a license for certain technology patents that pertain to certain aspects of the electronic collection, use and management of health-related electronic data. We do not believe these patents are material based on our initial review, and it is unlikely we will be interested in a license on any material terms. However, we are currently conducting a more detailed review of this matter.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our interim consolidated financial statements and related notes included in Item 1 of Part 1 of this Quarterly Report, and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

**Critical Accounting Policies.** Our most critical accounting policies, which are those that require significant judgment, include: revenue recognition, trade and other accounts receivable, goodwill and stock-based compensation. A more in-depth description of these can be found in Note 3 to the interim consolidated financial statements included in this Quarterly Report and Note 1 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

**General.** We are a leading provider of population health improvement services and programs to corporations, hospitals, communities and universities located in the United States and Canada. We provide staffing services as well as a comprehensive menu of programs, products and consulting services within our Health Management and Fitness Management business segments. Our broad suite of services enables our clients' employees to live healthier lives, and our clients to control rising healthcare costs, through participation in our assessment, education, coaching, physical activity, weight management and wellness program services, which can be offered as follows: (i) through on-site fitness centers we manage; (ii) remotely via the web and; (iii) through telephonic health coaching.

**Results of Operations**

The following table sets forth our statement of operations data as a percentage of total revenues for the three and six months ended June 30, 2007 and 2006:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
REVENUE	100.0%	100.0%	100.0%	100.0%
COSTS OF REVENUE	72.0	73.3	71.5	74.2
GROSS PROFIT	28.0	26.7	28.5	25.8
OPERATING EXPENSES				
Salaries	15.6	13.8	15.0	13.7
Other selling, general and administrative	10.0	7.8	9.5	7.8
Amortization of acquired intangible assets	0.2	0.7	0.3	0.7
Total operating expenses	25.8	22.3	24.7	22.2
OPERATING INCOME	2.2	4.4	3.8	3.6
OTHER INCOME (EXPENSE)		2.7	(0.1)	2.8
EARNINGS BEFORE INCOME TAXES	2.2	7.1	3.7	6.4
INCOME TAX EXPENSE	1.2	2.4	1.7	1.8

Edgar Filing: Health Fitness Corp /MN/ - Form 10-Q

NET EARNINGS	1.0	4.7	2.0	4.6
Dividend to preferred shareholders				0.3
NET EARNINGS TO COMMON SHAREHOLDERS	1.0%	4.7%	2.0%	4.3%

15

---

**Table of Contents**

**Results of Operations for the quarter ended June 30, 2007 compared to the quarter ended June 30, 2006.**

**Revenue.** Revenue increased \$1,404,000 or 9.0%, to \$16,979,000 for the three months ended June 30, 2007, from \$15,575,000 for the three months ended June 30, 2006.

Of this growth in revenue, our Fitness Management segment experienced a slight decline of \$71,000, which includes a decline of \$104,000 from staffing services and growth of \$33,000 from program and consulting services. Overall, the slight decline in Fitness Management segment revenue is primarily due to the termination of a large Fitness Management contract by an automotive client effective March 31, 2007. This revenue loss was partially offset by new staffing service contracts, the expansion of existing contracts, and by growth of program revenue at existing sites, including personal training and health coaching services.

Our Health Management segment contributed total growth of \$1,475,000, which includes growth of \$548,000 from staffing services and growth of \$927,000 from program and consulting services. Overall, Health Management revenue growth is attributed to new contracts and the expansion of existing contracts. The significant increase in program and consulting services, compared to last year, was primarily driven by an increase in biometric screening services, health coaching services and eHealth platform sales and customizations.

During the quarter, we obtained eleven new customer commitments in our Health Management segment, which may realize incremental annualized revenue of approximately \$2.2 million, which includes approximately \$0.7 million of potential annualized revenue for two existing Fitness Management customers. In our Fitness Management segment, we obtained one new customer commitment, and received a commitment to expand our management services for an existing customer, all of which may realize incremental annualized revenue of approximately \$0.7 million. The \$2.9 million combined total for this potential new, incremental annualized revenue will be offset by a potential annualized revenue loss of \$0.6 million from contract and site cancellations.

**Gross Profit.** Gross profit increased \$595,000, or 14.3%, to \$4,755,000 for the three months ended June 30, 2007, from \$4,160,000 for the three months ended June 30, 2006.

Of this increase in gross profit, our Fitness Management segment contributed a slight decline of \$31,000, which includes growth of \$5,000 from staffing services and a decline of \$36,000 from program and consulting services.

Our Health Management segment contributed total gross profit growth of \$626,000, which includes growth of \$115,000 from staffing services and growth of \$511,000 from program and consulting services.

As a percent of revenue, total gross profit increased to 28.0%, from 26.7% for the same period last year. Gross profit from our Health Management segment, as a percent of revenue, increased to 38.6%, from 37.5% for the prior year period. This increase is primarily due to revenue growth in our higher margin program and consulting services. Gross profit from our Fitness Management segment, as a percent of revenue, slightly decreased to 21.5%, from 21.6% in the prior year period. This result is primarily due to a margin decrease in program and consulting services, which fell to 37.0% of revenue, from 44.5% for the same period last year, and is due primarily to partial utilization of new health coaches we added during the quarter. This decline was partially offset by margin growth in staffing services, which grew to 20.4% of revenue, from 20.2% for the same period last year.

**Operating Expenses and Operating Income.** Operating expenses increased \$906,000 or 26.1%, to \$4,379,000 for the three months ended June 30, 2007, from \$3,473,000 for the three months ended June 30, 2006. This increase is attributable to a \$499,000 increase in salaries, a \$472,000 increase in other selling, general and administrative expenses, and a \$65,000 decrease in amortization expense attributable to prior acquisitions. Operating expenses as a percent of revenue for the three months ended June 30, 2007 increased to 25.8%, from 22.3% for the three months ended June 30, 2006

**Table of Contents**

Of the increase in salaries, \$433,000 is attributable to staff additions we made to strengthen our capabilities in certain functions, including research, development and outcomes, marketing, technology and account services, and \$66,000 is attributable to an increase in stock-based compensation.

The \$472,000 increase in other selling, general and administrative expenses is attributable to the costs associated with a higher employee count, including higher office rent, contract services, travel, legal fees and general office costs.

As a result of the previously discussed changes in gross profit and operating expenses, operating income decreased \$311,000, or 45.2%, to \$376,000 for the quarter ended June 30, 2007, from \$687,000 for quarter ended June 30, 2006. Operating margin for the three months ended June 30, 2007 declined to 2.2%, from 4.4% for the three months ended June 30, 2006. This decrease is primarily due to investments we have made to support our future growth plans.

**Other Income and Expense.** Interest expense was inconsequential during the quarters ended June 30, 2007 and 2006, respectively.

For the quarter ended June 30, 2006, we recorded a \$407,000 non-cash benefit related to a change in fair value for 1,530,000 warrants we issued in connection with the sale of \$10.2 million of our Series B Convertible Preferred Stock in November 2005. Refer to the section titled *Summary of Significant Accounting Policies, Valuation of Derivative Instruments*, contained elsewhere in this document for further discussion of the accounting we used to value these warrants. As of June 15, 2006, we were no longer required to revalue these warrants.

**Income Taxes.** Current income tax expense decreased \$175,000 to \$203,000 for the three months ended June 30, 2007, from \$378,000 for 2006. The decrease is primarily due to the lower operating income in 2007 compared to 2006.

Our effective tax rate, as a percent of earnings before income taxes, increased to 54% for the second quarter of 2007, compared to 34% for the same period last year. In the second quarter of 2006, we did not reflect a tax liability on the \$407,000 non-cash benefit related to the revaluation of warrants. Excluding this gain related to the revaluation of warrants, our effective tax rate would be 54% for the second quarter of 2006. Compared to our normal effective tax rate of 38%, our current effective tax rate is higher due to the tax rate effect of compensation expense for incentive stock options, which is deductible for tax purposes only when the underlying incentive stock options are exercised.

**Net Earnings Applicable to Common Shareholders.** As a result of the above, net earnings applicable to common shareholders for the quarter ended June 30, 2007 decreased approximately \$554,000 to \$173,000, compared to net earnings applicable to common shareholders of \$727,000 for the quarter ended June 30, 2006.

**Dividends to Preferred Shareholders.** There were no dividends to preferred shareholders for the three months ended June 30, 2007 and 2006, respectively. This is attributable to the conversion of our Series B Convertible Preferred Stock to common stock on March 10, 2006.

**Results of Operations for the six months ended June 30, 2007 compared to the six months ended June 30, 2006.**

**Revenue.** Revenue increased \$3,427,000 or 11.4%, to \$33,569,000 for the six months ended June 30, 2007, from \$30,142,000 for the six months ended June 30, 2006.



**Table of Contents**

Of this growth in revenue, our Fitness Management segment contributed total growth of \$352,000, which includes growth of \$189,000 from staffing services and growth of \$163,000 from program and consulting services. Overall, the growth in Fitness Management revenue is attributed to new contracts, the expansion of existing contracts, and growth of program revenue at existing sites, including personal training, weight management and massage therapy. This growth was partially offset by the previously announced termination of a large Fitness Management contract by an automotive client effective March 31, 2007.

Our Health Management segment contributed total growth of \$3,075,000, which includes growth of \$1,146,000 from staffing services and growth of \$1,929,000 from program and consulting services. Overall, Health Management revenue growth is attributed to new contracts and the expansion of existing contracts. The significant increase in program and consulting services, compared to last year, was primarily driven by an increase in biometric screening services, health coaching services and eHealth platform sales and customizations.

For the first six months of 2007, we obtained 23 new customer commitments in our Health Management segment that may realize incremental annualized revenue of approximately \$5.1 million, which includes \$0.7 million of potential annualized revenue from two existing Fitness Management customers. In our Fitness Management segment, we obtained four new customer commitments, and received a commitment to expand our management services for an existing customer, all of which may realize incremental annualized revenue of approximately \$2.1 million. The \$7.2 million combined total for this potential new, incremental annualized revenue will be offset by a potential annualized revenue loss of \$2.1 million from contract and site cancellations.

**Gross Profit.** Gross profit increased \$1,801,000, or 23.2%, to \$9,565,000 for the six months ended June 30, 2007, from \$7,764,000 for the six months ended June 30, 2006.

Of this increase in gross profit, our Fitness Management segment contributed a total of \$148,000, which includes growth of \$119,000 from staffing services and \$29,000 from program and consulting services.

Our Health Management segment contributed total gross profit growth of \$1,653,000, which includes \$366,000 from staffing services and growth of \$1,287,000 from program and consulting services.

As a percent of revenue, total gross profit increased to 28.5%, from 25.8% for the same period last year. Gross profit from our Health Management segment, as a percent of revenue, increased to 39.1%, from 34.2% for the prior year period. This increase was predominantly driven by the increase in gross margin for our program and consulting revenue, which increased to 60.9% for the six months ended June 30, 2007, from 57.0% for the same period last year. Gross profit from our Fitness Management segment, as a percent of revenue, increased to 22.3%, from 22.0% in the prior year period. This increase is due to margin growth for staffing services, which increased to 20.8% of revenue, from 20.4% for the same period last year. This margin growth was offset by a margin decrease in program and consulting services, which fell to 44.8% of revenue, from 48.6% for the same period last year.

**Operating Expenses and Operating Income.** Operating expenses increased \$1,606,000, or 24.0%, to \$8,303,000 for the six months ended June 30, 2007, from \$6,697,000 for the six months ended June 30, 2006. This increase is attributable to a \$902,000 increase in salaries, an \$835,000 increase in other selling, general and administrative expenses, and a \$131,000 decrease in amortization expense attributable to prior acquisitions. Operating expenses as a percent of revenue for the six months ended June 30, 2007 increased to 24.7%, from 22.2% for the six months ended June 30, 2006

Of the increase in salaries, \$754,000 is attributable to staff additions we made to strengthen our capabilities in certain functions, including research, development and outcomes, marketing, technology and account services, and \$148,000 is attributable to an increase in stock-based compensation.

The \$835,000 increase in other selling, general and administrative expenses is attributable to the costs associated with a higher employee count, including higher office rent, contract services, travel, legal fees and general office costs.

**Table of Contents**

As a result of the previously discussed changes in gross profit and operating expenses, operating income increased \$195,000, or 18.2%, to \$1,262,000 for the six months ended June 30, 2007, from \$1,067,000 for the six months ended June 30, 2006.

Operating margin for the six months ended June 30, 2007 expanded to 3.8%, from 3.5% for the six months ended June 30, 2006. This increase is primarily due to the gross margin expansion within our Health Management segment, which was partially offset by investments we have made to support our future growth plans.

**Other Income and Expense.** Interest expense was inconsequential during the six months ended June 30, 2007 and 2006, respectively.

For the six months ended June 30, 2006, we recorded a \$841,000 non-cash benefit related to a change in fair value for 1,530,000 warrants we issued in connection with the sale of \$10.2 million of our Series B Convertible Preferred Stock in November 2005. Refer to the section titled *Summary of Significant Accounting Policies, Valuation of Derivative Instruments*, contained elsewhere in this document for further discussion of the accounting we used to value these warrants. As of June 15, 2006, we were no longer required to revalue these warrants.

**Income Taxes.** Current income tax expense increased \$46,000 to \$573,000 for the six months ended June 30, 2007, from \$527,000 for 2006. The increase is primarily due to higher operating income and stock-based compensation in 2007 compared to 2006.

Our effective tax rate, as a percent of earnings before income taxes, increased to 46% for the first six months of 2007, compared to 28% for the same period last year. For the first six months of 2006, we did not reflect a tax liability on the \$841,000 non-cash benefit related to the revaluation of warrants. Excluding this gain related to the revaluation of warrants, our effective tax rate would be 49% for the first six months of 2006. Compared to our normal effective tax rate of 38%, our current effective tax rate is higher due to the tax rate effect of compensation expense for incentive stock options, which is deductible for tax purposes only when the underlying incentive stock options are exercised.

**Net Earnings Applicable to Common Shareholders.** As a result of the above, net earnings applicable to common shareholders for the six months ended June 30, 2007 decreased approximately \$606,000 to \$685,000, compared to net earnings applicable to common shareholders of \$1,291,000 for the six months ended June 30, 2006.

**Dividends to Preferred Shareholders.** Dividend to preferred shareholders decreased \$96,000 to \$0 for the six months ended June 30, 2007, compared to \$96,000 for the six months ended June 30, 2006. This decrease is attributable to the conversion of our Series B Convertible Preferred Stock to common stock on March 10, 2006.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

Our working capital increased \$1,731,000 to \$7,522,000 for the six months ended June 30, 2007, from \$5,791,000 at December 31, 2006. This increase is largely attributable to decreases in accounts payable, accrued expenses and accrued acquisition earnout.

In addition to cash flows generated from operating activities, our other primary source of liquidity and working capital is provided by a \$7,500,000 Credit Agreement with Wells Fargo Bank, N.A. (the Wells Loan ). At our option, the Wells Loan bears interest at prime, or the one-month LIBOR plus a margin of 2.25% to 2.75% based upon our Senior Leverage Ratio (effective rate of 8.25% at June 30, 2007 and December 31, 2006, respectively). The availability of the Wells Loan decreases \$250,000 on the last day of each calendar quarter, beginning September 30, 2003, and matures on June 30, 2008, as amended. Working capital advances from the Wells Loan are based upon a percentage of our eligible accounts receivable, less any amounts previously drawn. The facility provided maximum borrowing capacity of \$3,500,000 and \$4,000,000 at June 30, 2007 and December 31, 2006, respectively, and \$3,226,000 and \$4,000,000 was available for drawing on such respective dates. All borrowings are collateralized by substantially all of our assets. At June 30, 2007, we were in compliance with all of our financial covenants.

On November 14, 2005 (the Effective Date ), in a Private Investment in Public Equity transaction (the PIPE Transaction ), we issued an aggregate of 1,000 shares of Series B Convertible Preferred Stock (the Series B Stock ), together with warrants to purchase 1,530,000 shares of common stock at \$2.40 per share, to a limited number of accredited investors for aggregate gross proceeds of \$10.2 million. After selling commissions and expenses, we received net proceeds of approximately \$9.4 million. The Series B Stock automatically converted into 5,100,000 shares of our common stock on March 10, 2006, the date the Securities and Exchange Commission (the SEC ) first declared effective a registration statement covering these shares. We used the proceeds from this PIPE Transaction to redeem our Series A Convertible Preferred Stock and to fund the acquisition of HealthCalc.Net, Inc.

In accordance with the terms of the PIPE Transaction, we were required to file with the SEC, within sixty (60) days from the Effective Date, a registration statement covering the common shares issued and issuable in the PIPE Transaction. We were also required to cause the registration statement to be declared effective on or before the expiration of one hundred twenty (120) days from the Effective Date. We would have been subject to liquidated damages of one percent (1%) per month of the aggregate gross proceeds (\$10,200,000), if we failed to meet these date requirements. On March 10, 2006, the SEC declared effective our registration statement and, as a result, we did not pay any liquidated damages for failure to meet the filing and effectiveness date requirements. We could nevertheless be subject to the foregoing liquidated damages if we fail (subject to certain permitted circumstances) to maintain the effectiveness of the registration statement. On June 15, 2006, we entered into an agreement with the accredited investors to amend the Registration Rights Agreement to cap the amount of liquidated damages we could pay at 9% of the aggregate purchase price paid by each accredited investor.

The warrants, which were issued together with the Series B Stock, have a term of five years, and give the investors the option to require us to repurchase the warrants for a purchase price, payable in cash within five (5) business days after such request, equal to the Black Scholes value of any unexercised warrant shares, only if, while the warrants are outstanding, any of the following change in control transactions occur: (i) we effect any merger or consolidation, (ii) we effect any sale of all or substantially all of our assets, (iii) any tender offer or exchange offer is completed whereby holders of our common stock are permitted to tender or exchange their shares for other securities, cash or property, or (iv) we effect any reclassification of our common stock whereby it is effectively converted into or exchanged for other securities, cash or property. On June 15, 2006, we entered into an agreement with the accredited investors to amend the Warrant Agreement to give us the ability to repurchase the warrants, in the case of a change in control transaction, using shares of stock, securities or assets, including cash.

Under EITF 00-19 Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock (EITF 00-19 ), the fair value of the warrants issued under the PIPE Transaction have been

**Table of Contents**

reported as a liability due to the requirement to net-cash settle the transaction. There are two reasons for this treatment: (i) there are liquidated damages, payable in cash, of 1% of the gross proceeds per month (\$102,000) should we fail to maintain effectiveness of the registration statement in accordance with the PIPE Transaction; and (ii) our investors may put their warrants back to us for cash if we initiate a change in control that meets the definition previously discussed. As a result of the amendments we structured with the accredited investors on June 15, 2006, we were allowed to account for the warrants as equity. As a result of this accounting change, we made a final valuation of our warrant liability on June 15, 2006, which resulted in non-cash income of \$406,694 for our second quarter in 2006, and the remaining warrant liability of \$1,369,674 was reclassified to additional paid in capital. We are no longer required to revalue these warrants on a prospective basis.

On a short and long-term basis, we believe that sources of capital to meet our obligations will be provided by cash generated through operations and the Wells Loan. We also believe that our current and available resources will enable us to finance our expected 2007 operational investments without having to raise additional capital.

**INFLATION**

We do not believe that inflation has significantly impacted our results of operations in any of the last three completed fiscal years.

**OFF-BALANCE SHEET ARRANGEMENTS**

As of June 30, 2007, the Company had no off-balance sheet arrangements or transactions with unconsolidated, limited purpose entities.

**PRIVATE SECURITIES LITIGATION REFORM ACT**

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Such forward-looking information is included in this Form 10-Q, including the MD&A section, as well as in our Annual Report on Form 10-K for the year ended December 31, 2006 that was filed with the Securities and Exchange Commission, and in other materials filed or to be filed by the Company with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by the Company). Forward-looking statements include all statements based on future expectations and specifically include, among other things, all statements relating to increasing revenue, improving margins, growth of our Fitness and Health Management business segments, the development of new business models, our ability to expand our programs and services, the materiality of a letter inquiring about our interest in negotiating a license for certain technology patents or the materiality of such patents and the sufficiency of our liquidity and capital resources to meet our obligations and finance our expected operational investments. In addition, the estimated annualized revenue value of our new and lost contracts is a forward looking statement, which is based upon an estimate of the anticipated annualized revenue to be realized or lost. Such information should be used only as an indication of the activity we have recently experienced in our two business segments. These estimates, when considered together, should not be considered an indication of the total net, incremental revenue growth we expect to generate in 2007, or in any year, as actual net growth may differ from these estimates due to actual staffing levels, participation rates and contract duration, in addition to other revenue we may lose in the future due to contract termination. Any statements that are not based upon historical facts, including the outcome of events that have not yet occurred and our expectations for future performance, are forward-looking statements. The words potential, believe, estimate, expect, intend, may, could, will, p and similar words and expressions are intended to identify forward-looking

**Table of Contents**

statements. Such statements are based upon the current beliefs and expectations of our management. Such forward-looking information involves important risks and uncertainties that could significantly affect anticipated results in the future and, accordingly, such results may differ from those expressed in any forward-looking statements made by or on behalf of the Company. These risks and uncertainties include, but are not limited to those matters identified and discussed in Item 1A of the Company's Form 10-K for the year ended December 31, 2006 under Risk Factors.

**RECENTLY PASSED LEGISLATION**

**Sarbanes-Oxley.** On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, referred to herein as the Act, which immediately impacts Securities and Exchange Commission registrants, public accounting firms, lawyers and securities analysts. This legislation is the most comprehensive securities legislation since the passage of the Securities Acts of 1933 and 1934. It has far reaching effects on the standards of integrity for corporate management, board of directors, and executive management. Additional disclosures, certifications and procedures will be required of us. We do not expect any material adverse effect on our business as a result of the passage of this legislation. We expect to be in compliance with the Act by December 31, 2007.

Refer to management's certifications contained elsewhere in this report regarding our compliance with Sections 302 and 906 of the Act.

**HIPAA.** The Administrative Simplification provisions of the Health Insurance Portability and Accountability Act of 1996, referred to herein as HIPAA, require group health plans and health care providers who conduct certain administrative and financial transactions electronically, referred to herein as Standard Transactions, to (a) comply with a certain data format and coding standards when conducting electronic transactions; (b) use appropriate technologies to protect the security and integrity of individually identifiable health information transmitted or maintained in an electronic format; and (c) protect the privacy of patient health information. Our occupational health, health risk assessment and health coaching services, in addition to the group health plan we sponsor for our employees, are subject to HIPAA's requirements. We expect to be in compliance with HIPAA requirements within the timeline specified for our affected business segments. Our corporate, hospital, community and university-based fitness center management lines of business are not subject to the requirements of HIPAA.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risks related to changes in U.S. and international interest rates. All of the Company's long-term obligations bear interest at a variable rate.

We have no history of, and do not anticipate in the future, investing in derivative financial instruments, derivative commodity instruments or other such financial instruments. Transactions with international customers are entered into in U.S. dollars, precluding the need for foreign currency hedges. As a result, our exposure to market risk is not material.

**ITEM 4. CONTROLS AND PROCEDURES**

Our Chief Executive Officer and Chief Financial Officer (collectively, the Certifying Officers) are responsible for establishing and maintaining disclosure controls and procedures for the Company. The Certifying Officers have concluded (based upon their evaluation of these controls and procedures as of the end of the period covered by this report) that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules of the Securities and Exchange Commission. The Certifying Officers also have indicated that there were no significant changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

Refer to Item 3 (Legal Proceedings) in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, including the important information in Private Securities Litigation Reform Act, you should carefully consider the Risk Factors discussed in our Annual Report on Form 10-K for the year ended December 31, 2006. Those factors, if they were to occur, could cause our actual results to differ materially from those expressed in our forward-looking statements in this report, and materially adversely affect our financial condition or future results. Although we are not aware of any other factors that we currently anticipate will cause our forward-looking statements to differ materially from our future actual results, or materially affect the Company's financial condition or future results, additional risks and uncertainties not currently known to us or that we currently deem to be immaterial might materially adversely affect our actual business, financial condition and/or operating results.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

(a) The Annual Meeting of the Company's shareholders was held on Monday, May 21, 2007.

(b) Proxies for the Annual Meeting were solicited pursuant to Regulation 14A under the Securities Exchange Act of 1934. There was no solicitation in opposition to management's nominees, and the shareholders elected the following persons as directors of the Company to serve until the next annual meeting of shareholders:

Nominee	Number of Votes	Number of Votes
	For	Withheld
Gregg O. Lehman	14,267,186	176,103
K. James Ehlen, M.D	13,962,715	480,574
Robert J. Marzec	14,076,133	367,156
Jerry V. Noyce	14,267,286	176,003
John C. Penn	14,262,186	181,103
Mark W. Sheffert	14,076,233	367,056
Linda Hall Whitman	14,267,286	176,003
Rodney A. Young	14,267,186	176,103

(c) By a vote of 7,503,417 shares in favor, 357,763 shares opposed, 17,524 shares abstaining, and 6,564,585 shares represented by broker nonvotes, the shareholders approved our Amended and Restated Stock Option Plan.

(d) By a vote of 7,513,383 shares in favor, 346,764 shares opposed, 18,557 shares abstaining, and 6,564,585 shares represented by broker nonvotes, the shareholders approved our 2007 Equity Incentive Plan.

**Table of Contents**

(e) By a vote of 14,231,933 shares in favor, 198,553 shares opposed, 12,803 shares abstaining, and 0 shares represented by broker nonvotes, the shareholders ratified the selection of Grant Thornton LLP as the Company's independent auditors for the current fiscal year.

**ITEM 5. OTHER INFORMATION**

We entered into a new Lease Agreement for our corporate headquarters with United Properties Investment LLC on May 2, 2007. The Lease is for approximately 28,272 square feet of office space at the Southpoint Office Center in Bloomington, Minnesota. The Lease commences on January 1, 2008 and continues for five years, with an option to extend the term for an additional five-year period if certain terms and conditions are met. The rent starts at \$31,230.33 per month and increases at a rate of \$.50 per square foot each year for only 24,283 square feet of the space. We expect to move into this new space in the first quarter of 2008. A copy of the Lease is attached hereto as Exhibit 10.1.

On May 9, 2007, we entered into a Third Amendment to Lease with Parkway Commons, L.P. to add additional space to our facility in Plano, Texas, which we originally assumed in connection with our acquisition of HealthCalc.Net, Inc. in December 2005. The Amendment added an additional 2,174 square feet for a total of 8,213 square feet. The Lease continues until December 31, 2012. The rent for the full 8,213 square feet is currently \$14,030.54 per month and increases approximately \$340 per month at the beginning of each calendar year thereafter. This Amendment was a result of an expansion of our staff in technology development, customer service and research, development and outcomes. A copy of this Amendment is attached hereto as Exhibit 10.5. In addition, the original Lease and the First and Second Amendments are attached hereto as Exhibits 10.2, 10.3 and 10.4, respectively.

**ITEM 6. EXHIBITS**

(a) Exhibits See Exhibit Index on page following signatures

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: August 14, 2007

HEALTH FITNESS CORPORATION

By /s/ Gregg O. Lehman

Gregg O. Lehman  
President and Chief Executive Officer  
(Principal Executive Officer)

By /s/ Wesley W. Winnekins

Wesley W. Winnekins  
Chief Financial Officer and Treasurer  
(Principal Financial and Accounting  
Officer)

25

---



**Table of Contents**

EXHIBIT INDEX  
HEALTH FITNESS CORPORATION  
FORM 10-Q

Exhibit No.	Description
**10.1	Lease Agreement, dated as of May 2, 2007, by and between United Properties Investment LLC and the Company
**10.2	Office Lease, dated as of September 29, 2003, by and between CMD Realty Investment Fund II, L.P. and HealthCalc.Net, Inc.
**10.3	First Amendment to Lease, dated April 29, 2005, by and between Parkway Commons, L.P. (f/k/a CMD Realty Investment Fund II, L.P.) and HealthCalc.Net, Inc.
**10.4	Second Amendment to Lease, dated January 31, 2006, by and between Parkway Commons, L.P. and HealthCalc.Net, Inc.
**10.5	Third Amendment to Lease, dated May 9, 2007, by and between Parkway Commons, L.P. and the Company
10.6	Amended and Restated 2005 Stock Option Plan incorporated by reference to Exhibit 10.1 to our Form 8-K dated May 21, 2007 (1)
10.7	Form of Incentive Stock Option Agreement incorporated by reference to Exhibit 10.2 to our Form 8-K dated May 21, 2007 (1)
10.8	Form of Nonqualified Stock Option Agreement incorporated by reference to Exhibit 10.3 to our Form 8-K dated May 21, 2007 (1)
10.9	2007 Equity Incentive Plan incorporated by reference to Exhibit 10.4 to our Form 8-K dated May 21, 2007 (1)
10.10	Form of Restricted Stock Agreement incorporated by reference to Exhibit 10.5 to our Form 8-K dated May 21, 2007 (1)
**11.0	Statement re: Computation of Earnings per Share
**31.1	Certification of President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
**31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
**32.1	Certification of President and Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
**32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\*\* Filed herewith

- (1) Indicates management contract or compensatory plan or arrangement