Health Fitness Corp /MN/
Form 10-Q
November 19, 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 September 30, 2007
Commission File No. 000-25064

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

Minnesota	**No. 41-1580506**
(State or Other Jurisdiction of Incorporation or Organization)	**(IRS Employer Identification No.)**

3600 American Boulevard West, Bloomington, Minnesota 55431
(Address of Principal Executive Offices)
Registrant s telephone number (952) 831-6830

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 þ NO o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

The number of shares outstanding of the registrant s common stock as of November 12, 2007 was: Common Stock, $0.01 par value, 19,918,590 shares

Table of Contents

HEALTH FITNESS CORPORATION
EXPLANATORY NOTE

On November 12, 2007, subsequent to our 3rd quarter earnings release on November 5, 2007, we determined that a $1,576,454 deemed dividend to preferred shareholders should have been reflected in our financial statements by recording a reduction to net earnings applicable to common shareholders in the consolidated statement of operations for the quarter ended March 31, 2006, with a corresponding increase being recorded to additional paid in capital in the consolidated balance sheet as of March 31, 2006. This restatement will result in no change to total net earnings or to total stockholders equity as of September 30, 2007, or any other prior period.

This restatement will not affect the results of operations for the three and nine months ended September 30, 2007, nor will it affect our statement of cash flows for the nine months ended September 30, 2007. This Form 10-Q accurately reflects this deemed dividend in our consolidated balance sheet for the nine months ended September 30, 2007 and year ended December 31, 2006, and our consolidated statements of operations and cash flows for the nine months ended September 30, 2006. In addition, we do not intend to amend our previously filed Quarterly Reports on Form 10-Q for the periods ended March 31, 2007 and June 30, 2007.

The determination to restate these financial statements in the foregoing respects results from comments we received in a letter from the Securities and Exchange Commission (the SEC) following their routine review of our Form 10-K for the year ended December 31, 2006. We are in the process of resolving other comments that were addressed in the SEC s letter.

The $1,576,454 deemed dividend to preferred shareholders was determined in accordance with Emerging Issues Task Force (EITF) Number 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratio*. This deemed dividend is a one-time, non-cash adjustment related to the automatic conversion of our Series B Preferred Stock to common stock on March 10, 2006.

The Audit Committee worked closely with our management to review the restatement and our policies and practices related to the restatement. Further information on this adjustment can be found in Note 9, Restatement to the accompanying consolidated financial statements. The Audit Committee has determined that, despite this restatement, our internal controls over accounting and financial reporting are effective, and that the restatement does not relate to any misconduct on the part of management.

Management and the Audit Committee of the Company s Board of Directors discussed these matters with the Company s independent registered public accounting firm, Grant Thornton LLP.

HEALTH FITNESS CORPORATION
QUARTERLY REPORT ON FORM 10-Q
Table of Contents

	PAGE
PART I. FINANCIAL INFORMATION	
ITEM 1. Consolidated Financial Statements (unaudited)	
Consolidated Balance Sheets as of September 30, 2007 and December 31, 2006	4
Consolidated Statements of Operations for the three and nine months ended September 30, 2007 and 2006	5
Consolidated Statements of Cash Flows for the nine months ended September 30, 2007 and 2006	6
Notes to Consolidated Financial Statements	7
ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	17
ITEM 3. Quantitative and Qualitative Disclosures About Market Risk	24
ITEM 4. Controls and Procedures	25
PART II. OTHER INFORMATION	25
ITEM 1. Legal Proceedings	25
ITEM 1A. Risk Factors	25
ITEMS 2-3. Not Applicable	26
ITEM 4. Submission of Matters to a Vote of Security Holders	26
ITEM 5. Other Information	26
ITEM 6. Exhibits	26
Signatures	27
Exhibit Index	28

Statement Re: Computation of Earnings Per Share
Section 302 Certification
Section 302 Certification
Section 906 Certification
Section 906 Certification

Table of Contents

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

	September 30, 2007	December 31, 2006 (Restated)
ASSETS		
CURRENT ASSETS		
Cash	$ 251,760	$ 987,465
Trade and other accounts receivable, less allowances of $215,300 and $283,100	12,511,532	12,404,856
Inventories	677,592	326,065
Prepaid expenses and other	698,593	375,824
Deferred tax assets	217,476	217,476
Total current assets	14,356,953	14,311,686
PROPERTY AND EQUIPMENT, net	1,171,795	767,675
OTHER ASSETS		
Goodwill	14,542,383	14,509,469
Software technology, less accumulated amortization of $686,400 and $370,200	1,526,783	1,658,575
Trademark, less accumulated amortization of $320,700 and $246,300	172,372	246,809
Other intangible assets, less accumulated amortization of $223,800 and $166,500	305,293	362,528
Deferred tax assets	437,010	437,010
Other	14,011	24,597
	$ 32,526,600	$ 32,318,349
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Trade accounts payable	$ 1,154,040	$ 1,811,939
Accrued salaries, wages, and payroll taxes	2,483,172	3,249,424
Accrued acquisition earnout		1,475,000
Other accrued liabilities	366,761	120,044
Accrued self funded insurance	286,981	201,053
Line of credit	848,460	
Deferred revenue	1,180,252	1,663,121
Total current liabilities	6,319,666	8,520,581
LONG-TERM OBLIGATIONS		

COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Common stock, $0.01 par value; 50,000,000 shares authorized; 19,913,590 and 19,220,217 shares issued and outstanding	198,990	192,202
Additional paid-in capital	29,284,933	27,565,901
Accumulated comprehensive income	(53,534)	(35,186)
Accumulated deficit	(3,223,455)	(3,925,149)
	26,206,934	23,797,768
	$ 32,526,600	$ 32,318,349

See notes to consolidated financial statements.

Table of Contents

HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006 (Restated)
REVENUE	$ 17,153,058	$ 16,340,380	$ 50,722,258	$ 46,482,771
COSTS OF REVENUE	12,268,332	11,061,752	36,272,205	33,439,649
GROSS PROFIT	4,884,726	5,278,628	14,450,053	13,043,122
OPERATING EXPENSES				
Salaries	2,775,532	2,045,284	7,819,407	6,187,653
Other selling, general and administrative	1,835,136	1,133,118	5,008,770	3,471,455
Amortization of acquired intangible assets	42,771	96,986	128,311	313,058
Total operating expenses	4,653,439	3,275,388	12,956,488	9,972,166
OPERATING INCOME	231,287	2,003,240	1,493,565	3,070,956
OTHER INCOME (EXPENSE)				
Interest expense	(16,681)	(1,681)	(23,371)	(5,831)
Change in fair value of warrants				841,215
Other, net	(4,432)	(2,529)	(1,856)	7,532
EARNINGS BEFORE INCOME TAXES	210,174	1,999,030	1,468,338	3,913,872
INCOME TAX EXPENSE	193,151	825,189	766,644	1,352,884
NET EARNINGS	17,023	1,173,841	701,694	2,560,988
Deemed dividend to preferred shareholders				1,576,454
Dividend to preferred shareholders				96,410
NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS	$ 17,023	$ 1,173,841	$ 701,694	$ 888,124
NET EARNINGS PER SHARE:				
Basic	$ 0.00	$ 0.06	$ 0.04	$ 0.05
Diluted	0.00	0.06	0.03	0.00

WEIGHTED AVERAGE COMMON SHARES:				
Basic	19,834,858	18,963,948	19,618,221	17,665,550
Diluted	20,866,935	19,550,662	20,577,345	18,410,033

See notes to consolidated financial statements.

Table of Contents

HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Nine Months Ended September 30,	
	2007	2006 (Restated)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net earnings	$ 701,694	$ 2,560,988
Adjustments to reconcile net earnings to net cash used in operating activities:		
Depreciation	255,001	117,593
Amortization	447,865	571,256
Warrant valuation		(841,215)
Stock-based compensation	683,036	341,553
Deferred taxes		(30,160)
Change in assets and liabilities:		
Trade and other accounts receivable	(106,675)	(2,001,058)
Inventories	(350,415)	(113,176)
Prepaid expenses and other	(323,881)	(403,693)
Other assets	10,587	17,501
Trade accounts payable	(681,928)	187,437
Accrued liabilities and other	(433,607)	(209,515)
Deferred revenue	(482,869)	(187,369)
Net cash used in operating activities	(281,192)	10,142
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(837,843)	(584,863)
Business acquisition, net of cash acquired	(32,914)	
Accrued acquisition earnout	(737,500)	
Other		(100,599)
Net cash used in investing activities	(1,608,257)	(685,462)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Costs from issuance of preferred stock	(17,415)	(161,725)
Proceeds from the issuance of common stock	190,329	171,287
Proceeds from the exercise of stock options	132,370	3,706
Payment of dividend to preferred shareholders		(96,410)
Borrowings under line of credit	17,416,233	
Repayments under line of credit	(16,567,773)	
Net cash provided by (used in) financing activities	1,153,744	(83,142)
NET DECREASE IN CASH	(735,705)	(758,462)
CASH AT BEGINNING OF PERIOD	987,465	1,471,505
CASH AT END OF PERIOD	$ 251,760	$ 713,043

Supplemental cash flow information:		
Cash paid for interest	$ 19,835	$ 788
Cash paid for taxes	143,750	521,640
Non-cash investing and financing activities affecting cash flows:		
Common stock issued for accrued acquisition earnout	737,500	
Deemed dividend to preferred shareholders		(1,576,454)
Conversion of warrant liability to additional paid in capital		1,369,674

See notes to consolidated financial statements.

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 Fitn 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 252 corporate fitness center sites and 170 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 nine months ended September 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 nine months ended September 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.

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 September 30, 2007 and December 31, 2006, we had cash of approximately $54,300 and $36,900 (U.S. Dollars) in a Canadian bank account.

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

Table of Contents

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.

Inventories Inventories are stated at the lower of cost, determined on an average costs basis, or market.

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 nine months ended September 30, 2007, we capitalized $20,400 and $184,400, respectively, of software development costs related to enhancements we made to our eHealth platform, a web-based system we acquired from 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 approximately four years. We expect to recover our capitalized software development costs from revenue attributable to existing customers, in addition to new customers we obtain within our two operating segments.

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. In accordance with paragraph 45 of SFAS 142, *Accounting for Goodwill*, we allocate our total goodwill to our two reportable segments based upon the ratio of the estimated market value for each segment to the estimated market value for the entire company. We elected to complete the annual impairment test of goodwill on December 31 each year.

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 theses 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 normal effective tax rate of 38% is less than the tax rate resulting from income tax expense we recognized during the three and nine months ended September 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 September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
REVENUE:				
Fitness Management				
Staffing Services	$ 10,042,463	$ 10,129,304	$ 29,843,968	$ 29,781,526
Program and Consulting Services	579,607	593,604	1,901,553	1,793,603
	10,622,070	10,722,908	31,745,521	31,575,129
Health Management				
Staffing Services	4,017,025	3,652,879	11,617,304	10,068,134
Program and Consulting Services	2,513,963	1,964,593	7,359,433	4,839,508
	6,530,988	5,617,472	18,976,737	14,907,642
Total Revenue				
Staffing Services	14,059,488	13,782,183	41,461,272	39,849,660
Program and Consulting Services	3,093,570	2,558,197	9,260,986	6,633,111
	$ 17,153,058	$ 16,340,380	$ 50,722,258	$ 46,482,771
GROSS PROFIT:				
Fitness Management				
Staffing Services	$ 2,176,722	$ 2,672,146	$ 6,278,653	$ 6,674,676
Program and Consulting Services	294,052	277,366	877,902	860,235
	2,470,774	2,949,512	7,156,555	7,534,911

Health Management				
Staffing Services	1,036,109	1,118,053	2,958,681	2,653,074
Program and Consulting Services	1,377,843	1,211,063	4,334,817	2,855,137
	2,413,952	2,329,116	7,293,498	5,508,211
Total Gross Profit				
Staffing Services	3,212,831	3,790,199	9,237,334	9,327,750
Program and Consulting Services	1,671,895	1,488,429	5,212,719	3,715,372
	$ 4,884,726	$ 5,278,628	$ 14,450,053	$ 13,043,122

Table of Contents

The following table sets forth certain contract reclassifications we made between Fitness and Health Management segment revenue and gross profit for our first and second quarters ending March 31 and June 30, 2007, respectively, to conform to our contract classifications for segment revenue and gross profit for the quarter ended September 30, 2007. These reclassifications had no effect on total revenue, total net earnings, earnings per share or stockholders equity as previously reported.

	For the Three Months Ended		For the Three Months Ended	
	March 31, 2007 As Reported	March 31, 2007 Reclassified	June 30, 2007 As Reported	June 30, 2007 Reclassified
REVENUE:				
Fitness Management	$ 9,992,684	$ 9,980,516	$ 9,848,487	$ 9,820,989
Staffing Services	696,233	694,234	667,347	627,712
Program and Consulting Services	10,688,917	10,674,750	10,515,834	10,448,701
Health Management				
Staffing Services	3,667,338	3,679,504	3,893,275	3,920,775
Program and Consulting Services	2,233,778	2,235,779	2,570,058	2,609,691
	5,901,116	5,915,283	6,463,333	6,530,466
Total Revenue				
Staffing Services	13,660,022	13,660,020	13,741,762	13,741,764
Program and Consulting Services	2,930,011	2,930,013	3,237,405	3,237,403
Total Revenue	$ 16,590,033	$ 16,590,033	$ 16,979,167	$ 16,979,167
GROSS PROFIT:				
Fitness Management				
Staffing Services	$ 2,109,181	$ 2,099,858	$ 2,012,802	$ 2,002,073
Program and Consulting Services	364,851	362,851	246,668	220,999
	2,474,032	2,462,709	2,259,470	2,223,072
Health Management				
Staffing Services	907,236	911,965	999,876	1,010,607
Program and Consulting Services	1,428,626	1,435,220	1,496,087	1,521,754
	2,335,862	2,347,185	2,495,963	2,532,361
Total Gross Profit				
Staffing Services	3,016,417	3,011,823	3,012,678	3,012,680
Program and Consulting Services	1,793,477	1,798,071	1,742,755	1,742,753
Total Gross Profit	$ 4,809,894	$ 4,809,894	$ 4,755,433	$ 4,755,433

NOTE 5. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the Financial Accounting Standards Bound (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

Table of Contents

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 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.

Table of Contents

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.

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 September 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 nine months ended September 30, 2007, we recorded stock-based compensation expense of $296,700 and $683,000, respectively, compared to $103,200 and $341,600, respectively, for the three and nine months ended September 30, 2006. The compensation expense reduced diluted earnings per share by approximately $0.01 for the three months ended September 30, 2007 and nine months ended September 30, 2006, and $0.02 for the nine months ended September 30, 2007. The compensation expense reduced diluted earnings per share by less than $0.01 for the three months ended September 30, 2006.

As of September 30, 2007, approximately $932,600 of total unrecognized compensation costs related to non-vested awards is expected to be recognized over a weighted average period of approximately 2.75 years.

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

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life In Years	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$0.30 $0.39	145,200	1.12	$0.39	145,200	$0.39
0.47 0.69	342,500	1.09	0.52	342,500	0.52
0.95 1.25	239,000	2.76	1.15	179,250	1.16
1.26 2.27	436,100	4.14	1.86	365,825	1.84
2.28 3.00	1,190,500	4.46	2.74	398,625	2.70
	2,353,300	3.53	$1.95	1,431,400	$1.53

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:

Table of Contents

	Three Months Ended September 30,	
	2007	2006
Risk-free interest rate	4.28%	4.57%
Expected volatility	39.2%	54.8%
Expected life (in years)	3.0	3.78
Dividend yield		

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

	Options	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Term
Outstanding at June 30, 2007	2,370,150	$ 1.92		
Granted	30,000	2.98		
Forfeited	0			
Exercised	(46,850)	1.26		
Expired	0			
Outstanding at September 30, 2007	2,353,300	$ 1.95	$ 2,854,016	3.59
Exercisable at September 30, 2007	1,431,400	$ 1.53	$ 2,328,580	2.92

Option transactions under the 2005 Stock Option Plan during the nine months ended September 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	640,500	2.82		
Forfeited	(34,375)	2.75		
Exercised	(313,725)	0.78		
Expired	(190,000)	3.00		
Outstanding at September 30, 2007	2,353,300	$ 1.95	$ 2,854,016	3.59
Exercisable at September 30, 2007	1,431,400	$ 1.53	$ 2,328,580	2.92

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 nine months ended September 30, 2007, we recorded $16,600 and $93,900, 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 September 30, 2007, $38,600 of unrecognized compensation expense 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 nine months ended

Table of Contents

September 30, 2007, we recorded $24,200 and $40,300, respectively, 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 September 30, 2007, $1,754,100 of unrecognized compensation costs related to the non-vested portion of this program will be recognized through March 2010.

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.

NOTE 9. RESTATEMENT

On November 12, 2007, subsequent to our third quarter earnings release on November 5, 2007, we determined that a $1,576,454 deemed dividend to preferred shareholders should have been reflected in our financial statements by recording a reduction to net earnings applicable to common shareholders in the consolidated statement of operations for the quarter ended March 31, 2006, with a corresponding increase being recorded to additional paid in capital in the consolidated balance sheet as of March 31, 2006. This restatement will result in no change to total net earnings or to total stockholders equity as of September 30, 2007, or any other prior period.

This restatement will not affect the results of operations for the three and nine months ended September 30, 2007, nor will it affect our statement of cash flows for the nine months ended September 30, 2007. This Form 10-Q accurately reflects this deemed dividend in our consolidated balance sheet for the nine months ended September 30, 2007 and year ended December 31, 2006, and our consolidated statements of operations and cash flows for the nine months ended September 30, 2006. In addition, we do not intend to amend our previously filed Quarterly Reports on Form 10-Q for the periods ended March 31, 2007 and June 30, 2007.

The determination to restate these financial statements in the foregoing respects results from comments we received in a letter from the Securities and Exchange Commission (the SEC) following their routine review of our Form 10-K for the year ended December 31, 2006. We are in the process of resolving other comments that were addressed in the SEC s letter.

The $1,576,454 deemed dividend to preferred shareholders was determined in accordance with Emerging Issues Task Force (EITF) Number 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratio*. This deemed dividend is a one-time, non-cash adjustment related to the automatic conversion of our Series B Preferred Stock to common stock on March 10, 2006.

The Audit Committee worked closely with our management to review the restatement and our policies and practices related to the restatement. The Audit Committee has determined that, despite this restatement, the

Table of Contents

Company s internal controls over accounting and financial reporting are effective, and that the restatement does not relate to any misconduct on the part of management.

Management and the Audit Committee of the Company s Board of Directors discussed these matters with the Company s independent registered public accounting firm, Grant Thornton LLP.

Following is a presentation of the effects of this restatement on our consolidated financial statements for the periods that were affected by this restatement. All other numbers reported for these periods not affected by this restatement are the same as originally reported.

The following table presents the effect of the restatement on our consolidated balance sheet as of December 31, 2006:

	As Reported	Restatement	As Restated
STOCKHOLDERS EQUITY			
Common stock, $0.01 par value	$ 192,202		$ 192,202
Additional paid-in capital	25,989,447	1,576,454	27,565,901
Accumulated comprehensive income	(35,186)		(35,186)
Accumulated deficit	(2,348,695)	(1,576,454)	(3,925,149)
	$23,797,768		$23,797,768

The following table presents the effect of the restatement on our consolidated statement of operations for the nine months ended September 30, 2006:

	As Reported	Restatement	As Restated
NET EARNINGS	$ 2,560,988		$ 2,560,988
Deemed dividend to preferred shareholders		1,576,454	1,576,454
Dividend to preferred shareholders	96,410		96,410
NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS	$ 2,464,578	$(1,576,454)	$ 888,124
NET EARNINGS PER COMMON SHARE:			
Basic	$ 0.14		$ 0.05
Diluted	0.09		0.00
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING			
Basic	17,665,550		17,665,550
Diluted	19,680,363		18,410,033

The following table presents the effect of the restatement on our consolidated statement of cash flows for the nine months ended September 30, 2006:

	As Reported	Restatement	As Restated

Noncash investing and financing activities affecting cash flows:		
Deemed to preferred shareholders	$(1,576,454)	$(1,576,454)

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 nine months ended September 30, 2007 and 2006:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
REVENUE	100.0%	100.0%	100.0%	100.0%
COSTS OF REVENUE	71.5	67.7	71.5	71.9
GROSS PROFIT	28.5	32.3	28.5	28.1
OPERATING EXPENSES				
Salaries	16.2	12.5	15.4	13.3
Other selling, general and administrative	10.7	6.9	9.9	7.5
Amortization of acquired intangible assets	0.3	0.6	0.2	0.7
Total operating expenses	27.2	20.0	25.5	21.5
OPERATING INCOME	1.3	12.3	3.0	6.6
OTHER INCOME (EXPENSE)	(0.1)		(0.1)	1.8
EARNINGS BEFORE INCOME TAXES	1.2	12.3	2.9	8.4
INCOME TAX EXPENSE	1.1	5.1	1.5	2.9

NET EARNINGS	0.1	7.2	1.4	5.5
Dividend to preferred shareholders				3.6
NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS	0.1%	7.2%	1.4%	1.9%

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

Table of Contents

Revenue. Revenue increased $813,000 or 5.0%, to $17,153,000 for the three months ended September 30, 2007, from $16,340,000 for the three months ended September 30, 2006.

Of this growth in revenue, our Fitness Management segment experienced a slight decline of $101,000, which includes a decline of $87,000 from staffing services and $14,000 from program and consulting services**.** The decline in fitness management staffing revenue is due to revenue losses from terminated contracts outpacing revenue from 2007 new contracts. The revenue decrease for program and consulting services is primarily due to fewer biometric screening engagements at our fitness center sites.

Our Health Management segment contributed total growth of $914,000, which includes growth of $364,000 from staffing services and growth of $550,000 from program and consulting services. Overall, health management revenue growth is attributed to new customers and the expansion of existing customers. The 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. The decrease in sequential quarterly revenue growth is primarily due to longer service implementation planning schedules for our larger, new customer commitments we obtained during the first two quarters of 2007.

During the quarter, we obtained four new customer commitments in our health management segment that may realize incremental annualized revenue of approximately $2.0 million. In our fitness management segment, we obtained one new customer commitment that may realize incremental annualized revenue of approximately $0.6 million. The $2.6 million total for potential new, incremental annualized revenue is offset by a potential annualized revenue loss of $1.2 million from fitness management contract cancellations. Approximately $0.7 million of these contract cancellations is due to our decision to not renew an underperforming contract.

Gross Profit. Gross profit decreased $394,000, or 7.5%, to $4,885,000 for the three months ended September 30, 2007, from $5,279,000 for the three months ended September 30, 2006, which includes a $313,000 benefit related to a refund of workers compensation premiums for our 2005 plan year.

Of this decrease in gross profit, our Fitness Management segment contributed a decline of $479,000, which includes a decline of $496,000 from staffing services and a slight increase of $17,000 from program and consulting services.

Our Health Management segment contributed total gross profit growth of $85,000, which includes a slight decline of $82,000 from staffing services and growth of $167,000 from program and consulting services.

Total gross margin decreased to 28.5%, from 32.3% for the same period last year. Gross margin for our Health Management segment decreased to 37.0%, from 41.5% for the prior year period. This result is due to a gross margin decrease for staffing services, which fell to 25.8%, from 30.6% last year, and a gross margin decrease for programs and consulting services, which fell to 54.8%, from 61.6% last year. The gross margin decrease for staffing services is primarily due to the $0.3 million workers compensation premium refund in the third quarter of 2006, in addition to lower pricing for our new 2007 contracts. The gross margin decrease for programs and consulting is primarily due to a higher level of unproductive staff time for biometric screening services, and higher costs attributable to providing our eHealth platform.

Gross margin for our Fitness Management segment fell to 23.3%, from 27.5% in the prior year period. This result is primarily due to a gross margin decrease for staffing services, which fell to 21.7%, from 26.4%. This decline is primarily due to the $0.3 million workers compensation premium refund in the third quarter of 2006, lower pricing for our new 2007 contracts, and gross margin loss due to the cancellation of a large automotive contract effective March 31, 2007. This gross margin decrease was partially offset by gross margin growth in programs and consulting services, which grew to 50.7%, from 46.7%. This margin improvement is primarily due to lower costs for a number of services we provide at our fitness center sites.

Table of Contents

Operating Expenses and Operating Income. Operating expenses increased $1,378,000 or 42.1%, to $4,653,000 for the three months ended September 30, 2007, from $3,275,000 for the three months ended September 30, 2006. This increase is primarily due to a 25.6% increase in salaries, which excludes a $193,500 increase in stock-based compensation, and a 61.9% increase in other selling, general and administrative expenses. These increases are primarily due to planned investments in additional staff and other operating expenses within certain operating units, including Research, Development and Outcomes, Marketing, Technology and Account Services. During the quarter, we incurred approximately $0.4 million of unplanned expenses. Of this amount, approximately $0.3 million is attributed to the non-cash stock and stock option expense for two new board members, in addition to costs to enhance and improve our corporate governance and compliance procedures. The remaining $0.1 million of unplanned expenses is due to higher legal and business consulting services, which were largely nonrecurring in nature. These expense increases were partially offset by a decrease in amortization expense related to a prior acquisition.

Operating margin for the second quarter declined to 1.3%, from 12.3% for the prior year period. Excluding the effect of the $0.3 million workers compensation premium refund we received in the third quarter of 2006, operating margin was 10.3% for the third quarter of 2006. This decrease is primarily due to planned investments we made to support our future growth plans, in addition to unplanned expenses we incurred during the third quarter of 2007.

Other Income and Expense. Interest expense increased $15,000 to $17,000 for the three months ended September 30, 2007, from $2,000 for the three months ended September 30, 2006. The increase was due to the increased use of our credit line to fund temporarily working capital needs.

Income Taxes. Current income tax expense decreased $632,000 to $193,000 for the three months ended September 30, 2007, from $825,000 for 2006. The decrease is primarily due to the lower operating income in 2007 compared to 2006. Included in income tax expense for the quarter ended September 30, 2007 is an additional $99,400 of expense resulting from a change in estimated 2006 income taxes payable.

Our effective tax rate, which excludes the additional tax expense attributable to a change in estimated 2006 income tax payable, was 45% of earnings before income taxes for the third quarter of 2007, compared to 41% for the same period last year. Compared to a 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.

Dividend and Deemed Dividend to Preferred Shareholders. There was no dividend or deemed dividend to preferred shareholders for the three months ended September 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.

Net Earnings Applicable to Common Shareholders. As a result of the above, net earnings applicable to common shareholders for the quarter ended September 30, 2007 decreased approximately $1,157,000 to $17,000, compared to net earnings applicable to common shareholders of $1,174,000 for the quarter ended September 30, 2006.

Table of Contents

Results of Operations for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006.

Revenue. Revenue increased $4,239,000 or 9.1%, to $50,722,000 for the nine months ended September 30, 2007, from $46,483,000 for the nine months ended September 30, 2006.

Of this growth in revenue, our Fitness Management segment contributed total growth of $170,000, which includes growth of $62,000 from staffing services and growth of $108,000 from program and consulting services**.** The increase in fitness management segment revenue is attributed to new customers, the expansion of existing customers, and growth of program revenue at existing sites, including personal training, weight management services and massage therapy. This growth was mostly offset by the previously announced termination of a large automotive customer contract, in addition to other customer contracts that were terminated during our first nine months.

Our Health Management segment contributed total growth of $4,069,000, which includes growth of $1,549,000 from staffing services and growth of $2,520,000 from program and consulting services. Health management revenue growth is attributed to new customers and the expansion of existing customers. The significant increase in program and consulting services was primarily driven by an increase in biometric screening services, health coaching services and eHealth platform sales and customizations.

For the first nine months of 2007, we obtained 27 new customer commitments in our health management segment that may realize incremental annualized revenue of approximately $7.1 million, which includes approximately $0.7 million of potential annualized revenue from two existing fitness management customers. In our fitness management segment, we obtained five 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 $2.7 million. The $9.8 million combined total for this potential new, incremental annualized revenue will be offset by a potential annualized revenue loss of $3.3 million, which is entirely attributed to the cancellation of fitness management contracts. Approximately $0.7 million of these contract cancellations is due to our decision to not renew an underperforming contract.

Gross Profit. Gross profit increased $1,407,000, or 10.8%, to $14,450,000 for the nine months ended September 30, 2007, from $13,043,000 for the nine months ended September 30, 2006, which includes a $313,000 benefit related to a refund of workers compensation premiums for our 2005 plan year.

Of this change in gross profit, our Fitness Management segment experienced a total decline of $378,000, which includes a decline of $396,000 from staffing services and growth of $18,000 from program and consulting services.

Our Health Management segment contributed total gross profit growth of $1,785,000, which includes growth of $306,000 from staffing services and growth of $1,479,000 from program and consulting services.

Total gross margin increased to 28.5%, from 28.1% for the same period last year. Gross margin for our health management segment increased to 38.4%, from 36.9% for the prior year period. This increase is primarily due to the accelerated growth of our higher margin program and consulting services, which slightly fell to 58.9% of revenue, from 59.0%. Offsetting this margin expansion was a decrease of gross margin from staffing services, which fell to 25.5% from 26.4%, due primarily to the refund of workers compensation premiums in the third quarter of 2006.

Gross margin for our fitness management segment decreased to 22.5%, from 23.9% for the prior year period. This decrease is due in part to gross margins from staffing services of 21.0%, compared to 22.4% for the same period last year, which is primarily due to the refund of workers compensation premiums in the third quarter of 2006, and a decrease of gross margin for program and consulting services to 46.2%, from 48.0% for the same period last year, which is primarily due to slight gross margin decreases for personal training services, weight management products and eHealth platform services.

Table of Contents

Operating Expenses and Operating Income. Operating expenses increased $2,984,000, or 29.9%, to $12,956,000 for the nine months ended September 30, 2007, from $9,972,000 for the nine months ended September 30, 2006. This increase is primarily due to a 21.4% increase in salaries, which excludes a $341,500 increase in stock-based compensation, and a 44.3% increase in other selling, general and administrative expenses. These increases are primarily due to planned investments in additional staff and other operating expenses within certain operating units, including Research, Development and Outcomes, Marketing, Technology and Account Services, in addition to the unplanned expenses we incurred during the third quarter of 2007, which were largely nonrecurring in nature. These expense increases were partially offset by a decrease in amortization expense related to a prior acquisition.

Operating margin for the nine months ended September 30, 2007 decreased to 2.9%, from 6.6% for the prior year period. Excluding the effect of the $0.3 million workers compensation premium refund we received in the third quarter of 2006, operating margin was 5.9% for the first nine months of 2006. This decrease is primarily due to planned investments we made to support our future growth plans, in addition to unplanned expenses we incurred during the third quarter of 2007.

Other Income and Expense. Interest expense increased $17,000 to $23,000 for the nine months ended September 30, 2007, from $6,000 for the nine months ended September 30, 2006. The increase was due to the increased use of our credit line to fund temporary working capital needs.

For the nine months ended September 30, 2006, we recorded an $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 decreased $586,000 to $767,000 for the nine months ended September 30, 2007, from $1,353,000 for 2006. The decrease is primarily due to lower operating income in 2007 compared to 2006. Included in income tax expense for the nine months ended September 30, 2007 is an additional $99,400 of expense resulting from a change in estimated 2006 income taxes payable.

Our effective tax rate, which excludes the additional tax expense attributable to a change in estimated 2006 income tax payable, was 45% of earnings before income taxes for the first nine months of 2007, compared to 35% for the same period last year. For the first nine 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 44% for the first nine months of 2006. Compared to our past 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.

Dividend and Deemed Dividend to Preferred Shareholders. Dividend to preferred shareholders decreased $96,000 to $0 for the nine months ended September 30, 2007, compared to $96,000 for the nine months ended September 30, 2006. In addition, the deemed dividend to preferred shareholders decreased to $0, from $1,576,000 for the nine months ended September 30, 2006. These decreases are attributable to the conversion of our Series B Stock to common stock on March 10, 2006.

Net Earnings Applicable to Common Shareholders. As a result of the above, net earnings applicable to common shareholders for the nine months ended September 30, 2007 decreased approximately $186,000 to $702,000, compared to net earnings applicable to common shareholders of $888,000 for the nine months ended September 30, 2006.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

Our working capital increased $2,246,000 to $8,037,000 for the nine months ended September 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 September 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, 2009, 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 September 30, 2007 and December 31, 2006, respectively, and $2,652,000 and $4,000,000 was available for drawing on such respective dates. All borrowings are collateralized by substantially all of our assets. At September 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. On the date of this conversion, we recorded a $1,576,454 deemed dividend to preferred shareholders by recording a reduction to net earnings applicable to common shareholders in the consolidated statement of operations for the quarter ended March 31, 2006, with a corresponding increase being recorded to additional paid in capital in the consolidated balance sheet as of March 31, 2006. 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.

Table of Contents

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.

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 September 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 the restatement on our financial statements, the effectiveness of our internal controls, 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

Table of Contents

statements. The words potential, believe, estimate, expect, intend, may, could, will, plan, anticipate and expressions are intended to identify forward-looking 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/A for the year ended December 31, 2006 under Risk Factors. and the risk factors contained in Item 1A of Part II of this Form 10-Q.

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.

Table of Contents

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.

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.

The following risk factor has been added to those previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006:

Any further restatements of our financial statements may divert management s attention, result in litigation or otherwise harm our business.

As explained in Note 9 to this 10-Q, we have issued a Restatement resulting from comments we received in a letter from the Securities and Exchange Commission following their routine review of our Form 10-K for the year ended December 31, 2006. We are in the process of responding to the SEC s other comments contained in their letter. Any need to further restate our financial statements could be costly and could divert the efforts and attention of our management team. In addition, any further restatements may result in increased regulatory scrutiny towards us, private civil actions against us, a reduction in the price of our stock, or other adverse consequences.

Table of Contents

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

None.

ITEM 5. OTHER INFORMATION

On September 27, 2007, we entered into the Fifth Amendment to the Credit Agreement with Wells Fargo Bank, National Association. The Fifth Amendment changes the maturity date of the Credit Agreement to June 30, 2009 and eliminates a restriction on making capital expenditures. The foregoing description of the Fifth Amendment is qualified by the provisions of the Fifth Amendment, which is filed herewith as Exhibit 10.1 and incorporated herein by reference.

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: November 19, 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)

Table of Contents

EXHIBIT INDEX
HEALTH FITNESS CORPORATION
FORM 10-Q

Exhibit No.	Description
10.1	Fifth Amendment dated September 27, 2007 to Credit Agreement, dated August 22, 2003, between the Company and Wells Fargo Bank, N.A. incorporated by reference to Exhibit 10.1 to our Form 8-K filed November 14, 2007
**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