Health Fitness Corp /MN/
Form 10-Q
August 15, 2005

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, 2005

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) 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 [X] NO [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).

YES [ ] NO [X]

The number of shares outstanding of the registrant's common stock as of August 15, 2005 was: Common Stock, $0.01 par value, 12,839,217 shares

HEALTH FITNESS CORPORATION
CONSOLIDATED FINANCIAL STATEMENTS

TABLE OF CONTENTS

P

PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (unaudited)

Consolidated Balance Sheets as of June 30, 2005 and December 31, 2004

Consolidated Statements of Earnings for the three and six months ended June 30, 2005 and 2004

Consolidated Statements of Cash Flows for the six

months ended June 30, 2005 and 2004

Notes to Consolidated Financial Statements

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 1

Item 3. Quantitative and Qualitative Disclosures About Market Risk 1

Item 4. Controls and Procedures 1

PART II. OTHER INFORMATION 1

Item 1. Legal Proceedings

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Item 3. Defaults Upon Senior Securities

Item 4. Submission of Matters to a Vote of Security Holders

Item 5 Other Information

Item 6. Exhibits

Signatures 1

Exhibit Index 2

HEALTH FITNESS CORPORATION
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	June 30, 2005
ASSETS	
CURRENT ASSETS	

Cash	$ 20,155
Trade and other accounts receivable, less allowances of $208,500 and $210,700	8,092,592
Prepaid expenses and other	427,353
Deferred tax assets	911,549
Total current assets	9,451,649
PROPERTY AND EQUIPMENT, net	145,993
OTHER ASSETS	
Goodwill	9,022,501
Customer contracts, less accumulated amortization of $1,279,900 and $875,700	450,139
Trademark, less accumulated amortization of $111,000 and $75,800	246,080
Other intangible assets, less accumulated amortization of $84,600 and $81,300	13,448
Deferred tax assets	306,700
Other	66,307
	$ 19,702,817
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES	
Trade accounts payable	$ 595,321
Accrued salaries, wages, and payroll taxes	2,356,395
Other accrued liabilities	550,743
Accrued self funded insurance	137,143
Deferred revenue	1,826,490
Total current liabilities	5,466,092
LONG-TERM OBLIGATIONS	22,774
COMMITMENTS AND CONTINGENCIES	-
CUMULATIVE CONVERTIBLE PREFERRED STOCK, 10,000,000 shares authorized, 1,093,699 and 1,063,945 issued and outstanding	1,542,896
STOCKHOLDERS' EQUITY	
Common stock, $0.01 par value; 50,000,000 shares authorized; 12,652,370 and 12,582,170 shares issued and outstanding	126,524
Additional paid-in capital	17,895,457
Accumulated comprehensive income	4,180
Accumulated deficit	(5,355,106
	12,671,055
	$ 19,702,817

See notes to consolidated financial statements.

HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF EARNINGS

(UNAUDITED)

	Three Months Ended June 30,		Si
	2005	2004	2005
REVENUE	$ 13,678,615	$ 13,129,715	$ 27,143,7
COSTS OF REVENUE	10,227,999	9,687,357	20,251,2
GROSS PROFIT	3,450,616	3,442,358	6,892,4
OPERATING EXPENSES			
Salaries	1,406,562	1,429,569	2,794,4
Other selling, general and administrative	942,631	823,504	1,679,4
Amortization of acquired intangible assets	219,754	219,583	439,3
Total operating expenses	2,568,947	2,472,656	4,913,3
OPERATING INCOME	881,669	969,702	1,979,0
OTHER INCOME (EXPENSE)			
Interest expense	(16,326)	(128,344)	(28,2
Other, net	(340)	469	(1,9
EARNINGS BEFORE INCOME TAXES	865,003	841,827	1,948,8
INCOME TAX EXPENSE	345,220	342,873	779,5
NET EARNINGS	519,783	498,954	1,169,3
Dividend to preferred shareholders	21,600	28,200	43,2
NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS	$ 498,183	$ 470,754	$ 1,126,1
NET EARNINGS PER SHARE:			
Basic	$ 0.04	$ 0.04	$ 0.0
Diluted	0.03	0.03	0.0
WEIGHTED AVERAGE COMMON SHARES:			
Basic	12,652,370	12,483,979	12,636,4
Diluted	16,618,997	16,066,003	16,617,8

See notes to consolidated financial statements.

4

HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six Months June 3
	2005
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net earnings	$ 1,169,317
Adjustments to reconcile net earnings to net cash provided by operating activities:	
Depreciation of property and equipment	39,066
Amortization of intangible assets	431,574
Deferred taxes	663,251
Common stock issued for compensation	-
Changes in operating assets and liabilities, net of assets acquired:	
Trade and other accounts receivable, net	54,838
Prepaid expenses and other	(213,399)
Other assets	20,707
Trade accounts payable	(243,113)
Accrued liabilities and other	(445,723)
Deferred revenue	(150,603)
Net cash provided by operating activities	1,325,915
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchases of property and equipment	(34,749)
Other	(7,084)
Acquisition of business	-
Net cash used in investing activities	(41,833)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Borrowings under note payable	12,440,808
Repayments of note payable	(14,030,793)
Proceeds from issuance of common stock	73,328
Proceeds from the exercise of stock options	11,428
Net cash (used in) financing activities	(1,505,229)
NET DECREASE IN CASH	(221,147)
CASH AT BEGINNING OF PERIOD	241,302
CASH AT END OF PERIOD	$ 20,155
SUPPLEMENTAL CASH FLOW DISCLOSURES	
Supplemental cash flow information	
Cash paid for interest	$ 28,876
Cash paid for taxes	226,750
Noncash investing and financing activities affecting cash flows:	
Dividend to preferred shareholders	43,200

See notes to consolidated financial statements.

HEALTH FITNESS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements for the second quarter ended June 30, 2005 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, 2004 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, 2004, and footnotes thereto included in the Company's Form 10-K as filed with the United States Securities and Exchange Commission on March 31, 2005.

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 six months ended June 30, 2005 are not necessarily indicative of the operating results that may be expected for the year ended December 31, 2005.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business - Health Fitness Corporation and its wholly owned subsidiaries (the Company) provide fitness and health management services and programs to corporations, hospitals, communities and universities located in the United States and Canada. Fitness and health management services include the development, marketing and management of corporate, hospital, community and university based fitness centers, injury prevention and work-injury management consulting, on-site physical therapy and employee health management services. Programs include wellness and health programs for individual customers, including health risk assessments, biometric screenings, nutrition and weight loss programs, smoking cessation, massage therapy, back care and ergonomic injury prevention.

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

Cash - The Company maintains cash balances at several financial institutions, and at times, such balances exceed insured limits. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash.

Trade and Other Accounts Receivable - Trade and other accounts receivable represent amounts due from companies and individuals for services and products. The Company grants credit to customers in the ordinary course of business, but generally does not require collateral or any other security to support amounts due. Management performs ongoing credit evaluations of customers. The Company determines its allowance for discounts and doubtful accounts by considering a

number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes 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.

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 not amortized, but 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.

Intangible Assets - The Company's intangible assets include customer contracts, trademark, and deferred financing costs and are amortized on a straight-line basis. Customer contracts represent the fair value assigned to acquired management contracts and are amortized over the remaining life of the contracts, of which 7 months remain at June 30, 2005. Trademark represents the value assigned to an acquired trademark and is amortized over a period of five years. Deferred financing costs are amortized over the term of the related credit agreement.

Revenue Recognition - Revenue is recognized at the time the service is provided to the customer. 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 based the cost of the services.

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

The Company has contracts with third-parties (e.g. janitorial services) 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 the Company based on transactions with the ultimate customer. The Company does not recognize revenues related to such transactions as the ultimate 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.

Comprehensive Income - Comprehensive income represents net earnings adjusted for foreign currency translation adjustments. Total comprehensive income was $1,127,838 and $804,042 for the six months ended June 30, 2005 and 2004.

Net Earnings Per Share - Basic net earnings per common share is computed by dividing net earnings applicable to common shareholders by the number of 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) by the number of weighted

average common shares outstanding, and common share equivalents relating to stock options and stock warrants, when dilutive.

Common stock options and warrants to purchase 450,000 and 365,100 shares of common stock were excluded from the calculation for the three months ended June 30, 2005 and 2004, and 375,000 and 365,100 were excluded from the calculation for the six months ended June 30, 2005 and 2004 because they are anti-dilutive.

Stock-based Compensation - The Company utilizes the intrinsic value method of accounting for its stock based employee compensation plans. All options granted had an exercise price equal to the market value of the underlying common stock on the date of grant and accordingly, no compensation cost is reflected in net earnings for the three and six months ended June 30, 2005 and 2004. The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value method of accounting for stock options:

	Three Months ended June 30,		Six Month June
	2005	2004	2005
Net earnings, applicable to common Shareholders - basic	$ 498,183	$ 470,754	$ 1,126,117
Add: Dividends to preferred shareholders	21,600	28,200	43,200
Net earnings - diluted	519,783	498,954	1,169,317
Less: Compensation expense determined under the fair value method, net of tax	(100,482)	(90,371)	(137,665)
Proforma net earnings - basic	$ 397,701	$ 380,383	$ 988,452
Proforma net earnings - diluted	$ 419,301	$ 408,583	$ 1,031,652
Earnings per Share:			
Basic, as reported	$ 0.04	$ 0.04	$ 0.09
Basic, proforma	$ 0.03	$ 0.03	$ 0.08
Diluted, as reported	$ 0.03	$ 0.03	$ 0.07
Diluted, proforma	$ 0.03	$ 0.03	$ 0.06

The proforma information above should be read in conjunction with the related historical information.

The fair value of each option grant is estimated on the grant date using the Black-Scholes option-pricing model with the following assumptions and results for the grants:

	2005	2004
Dividend yield	None	None
Expected volatility	69% - 78%	88%
Expected life of option	1 - 4 years	1 - 4 years
Risk-free interest rate	2.43% - 2.97%	3.27%
Weighted average fair value of options on grant date	$1.29	$1.02

In December 2004, the Financial Accounting Standards Board (FASB), issued Statement 123R, Share-Based Payment. Statement 123R is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation, and supercedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. The revision requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments granted to employees.

In April 2005, the United States Securities and Exchange Commission announced the adoption of a new rule that amended the compliance dates for Statement 123R as first adopted by the FASB. As a result of this change, the Company is required to implement Statement 123R beginning with the Company's next fiscal year starting January 1, 2006. The Company expects that the adoption of Statement 123R will result in a decrease of net income due to additional compensation expense attributed to employee stock options.

Fair Values of Financial Instruments - Due to their short-term nature, the carrying value of the Company's 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.

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 3. FINANCING

On August 22, 2003, the Company entered into a $7,500,000 Credit Agreement with Wells Fargo Bank, N.A. to provide the Company with acquisition financing and general working capital (the "Wells Loan"). Working capital advances from the Wells Loan are available on a revolving basis and are based upon a percentage of the Company's eligible accounts receivable, less any amounts previously drawn. At the option of the Company, the Wells Loan bears interest at prime or the one-month LIBOR plus a margin of 2.25% to 2.75% based upon the Company's Senior Leverage Ratio (effective rate of 6.25% and 5.25% at June 30, 2005 and December 31, 2004). Borrowing capacity under the Wells Loan decreases $250,000 on the last day of each calendar quarter, beginning September 30, 2003, and matures on June 30, 2007. The facility provided maximum borrowing capacity of $5,500,000 and $6,000,000 at June 30, 2005 and December 31, 2004. Excluding current outstanding balances, $4,754,526 and $3,758,851 was available for borrowing on such respective dates. Borrowings under the Wells Loan are collateralized by substantially all of the Company's assets. The Company is required to comply

with certain monthly financial covenants, including a fixed charge coverage ratio, minimum earnings before interest, taxes, depreciation and amortization, cash flow leverage ratio and a senior leverage ratio. At June 30, 2005, the Company had $22,774 outstanding under the Wells Loan, and was in compliance with all of its financial covenants.

On August 25, 2003, the Company entered into a $3,000,000 Securities Purchase Agreement with Bayview Capital Partners LP ("Bayview") to provide the Company with acquisition financing and general working capital (the "Bayview Investment"). The Bayview Investment was initially structured as a bridge note (the "Bridge Note"), the proceeds of which were placed into escrow to fund a portion of our purchase of the Health & Fitness Services Division of Johnson & Johnson Health Care Systems Inc.

On December 8, 2003 (the "Effective Date"), the $3,000,000 Bridge Note issued to Bayview was converted into a $2,000,000 term note (the "Term Note"), $1,000,000 in Series A Convertible Preferred Stock (the "Preferred Stock") and a warrant to purchase common stock of the Company (the "Warrant") pursuant to the terms set forth in the August 25, 2003 Securities Purchase Agreement.

The Preferred Stock was issued to Bayview at a price of $1.00 per share, resulting in 1,000,000 shares issued on the Effective Date. The Preferred Stock has a stated dividend rate of 6% per year, computed on a simple interest basis, paid in kind in the form of additional shares of Preferred Stock using a price of $1.00 per share ("PIK Dividends"). At the option of the holder, the Preferred Stock, including any PIK Dividends, may be converted, at any time and from time to time, into common stock of the Company at a price of $0.50 per share. In addition, Bayview may require redemption of the Preferred Stock and PIK Dividends upon a change of control or default (including default under the Term Note).

The Warrant issued to Bayview on the Effective Date represents the right to purchase 1,210,320 shares of common stock, which represented 8% of the Company's common stock outstanding on a fully diluted basis at the Effective Date, excluding the common stock issuable to Bayview upon conversion of the Preferred Stock. The Warrant is exercisable at any time for a period of ten years at an exercise price equal to $0.50 per share, and the shares obtainable upon exercise of the Warrant may be put to the Company at fair market value (net of the exercise price) upon a change of control or default.

On December 29, 2004, the Company prepaid its Bayview Term Note by utilizing funds from the Wells Loan. In connection with the Term Note repayment, the Company also paid a prepayment penalty of $80,000, which represents 4% of the face value of the Term Note. In addition, the Company incurred a one-time, non-cash charge to interest expense of $394,669, representing $345,754 of unamortized difference between the face value of the Term Note and its assigned relative fair value, as well as $48,916 of unamortized financing costs related to the Term Note. At the same time, the Company and Wells Fargo agreed to amend the Wells Loan to change the senior leverage ratio covenant to reflect the Company's financial position subsequent to the Term Note repayment. The Company was in compliance with this change in covenant at June 30, 2005.

9

Balances of long-term obligations are as follows:

	June 30, 2005	December 31, 2004

Wells Loan	$ 22,774	$ 1,612,759

The outstanding principal balance on the Wells Loan matures June 2007.

NOTE 4. 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 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. 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 an effective state tax rate of 6%.

NOTE 5. STOCK OPTIONS

The Company maintains a stock option plan for the benefit of certain eligible employees and directors of the Company. A total of 1,181,100 shares of common stock are reserved for additional grants of options under the plan at June 30, 2005. Generally, the options outstanding (1) are granted at prices equal to the market value of the stock on the date of grant, (2) vest over various terms and, (3) expire over a period of five or ten years from the date of grant.

A summary of stock option activity for the six months ended June 30, 2005 is as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 2004	1,921,550	$ 1.06
Granted	175,000	2.70
Exercised	(23,375)	0.49
Outstanding at March 31, 2005	2,073,175	1.21
Granted	150,000	2.48
Outstanding at June 30, 2005	2,223,175	$ 1.29

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 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, 2004.

CRITICAL ACCOUNTING POLICIES. Our most critical accounting policies, which are those that require significant estimates and judgment, include: revenue recognition, trade and other accounts receivable, goodwill and stock-based compensation. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. Actual results may differ from these estimates under different assumptions or conditions. A more in-depth description of our accounting policies can be found in footnote 2 to the interim financial statements included in this report and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

RESULTS OF OPERATIONS

The following table sets forth our statement of operations data as a percentage of total revenues and also sets forth other financial and operating data for the quarter ended June 30, 2005 and 2004, and for the six months ended June 30, 2005 and 2004:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
REVENUE	100.0%	100.0%	100.0%	100.0%
COSTS OF REVENUE	74.8	73.8	74.6	74.7
GROSS PROFIT	25.2	26.2	25.4	25.3
OPERATING EXPENSES				
Salaries	10.3	10.9	10.3	10.7
Other selling, general and administrative	6.9	6.2	6.2	6.4
Amortization of acquired intangible assets	1.6	1.7	1.6	1.7
Total operating expenses	18.8	18.8	18.1	18.8
OPERATING INCOME	6.4	7.4	7.3	6.5
OTHER INCOME (EXPENSE)	(0.1)	(1.0)	(0.1)	(1.0)
EARNINGS BEFORE INCOME TAXES	6.3	6.4	7.2	5.5
INCOME TAX EXPENSE	2.5	2.6	2.9	2.1
NET EARNINGS	3.8	3.8	4.3	3.4
Dividend to preferred shareholders	0.2	0.2	0.2	0.2
NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS	3.6%	3.6%	4.1%	3.2%

OTHER FINANCIAL AND OPERATING DATA:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Fitness Management Revenue				
Staffing Services	$ 9,671,877	$ 9,892,295	$19,297,301	$19,480,786
Program Services	875,258	532,520	1,580,660	940,848
Consulting Services	98,267	63,765	112,717	71,265
	10,645,402	10,488,580	20,990,678	20,492,899
Health Management Revenue				
Staffing Services	2,868,171	2,581,181	5,846,914	5,200,791
Program Services	156,650	54,761	291,693	92,918
Consulting Services	8,392	5,193	14,431	9,481
	3,033,213	2,641,135	6,153,038	5,303,190
Total Revenue				
Staffing Services	12,540,048	12,473,476	25,144,215	24,681,577
Program Services	1,031,908	587,281	1,872,353	1,033,766
Consulting Services	106,659	68,958	127,148	80,746
	$13,678,615	$13,129,715	$27,143,716	$25,796,089

RESULTS OF OPERATIONS FOR THE QUARTER ENDED JUNE 30, 2005 AS COMPARED TO THE QUARTER ENDED JUNE 30, 2004.

REVENUE. Revenues increased $549,000, or 4.2%, to $13,679,000 for the three months ended June 30, 2005, from $13,130,000 for the three months ended June 30, 2004. This increase is attributable to fitness and health program services growth of $445,000, staffing services growth of $66,000 and growth from consulting services of $38,000.

GROSS PROFIT. Gross profit increased $8,000, or 0.2%, to $3,451,000 for the three months ended June 30, 2005, from $3,443,000 for the three months ended June 30, 2004. This increase is primarily attributed to a $167,000 increase in gross profit from program and consulting services revenue growth. These increases were mostly offset by a decrease in staffing services gross profit of $159,000, which is primarily due to termination of fitness center staffing contracts.

As a percent of revenue, gross profit decreased to 25.2%, from 26.2% for the second quarter of 2004. This decrease is due primarily to contract terminations and business pricing pressures.

OPERATING EXPENSES AND OPERATING INCOME. Operating expenses increased $96,000, or 3.9%, to $2,569,000 for the three months ended June 30, 2005 from $2,473,000 for the three months ended June 30, 2004. This increase is primarily attributed to anticipated expense increases in our contract administration, programs management, sales and human resource business areas.

OTHER INCOME AND EXPENSE. Interest expense decreased $112,000 to $16,000 for the three months ended June 30, 2005, compared to $128,000 for the same period in 2004. This decrease is primarily due to the December 2004 repayment of the Company's $2,000,000 Senior Subordinated Note held by Bayview Capital Partners

LP, the proceeds of which were used to fund an acquisition. The Company's cost of borrowed funds increased to 6.8% for the second quarter of 2005 from 6.7% for the second quarter of 2004.

INCOME TAXES. Income tax expense increased $2,000 to $345,000 for the three months ended June 30, 2005 compared to $343,000 for the same period in 2004. The increase is primarily due to the $23,000 increase in earnings before taxes.

NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS. As a result of the above, net earnings applicable to common shareholders for the three months ended June 30, 2005 increased $27,000, or 5.7%, to $498,000 from $471,000 for the three months ended June 30, 2004.

RESULTS OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2005 AS COMPARED TO THE SIX MONTHS ENDED JUNE 30, 2004.

REVENUE. Revenues increased $1,348,000, or 5.2%, to $27,144,000 for the six months ended June 30, 2005, from $25,796,000 for the six months ended June 30, 2004. This increase is attributable to fitness and health program services growth of $839,000, staffing services growth of $463,000 and growth from consulting services of $46,000.

GROSS PROFIT. Gross profit increased $363,000, or 5.6%, to $6,892,000 for the six months ended June 30, 2005, from $6,529,000 for the six months ended June 30, 2004. This increase is due primarily to the revenue growth discussed previously, as well as lower medical benefit costs for full-time employees.

As a percent of revenue, gross profit increased to 25.4%, from 25.3% for the six months ended June 30, 2005. This increase is primarily attributed to lower medical costs for full time employees, which were mostly offset by contract terminations and business pricing pressures.

OPERATING EXPENSES AND OPERATING INCOME. Operating expenses increased $48,000, or 1.0%, to $4,913,000 for the six months ended June 30, 2005, from $4,865,000 for the six months ended June 30, 2004. This increase is primarily attributed to anticipated expense increases in our contract administration, programs management, sales and human resource business areas.

OTHER INCOME AND EXPENSE. Interest expense decreased $234,000 to $28,000 for the six months ended June 30, 2005, compared to $262,000 for the same period in 2004. This decrease is primarily due to the December 2004 repayment of the Company's $2,000,000 Senior Subordinated Note held by Bayview Capital Partners LP, the proceeds of which were used to fund an acquisition. The Company's cost of borrowed funds decreased to 6.0% for the six months ended June 30, 2005 from 6.8% for the same period in 2004.

INCOME TAXES. Income tax expense increased $227,000 to $779,000 for the six months ended June 30, 2005, compared to $552,000 for the same period in 2004. The increase is primarily due to the $546,000 increase in earnings before taxes.

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, 2005 increased $319,000, or 39.5%, to $1,126,000, from $807,000 for the six months ended June 30, 2004.

LIQUIDITY AND CAPITAL RESOURCES

The Company's working capital increased $30,000 to $3,986,000 at June 30, 2005, compared to working capital of $3,956,000 at December 31, 2004. The increase in working capital is due primarily to an increase in prepaid expense and decreases in trade accounts payable and accrued expenses, which were offset by decreases in deferred tax assets and cash.

In addition to cash flows generated from operating activities, the Company's other source of liquidity and working capital is provided by a $7,500,000 Credit Agreement with Wells Fargo Bank, N.A. (the "Wells Loan"). 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, 2007. Working capital advances from the Wells Loan are based upon a percentage of the Company's eligible accounts receivable, less any amounts previously drawn. The facility provided maximum borrowing capacity of $5,500,000 and $6,000,000 at June 30, 2005 and December 31, 2004. Excluding current outstanding balances, $4,754,526 and $3,758,851 was available for borrowing on such respective dates.

As of June 30, 2005, the Company had no off-balance sheet arrangements or transactions with unconsolidated, limited purpose entities. Refer to the footnotes in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 for disclosure related to the Company's "Commitments and Contingencies."

The Company believes that sources of capital to meet future obligations over the next 12 months will be provided by cash generated through operations and the Company's Wells Loan. Currently, the Company does not have plans to make any significant investments in capital assets or any other one-time expenses that may affect our cash flows from investing activities.

The Company does not believe that inflation has had a significant impact on the results of its operations.

RISK FACTORS / FORWARD-LOOKING STATEMENTS

The foregoing discussion contains various "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are based on current expectations or beliefs concerning future events. 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. Such statements can be identified by the use of terminology such as "anticipate," "believe," "estimate," "expect," "intend," "may," "could," "possible," "plan," "project," "will," "forecast" and similar words or expressions. The Company's forward-looking statements generally relate to its growth strategies, recent reorganization, financial results, marketing efforts, acquisition plans and cash requirements. Although it is not possible to foresee all of the factors that may cause actual results to differ from the Company's forward-looking statements, such factors include, among others, the risk factors that follow. You should not consider the below risks to be the only ones we may face from time to time. You should take such factors into account when making investment decisions and are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date on which they are made. We undertake no obligation to update any forward-looking statements.

THE TIMING OF NEW AND LOST MANAGEMENT SERVICE CONTRACTS MAY NOT BE INDICATIVE OF TRENDS IN OUR BUSINESS OR OF FUTURE QUARTERLY FINANCIAL RESULTS. The Company evaluates its business, in part, by reviewing trends in its financial performance. Management believes an important indicator of the Company's outlook

is revenue to be derived from fitness and health management service contracts the Company enters into with customers. Fitness and health management service contracts are often long-term contracts (i.e., 3 - 5 years), contain annual, automatic renewals and generally require 30 to 60 days notice to terminate, or to avoid the automatic annual renewal feature. Revenue from new contracts often is not recognized for a period of 90 to 180 days after

14

proposal acceptance due to lead times necessary to execute a contract and hire staff to begin providing services. Since termination notice periods are considerably less than the time it takes to begin servicing new contracts, the revenue lost in a reporting period may significantly exceed the revenue gained from new contracts.

Because of these timing differences, management generally does not view changes in quarterly revenue, whether sequential or comparable prior quarter changes, to be indicative of its outlook or trends in the Company's business or to be reflective of revenue expected in succeeding quarters. Rather, management generally evaluates revenue trends in the Company's fitness and health management services business based upon 12- to 18-month periods since it believes this helps minimize the timing impact from new and terminated contracts. Management cautions investors not to place undue reliance upon fluctuations in quarterly revenue viewed in isolation from revenue information over longer periods of time (e.g., comparative trailing 12-month information), and to not view quarterly revenue as necessarily being indicative of the Company's outlook or results to be expected in future quarters.

THE COMPANY MAY EXPERIENCE DIFFICULTY MANAGING GROWTH, INCLUDING ATTRACTING QUALIFIED STAFF. The Company has experienced substantial growth during the past few years, both organically and by acquisition. The Company's ability to grow in the future will depend on a number of factors, including the ability to obtain new customers, expand existing customer relationships, develop additional fitness and health improvement programs and services and hire and train qualified staff. The Company may experience difficulty in attracting and retaining qualified staff in various markets to meet growth opportunities. Further, in order to attract qualified staff, the Company may be required to pay higher salaries and enhance benefits in more competitive markets, which may result in a material adverse effect on the Company's results of operation and financial condition. Sustaining growth may require the Company to sell its services at lower prices to remain competitive, which may result in a material adverse effect on the Company's results of operation and financial condition. There can be no assurance that the Company will be able to manage expanding operations effectively or that it will be able to maintain or accelerate its growth, and any failure to do so may result in a material adverse effect on the Company's results of operation and financial condition.

FAILURE TO RENEW EXISTING CUSTOMER CONTRACTS COULD HAVE A NEGATIVE EFFECT ON OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS. The Company's growth strategy depends in part upon continuous development and improvement of attractive and effective health management programs and services. The Company's failure to anticipate trends or to successfully develop, improve or implement such programs or services may have a material adverse effect on the Company's results of operation and financial condition. The Company currently contracts with third party partners to provide a portion of such programs and services and anticipates that this will continue to be the case. If any of such third party partners no longer made these programs and services available to the Company, there is no assurance that the Company would be able to replace such third-party partner programs and services, and if the Company could not do so, the Company's ability to pursue its growth strategies would be seriously compromised.

THE COMPANY IS DEPENDENT ON MAINTAINING ITS CORPORATE RELATIONSHIPS. The majority of the Company's contracts are with large corporations regarding the management of on-site fitness centers. While the specific terms of such agreements vary, some contracts are subject to early termination by the corporate customer without cause. Although the Company has a history of consistent contract renewals, there can be no assurance that future renewals will be secured. The early termination or non-renewal of corporate contracts may have a material adverse effect on the Company's results of operation and financial condition.

THE COMPANY'S CUSTOMERS ARE PRIMARILY CORPORATIONS AND THEREFORE ITS FINANCIAL RESULTS ARE SUBJECT TO GENERAL ECONOMIC CONDITIONS. The Company's revenue, expenses and net income are subject to general economic conditions. A significant portion of the Company's revenue is derived from companies who historically have reduced their expenditures for on-site fitness management services during economic downturns. Should the economy weaken, or experience more significant recessionary pressures, corporate customers may reduce or eliminate their expenditures for on-site fitness center management services, and

prospective customers may not commit resources to such services. Also, should the size of a customer's workforce be reduced, the Company may have to reduce the number of staff assigned to manage a customer's fitness center. Additionally, the Company's operations in Canada are subject to foreign currency risk, although these operations currently represent less than 5% of the Company's overall revenues. These factors may have a material adverse effect on the Company's results of operation and financial condition.

THE COMPANY IS DEPENDENT ON ITS KEY EMPLOYEES. THE LOSS OF ANY OF THESE EMPLOYEES COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR PERFORMANCE AND RESULTS OF OPERATIONS. The success of the Company is highly dependent on the efforts, abilities and continued services of its executive officers and other key employees. The loss of any of the executive officers or key employees may have a material adverse effect on the Company results of operation and financial condition. The Company believes that its future success will depend on its ability to attract, motivate and retain highly-skilled corporate, divisional, regional and site-based personnel. Although historically the Company has been successful in retaining the services of its senior management, there can be no assurance that the Company will be able to do so in the future.

THE COMPANY OPERATES WITHIN A HIGHLY COMPETITIVE MARKET AGAINST FORMIDABLE COMPANIES. The Company competes for new and existing corporate customers in a highly fragmented and competitive market. Management believes that the Company's ability to compete successfully depends on a number of factors, including quality and depth of service, locational convenience and cost. The market for on-site fitness center management services is price-sensitive. From time to time, the Company may be at a price disadvantage with respect to the competition, as such competition may propose a substantially lower price than the Company. There can be no assurance that the Company will be able to compete successfully against current and future competitors, or that competitive pressures faced by the Company will not have a material adverse effect on the Company's results of operation and financial condition.

THE COMPANY'S RESULTS OF OPERATIONS COULD BE ADVERSELY IMPACTED BY LITIGATION. Because of the nature of its business, the Company expects that it may be subject to claims and litigation alleging negligence or other grounds for liability arising from injuries or other harm to the customers it serves. The Company has occasionally been named a defendant in claims relating to accidents

that occurred in the fitness centers it manages. There can be no assurance that additional claims will not be filed, and that the Company's insurance will be adequate to cover liabilities resulting from any claim.

THE COMPANY COULD EXPERIENCE A POTENTIAL DEPRESSIVE EFFECT ON THE PRICE OF ITS COMMON STOCK FOLLOWING THE EXERCISE AND SALE OF EXISTING CONVERTIBLE SECURITIES. At June 30, 2005, the Company had outstanding stock options and warrants to purchase an aggregate of 3,638,495 shares of common stock. The Company also had outstanding 1,093,699 shares of preferred stock that are convertible into 2,187,398 shares of common stock. The exercise of such outstanding stock options and warrants and the sale of the common stock acquired thereby, as well as the conversion of preferred stock and the sale of common stock acquired thereby, may have a material adverse effect on the price of the Company's common stock. In addition, the exercise of such outstanding stock options and warrants and sale of such shares of the Company's common stock could occur at a time when the Company might otherwise be able to obtain additional equity capital on terms and conditions more favorable to the Company.

THE COMPANY HAS IMPLEMENTED, ON A LIMITED BASIS, A BUSINESS MODEL FOR MANAGING CORPORATE FITNESS CENTERS ON A COST-NEUTRAL OR FOR-PROFIT BASIS. The Company has, on a limited basis, implemented a model of managing corporate fitness centers on a cost-neutral or for-profit basis without receiving a management fee from the corporate owner of such centers. Corporate-owned centers are resistant to significant membership fees and fee increases, and the Company may not be successful in sufficiently managing costs and/or in raising service levels and associated revenues, as required to achieve profit objectives.

FAILURE TO IDENTIFY ACQUISITION OPPORTUNITIES MAY LIMIT OUR GROWTH. An important part of the Company's growth has been the acquisition of complementary businesses. The Company may choose to continue this

strategy in the future. Management's identification of suitable acquisition candidates involves risks inherent in assessing the value, strengths, weaknesses, overall risks and profitability of acquisition candidates. Management may be unable to identify suitable acquisition candidates. If the Company does not make suitable acquisitions, it may find it more difficult to realize growth objectives and to enhance shareholder value.

In addition, future acquisitions by the Company may be dilutive to shareholders, cause the Company to incur additional indebtedness and large one-time expenses or create intangible assets that could result in significant amortization expense. If the Company spends significant funds or incurs additional debt, the Company's ability to obtain necessary financing may decline and it may be more vulnerable to economic downturns and competitive pressures. Management cannot guarantee that the Company will be able to successfully complete any future acquisitions, that it will be able to finance acquisitions or that it will realize any anticipated benefits from completed acquisitions.

RECENTLY PASSED LEGISLATION

HIPPA. The Administrative Simplification provisions of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") require group health plans and health care providers who conduct certain administrative and financial transactions electronically ("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. The Company's occupational health line of business, which accounts for approximately five percent of the Company's total revenue, and the group health plan the Company sponsors for its employees are subject to HIPAA's requirements. The Company expects to be in compliance with HIPPA requirements within the timeline specified for the Company's affected business areas. The Company's 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

The Company is 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. An interest rate increase by one percentage point would reduce the Company's future annual net income by less than $10,000 at current debt levels.

The Company has no history of, and does 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, the exposure to market risk is not material.

ITEM 4. CONTROLS AND PROCEDURES

The Company's 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 the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules of the Securities and Exchange Commission. The Certifying Officers also have indicated that there were no significant changes in the Company's 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, the Company's 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, 2004.

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 Tuesday, June 7, 2005.

(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 For	Number of Votes Withheld
James A. Bernards	11,398,856	38,417
K. James Ehlen, M.D	11,256,292	180,981
Robert J. Marzec	11,398,856	38,417
Cary Musech	11,397,331	39,942
Jerry V. Noyce	11,397,055	40,218
John C. Penn	11,398,856	38,417
Mark W. Sheffert	11,398,856	38,417
Linda Hall Whitman	11,399,856	37,417
Rodney A. Young	11,398,856	38,417

(c) By a vote of 4,888,606 shares in favor, 504,218 shares opposed, 36,109 shares abstaining, and 6,008,340 shares represented by broker nonvotes, the shareholders approved the 2005 Stock Option Plan

(d) By a vote of 11,355,989 shares in favor, 52,500 shares opposed, 28,784 shares abstaining, and no 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

None.

Item 6. Exhibits

(a) Exhibits

See Exhibit Index on page following signatures

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 15, 2005
HEALTH FITNESS CORPORATION

By /s/ Jerry V. Noyce

Jerry V. Noyce
Chief Executive Officer
(Principal Executive Officer)

By /s/ Wesley W. Winnekins

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

EXHIBIT INDEX
HEALTH FITNESS CORPORATION
FORM 10-Qx

Exhibit No.	Description
**11.0	Statement re: Computation of Earnings per Share
**31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
**31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
**32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
**32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

** Filed herewith