

NATURAL HEALTH TRENDS CORP
Form 10-Q
August 13, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____-__ to _____

Commission File Number: 0-26272

NATURAL HEALTH TRENDS CORP.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

59-2705336
(I.R.S. Employer
Identification No.)

4514 Cole Avenue
Suite 1400
Dallas, Texas 75205
(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (972) 241-4080

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer,

Edgar Filing: NATURAL HEALTH TRENDS CORP - Form 10-Q

or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

At August 10, 2012, the number of shares outstanding of the registrant’s common stock was 11,326,323 shares.

NATURAL HEALTH TRENDS CORP.
Quarterly Report on Form 10-Q
June 30, 2012

INDEX

| | Page |
|---------------------------------------|--|
| PART I – FINANCIAL INFORMATION | |
| Item 1. | Financial Statements 1 |
| Item 2. | Management’s Discussion and Analysis of Financial Condition and Results of Operations 10 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk 16 |
| Item 4. | Controls and Procedures 16 |
| PART II – OTHER INFORMATION | |
| Item 1. | Legal Proceedings 17 |
| Item 1A. | Risk Factors 17 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds 17 |
| Item 3. | Defaults Upon Senior Securities 17 |
| Item 4. | Mine Safety Disclosures 17 |
| Item 5. | Other Information 17 |
| Item 6. | Exhibits 17 |
| Signatures | 18 |

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, in particular “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations,” includes “forward-looking statements” within the meaning of section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). When used in this report, the words or phrases “will likely result,” “expect,” “intend,” “will continue,” “anticipate,” “estimate,” “project,” “believe” and similar expressions are intended to identify “forward-looking statements” within the meaning of the Exchange Act. These statements represent our expectations or beliefs concerning, among other things, future revenue, earnings, growth strategies, new products and initiatives, future operations and operating results, and future business and market opportunities.

Forward-looking statements in this report speak only as of the date hereof, and forward looking statements in documents incorporated by reference speak only as of the date of those documents. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as required by law. We caution and advise readers that these statements are based on certain assumptions that may not be realized and involve risks and uncertainties that could cause actual results to differ materially from the expectations and beliefs contained herein.

For a summary of certain risks related to our business, see “Item 1A. Risk Factors” in our most recent Annual Report on Form 10-K, which include the following:

- Difficult economic conditions could harm our business;
- We may experience substantial negative cash flows, which may have a significant adverse effect on our business and could threaten our solvency;
- If we experience negative cash flows, we may need to seek additional debt or equity financing, which may not be available on acceptable terms or at all. If available, it could have a highly dilutive effect on the holdings of existing stockholders;
- We could be adversely affected by additional management changes or an inability to attract and retain key management, directors and consultants;
- Because our Hong Kong operations account for a majority of our overall business, and most of our Hong Kong business is derived from the sale of products to members in China, any material adverse change in our business relating to either Hong Kong or China would likely have a material adverse impact on our overall business;
- As a network marketing company, we rely on an independent sales force and we do not have direct control over the marketing of our products;
 - Our failure to maintain and expand our distributor relationships could adversely affect our business;
 - The high level of competition in our industry could adversely affect our business;
 - An increase in the amount of compensation paid to distributors would reduce profitability;
 - Failure of new products to gain distributor and market acceptance could harm our business;
- Direct-selling laws and regulations may prohibit or severely restrict our direct sales efforts and cause our revenue and profitability to decline, and regulators could adopt new regulations that harm our business;
 - Challenges by third parties to the form of our business model could harm our business;
 - Our products and related activities are subject to extensive government regulation, which could delay, limit or prevent the sale of some of our products in some markets;
 - New regulations governing the marketing and sale of nutritional supplements could harm our business;
 - Regulations governing the production and marketing of our personal care products could harm our business;
 - If we are found not to be in compliance with good manufacturing practices our operations could be harmed;
- Failure to comply with domestic and foreign laws and regulations governing product claims and advertising could harm our business;
- Although our distributors are independent contractors, improper distributor actions that violate laws or regulations could harm our business;

Edgar Filing: NATURAL HEALTH TRENDS CORP - Form 10-Q

- Adverse publicity associated with our products, ingredients or network marketing program, or those of similar companies, could harm our financial condition and operating results;
 - We have a limited product line;
 - We do not manufacture our own products so we must rely on independent third parties for the manufacturing and supply of our products;
 - Growth may be impeded by the political and economic risks of entering and operating foreign markets;
 - Currency exchange rate fluctuations could lower our revenue and net income;
 - Transfer pricing, duties and other tax regulations affect our business;
 - Failure to properly pay business taxes or customs duties, including those in China, could have a material adverse effect;
 - We may be held responsible for certain taxes or assessments relating to the activities of our distributors, which could harm our financial condition and operating results;
-

- We may face litigation that could harm our business;
- We may be unable to protect or use our intellectual property rights;
- We do not have product liability insurance and product liability claims could hurt our business;
- Our internal controls and accounting methods may require modification;
- If we fail to achieve and maintain an effective system of internal controls in the future, we may not be able to accurately report our financial results or prevent fraud. As a result, investors may lose confidence in our financial reporting;
 - We rely on and are subject to risks associated with our reliance upon information technology systems;
 - System failures and attacks could harm our business;
- Terrorist attacks, cyber attacks, acts of war, epidemics or other communicable diseases or any other natural disasters may seriously harm our business;
 - Disappointing quarterly revenue or operating results could cause the price of our common stock to fall;
 - Our common stock is particularly subject to volatility because of the industry in which we operate;
 - There is no assurance that an active public trading market will continue;
- The exercise of our warrants may result in substantial dilution and may depress the market price of our common stock;
 - Future sales by us or our existing stockholders could depress the market price of our common stock; and
 - Penny stock regulations are applicable to investment in our shares of common stock.

Additional factors that could cause actual results to differ materially from our forward-looking statements are set forth in this report, including under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and in our financial statements and the related notes.

PART I – FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)

| | December 31, 2011 | June 30, 2012 (Unaudited) |
|---|----------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$1,617 | \$4,637 |
| Restricted cash | 494 | – |
| Accounts receivable | 93 | 203 |
| Inventories, net | 1,089 | 1,258 |
| Other current assets | 537 | 627 |
| Total current assets | 3,830 | 6,725 |
| Property and equipment, net | 68 | 114 |
| Goodwill | 1,764 | 1,764 |
| Restricted cash | 220 | 221 |
| Other assets | 241 | 247 |
| Total assets | \$6,123 | \$9,071 |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) | | |
| Current liabilities: | | |
| Accounts payable | \$2,208 | \$2,480 |
| Income taxes payable | 11 | 66 |
| Accrued distributor commissions | 1,177 | 1,513 |
| Other accrued expenses | 1,471 | 1,749 |
| Deferred revenue | 967 | 1,627 |
| Deferred tax liability | 148 | 148 |
| Other current liabilities | 950 | 903 |
| Total current liabilities | 6,932 | 8,486 |
| Commitments and contingencies | | |
| Stockholders' equity (deficit): | | |
| Preferred stock, \$0.001 par value; 5,000,000 shares authorized; 1,761,900 shares designated Series A convertible preferred stock, 138,400 shares issued and outstanding at December 31, 2011 and June 30, 2012, aggregate liquidation value of \$320 | 124 | 124 |
| Common stock, \$0.001 par value; 50,000,000 shares authorized; 11,326,323 shares issued and outstanding at December 31, 2011 and June 30, 2012 | 11 | 11 |
| Additional paid-in capital | 80,493 | 80,533 |
| Accumulated deficit | (81,338) | (79,985) |
| Accumulated other comprehensive loss: | | |
| Foreign currency translation adjustments | (99) | (98) |

Edgar Filing: NATURAL HEALTH TRENDS CORP - Form 10-Q

| | | | |
|--|---------|---|---------|
| Total stockholders' equity (deficit) | (809 |) | 585 |
| Total liabilities and stockholders' equity (deficit) | \$6,123 | | \$9,071 |

See accompanying notes to consolidated financial statements.

1

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In Thousands, Except Per Share Data)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|-----------|---------------------------|-----------|
| | 2011 | 2012 | 2011 | 2012 |
| Net sales | \$ 7,208 | \$ 10,980 | \$ 12,383 | \$ 20,070 |
| Cost of sales | 1,977 | 2,884 | 3,506 | 5,283 |
| Gross profit | 5,231 | 8,096 | 8,877 | 14,787 |
| Operating expenses: | | | | |
| Distributor commissions | 2,714 | 4,886 | 4,476 | 8,577 |
| Selling, general and administrative expenses (including stock-based compensation expense of \$21 and \$20 during the three months ended June 30, 2011 and 2012, respectively, and \$35 and \$40 during the six months ended June 30, 2011 and 2012, respectively) | 1,836 | 2,313 | 3,866 | 4,750 |
| Depreciation and amortization | 26 | 8 | 258 | 20 |
| Total operating expenses | 4,576 | 7,207 | 8,600 | 13,347 |
| Income from operations | 655 | 889 | 277 | 1,440 |
| Other income (expense), net | 26 | 2 | (69) | (61) |
| Income before income taxes | 681 | 891 | 208 | 1,379 |
| Income tax provision | 13 | 45 | 20 | 26 |
| Net income | 668 | 846 | 188 | 1,353 |
| Plus: Net loss attributable to the noncontrolling interest | 1 | – | 9 | – |
| Net income attributable to Natural Health Trends | 669 | 846 | 197 | 1,353 |
| Preferred stock dividends | (4) | (4) | (8) | (8) |
| Net income attributable to common stockholders of Natural Health Trends | \$ 665 | \$ 842 | \$ 189 | \$ 1,345 |
| Income per share of Natural Health Trends – basic and diluted | \$ 0.06 | \$ 0.08 | \$ 0.02 | \$ 0.12 |
| Weighted-average number of shares outstanding: | | | | |
| Basic | 10,675 | 10,919 | 10,655 | 10,891 |
| Diluted | 10,706 | 11,219 | 10,659 | 11,208 |

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(In Thousands)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|--------|---------------------------|----------|
| | 2011 | 2012 | 2011 | 2012 |
| Net income | \$ 668 | \$ 846 | \$ 188 | \$ 1,353 |
| Other comprehensive income (loss), net of tax: | | | | |
| Foreign currency translation adjustment | (42) | (50) | 61 | 1 |
| Comprehensive income | 626 | 796 | 249 | 1,354 |
| Plus: Comprehensive loss attributable to the noncontrolling interest | 17 | – | 27 | – |
| Comprehensive income attributable to Natural Health Trends | \$ 643 | \$ 796 | \$ 276 | \$ 1,354 |

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In Thousands)

| | Six Months Ended June 30, | |
|---|---------------------------|----------|
| | 2011 | 2012 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 188 | \$ 1,353 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of property and equipment | 58 | 20 |
| Amortization of intangibles | 200 | – |
| Stock-based compensation | 35 | 40 |
| Deferred income taxes | (1 |) – |
| Changes in assets and liabilities: | | |
| Accounts receivable | (19 |) (118 |
| Inventories, net | (431 |) (170 |
| Other current assets | (577 |) (97 |
| Other assets | 84 | (6 |
| Accounts payable | (502 |) 271 |
| Income taxes payable | 18 | 55 |
| Accrued distributor commissions | (16 |) 347 |
| Other accrued expenses | (107 |) 278 |
| Deferred revenue | 1,654 | 661 |
| Other current liabilities | (1 |) (48 |
| Net cash provided by operating activities | 583 | 2,586 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment, net | (9 |) (65 |
| Decrease (increase) in restricted cash | (72 |) 494 |
| Net cash provided by (used in) investing activities | (81 |) 429 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Advance from related party | 233 | – |
| Net cash provided by financing activities | 233 | – |
| Effect of exchange rates on cash and cash equivalents | 54 | 5 |
| Net increase in cash and cash equivalents | 789 | 3,020 |
| CASH AND CASH EQUIVALENTS, beginning of period | 648 | 1,617 |
| CASH AND CASH EQUIVALENTS, end of period | \$ 1,437 | \$ 4,637 |

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Nature of Operations

Natural Health Trends Corp. (the “Company”), a Delaware corporation, is an international direct-selling and e-commerce company headquartered in Dallas, Texas. Subsidiaries controlled by the Company sell personal care, wellness, and “quality of life” products under the “NHT Global” brand. In most markets, we sell our products to an independent distributor network that either uses the products themselves or resells them to consumers.

Our majority-owned subsidiaries have an active physical presence in the following markets: North America; Greater China, which consists of Hong Kong, Taiwan and China; Russia; South Korea; Japan; and Europe, which consists of Italy and Slovenia.

Basis of Presentation

The unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. As a result, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the Company’s financial information for the interim periods presented. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. These consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in our 2011 Annual Report on Form 10-K filed with the United States Securities and Exchange Commission (SEC) on March 27, 2012.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and all of its majority-owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period.

The most significant accounting estimates inherent in the preparation of the Company’s financial statements include estimates associated with obsolete inventory and the fair value of acquired intangible assets, including goodwill, as well as those used in the determination of liabilities related to sales returns and income taxes. Various assumptions

and other factors prompt the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account historical experience and current and expected economic conditions. The actual results may differ materially and adversely from the Company's estimates. To the extent that there are material differences between the estimates and actual results, future results of operations will be affected.

Income Taxes

The Company recognizes income taxes under the liability method of accounting for income taxes. Deferred income taxes are recognized for differences between the financial reporting and tax bases of assets and liabilities at enacted statutory tax rates in effect for the years in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be ultimately realized. The Company recognizes tax benefits from uncertain tax positions only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate resolution. The Company recognizes interest and penalties related to unrecognized tax benefits as a component of income tax expense. Deferred taxes are not provided on the portion of undistributed earnings of subsidiaries outside of the United States when these earnings are considered permanently reinvested.

The Company and its subsidiaries file income tax returns in the United States, various states, and foreign jurisdictions. The Company is no longer subject to U.S. federal income tax examinations for years prior to 2008, and is no longer subject to state income tax examinations for years prior to 2007. No jurisdictions are currently examining any income tax returns of the Company or its subsidiaries.

Fair Value of Financial Instruments

The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, approximate fair value because of their short maturities. The carrying amount of the noncurrent restricted cash approximates fair value since, absent the restrictions, the underlying assets would be included in cash and cash equivalents.

Accounting standards permit companies, at their option, to choose to measure many financial instruments and certain other items at fair value. The Company has elected to not fair value existing eligible items.

Revenue Recognition

Product sales are recorded when the products are shipped and title passes to independent distributors. Product sales to distributors are made pursuant to a distributor agreement that provides for transfer of both title and risk of loss upon our delivery to the carrier that completes delivery to the distributors, which is commonly referred to as "F.O.B. Shipping Point." The Company primarily receives payment by credit card at the time distributors place orders. Amounts received for unshipped product are recorded as deferred revenue. The Company's sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return.

Actual product returns are recorded as a reduction to net sales. The Company estimates and accrues a reserve for product returns based on its return policies and historical experience.

Enrollment package revenue, including any nonrefundable set-up fees, is deferred and recognized over the term of the arrangement, generally twelve months. Enrollment packages provide distributors access to both a personalized marketing website and a business management system. No upfront costs are deferred as the amount is nominal.

Shipping charges billed to distributors are included in net sales. Costs associated with shipments are included in cost of sales.

Various taxes on the sale of products and enrollment packages to distributors are collected by the Company as an agent and remitted to the respective taxing authority. These taxes are presented on a net basis and recorded as a liability until remitted to the respective taxing authority.

Selling, General and Administrative Expenses

During the second quarter of 2011, the Company successfully negotiated and entered into agreements with certain legacy and on-going vendors to settle prior outstanding payable balances. The impact of such agreements to settle outstanding payable balances was \$209,000 less than carrying value, which was immediately recognized as a credit to selling, general and administrative expenses upon settlement.

Income Per Share

Basic income per share is computed by dividing net income applicable to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted income per share is determined using the weighted-average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents, consisting of non-vested restricted stock and shares that might be issued upon the exercise of outstanding stock options and warrants and the conversion of preferred stock.

The dilutive effect of non-vested restricted stock, stock options and warrants is reflected by application of the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefit that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares. The potential tax benefit derived from exercise of non-qualified stock options has been excluded from the treasury stock calculation as the Company is uncertain that the benefit will be realized.

The following tables illustrate the computation of basic and diluted income per share for the periods indicated (in thousands, except per share data):

| | Three Months Ended June 30, | | | | | |
|--|-----------------------------|---------------------------------|---------------------|-----------------------|---------------------------------|---------------------|
| | Income (Numerator) | 2011 Shares (Denominator) | Per Share Amount | Income (Numerator) | 2012 Shares (Denominator) | Per Share Amount |
| Basic EPS: | | | | | | |
| Net income attributable to common stockholders of Natural Health Trends | \$ 665 | 10,675 | \$ 0.06 | \$ 842 | 10,919 | \$ 0.08 |
| Effect of dilutive securities: | | | | | | |
| Non-vested restricted stock | | 31 | | | 300 | |
| Diluted EPS: | | | | | | |
| Net income attributable to common stockholders of Natural Health Trends plus assumed conversions | \$ 665 | 10,706 | \$ 0.06 | \$ 842 | 11,219 | \$ 0.08 |
| | Six Months Ended June 30, | | | | | |
| | Income (Numerator) | 2011 Shares (Denominator) | Per Share Amount | Income (Numerator) | 2012 Shares (Denominator) | Per Share Amount |
| Basic EPS: | | | | | | |
| Net income attributable to common stockholders | \$ 189 | 10,655 | \$ 0.02 | \$ 1,345 | 10,891 | \$ 0.12 |

of Natural Health
Trends

Effect of dilutive
securities:

Non-vested restricted
stock

4

317

Diluted EPS:

Net income
attributable to
common stockholders
of Natural Health

Trends plus assumed
conversions

\$ 189

10,659

\$ 0.02

\$ 1,345

11,208

\$ 0.12

7

Certain non-vested restricted stock is anti-dilutive upon applying the treasury stock method since the amount of compensation cost for future service results in the hypothetical repurchase of shares exceeding the actual number of shares to be vested. Other common stock equivalents are also anti-dilutive since the average market price of the related common stock for the period exceeds the exercise price.

The following securities were not included for the time periods indicated as their effect would have been anti-dilutive:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-----------------------------------|-----------------------------|-----------|---------------------------|-----------|
| | 2011 | 2012 | 2011 | 2012 |
| Options to purchase common stock | 22,500 | – | 22,500 | – |
| Warrants to purchase common stock | 3,704,854 | 3,704,854 | 3,704,854 | 3,704,854 |
| Non-vested restricted stock | 9,998 | – | 624,523 | – |
| Convertible preferred stock | 138,400 | 138,400 | 138,400 | 138,400 |

Warrants to purchase 3,704,854 shares of common stock were still outstanding at June 30, 2012. Such warrants have expirations through April 21, 2015.

Recently Issued and Adopted Accounting Pronouncements

On January 1, 2012, the Company adopted the new Financial Accounting Standards Board guidance on the presentation of comprehensive income. Specifically, the new guidance requires an entity to present components of net income and other comprehensive income in either a single continuous statement of comprehensive income, or in two separate but consecutive statements, which is the approach the Company has selected. The new guidance eliminated the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. While the new guidance changed the presentation of comprehensive income, there were no changes to the components that are recognized in net income or other comprehensive income from that of previous accounting guidance.

Other recently issued accounting pronouncements did not or are not believed by management to have a material impact on the Company's present or future financial statements.

3. STOCK-BASED COMPENSATION

Stock-based compensation expense totaled approximately \$21,000 and \$20,000 for the three months ended June 30, 2011 and 2012, respectively, and approximately \$35,000 and \$40,000 for the six months ended June 30, 2011 and 2012, respectively. No tax benefits were attributed to the share-based compensation because a valuation allowance was maintained for substantially all net deferred tax assets.

The following table summarizes the Company's restricted stock activity:

| | Shares | Wtd. Avg. Price at Date of Issuance |
|----------------------------------|------------|--|
| Outstanding at December 31, 2011 | 473,688 | \$0.37 |
| Granted | – | – |
| Vested | (108,694) | 0.36 |

| | | |
|------------------------------|---------|------|
| Forfeited | – | – |
| Outstanding at June 30, 2012 | 364,994 | 0.37 |

As of June 30, 2012, total unrecognized stock-based compensation expense related to non-vested restricted stock was approximately \$140,000, which is expected to be recognized over a weighted-average period of 1.7 years.

4. CONTINGENCIES

Consumer Indemnity

As required by the Door-to-Door Sales Act in South Korea, the Company maintains insurance for consumer indemnity claims with a mutual aid cooperative by possessing a mutual aid contract with Mutual Aid Cooperative & Consumer (the "Cooperative"). The contract secures payment to distributors in the event that the Company is unable to provide refunds to distributors. Typically, requests for refunds are paid directly by the Company according to the Company's normal Korean refund policy, which requires that refund requests be submitted within three months. Accordingly, the Company estimates and accrues a reserve for product returns based on this policy and its historical experience. Depending on the sales volume, the Company may be required to increase or decrease the amount of the contract. The maximum potential amount of future payments the Company could be required to make to address actual distributor claims under the contract is equivalent to three months of rolling sales. At June 30, 2012, non-current other assets include KRW 100 million (USD \$86,000) underlying the contract, which can be utilized by the Cooperative to fund any outstanding distributor claims. The Company believes that the likelihood of utilizing these funds to provide for distributors claims is remote.

Registration Payment Arrangements

Pursuant to the agreement with the original investors and the placement agent in the May 2007 financing for the sale of 1,759,307 shares of Series A preferred stock and warrants representing the right to purchase 1,759,307 shares of common stock, the Company is obligated for a specified period of time to maintain the effectiveness of the registration statement that was filed with the SEC covering the resale of the shares of common stock issuable upon the exercise of warrants issued in the financing. On March 18, 2010, the Company filed a post-effective amendment withdrawing unsold shares from registration. If the Company fails to file a new registration statement, and maintain its effectiveness, then it may be liable for payment in cash of an amount equal to 2% of the product of \$1.70 times the number of shares of Series A preferred stock sold in the financing to the relevant purchasers, or up to approximately \$60,000, but only if the quoted closing price of the Company's common stock exceeds the warrant exercise price of the warrants. The exercise price of the warrants was \$3.80 per share until May 3, 2010, \$4.35 per share until November 3, 2011, and is currently \$5.00 per share until May 4, 2013, when the warrants expire.

Pursuant to the agreement with the investors in the Company's October 2007 financing of variable rate convertible debentures having an aggregate face amount of \$4,250,000, seven-year warrants to purchase 1,495,952 shares of the Company's common stock, and one-year warrants to purchase 1,495,952 shares of the Company's common stock, the Company was obligated to (i) file a registration statement covering the resale of the maximum number of Registrable Securities (as defined) that is permitted by SEC Guidance (as defined) prior to November 18, 2007, (ii) cause the registration statement to be declared effective within certain specified periods of time and (iii) maintain the effectiveness of the registration statement until all Registrable Securities have been sold, or may be sold without volume restrictions pursuant to Rule 144(k) under the Securities Act. The Company timely filed that registration statement covering the shares of common stock underlying the debentures, which have been redeemed, and the one-year warrants, which have expired. At the time, the 1,495,952 shares of common stock underlying the seven-year warrants, and 149,595 shares of common stock underlying certain five-year warrants issued to the placement agent in the transaction, were not deemed Registrable Securities and were not included in the registration statement. If they are subsequently deemed Registrable Securities and we fail to file a new registration statement covering them, then the warrants may be exercised by means of a cashless exercise. The maximum number of shares that could be required to be issued upon exercise of the warrants (whether on a cashless basis or otherwise) is limited to the number of shares indicated on the face of the warrants.

As of June 30, 2012, no contingent obligations have been recognized under registration payment arrangements.

5. RELATED PARTY TRANSACTIONS

George Broady, a director of the Company and owner of more than 5% of its outstanding common stock, advanced \$2,500 on January 13, 2011, and \$30,000 on March 14, 2011 to settle certain claims against the Company. The aggregate amount of these advances, plus a \$4,000 advance on December 17, 2010, totaling \$36,500 was repaid on August 8, 2011.

Additionally, Mr. Broady advanced \$100,000 to the Company on February 28, 2011 and \$100,000 on March 14, 2011. The Company agreed to pay Mr. Broady interest of 9% per annum on the aggregate amount of the advances. The Company repaid Mr. Broady in full, plus accumulated interest, during the third and fourth quarters of 2011.

The Company is considering entering into a Royalty Agreement and License Agreement with Broady Health Sciences, L.L.C. (“BHS”) regarding the manufacture and sale of a new product called Restor™. BHS has patents pending on that product. Mr. Broady is a member of BHS, a Texas limited liability company. During 2011, BHS permitted the Company to manufacture (or have manufactured), market and sell the Restor™ product. In April 2012, the Company reimbursed BHS \$42,000 in expenses incurred in 2011 to promote the Restor™ product on the Company’s behalf. To continue selling Restor™ and obtain certain exclusive rights outside of the United States, BHS has requested that the Company pay a royalty of 2.5% of sales revenues for 2011 and subsequent years. The Company is considering that proposal and discussing the terms of a definitive agreement. At a royalty of 2.5% of net sales, the Company calculates that royalties for 2011 and the first six months of 2012 would total approximately \$24,000.

Item 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Business Overview

We are an international direct-selling and e-commerce company. Subsidiaries controlled by us sell personal care, wellness, and “quality of life” products under the “NHT Global” brand. In most markets, we sell our products to an independent distributor network that either uses the products themselves or resells them to consumers. Our majority-owned subsidiaries have an active physical presence in the following markets: North America; Greater China, which consists of Hong Kong, Taiwan and China; Russia; South Korea; Japan; and Europe, which consists of Italy and Slovenia.

Our distributor network operates in a seamless manner from market to market, except for the Chinese market. We believe that each of our operating segments should be aggregated into a single reportable segment as they have similar economic characteristics. Additionally, we believe that each of the operating segments are similar in the nature of the products sold, the product acquisition process, the types of customers products are sold to, the methods used to distribute the products, and the nature of the regulatory environment. Our e-commerce retail business in China does not require a direct selling license and allows for discounts on volume purchases. There is no separate segment manager who is held accountable by our chief operating decision-makers, or anyone else, for operations, operating results and planning for the Chinese market on a stand-alone basis. Accordingly, we consider ourselves to be in a single reporting segment and operating unit structure.

As of June 30, 2012, we were conducting business through approximately 21,000 active distributors. We consider a distributor “active” if they have placed at least one product order with us during the preceding year. Currently we do not intend to devote material resources to opening any additional foreign markets in the near future. Our priority is to focus our resources in our most promising markets, which we consider to be Greater China and certain Commonwealth of Independent States (“CIS”) countries, namely Russia and Kazakhstan.

We generate about 95% of our net sales from subsidiaries located outside North America, with sales in Hong Kong representing 74% of net sales in the latest fiscal quarter. Because of the size of our foreign operations, operating results can be impacted negatively or positively by factors such as foreign currency fluctuations, and economic, political and business conditions around the world. In addition, our business is subject to various laws and regulations, in particular regulations related to direct selling activities that create certain risks for our business, including improper claims or activities by our distributors and potential inability to obtain necessary product registrations.

China has been and continues to be our most important business development project. In June 2004, NHT Global obtained a general business license in China. Direct selling is prohibited in China without a direct selling license that we do not have. In December 2005, we submitted a preliminary application for a direct selling license. In June 2006,

we submitted a revised application package in accordance with new requirements issued by the Chinese government. In June 2007, we launched a new e-commerce retail platform in China that does not require a direct selling license and is separate from our current worldwide platform. We believe this model, which offers discounts based on volume purchases, will encourage repeat purchases of our products for personal consumption in the Chinese market. The platform is designed to be in compliance with our understanding of current laws and regulations in China. In November 2007, we filed a new, revised direct selling application incorporating a name change, our new e-commerce model and other developments. These direct selling applications were not approved or rejected by the pertinent authorities, but did not appear to materially progress. By now, the information contained in the most recent application is stale. The Company applied to temporarily withdraw the license application in February 2009 to furnish new information and intends to amend its application with the goal to re-apply in the future. We are unable to predict whether we will be successful in obtaining a direct selling license to operate in China, and if we are successful, when we will be permitted to enhance our e-commerce retail platform with direct selling operations.

Most of the Company's Hong Kong revenue is derived from the sale of products that are delivered to members in China. After consulting with outside professionals, the Company believes that its Hong Kong e-commerce business does not violate any applicable laws in China even though it is used for the internet purchase of our products by buyers in China. But the government in China could, in the future, officially interpret its laws and regulations – or adopt new laws and regulations – to prohibit some or all of our e-commerce activities with China and, if our members engage in illegal activities in China, those actions could be attributable to us. In addition, other Chinese laws regarding how and when members may assemble and the activities that they may conduct, or the conditions under which the activities may be conducted, in China are subject to interpretations and enforcement attitudes that sometimes vary from province to province, among different levels of government, and from time to time. Members sometimes violate one or more of the laws regulating these activities, notwithstanding training that the Company attempts to provide. Enforcement measures regarding these violations, which can include arrests, raise the uncertainty and perceived risk associated with conducting this business, especially among those who are aware of the enforcement actions but not the specific activities leading to the enforcement. The Company believes that this has led some existing members in China – who are signed up as distributors in Hong Kong - to leave the business or curtail their selling activities and has led potential members to choose not to participate. Among other things, the Company is combating this with more training and public relations efforts that are designed, among other things, to distinguish the Company from businesses that make no attempt to comply with the law. This environment creates uncertainty about the future of doing this type of business in China generally and under our business model, specifically.

Income Statement Presentation

We derive revenue from sales of products, enrollment packages, and shipping charges. Substantially all of our product sales are to independent distributors at published wholesale prices. Product sales are recorded when the products are shipped and title passes to independent distributors, which generally is upon our delivery to the carrier that completes delivery to the distributors. We estimate and accrue a reserve for product returns based on our return policies and historical experience. Enrollment package revenue, including any nonrefundable set-up fees, is deferred and recognized over the term of the arrangement, generally twelve months.

Cost of sales consist primarily of products purchased from third-party manufacturers, freight cost for shipping products to distributors, import duties, costs of promotional materials sold to the Company's distributors at or near cost, and provisions for slow moving or obsolete inventories. Cost of sales also includes purchasing costs, receiving costs, inspection costs and warehousing costs.

Distributor commissions are typically our most significant expense and are classified as an operating expense. Under our compensation plan, distributors are paid weekly commissions, generally in their home country currency, for product sold by their down-line distributor network across all geographic markets, except China, where we launched an e-commerce retail platform and do not pay any commissions. Distributors are not paid commissions on purchases or sales of our products made directly by them. This "seamless" compensation plan enables a distributor located in one country to sponsor other distributors located in other countries where we are authorized to conduct our business. Currently, there are basically two ways in which our distributors can earn income:

- Through retail markups on sales of products purchased by distributors at wholesale prices (in some markets, sales are for personal consumption only and income may not be earned through retail mark-ups on sales in that market); and
- Through commissions paid on product purchases made by their down-line distributors.

Each of our products is designated a specified number of sales volume points, also called bonus volume or "BV." Commissions are based on total personal and group sales volume points per sales period. Sales volume points are essentially a percentage of a product's wholesale cost. As the distributor's business expands from successfully

sponsoring other distributors who in turn expand their own businesses by sponsoring other distributors, the distributor receives higher commissions from purchases made by an expanding down-line network. To be eligible to receive commissions, a distributor may be required to make nominal monthly or other periodic purchases of our products. Certain of our subsidiaries do not require these nominal purchases for a distributor to be eligible to receive commissions. In determining commissions, the number of levels of down-line distributors included within the distributor's commissionable group increases as the number of distributorships directly below the distributor increases. Under our current compensation plan, certain of our commission payouts may be limited to a hard cap in terms of a specific percentage of total product sales. In some markets, commissions may be further limited. In some markets, we also pay certain bonuses on purchases by several generations of personally sponsored distributors, as well as bonuses on commissions earned by several generations of personally sponsored distributors. Distributors can also earn income, trips and other prizes in specific time-limited promotions and contests we hold from time to time. Distributor commissions are dependent on the sales mix and, for the first six months of 2011 and 2012, represented 36% and 43% of net sales, respectively. From time to time we make modifications and enhancements to our compensation plan to help motivate distributors, which can have an impact on distributor commissions. From time to time we also enter into agreements for business or market development, which may result in additional compensation to specific distributors.

Selling, general and administrative expenses consist of administrative compensation and benefits (including stock-based compensation), travel, credit card fees and assessments, professional fees, certain occupancy costs, and other corporate administrative expenses. In addition, this category includes selling, marketing, and promotion expenses including costs of distributor conventions, which are designed to increase both product awareness and distributor recruitment. Because our various distributor conventions are not always held at the same time each year, interim period comparisons will be impacted accordingly.

The functional currency of our international subsidiaries is generally their local currency. Local currency assets and liabilities are translated at the rates of exchange on the balance sheet date, and local currency revenues and expenses are translated at average rates of exchange during the period. Equity accounts are translated at historical rates. The resulting translation adjustments are recorded directly into a separate component of stockholders' equity and represent the only component of accumulated other comprehensive income.

Sales to customers outside the United States are transacted in the respective local currencies and are translated into U.S. dollars using average rates of exchange for each monthly accounting period to which they relate. Most of our product purchases from third-party manufacturers are transacted in U.S. dollars. Consequently, our sales and net earnings are affected by changes in currency exchange rates, with sales and earnings generally increasing with a weakening U.S. dollar and decreasing with a strengthening U.S. dollar.

Results of Operations

The following table sets forth our operating results as a percentage of net sales for the periods indicated.

| | Three Months Ended June 30, | | Six Months Ended June 30, | | | | | |
|--|-----------------------------|------|---------------------------|------|-------|---|-------|---|
| | 2011 | 2012 | 2011 | 2012 | | | | |
| Net sales | 100.0 | % | 100.0 | % | 100.0 | % | 100.0 | % |
| Cost of sales | 27.4 | | 26.3 | | 28.3 | | 26.3 | |
| Gross profit | 72.6 | | 73.7 | | 71.7 | | 73.7 | |
| Operating expenses: | | | | | | | | |
| Distributor commissions | 37.6 | | 44.5 | | 36.2 | | 42.7 | |
| Selling, general and administrative expenses | 25.5 | | 21.0 | | 31.2 | | 23.7 | |
| Depreciation and amortization | 0.4 | | 0.1 | | 2.1 | | 0.1 | |
| Total operating expenses | 63.5 | | 65.6 | | 69.5 | | 66.5 | |
| Income from operations | 9.1 | | 8.1 | | 2.2 | | 7.2 | |
| Other income (expense), net | 0.4 | | – | | (0.5) |) | (0.3) |) |
| Income before income taxes | 9.5 | | 8.1 | | 1.7 | | 6.9 | |
| Income tax provision | 0.2 | | 0.4 | | 0.2 | | 0.2 | |
| Net income | 9.3 | % | 7.7 | % | 1.5 | % | 6.7 | % |

Net Sales

The following table sets forth revenue by market for the periods indicated (in thousands):

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | | | | | | | |
|---------------|-----------------------------|------|---|---------------------------|------|---|--------|------|---|--------|------|---|
| | 2011 | 2012 | | 2011 | 2012 | | | | | | | |
| North America | \$ 329 | 4.6 | % | \$ 534 | 4.9 | % | \$ 626 | 5.1 | % | \$ 969 | 4.8 | % |
| Hong Kong | 4,688 | 65.0 | | 8,142 | 74.1 | | 7,064 | 57.0 | | 14,268 | 71.1 | |
| China | 232 | 3.2 | | 159 | 1.4 | | 518 | 4.2 | | 374 | 1.9 | |
| Taiwan | 447 | 6.2 | | 460 | 4.2 | | 1,106 | 8.9 | | 959 | 4.8 | |
| South Korea | 122 | 1.7 | | 51 | 0.5 | | 232 | 1.9 | | 165 | 0.8 | |
| Japan | 60 | 0.8 | | 42 | 0.4 | | 135 | 1.1 | | 87 | 0.4 | |
| Russia | 1,236 | 17.2 | | 1,515 | 13.8 | | 2,504 | 20.2 | | 3,088 | 15.4 | |
| Europe | 94 | 1.3 | | 77 | 0.7 | | 198 | 1.6 | | 160 | 0.8 | |

Edgar Filing: NATURAL HEALTH TRENDS CORP - Form 10-Q

| | | | | | | | | |
|-------|----------|---------|-----------|---------|-----------|---------|-----------|---------|
| Total | \$ 7,208 | 100.0 % | \$ 10,980 | 100.0 % | \$ 12,383 | 100.0 % | \$ 20,070 | 100.0 % |
|-------|----------|---------|-----------|---------|-----------|---------|-----------|---------|

Net sales were \$11.0 million for the three months ended June 30, 2012 compared with \$7.2 million for the comparable period a year ago, an increase of \$3.8 million, or 52%. Hong Kong net sales increased \$3.5 million, or 74%, over the comparable period a year ago. In 2011, the Company's 10th Anniversary celebration in Hong Kong may have deferred or pulled forward more orders into the late second and early third quarters. For year-on-year evaluation, we believe that a year-to-date comparison with the comparable periods a year ago through June and September may be more indicative of our business trend.

Net sales were \$20.1 million for the six months ended June 30, 2012 compared with \$12.4 million for the comparable period a year ago, an increase of \$7.7 million, or 62%. Hong Kong net sales increased \$7.2 million, or 102%, over the comparable period a year ago. The increase in Hong Kong was primarily due to new incentive programs launched at the beginning of the year surrounding our recognition program. These specific programs concluded at the end of the second quarter of 2012, but similar programs are expected to continue throughout the second half of the year.

Outside of our Hong Kong business, net sales elsewhere increased \$483,000, or 9%, over the six months ended June 30, 2012 compared with the same period in the prior year primarily due to incentive trip programs in Russia that occurred throughout the first six months of 2012, as well as the introduction of new product promotions in Russia and North America during late 2011. The North American market also benefited from increased orders received from members located in Kazakhstan and Ukraine.

As of June 30, 2012, the operating subsidiaries of the Company had approximately 21,000 active distributors, compared to 16,000 active distributors at June 30, 2011. Hong Kong experienced an increase of 5,100 active distributors, or 52%, over the same timeframe.

As of June 30, 2012, the Company had deferred revenue of approximately \$1.6 million, of which approximately \$1.4 million pertained to product sales and approximately \$203,000 pertained to unamortized enrollment package revenue.

Gross Profit

Gross profit was 73.7% of net sales for the three months ended June 30, 2012 compared with 72.6% of net sales for the three months ended June 30, 2011. The margin increase is attributable to less importation costs as a percentage of overall net sales, which occurs when the Hong Kong market sales increase at a faster rate than the more costly Russian market. Also, the percentage increase was partially due to lower fees paid to our third-party logistics provider in Russia due to a rate reduction effective in June 2011.

Gross profit was 73.7% of net sales for the six months ended June 30, 2012 compared with 71.7% of net sales for the six months ended June 30, 2011. The margin increase for the six month period was also mainly due to, as described above, less importation costs as a percentage of overall net sales and less fees paid to our third-party logistics provider in Russia.

Distributor Commissions

Distributor commissions were 44.5% and 42.7% of net sales for each of the three and six month periods ended June 30, 2012, respectively, compared with 37.6% and 36.2% of net sales for each of the three and six month periods ended June 30, 2011, respectively. The increase as a percent of net sales can be largely attributable to the monetization of and promotions surrounding the recognition program in Hong Kong that commenced during the fourth quarter of 2011, as well as an overall increase in payout in the Hong Kong and Russian markets.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$2.3 million for the three months ended June 30, 2012 compared with \$1.8 million for the comparable period a year ago. Selling, general and administrative expenses increased by \$477,000, or 26%, mainly due to the following:

- increased credit card fees and assessments of \$89,000 due to the increase in sales over the comparable period a year ago;
- higher employee-related costs totaling \$191,000 primarily resulting from employee incentive programs; and

- the impact of agreements with vendors to settle outstanding amounts at \$209,000 less than carrying value during the three month period in the prior year.

Selling, general and administrative expenses were \$4.8 million for the six months ended June 30, 2012 compared with \$3.9 million for the comparable period a year ago. Selling, general and administrative expenses increased by \$884,000, or 23%, mainly due to the following:

- increased audit-related costs totaling \$114,000 as, unlike the audits for fiscal 2010, both the corporate and Hong Kong statutory audits for fiscal 2011 occurred during the first quarter;
- increased credit card fees and assessments of \$173,000 due to the increase in sales over the comparable period a year ago;
- higher employee-related costs totaling \$424,000 primarily resulting from employee incentive programs and travel; and
- the net impact of agreements with vendors and other credits to settle outstanding amounts amounting to \$145,000 less than carrying value during the six month period in the prior year.

Other Income (Expense), Net

Loss on foreign exchange was \$64,000 for the six months ended June 30, 2012 due to impact of strengthening currencies (against the U.S. dollar) earlier in the year on inter-company balances, namely the European euro and Russian ruble. The Company took certain steps during the second quarter to mitigate its exposure to the European euro going forward. Loss on foreign exchange totaling \$73,000 was similarly incurred during the comparable period in the prior year.

Income Taxes

An income tax provision of \$45,000 and \$26,000 was recorded during the three and six months ended June 30, 2012, respectively, related to the Company's operations outside the United States. The Company did not recognize a tax benefit for U.S. tax purposes due to uncertainty that the benefit will be realized.

As stated above, in 2011, the Company's 10th Anniversary celebration in Hong Kong may have deferred or pulled forward more orders into the late second and early third quarters. In 2012, new incentive programs launched at the beginning of the year were effective in generating orders during the first and second quarters. As such, for year-on-year evaluation, we believe that a year-to-date comparison with the comparable periods a year ago through June and September may be more indicative of our business trend, profitability and income per share.

Liquidity and Capital Resources

In 2007 through early 2011, the Company supplemented its working capital and capital expenditure needs with capital raised from several private placements and advances from a director.

On May 4, 2007, the Company consummated a private equity placement generating gross proceeds of approximately \$3.0 million. The May 2007 financing consisted of the sale of 1,759,307 shares of the Company's Series A convertible preferred stock and the sale of warrants evidencing the right to purchase 1,759,307 shares of the Company's common stock. As partial consideration for placement agency services, the Company issued warrants evidencing the right to purchase an additional 300,000 shares of the Company's common stock to the placement agent that assisted in the financing. The warrants are exercisable at any time during the period beginning November 4, 2007 (six months after their issuance) and ending May 4, 2013 (six years after their issuance). The exercise price of the warrants is \$5.00 per share.

On October 19, 2007, the Company raised gross proceeds of \$3.7 million in a private placement of variable rate convertible debentures having an aggregate face amount of \$4,250,000, seven-year warrants to purchase 1,495,952 shares of the Company's common stock, and one-year warrants to purchase 1,495,952 shares of the Company's common stock. The debentures were redeemed on August 10, 2009. The warrants are exercisable beginning six months and one day after their respective issuance and have an exercise price of \$3.52 per share. The placement agent and its assigns also received five-year warrants to purchase 149,595 shares of the Company's common stock at an exercise price of \$3.52 per share. Such one-year warrants expired unexercised on April 21, 2009.

At June 30, 2012, the Company's cash and cash equivalents totaled approximately \$4.6 million. Total cash and cash equivalents increased by \$3.0 million from December 31, 2011 to June 30, 2012.

At June 30, 2012, the ratio of current assets to current liabilities was 0.79 to 1.00 and the Company had a working capital deficit of approximately \$1.8 million. Current liabilities included deferred revenue of \$1.6 million that consisted of unamortized enrollment package revenues and unshipped orders. The ratio of current assets to current liabilities, excluding deferred revenue, was 0.98 to 1.00. Working capital as of June 30, 2012 increased \$1.3 million

compared to the Company's working capital as of December 31, 2011, due to cash generated from operations.

Cash provided by operations for the first six months of 2012 was \$2.6 million compared to \$583,000 in the comparable period of 2011. The increase in operating cash flows resulted primarily from the net sales increase over the same period in the prior year.

Cash provided by investing activities for the first six months of 2012 was \$429,000, which resulted from a \$494,000 decrease in restricted cash. In April 2010, the Company's primary credit card processing company required that the Company gradually increase to and maintain a reserve balance at \$500,000. The Company reached the necessary reserve requirement during the second quarter of 2011. One-half of the reserve balance was returned to the Company in January 2012 and the remainder was returned in May 2012.

No financing activities occurred during the first six months of 2012. Cash provided by financing activities during first six months of 2011 was \$233,000. George Broady, a director of the Company and owner of more than 5% of its outstanding common stock, advanced \$2,500 on January 13, 2011, and \$30,000 on March 14, 2011 to settle certain claims against the Company. The aggregate amount of these advances, plus a \$4,000 advance on December 17, 2010, totaling \$36,500 was repaid on August 8, 2011. Additionally, Mr. Broady advanced \$100,000 to the Company on February 28, 2011 and an additional \$100,000 on March 14, 2011. The Company agreed to pay Mr. Broady interest of 9% per annum on the aggregate amount of these advances. The Company repaid Mr. Broady in full, plus accumulated interest, during the third and fourth quarters of 2011.

The Company believes that its existing internal liquidity, supported by cash on hand and cash flows from operations should be adequate to fund normal business operations and address its financial commitments for at least the next 12 months, assuming no significant unforeseen expense or revenue decline. If the Company's foregoing beliefs or assumptions prove to be incorrect, however, the Company's business, results of operations and financial condition could be materially adversely affected.

The Company does not have any significant unused sources of liquid assets. Potentially the Company might receive additional external funding if currently outstanding warrants are exercised. Furthermore, if necessary, the Company may attempt to generate more funding from the capital markets, but currently does not believe that will be necessary.

We do not intend to devote material resources to opening any additional foreign markets in the near future. Our priority is to focus our resources in our most promising markets, which we consider to be Greater China and certain CIS countries, namely Russia and Kazakhstan.

Critical Accounting Policies and Estimates

The Company has identified certain policies and estimates that are important to the portrayal of its financial condition and results of operations. Critical accounting policies and estimates are defined as both those that are material to the portrayal of our financial condition and results of operations and as those that require management's most subjective judgments. These policies and estimates require the application of significant judgment by the Company's management.

The most significant accounting estimates inherent in the preparation of the Company's financial statements include estimates associated with obsolete inventory and the fair value of acquired intangible assets, including goodwill, as well as those used in the determination of liabilities related to sales returns and income taxes. Various assumptions and other factors prompt the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account historical experience and current and expected economic conditions. The actual results may differ materially and adversely from the Company's estimates. To the extent that there are material differences between the estimates and actual results, future results of operations will be affected. The Company's critical accounting policies at June 30, 2012 include the following:

Inventory Valuation. The Company reviews its inventory carrying value and compares it to the net realizable value of its inventory and any inventory value in excess of net realizable value is written down. In addition, the Company reviews its inventory for obsolescence and any inventory identified as obsolete is reserved or written off. The Company's determination of obsolescence is based on assumptions about the demand for its products, product expiration dates, estimated future sales, and management's future plans. Also, if actual sales or management plans are less favorable than those originally projected by management, additional inventory reserves or write-downs may be required. At December 31, 2011 and June 30, 2012, the Company's inventory value was \$1.1 million and \$1.3 million, respectively, net of reserves of \$43,000 and \$104,000, respectively. No significant provision was recorded during the periods presented.

Valuation of Goodwill and Other Intangible Assets. In accordance with accounting principles generally accepted in the United States of America, the value of indefinite-lived intangible assets and residual goodwill is not amortized, but is tested at least annually for impairment. Our impairment testing for goodwill is performed separately from our impairment testing of indefinite-lived intangibles. During the fourth quarter of 2011, the Company early adopted new guidance which simplifies the goodwill impairment test by allowing the option to first assess qualitative factors in order to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, through this qualitative assessment, the conclusion is made that it is more likely than not that a reporting unit's fair value is less than its carrying amount, a two-step impairment test is performed. We test individual

indefinite-lived intangibles by reviewing the individual book values compared to the fair value. The Company's policy is to test for impairment annually during the fourth quarter. At December 31, 2011 and June 30, 2012, goodwill of approximately \$1.8 million was reflected on the Company's balance sheet. No impairment of goodwill or intangible assets was recognized during the periods presented.

Allowance for Sales Returns. An allowance for sales returns is provided during the period the product is shipped. The allowance is based upon the return policy of each country, which varies from 14 days to one year, and their historical return rates, which range from approximately 1% to 4% of sales. Sales returns were approximately 2% of sales for each of the six month periods ended June 30, 2011 and 2012. The allowance for sales returns was approximately \$205,000 and \$195,000 at December 31, 2011 and June 30, 2012, respectively. No material changes in estimates have been recognized during the periods presented.

Revenue Recognition. Product sales are recorded when the products are shipped and title passes to independent distributors. Product sales to distributors are made pursuant to a distributor agreement that provides for transfer of both title and risk of loss upon our delivery to the carrier that completes delivery to the distributors, which is commonly referred to as "F.O.B. Shipping Point." The Company primarily receives payment by credit card at the time distributors place orders. The Company's sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return. Amounts received for unshipped product are recorded as deferred revenue. Such amounts totaled \$776,000 and \$1.4 million at December 31, 2011 and June 30, 2012, respectively. Shipping charges billed to distributors are included in net sales. Costs associated with shipments are included in cost of sales.

Enrollment package revenue, including any nonrefundable set-up fees, is deferred and recognized over the term of the arrangement, generally twelve months. Enrollment packages provide distributors access to both a personalized marketing website and a business management system. No upfront costs are deferred as the amount is nominal. At December 31, 2011 and June 30, 2012, enrollment package revenue totaling \$191,000 and \$203,000 was deferred, respectively. Although the Company has no immediate plans to significantly change the terms or conditions of enrollment packages, any changes in the future could result in additional revenue deferrals or could cause us to recognize the deferred revenue over a longer period of time.

Tax Valuation Allowance. The Company evaluates the probability of realizing the future benefits of any of its deferred tax assets and records a valuation allowance when it believes a portion or all of its deferred tax assets may not be realized. The Company increased the valuation allowance to equal its net deferred tax assets during 2005 due to the uncertainty of future operating results. The valuation allowance will be reduced at such time as management believes it is more likely than not that the deferred tax assets will be realized. During each of the six month periods ended June 30, 2011 and 2012, no such reduction in the valuation allowance occurred. Any reductions in the valuation allowance will reduce future income tax provisions.

Provision for income taxes depends on the statutory tax rates in each of the jurisdictions in which we operate. We believe that we operate in compliance with all applicable transfer pricing laws and we intend to continue to operate in compliance with such laws. However, there can be no assurance that we will continue to be found to be operating in compliance with transfer pricing laws, or that those laws would not be modified, which, as a result, may require changes in our operating procedures. If the United States Internal Revenue Service or the taxing authorities of any other jurisdiction were to successfully challenge these agreements, plans, or arrangements, or require changes in our transfer pricing practices, we could be required to pay higher taxes, interest and penalties, and our earnings would be adversely affected.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable under smaller reporting company disclosure rules.

Item 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Management, with the participation of the Company's principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of June 30, 2012. The Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and

forms, and that such information is accumulated and communicated to management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, the principal executive officer and principal financial officer concluded that, as of June 30, 2012, the Company's disclosure controls and procedures were effective.

Changes in Internal Control over Financial Reporting

There were no changes in internal control over financial reporting that occurred during the fiscal quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

None.

Item 1A. RISK FACTORS

Not applicable under smaller reporting company disclosure rules.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

Item 5. OTHER INFORMATION

On August 13, 2012, the Company’s board of directors authorized the Company, acting as trustee for certain of its distributors, to execute a Rule 10b5-1 plan to purchase up to \$60,000 of its common stock (less commissions and other transaction costs) in accordance with guidelines specified under Rule 10b5-1 of the Securities Exchange Act of 1934 and the Company's policies regarding stock transactions (the “Distributor Plan”). On that same date, the Company’s board of directors authorized the Company, acting as trustee for certain of its employees, to execute a Rule 10b5-1 plan to purchase 100,000 shares of its common stock in accordance with guidelines specified under Rule 10b5-1 of the Securities Exchange Act of 1934 and the Company's policies regarding stock transactions (the “Employee Plan”). A plan under Rule 10b5-1 allows a company or an insider to purchase the company’s shares at times when it otherwise might be prevented from doing so under insider trading laws or because of self-imposed trading blackout periods. A broker selected by the Company will have the authority under the terms and limitations specified in the plan to purchase shares in accordance with the terms of the plan. The purchases are subject to SEC regulations as well as certain price, market volume and timing constraints specified in the plan. The Company may terminate the plan at any time. The distributors for whom the Company will purchase the stock as trustee under the Distributor Plan will receive the stock as compensation under a special incentive plan offered to certain distributors who are not citizens or residents of the United States. The employees for whom the Company will purchase stock as trustee under the Employee Plan will receive the stock as incentive compensation in quarterly increments over three years beginning March 15, 2013, provided that they are employees of the Company on the date of the distribution. Any stock that is purchased under the Employee Plan that is forfeited by an employee whose employment terminates will be delivered to the Company and held by it as treasury stock.

Item 6. EXHIBITS

Exhibit
Number

Exhibit Description

- 31.1 Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certifications of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS** XBRL Instance
- 101.SCH** XBRL Taxonomy Extension Schema
- 101.CAL** XBRL Taxonomy Extension Calculation
- 101.DEF** XBRL Taxonomy Extension Definition
- 101.LAB** XBRL Taxonomy Extension Labels
- 101.PRE** XBRL Taxonomy Extension Presentation

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NATURAL HEALTH TRENDS CORP.

Date: August 13, 2012

/s/ Timothy S. Davidson
Timothy S. Davidson
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

EXHIBIT INDEX

| Exhibit Number | Exhibit Description |
|-------------------|---|
| 31.1 | Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certifications of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS** | XBRL Instance |
| 101.SCH** | XBRL Taxonomy Extension Schema |
| 101.CAL** | XBRL Taxonomy Extension Calculation |
| 101.DEF** | XBRL Taxonomy Extension Definition |
| 101.LAB** | XBRL Taxonomy Extension Labels |
| 101.PRE** | XBRL Taxonomy Extension Presentation |