

Edgar Filing: NATURAL HEALTH TRENDS CORP - Form 10QSB

NATURAL HEALTH TRENDS CORP  
Form 10QSB  
November 19, 2003

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For Quarter Ended September 30, 2003

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: 0-25238

NATURAL HEALTH TRENDS CORP.

(Exact Name of Small Business Issuer as Specified in its Charter)

|   |   |
|---|---|
| Florida   | 59-2705336                              |
| State or other jurisdiction of<br>incorporation or organization | (I.R.S. Employer<br>Identification No.) |

12901 Hutton Drive  
Dallas, Texas 75234  
(Address of Principal Executive Office) (Zip Code)

(972) 241-4080  
(Issuer's telephone number including area code)

Indicate by check mark whether the issuer (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 and (2) has been  
subject to such filing requirements for the past 90 days.

Yes  No

The number of shares of issuer's Common Stock, \$.001 par value,  
outstanding as of November 19, 2003 were 4,656,408 shares.

NATURAL HEALTH TRENDS CORP.

FORM 10-QSB

For Quarter Ended September 30, 2003

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NATURAL HEALTH TRENDS CORP.

CONSOLIDATED BALANCE SHEET

(UNAUDITED)

September 30,  
2003  
-----

ASSETS

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|  |               |
|--|---------------|
| Current Assets:  |               |
| Cash   | \$ 4,086,437  |
| Accounts receivable  | 1,482,887     |
| Inventories  | 4,102,266     |
| Prepaid expenses and other current assets  | 769,734       |
| Restricted cash  | 1,179,728     |
|  | -----         |
| Total Current Assets   | 11,621,052    |
|  |               |
| Property and equipment, net  | 860,611       |
| Deposits and other assets  | 928,658       |
| Goodwill   | 207,765       |
| Database   | 792,581       |
| Website  | 22,167        |
|  | -----         |
| Total Assets   | \$ 14,432,834 |
|  | =====         |
| LIABILITIES AND STOCKHOLDERS' EQUITY   |               |
| Current Liabilities:   |               |
| Accounts payable   | \$ 2,310,114  |
| Accrued expenses   | 952,918       |
| Accrued associate commissions  | 1,544,908     |
| Notes payable  | 275,051       |
| Current portion of long term debt  | 90,147        |
| Income tax payable   | 1,800,322     |
| Deferred revenue   | 2,048,837     |
| Other current liabilities  | 206,605       |
|  | -----         |
| Total Current Liabilities  | 9,228,902     |
|  | -----         |
|  |               |
| Long term debt   | 39,864        |
|  | -----         |
| Total Liabilities  | 9,268,766     |
|  |               |
| Minority interest  | 772,090       |
|  |               |
| Stockholders' Equity:  |               |
| Preferred stock (\$1,000 par value; authorized 1,500,000 shares; issued and outstanding shares are zero) | --            |
| Common stock (\$.001 par value; authorized 500,000,000 shares; issued and outstanding 4,656,408 shares)  | 4,656         |
| Additional paid in capital   | 32,647,500    |
| Accumulated deficit  | (28,307,660)  |
| Accumulated other comprehensive income   | 47,482        |
|  | -----         |
| Total Stockholders' Equity   | 4,391,978     |
|  | -----         |
|  |               |
| Total Liabilities and Stockholders' Equity   | \$ 14,432,834 |
|  | =====         |

The accompanying notes are an integral part of these consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

|   | Three Months Ended<br>September 30, |                     | Nine Months Ended<br>September 30, |                     |
|---|-------------------------------------|---------------------|------------------------------------|---------------------|
|   | 2003                                | 2002<br>As Restated | 2003                               | 2002<br>As Restated |
| Net sales                                       | \$ 16,739,765                       | \$ 10,840,365       | \$ 39,356,027                      | \$ 24,555,530       |
| Cost of sales                                   | 3,671,037                           | 1,995,547           | 7,449,727                          | 4,415,042           |
| Gross profit                                    | 13,068,728                          | 8,844,818           | 31,906,300                         | 20,140,488          |
| Associate commissions                           | 6,988,233                           | 4,665,503           | 16,039,575                         | 12,412,739          |
| Selling, general and<br>administrative expenses | 4,132,870                           | 2,878,837           | 10,982,699                         | 7,216,289           |
| Operating income                                | 1,947,625                           | 1,300,478           | 4,884,026                          | 511,460             |
| Minority interest in<br>subsidiary              | (22,112)                            | (35,161)            | (45,343)                           | (95,539)            |
| Gain (loss) on foreign<br>currency              | (87,754)                            | 45,113              | (99,246)                           | (33,758)            |
| Other income, net                               | (26,913)                            | 205,222             | (37,717)                           | 528,753             |
| Interest expense, net                           | (34,546)                            | (11,729)            | (54,722)                           | (44,338)            |
| Net income before taxes                         | 1,776,300                           | 1,503,923           | 4,646,998                          | 866,578             |
| Income tax expense                              | 500,000                             | --                  | 1,200,322                          | --                  |
| Net income                                      | 1,276,300                           | 1,503,923           | 3,446,676                          | 866,578             |
| Preferred stock dividends                       | --                                  | 19,313              | 810                                | 60,773              |
| Net income to common<br>stockholders            | \$ 1,276,300                        | \$ 1,484,610        | \$ 3,445,866                       | \$ 805,805          |
| Basic income per common<br>share                | \$ 0.27                             | \$ 0.49             | \$ 0.75                            | \$ 0.28             |
| Basic weighted common<br>shares used            | 4,656,408                           | 3,049,246           | 4,589,516                          | 2,897,142           |

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|                                     |           |           |           |           |
|-------------------------------------|-----------|-----------|-----------|-----------|
| Diluted income per common share     | \$ 0.22   | \$ 0.49   | \$ 0.61   | \$ 0.28   |
|                                     | =====     | =====     | =====     | =====     |
| Diluted weighted common shares used | 5,751,697 | 3,058,679 | 5,684,805 | 2,906,576 |
|                                     | =====     | =====     | =====     | =====     |

The accompanying notes are an integral part of these consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

|  | Three Months Ended<br>September 30, |                     | Nine Months Ended<br>September 30, |                     |
|--|-------------------------------------|---------------------|------------------------------------|---------------------|
|  | 2003                                | 2002<br>As Restated | 2003                               | 2002<br>As Restated |
|  | -----                               | -----               | -----                              | -----               |
| Net income                               | \$ 1,276,300                        | \$ 1,503,923        | \$ 3,446,676                       | \$ 866,578          |
| Other comprehensive income, net of tax:  |                                     |                     |                                    |                     |
| Foreign currency translation adjustments | 41,611                              | 96,328              | 57,048                             | 155,985             |
|  | -----                               | -----               | -----                              | -----               |
| Comprehensive income                     | \$ 1,317,911                        | \$ 1,600,251        | \$ 3,503,724                       | \$ 1,022,563        |
|  | =====                               | =====               | =====                              | =====               |

The accompanying notes are an integral part of these consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

|                                       | Nine Months Ended<br>September 30, |                     |
|---------------------------------------|------------------------------------|---------------------|
|                                       | 2003                               | 2002<br>As Restated |
|                                       | -----                              | -----               |
| CASH FLOWS FROM OPERATING ACTIVITIES: |                                    |                     |
| Net income                            | \$ 3,446,676                       | \$ 866,578          |
|                                       | -----                              | -----               |

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|   |              |              |
|---|--------------|--------------|
| Adjustments to reconcile net income to net cash provided by operating activities: |              |              |
| Depreciation and amortization   | 467,198      | 289,876      |
| Stock issued for compensation   | 50,263       | 285,472      |
| Minority interest of subsidiary   | 45,343       | 95,539       |
| Changes in operating assets and liabilities:                                      |              |              |
| Accounts receivable   | (963,135)    | (339,411)    |
| Inventories   | (948,642)    | (962,228)    |
| Prepaid expenses and other current assets   | 390,212      | (110,598)    |
| Deposits and other assets   | (597,052)    | (469,174)    |
| Accounts payable and accrued expenses   | (594,526)    | 2,832,671    |
| Income tax payable  | 1,200,322    | --           |
| Deferred revenue  | (442,415)    | 1,540,315    |
| Other current liabilities   | (146,437)    | 323,015      |
|   | -----        | -----        |
| Total Adjustments   | (1,538,869)  | 3,485,477    |
|   | -----        | -----        |
| NET CASH PROVIDED BY OPERATING ACTIVITIES   | 1,907,807    | 4,352,055    |
|   | -----        | -----        |
| CASH FLOWS FROM INVESTING ACTIVITIES:   |              |              |
| Capital expenditures  | (449,392)    | (364,031)    |
| Database purchase   | (162,581)    | --           |
| Increase in restricted cash   | (851,843)    | (147,918)    |
|   | -----        | -----        |
| NET CASH USED IN INVESTING ACTIVITIES   | (1,463,816)  | (511,949)    |
|   | -----        | -----        |
| CASH FLOWS FROM FINANCING ACTIVITIES:   |              |              |
| Investments by minority interest owner  | --           | 135,714      |
| Payments of notes payable and long-term debt                                      | (278,548)    | (32,137)     |
|   | -----        | -----        |
| NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES                               | (278,548)    | 103,577      |
|   | -----        | -----        |
| Effect of exchange rate changes on cash   | 57,048       | 155,985      |
| NET INCREASE IN CASH  | 222,491      | 4,099,668    |
| CASH, BEGINNING OF PERIOD   | 3,863,946    | 324,315      |
|   | -----        | -----        |
| CASH, END OF PERIOD   | \$ 4,086,437 | \$ 4,423,983 |
|   | =====        | =====        |

The accompanying notes are an integral part of these consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NINE MONTHS ENDED SEPTEMBER 30, 2003

(UNAUDITED)

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### 1. Basis of Presentation

We are Natural Health Trends Corp. ("NHTC"), an international direct-selling company. We operate through our subsidiaries that distribute products to promote health, wellness and vitality. Lexxus International, Inc., our majority-owned subsidiary and other Lexxus subsidiaries (collectively, "Lexxus"), sell certain cosmetic products as well as "quality of life" products. eKaire.com, Inc., our wholly-owned subsidiary ("eKaire"), distributes nutritional supplements aimed at general health and wellness.

The accompanying unaudited financial statements of Natural Health Trends Corp. and its subsidiaries (the "Company") have been prepared in accordance with accounting principles generally accepted in the USA for interim financial information and with instructions to Form 10-QSB and Article 10 of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the USA for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation (consisting of normal recurring accruals) of financial position and results of operations for the interim periods have been presented. Operating results for the three and nine months ended September 30, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003, or any other interim period, and the Company makes no representation related thereto. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual report on Form 10-KSB for the year ended December 31, 2002.

### 2. Restatement of Previously Issued Financial Statements

During the quarter ended September 30, 2003, the Company re-evaluated its prior accounting treatment for administrative enrollment fees received from distributors under the principles contained in Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements", ("SAB 101") and related guidance. The Company determined that under SAB 101 such fees actually received and recorded as current sales in prior quarters should have been deferred and recognized as revenue on a straight-line basis over the twelve-month term of the membership. The restatement resulted in net sales for the three and nine-month periods ended September 30, 2002 being decreased by approximately \$156,000 and \$1,537,000, respectively. The restatement in net sales resulted in a corresponding adjustment to cost of sales for direct costs paid to a third party associated with the administrative enrollment fees received from distributors. Compared to amounts previously reported, the restatement decreased cost of sales by approximately \$115,000 and \$324,000 for the three and nine-month periods ended September 30, 2002, respectively.

In addition, the Company reviewed the adequacy of its reserves for distributor returns and refunds as of September 30, 2003 and for comparative prior periods. Based upon an analysis of the Company's historical returns and refund trends by country, it was determined that the reserves for returns and refunds for prior quarters were not adequate and should be restated. The restatement resulted in net sales for the three and nine-month periods ended September 30, 2002 being decreased by approximately \$88,000 and \$262,000, respectively, with corresponding adjustments to cost of sales for the estimated cost of products returned.

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Company sold in 2001 all of the outstanding common stock in Kaire Nutraceuticals, Inc. ("Kaire"), a Delaware corporation and wholly-owned subsidiary, to a third party. The gain on the sale of Kaire of approximately \$3.1 million was previously deferred. The Company subsequently recognized into income approximately \$1.9 million from the transaction over the period from Q4 2001 through Q2 2003. Based upon a review of the transaction, the Company now believes the gain on sale of Kaire should have been recognized only in 2001 and 2002. There is no impact of this restatement for the three or nine months ended September 30, 2002.

The Company disclosed in it's 2002 Form 10-KSB that it had a net operating loss carry forward at December 31, 2002 of approximately \$6,000,000, subject to certain limitations. Consequently, the Company made no provision for income taxes for any period in either 2001 or 2002. Upon further review, it has been determined that the available net operating loss is not expected to be sufficient to offset all of the taxable income in 2002 and 2003 and that an estimated income tax provision in the amount of \$600,000 and \$1,200,000 is necessary for the year ended December 31, 2002 and the nine months ended September 30, 2003, respectively. There is, however, no impact of this restatement for the three or nine months ended September 30, 2002.

The following table presents amounts from operations as previously reported and as restated (in thousands, except for per share data):

|  | Three Months Ended<br>September 30, 2002 |                | Nine Months Ended<br>September 30, 2002 |                |
|--|--|----------------|---|----------------|
|  | As<br>Previously<br>Reported             | As<br>Restated | As<br>Previously<br>Reported            | As<br>Restated |
| Net sales  | \$ 11,084                                | \$ 10,840      | \$ 26,355                               | \$ 24,000      |
| Cost of sales  | 2,128                                    | 1,995          | 4,792                                   | 4,000          |
| Gross profit   | 8,956                                    | 8,845          | 21,563                                  | 20,000         |
| Operating expenses   | 7,544                                    | 7,544          | 19,630                                  | 19,000         |
| Operating income   | 1,412                                    | 1,301          | 1,933                                   |                |
| Interest expense, other income,<br>loss on foreign exchange and gain on<br>discontinued operations | 203                                      | 203            | 355                                     |                |
| Net income   | 1,615                                    | 1,504          | 2,288                                   |                |
| Preferred stock dividends  | 19                                       | 19             | 61                                      |                |
| Net income available to common<br>stockholders   | \$ 1,596                                 | \$ 1,485       | \$ 2,227                                | \$ 2,000       |
| Basic income per share   | \$ 0.52                                  | \$ 0.49        | \$ 0.77                                 | \$ 0.70        |
| Basic weighted common share used   | 3,049                                    | 3,049          | 2,897                                   | 2,857          |



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|                                     |    |       |    |       |    |       |    |       |
|-------------------------------------|----|-------|----|-------|----|-------|----|-------|
| Diluted income per share            | \$ | 0.52  | \$ | 0.49  | \$ | 0.77  | \$ | 0     |
|                                     |    | ===== |    | ===== |    | ===== |    | ===== |
| Diluted weighed commons shares used |    | 3,059 |    | 3,059 |    | 2,907 |    | 2,    |
|                                     |    | ===== |    | ===== |    | ===== |    | ===== |

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Basic and Diluted Income per share:

The adjustments in net sales and cost of sales resulted in a net decrease in net income available to stockholders of approximately \$111,000 and \$1,421,000 over the amounts previously reported for the three and nine months ended September 30, 2002, respectively. Restated basic and diluted income per share decreased \$0.03 and \$0.49 for the three and nine months ended September 30, 2002, respectively.

### 3. Principles of Consolidation and Accounting Policies

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

#### Reclassifications

Certain reclassifications were made to the prior year financial statements to conform to the current year presentation.

#### Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the USA requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### Revenue Recognition

The Company's revenues are primarily derived from sales of products, sales of starter and renewal administrative enrollment packs and shipping fees. Substantially all product sales are sales to associates at published wholesale prices. The Company defers a portion of its revenue from the sale of its starter and renewal packs related to its administrative enrollment fee. The Company amortizes its deferred revenue and its associated direct costs over twelve months, the term of the membership. Total deferred revenue for the Company was approximately \$2.0 million as of September 30, 2003.

The Company also estimates and records a sales return reserve for possible sales refunds based on historical experience.

#### Shipping and Handling Costs

The Company records freight and shipping revenues collected from associates as revenue. The Company records shipping and handling costs associated with shipping products to its associates as cost of goods sold.

#### Earnings Per Share

Basic earnings per share is computed based on the weighted average number

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of common shares outstanding during the periods presented. Diluted earnings per share data gives effect to all potentially dilutive common shares that were outstanding during the periods presented.

### 4. Recent Accounting Pronouncements

FASB Interpretation No. 45. In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45). FIN 45 requires that upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 also requires additional disclosures by a guarantor in its interim and annual financial statements about the obligations associated with guarantees issued. The recognition provisions

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of FIN 45 are effective for any guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002. The adoption of FIN 45 did not have a material effect on the Company's financial position, results of operations, or cash flows.

FASB Interpretation No. 46. In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities." Interpretation 46 changes the criteria by which one company includes another entity in its consolidated financial statements. Previously, the criteria was based on control through voting interest. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. A company that consolidates a variable interest entity is called the primary beneficiary of that entity. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after December 31 2003. The adoption of this statement did not have a material impact to the Company's financial position or results of operations.

SFAS 149. In April 2003, FASB issued Statements of Financial Accounting Standards No. 149 ("SFAS 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS 149 amends SFAS 133 "Accounting for Derivatives Instruments and Hedging Activities" and the related implementation guidance and is effective for contracts entered into or modified after June 30, 2003, except for hedging relationships designated after June 30, 2003. SFAS 149 clarifies the definition of a derivative and amends the financial accounting and reporting required for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. In addition, SFAS 149 improves the financial reporting requirements by requiring a more consistent reporting of contracts as either derivatives or hybrid instruments. The adoption of this standard did not have a significant impact on the Company's financial condition, results of operations, or cash flows.

SFAS 150. In May 2003, FASB issued Statement of Financial Accounting Standards No. 150 ("SFAS 150"), "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS 150 broadens the definition of financial instruments and establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS 150 also requires that an issuer classify a financial instrument that is within its scope as

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a liability or as an asset. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the first interim period beginning after June 15, 2003. SFAS 150 is to be implemented by reporting the cumulative effect of any change in accounting principle at the beginning of the period adopted. The adoption of SFAS 150 is not expected to have a significant impact on the Company's financial condition, results of operations, or cash flows.

### 5. Segment Information

The Company operates in a single reportable operating segment by selling products to a global network of independent distributors who operate in a seamless manner from market to market. The Company's largest expense is the commissions paid on product sales through this distributor network. The Company manages its business primarily by managing this global distributor network. However, the Company does recognize revenue from sales to distributors in thirty countries. The Company's chief operating decision makers review both geographic and product line information. The Company has operations throughout the world (30 countries as of September 30, 2003) and is organized and managed by geographic areas. Information reviewed by the Company's chief operating decision makers on significant geographic segments, as defined under SFAS 131, is prepared on the same basis as the consolidated financial statements.

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### 6. Equity Transactions

In January 2003, the Company issued 18,500 shares of Common Stock to a law firm for legal services of approximately \$34,000.

In January 2003, the Company issued 10,000 shares of Common Stock to a consulting firm for consulting services of approximately \$19,000.

On January 31, 2003, the Company entered into a Database Purchase Agreement with NuEworld.com Commerce, Inc. ("NuEworld") and Lighthouse Marketing Corporation, our wholly-owned subsidiary ("Lighthouse"), pursuant to which Lighthouse purchased a database of associates from NuEworld in exchange for the issuance of 360,000 shares of our Common Stock. NuEworld was in the business of marketing and selling a variety of products and services through its direct-selling distribution network.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

The following discussions should be read in conjunction with the consolidated financial statements and notes contained in Item 1 hereof.

### Forward Looking Statements

When used in Form 10-QSB and in future filings by the Company with the Securities and Exchange Commission, the words "will likely result", "the Company expects", "will continue", "is anticipated", "estimated", "projected", "outlook" or similar expressions are intended to identify "forward looking statements" within the meaning of the Private Securities Litigation Act of 1995. The Company wishes to caution readers not to place undue reliance on such forward-looking statements, each of which speak only as of the date made. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company has no obligation to

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publicly release the results of any revisions, which may be made to any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements.

### Overview

Natural Health Trends Corp. was incorporated on December 1, 1988, in the state of Florida. NHTC is an international direct-selling company, currently operating in more than 30 markets throughout Asia, North America and Eastern Europe.

The Company markets premium quality personal care products under the Lexxus brand and markets its nutritional supplement products under the Kaire brand. NHTC's common stock, par value \$0.001 per share (the "Common Stock"), is listed on the OTC Bulletin Board (the "OTCBB"). In March 2003, we effected a 1-for-100 reverse stock split with respect to our outstanding shares of Common Stock. In addition, the trading symbol for the shares of our Common Stock changed from "NHTC" to "NHLC".

NHTC is a holding company that operates two businesses, Lexxus and eKaire, which distribute products that promote health, wellness and vitality through two distinct multi-level marketing ("MLM") channels. The following paragraphs will outline the progression of NHTC as it is organized today.

In February 1999, NHTC Holdings Inc. acquired certain assets (the "Kaire Assets") of Kaire International, Inc., a Delaware corporation ("KII"). The assets included, but not limited to, the corporate name, all variations and any other product names, registered and unregistered trademarks, tradenames, servicemarks, patents, logos and copyrights of KII, and independent associate lists.

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In January 2001, NHTC entered into a joint venture with Lexxus International and formed a new majority-owned subsidiary, Lexxus International, Inc., a Delaware corporation. The original founders of Lexxus International received an aggregate of 100,000 shares of our Common Stock and own 49% of the total number of shares of capital stock of Lexxus International, Inc.

In the second quarter of 2001, we incorporated Lexxus International (SW Pacific) Pty. Ltd., an Australian corporation and our majority-owned subsidiary, which does business in Australia ("Lexxus Australia"). In addition, we incorporated Lexxus International (New Zealand) Limited, a New Zealand corporation and majority-owned subsidiary of NHTC, which does business in New Zealand ("Lexxus New Zealand").

In June 2001, we incorporated Lighthouse Marketing Corporation ("Lighthouse"), a Delaware Corporation and our wholly-owned subsidiary. As of January 31, 2003, Lighthouse acquired certain assets from NuEworld. See Footnote 6 for more detail.

In June 2001, we sold all of the outstanding Common Stock in Kaire Nutraceuticals, Inc., a Delaware corporation, to a South African firm.

In November 2001, we incorporated Lexxus International Co., Ltd., a corporation organized under the laws of the Republic of China and our majority-owned subsidiary ("Lexxus Taiwan") which does business in Taiwan.

In January 2002, we incorporated MyLexxus Europe AG, a corporation organized under the laws of Switzerland and our majority-owned subsidiary ("MyLexxus Europe"). This company manages the sales of product into sixteen

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eastern European countries, including Russia.

In March 2002, we incorporated Lexxus International Co., Ltd., a corporation organized under the laws of Hong Kong and our wholly-owned subsidiary ("Lexxus Hong Kong") which does business in Hong Kong.

In April 2002, we incorporated Personal Care International India Pvt. Ltd., a corporation organized under the laws of India and our wholly-owned subsidiary ("MyLexxus India") which does business in India.

In June 2002, we incorporated Lexxus International Marketing Ltd., a corporation organized under the laws of Singapore and our majority-owned subsidiary ("Lexxus Singapore"), which does business in Singapore.

In November 2002, we incorporated Lexxus International (Philippines) Inc., a corporation organized under the laws of the Philippines and our majority-owned subsidiary ("Lexxus Philippines"), which does business in the Philippines.

In June 2003, we incorporated LXX Ltd. (South Korea), a corporation organized under the laws of South Korea and our wholly-owned subsidiary ("Lexxus Korea"), which does business in South Korea.

Results of Operations - Nine Months Ended September 30, 2003 Compared To The Nine Months Ended September 30, 2002.

As discussed in Note 2 to the consolidated financial statements, we have restated our results for the three and nine-month periods ended September 30, 2002. All of the following analyses apply the basis of the restated amounts.

Net Sales. Revenues were approximately \$39,356,000 and \$24,556,000 for the nine months ended September 30, 2003 and September 30, 2002, respectively, an increase of \$14,800,000 or 60%. The increased sales were primarily from additional sales of Lexxus products, new distributors and the expansion of Lexxus into new international markets, including South Korea in June 2003. In addition, revenues increased due to the deferral of revenue related to the administrative enrollment fee of distributors, partially offset by a reserve related to sales returns and refunds and a slight decrease in the sales of eKaire products.

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Cost of Sales. Cost of sales for the nine months ended September 30, 2003 was approximately \$7,450,000 or 19% of net sales. Cost of sales for the nine months ended September 30, 2002 was approximately \$4,415,000 or 18% of net sales. The total cost of sales increased due to increased sales volume and increased costs associated with the packaging of the Lexxus product line partially offset by the deferral of the cost of sales related to the direct cost of the administrative enrollment fee of the distributors.

Gross Profit. Gross profit increased from approximately \$20,140,000 in the nine months ended September 30, 2002 to approximately \$31,906,000 in the nine months ended September 30, 2003, or an increase of 58%. The increase in gross profit of approximately \$11,766,000 was attributable to higher sales volumes by Lexxus and also attributable to the deferral of both revenue and cost of sales related to the administrative enrollment fee of distributors.

Associate Commissions. Associate commissions were approximately \$16,040,000 or 41% of sales in the nine months ended September 30, 2003 compared to approximately \$12,413,000 or 51% of sales for the nine months ended September 30, 2002. The increase of commission expense is directly related to the increase in gross sales and the terms of the Company's compensation plans. The decrease

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in commission expense as a percentage of sales is due to the normal fluctuations that occur in the compensation plan and as well as the amount of revenues allocatable to the compensation plan.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses increased from approximately \$7,216,000 or 29% of sales in the nine months ended September 30, 2002 to approximately \$10,983,000 or 28% of sales in the nine months ended September 30, 2003. These costs as a percentage of net sales decreased primarily due to the change in the revenue amounts with effect to the restatement for the administrative enrollment fee of the distributors partially offset by general and administrative costs, such as hiring staff, leasing office space and initial marketing efforts for expansion into new international markets.

**Operating income and net income.** Operating income increased from an operating income of approximately \$511,000 for the nine months ended September 30, 2002 to operating income of approximately \$4,884,000 for the nine months ended September 30, 2003. Net income was approximately \$3,447,000 for the nine months ended September 30, 2003 as compared to approximately \$867,000 for the nine months ended September 30, 2002. The increase in net income was due to increased sales and efficient cost containment efforts partially offset by a provision for income taxes.

### Liquidity and Capital Resources

The Company has historically met its working capital and capital expenditure requirements, including funding for expansion of operations, through net cash flows provided by operating activities and through sale of preferred stock. The Company's principal source of liquidity is its operating cash flows. A substantial decrease in sales of the Company's products would reduce the availability of funds.

At September 30, 2003, the ratio of current assets to current liabilities was 1.26 to 1.0 and the Company had working capital of approximately \$2,392,000.

Cash provided by operations for the nine months ended September 30, 2003 was approximately \$1,908,000 primarily due from increased sales, the launch of the Company's South Korean operations which were partially offset by increased accounts receivable, inventory and income tax payable and the reduction of accounts payable.

Cash used in investing activities for the nine months ended September 30, 2003 was approximately \$1,464,000 due to the purchase of an associate database, increased capital expenditures and an increase in restricted cash. Restricted cash represents the reserves required by the Company's credit card processor.

Cash used in financing activities for the nine months ended September 30, 2003 was approximately \$279,000. Total cash increased by approximately \$222,000 during the period.

### CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the USA. The preparation of financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenue and expenses and disclosures at the date of the financial

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statements. We evaluate our estimates on an on-going basis, including those related to revenue recognition, legal contingencies and income taxes. We use authoritative pronouncements, historical experience and other assumptions as the basis for making estimates. Actual results could differ from those estimates.

### SEASONALITY

In addition to general economic factors, we are impacted by seasonal factors and trends such as major cultural events and vacation patterns. For example, most Asian markets celebrate their respective local New Year in the first quarter, which generally has a negative impact on that quarter. We believe that direct selling in the United States and Europe is also generally negatively impacted during the month of August, which is in our third quarter, when many individuals, including our distributors, traditionally take vacations.

### CURRENCY RISK AND EXCHANGE RATE INFORMATION

Some of our revenue and some of our expenses are recognized outside of the United States, except for inventory purchases which are primarily transacted in U.S. dollars from vendors in the United States. The local currency of each of our subsidiary's primary markets is considered the functional currency. Revenue and expenses are translated at the weighted average exchange rates for the periods reported. Therefore, our reported revenue and earnings will be positively impacted by a weakening of the U.S. dollar and will be negatively impacted by a strengthening of the U.S. dollar. Given the uncertainty of exchange rate fluctuations, we cannot estimate the effect of these fluctuations on our future business, product pricing, results of operations or financial condition.

### ITEM 3. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our President and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

During the quarter ended September 30, 2003, the Company identified certain matters that resulted in the restatement of the Company's financial statements for the three and nine months ended September 30, 2002, as set forth in Note 2 to the Consolidated Financial Statements. Consistent with the foregoing, the Company intends to restate in the near future the remaining affected periods, including all quarters in 2001 and 2002 and the first and second quarters of 2003 as well as its Forms 10-KSB for the years ended December 31, 2001 and 2002.

The restatement was the result of misinterpretations of certain accounting standards and related guidance pertaining to a) revenue recognition of administrative enrollment fees, b) reserves for returns and refunds, c) a gain on sale of a subsidiary, and d) income tax provisions. Management together with the Audit Committee have identified certain improvements that they believe will result in continuing enhancements to the Company's accounting and reporting functions and their implementation is ongoing at this time.

Within ninety (90) days prior to the date of this report, the Company's President and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures. Based upon his evaluation and as a result, in part, of the matters noted above, the Company's President and Chief Financial Officer has concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1937, as amended) are effective, with the qualification that the restatements mentioned above were just recently identified and implemented for the three and nine months ended September 30, 2002. Management requires additional time to fully (i) assess their correction plan and (ii) implement appropriate enhancements to its controls and procedures, if and so warranted in the circumstances.

Since the date of his evaluation, there have been no significant changes to the Company's internal controls or other factors that could significantly affect these controls.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

On April 10, 2003, Bobby R. Porter and wife, Betty R. Porter, filed suit against Lexxus International, Inc. (a majority-owned subsidiary) and Alex Arnold (an employee of Lexxus International, Inc.) in the 170th District Court of McLennan County, Texas alleging misrepresentations made by the former owners of NuEworld.com Commerce, Inc. ("NuEworld") pertaining to a stock investment made by the plaintiffs in June 2000. The plaintiffs are seeking the sum of \$40,000, court costs and other relief. As disclosed in Note 6, the Company acquired certain assets of NuEworld in January 2003. The Company filed a motion to transfer venue in April 2003 and intends to vigorously defend itself in this case.

The Company is subject to claims and assessments from time to time in the ordinary course of business. Management does not believe that any such matters, individually or in the aggregate, will have a material adverse effect on the Company's financial condition, results of operations or cashflows.

### Item 2. Changes in Securities and Use of Proceeds

In March 2003, NHTC issued 360,000 shares of our Common Stock to NuEworld.com Commerce, Inc. pursuant to a database purchase agreement.

In January 2003, the Company issued 18,500 shares of Common Stock to a law firm for legal services of approximately \$34,000.

In January 2003, the Company issued 10,000 shares of Common Stock to a consulting firm for consulting services of approximately \$19,000.

### Item 3. Defaults Upon Senior Securities

Not applicable.

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

Not applicable.

### Item 5. Other Information



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Not applicable.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification of the President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of the President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K None.

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SIGNATURE

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.

By: /s/ MARK D. WOODBURN

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Mark D. Woodburn  
President and Chief  
Financial Officer

Date: November 19, 2003

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