

NATURAL HEALTH TRENDS CORP  
Form 10-Q  
July 29, 2014

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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, 2014

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

59-2705336

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(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) 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, 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 July 24, 2014, the number of shares outstanding of the registrant's common stock was 12,221,292 shares.

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NATURAL HEALTH TRENDS CORP.  
Quarterly Report on Form 10-Q  
June 30, 2014

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## 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 Operation,” 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 includes the following:

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 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;

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;  
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 rely on a limited number of independent third parties to manufacture and supply 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;

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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;

Because our systems, software and data reside on third-party servers, our access could be temporarily or permanently interrupted;

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;

Trading of our common stock may be volatile and sporadic, which could depress the market price of our common stock and make it difficult for our stockholders to resell their shares;

The exercise of our warrants may result in substantial dilution and may depress the market price of our common stock; and

Future sales by us or our existing stockholders could depress the market price of our 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<br>31, 2013 | June 30,<br>2014<br>(Unaudited) |
|---|----------------------|---------------------------------|
| <b>ASSETS</b>                               |                      |                                 |
| Current assets:                             |                      |                                 |
| Cash and cash equivalents                   | \$ 14,550            | \$ 29,622                       |
| Accounts receivable                         | 134                  | 109                             |
| Inventories, net                            | 1,828                | 4,321                           |
| Other current assets                        | 658                  | 754                             |
| Total current assets                        | 17,170               | 34,806                          |
| Property and equipment, net                 | 265                  | 305                             |
| Goodwill                                    | 1,764                | 1,764                           |
| Restricted cash                             | 328                  | 340                             |
| Other assets                                | 300                  | 323                             |
| Total assets                                | \$ 19,827            | \$ 37,538                       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                      |                                 |
| Current liabilities:                        |                      |                                 |
| Accounts payable                            | \$ 3,058             | \$ 4,641                        |
| Income taxes payable                        | 25                   | 111                             |
| Accrued distributor commissions             | 3,962                | 5,224                           |
| Other accrued expenses                      | 3,146                | 5,599                           |
| Deferred revenue                            | 2,569                | 3,171                           |
| Deferred tax liability                      | 108                  | 108                             |
| Other current liabilities                   | 882                  | 1,030                           |
| Total current liabilities                   | 13,750               | 19,884                          |
| Commitments and contingencies               |                      |                                 |
| Stockholders' equity:                       | 111                  | 82                              |



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|  |           |           |
|--|-----------|-----------|
| Preferred stock, \$0.001 par value; 5,000,000 shares authorized; 1,761,900 shares designated Series A convertible preferred stock, 123,693 and 91,693 shares issued and outstanding at December 31, 2013 and June 30, 2014, respectively, aggregate liquidation value of \$183 |           |           |
| Common stock, \$0.001 par value; 50,000,000 shares authorized; 11,332,771 and 12,113,392 shares issued and outstanding at December 31, 2013 and June 30, 2014, respectively  | 11        | 12        |
| Additional paid-in capital   | 80,655    | 83,284    |
| Accumulated deficit  | (74,619 ) | (65,658 ) |
| Accumulated other comprehensive loss:  |           |           |
| Foreign currency translation adjustments   | (81 )     | (66 )     |
| Total stockholders' equity   | 6,077     | 17,654    |
| Total liabilities and stockholders' equity   | \$ 19,827 | \$ 37,538 |

See accompanying notes to consolidated financial statements.

## NATURAL HEALTH TRENDS CORP.

## CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In Thousands, Except Per Share Data)

|  | Three Months<br>Ended June 30, |          | Six Months Ended<br>June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2013                           | 2014     | 2013                         | 2014     |
| Net sales  | \$10,598                       | \$34,189 | \$19,249                     | \$57,351 |
| Cost of sales  | 2,570                          | 7,509    | 4,798                        | 12,761   |
| Gross profit   | 8,028                          | 26,680   | 14,451                       | 44,590   |
| Operating expenses:  |                                |          |                              |          |
| Distributor commissions  | 4,443                          | 15,458   | 8,117                        | 25,881   |
| Selling, general and administrative expenses (including stock-based compensation expense of \$23 and \$9 during the three months ended June 30, 2013 and 2014, respectively, and \$53 and \$34 during the six months ended June 30, 2013 and 2014, respectively) | 2,609                          | 5,031    | 5,054                        | 9,378    |
| Depreciation and amortization  | 28                             | 23       | 40                           | 44       |
| Total operating expenses   | 7,080                          | 20,512   | 13,211                       | 35,303   |
| Income from operations   | 948                            | 6,168    | 1,240                        | 9,287    |
| Other income (expense), net  | (28 )                          | 1        | (21 )                        | (8 )     |
| Income before income taxes   | 920                            | 6,169    | 1,219                        | 9,279    |
| Income tax provision   | 16                             | 59       | 28                           | 98       |
| Net income   | 904                            | 6,110    | 1,191                        | 9,181    |
| Preferred stock dividends  | (4 )                           | (3 )     | (8 )                         | (7 )     |
| Net income available to common stockholders  | \$900                          | \$6,107  | \$1,183                      | \$9,174  |
| Income per common share:   |                                |          |                              |          |
| Basic  | \$0.08                         | \$0.51   | \$0.11                       | \$0.78   |
| Diluted  | \$0.08                         | \$0.49   | \$0.11                       | \$0.76   |
| Weighted-average number of common shares outstanding:  |                                |          |                              |          |
| Basic  | 11,131                         | 11,821   | 11,100                       | 11,592   |
| Diluted  | 11,269                         | 12,305   | 11,265                       | 12,050   |
| Cash dividends declared per share:   |                                |          |                              |          |
| Common   | \$-                            | \$0.005  | \$-                          | \$0.010  |
| Series A preferred stock   | \$-                            | \$0.020  | \$-                          | \$0.835  |

See accompanying notes to consolidated financial statements.



NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(In Thousands)

|  | Three Months<br>Ended June<br>30, |         | Six Months<br>Ended June 30, |         |
|--|-----------------------------------|---------|------------------------------|---------|
|  | 2013                              | 2014    | 2013                         | 2014    |
| Net income                                     | \$904                             | \$6,110 | \$1,191                      | \$9,181 |
| Other comprehensive income (loss), net of tax: |                                   |         |                              |         |
| Foreign currency translation adjustment        | 2                                 | 42      | (26 )                        | 15      |
| Comprehensive income                           | \$906                             | \$6,152 | \$1,165                      | \$9,196 |

See accompanying notes to consolidated financial statements.

## NATURAL HEALTH TRENDS CORP.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In Thousands)

|   | Six Months<br>Ended June 30, |           |
|---|------------------------------|-----------|
|   | 2013                         | 2014      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                              |           |
| Net income  | \$ 1,191                     | \$ 9,181  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |           |
| Depreciation and amortization   | 40                           | 44        |
| Stock-based compensation  | 53                           | 34        |
| Changes in assets and liabilities:  |                              |           |
| Accounts receivable   | (60 )                        | 24        |
| Inventories, net  | (183 )                       | (2,502 )  |
| Other current assets  | 110                          | (104 )    |
| Other assets  | (1 )                         | (16 )     |
| Accounts payable  | 242                          | 1,586     |
| Income taxes payable  | 28                           | 86        |
| Accrued distributor commissions   | 483                          | 1,268     |
| Other accrued expenses  | 382                          | 2,466     |
| Deferred revenue  | 297                          | 606       |
| Other current liabilities   | (4 )                         | 152       |
| Net cash provided by operating activities   | 2,578                        | 12,825    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                              |           |
| Purchases of property and equipment, net  | (57 )                        | (97 )     |
| Net cash used in investing activities   | (57 )                        | (97 )     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                              |           |
| Proceeds from exercise of warrants  | –                            | 2,630     |
| Dividends paid  | –                            | (195 )    |
| Repurchase of common stock  | (21 )                        | (63 )     |
| Net cash provided by (used in) financing activities                               | (21 )                        | 2,372     |
| Effect of exchange rates on cash and cash equivalents                             | (12 )                        | (28 )     |
| Net increase in cash and cash equivalents   | 2,488                        | 15,072    |
| CASH AND CASH EQUIVALENTS, beginning of period                                    | 4,207                        | 14,550    |
| CASH AND CASH EQUIVALENTS, end of period  | \$ 6,695                     | \$ 29,622 |
| <b>NON-CASH FINANCING ACTIVITY:</b>   |                              |           |

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|   |      |      |
|---|------|------|
| Conversion of preferred stock             | \$13 | \$29 |
| Cash dividends declared, but not yet paid | –    | 25   |

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 member network that either uses the products themselves or resells them to consumers.

Our wholly-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. In June 2013, we opened a marketing center in Almaty, Kazakhstan through our engagement with our Russian service provider. The center also opened for sales and distribution purposes in September 2013. A similar fully-operational facility opened in Odessa, Ukraine in February 2014.

### *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 2013 Annual Report on Form 10-K filed with the United States Securities and Exchange Commission (SEC) on March 7, 2014.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### *Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and all of its wholly-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, revenue recognition, as well as those used in the determination of liabilities related to sales returns, distributor commissions 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 2010, and is no longer subject to state income tax examinations for years prior to 2009. 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.

#### *Income Per Share*

Basic income per share is computed via the “two-class” method by dividing net income allocated to common stockholders by the weighted-average number of common shares outstanding during the period. Net income available to common stockholders is allocated to both common stock and participating securities as if all of the income for the period had been distributed. The Company’s Series A convertible preferred stock is a participating security due to its participation rights related to dividends declared by the Company. If dividends are distributed to common stockholders, the Company is also required to pay dividends to the holders of the preferred stock in an amount equal to the greater of (1) the amount of dividends then accrued and not previously paid on such shares of preferred stock or (2) the amount payable if dividends were distributed to the common stockholders on an as-converted basis.

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. The dilutive effect of non-vested restricted stock and warrants is reflected by application of the treasury stock method. Under the treasury stock method, 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 dilutive effect of the Company's Series A convertible preferred stock is calculated using the more dilutive of the "two-class" method and the "if-converted" method, which assumes that the preferred stock was converted into common stock at the beginning of each period presented.

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

|  | Three Months Ended June 30, |               |           |             |               |           |
|--|-----------------------------|---------------|-----------|-------------|---------------|-----------|
|  | 2013                        |               |           | 2014        |               |           |
|  | Income                      | Shares        | Per Share | Income      | Shares        | Per Share |
|  | (Numerator)                 | (Denominator) | Amount    | (Numerator) | (Denominator) | Amount    |
| <b>Basic EPS:</b>  |                             |               |           |             |               |           |
| Net income available to common stockholders                              | \$900                       |               |           | \$6,107     |               |           |
| Less: undistributed earnings to participating securities                 | (6 )                        |               |           | (48 )       |               |           |
| Net income allocated to common stockholders                              | 894                         | 11,131        | \$ 0.08   | 6,059       | 11,821        | \$ 0.51   |
| <b>Effect of dilutive securities:</b>                                    |                             |               |           |             |               |           |
| Warrants to purchase common stock  | -                           | -             |           | -           | 444           |           |
| Non-vested restricted stock  | -                           | 138           |           | -           | 40            |           |
| Plus: reallocation of undistributed earnings to participating securities | -                           |               |           | 2           |               |           |
| <b>Diluted EPS:</b>  |                             |               |           |             |               |           |
| Net income allocated to common stockholders plus assumed conversions     | \$894                       | 11,269        | \$ 0.08   | \$6,061     | 12,305        | \$ 0.49   |
| <br>   |                             |               |           |             |               |           |
|  | Six Months Ended June 30,   |               |           |             |               |           |
|  | 2013                        |               |           | 2014        |               |           |
|  | Income                      | Shares        | Per Share | Income      | Shares        | Per Share |
|  | (Numerator)                 | (Denominator) | Amount    | (Numerator) | (Denominator) | Amount    |
| <b>Basic EPS:</b>  |                             |               |           |             |               |           |
| Net income available to common stockholders                              | \$1,183                     |               |           | \$9,174     |               |           |
| Less: undistributed earnings to participating securities                 | (6 )                        |               |           | (80 )       |               |           |

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|  |         |        |         |         |        |         |
|--|---------|--------|---------|---------|--------|---------|
| Net income allocated to common stockholders                              | 1,177   | 11,100 | \$ 0.11 | 9,094   | 11,592 | \$ 0.78 |
| Effect of dilutive securities:   |         |        |         |         |        |         |
| Warrants to purchase common stock  | –       | –      |         | –       | 396    |         |
| Non-vested restricted stock  | –       | 165    |         | –       | 62     |         |
| Plus: reallocation of undistributed earnings to participating securities | –       |        |         | 4       |        |         |
| Diluted EPS:   |         |        |         |         |        |         |
| Net income allocated to common stockholders plus assumed conversions     | \$1,177 | 11,265 | \$ 0.11 | \$9,098 | 12,050 | \$ 0.76 |

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 applicable exercise price exceeds the average market price of the related common stock for the period.

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

|                                   | Three Months<br>Ended June 30, |      | Six Months<br>Ended June 30, |      |
|-----------------------------------|--------------------------------|------|------------------------------|------|
|                                   | 2013                           | 2014 | 2013                         | 2014 |
| Warrants to purchase common stock | 2,259,731                      | –    | 2,986,285                    | –    |
| Non-vested restricted stock       | 81,041                         | –    | 85,161                       | –    |

Warrants to purchase 748,069 shares of common stock were still outstanding at June 30, 2014. Such warrants have expirations through April 21, 2015.

#### *Recently Issued and Adopted Accounting Pronouncements*

In March 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2013-05, *Foreign Currency Matters (Topic 830) — Parent’s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity*, to clarify the guidance for entities that cease to hold a controlling financial interest in a subsidiary or group of assets within a foreign entity when (1) the subsidiary or group of assets is a nonprofit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) and (2) there is a cumulative translation adjustment balance associated with that foreign entity. ASU 2013-05 is effective prospectively for reporting periods, including interim periods, beginning after December 15, 2013. The Company’s adoption of the standard on January 1, 2014 did not have a material impact on its consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-11, *Income Taxes (Topic 740) — Presentation of an Unrecognized Tax Benefit When A Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*, to provide explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The amendments in this update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013 and should be applied prospectively to all tax benefits that exist at the effective date. Retrospective application is permitted. The Company’s adoption of the standard on January 1, 2014 did not have a material impact on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue From Contracts With Customers*, that outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. ASU 2014-09 is based on the principle that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or

services. It also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to fulfill a contract. Entities have the option of using either a full retrospective or a modified retrospective approach for the adoption of the new standard. ASU 2014-09 becomes effective for reporting periods, including interim periods, beginning after December 15, 2016. Early adoption is not permitted. The company is currently assessing the impact that this standard will have on its consolidated financial statements.

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 \$23,000 and \$9,000 for the three months ended June 30, 2013 and 2014, respectively, and \$53,000 and \$34,000 for the six months ended June 30, 2013 and 2014, respectively. No tax benefits were attributed to the stock-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.<br>Avg.<br>Price at<br>Date of<br>Issuance |
|--------------------------------|----------|---|
| Nonvested at December 31, 2013 | 54,986   | \$ 0.37   |
| Vested                         | (53,323) | 0.37  |
| Nonvested at June 30, 2014     | 1,663    | 0.52  |

As of June 30, 2014, total unrecognized stock-based compensation expense related to non-vested restricted stock was \$1,000, which is expected to be recognized over a weighted-average period of 0.2 years.

On August 13, 2012, the Company's Board of Directors authorized the Company, acting as trustee for certain of its non-officer, overseas 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. Pursuant to this authority, the Company, as Trustee, entered into a 10b5-1 plan and began purchasing in December 2012. The current 10b5-1 plan for the purchase of up to 2,100 shares per month will expire on November 11, 2014, unless terminated earlier, and the Company, as Trustee, intends at or after that time to enter into a new 10b5-1 plan or plans to complete the purchases authorized. The Company may terminate the plan at any time. The employees 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 common stock that is forfeited by an employee whose employment terminates will be delivered to the Company and held as treasury stock.

|                                | Shares   | Wtd. Avg.<br>Grant-Date<br>Fair Value |
|--------------------------------|----------|---------------------------------------|
| Nonvested at December 31, 2013 | 53,324   | \$ 1.37                               |
| Vested                         | (13,338) | 1.37                                  |
| Nonvested at June 30, 2014     | 39,986   | 1.37                                  |

As of June 30, 2014, total unrecognized stock-based compensation expense related to these stock awards was \$47,000, which is expected to be recognized over a weighted-average period of 1.5 years.

#### 4. STOCKHOLDERS' EQUITY

##### *Dividends*

On March 7, 2014, the Board of Directors declared a dividend on each share of outstanding Series A preferred stock in the amount of \$0.81507 per share representing the accrued and cumulative dividends from May 4, 2007 through March 7, 2014. Simultaneously, the Board of Directors also declared a dividend of \$0.005 on each share of common stock outstanding. All such dividends totaled \$158,000 and were payable in cash on April 8, 2014 to stockholders of record on March 28, 2014. Then, on May 6, 2014, the Board of Directors declared another dividend of \$0.0196 on each share of outstanding Series A preferred stock, which represented the accrued unpaid dividends through the declaration date, and a dividend of \$0.005 on each share of outstanding common stock, totaling aggregate dividends of \$62,000. All such dividends were payable in cash on June 4, 2014 to stockholders of record on May 27, 2014.

##### *Common Stock Purchase Warrants*

Since February 2014, warrants to purchase 747,883 shares of common stock were exercised at exercise prices ranging from \$3.5137 to \$3.52 per share for total proceeds of \$2.6 million. As a result of the cash dividend of \$0.005 declared on March 7, 2014 on each share of outstanding common stock and in accordance with the warrant agreement, the exercise price per share for each warrant was adjusted from \$3.52 per share to \$3.5164 per share. The exercise price was subsequently adjusted to \$3.5137 on May 6, 2014 when the second common stock dividend was declared by the Board of Directors.



## 5. 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, 2014, non-current other assets include KRW 144 million (USD \$142,000) 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 a Registration Rights 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 were not deemed Registrable Securities and were not included in the Registration Statement. If they are subsequently deemed Registrable Securities at a time when a registration statement covering them is required to be effective under the Registration Rights Agreement, and such registration statement is not then effective, 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. The Company filed a registration statement on November 22, 2013 covering the maximum number of shares that could be required to be issued upon exercise of the warrants, and such registration statement was declared effective on December 5, 2013. The Company filed a post-effective amendment to that registration statement on June 9, 2014, which was declared effective on June 16, 2014. As of June 30, 2014, no contingent obligations have been recognized under registration payment arrangements.

## 6. RELATED PARTY TRANSACTIONS

In February 2013, the Company entered into a Royalty Agreement and License with Broady Health Sciences, L.L.C., a Texas limited liability company, (“BHS”) regarding the manufacture and sale of a product called *ReStor*<sup>™</sup>. Under this agreement, the Company agreed to pay BHS a royalty of 2.5% of sales revenue in return for the right to manufacture (or have manufactured), market, import, export and sell this product worldwide, with certain rights being exclusive outside the United States. George Broady, a director of the Company and owner of more than 5% of its outstanding common stock, is owner of BHS. The Company recognized royalties of \$8,000 and \$36,000 during each of the three month periods ended June 30, 2013 and 2014, respectively, and \$15,000 and \$65,000 during each of the six month periods ended June 30, 2013 and 2014, respectively. The Company is not required to purchase any product under the agreement, and the agreement may be terminated at any time on 120 days’ notice or, under certain circumstances, with no notice.

The Company is considering entering into another royalty agreement and license with BHS regarding the manufacture and sale of a product called *Soothe*<sup>™</sup>, which the Company began selling in the fourth quarter of 2012 with the permission of BHS. To continue selling this product, BHS has requested that the Company pay a royalty of 2.5% of sales revenue for this product for 2012 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 through the end of the second quarter of 2014 would total \$8,200.

## 7. SUBSEQUENT EVENTS

In July 2014, warrants to purchase 110,000 shares of common stock were exercised at \$3.5137 per share for total proceeds of \$387,000.

On July 29, 2014, the Board of Directors declared a dividend on each share of outstanding Series A preferred stock, which represents the accrued unpaid dividends through the declaration date, and a dividend of \$0.01 on each share of outstanding common stock, totaling aggregate dividends of approximately \$124,000. All such dividends are payable in cash on August 27, 2014 to stockholders of record on August 19, 2014.

## **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 wholly-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. In June and December 2013, we opened marketing centers in Almaty, Kazakhstan and Odessa, Ukraine, respectively, through our engagement with our Russian service provider. The Kazakhstan and Ukraine centers also opened for sales and distribution purposes in September 2013 and February 2014, respectively.

Our distributor network operates in a seamless manner from market to market, except for the Chinese market, where we sell to consumers through an e-commerce platform. 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, 2014, we were conducting business through 42,400 active distributors. We consider a distributor "active" if they have placed at least one product order with us during the preceding year. Our priority is to focus our resources

in our most promising markets, which we consider to be Greater China and countries where our existing members have the connections to recruit prospects and sell our products, potentially Southeast Asia. Up to \$10.0 million of our available cash may be invested in our Mainland China entity within the next 18 months for such purposes as establishing China-based manufacturing capabilities, opening additional Healthy Lifestyle Centers or branch offices, and ultimately, funding the required deposit for a China direct selling license application. We also may evaluate product or distribution opportunities to diversify from our current Greater China concentration.

We generate over 98% of our net sales from subsidiaries located outside North America, with sales in Hong Kong representing 93% 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 which 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. 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 2009, the information contained in the most recent application was 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 attributed 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 some 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 consists primarily of products purchased from third-party manufacturers, freight cost for transporting products to our foreign subsidiaries and shipping products to distributors, import duties, packing materials, product royalties, 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 purchases 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. 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 bonus volume points. Commissions are based on total personal and group bonus volume points per sales period. Bonus 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 up to three generations of personally sponsored distributors, as well as bonuses on commissions earned by up to three 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 2013 and 2014, represented 42% and 45% 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 training events and 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 by our foreign subsidiaries 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<br>Ended June 30, |        | Six Months<br>Ended June 30, |        |
|--|--------------------------------|--------|------------------------------|--------|
|  | 2013                           | 2014   | 2013                         | 2014   |
| Net sales                                    | 100.0%                         | 100.0% | 100.0%                       | 100.0% |
| Cost of sales                                | 24.2                           | 22.0   | 24.9                         | 22.3   |
| Gross profit                                 | 75.8                           | 78.0   | 75.1                         | 77.7   |
| Operating expenses:                          |                                |        |                              |        |
| Distributor commissions                      | 41.9                           | 45.2   | 42.2                         | 45.1   |
| Selling, general and administrative expenses | 24.6                           | 14.7   | 26.3                         | 16.3   |
| Depreciation and amortization                | 0.3                            | 0.1    | 0.2                          | 0.1    |
| Total operating expenses                     | 66.8                           | 60.0   | 68.7                         | 61.5   |
| Income from operations                       | 9.0                            | 18.0   | 6.4                          | 16.2   |
| Other income (expense), net                  | (0.3 )                         | –      | (0.1 )                       | –      |
| Income before income taxes                   | 8.7                            | 18.0   | 6.3                          | 16.2   |

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|                      |       |        |       |        |
|----------------------|-------|--------|-------|--------|
| Income tax provision | 0.2   | 0.2    | 0.1   | 0.2    |
| Net income           | 8.5 % | 17.8 % | 6.2 % | 16.0 % |

*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, |        |          |        |
|--------------------------------|-----------------------------|--------|----------|--------|---------------------------|--------|----------|--------|
|                                | 2013                        |        | 2014     |        | 2013                      |        | 2014     |        |
| North America                  | \$525                       | 5.0 %  | \$585    | 1.7 %  | \$1,054                   | 5.5 %  | \$1,139  | 2.0 %  |
| Hong Kong                      | 7,766                       | 73.3   | 31,609   | 92.5   | 13,814                    | 71.8   | 52,020   | 90.7   |
| China                          | 227                         | 2.1    | 216      | 0.6    | 371                       | 1.9    | 423      | 0.7    |
| Taiwan                         | 754                         | 7.1    | 829      | 2.4    | 1,355                     | 7.0    | 1,502    | 2.6    |
| South Korea                    | 137                         | 1.3    | 114      | 0.3    | 233                       | 1.2    | 376      | 0.7    |
| Japan                          | 24                          | 0.2    | 22       | 0.1    | 53                        | 0.3    | 48       | 0.1    |
| Russia, Kazakhstan and Ukraine | 1,102                       | 10.4   | 717      | 2.1    | 2,232                     | 11.6   | 1,661    | 2.9    |
| Europe                         | 63                          | 0.6    | 97       | 0.3    | 137                       | 0.7    | 182      | 0.3    |
| Total                          | \$10,598                    | 100.0% | \$34,189 | 100.0% | \$19,249                  | 100.0% | \$57,351 | 100.0% |



Net sales were \$34.2 million for the three months ended June 30, 2014 compared with \$10.6 million for the comparable period a year ago, an increase of \$23.6 million, or 223%. Hong Kong net sales increased \$23.8 million, or 307%, over the comparable period a year ago. The sales increase was due to the effectiveness of the Company's leadership development, promotional programs, incentives, events, new products, training, commission plans and services.

Outside of our Hong Kong business, net sales in our Commonwealth of Independent States ("CIS") markets for the three months ended June 30, 2014, negatively impacted by the political unrest in the region, decreased \$385,000, or 35%, as compared to the same period a year ago. Elsewhere, net sales increased \$133,000, or 8%, over the same period in the prior year.

Net sales were \$57.4 million for the six months ended June 30, 2014 compared with \$19.2 million for the comparable period a year ago, an increase of \$38.1 million, or 198%. Hong Kong net sales increased \$38.2 million, or 277%, over the comparable period a year ago. Outside of our Hong Kong business, net sales in our CIS markets decreased \$571,000, or 26%, during the six months ended June 30, 2014, as compared to the same period a year ago due to the political unrest mentioned above. Elsewhere, net sales increased \$467,000, or 15%. Taiwan, up 11% over the same six month period a year ago, benefited from being a part of the Greater China market momentum. In addition, both the South Korean and North American markets, up 18% in the aggregate, largely benefited from new team building efforts conducted this year.

As of June 30, 2014, the operating subsidiaries of the Company had 42,400 active distributors, compared to 20,100 at June 30, 2013. As of June 30, 2014, the Company had deferred revenue of \$3.2 million, which primarily consisted of \$2.1 million pertaining to unshipped product orders, \$625,000 pertaining to auto ship advances and \$219,000 pertaining to unamortized enrollment package revenue.

### *Gross Profit*

Gross profit was 78.0% of net sales for the three months ended June 30, 2014 compared with 75.8% of net sales for the three months ended June 30, 2013. The gross profit margin percentage increase is primarily attributable to lower fees paid to our third-party service provider in Russia and less importation costs as a percentage of overall net sales, which occurs when sales from the Russian market comprise a lower percentage of our overall net sales. Additionally, the increase is attributable to higher product margins in Hong Kong due to more favorable product mix. The margin increases are somewhat offset by a cost increase assessed by our Hong Kong third party logistics service provider effective in the fourth quarter of 2013.

Gross profit was 77.7% of net sales for the six months ended June 30, 2014 compared with 75.1% of net sales for the six months ended June 30, 2013 due to, as stated above, lower third party service provider fees and importation costs in Russia, a more favorable product mix in Hong Kong, partially offset by a logistics cost increase in Hong Kong effective in the fourth quarter of 2013.

#### *Distributor Commissions*

Distributor commissions were 45.2% of net sales for the three months ended June 30, 2014 compared with 41.9% of net sales for the three months ended June 30, 2013, and 45.1% of net sales for the six months ended June 30, 2014, compared with 42.2% for the comparable period a year ago. The increase as a percentage of net sales for both the three and six month periods ended June 30, 2014 is primarily the result of more expense recognized for the incentive program surrounding our international recognition program, called the Supreme Bonus program.

#### *Selling, General and Administrative Expenses*

Selling, general and administrative expenses were \$5.0 million for the three months ended June 30, 2014 compared with \$2.6 million in the same period a year ago. For the six month period ended June 30, 2014, selling, general and administrative expenses were \$9.4 million compared with \$5.1 million for the comparable period a year ago. Selling, general and administrative expenses increased by 93% and 86%, respectively, during the three and six month periods mainly due to increases in employee-related costs and incentive program accruals, as well as increases in credit card fees and assessments due to higher net sales as compared to the same periods in the prior year.

#### *Income Taxes*

An income tax provision of \$59,000 and \$98,000 was recognized during the three and six months ended June 30, 2014, respectively, related to our operations outside the United States. An income tax provision of \$16,000 and \$28,000 was recognized during the three and six months ended June 30, 2013, respectively. The Company did not recognize a tax benefit for U.S. tax purposes due to uncertainty that the benefit will be realized.

## Liquidity and Capital Resources

At June 30, 2014, the Company's cash and cash equivalents totaled \$29.6 million. Total cash and cash equivalents increased by \$15.1 million from December 31, 2013 to June 30, 2014.

At June 30, 2014, the ratio of current assets to current liabilities was 1.75 to 1.00 and the Company had \$14.9 million of working capital. Current liabilities included deferred revenue of \$3.2 million that consisted primarily of unshipped product orders, auto ship advances and unamortized enrollment package revenues. The ratio of current assets to current liabilities excluding deferred revenue was 2.08 to 1.00. Working capital as of June 30, 2014 increased \$11.5 million compared to the Company's working capital as of December 31, 2013, due to cash generated from operations.

Cash provided by operations for the first six months of 2014 was \$12.8 million compared with \$2.6 million in the comparable period of 2013. The increase in operating cash flows results primarily from the net sales increase over the same period in the prior year. Additionally, more accrued costs associated with both distributor and employee incentive programs contributed to the increase over the period year period.

Cash flows used in investing activities totaled \$97,000 during the first six months of 2014, of which \$57,000 were additional buildout costs incurred for the multi-purposed facility in Zhongshan, China. No significant investing activities occurred during the first six months of 2013.

Cash flows provided by financing activities during the first six months of 2014 totaled \$2.4 million. Warrants to purchase 747,883 shares of common stock were exercised during the first six months of 2014 at exercise prices ranging from \$3.5137 to \$3.52 per share for total proceeds of \$2.6 million. This amount was partly offset by cash dividend payments of \$195,000 and the repurchase of common stock in accordance with the Rule 10b5-1 plan authorized by the Board of Directors on August 13, 2012 to purchase 100,000 shares of its common stock on behalf of its non-officer, overseas employees. Such repurchases totaled \$21,000 and \$63,000 during the first six months of 2013 and 2014, respectively. No additional financing activities occurred during the first six months of 2013.

On March 7, 2014 and again on May 6, 2014, the Board of Directors declared a dividend of \$0.81507 and \$0.0196, respectively, on each share of outstanding Series A preferred stock in the amount per share representing the accrued unpaid dividends through the declaration date. Simultaneously, on each date the Board of Directors also declared a dividend of \$0.005 on each share of common stock outstanding. The dividends were payable in cash on April 8, 2014 to stockholders of record on March 28, 2014, and on June 4, 2014 to stockholders of record on May 27, 2014. All such dividends totaled \$220,000. On July 29, 2014, the Board of Directors declared another dividend on each share of outstanding Series A preferred stock in the amount per share representing the accrued unpaid dividends through that date, and a dividend of \$0.01 on each share of outstanding common stock, totaling aggregate dividends of

approximately \$124,000. All such dividends are payable in cash on August 27, 2014 to stockholders of record on August 19, 2014. Payment of any future dividends on shares of Series A preferred stock and common stock will be at the discretion of the Company's Board of Directors.

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.

On October 19, 2007, the Company issued warrants to purchase 3,141,499 shares of common stock in connection with a convertible debentures financing. The warrants consisted of seven-year warrants to purchase 1,495,952 shares of common stock, one-year warrants to purchase 1,495,952 shares of common stock, and five-year warrants to purchase 149,595 shares of common stock. The term for each of the warrants began six months and one day after their respective issuance and each had an exercise price of \$3.52 per share. Such one-year warrants expired unexercised on April 21, 2009 and such five-year warrants expired unexercised on April 21, 2013. Of the seven-year warrants to purchase 1,495,952 shares of common stock, as of July 24, 2014 warrants to purchase 857,883 shares of common stock were exercised (resulting in gross proceeds of \$3.0 million), leaving warrants to purchase 638,069 shares of common stock outstanding. As a result of the cash dividends of \$0.005 declared on March 7, 2014 and May 6, 2014 on each share of outstanding common stock and in accordance with the warrant agreement, the exercise price per share for each warrant was adjusted from \$3.52 per share to \$3.5137 per share. The exercise price may be further adjusted on August 19, 2014, the record date of the dividends declared on July 29, 2014. The unexercised warrants expire April 21, 2015 if not previously exercised.

Our priority is to focus our resources in our most important markets, which we consider to be Greater China and countries where our existing members may have the connection to recruit prospects and sell our products, potentially Southeast Asia. Up to \$10.0 million of our available cash may be invested in our Mainland China entity within the next 18 months for such purposes as establishing China-based manufacturing capabilities, opening additional Healthy Lifestyle Centers or branch offices, and ultimately, funding the required deposit for a China direct selling license application. We also may evaluate product or distribution opportunities to diversify from our current Greater China concentration.

### **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, revenue recognition, as well as those used in the determination of liabilities related to sales returns, distributor commissions 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, 2014 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, 2013 and June 30, 2014, the Company's inventory value was \$1.8 million and \$4.3 million, respectively, net of reserves of zero and \$10,000, respectively. No significant provision was recorded during the periods presented.

*Valuation of Goodwill.* In accordance with accounting principles generally accepted in the United States of America, the Company assesses 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. The Company's policy is to test for impairment annually during the fourth quarter. At December 31, 2013 and June 30, 2014, goodwill of \$1.8 million was reflected on the Company's balance sheet. No impairment of goodwill 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 5% of sales. Sales returns were 2% and 1% of sales for the six month periods ended June 30, 2013 and 2014, respectively. The allowance for sales returns was \$504,000 and \$494,000 at December 31, 2013 and June 30, 2014, 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 \$1.9 million and \$2.1 million at December 31, 2013 and June 30, 2014, 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, 2013 and June 30, 2014, enrollment package revenue totaling \$182,000 and \$219,000 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. Additionally, deferred revenue includes advances for auto ship orders. In certain markets, when a distributor's cumulative commission income reaches a certain threshold, a percentage of the distributor's weekly commission is held back as an advance and applied to an auto ship order once the accumulated amount of the advances is sufficient to pay for the pre-selected auto ship package of the distributor. Such advances were \$449,000 and \$625,000 at December 31, 2013 and June 30, 2014, respectively.

*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 has a valuation allowance equal its net deferred tax assets 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, 2013 and 2014, 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, 2014. 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, 2014, 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, 2014 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****(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

A summary of the Company's purchases, as Trustee, of shares of its common stock during the quarter ended June 30, 2014 is as follows:

| Period           | Total<br>Number<br>of Shares<br><br>Purchased<br>(a) | Average<br>Price<br>Paid<br><br>Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs (b) | Maximum<br>Number (or<br>Approximate<br>Dollar Value)<br>of Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans<br>or Programs<br>(c) |
|------------------|--|--|--|--|
| April 1—30, 2014 | 2,100  | \$ 5.00                                      | 43,335   | 56,665   |
| May 1—31, 2014   | 2,100  | 6.59   | 45,435   | 54,565   |
| June 1—30, 2014  | 2,100  | 5.65   | 47,535   | 52,465   |

(a) The shares were purchased in open market transactions under the plan described in footnote (b) below.

On August 13, 2012, the Company disclosed in its Quarterly Report on Form 10-Q that its Board of Directors had, on that day, 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 Company may terminate the plan at any time. The employees for whom the Company will purchase stock as trustee under the 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 plan that is forfeited by an employee whose employment terminates will be delivered to the Company and held by it as treasury stock.

(c) The Company, as Trustee, began purchasing under the plan in December 2012. Under the initial 10b5-1 plan executed by the Company, as Trustee, with the Board's authorization, the Company, as Trustee, would not purchase more than 2,800 shares per month. That 10b5-1 plan was replaced by a new 10b5-1 plan effective November 11,

2013, which was amended on May 13, 2014. The Company, as Trustee, will not purchase more than 2,100 shares per month under the new 10b5-1 plan. The current 10b5-1 plan will expire on November 11, 2014, unless terminated earlier, and the Company, as Trustee, intends at or after that time to enter into a new 10b5-1 plan or plans to complete the purchases authorized by the Board.

**Item 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**Item 4. MINE SAFETY DISCLOSURES**

Not applicable.

**Item 5. OTHER INFORMATION**

None.

**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*

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**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: July 29, 2014 /s/ Timothy S. Davidson  
Timothy S. Davidson  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

**EXHIBIT INDEX**

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