NATURAL HEALTH TRENDS CORP
Form 10-Q
November 14, 2011

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

FORM 10-Q

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

For the quarterly period ended September 30, 2011

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
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2603 Oak Lawn Avenue
5th Floor
Dallas, Texas 75219
(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 þ

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 þ 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 o	Smaller reporting company þ

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

At November 7, 2011, the number of shares outstanding of the registrant's common stock was 11,326,323 shares.

NATURAL HEALTH TRENDS CORP.
Quarterly Report on Form 10-Q
September 30, 2011

INDEX

		Page
PART I – FINANCIAL INFORMATION		
Item 1.	Financial Statements	1
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	12
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	19
Item 4.	Controls and Procedures	19
PART II – OTHER INFORMATION		
Item 1.	Legal Proceedings	20
Item 1A.	Risk Factors	20
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	20
Item 3.	Defaults Upon Senior Securities	20
Item 4.	(Removed and Reserved)	20
Item 5.	Other Information	20
Item 6.	Exhibits	20
Signatures		21

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 inte identify "forward-looking statements" within the meaning of the Exchange Act. These statements represent our expectations or beliefs concerning, among other things, future revenue, earnings, growth strategies, new products and initiatives, future operations and operating results, and future business and market opportunities.

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

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

Difficult economic conditions could harm our business;

We may experience substantial negative cash flows, which may have a significant adverse effect on our business and could threaten our solvency;

If we experience negative cash flows, we may need to seek additional debt or equity financing, which may not be available on acceptable terms or at all. If available, it could have a highly dilutive effect on the holdings of existing stockholders;

We could be adversely affected by additional management changes or an inability to attract and retain key management, directors and consultants;

Because our Hong Kong operations account for a majority of our overall business, and most of our Hong Kong business is derived from the sale of products to members in China, any material adverse change in our business relating to either Hong Kong or China would likely have a material adverse impact on our overall business;

As a network marketing company, we rely on an independent sales force and we do not have direct control over the marketing of our products;

Our failure to maintain and expand our distributor relationships could adversely affect our business;

The high level of competition in our industry could adversely affect our business;

An increase in the amount of compensation paid to distributors would reduce profitability;

Failure of new products to gain distributor and market acceptance could harm our business;

Direct-selling laws and regulations may prohibit or severely restrict our direct sales efforts and cause our revenue and profitability to decline, and regulators could adopt new regulations that harm our business;

Challenges by third parties to the form of our business model could harm our business;

Our products and related activities are subject to extensive government regulation, which could delay, limit or prevent the sale of some of our products in some markets;

New regulations governing the marketing and sale of nutritional supplements could harm our business;

Regulations governing the production and marketing of our personal care products could harm our business;

If we are found not to be in compliance with good manufacturing practices our operations could be harmed;

Failure to comply with domestic and foreign laws and regulations governing product claims and advertising could harm our business;

Although our distributors are independent contractors, improper distributor actions that violate laws or regulations could harm our business;

Adverse publicity associated with our products, ingredients or network marketing program, or those of similar companies, could harm our financial condition and operating results;

We have a limited product line;

We do not manufacture our own products so we must rely on independent third parties for the manufacturing and supply of our products;

Growth may be impeded by the political and economic risks of entering and operating foreign markets;

Currency exchange rate fluctuations could lower our revenue and net income;

Transfer pricing, duties and other tax regulations affect our business;

Failure to properly pay business taxes or customs duties, including those in China, could have a material adverse effect;

We may be held responsible for certain taxes or assessments relating to the activities of our distributors, which could harm our financial condition and operating results;

We may face litigation that could harm our business;

We may be unable to protect or use our intellectual property rights;

We do not have product liability insurance and product liability claims could hurt our business;

Our internal controls and accounting methods may require modification;

If we fail to achieve and maintain an effective system of internal controls in the future, we may not be able to accurately report our financial results or prevent fraud. As a result, investors may lose confidence in our financial reporting;

We rely on and are subject to risks associated with our reliance upon information technology systems;

System failures and attacks could harm our business;

Terrorist attacks, cyber attacks, acts of war, epidemics or other communicable diseases or any other natural disasters may seriously harm our business;

Disappointing quarterly revenue or operating results could cause the price of our common stock to fall;

Our common stock is particularly subject to volatility because of the industry in which we operate;

There is no assurance that an active public trading market will continue;

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

Future sales by us or our existing stockholders could depress the market price of our common stock; and

Penny stock regulations are applicable to investment in our shares of common stock.

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

PART I – FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

	December 31, 2010	September 30, 2011 (Unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$648	$1,727
Restricted cash	422	496
Accounts receivable	105	91
Inventories, net	751	1,105
Other current assets	639	576
Total current assets	2,565	3,995
Property and equipment, net	203	131
Goodwill	1,764	1,764
Intangible assets, net	200	–
Restricted cash	225	217
Other assets	406	237
Total assets	$5,363	$6,344
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	$3,115	$2,452
Income taxes payable	330	325
Accrued distributor commissions	723	1,031
Other accrued expenses	1,792	1,086
Deferred revenue	1,029	1,458
Deferred tax liability	178	177
Advance from related party	4	123
Other current liabilities	1,013	1,046
Total current liabilities	8,184	7,698
Commitments and contingencies		
Stockholders' deficit:		
Natural Health Trends stockholders' deficit:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; 1,761,900 shares designated Series A convertible preferred stock, 138,400 shares issued and outstanding at December 31, 2010 and September 30, 2011, aggregate liquidation value of $308	124	124
Common stock, $0.001 par value; 50,000,000 shares authorized; 10,725,899 and 11,306,323 shares issued and outstanding at December 31, 2010 and September 30, 2011, respectively	11	11

Additional paid-in capital	80,414	80,471
Accumulated deficit	(83,643)	(81,813)
Accumulated other comprehensive income (loss):		
Foreign currency translation adjustments	366	(39)
Total Natural Health Trends stockholders' deficit	(2,728)	(1,246)
Noncontrolling interest	(93)	(108)
Total stockholders' deficit	(2,821)	(1,354)
Total liabilities and stockholders' deficit	$5,363	$6,344

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2011	2010	2011
Net sales	$5,216	$10,562	$17,384	$22,945
Cost of sales	1,565	2,536	5,075	6,042
Gross profit	3,651	8,026	12,309	16,903
Operating expenses:				
Distributor commissions	2,081	4,166	6,313	8,642
Selling, general and administrative expenses (including stock-based compensation expense of $38 and $22 during the three months ended September 30, 2010 and 2011, respectively, and $140 and $57 during the nine months ended September 30, 2010 and 2011, respectively)	2,194	2,613	7,586	6,479
Depreciation and amortization	249	23	967	281
Total operating expenses	4,524	6,802	14,866	15,402
Income (loss) from operations	(873)	1,224	(2,557)	1,501
Other income, net:				
Gain on foreign exchange	141	428	421	355
Interest income	–	1	7	3
Interest expense	(1)	(13)	(11)	(14)
Other	24	9	69	12
Total other income, net	164	425	486	356
Income (loss) before income taxes	(709)	1,649	(2,071)	1,857
Income tax provision	29	16	12	36
Net income (loss)	(738)	1,633	(2,083)	1,821
Plus: Net (income) loss attributable to the noncontrolling interest	(4)	–	3	9
Net income (loss) attributable to Natural Health Trends	(742)	1,633	(2,080)	1,830
Preferred stock dividends	(4)	(4)	(12)	(12)
Net income (loss) attributable to common stockholders of Natural Health Trends	$(746)	$1,629	$(2,092)	$1,818
Income (loss) per share of Natural Health Trends – basic and diluted	$(0.07)	$0.15	$(0.20)	$0.17
Weighted-average number of shares outstanding – basic	10,536	10,732	10,480	10,669
Weighted-average number of shares outstanding – diluted	10,536	10,898	10,480	10,699

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In Thousands)

	Nine Months Ended September 30,	
	2010	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$(2,083)	$1,821
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization of property and equipment	367	81
Amortization of intangibles	600	200
Stock-based compensation	140	57
Loss on disposal of property and equipment	35	–
Deferred income taxes	–	(1)
Changes in assets and liabilities:		
Accounts receivable	(1)	12
Inventories, net	201	(362)
Other current assets	499	72
Other assets	423	170
Accounts payable	863	(661)
Income taxes payable	(2)	(15)
Accrued distributor commissions	88	318
Other accrued expenses	17	(706)
Deferred revenue	(1,521)	418
Other current liabilities	(20)	33
Net cash provided by (used in) operating activities	(394)	1,437
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment, net	1	(7)
Decrease (increase) in restricted cash	80	(72)
Net cash provided by (used in) investing activities	81	(79)
CASH FLOWS FROM FINANCING ACTIVITIES		
Advance from related party	–	233
Repayment to related party	–	(114)
Dividend paid to noncontrolling interest	(62)	–
Net cash provided by (used in) financing activities	(62)	119
Effect of exchange rates on cash and cash equivalents	(476)	(398)
Net increase (decrease) in cash and cash equivalents	(851)	1,079
CASH AND CASH EQUIVALENTS, beginning of period	1,552	648
CASH AND CASH EQUIVALENTS, end of period	$701	$1,727

See accompanying notes to consolidated financial statements.

3

NATURAL HEALTH TRENDS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Nature of Operations

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

Our majority-owned subsidiaries have an active physical presence in the following markets: North America; Greater China, which consists of Hong Kong, Taiwan and China; Russia; South Korea; Japan; and Europe, which consists of Italy and Slovenia. In July 2009, the Company activated an engagement with a service provider in Russia to provide storage, distribution and order processing services.

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 2010 Annual Report on Form 10-K filed with the United States Securities and Exchange Commission (SEC) on November 14, 2011.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Use of Estimates

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

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

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

Reclassification

Certain balances have been reclassified in the prior year consolidated financial statements to conform to current year presentation.

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 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 2007, and is no longer subject to state income tax examinations for years prior to 2006. 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, restricted cash, 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 specify a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs have created the following fair-value hierarchy:

Level 1 – quoted prices in active markets for identical assets or liabilities;

Level 2 – inputs, other than the quoted prices in active markets, that are observable either directly or indirectly;

Level 3 – unobservable inputs based on the Company's own assumptions.

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

Revenue Recognition

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

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

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

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

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

Selling, General and Adminstrative Expenses

During 2011 the Company successfully negotiated and entered into agreements with certain legacy and on-going vendors to settle prior outstanding payable balances. The impact of such agreements to settle outstanding payable balances was $220,000 and $482,000 less than carrying value during the three and nine months ended September 30, 2011, respectively, which was immediately recognized as a credit to selling, general and administrative expenses upon settlement.

Income Per Share

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

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

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

	Three Months Ended September 30,					
	2010			2011		
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS:						
Net income (loss) attributable to common stockholders of Natural Health Trends	$(746)	10,536	$(0.07)	$1,629	10,732	$0.15
Effect of dilutive securities:						
Non-vested restricted stock		–			166	
Diluted EPS:						
Net income (loss) attributable to common stockholders of Natural Health Trends plus assumed conversions	$(746)	10,536	$(0.07)	$1,629	10,898	$0.15

	Nine Months Ended September 30,					
	2010			2011		
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS:						
Net income (loss) attributable to common stockholders of Natural Health Trends	$(2,092)	10,480	$(0.20)	$1,818	10,669	$0.17
Effect of dilutive securities:						
Non-vested restricted stock		–			30	
Diluted EPS:						
Net income (loss) attributable to common stockholders of Natural Health Trends plus assumed conversions	$(2,092)	10,480	$(0.20)	$1,818	10,699	$0.17

In periods where losses are reported, the weighted-average number of common shares outstanding excludes common stock equivalents because their inclusion would be anti-dilutive. In periods where income is reported, certain non-vested restricted stock is anti-dilutive upon applying the treasury stock method since the amount of compensation cost for future service results in the hypothetical repurchase of shares exceeding the actual number of shares to be vested. Other common stock equivalents are also anti-dilutive since the average market price of the related common stock for the period exceeds the exercise price.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2011	2010	2011
Options to purchase common stock	27,500	22,500	27,500	22,500
Warrants to purchase common stock	3,704,854	3,704,854	3,704,854	3,704,854
Non-vested restricted stock	339,296	–	412,112	20,415
Convertible preferred stock	138,400	138,400	138,400	138,400

Options and warrants to purchase 22,500 and 3,704,854 shares of common stock, respectively, were outstanding at September 30, 2011. Such options expire on November 17, 2011. The warrants have expirations through April 21, 2015.

Recently Issued and Adopted Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-08, Intangibles—Goodwill and Other (Topic 350) — Testing Goodwill for Impairment, to allow entities to use a qualitative approach to test goodwill for impairment. ASU 2011-08 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 31, 2011. Early adoption is permitted. The Company is currently evaluating the impact of adopting ASU 2011-08 on its consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220)—Presentation of Comprehensive Income, to require an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of equity. ASU 2011-05 is effective for interim and annual financial periods beginning after December 15, 2011. Early adoption is permitted. The Company does not expect adoption of this standard to have a material impact on its consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. ASU 2011-04 provides a consistent definition of fair value and ensures that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles and enhances the disclosure requirements particularly for level 3 fair value measurements. This guidance will be effective for interim and annual reporting periods beginning after December 15, 2011, and will be applied prospectively. The Company is currently evaluating the impact of adopting ASU 2011-04, but believes

there will be no significant impact 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 approximately $38,000 and $22,000 for the three months ended September 30, 2010 and 2011, respectively, and approximately $140,000 and $57,000 for the nine months ended September 30, 2010 and 2011, 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 stock option activity:

	Shares	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Life	Aggregate Intrinsic Value1
Outstanding at December 31, 2010	22,500	$1.80		
Cancelled, forfeited or expired	–	–		
Outstanding at September 30, 2011	22,500	1.80	0.1	$–
Vested and expected to vest at September 30, 2011	22,500	1.80	0.1	–
Exercisable at September 30, 2011	22,500	1.80	0.1	–

1 Aggregate intrinsic value is defined as the positive difference between the current market value and the exercise price and is estimated using the closing price of the Company's common stock on the last trading day of the periods ended as of the dates indicated (in thousands).

No stock options vested during the nine months ended September 30, 2010 and 2011. As of September 30, 2011, no unrecognized stock-based compensation expense related to stock options is remaining. All stock options outstanding at September 30, 2011 have an exercise price of $1.80 per share.

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

	Shares	Wtd. Avg. Price at Date of Issuance
Outstanding at December 31, 2010	114,613	$0.45
Granted	600,000	0.36
Vested	(185,137)	0.38
Forfeited	(18,748)	0.69
Outstanding at September 30, 2011	510,728	0.36

On May 12, 2011, the Company granted 600,000 shares of restricted stock under the 2007 Equity Incentive Plan to its executive officers, directors, and certain key employees. The restricted stock vests quarterly on a pro rata basis over a three-year period.

As of September 30, 2011, total unrecognized stock-based compensation expense related to non-vested restricted stock was approximately $202,000, which is expected to be recognized over a weighted-average period of 2.4 years.

4. COMPREHENSIVE INCOME (LOSS) (In Thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2011	2010	2011
Net income (loss)	$(738)	$1,633	$(2,083)	$1,821
Other comprehensive loss, net of tax:				
Foreign currency translation adjustment	(123)	(466)	(457)	(405)
Comprehensive income (loss)	(861)	1,167	(2,540)	1,416
Plus: Comprehensive (income) loss attributable to the noncontrolling interest	(4)	–	3	9
Comprehensive income (loss) attributable to Natural Health Trends	$(865)	$1,167	$(2,537)	$1,425

5. CONTINGENCIES

Legal Matters

On or about January 4, 2010, Steve Francisco sued the Company's subsidiary, NHT Global, Inc., in the Superior Court for Orange County, California, in Case No. 30-2010-00333395, styled Steve Francisco, Starsearch International, LLC, and Healthlik Resources, LLC v. NHT Global, Inc., eKaire.com, Inc. and Does 1 through 20. Mr. Francisco sought damages for the alleged breach of a prior settlement agreement under which NHT Global had agreed to pay Mr. Francisco payments of not less than $10,000 and not more than $30,000 per month unless and until Mr. Francisco violated NHT Global's policies and procedures. On March 12, 2009, NHT Global had terminated payments to Mr.

Francisco for violating the policies and procedures. Mr. Francisco sought recovery of $100,000 in damages accrued through the date of filing of the lawsuit and an order requiring NHT Global to continue making the monthly payments required by the settlement agreement, as well as an accounting, attorneys' fees and costs. Mr. Francisco's lawsuit also sought payment of certain promissory notes in the aggregate amount of $102,000 made by eKaire.com, Inc., a former subsidiary no longer affiliated with the Company, who separately answered the lawsuit. Trial of this lawsuit was set for February 14, 2011. On February 14, 2011, the parties announced to the court that they had reached an oral settlement agreement that was pending documentation. On or about March 8, 2011, NHT Global, Inc. and the plaintiffs in this lawsuit signed a Confidential Settlement Agreement and Mutual Release, containing a mutually agreeable, confidential settlement of the case.

On or about June 9, 2010, the Company vacated the premises it leased at 2050 Diplomat Drive, Dallas, Texas, so that it could be leased to a new tenant. The landlord, CLP Properties Texas, LP (the "Landlord"), terminated the lease as of June 17, 2010 and entered into a lease with a new tenant. On or about August 17, 2010, the Company received the Landlord's written demand for payment of $413,000 for unpaid rent and other charges due under the lease through June 17, 2010. On September 30, 2010, CLP Properties Texas, LP, sued the Company in the 116th Judicial District Court, Dallas County, Texas, in Cause No. 10-13043, styled CLP Properties Texas, LP v. Natural Health Trends Corp. The lawsuit alleged breach of the lease and sought actual damages, interest, costs and attorneys' fees. The Company answered with a general denial, and gave notice to the Landlord that it intended to assert an affirmative defense of failure to mitigate damages. On or about June 2, 2011, the parties signed a Settlement Agreement under which the Company agreed to pay the Landlord $50,000 by June 3, 2011 and an additional $75,000 by September 15, 2011. These amounts were timely paid, and the lawsuit was dismissed with prejudice.

Currently, there is no other litigation pending against the Company other than as disclosed in the paragraphs above. From time to time, the Company may become a party to litigation and subject to claims incident to the ordinary course of the Company's business. Although the results of such litigation and claims in the ordinary course of business cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material adverse effect on the Company's business, results of operations or financial condition. Regardless of outcome, litigation can have an adverse impact on the Company because of defense costs, diversion of management resources and other factors.

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 September 30, 2011, non-current other assets include KRW 100 million (USD $85,000) underlying the contract, which can be utilized by the Cooperative to fund any outstanding distributor claims. The Company believes that the likelihood of utilizing these funds to provide for distributors claims is remote.

Registration Payment Arrangements

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

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

As of September 30, 2011, no contingent obligations have been recognized under registration payment arrangements.

6. RELATED PARTY TRANSACTIONS

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

Additionally, Mr. Broady advanced $100,000 to the Company on February 28, 2011 and an additional $100,000 on March 14, 2011. The Company has agreed to pay Mr. Broady interest of 9% per annum on the aggregate amount of the advances. The Company repaid Mr. Broady principal of approximately $128,000 during the third and fourth quarters of 2011, and expects to repay the balance of the principal and interest before the end of 2011.

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

Business Overview

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

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

As of September 30, 2011, we are conducting business through approximately 18,000 active distributors. We consider a distributor "active" if they have placed at least one product order with us during the preceding year. Currently we do not intend to devote material resources to opening any additional foreign markets in the near future. Our priority is to focus our resources in our most promising markets, namely Greater China and Russia.

We generate about 95% of our net sales from subsidiaries located outside North America, with sales in Hong Kong representing about 80% of net sales in the latest quarter. Because of the size of our foreign operations, operating results can be impacted negatively or positively by factors such as foreign currency fluctuations, and economic, political and business conditions around the world. In addition, our business is subject to various laws and regulations, in particular regulations related to direct selling activities that create certain risks for our business, including improper claims or activities by our distributors and potential inability to obtain necessary product registrations.

China has been and continues to be our most important business development project. In June 2004, NHT Global obtained a general business license in China. Direct selling is prohibited in China without a direct selling license that we do not have. In December 2005, we submitted a preliminary application for a direct selling license. In June 2006, we submitted a revised application package in accordance with new requirements issued by the Chinese government. In June 2007, we launched a new e-commerce retail platform in China that does not require a direct selling license and is separate from our current worldwide platform. We believe this model, which offers discounts based on volume purchases, will encourage repeat purchases of our products for personal consumption in the Chinese market. The platform is designed to be in compliance with our understanding of current laws and regulations in China. In November 2007, we filed a new, revised direct selling application incorporating a name change, our new e-commerce model and other developments. These direct selling applications were not approved or rejected by the pertinent authorities, but did not appear to materially progress. By now, the information contained in the most recent application is stale. The Company applied to temporarily withdraw the license application in February 2009 to furnish new information and intends to amend its application with the goal to re-apply in the future. We are unable to predict whether we will be successful in obtaining a direct selling license to operate in China, and if we are successful, when we will be permitted to enhance our e-commerce retail platform with direct selling operations.

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

Income Statement Presentation

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

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

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

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

Through commissions paid on product purchases made by their down-line distributors.

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

sponsoring other distributors who in turn expand their own businesses by sponsoring other distributors, the distributor receives higher commissions from purchases made by an expanding down-line network. To be eligible to receive commissions, a distributor may be required to make nominal monthly or other periodic purchases of our products. Certain of our subsidiaries do not require these nominal purchases for a distributor to be eligible to receive commissions. In determining commissions, the number of levels of down-line distributors included within the distributor's commissionable group increases as the number of distributorships directly below the distributor increases. Under our current compensation plan, certain of our commission payouts may be limited to a hard cap in terms of a specific percentage of total product sales. In some markets, commissions may be further limited. In some markets, we also pay certain bonuses on purchases by several generations of personally sponsored distributors, as well as bonuses on commissions earned by several generations of personally sponsored distributors. Distributors can also earn income, trips and other prizes in specific time-limited promotions and contests we hold from time to time. Distributor commissions are dependent on the sales mix and, for the first nine months of 2010 and 2011, represented 36% and 38% of net sales, respectively. From time to time we make modifications and enhancements to our compensation plan to help motivate distributors, which can have an impact on distributor commissions. From time to time we also enter into agreements for business or market development, which may result in additional compensation to specific distributors.

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

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

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

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2011	2010	2011
Net sales	100.0 %	100.0 %	100.0 %	100.0 %
Cost of sales	30.0	24.0	29.2	26.3
Gross profit	70.0	76.0	70.8	73.7
Operating expenses:				
Distributor commissions	39.9	39.4	36.3	37.7
Selling, general and administrative expenses	42.0	24.7	43.6	28.2
Depreciation and amortization	4.8	0.2	5.6	1.2
Total operating expenses	86.7	64.3	85.5	67.1
Income (loss) from operations	(16.7)	11.7	(14.7)	6.6
Other income, net	3.1	4.0	2.8	1.5
Income (loss) before income taxes	(13.6)	15.7	(11.9)	8.1
Income tax provision	0.5	0.2	0.1	0.2
Net income (loss)	(14.1)%	15.5 %	(12.0)%	7.9 %

Net Sales

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

	Three Months Ended September 30,						Nine Months Ended September 30,					
	2010			2011			2010			2011		
North America	$180	3.4	%	$406	3.8	%	$1,079	6.2	%	$1,032	4.5	%
Hong Kong	3,191	61.2		8,454	80.0		10,305	59.3		15,518	67.6	
China	260	5.0		122	1.1		915	5.3		640	2.8	
Taiwan	476	9.1		471	4.4		1,329	7.6		1,577	6.9	
South Korea	194	3.7		114	1.2		648	3.7		346	1.5	
Japan	92	1.8		50	0.5		340	2.0		185	0.8	
Russia	705	13.5		874	8.3		2,312	13.3		3,378	14.7	
Europe	118	2.3		71	0.7		456	2.6		269	1.2	
Total	$5,216	100.0	%	$10,562	100.0	%	$17,384	100.0	%	$22,945	100.0	%

Net sales were $10.6 million for the three months ended September 30, 2011 compared with $5.2 million for the comparable period a year ago, an increase of $5.3 million, or 102%. Hong Kong net sales increased $5.3 million, or 165%, over the comparable period a year ago, of which $1.9 million was due to product unshipped at the end of June 2011, but shipped in the third quarter and ticket sales for the Hong Kong 10th Anniversary event. The additional increase in Hong Kong can be attributed to successful product launch and a series of local market events to support its introduction as well as a robust incentive program developed for distributors leading up to the Hong Kong 10th Anniversary event, which occurred in July 2011. China net sales decreased $138,000 during the same three month period as compared to the comparable period in the prior year as a one-time product promotion aggregating $699,000 won't be recognized until the product is shipped next year. North America net sales increased $226,000 over the comparable period a year ago largely due to emerging market development in the CIS countries, Kazakhstan and Ukraine, which resulted in increased sales. This emerging market business is serviced and delivered through the United States and stems from our Russian marketplace and distributor base.

Year to date net sales were $22.9 million for the nine months ended September 30, 2011 compared with $17.4 million a year ago. The first quarter of 2010 included $708,000 of product orders taken during 2009, but recognized as revenue in Hong Kong during 2010 when operational issues with our third party logistics partners were resolved. Aside from the increase in Hong Kong net sales discussed above, Russia net sales increased $1.1 million, or 46%, for the same time frame due to local market events held in St. Petersburg, Rostov and Khabarovsk, Russia as well an incentive program building toward the 10th Anniversary event held in Hong Kong in July 2011 for which Russian distributors were able to attend.

The operating subsidiaries of the Company had approximately 18,000 active distributors at September 30, 2010 and 2011. As of September 30, 2011, the Company had deferred revenue of approximately $1.5 million, of which approximately $1.3 million pertained to product sales and approximately $204,000 pertained to unamortized enrollment package revenue.

Gross Profit

Gross profit was 76.0% of net sales for the three months ended September 30, 2011 compared with 70.0% of net sales for the three months ended September 30, 2010. The margin increase was mainly derived from a price increase implemented in Russia, ticket sales for the 10th Anniversary event held in Hong Kong in July 2011, higher margin pre-assorted product offerings in Hong Kong leading up to the 10th Anniversary event, and less fees paid to our

third-party logistics provider in Russia due to a rate reduction effective in June 2011.

Gross profit was 73.7% of net sales for the nine months ended September 30, 2011 compared with 70.8% of net sales for the comparable period in the prior year due to those margin improvement items that occurred during the third quarter of 2011.

Distributor Commissions

Distributor commissions were relatively stable during the three months ended September 30, 2011 compared with the comparable period a year ago at 39.4% versus 39.9%, respectively. Distributor commissions were slightly higher during the nine month period ended September 30, 2011 as the percentage to net sales was 37.7% compared with 36.3% a year ago. The increase as a percent of net sales is primarily due to modifications and enhancements to the Hong Kong and Russian compensation plans in June 2010 and February 2011, respectively, to add among other things, both a generational and matching bonus. Additionally, payout increased somewhat due to sales goals reached by distributor-owned healthy lifestyle centers ("HLCs") that began operating in China in the third quarter of 2010. This additional payout was slightly offset by the immediate, nonrecurring one-time commission payout from the adoption of lower commission payout thresholds in Hong Kong and Russia in February 2010.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased $419,000 for the three months ended September 30, 2011, compared with the comparable period in the prior year, mainly due to the following:

event-related costs increased $400,000 due to the Hong Kong 10th Anniversary event held in July 2011;
professional fees increased $70,000 due to the audit of our consolidated financial statements for fiscal years 2009 and 2010;
credit card fees and assessments in Hong Kong increased $75,000 due to the increase in sales;
additional costs incurred in China totaling $55,000 to develop local market presence; partly offset by
impact of agreements with vendors to settle outstanding amounts at $220,000 less than carrying value.

Selling, general and administrative expenses decreased $1.1 million for the nine months ended September 30, 2011, compared with the comparable period in the prior year, mainly due to the following:

lower salaries, employee-related costs, and consulting fees at the corporate office totaling $525,000 mainly due to the elimination of several administrative positions in the first quarter of 2011;
lower rent, utilities, and other business expenses in North America totaling $62,000 as a result of our corporate office move in the prior year;
lower salaries and employee-related costs and rent and utilities in China totaling $50,000 and $70,000, respectively, due to the on-going transition of our facility in Zhuhai, China to northern China;
lower overall costs in South Korea aggregating $350,000 as a result of management changes and other cost reductions that occurred in 2010;
impact of agreements with vendors to settle outstanding amounts at $482,000 less than carrying value; and
lower stock-based compensation expense in the amount of $83,000 as certain shares of restricted stock began to fully vest in 2010; partially offset by
event-related costs increased $360,000 primarily due to the Hong Kong 10th Anniversary event held in July 2011;
credit card fees and assessments in Hong Kong increased $135,000 due to the increase in sales;
additional costs incurred in China totaling $55,000 to develop local market presence.

Other Income, Net

Gain on foreign exchange totaling $428,000 was recognized in the third quarter of 2011 due primarily to the impact of the Japanese yen, South Korean won and European euro on inter-company balances. Gain on foreign exchange was $141,000 during the third quarter of 2010 also mainly due to the impact of the Japanese yen and European euro on inter-company balances.

Income Taxes

An income tax provision of $16,000 and $36,000 was recorded during the three and nine months ended September 30, 2011, respectively, related to its operations outside the United States. The Company did not recognize a tax benefit for U.S. tax purposes due to uncertainty that the benefit will be realized.

Liquidity and Capital Resources

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

On May 4, 2007, the Company consummated a private equity placement generating gross proceeds of approximately $3.0 million. The May 2007 financing consisted of the sale of 1,759,307 shares of the Company's Series A convertible preferred stock and the sale of warrants evidencing the right to purchase 1,759,307 shares of the Company's common stock. As partial consideration for placement agency services, the Company issued warrants evidencing the right to purchase an additional 300,000 shares of the Company's common stock to the placement agent that assisted in the financing. The warrants are exercisable at any time during the period beginning November 4, 2007 (six months after their issuance) and ending May 4, 2013 (six years after their issuance). The exercise price of the warrants was $3.80 per share until May 3, 2010, $4.35 per share until November 3, 2011, and is currently $5.00 per share until May 4, 2013, when the warrants expire.

On October 19, 2007, the Company raised gross proceeds of $3.7 million in a private placement of variable rate convertible debentures (the "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. One-half of the original principal amount of the Debentures was payable in 12 equal monthly installments beginning on November 1, 2008, and the balance was payable on October 19, 2009, unless extended by the holders to October 19, 2012. The warrants are exercisable beginning six months and one day after their respective issuance and have an exercise price of $3.52 per share. The placement agent and its assigns also received five-year warrants to purchase 149,595 shares of the Company's common stock at an exercise price of $3.52 per share. Such one-year warrants expired unexercised on April 21, 2009. The Debenture were redeemed on August 10, 2009.

At September 30, 2011, the Company's cash and cash equivalents totaled approximately $1.7 million. Total cash and cash equivalents increased by $1.1 million from December 31, 2010 to September 30, 2011.

At September 30, 2011, the ratio of current assets to current liabilities was 0.52 to 1.00 and the Company had a working capital deficit of approximately $3.7 million. Current liabilities included deferred revenue of $1.5 million that consisted of unamortized enrollment package revenues and unshipped orders. The ratio of current assets to current liabilities, excluding deferred revenue, is 0.64 to 1.00. Working capital as of September 30, 2011 increased $1.9 million compared to the Company's working capital as of December 31, 2010, mainly due to cash generated from operations, but also due to effect of negotiated settlements with certain legacy vendors.

Cash provided by operations for the nine months ended September 30, 2011 was $1.4 million compared to cash used in operations of $394,000 in the comparable period of 2010. Cash generated from operations directly resulted from the net sales increase during the first nine months of 2011, while we simultaneously maintained our ability to control operating expenses.

Cash used in investing activities during the period was $79,000, of which $72,000 was due to an increase in restricted cash. In April 2010, the Company's primary processing company required that the Company gradually increase to and maintain the reserve balance at $500,000. The Company reached the necessary reserve requirement during the second quarter of 2011. The Company's expectation is that its reserve requirement will revert back to a percentage of sales calculation in the near future.

Cash provided by financing activities during the first nine months of 2011 was $119,000. George Broady, a director of the Company and owner of more than 5% of its outstanding common stock, advanced $2,500 on January 13, 2011, and $30,000 on March 14, 2011 to settle certain claims against the Company. The aggregate amount of these advances, plus a $4,000 advance on December 17, 2010, totaling $36,500 was repaid on August 8, 2011. Additionally, Mr. Broady advanced $100,000 to the Company on February 28, 2011 and an additional $100,000 on March 14, 2011. The Company has agreed to pay Mr. Broady interest of 9% per annum on the aggregate amount of these advances. The Company repaid Mr. Broady principal of approximately $128,000 during the third and fourth quarters of 2011, and expects to repay the balance of the principal and interest before the end of 2011.

The Company has taken numerous actions to ensure that it will continue as a going concern. It planned and executed many cost reduction and margin improvement initiatives since the end of the third quarter of 2007, such as (1) reducing headcount, which includes the termination of multiple management-level positions in Greater China, South Korea and North America; (2) down-sizing offices in Greater China and South Korea; (3) closing offices in Latin America and Southeast Asia; (4) renegotiating vendor contracts in Greater China; (5) increasing product pricing in Greater China, Europe and the U.S.; (6) changing commission plans worldwide; (7) streamlining logistics processes in Greater China; (8) introducing better margin pre-assortments; and (9) working actively with our service providers in Greater China to ensure continued services and reduce service charges; and (10) reducing Company-wide

discretionary expenses. Also, we believe that we have taken a number of effective steps toward stabilizing the Company's revenues on a sequential basis, especially in the Hong Kong market. As a result, the Company believes that its current cash breakeven level has been significantly reduced and is attainable.

Excluding the effects of seasonality factors such as the Chinese New Year, the Chinese Golden Week (in October) and the summertime, the Company forecasts that it can generate cash from operations in a normal month at a pace of $100,000 to $200,000. The third quarter of 2011 ran at above this level due to the 10th Anniversary event in Hong Kong and a one-time product promotion in China and is not expected to be representative for our near-term prospect. The Company believes that its existing internal liquidity, supported by cash on hand, anticipated improvement in cash flows from operations with more stabilized revenue and much lower fixed costs since October 2007 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 further revenue decline. If the Company's foregoing beliefs or assumptions prove to be incorrect, however, the Company's business, results of operations and financial condition could be materially adversely affected.

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

We do not intend to devote material resources to opening any additional foreign markets in the near future. Our priority is to focus our resources in our most promising markets, namely Greater China and Russia.

Critical Accounting Policies and Estimates

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

The most significant accounting estimates inherent in the preparation of the Company's financial statements include estimates associated with obsolete inventory and the fair value of acquired intangible assets, including goodwill, as well as those used in the determination of liabilities related to sales returns and income taxes. Various assumptions and other factors prompt the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account historical experience and current and expected economic conditions. The actual results may differ materially and adversely from the Company's estimates. To the extent that there are material differences between the estimates and actual results, future results of operations will be affected. The Company's critical accounting policies at September 30, 2011 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, 2010 and September 30, 2011, the Company's inventory value was $751,000 and $1.1 million, respectively, net of reserves of $59,000 and $46,000, respectively. No significant provision was recorded during the periods presented.

Valuation of Goodwill and Other Intangible Assets. In accordance with accounting principles generally accepted in the United States of America, the value of indefinite-lived intangible assets and residual goodwill is not amortized, but is tested at least annually for impairment. Our impairment testing for goodwill is performed separately from our impairment testing of indefinite-lived intangibles. We test goodwill for impairment, at least annually, by reviewing the book value compared to the fair value at the reportable unit level. We test individual indefinite-lived intangibles at least annually by reviewing the individual book values compared to the fair value. At December 31, 2010 and September 30, 2011, goodwill of approximately $1.8 million was reflected on the Company's balance sheet. No impairment of goodwill or intangible assets was recognized during the periods presented.

Allowance for Sales Returns. An allowance for sales returns is provided during the period the product is shipped. The allowance is based upon the return policy of each country, which varies from 14 days to one year, and their historical return rates, which range from approximately 1% to 6% of sales. Sales returns were approximately 2% of sales for the nine months ended September 30, 2010 and 2011. The allowance for sales returns was approximately $380,000 and $144,000 at December 31, 2010 and September 30, 2011, respectively. No material changes in estimates have been recognized during the periods presented.

Revenue Recognition. Product sales are recorded when the products are shipped and title passes to independent distributors. Product sales to distributors are made pursuant to a distributor agreement that provides for transfer of both title and risk of loss upon our delivery to the carrier that completes delivery to the distributors, which is commonly referred to as "F.O.B. Shipping Point." The Company primarily receives payment by credit card at the time distributors place orders. The Company's sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return. Amounts received for unshipped product are recorded as deferred revenue. Such amounts totaled $776,000 and $1.3 million at December 31, 2010 and September 30, 2011, 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, 2010 and September 30, 2011, enrollment package revenue totaling $253,000 and $204,000 was deferred, respectively. Although the Company has no immediate plans to significantly change the terms or conditions of enrollment packages, any changes in the future could result in additional revenue deferrals or could cause us to recognize the deferred revenue over a longer period of time.

Tax Valuation Allowance. The Company evaluates the probability of realizing the future benefits of any of its deferred tax assets and records a valuation allowance when it believes a portion or all of its deferred tax assets may not be realized. The Company increased the valuation allowance to equal its net deferred tax assets during 2005 due to the uncertainty of future operating results. The valuation allowance will be reduced at such time as management believes it is more likely than not that the deferred tax assets will be realized. During the nine months ended September 30, 2010 and 2011, 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 September 30, 2011. 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 September 30, 2011, the Company's disclosure controls and procedures were not effective since its internal control over financial reporting was deemed not effective.

Due to the financial difficulties encountered by the Company during 2009 and 2010, the Company was not able to devote enough resources to obtain sufficient documentary evidence of its internal controls over financial reporting. Therefore, management concluded that the Company's internal control over financial reporting as of December 31, 2009 and 2010 was not effective. Management intends to try to complete its collection of documentary evidence of its internal controls over financial reporting by the end of 2011. However, there can be no assurance that it will be able to obtain sufficient documentary evidence by that target date or that, if it does, that evidence won't point out one or more material weaknesses in internal controls over financial reporting.

Notwithstanding the conclusion that the Company's internal control over financial reporting was not effective, the Company believes that the financial statements contained in this Form 10-Q fairly present, in all material respects, the financial condition and results of operations of the Company.

Changes in Internal Control over Financial Reporting

There were no changes in internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2011 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

The Company is not, at the time of this report, subject to any legal proceedings which could have an adverse effect on its business, results of operations, or financial condition.

Item 1A. RISK FACTORS

Not applicable under smaller reporting company disclosure rules.

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

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

Item 4. (REMOVED AND RESERVED)

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.

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: November 14, 2011

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

EXHIBIT INDEX

Exhibit Number	Exhibit Description
31.1	Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certifications of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.