HEALTH FITNESS CORP /MN/
Form 10-Q
May 17, 2004

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

FORM 10-Q

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

For the quarterly period ended March 31, 2004

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: 0-25064

HEALTH FITNESS CORPORATION
(Exact name of registrant as specified in its charter)

Minnesota
(State of incorporation or organization) (I.R

3600 American Boulevard W., Suite 560, Bloomington, Minnesota
(Address of principal executive offices)

(952) 831-6830
(Registrant's telephone number, including area code)

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 [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes [ ] No [X]

The number of shares outstanding of each of the registrant's classes of capital stock, as of May 3, 2004 was:

Common Stock, $0.01 par value, 12,461,995 shares

HEALTH FITNESS CORPORATION
CONSOLIDATED FINANCIAL STATEMENTS

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HEALTH FITNESS CORPORATION
CONSOLIDATED BALANCE SHEETS

	(Unaudited) March 31, 2004
ASSETS	
CURRENT ASSETS	
Cash	$ 907
Trade and other accounts receivable, less allowances of $141,000 and $131,000	8,162,
Prepaid expenses and other	270,

Deferred tax assets	850,
Total current assets	10,191,
PROPERTY AND EQUIPMENT, net	192,
OTHER ASSETS	
Goodwill	8,915,
Customer contracts, less accumulated amortization of $269,400 and $67,400	1,460,
Trademark, less accumulated amortization of $23,300 and $5,800	326,
Other intangible assets, less accumulated amortization of $11,700 and $4,200	131,
Cash held in escrow	473,
Deferred tax assets	1,509,
Other	63,
	$ 23,263,
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES	
Trade accounts payable	$ 462,
Accrued salaries, wages, and payroll taxes	2,434,
Other accrued liabilities	521,
Accrued self funded insurance	588,
Deferred revenue	1,474,
Total current liabilities	5,481,
LONG-TERM OBLIGATIONS	6,220,
COMMITMENTS AND CONTINGENCIES	
CUMMULATIVE CONVERTIBLE PREFERRED STOCK, 5,000,000 shares authorized, 1,018,833 and 1,003,833 issued and outstanding	1,458,
STOCKHOLDERS' EQUITY	
Common stock, $0.01 par value; 25,000,000 shares authorized; 12,438,245 and 12,357,334 shares issued and outstanding	124,
Additional paid-in capital	17,705,
Accumulated comprehensive income	4,
Accumulated deficit	(7,732,
	10,101,
	$ 23,263,

See notes to consolidated financial statements.

HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF EARNINGS

	Thre
	2004
REVENUE	$ 12,666,3
COSTS OF REVENUE	9,579,4
GROSS PROFIT	3,086,9
OPERATING EXPENSES	
Salaries	1,342,7
Other selling, general and administrative	830,1
Amortization of acquired intangible assets	219,5
Total operating expenses	2,392,3
OPERATING INCOME	694,5
OTHER INCOME (EXPENSE)	
Interest expense	(134,2
Other, net	9
EARNINGS BEFORE INCOME TAX EXPENSE	561,2
INCOME TAX EXPENSE	209,5
NET EARNINGS	351,7
Dividend to preferred shareholders	15,0
NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS	$ 336,7
NET EARNINGS PER COMMON SHARE:	
Basic	$ 0.
Diluted	0.
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING	
Basic	12,409,6
Diluted	16,038,9

See notes to consolidated financial statements

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HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudite

	Three Months March 3
	2004
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net earnings	$ 351,707
Adjustments to reconcile net earnings to net cash used in operating activities, net of acquired assets:	
Depreciation	24,170
Amortization	248,724
Deferred taxes	177,268
Change in assets and liabilities:	
Trade and other accounts receivable	(2,944,325)
Prepaid expenses and other	(83,463)
Other assets	(113)
Trade accounts payable	(108,222)
Accrued liabilities and other	1,258,955
Deferred revenue	47,629
Net cash used in operating activities	(1,027,670)
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchases of property and equipment	(39,687)
Acquisition of business	(189,706)
Net cash used in investing activities	(229,393)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Borrowings under long-term obligations	2,450,000
Repayments of long-term obligations	(600,862)
Proceeds from the issuance of common stock	13,277
Proceeds from the exercise of stock options	21,000
Net cash provided by financing activities	1,883,415
NET INCREASE (DECREASE) IN CASH	626,352
CASH AT BEGINNING OF PERIOD	281,294
CASH AT END OF PERIOD	$ 907,646

See notes to consolidated financial statements.

HEALTH FITNESS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. They should be read in conjunction with the annual financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003. In the opinion of management, the interim consolidated financial statements include all adjustments (consisting of normal recurring accruals) necessary for the fair presentation of the results for interim periods presented. Operating results for the three months ended March 31, 2004 are not necessarily indicative of the operating results for the year ended December 31, 2004.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

Trade and Other Accounts Receivable - Trade and other accounts receivable represent amounts due from companies and individuals for services and products. The Company grants credit to customers in the ordinary course of business, but generally does not require collateral or any other security to support amounts due. Management performs ongoing credit evaluations of customers. The Company determines its allowance for discounts and doubtful accounts by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivable are credited to the allowance. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers and their geographic dispersion.

Property and Equipment - Property and equipment is stated at cost. Depreciation and amortization are computed using both straight-line for book purposes and accelerated methods for tax purposes over the useful lives of the assets.

Goodwill - Goodwill represents the excess of the purchase price and related costs over the fair value of net assets of businesses acquired. The carrying value of goodwill is not amortized, but is tested for impairment on an annual basis or when factors indicating impairment are present. Projected discounted cash flows are used in assessing these assets.

Intangible Assets - The Company's intangible assets include customer contracts, trademark, and deferred financing costs and are amortized on a straight-line basis. Customer contracts represent the fair value assigned to acquired management contracts and are amortized over the remaining life of the contracts, approximately 25-35 months. Trademark represents the value assigned to an acquired trademark and is amortized over a period of five years. Deferred financing costs are amortized over the term of the related credit agreement.

Cash Held In Escrow - Cash held in escrow represents the funds remaining after payment of the purchase price for the Company's acquisition (see Note 3). Such funds will remain in escrow until all parties subject to the escrow agreement agree that all conditions related to the acquisition have been satisfied. At that time, any funds remaining in escrow will be used to pay down the Company's long-term obligations.

Revenue Recognition - Revenue is recognized at the time the service is provided to the customer. For annual contracts, monthly amounts are recognized ratably over the term of the contract. Certain services provided to the customer may vary on a periodic basis and are invoiced to the customer in arrears. The revenues relating to theses services are estimated in the month that the service is performed.

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

The Company has contracts with third-parties to provide ancillary services in connection with their fitness and wellness management services and programs. Under such arrangements the third-parties invoice and receive payments from the Company based on transactions with the ultimate customer. The Company does not recognize revenues related to such transactions as the ultimate customer assumes the risk and rewards of the contract and the amounts billed to the customer are either at cost or with a fixed markup.

Comprehensive Income - Comprehensive income represents net earnings adjusted for foreign currency translation adjustments. Comprehensive income is disclosed in the consolidated statement of stockholders' equity.

Net Earnings Per Common Share - Basic net earnings per common share is computed by dividing net earnings by the number of weighted average common shares outstanding. Diluted net earnings per common share is computed by dividing net earnings plus dividends to preferred shareholders by the number of weighted average common shares outstanding, and common share equivalents relating to stock options and stock warrants, when dilutive.

Fair Values of Financial Instruments - Due to their short-term nature, the carrying value of the Company's current financial assets and liabilities approximates their fair values. The fair value of long-term obligations, if recalculated based on current interest rates, would not significantly differ from the recorded amounts.

Use of Estimates - Preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 3. PURCHASE OF ASSETS

On December 8, 2003 (the "Effective Date"), the Company purchased the business assets of the Health & Fitness Services Business of Johnson & Johnson Health

Care Systems Inc. ("JJHCS"). Assets acquired by the Company consist primarily of client contracts, proprietary wellness, lifestyle and health promotion programs, software, and other health and wellness services. As part of the transaction, the Company entered into a multi-year management contract with another subsidiary of Johnson & Johnson whereby the Company will manage more than 50 Johnson & Johnson affiliate fitness center sites. The Company also entered into a one-year agreement to use 660 square feet of office space of JJHCS for a fee of $1,500 per month.

The acquisition has been accounted for using the purchase method of accounting. The fair market value of the assets acquired resulted in the following purchase price allocation:

Cash price paid for assets	$4,927,500
Acquisition costs incurred	833,019
Total purchase price	$5,760,519
Purchase Price Allocation	
Inventory	$ 40,000
Property and equipment	34,000
Customer contracts	1,730,000
Trademark	350,000
Excess of cost over assets acquired	3,606,519
	$5,760,519

During the three months ended March 31, 2004, an additional $142,111 was paid to JJHCS for two contract assignments. The Company also incurred an additional $47,595 of acquisition related costs. These payments were recorded entirely to goodwill.

NOTE 4. FINANCING

On August 22, 2003, the Company entered into a $7,500,000 Credit Agreement with Wells Fargo Bank, N.A. ("Wells Fargo") to provide the Company with acquisition financing and general working capital (the "Wells Loan"). The initial draw on the Wells Loan totaled $1,255,204, which was used to refinance the revolving line of credit ("Merrill Lynch Loan") the Company previously maintained with Merrill Lynch Business Financial Services, Inc. ("Merrill Lynch"). The Company repaid all amounts owed to Merrill Lynch and canceled the line of credit, which accrued interest at the one-month LIBOR rate plus 2.35% (effective rate of 3.77% at December 31, 2002). On August 25, 2003, the Company made a draw of $2,250,000 on the Wells Loan, the proceeds of which were placed into escrow to fund a portion of the JJHCS asset purchase.

Working capital advances from the Wells Loan are based upon a percentage of the Company's eligible accounts receivable, less any amounts previously drawn. At the option of the Company, the Wells Loan bears interest at prime or the one-month LIBOR plus a margin of 2.25% to 2.75% based upon the Company's Senior Leverage Ratio (effective rate of 4% at March 31, 2004 and December 31, 2003). The availability of the Wells Loan will decrease $250,000 on the last day of each calendar quarter, beginning September 30, 2003, and will expire on June 30, 2007. Availability of the Wells Loan totaled $6,750,000 and $7,000,000 at March 31, 2004 and December 31, 2003. Borrowings under the Wells Loan are collateralized by substantially all of the Company's assets. The Company is required to comply with certain monthly financial covenants, including a senior cash flow leverage ratio, senior leverage ratio and current ratio. At March 31, 2004, the Company had $4,624,138 outstanding under the Wells Loan. Beginning on January 31, 2004 and continuing throughout the remainder of the period ending March 31, 2004, the Company was not in compliance with certain covenants relating to the

Wells Loan. On May 14, 2004, Wells Fargo agreed to waive the noncompliance and amend the loan covenants, effective as of January 31, 2004. The Company believes that the new loan covenants are more appropriate after taking into consideration the Company's actual financial position following the acquisition of the business assets of JJHCS. Wells Fargo was made aware of the noncompliance shortly after January 31, 2004 and agreed to continue making capital advances available to the Company throughout the period as new loan covenants were negotiated. Therefore, the noncompliance had no impact on the Company's liquidity, capital resources or results of operations.

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

On December 8, 2003 (the "Effective Date"), the $3,000,000 Bridge Note issued to Bayview was converted into a $2,000,000 term note (the "Term Note"), $1,000,000 in Series A Convertible Preferred Stock, 0.01 par value (the "Preferred Stock") and a warrant to purchase common stock of the Company (the "Warrant") per the terms set forth in the August 25, 2003 Securities Purchase Agreement. The Term Note bears interest at 12% per year, payable monthly, and will mature on the fifth anniversary of the Effective Date. The Term Note may be prepaid, in whole or in part, at any time, provided that the prepayment is accompanied by a premium ranging from 5% in year 1 to 1% in year 5. The Bayview Investment is secured by a subordinated security interest in substantially all of the Company's assets. The Bayview Investment contained identical financial covenants to those in the Wells Loan described above, and on May 14, 2004 Bayview agreed to join with Wells Fargo in waiving this noncompliance and amending the covenants. The noncompliance with these financial covenants had no impact on the Company's liquidity, capital resources or results of operations, and the Company believes the amended covenants are more appropriate after taking into consideration the Company's actual financial position following the acquisition of the business assets of JJHCS.

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

The Warrant issued to Bayview on the Effective Date represents the right to purchase 1,210,320 shares of common stock, which represented 8% of the Company's outstanding common stock on a fully diluted basis at the Effective Date, excluding the common stock issuable to Bayview upon conversion of the Preferred Stock. The Warrant is exercisable at any time for a period of 10 years at an exercise price equal to $0.50 per share, and the shares obtainable upon exercise of the Warrant may be put to the Company at fair market value (net of the exercise price) upon a change of control or default.

The investment proceeds received from Bayview were allocated based upon the relative fair value of each instrument, which resulted in the following allocation:

Value assigned to Preferred Stock	$ 783,904
Value assigned to Warrants	648,288
Value assigned to Term Note	1,567,808
	$3,000,000

The $432,192 difference between the $2,000,000 face value of the Term Note and its assigned relative fair value is being amortized as interest expense over the 5-year term of the Term Note. Balances of long-term obligations are as follows:

	March 31, 2004	December 31, 2003
Wells Loan	$ 4,624,138	$ 2,775,000
Bayview Term Note	2,000,000	2,000,000
	6,624,138	4,775,000
Discount on Bayview Term Note	(403,379)	(424,988)
	$ 6,220,759	$ 4,350,012

Outstanding principal balances on the Wells Loan and Bayview Term Note mature in June 2007 and August 2008, respectively.

NOTE 5. STOCK-BASED COMPENSATION

The Company utilizes the intrinsic value method of accounting for its stock based employee compensation plans. All options granted had an exercise price equal to the market value of the underlying common stock on the date of grant and accordingly, no compensation cost is reflected in net earnings for the three months ended March 31, 2004 and 2003. The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value method of accounting for stock options:

	Three Mon Marc
	2004

Net earnings applicable to common shareholders - basic	$ 336,707
Add: Dividends to preferred shareholders	15,000
Net earnings - diluted	351,707
Less: Compensation expense determined under the fair value method, net of tax	(23,621)
Proforma net earnings - basic	313,086
Proforma net earnings - diluted	328,086
Earnings per Share:	
Basic-as reported	$ 0.03
Basic-proforma	$ 0.03
Diluted-as reported	$ 0.02
Diluted-proforma	$ 0.02

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

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

	2004	2003
Dividend yield	None	None
Expected volatility	88.43%	90%
Expected life of option	4 years	4 years
Risk-free interest rate	3.27%	2.9%
Weighted average fair value of options on grant date	$1.34	$0.26

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NOTE 6. INCOME TAXES

Deferred income taxes are provided for temporary differences between the financial reporting and tax basis of assets and liabilities and federal operating loss carryforwards. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of the enactment. Income taxes are calculated based on management's estimate of the Company's effective tax rate, which takes into consideration a federal tax rate of 34% and a state tax rate of 6%.

NOTE 7. STOCK OPTIONS

The Company maintains a stock option plan for the benefit of certain eligible employees and directors of the Company. A total of 149,000 shares of common stock are reserved for additional grants of options under the plan at March 31, 2004. Generally, the options outstanding (1) are granted at prices equal to the market value of the stock on the date of grant, (2) vest over various terms and, (3) expire over a period of five or ten years from the date of grant.

A summary of stock option activity for the quarter ended March 31, 2004 is as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 2003	1,710,900	$0.88
Granted	165,100	2.07
Exercised	(59,750)	0.53
Forfeited	(31,250)	0.44
Outstanding at March 31, 2004	1,785,000	$1.01

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

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

RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 31, 2004 COMPARED TO THE QUARTER ENDED MARCH 31, 2003.

REVENUE. Revenues increased $5,148,000 or 68.5% to $12,666,000 for the three months ended March 31, 2004, from $7,518,000 for the three months ended March 31, 2003. This increase is primarily attributed to the acquisition of the business assets of the Health & Fitness Services Business of Johnson & Johnson Health Care Systems Inc. ("JJHCS"), which acquired business contributed revenue of $5,113,000.

GROSS PROFIT. Gross profit increased $1,433,000 or 86.6% to $3,087,000 for the three months ended March 31, 2004, from $1,654,000 for the three months ended March 31, 2003. This increase is primarily attributed to the acquisition of JJHCS. In addition, the JJHCS acquisition improved gross profit as a percent of revenue, increasing to 24.4% for the three months ended March 31, 2004 compared to 22.0% for the three months ended March 31, 2003.

OPERATING EXPENSES AND OPERATING INCOME. Operating expenses increased $1,199,000 to $2,392,000 for the three months ended March 31, 2004 from $1,193,000 for the three months ended March 31, 2003. Of this increase, $219,000 represents a non-cash expense related to the amortization of acquired intangible assets. The remaining increase of $980,000 represents the cost of salaries, benefits and other expenses of the management team of JJHCS.

OTHER INCOME AND EXPENSE. Interest expense increased $123,000 to $134,000 for the three months ended March 31, 2004, compared to $11,000 for the same period in 2003. This increase is due to debt facilities the company secured to finance the JJHCS acquisition and to provide working capital for the combined company. The Company's cost of borrowed funds increased to 6.6% for the first quarter of 2004 from 3.8% for the first quarter of 2003.

INCOME TAXES. Income tax expense increased $27,000 to $209,000 for the three months ended March 31, 2004 compared to $182,000 for the same period in 2003. The increase is primarily due to the increase in operating profit.

DIVIDENDS TO PREFERRED SHAREHOLDERS. To finance the Company's acquisition of the JJHCS, the Company sold $1,000,000 in Series A Convertible Preferred Stock (the "Preferred Stock") to Bayview Capital Partners LP ("Bayview"). The Preferred Stock was issued to Bayview at a price of $1.00 per share, resulting in the issuance of 1,000,000 shares. The Preferred Stock has a stated dividend rate of 6% per year, computed on a simple interest basis, paid in kind in the form of additional shares of Preferred Stock using a price of $1.00 per share ("PIK Dividends"). For the quarter ended March 31, 2004, the Company accrued dividends of $15,000.

NET EARNINGS. As a result of the above, net earnings for the three months ended March 31, 2004 increased $69,000 or 25.7% to $337,000 for the three months ended March 31, 2004, compared to $268,000 for the same period in 2003.

LIQUIDITY AND CAPITAL RESOURCES

The Company's working capital increased $2,455,000 to $4,710,000 at March 31, 2004, compared to working capital of $2,255,000 at December 31, 2003. The increase in working capital is primarily due to an increase in accounts receivable resulting from the acquired JJHCS contracts.

On August 22, 2003, the Company entered into a $7,500,000 Credit Agreement with Wells Fargo Bank, N.A. to provide the Company with acquisition financing and general working capital (the "Wells Loan"). The initial draw on the Wells Loan totaled $1,255,204, which was used to refinance the revolving line of credit ("Merrill Lynch Loan") the Company previously maintained with Merrill Lynch Business Financial Services, Inc. ("Merrill Lynch"). The Company repaid all amounts owed to Merrill Lynch, and canceled the line of credit, which accrued interest at the one-month LIBOR rate plus 2.35% (effective rate of 3.77% at December 31, 2002). On August 25, 2003, the Company made a draw of $2,250,000 on the Wells Loan, the proceeds of which were placed into escrow to fund a portion of the JJHCS asset purchase.

Working capital advances from the Wells Loan are based upon a percentage of the Company's eligible accounts receivable, less any amounts previously drawn. At the option of the Company, the Wells Loan bears interest at prime or the one-month LIBOR plus a margin of 2.25% to 2.75% based upon the Company's Senior Leverage Ratio (effective rate of 4% at March 31, 2004 and December 31, 2003). The availability of the Wells Loan will decrease $250,000 on the last day of each calendar quarter, beginning September 30, 2003, and will expire on June 30, 2007. Availability of the Wells Loan totaled $6,750,000 and $7,000,000 at March

31, 2004 and December 31, 2003. Borrowings under the Wells Loan are collateralized by substantially all of the Company's assets. The Company is required to comply with certain monthly financial covenants, including a senior cash flow leverage ratio, senior leverage ratio and current ratio. Beginning on January 31, 2004 and continuing throughout the remainder of the period ending March 31, 2004, the Company was not in compliance with certain covenants relating to the Wells Loan. On May 14, 2004, Wells Fargo agreed to waive the noncompliance and amend the loan covenants, effective as of January 31, 2004. The Company believes that the new loan covenants are more appropriate after taking into consideration the Company's actual financial position following the acquisition of the business assets of JJHCS. Wells Fargo was made aware of the noncompliance shortly after January 31, 2004 and agreed to continue making capital advances available to the Company throughout the period as new loan covenants were negotiated. Therefore, the noncompliance had no impact on the Company's liquidity, capital resources or results of operations.

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

On December 8, 2003 (the "Effective Date"), the $3,000,000 Bridge Note issued to Bayview was converted into a $2,000,000 term note (the "Term Note"), $1,000,000 in Series A Convertible Preferred Stock (the "Preferred Stock") and a warrant to purchase common stock of the Company (the "Warrant") per the terms set forth in the August 25, 2003 Securities Purchase Agreement. The Term Note bears interest at 12% per year, payable monthly, and will mature on the fifth anniversary of the Effective Date. The Term Note may be prepaid, in whole or in part, at any time, provided that the prepayment is accompanied by a premium ranging from 5% in year 1 to 1% in year 5. The Bayview Investment is secured by a subordinated security interest in substantially all of the Company's assets. The Bayview Investment contained identical financial covenants to those in the Wells Loan described above, and on May 14, 2004 Bayview agreed to join with Wells Fargo in waiving this noncompliance and amending the covenants. The noncompliance with these financial covenants had no impact on the Company's liquidity, capital resources or results of operations, and the Company believes the amended covenants are more appropriate after taking into consideration the Company's actual financial position following the acquisition of the business assets of JJHCS.

The Preferred Stock was issued to Bayview at a price of $1.00 per share, resulting in 1,000,000 shares issued on the Effective Date. The Preferred Stock has a stated dividend rate of 6% per year, computed on a simple interest

basis, paid in kind in the form of additional shares of Preferred Stock using a price of $1.00 per share ("PIK Dividends"). At the option of the holder, the Preferred Stock, including any PIK Dividends, may be converted, at any time and from time to time, into common stock of the Company at a price of $0.50 per share. In addition, Bayview may require redemption of the Preferred Stock and PIK Dividends upon a change of control or default (including default under the Term Note).

As of March 31, 2004, the Company has no off-balance sheet arrangements or transactions with unconsolidated, limited purpose entities. Refer to the footnotes in the Company's Annual Report on Form 10-K for the year ended December 31, 2003 for disclosure related to the Company's "Commitments and

Contingencies."

On a short and long-term basis, the Company believes that sources of capital to meet future obligations will be provided by cash generated through operations and the Company's revolving line of credit. The Company does not believe that inflation has had a significant impact on the results of its operations.

RECENTLY ISSUED ACCOUNTING POLICIES

As indicated in our notes to the financial statements, we are not aware of any recently issued accounting pronouncements that will have a material impact on the Company's financial position or results of operations.

RECENTLY PASSED LEGISLATION

HIPPA. The Administrative Simplification provisions of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") require group health plans and health care providers who conduct certain administrative and financial transactions electronically ("Standard Transactions") to (a) comply with a certain data format and coding standards when conducting electronic transactions; (b) use appropriate technologies to protect the security and integrity of individually identifiable health information transmitted or maintained in an electronic format; and (c) protect the privacy of patient health information. The Company's occupational health line of business, which accounts for approximately five percent of the Company's total revenue, and the group health plan the Company sponsors for its employees are subject to HIPAA's requirements. The Company expects to be in compliance with HIPPA requirements within the timeline specified for the Company's affected business areas. The Company's corporate, hospital, community and university based fitness center management lines of business are not subject to the requirements of HIPAA.

CAUTIONARY STATEMENT

This Form 10-Q contains forward-looking statements within the meaning of federal securities laws. These statements include statements regarding intent, belief, or current expectations of the Company and its management and specifically include the statement regarding cash expected to be available from operations. These forward-looking statements are not guarantees of the future performance and involve a number of risks and uncertainties that may cause the Company's actual results to differ materially from the results discussed in these statements. Please refer to Management's Discussion and Analysis contained within the Company's Annual Report on Form 10-K for the year ended December 31, 2003, for cautionary statements on important factors to consider in evaluating the forward-looking statements included in this Form 10-Q.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has no history of, and does not anticipate in the future, investing in derivative financial instruments, derivative commodity instruments or other such financial instruments. Transactions with international customers are entered into in U.S. dollars, precluding the need for foreign currency hedges. As a result, the exposure to market risk is not material.

ITEM 4. CONTROLS AND PROCEDURES

The Company's Chief Executive Officer and Chief Financial Officer (collectively, the "Certifying Officers") are responsible for establishing and maintaining disclosure controls and procedures for the Company. The

Certifying Officers have concluded (based upon their evaluation of these controls and procedures as of the end of the period covered by this report) that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules of the Securities and Exchange Commission. The Certifying Officers also have indicated that there were no changes in the Company's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Refer to Item 3 (Legal Proceedings) of the Company's Annual Report on Form 10-K for the year ended December 31, 2003

Item 2. Changes in Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

On August 22, 2003, the Company entered into a $7,500,000 Credit Agreement with Wells Fargo Bank, N.A. ("Wells Fargo") to provide the Company with acquisition financing and general working capital (the "Wells Loan"). Beginning on January 31, 2004 and continuing throughout the remainder of the period ending March 31, 2004, the Company was not in compliance with certain covenants relating to the Wells Loan. The Company also was not in compliance with the identical covenants set forth in the Securities Purchase Agreement with Bayview Capital Partners LP ("Bayview") pertaining to a $2,000,000 term note and $1,000,000 of Series A Convertible Preferred Stock issued to Bayview on December 8, 2003. Wells Fargo continued to make working capital available throughout the period ending March 31, 2004, and on May 14, 2004, Wells Fargo and Bayview agreed to waive the noncompliance and to amend the covenants. Therefore, the noncompliance has had no impact on the Company's liquidity, capital resources or results of operations.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

See Exhibit Index on page following signatures

(b) Reports on Form 8-K

On February 6, 2004, the Company filed an Amendment to its Form 8-K dated December 8, 2003, providing financial statements and exhibits under Item 7 with respect to the Company's acquisition of the Health & Fitness Services Business of Johnson & Johnson Health Care Systems Inc.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: May 17, 2004 HEALTH FITNESS CORPORATION

By /s/ Jerry V. Noyce

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

By /s/ Wesley W. Winnekins

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

EXHIBIT INDEX
HEALTH FITNESS CORPORATION
FORM 10-Q

Exhibit No.	Description
3.1	Articles of Incorporation, as amended, of the Company - incorporated by refer Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997
3.2	Restated By-Laws of the Company - incorporated by reference to the Company's on Form SB-2 No. 33-83784C
4.1	Specimen of Common Stock Certificate - incorporated by reference to the Compa Statement on Form SB-2 No. 33-83784C
10.1	Standard Office Lease Agreement (Net) dated as of June 13, 1996 covering a po headquarters - incorporated by reference to the Company's Annual Report on Fo ended December 31, 1996
10.2	Amendment dated March 1, 2001 to Standard Office Lease Agreement (Net) dated covering a portion of the Company's headquarters-incorporated by reference to for the year ended December 31, 2000.
10.3	Second Amendment, dated June 12, 2002, to Standard Office Lease Agreement dat incorporated by reference to the Company's Form 10-Q for the quarter ended Ju
*10.4	Company's 1995 Stock Option Plan - incorporated by reference to the Company's 10-KSB for the year ended December 31, 1995

*10.5	Amendment to Company's 1995 Stock Option Plan - incorporated by reference to Company's Form 10-QSB for the quarter ended June 30, 1997
*10.6	Employment agreement dated November 30, 2000 between Company and Jerry V. Noy reference to the Company's Form 10-K for the year ended December 31, 2000.
*10.7	Employment agreement dated April 21, 1995 between the Company and James A. Na 19, 1999, November 2, 2000 and March 25, 2003-incorporated by reference to th for the year ended December 31, 2002.
*10.8	Employment agreement dated February 9, 2001 between Company and Wesley W. Win reference to the Company's Form 10K for the year ended December 31, 2000.
*10.9	Employment agreement dated March 1, 2003 between Company and Jeanne Crawford- reference to the Company's Form 10-K for the year ended December 31, 2002.

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Exhibit No.	Description
10.10	Agreement of Purchase and Sale of Stock of David W. Pickering, Inc. dated Jan incorporated by reference to the Company's Quarterly Report on form 10-QSB fo September 30, 2001
10.11	WCMA Loan and Security Agreement dated October 31, 2002 between the Company a Business Financial Services, Inc. incorporated by reference to the Company's quarter ended September 30, 2002
10.12	Credit Agreement, dated August 22, 2003, between the Company and Wells Fargo Association - incorporated by reference to the Company's Quarterly Report on quarter ended September 30, 2003
10.13	Securities Purchase Agreement, dated August 25, 2003, between the Company and subsidiaries, on the one hand, and Bayview Capital Partners LP, on the other reference to the Company's Quarterly Report on form 10-QSB for the quarter en
10.14	Asset Purchase Agreement, dated August 25, 2003, between the Company and John Care Systems Inc. - incorporated by reference to the Company's Quarterly Repo the quarter ended September 30, 2003
10.15	Third Amendment, dated August 25, 2003, to Standard Office Lease Agreement da 1996, between the Company and NEOC Holdings LLC - incorporated by reference t Quarterly Report on form 10-QSB for the quarter ended September 30, 2003
**10.16	Second Amendment to Credit Agreement and Waiver of Defaults between the Compa Bank, N.A., dated May 14, 2004
**10.17	Amendment No. 2 to Securities Purchase Agreement between the Company and cert subsidiaries, on the one hand, and Bayview Capital Partners LP, on the other 2004
**10.18	Amendment No. 3 to Securities Purchase Agreement between the Company and cert subsidiaries, on the one hand, and Bayview Capital Partners LP, on the other 2004

**11.0	Statement re: Computation of Earnings per Share
**31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarba
**31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarba
**32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarba
**32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarba

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* Indicates management contract or compensatory plan or arrangement

** Filed herewith