Health Fitness Corp /MN/
Form 10-Q
May 15, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2007
Commission File No. 000-25064

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

Minnesota	**No. 41-1580506**
(State or Other Jurisdiction of Incorporation or Organization)	**(IRS Employer Identification No.)**

3600 American Boulevard West, Bloomington, Minnesota 55431
(Address of Principal Executive Offices)
Registrant s telephone number (952) 831-6830

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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 þ NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO þ

The number of shares outstanding of the registrant s common stock as of May 11, 2007 was: Common Stock, $0.01 par value, 19,688,073 shares

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PART I. FINANCIAL INFORMATION
ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
HEALTH FITNESS CORPORATION
CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	March 31, 2007	December 31, 2006
ASSETS		
CURRENT ASSETS		
Cash	$ 54,404	$ 987,465
Trade and other accounts receivable, less allowances of $284,500 and $283,100	12,058,954	12,404,856
Prepaid expenses and other	1,110,698	701,889
Deferred tax assets	217,476	217,476
Total current assets	13,441,532	14,311,686
PROPERTY AND EQUIPMENT, net	888,408	767,675
OTHER ASSETS		
Goodwill	14,522,877	14,509,469
Software technology, less accumulated amortization of $471,600 and $370,200	1,682,617	1,658,575
Trademark, less accumulated amortization of $271,100 and $246,300	221,996	246,809
Other intangible assets, less accumulated amortization of $186,200 and $166,500	342,890	362,528
Deferred tax assets	437,011	437,010
Other	21,260	24,597
	$ 31,558,591	$ 32,318,349
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Trade accounts payable	$ 1,448,255	$ 1,811,939
Accrued salaries, wages, and payroll taxes	2,257,352	3,249,424
Accrued acquisition earnout		1,475,000
Other accrued liabilities	339,099	120,044
Accrued self funded insurance	332,114	201,053
Line of credit	619,649	
Deferred revenue	1,253,967	1,663,121
Total current liabilities	6,250,436	8,520,581
LONG-TERM OBLIGATIONS		
COMMITMENTS AND CONTINGENCIES		

STOCKHOLDERS EQUITY

Common stock, $0.01 par value; 50,000,000 shares authorized; 19,664,073 and 19,220,217 shares issued and outstanding	196,370	192,202
Additional paid-in capital	26,976,912	25,989,447
Accumulated comprehensive income	(28,099)	(35,186)
Accumulated deficit	(1,837,028)	(2,348,695)
	25,308,155	23,797,768
	$ 31,558,591	$ 32,318,349

See notes to consolidated financial statements.

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HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended March 31,	
	2007	2006
REVENUE	$ 16,590,033	$ 14,567,261
COSTS OF REVENUE	11,780,139	10,962,781
GROSS PROFIT	4,809,894	3,604,480
OPERATING EXPENSES		
Salaries	2,398,802	1,995,899
Selling, general and administrative	1,482,525	1,119,176
Amortization of intangible assets	42,770	108,462
Total operating expenses	3,924,097	3,223,537
OPERATING INCOME	885,797	380,943
OTHER INCOME (EXPENSE)		
Interest expense	(2,099)	(1,680)
Change in fair value of warrants		434,521
Other, net	(1,514)	(4,010)
EARNINGS BEFORE INCOME TAX EXPENSE	882,184	809,774
INCOME TAX EXPENSE	370,517	150,101
NET EARNINGS	511,667	659,673
Dividend to preferred shareholders		96,410
NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS	$ 511,667	$ 563,263
NET EARNINGS PER COMMON SHARE:		
Basic	$ 0.03	$ 0.04
Diluted	0.03	0.01
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING		
Basic	19,306,797	15,001,832
Diluted	20,252,110	19,666,941

See notes to consolidated financial statements

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HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Three Months Ended March 31,	
	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net earnings	$ 511,667	$ 563,263
Adjustments to reconcile net earnings to net cash used in operating activities:		
Depreciation	176,004	120,289
Amortization	44,450	110,142
Warrant valuation		(434,521)
Stock-based compensation	157,001	75,459
Deferred taxes		(208,401)
Loss on disposal of assets		159
Change in assets and liabilities:		
Trade and other accounts receivable	345,903	(298,965)
Prepaid expenses and other	(408,809)	(47,939)
Other assets	3,336	5,836
Trade accounts payable	(356,596)	50,072
Accrued liabilities and other	(641,956)	(639,482)
Deferred revenue	(409,154)	(135,682)
Net cash used in operating activities	(578,154)	(839,770)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(320,780)	(144,486)
Business acquisition, net of cash acquired	(13,408)	(64,072)
Accrued acquisition earnout	(737,500)	
Net cash used in investing activities	(1,071,688)	(208,558)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Costs from issuance of preferred stock	(17,415)	(95,403)
Proceeds from the issuance of common stock	21,249	85,698
Proceeds from the exercise of stock options	93,298	3,125
Proceeds from the line of credit	619,649	
Net cash provided by (used in) financing activities	716,781	(6,580)
NET DECREASE IN CASH	(933,061)	(1,054,908)
CASH AT BEGINNING OF PERIOD	987,465	1,471,505
CASH AT END OF PERIOD	$ 54,404	$ 416,597

Non-cash investing and financing activities affecting cash flows:

Common stock issued for acquisition earnout	$	737,500

See notes to consolidated financial statements.

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HEALTH FITNESS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1. ORGANIZATION

Health Fitness Corporation, a Minnesota corporation (also referred to as we, us, our, the Company, or Health Fitn
is a leading provider of population health improvement services and programs to corporations, hospitals, communities and universities located in the United States and Canada. We currently manage 250 corporate fitness center sites for 125 customers, and 158 corporate health improvement programs for 168 customers.

We provide staffing services as well as a comprehensive menu of programs, products and consulting services within our Health Management and Fitness Management business segments. Our broad suite of services enables our clients employees to live healthier lives, and our clients to control rising healthcare costs, through participation in our assessment, education, coaching, physical activity, weight management and wellness program services, which can be offered as follows: (i) through on-site fitness centers we manage; (ii) remotely via the web and; (iii) through telephonic health coaching.

NOTE 2. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements for the first quarter ended March 31, 2007 have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Financial information as of December 31, 2006 has been derived from our audited consolidated financial statements. In accordance with the rules and regulations of the United States Securities and Exchange Commission, the Company has omitted footnote disclosures that would substantially duplicate the disclosures contained in the audited financial statements of the Company. The unaudited consolidated financial statements should be read together with the financial statements for the year ended December 31, 2006, and the footnotes thereto included in the Company s Form 10-K as filed with the United States Securities and Exchange Commission on March 30, 2007.

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. These financial statements include some amounts that are based on management s best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of earnings in the period in which the change in estimate is identified. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the operating results that may be expected for the year ended December 31, 2007.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Reclassifications Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications had no net effect on assets, liabilities, shareholders equity or results of operations as previously reported.

Cash We maintain cash balances at several financial institutions, and at times, such balances exceed insured limits. We have not experienced any losses in such accounts and we believe we are not exposed to any significant

credit risk on cash. At March 31, 2007 and December 31, 2006, we had cash of approximately $54,400 and $36,900 (U.S. Dollars) in a Canadian bank account.

Trade and Other Accounts Receivable Trade and other accounts receivable represent amounts due from companies and individuals for services and products. We grant credit to customers in the ordinary course of business, but generally do not require collateral or any other security to support amounts due. Management performs ongoing credit evaluations of customers. Accounts receivable from sales of services are typically due from customers within 30 to 90 days. Accounts outstanding longer than contractual payment terms are considered past due. We determine our allowance for discounts and doubtful accounts by considering a number of factors, including the length of time trade accounts receivable are past due, our previous loss history, the customer s current ability to pay its obligation to us, and the condition of the general economy and the industry as a whole. We write 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 are stated at cost. Depreciation and amortization are computed using both straight-line and accelerated methods over the useful lives of the assets.

Software Development Costs - Software development costs are accounted for in accordance with Statement SFAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed. Accordingly, software development costs incurred subsequent to the determination of technological feasibility and marketability of a software product are capitalized. Capitalization of costs ceases and amortization of capitalized software development costs commences when the products are available for general release. Amortization is determined on a product by product basis using the greater of a ratio of current product revenues to projected current and future product revenues or an amount calculated using the straight-line method over the estimated economic life of the product, which is generally three to five years.

Capitalized software development costs are stated at the lower of amortized cost or net realizable value. Recoverability of these capitalized costs is determined by comparing the forecasted future revenues from the related products, based on management s best estimates using appropriate assumptions and projections at the time, to the carrying amount of the capitalized software development costs. If the carrying value is determined not to be recoverable from future revenues, an impairment loss is recognized equal to the amount by which the carrying amount exceeds the future revenues.

During the three months ended March 31, 2007, we capitalized $125,500 of software development costs related to enhancements we made to our eHealth platform, a system we acquired through our acquisition of HealthCalc. Capitalized software development costs are captured within Software Technology. These software development costs will be amortized over the remaining economic life of the eHealth platform, or five years. We expect to recover our capitalized software development costs due to the growth of our Health Management segment.

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 tested for impairment on an annual basis or when factors indicating impairment are present. Projected discounted cash flows are used in assessing these assets. We elected to complete the annual impairment test of goodwill on December 31 each year and determined that our goodwill relates to two reporting units for purposes of impairment testing.

Intangible Assets Our intangible assets include trademarks and tradenames, software and other intangible assets, all of which are amortized on a straight-line basis. Trademarks and tradenames represent the value assigned to acquired trademarks and tradenames, and are amortized over a period of five years. Software represents the value assigned to an acquired web-based software program and is amortized over a period of five years. Other intangible assets include the value assigned to acquired customer lists, which is amortized over a period of six years, as well as deferred financing costs, which are amortized over the term of the related credit agreement.

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Revenue Recognition Revenue is recognized at the time the service is provided to the customer. We determine our allowance for discounts by considering historical discount history and current payment practices of our customers. 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.

We also provide services to companies located in Canada. Although we invoice these customers in their local currency, we do not believe there is a risk of material loss due to foreign currency translation.

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

We have 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 us based on transactions with our customer. We do not recognize revenues related to such transactions as our 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.

Net Earnings Per Common Share Basic net earnings per common share is computed by dividing net earnings applicable to common shareholders by the number of basic weighted average common shares outstanding. Diluted net earnings per share is computed by dividing net earnings applicable to common shareholders, plus dividends to preferred shareholders (net earnings), less the non-cash benefit related to a change in fair value of warrants by the number of diluted weighted average common shares outstanding, and common share equivalents relating to stock options, unearned restricted stock and stock warrants, if dilutive. Refer to Exhibit 11.0 attached hereto for a detailed computation of earnings per share.

Stock-Based Compensation We maintain a stock option plan for the benefit of certain eligible employees and directors of the Company. Commencing January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123R, Share Based Payment (SFAS 123R), using the modified prospective method of adoption, which requires all share-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair values over the requisite service period. The compensation cost we record for these awards is based on their fair value on the date of grant. The Company continues to use the Black Scholes option-pricing model as its method for valuing stock options. The key assumptions for this valuation method include the expected term of the option, stock price volatility, risk-free interest rate and dividend yield. Many of these assumptions are judgmental and highly sensitive in the determination of compensation expense. Further information on our share-based payments can be found in Note 7 in the Notes to the Consolidated Financial Statements under Part I, Item 1.

Fair Values of Financial Instruments Due to their short-term nature, the carrying value of our 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.

Valuation of Derivative Instruments In accordance with the interpretive guidance in EITF Issue No. 05-4, The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock, we valued warrants we issued in November 2005 in our financing transaction as a derivative liability. We were required to make certain periodic assumptions and estimates to value the derivative liability. Factors affecting the amount of this liability include changes in our stock price, the computed volatility of our stock price and other assumptions. The change in value is reflected in our statements of operations as non-cash income or expense, and the changes in the carrying value of derivatives can have a material impact on our financial statements.

Income Taxes The Company records income taxes in accordance with the liability method of accounting. 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. We do not record a tax liability or benefit in connection with the change in fair value of certain of our warrants. 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 net effective state tax rate of 4%. This total effective tax rate of 38% is less than the tax rate resulting from income tax expense we recognized during the quarter due to the tax rate effects related to compensation expense for incentive stock options.

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 4. SEGMENT REPORTING

The Company discloses segment information in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, which defines an operating segment as a component of a company for which operating results are reviewed regularly by the chief operating decision-makers to determine resource allocation and assess performance. The Company has two reportable segments, Fitness Management and Health Management. Total assets are not allocated to the segments for internal reporting purposes.

Financial information by segment is as follows:

Segment Data:

	Three Months Ended March 31,	
	2007	2006
REVENUE:		
Fitness Management Revenue		
Staffing Services	$ 9,992,694	$ 9,699,524
Program and Consulting Services	696,233	566,073
	10,688,917	10,265,597
Health Management Revenue		
Staffing Services	3,667,338	3,070,012
Program and Consulting Services	2,233,778	1,231,652
	5,901,116	4,301,664
Total Revenue		
Staffing Services	13,660,022	12,769,536
Program and Consulting Services	2,930,011	1,797,725
	$ 16,590,033	$ 14,567,261
GROSS PROFIT:		
Fitness Management Revenue		
Staffing Services	$ 2,109,181	$ 1,994,580
Program and Consulting Services	364,851	300,527

	2,474,032	2,295,107
Health Management Revenue		
Staffing Services	907,236	656,076
Program and Consulting Services	1,428,626	653,297
	2,335,862	1,309,373
Total Gross Profit		
Staffing Services	3,016,417	2,650,656
Program and Consulting Services	1,793,477	953,824
	$ 4,809,894	$ 3,604,480

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NOTE 5. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the Financial Accounting Standards Bound (FASB) issued FIN No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. (SFAS 109) FIN 48 clarifies the application of SFAS No. 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise s financial statements. Additionally, FIN 48 provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 was effective for us on January 1, 2007.

The Company adopted the provisions of FIN 48 on January 1, 2007. Previously, the Company had accounted for tax contingencies in accordance with SFAS No. 5, Accounting for Contingencies. As required by FIN 48, the Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, the Company applied FIN 48 to all tax positions for which the statute of limitations remained open. At January 1, 2007, the Company s existing reserve for income tax uncertainties was not material. The Company recognized no additional liabilities for unrecognized tax benefits as a result of the implementation of FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, (SFAS 157). SFAS 157 does not address what to measure at fair value; instead, it addresses how to measure fair value. SFAS 157 applies (with limited exceptions) to existing standards that require assets or liabilities to be measured at fair value. SFAS 157 establishes a fair value hierarchy, giving the highest priority to quoted prices in active markets and the lowest priority to unobservable data and requires new disclosures for assets and liabilities measured at fair value based on their level in the hierarchy. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We do not believe that the adoption of SFAS 157 will have a material effect on our financial position or results of operation.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, (SFAS 159) which permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact, if any, the adoption of SFAS 159 will have on our financial statements.

NOTE 6. FINANCING

On November 14, 2005 (the Effective Date), in a Private Investment in Public Equity transaction (the PIPE Transaction), we issued an aggregate of 1,000 shares of Series B Convertible Preferred Stock (the Series B Stock), together with warrants to purchase 1,530,000 shares of common stock at $2.40 per share, to a limited number of accredited investors for aggregate gross proceeds of $10.2 million. After selling commissions and expenses, we received net proceeds of approximately $9.4 million. The Series B Stock automatically converted into 5,100,000 shares of our common stock on March 10, 2006, the date the Securities and Exchange Commission (the SEC) first declared effective a registration statement covering these shares. We used the proceeds from this PIPE Transaction to redeem our Series A Convertible Preferred Stock and to fund the acquisition of HealthCalc.Net, Inc.

In accordance with the terms of the PIPE Transaction, we were required to file with the SEC, within sixty (60) days from the Effective Date, a registration statement covering the common shares issued and issuable in the PIPE Transaction. We were also required to cause the registration statement to be declared effective on or before the expiration of one hundred twenty (120) days from the Effective Date. We would have been subject to liquidated damages of one percent (1%) per month of the aggregate gross proceeds ($10,200,000), if we failed to meet these

date requirements. On March 10, 2006, the SEC declared effective our registration statement and, as a result, we did not pay any liquidated damages for failure to meet the filing and effectiveness date requirements. We could nevertheless be subject to the foregoing liquidated damages if we fail (subject to certain permitted circumstances) to maintain the effectiveness of the registration statement. On June 15, 2006, we entered into an agreement with the accredited investors to amend the Registration Rights Agreement to cap the amount of liquidated damages we could pay at 9% of the aggregate purchase price paid by each accredited investor.

The warrants, which were issued together with the Series B Stock, have a term of five years, and give the investors the option to require us to repurchase the warrants for a purchase price, payable in cash within five (5) business days after such request, equal to the Black Scholes value of any unexercised warrant shares, only if, while the warrants are outstanding, any of the following change in control transactions occur: (i) we effect any merger or consolidation, (ii) we effect any sale of all or substantially all of our assets, (iii) any tender offer or exchange offer is completed whereby holders of our common stock are permitted to tender or exchange their shares for other securities, cash or property, or (iv) we effect any reclassification of our common stock whereby it is effectively converted into or exchanged for other securities, cash or property. On June 15, 2006, we entered into an agreement with the accredited investors to amend the Warrant Agreement to give us the ability to repurchase the warrants, in the case of a change in control transaction, using shares of stock, securities or assets, including cash.

Under EITF 00-19 Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock (EITF 00-19), the fair value of the warrants issued under the PIPE Transaction have been reported as a liability due to the requirement to net-cash settle the transaction. There are two reasons for this treatment: (i) there are liquidated damages, payable in cash, of 1% of the gross proceeds per month ($102,000) should we fail to maintain effectiveness of the registration statement in accordance with the PIPE Transaction; and (ii) our investors may put their warrants back to us for cash if we initiate a change in control that meets the definition previously discussed. As a result of the amendments we structured with the accredited investors on June 15, 2006, we were allowed to account for the warrants as equity. As a result of this accounting change, we made a final valuation of our warrant liability on June 15, 2006, which resulted in non-cash income of $406,694 for our second quarter in 2006, and the remaining warrant liability of $1,369,674 was reclassified to additional paid in capital. We are no longer required to revalue these warrants on a prospective basis.

NOTE 7**.** EQUITY

Stock Options We maintain a stock option plan for the benefit of certain eligible employees and our directors. We have authorized 4,000,000 shares for grant under our 2005 Stock Option Plan, and a total of 763,525 shares of common stock are reserved for additional grants of options at March 31, 2007. Generally, the options outstanding are granted at prices equal to the market value of our stock on the date of grant, generally vest over four years and expire over a period of six or ten years from the date of grant.

Commencing January 1, 2006, we adopted Statement of Financial Accounting Standard No. 123R, Share Based Payment (SFAS 123R), which requires all share-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair values over the requisite service period. Prior to 2006, the compensation cost we recorded for option awards was based on their grant date fair value as calculated for the proforma disclosures required by Statement 123.

For the three months ended March 31, 2007 and 2006, we recorded stock-based compensation expense of $96,300 and $75,500, respectively. The compensation expense reduced diluted earnings per share by less than $0.01 for the three months ended March 31, 2007 and 2006.

As of March 31, 2007, approximately $1,170,000 of total unrecognized compensation costs related to non-vested awards is expected to be recognized over a weighted average period of approximately 3.14 years.

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The following table summarizes information about stock options at March 31, 2007:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life In Years	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 0.30 - $0.39	155,400	1.12	$0.39	155,400	$0.39
0.47 - 0.69	494,650	0.69	0.54	494,650	0.54
0.95 - 1.25	239,000	2.76	1.15	179,250	1.16
1.26 - 2.27	458,600	3.91	1.85	380,200	1.84
2.28 - 3.00	1,283,000	3.58	2.77	462,375	2.78
	2,630,650	2.87	$1.90	1,671,875	$1.51

We use the Black-Scholes option pricing model to determine the weighted average fair value of options. The assumptions utilized to determine fair value of options at the date of grant are indicated in the following table:

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Risk-free interest rate	4.69%	4.32%
Expected volatility	52.6%	76.0%
Expected life (in years)	4.25	4.24
Dividend yield		

Option transactions under the 2005 Stock Option Plan during the first quarter ended March 31, 2007 are summarized as follows:

	Options	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Term
Outstanding at December 31, 2006	2,250,900	$ 1.64		
Granted	505,500	2.81		
Exercised	(122,000)	0.76		
Canceled/Forfeited	(3,750)	2.72		
Outstanding at March 31, 2007	2,630,650	$ 1.90	$ 2,406,147	3.48
Exercisable at March 31, 2007	1,671,875	$ 1.51	$ 2,173,476	2.53

Restricted Stock - In connection with our employment agreement dated as of December 1, 2006 with Gregg O. Lehman, Ph.D., our President and Chief Executiv