WIDEPOINT CORP
Form 10-Q
November 12, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

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 001-33035

WIDEPOINT CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	52-2040275
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

18W100 22nd St. Suite 124, Oakbrook Terrace, IL	60181
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (630) 629-0003

Indicate by check 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 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company x

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

As of November 12, 2010, 62,095,133 shares of common stock, $.001 par value per share, were outstanding.

WIDEPOINT CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

WIDEPOINT CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2010 (unaudited)	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 3,702,895	$ 6,238,788
Accounts receivable, net of allowance of $156,010 and $52,650, respectively	9,263,580	7,055,525
Unbilled accounts receivable	2,584,604	1,334,455
Prepaid expenses and other assets	343,387	359,563
Total current assets	15,894,466	14,988,331
Property and equipment, net	472,841	538,811
Goodwill	10,475,513	9,770,647
Other Intangibles, net	1,196,996	1,381,580
Other assets	62,377	75,718
Total assets	$ 28,102,193	$ 26,755,087
Liabilities and stockholders' equity		
Current liabilities:		
Short term note payable	$ 25,922	$ 102,074
Accounts payable	6,546,112	7,120,168
Accrued expenses	2,819,436	2,304,995
Deferred revenue	393,317	768,504
Short-term portion of long-term debt	548,195	520,855
Short-term portion of deferred rent	15,793	54,497
Short-term portion of capital lease obligation	59,286	112,576
Total current liabilities	10,408,061	10,983,669
Deferred income tax liability	431,450	313,782
Long-term debt, net of current portion	192,707	604,048
Fair value of earnout liability	300,000	—
Deferred rent, net of current portion	102,462	7,312
Capital lease obligation, net of current portion	32,485	67,632
Total liabilities	$ 11,467,165	$ 11,976,443
Stockholders' equity:		
Common stock, $0.001 par value; 110,000,000 shares authorized; 61,380,133 and 61,375,333 shares issued and outstanding, respectively	61,380	61,375
Stock warrants	24,375	24,375
Additional paid-in capital	67,963,301	67,874,394
Accumulated deficit	(51,414,028)	(53,181,500)
Total stockholders' equity	16,635,028	14,778,644
Total liabilities and stockholders' equity	$ 28,102,193	$ 26,755,087

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

WIDEPOINT CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009	
	(unaudited)				
Revenues, net	$ 13,757,098	$ 11,378,793	$ 37,372,274	$ 31,906,457	
Cost of sales (including amortization and depreciation of $201,375, $245,876, $670,937, and $731,767, respectively)	9,824,729	8,704,275	27,985,311	24,986,779	
					(533) 7134
Income (loss) from continuing operations	(486)	(2,196)	2,161	(1,075)	
Discontinued operation:					
Income (loss) from discontinued operation before income taxes	237	(1,035)	114	(490)	
Income tax expense (benefit) of discontinued operation	(85)	37	(83)	97	
Income (loss) from discontinued operation	322	(1,072)	197	(587)	
Net income (loss)	$ (164)	$ (3,268)	$ 2,358	$ (1,662)	
Income (loss) per share from continuing operations:					
Basic	$ (0.02)	$ (0.07)	$ 0.07	$ (0.03)	
Diluted	(0.02)	(0.07)	0.07	(0.03)	
Income (loss) per share from discontinued operation:					
Basic	$ 0.01	$ (0.04)	$ 0.01	$ (0.02)	
Diluted	0.01	(0.04)	0.01	(0.02)	
Net income (loss) per share:					
Basic	$ (0.01)	$ (0.11)	$ 0.08	$ (0.05)	
Diluted	(0.01)	(0.11)	0.08	(0.05)	
Weighted average shares outstanding:					
Basic	30,878	30,745	30,878	30,745	
Diluted	30,878	30,745	30,987	30,745	

See accompanying notes to condensed consolidated financial statements.

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NAUTILUS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited and in thousands)

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Net income (loss)	$(164)	$(3,268)	$2,358	$(1,662)
Other comprehensive income (loss), net of tax:				
Foreign currency translation	(254)	220	(75)	(231)
Total comprehensive income (loss)	$(418)	$(3,048)	$2,283	$(1,893)

See accompanying notes to condensed consolidated financial statements.

NAUTILUS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited and in thousands)

	Six months ended June 30, 2012	2011
Cash flows from operating activities:		
Income (loss) from continuing operations	$2,161	$(1,075)
Income (loss) from discontinued operation	197	(587)
Net income (loss)	2,358	(1,662)
Adjustments to reconcile net income (loss) to cash provided by operating activities:		
Depreciation and amortization	1,528	2,081
Bad debt expense reduction	(123)	(17)
Stock-based compensation expense	294	(7)
Loss on asset disposals	14	—
Reduction of previously estimated asset disposal loss	(77)	(627)
Deferred income taxes, net of valuation allowances	385	470
Changes in operating assets and liabilities:		
Trade receivables	13,234	11,586
Inventories	(993)	(2,162)
Prepaids and other current assets	1,445	1,937
Income taxes	(200)	(569)
Trade payables	(11,645)	(8,530)
Accrued liabilities, including warranty obligations	(1,676)	(961)
Net cash provided by operating activities	4,544	1,539
Cash flows from investing activities:		
Proceeds from sale of discontinued operation	217	1,006
Purchases of software and equipment	(1,110)	(1,884)
Net increase in restricted cash	—	351
Net cash used in investing activities	(893)	(527)
Cash flows from financing activities:		
Repayment of long-term borrowings	(5,000)	—
Financing costs	—	(36)
Proceeds from exercise of stock options	89	4
Net cash provided by (used in) financing activities	(4,911)	(32)
Effect of exchange rate changes on cash and cash equivalents	(36)	(224)
Net increase in cash and cash equivalents	(1,296)	756
Cash and cash equivalents, beginning of year	17,427	14,296
Cash and cash equivalents, end of period	$16,131	$15,052
Supplemental disclosure of cash flow information:		
Cash paid for interest	$524	$—
Cash refunded for income taxes, net	(119)	(20)

See accompanying notes to condensed consolidated financial statements.

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NAUTILUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(1) GENERAL INFORMATION

Basis of Consolidation and Presentation

The accompanying condensed consolidated financial statements present the financial position, results of operations and cash flows of Nautilus, Inc. and its subsidiaries (collectively, "Nautilus" or the "Company"), all of which are wholly owned. Intercompany transactions and balances have been eliminated in consolidation.

The accompanying condensed consolidated financial statements have not been audited. Nautilus has condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). Management believes the disclosures contained herein are adequate to make the information presented not misleading. However, these condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in its Annual Report on Form 10-K for the year ended December 31, 2011 (the "2011 Form 10-K").

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Further information regarding significant estimates can be found in the Company's 2011 Form 10-K.

In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments necessary to present fairly the Company's financial position as of June 30, 2012 and December 31, 2011, results of operations for the three and six months ended June 30, 2012 and 2011 and cash flows for the six months ended June 30, 2012 and 2011. Interim results are not necessarily indicative of results for a full year. The Company's revenues typically vary seasonally and this seasonality can have a significant effect on operating results, inventory levels and working capital needs.

Unless indicated otherwise, all information regarding the Company's operating results pertains to its continuing operations.

New Accounting Pronouncements

In the first quarter of 2012, the Company adopted Accounting Standards Update No. 2011-05, Presentation of Comprehensive Income ("ASU 2011-05"), which revises the manner in which entities present comprehensive income in their financial statements. Since the requirements of ASU 2011-05 relate only to presentation, its adoption did not have any effect on the Company's financial position, results of operations or cash flows.

In July 2012, the Financial Accounting Standards Board issued ASU 2012-02, Testing Indefinite-Lived Intangible Assets for Impairment, which amends the guidance in Accounting Standards Topic 350-30, Intangibles - Goodwill and Other, on testing indefinite-lived intangible assets, other than goodwill, for impairment. Under ASU 2012-02, entities testing indefinite-lived intangible assets for impairment would have the option of performing a qualitative assessment before calculating the fair value of the asset. If an entity determines, on the basis of qualitative factors, that the indefinite-lived intangible asset is not more likely than not impaired, a quantitative fair value calculation would not be needed. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, although early adoption is permitted. The adoption of ASU 2012-02 will not affect the Company's financial position, results of operations or cash flows.

(2) DISCONTINUED OPERATION

On September 25, 2009, in light of continuing operating losses in its Commercial business and in order to focus exclusively on managing its Direct and Retail businesses, the Company committed to a plan for the complete divestiture of its Commercial business, which qualified for held-for-sale accounting treatment. The Commercial business is presented as a discontinued operation in the Company's condensed consolidated statements of operations for all periods. Following is a summary of the operating results of the Company's former Commercial business for the three and six months ended June 30, 2012 and 2011 (in thousands):

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	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Revenue	$—	$40	$—	$141
Operating income (loss)	$219	$(1,323)	$67	$(1,117)
Disposal gain	18	288	47	627
Income tax benefit (expense)	85	(37)	83	(97)
Total income (loss) from discontinued operation	$322	$(1,072)	$197	$(587)

The disposal of Commercial business assets was completed in April 2011. The Company may incur additional expenses in future periods in connection with the settlement of contingencies arising from and directly related to the Commercial business prior to its disposal. For further information regarding contingencies related to the Company's former Commercial business, see Note 10, Commitments and Contingencies.

The following table summarizes liabilities for exit costs related to the discontinued operation, included in "Accrued liabilities" and "Other long-term liabilities" in the Company's condensed consolidated balance sheets (in thousands):

	Severance and Benefits	Facilities Leases	Total Liabilities
Balance as of December 31, 2011	$175	$1,929	$2,104
Accruals	—	(390)	(390)
Payments	(173)	(218)	(391)
Balance as of June 30, 2012	$2	$1,321	$1,323

(3) INVENTORIES

Inventories, net of valuation allowances, as of June 30, 2012 and December 31, 2011 consisted of the following (in thousands):

	As of	
	June 30, 2012	December 31, 2011
Finished goods	$10,970	$9,832
Parts and components	1,621	1,769
Total inventories	$12,591	$11,601

Valuation allowances were $1.1 million and $1.0 million as of June 30, 2012 and December 31, 2011, respectively, and related primarily to excess parts inventories.

(4) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment as of June 30, 2012 and December 31, 2011 consisted of the following (in thousands):

	Estimated Useful Life (in years)	As of	
		June 30, 2012	December 31, 2011
Leasehold improvements	5 to 20	$2,662	$2,557
Computer equipment	3 to 5	37,422	36,872
Machinery and equipment	3 to 5	5,018	4,759
Furniture and fixtures	5	438	666
Work in progress [1]	N/A	2,210	1,937

Total cost	47,750	46,791
Accumulated depreciation	(42,290)	(42,386)
Total property, plant and equipment, net	$5,460	$4,405

[1] Work in progress includes internal use software development and production tooling construction in progress.

(5) GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and other intangible assets as of June 30, 2012 and December 31, 2011 consisted of the following (in thousands):

	Estimated Useful Life (in years)	As of June 30, 2012	December 31, 2011
Goodwill	N/A	$2,859	$2,873
Other intangible assets:			
Indefinite-lived trademarks	N/A	$9,052	$9,052
Patents	1 to 16	18,154	18,154
		27,206	27,206
Accumulated amortization - patents		(11,515)	(10,490)
		$15,691	$16,716

Nautilus reviews goodwill and indefinite-lived intangible assets for impairment in the fourth quarter of each year, or more frequently when events or changes in circumstances indicate the assets may be impaired. The change in goodwill since December 31, 2011 is due to currency exchange rate fluctuations between the U.S. and Canadian dollars.

(6) PRODUCT WARRANTIES

The Company's products carry limited, defined warranties for defects in materials or workmanship which, according to their terms, generally obligate Nautilus to pay the costs of supplying and shipping replacement parts to customers and, in certain instances, for labor and other costs to service products. Outstanding product warranty periods range from sixty days to the lifetime of certain product components in limited situations. Changes in the Company's product warranty liability in the three and six months ended June 30, 2012 and 2011 were as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Balance, Beginning of period	$1,872	$3,671	$2,017	$3,935
Accruals	735	320	1,275	1,019
Adjustments	—	(251)	(171)	(360)
Payments	(454)	(382)	(968)	(1,236)
Balance, June 30	$2,153	$3,358	$2,153	$3,358

Product warranty liability adjustments in 2011 primarily relate to the assignment of certain outstanding Commercial warranty obligations of the Company's former Commercial business. Total outstanding obligations of the Company's discontinued Commercial business included in product warranty liability were $0.4 million and $2.0 million as of June 30, 2012 and 2011, respectively.

(7) BORROWINGS

The Company has a Credit Agreement (the "Loan Agreement") with Bank of the West that, as amended and restated on March 30, 2012, provides for a $15,750,000 maximum revolving secured credit line, which is available through March 31, 2015 for working capital, standby letters of credit and general corporate purposes. Borrowing availability under the Loan Agreement is subject to the Company's compliance with certain financial and operating covenants at the time borrowings are requested. Standby letters of credit under the Loan Agreement are treated as a reduction of the available borrowing amount and are subject to covenant testing.

The interest rate applicable to borrowings under the Loan Agreement is based on Bank of the West's base rate, floating rate or LIBOR, plus an applicable margin based on certain Company financial performance metrics. The Company's borrowing rate was 2.25% as of June 30, 2012. The Loan Agreement contains customary covenants, including minimum fixed charge coverage ratio and leverage ratio, and limitations on capital expenditures, mergers and acquisitions, indebtedness, liens, dispositions, dividends and investments. The Loan Agreement also contains customary events of default. Upon an event of default, the lender has the option of terminating its commitment with respect to the credit line and accelerating all obligations under the Loan Agreement. Borrowings under the Loan Agreement are collateralized by substantially all of the Company's assets, including intellectual property assets.

As of June 30, 2012, the Company had no outstanding borrowings and $1.3 million in standby letters of credit issued under the Loan Agreement. As of June 30, 2012, the Company was in compliance with the financial covenants of the Loan Agreement and approximately $14.5 million was available for borrowing.

On September 3, 2010, the Company entered into a Note Purchase Agreement (the "Purchase Agreement") with certain entities (collectively, the "Sherborne Purchasers") under common control of Sherborne Investors GP, LLC and its affiliates (collectively "Sherborne"). Sherborne was formerly the Company's largest shareholder and is controlled by Edward J. Bramson, the Company's former Chairman and Chief Executive Officer, and Craig L. McKibben, a former member of the Company's Board of Directors.

Pursuant to the Purchase Agreement, the Company issued to the Sherborne Purchasers $6,096,996 in aggregate principal amount at maturity of Increasing Rate Senior Discount Notes due December 31, 2012 (the "Notes"). The Notes had an original principal amount totaling $5,000,000 and an original maturity date of December 31, 2012. On March 12, 2012, the maturity date of the Notes was automatically extended under certain terms of the Purchase Agreement to May 2, 2013.

On July 19, 2011, beneficial interest in the Notes was assigned by the Sherborne Purchasers pro-rata to their respective investors in the manner permitted by the Purchase Agreement. Such assignment was made in connection with the resignation of Messrs. Bramson and McKibben from their respective positions with Nautilus on May 26, 2011, and the subsequent pro-rata distribution by certain Sherborne-affiliated entities to their respective investors of the common stock of the Company owned by such entities.

The Company repaid all amounts outstanding under the Notes on March 30, 2012. If all of the Notes were paid on the original maturity date, the effective rate of interest over the term of the Purchase Agreement would have been approximately 8.7% per annum, which was the rate at which interest expense was accrued by the Company in periods preceding the repayment date. The actual effective rate of interest through the repayment date was approximately 6.4%.

(8) INCOME PER SHARE

Basic income per share was computed using the weighted average number of common shares outstanding. For the computation of diluted income per share, the number of basic weighted average shares outstanding was increased by dilutive potential common shares related to stock-based compensation, as determined by the treasury stock method. The weighted average numbers of shares outstanding used to compute income per share were as follows:

	Three months ended June 30,		Six months ended June 30,	
(Number of shares in thousands)	2012	2011	2012	2011
Basic weighted average shares outstanding	30,878	30,745	30,878	30,745
Dilutive potential common shares [1]	—	—	109	—
Diluted weighted average shares outstanding	30,878	30,745	30,987	30,745
[1] Dilutive potential common shares omitted due to net loss	116	20	—	20

The weighted average numbers of shares outstanding listed in the table below were anti-dilutive and excluded from the computation of diluted income per share, primarily because the average market price did not exceed the exercise price. These shares may be dilutive potential common shares in the future

	Three months ended June 30,		Six months ended June 30,	
(Number of shares in thousands)	2012	2011	2012	2011

Stock options	1,098	1,034	1,046	1,025
Performance stock units	109	146	49	97
Restricted stock units	—	46	—	23

(9) SEGMENT INFORMATION

The Company has two reportable segments - Direct and Retail. Contribution is the measure of profit or loss used by the Company's chief operating decision maker and is defined as net sales less product costs and directly attributable expenses. Directly attributable expenses include selling and marketing expenses, general and administrative expenses, and research and development expenses that are directly related to segment operations. Following is summary information by reportable segment for the three and six months ended June 30, 2012 and 2011 (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Net sales:				
Direct	$24,707	$22,455	$58,441	$52,709
Retail	14,030	11,417	30,669	28,380
Unallocated royalty income	846	852	1,735	1,936
Consolidated net sales	$39,583	$34,724	$90,845	$83,025
Contribution:				
Direct	$993	$(1,022)	$4,021	$1,178
Retail	1,088	872	3,355	3,101
Unallocated royalty income	846	852	1,735	1,936
Consolidated contribution	$2,927	$702	$9,111	$6,215
Reconciliation of consolidated contribution to income (loss) from continuing operations:				
Consolidated contribution	$2,927	$702	$9,111	$6,215
Less expenses not directly related to segments:				
General and administrative	(3,526)	(3,379)	(6,881)	(7,115)
Other income (expense), net	(80)	(52)	2	(141)
Income tax benefit (expense)	193	533	(71)	(34)
Income (loss) from continuing operations	$(486)	$(2,196)	$2,161	$(1,075)

(10) COMMITMENTS AND CONTINGENCIES

Guarantees, Commitments and Off-Balance Sheet Arrangements

As of June 30, 2012, the Company had approximately $1.3 million in standby letters of credit with certain vendors with expiration dates through March 2013.

The Company has long lead times for inventory purchases and, therefore, must secure factory capacity from its vendors in advance. As of June 30, 2012, the Company had approximately $14.8 million in non-cancelable market-based purchase obligations, primarily for inventory purchases expected to be received in 2012.

In the ordinary course of business, the Company enters into agreements that require it to indemnify counterparties against third-party claims. These may include: agreements under which the Company may indemnify vendors and suppliers against claims arising from use of their products or services; agreements under which the Company may indemnify customers against claims arising from their use or sale of the Company's products; real estate and equipment leases under which the Company may indemnify lessors against third-party claims relating to the use of their property; agreements with licensees or licensors under which the Company may indemnify the licensee or licensor against claims arising from their use of the Company's intellectual property or the Company's use of their intellectual property; and agreements with parties to debt arrangements under which the Company may indemnify them against claims relating to their participation in the transactions.

The nature and terms of these indemnification obligations vary from contract to contract, and generally a maximum obligation is not stated within the agreements. The Company holds insurance policies that mitigate potential losses arising from certain types of indemnification obligations. Management does not deem these obligations to be significant to the Company's financial position, results of operations or cash flows and, therefore, no related liabilities were recorded as of June 30, 2012.

Guarantees, Commitments and Contingencies of Discontinued Operation

Prior to its divestiture, the Company's discontinued Commercial business would, from time-to-time, use third-party lease and financing arrangements to assist customers in purchasing products. While these arrangements generally were without recourse to Nautilus, in certain cases the Company offered a guarantee or other recourse provisions. The maximum contingent liability under all such recourse provisions was approximately $0.6 million as of June 30, 2012.

The Company retained certain warranty obligations in connection with its discontinued Commercial operation and remains contingently liable for certain product warranty obligations that were assumed by buyers of its Commercial business product lines to the extent a buyer fails to fulfill its assumed obligations. Uncertainties exist with respect to these warranty obligations, as units previously sold to customers approach end-of-life and settlements are reached with certain customers in connection with the Company's exit from the discontinued Commercial operation. As of June 30, 2012, the Company's warranty liability included $0.4 million for estimated future warranty costs of the discontinued Commercial operation.

Legal Matters

The Company is party to various legal proceedings arising from normal course business activities. In addition, the Company's tax filings are subject to audit by authorities in the jurisdictions where it conducts business, which may result in assessments of additional taxes. Management believes it has adequately provided for obligations that would result from these legal and tax proceedings. Management believes that the ultimate resolution of these matters will not have a material effect on the Company's financial position, results of operations or cash flows.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

The following discussion and analysis is based upon our financial statements as of the dates and for the periods presented in this section. You should read this discussion and analysis in conjunction with the financial statements and notes thereto found in Part I, Item 1 of this Form 10-Q and our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011 (the “2011 Form 10-K”). All references to the second quarter and first six months of 2012 and 2011 mean the three- and six-month periods ended June 30, 2012 and 2011, respectively. Unless the context otherwise requires, “Nautilus,” “we,” “us” and “our” refer to Nautilus, Inc. and its subsidiaries. Unless indicated otherwise, all information regarding our operating results pertains to our continuing operations.

Our results of operations may vary significantly from period-to-period. Our revenues typically fluctuate due to the seasonality of our industry, customer buying patterns, product innovation, the nature and level of competition for health and fitness products, our ability to procure products to meet customer demand, the level of spending on, and effectiveness of, our media and advertising programs and our ability to attract new customers and maintain existing sales relationships. In addition, our revenues are highly susceptible to economic factors, including, among other things, the overall condition of the economy and the availability of consumer credit in both the United States and Canada. Our profit margins may vary in response to the aforementioned factors and our ability to manage product costs. Profit margins may also be affected by fluctuations in the costs or availability of materials used to manufacture our products, product warranty costs, higher or lower fuel prices, and changes in costs of other distribution or manufacturing-related services. Our operating profits or losses may also be affected by the efficiency and effectiveness of our organization. Historically, our operating expenses have been influenced by media costs to produce and air television advertisements of our products, facility costs, operating costs of our information and communications systems, product supply chain management, customer support and new product development activities. In addition, our operating expenses have been affected from time-to-time by asset impairment charges, restructuring charges and other significant unusual or infrequent expenses.

As a result of the above and other factors, our period-to-period operating results may not be indicative of future performance. You should not place undue reliance on our operating results and should consider our prospects in light of the risks, expenses and difficulties typically encountered by us and other companies, both within and outside our industry. We may not be able to successfully address these risks and difficulties and, consequently, we cannot assure you of any future growth or profitability. For more information, see our discussion of Risk Factors located at Part I, Item 1A of our 2011 Form 10-K.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "plan," "expect," "aim," "believe," "project," "intend," "estimate," "will," "should," "could," and other terms of similar meaning typically identify forward-looking statements. The forward-looking statements in this Form 10-Q include, without limitation, anticipated declines in sales of strength products, anticipated sales increases of cardio-oriented products and the expectation that increased sales of cardio products will offset anticipated declines in sales of strength products; the expectation that approval rates of consumer credit financing applications will continue at current rates; and the expectation that certain operating expenses will increase due to continued investment in new product development. Forward-looking statements also include any statements related to our expectations regarding future business and financial performance or conditions, anticipated sales growth across markets, distribution channels and product categories, expenses and gross margins, profits or losses, losses from discontinued operation, settlements of warranty obligations, new product introductions, and financing and working capital requirements and resources. These forward-looking statements, and others we make from time-to-time, are subject to a number of risks and uncertainties. Many factors could cause actual results to differ materially from those projected in forward-looking statements, including the risks described in Part I, Item 1A, "Risk Factors," in our 2011 Form 10-K as supplemented or modified in our quarterly reports on Form 10-Q. We do not undertake any duty to update forward-looking statements after the date they are made or to conform them to actual results or to changes in circumstances or expectations.

Available Information

We make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, available free of charge on our website, www.nautilusinc.com. In addition, our Code of Business Conduct and Ethics, corporate governance policies, and the charters of our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee are available on our corporate website. The information presented on our website is not part of this report.

OVERVIEW

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Nautilus is committed to providing innovative, quality solutions to help people achieve a fit and healthy lifestyle. Our principal business activities include designing, developing, sourcing and marketing high-quality cardiovascular and strength fitness products and related accessories for consumer home use, primarily in the United States and Canada. Our products are sold under some of the most recognized brand names in the fitness industry, including Nautilus®, Bowflex®, Schwinn®, Schwinn Fitness™ and Universal®.

We market our products through two distinct distribution channels, Direct and Retail, which we consider to be separate business segments. Our Direct business offers products to consumers through television advertising, the Internet and catalogs. Our Retail business offers our products through a network of third-party retailers with stores and websites located in the United States and internationally.

Net sales for the second quarter of 2012 were $39.6 million, an increase of $4.9 million, or 14.0%, as compared to net sales of $34.7 million for the second quarter of 2011. Our Retail and Direct segments both reported significant year over year revenue increases for the second quarter of 2012 Net sales in our Retail segment for the second quarter of 2012 rose $2.6 million, or 22.9%, compared to the 2011 second quarter. We believe some Retail customers accelerated a portion of their purchases into the second quarter of 2012, compared to their typical buying patterns, in anticipation of an impending price increase. Net sales in our Direct segment for the second quarter of 2012 rose $2.3 million, or 10.0%, compared to the 2011 second quarter, driven by continued strong demand for our cardio products and an increase in consumer credit approval rates.

Loss from continuing operations was $0.5 million for the second quarter of 2012, compared to a loss of $2.2 million for the second quarter of 2011. Loss per diluted share from continuing operations was $(0.02) for the second quarter of 2012, compared to $(0.07) for the second quarter of 2011. The significant improvement in our results of continuing operations for the second quarter of 2012 reflected higher sales volume in both of our segments, improved Direct segment gross margin and lower total operating expenses as a percentage of sales, primarily due to reduced sales and marketing expense as a percentage of sales in our Direct segment.

Net loss for the second quarter of 2012 was $0.2 million, an improvement of $3.1 million, or 95.0%, over net loss of $3.3 million for the second quarter of 2011. Net loss per diluted share was $(0.01) for the second quarter of 2012, compared to $(0.11) for the second quarter of 2011.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30, 2012 AND 2011

The following table compares selected financial information in our condensed consolidated statements of operations for the three months ended June 30, 2012 and 2011 (unaudited and in thousands):

	Three months ended June 30,		Change	
	2012	2011	$	%
Net sales	$39,583	$34,724	$4,859	14.0 %
Cost of sales	22,415	20,181	2,234	11.1 %
Gross profit	17,168	14,543	2,625	18.0 %
Operating expenses:				
Selling and marketing	12,557	12,219	338	2.8 %
General and administrative	4,291	4,277	14	0.3 %
Research and development	919	724	195	26.9 %
Total operating expenses	17,767	17,220	547	3.2 %
Operating loss	(599)	(2,677)	2,078	77.6 %
Other income (expense):				
Interest income	7	8	(1)	
Interest expense	(3)	(113)	110	
Other	(84)	53	(137)	
Total other expense, net	(80)	(52)	(28)	
Loss from continuing operations before income taxes	(679)	(2,729)	2,050	75.1 %
Income tax benefit	(193)	(533)	340	
Loss from continuing operations	(486)	(2,196)	1,710	77.9 %
Loss from discontinued operation, net of income taxes	322	(1,072)	1,394	
Net loss	$(164)	$(3,268)	$3,104	95.0 %

The following table compares the net sales, cost of sales and gross profits of our business segments for the three months ended June 30, 2012 and 2011 (unaudited and in thousands):

	Three months ended June 30,		Change	
	2012	2011	$	%
Net sales:				
Direct	$24,707	$22,455	$2,252	10.0 %
Retail	14,030	11,417	2,613	22.9 %
Royalty income	846	852	(6)	(0.7)%
	$39,583	$34,724	$4,859	14.0 %
Cost of sales:				
Direct	$11,084	$11,236	$(152)	(1.4)%
Retail	11,331	8,944	2,387	26.7 %
Royalty income	—	1	(1)	
	$22,415	$20,181	$2,234	11.1 %
Gross profit:				
Direct	$13,623	$11,219	$2,404	21.4 %
Retail	2,699	2,473	226	9.1 %
Royalty income	846	851	(5)	(0.6)%
	$17,168	$14,543	$2,625	18.0 %
Gross margin:				
Direct	55.1 %	50.0 %	510	basis points
Retail	19.2 %	21.7 %	(250)	basis points

The following table compares the net sales of our major product lines within each business segment for the three months ended June 30, 2012 and 2011 (unaudited and in thousands):

	Three months ended June 30,		Change	
	2012	2011	$	%
Direct net sales:				
Cardio products(1)	$19,466	$14,678	$4,788	32.6 %
Strength products(2)	5,241	7,777	(2,536)	(32.6)%
	24,707	22,455	2,252	10 %
Retail net sales:				
Cardio products(1)	7,101	6,261	840	13.4 %
Strength products(2)	6,929	5,156	1,773	34.4 %
	14,030	11,417	2,613	22.9 %
Royalty income	846	852	(6)	(0.7)%
	$39,583	$34,724	$4,859	14.0 %

(1) Cardio products include: TreadClimbers, treadmills, exercise bikes, ellipticals and CoreBody Reformer.
(2) Strength products include: home gyms, selectorized dumbbells, kettlebell weights and accessories.

Direct

Net sales for our Direct business totaled $24.7 million for the second quarter of 2012, an increase of $2.3 million, or 10.0%, compared to $22.5 million for the second quarter of 2011. The comparative increase in Direct sales reflected a $4.8 million, or 32.6%, increase in sales of cardio products, driven by continued strong demand for our cardio products. We believe the year over year improvement in Direct sales underscores broadening product appeal, the effectiveness of our media advertising strategy and improved consumer credit approval rates. The increase in Direct sales of cardio products was partially offset by a $2.5 million, or 32.6%, decline in Direct sales of strength products, including a significant decline in sales of rod-based home

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gyms. The decline in sales of rod-based home gyms was attributable in part to the cessation of U.S. television advertising for these products, as television ad spending on this mature product category was generating unsatisfactory returns. We currently market our rod-based home gyms through more cost efficient online media. We expect that increased sales of cardio products will continue to more than offset anticipated declines in sales of strength products through our Direct channel during the remainder of 2012.

Combined consumer credit approvals by our primary and secondary third-party U.S. financing providers increased to 30% in the second quarter of 2012 from 24% in the second quarter of 2011, primarily due to increased participation by our financing providers. Management expects combined consumer credit approval rates during the remainder of 2012 to remain at approximately the same level as the second quarter of 2012.

Cost of sales for our Direct business decreased slightly to $11.1 million for the second quarter of 2012, compared to $11.2 million for the second quarter of 2011. Included in the $0.1 million decrease in Direct cost of sales was a decrease in product costs of approximately $1.3 million, which was largely offset by a $1.2 million net increase in costs, primarily attributable to higher sales volume in the second quarter of 2012.

Gross margin for our Direct business was 55.1% of net sales for the second quarter of 2012, an increase of 510 basis points compared to the second quarter of 2011. The increase in Direct gross margin was primarily attributable to a shift in sales toward higher margin cardio products in the second quarter of 2012, compared to the same period last year.

Retail

Net sales for our Retail business totaled $14.0 million for the second quarter of 2012, an increase of $2.6 million, or 22.9%, compared to $11.4 million for the second quarter of 2011. As previously disclosed, in the first half of 2012, we took various steps to stabilize declining gross margins in our Retail business. These steps included a price increase for the second half of 2012, which we believe resulted in some Retail customers accelerating a portion of their purchases into the second quarter of 2012, compared to their typical buying patterns.

Cost of sales for our Retail business increased by 26.7% to $11.3 million for the second quarter of 2012, compared to $8.9 million for the second quarter of 2011. Of the $2.4 million increase in Retail cost of sales, approximately $1.7 million was attributable to higher sales volume in the second quarter of 2012 and $0.7 million was primarily due to increased product costs paid to our suppliers for certain models.

Gross margin for our Retail business was 19.2% of net sales for the second quarter of 2012, a decrease of 250 basis points compared to the second quarter of 2011, primarily due to higher product costs paid to our suppliers for certain models.

Operating Expenses

Operating expenses increased by 3.2% to $17.8 million for the second quarter of 2012, compared to $17.2 million for the second quarter of 2011. The $0.5 million increase in operating expenses consisted of a $0.3 million increase in selling and marketing expense and a $0.2 million increase in research and development expense as we increased our investment in new product development resources and capabilities.

Selling and Marketing

Selling and marketing expense was $12.6 million for the second quarter of 2012, an increase of $0.3 million, or 2.8%, compared to the second quarter of 2011. As a percent of sales, selling and marketing expense declined to 31.7% for the second quarter of 2012, compared to 35.2% for the second quarter of 2011. Media advertising expense of our Direct business is the largest component of selling and marketing expense. Media advertising expense was $6.4 million for the second quarter of 2012, an increase of $0.1 million, or 2.1%, compared to the second quarter of 2011. In addition, call center and internet marketing costs each increased by $0.1 million in the second quarter of 2012, compared to the same period last year.

General and Administrative

General and administrative expense of $4.3 million for the second quarter of 2012 was essentially unchanged from the second quarter of 2011.

Research and Development

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Research and development expense was $0.9 million for the second quarter of 2012, an increase of $0.2 million, or 26.9%, compared to the second quarter of 2011. We expect research and development expense to increase for the full year 2012, compared to 2011, as we continue to invest in new product development.

Income Tax Benefit

Income tax benefit was $0.2 million and $0.5 million for the second quarters of 2012 and 2011, respectively. Income tax benefit for the second quarter of 2012 was primarily related to the expiration of statutes of limitation applicable to our liabilities for uncertain tax positions in certain jurisdictions. Income tax benefit for the second quarter of 2011 was attributable to our pre-tax loss for the period.

Discontinued Operation

We completed the disposal of our former Commercial business, reported as a discontinued operation, in April 2011. Income from discontinued operation was $0.3 million for the second quarter of 2012, compared to loss from discontinued operation of $1.1 million for the second quarter of 2011. Income from discontinued operation for the second quarter of 2012 related to the favorable settlement of certain previously estimated liabilities of the Commercial business that were outstanding prior to its disposal. In the second quarter of 2011, we settled certain outstanding contingencies related to completed asset disposal transactions and, accordingly, we decreased by $0.3 million the amount of disposal loss we had previously estimated, which reduced the amount of our loss from discontinued operation. Disposal loss adjustments in the second quarter of 2012 were not significant. We may incur additional expenses in future periods in connection with the settlement of contingencies arising from and directly related to the Commercial business prior to its disposal.

COMPARISON OF OPERATING RESULTS FOR THE SIX MONTHS ENDED JUNE 30, 2012 AND 2011

The following table compares selected financial information in our condensed consolidated statements of operations for the six months ended June 30, 2012 and 2011 (unaudited and in thousands

	Six months ended June 30,				Change			
	2012		2011		$		%	
Net sales	$90,845		$83,025		$7,820		9.4	%
Cost of sales	49,772		46,395		3,377		7.3	%
Gross profit	41,073		36,630		4,443		12.1	%
Operating expenses:								
Selling and marketing	28,623		27,084		1,539		5.7	%
General and administrative	8,301		8,969		(668	)	(7.4	)%
Research and development	1,919		1,477		442		29.9	%
Total operating expenses	38,843		37,530		1,313		3.5	%
Operating income (loss)	2,230		(900	)	3,130		n.m.	
Other income (expense):								
Interest income	13		9		4			
Interest expense	75		(232	)	307			
Other	(86	)	82		(168	)		
Total other income (expense), net	2		(141	)	143			
Income (loss) from continuing operations before income taxes	2,232		(1,041	)	3,273		n.m.	
Income tax expense	71		34		37			
Income (loss) from continuing operations	2,161		(1,075	)	3,236		n.m.	
Income (loss) from discontinued operation, net of	197		(587	)	784			

income taxes				
Net income (loss)	$2,358	$(1,662)	$4,020	n.m.

n.m. = not meaningful

The following table compares the net sales, cost of sales and gross profits of our business segments for the six months ended June 30, 2012 and 2011 (unaudited and in thousands):

	Six months ended June 30,		Change	
	2012	2011	$	%
Net sales:				
Direct	$58,441	$52,709	$5,732	10.9 %
Retail	30,669	28,380	2,289	8.1 %
Royalty income	1,735	1,936	(201)	(10.4)%
	$90,845	$83,025	$7,820	9.4 %
Cost of sales:				
Direct	$25,754	$24,456	$1,298	5.3 %
Retail	24,018	21,939	2,079	9.5 %
Royalty income	—	—	—	
	$49,772	$46,395	$3,377	7.3 %
Gross profit:				
Direct	$32,687	$28,253	$4,434	15.7 %
Retail	6,651	6,441	210	3.3 %
Royalty income	1,735	1,936	(201)	(10.4)%
	$41,073	$36,630	$4,443	12.1 %
Gross margin:				
Direct	55.9 %	53.6 %	230	basis points
Retail	21.7 %	22.7 %	(100)	basis points

The following table compares the net sales of our major product lines within each business segment for the six months ended June 30, 2012 and 2011 (unaudited and in thousands):

	Six months ended June 30,		Change	
	2012	2011	$	%
Direct net sales:				
Cardio products[(1)]	$45,942	$35,263	$10,679	30.3 %
Strength products[(2)]	12,499	17,446	(4,947)	(28.4)%
	58,441	52,709	5,732	10.9 %
Retail net sales:				
Cardio products[(1)]	17,566	16,748	818	4.9 %
Strength products[(2)]	13,103	11,632	1,471	12.6 %
	30,669	28,380	2,289	8.1 %
Royalty income	1,735	1,936	(201)	(10.4)%
	$90,845	$83,025	$7,820	9.4 %

(1) Cardio products include: TreadClimbers, treadmills, exercise bikes, ellipticals and CoreBody Reformer.
(2) Strength products include: home gyms, selectorized dumbbells, kettlebell weights and accessories.

Direct

Net sales for our Direct business totaled $58.4 million for the first six months of 2012, an increase of $5.7 million, or 10.9%, compared to $52.7 million for the first six months of 2011. The comparative increase in Direct sales reflected a $10.7 million, or 30.3%, increase in sales of cardio products. We believe the year over year improvement in Direct sales underscores broadening product appeal, the effectiveness of our media advertising strategy and improved consumer credit approval rates. The increase in Direct sales of cardio products was partially offset by a $4.9 million, or 28.4%, decline in Direct sales of strength products, including a significant decline in sales of rod-based home gyms. The decline in sales of rod-based home gyms was attributable in part to the cessation of U.S. television advertising for these products, as television ad spending on this mature product category was generating unsatisfactory returns. We currently market our rod-based home gyms through more cost efficient online media. We expect that increased sales of cardio products will continue to more than offset anticipated declines in sales of strength products through our Direct channel during the remainder of 2012.

Combined consumer credit approvals by our primary and secondary third-party U.S. financing providers increased to 30% in the first six months of 2012 from 24% in the first six months of 2011, primarily due to increased participation by our financing providers. Management expects combined consumer credit approval rates during the remainder of 2012 to remain at approximately the same level as the first six months of 2012.

Cost of sales for our Direct business increased by 5.3% to $25.8 million for the first six months of 2012, compared to $24.5 million for the first six months of 2011. Included in the $1.3 million increase in Direct cost of sales was a $2.3 million increase attributable to higher sales volume in the first six months of 2012, partially offset by a $1.0 million net cost decrease, primarily related to lower product costs.

Gross margin for our Direct business was 55.9% of net sales for the first six months of 2012, an increase of 230 basis points compared to the first six months of 2011. The increase in Direct gross margin percent was primarily attributable to a shift in sales toward higher margin cardio products in the first six months of 2012, compared to the same period last year.

Retail

Net sales for our Retail business totaled $30.7 million for the first six months of 2012, an increase of $2.3 million, or 8.1%, compared to $28.4 million for the first six months of 2011. As previously disclosed, in the first half of 2012, we took various steps to stabilize declining gross margins in our Retail business. These steps included a price increase for the second half of 2012, which we believe resulted in some Retail customers accelerating a portion of their purchases into the second quarter of 2012, compared to their typical buying patterns.

Retail cost of sales increased by 9.5% to $24.0 million for the first six months of 2012, compared to $21.9 million for the first six months of 2011. Of the $2.1 million increase in Retail cost of sales, approximately $1.5 million was attributable to higher sales volume in the first six months of 2012 and $0.6 million was primarily due to higher product costs paid to our suppliers for certain models.

Gross margin for our Retail business was 21.7% of net sales for the first six months of 2012, a decrease of 100 basis points compared to the first six months of 2011, primarily due to higher product costs paid to our suppliers for certain models.

Operating Expenses

Operating expenses increased by 3.5% to $38.8 million for the first six months of 2012, compared to $37.5 million for the first six months of 2011. Included in the $1.3 million increase in operating expenses was a $1.5 million increase in selling and marketing expense, primarily due to higher media advertising expense, and a $0.4 million increase in research and development expense, partially offset by a $0.7 million decrease in general and administrative expense.

Selling and Marketing

Selling and marketing expense was $28.6 million for the first six months of 2012, an increase of $1.5 million, or 5.7%, compared to the first six months of 2011, primarily due to higher media advertising expense. As a percent of sales, selling and marketing expense for the first six months of 2012 decreased to 31.5%, compared to 32.6% for the first six months of 2011. Media advertising expense of our Direct business is the largest component of selling and marketing expense. Media advertising expense was $15.1 million for the first six months of 2012, an increase of $1.0 million, or 7.1%, compared to the first six months of 2011.

General and Administrative

General and administrative expense was $8.3 million for the first six months of 2012, a decrease of $0.7 million, or 7.4%, compared to the first six months of 2011, primarily due to declines of $0.3 million each in personnel costs and depreciation expense.

Research and Development

Research and development expense was $1.9 million for the first six months of 2012, an increase of $0.4 million, or 29.9%, compared to the first six months of 2011. We expect research and development expense to increase for the full year 2012, as compared to 2011, as we continue to invest in new product development.

Other Income and Expense

Interest Expense

Negative interest expense of $0.1 million for the first six months of 2012 arose from the prepayment in March 2012 of our Increasing-Rate Senior Discount Notes. Early repayment of the notes resulted in a lower average effective interest rate over the term of the notes than would have applied if the notes had been held to maturity. In periods preceding the repayment date, we used the average effective interest rate as if the notes were held to maturity in determining the amount of interest expense incurred. For more information, see "LIQUIDITY AND CAPITAL RESOURCES - Financing Arrangements."

Income Tax Expense

Income tax expense of $0.1 million for the first six months of 2012 was primarily related to increases in the amount of our deferred tax liability for indefinite lived tradename intangible assets that cannot be used to reduce our valuation allowance in the United States. Income tax expense for the first six months of 2011 was not significant.

Discontinued Operation

We completed the disposal of our former Commercial business, reported as a discontinued operation, in April 2011. Income from discontinued operation was $0.2 million for the first six months of 2012, compared to loss from discontinued operation of $0.6 million for the first six months of 2011. Income for the first six months of 2012 related to the favorable settlement of certain previously estimated liabilities of the Commercial business that were outstanding prior to its disposal. In the first six months of 2011, we settled certain outstanding contingencies related to completed asset disposal transactions and, accordingly, we decreased by $0.6 million the amount of disposal loss we had previously estimated, which reduced the amount of our loss from discontinued operation. Disposal loss adjustments in the first six months of 2012 were not significant. We may incur additional expenses in future periods in connection with the settlement of contingencies arising from and directly related to the Commercial business prior to its disposal.

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2012, we had $16.1 million of cash and cash equivalents, compared to $17.4 million as of December 31, 2011. Cash provided by operating activities was $4.5 million for the six months ended June 30, 2012, compared to $1.5 million for the six months ended June 30, 2011. The improvement in cash flows from operating activities was primarily due to net income of $2.4 million for the six months ended June 30, 2012, compared to net loss of $1.7 million for the six months ended June 30, 2011. In addition, cash provided by the reduction of trade receivables was $13.2 million for the six months ended June 30, 2012, compared to $11.6 million for the six months ended June 30, 2011. During the six months ended June 30, 2012, we used $1.0 million in cash to improve our inventory in-stock condition in order to meet our future sales expectations, compared to $2.2 million for the six months ended June 30, 2011.

These contributions to the improvement in our operating cash flows were partially offset by an increase in the amount of cash used in reducing trade payables. Cash used in reducing trade payables was $11.6 million for the six months ended June 30, 2012, compared to $8.5 million for the six months ended June 30, 2011.

Trade receivables were $10.6 million as of June 30, 2012, compared to $23.8 million at the end of 2011, reflecting seasonally lower activity with our Retail business customers. Trade payables decreased to $16.9 million as of June 30, 2012, compared to $28.6 million at December 31, 2011, due to the seasonally lower level of business activity between the fourth quarter of 2011 and the second quarter of 2012.

Cash used in investing activities of $0.9 million for the six months ended June 30, 2012 consisted of $1.1 million used for the development of new computer software and purchases of tooling for new cardio products, partially offset by $0.2 million in proceeds from the sale of our Commercial discontinued operation.

Cash used in financing activities of $4.9 million for six months ended June 30, 2012 was primarily attributable to the early repayment of all amounts outstanding under our Increasing-Rate Senior Discount Notes.

Financing Arrangements

We have a Credit Agreement (the "Loan Agreement") with Bank of the West that, as amended and restated on March 30, 2012, provides for a $15,750,000 million maximum revolving secured credit line, which is available through March 31, 2015 for working capital, standby letters of credit and general corporate purposes. Borrowing availability under the Loan Agreement is subject to our compliance with certain financial and operating covenants at the time borrowings are requested. Standby letters of credit under the Loan Agreement are treated as a reduction of our available borrowing amount and are subject to covenant testing.

The interest rate applicable to borrowings under the Agreement is based on Bank of the West's base rate, floating rate or LIBOR, plus an applicable margin based on certain Company financial performance metrics. Our borrowing rate was 2.25% as of June 30, 2012. The Loan Agreement contains customary covenants, including minimum fixed charge coverage ratio and leverage ratio, and limitations on capital expenditures, mergers and acquisitions, indebtedness, liens, dispositions, dividends and investments. The Loan Agreement also contains customary events of default. Upon an event of default, the lender has the option of terminating its commitment with respect to the credit line and accelerating all obligations under the Loan Agreement. Borrowings under the Loan Agreement are collateralized by substantially all of our assets, including intellectual property assets.

As of June 30, 2012, we had no outstanding borrowings and $1.3 million in standby letters of credit issued under the Loan Agreement. As of June 30, 2012, we were in compliance with the financial covenants of the Loan Agreement and approximately $14.5 million was available for borrowing.

On September 3, 2010, we entered into a Note Purchase Agreement (the “Purchase Agreement”) with certain entities (collectively, the “Sherborne Purchasers”) under common control of Sherborne Investors GP, LLC and its affiliates (collectively “Sherborne”). Sherborne was formerly our largest shareholder and is controlled by Edward J. Bramson, our former Chairman and Chief Executive Officer, and Craig L. McKibben, a former member of our Board of Directors.

Pursuant to the Purchase Agreement, we issued to the Sherborne Purchasers $6,096,996 in aggregate principal amount at maturity of Increasing Rate Senior Discount Notes due December 31, 2012 (the “Notes”). The Notes had an original principal amount totaling $5,000,000 and an original maturity date of December 31, 2012. On March 12, 2012, the maturity date of the Notes was automatically extended under certain terms of the Purchase Agreement to May 2, 2013.

On July 19, 2011, beneficial interest in the Notes was assigned by the Sherborne Purchasers pro-rata to their respective investors in the manner permitted by the Purchase Agreement. Such assignment was made in connection with the resignation of Messrs. Bramson and McKibben from their respective positions with Nautilus on May 26, 2011, and the subsequent pro-rata distribution by certain Sherborne-affiliated entities to their respective investors of our common stock owned by such entities.

We repaid all amounts outstanding under the Notes on March 30, 2012. If all of the Notes were paid on the original maturity date, the effective rate of interest over the term of the Purchase Agreement would have been approximately 8.7% per annum, which was the rate at which we accrued interest expense in periods preceding the repayment date. The actual effective rate of interest through the repayment date was approximately 6.4%.

Commitments and Contingencies

For a description of our commitments and contingencies, refer to Note 10 to our condensed consolidated financial statements in Item 1 of this Form 10-Q.

Seasonality

We expect sales of fitness equipment products to vary seasonally. Sales are typically strongest in the first and fourth quarters of a calendar year and are generally weakest in the second quarter. During the spring and summer months, consumers tend to be more involved in outdoor activities, including exercise, which may affect sales of fitness equipment used indoors. This seasonality can have a significant effect on our operating results, inventory levels and working capital requirements.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our critical accounting policies have not changed from those discussed in our 2011 Form 10-K.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

In accordance with Rule 13a-15 of the Securities Exchange Act of 1934 (the "Exchange Act"), as of the end of the period covered by this Quarterly Report on Form 10-Q, our management evaluated, with the participation of our Chief Executive Officer and Acting Principal Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a- 15(e) and Rule 15d-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, our management, including the Chief Executive Officer and Acting Principal Financial Officer, have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the three months ended June 30, 2012, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are party to various legal proceedings and claims arising from normal business activities. In addition, our tax filings are subject to audit by authorities in the jurisdictions where we conduct business, which may result in assessments of additional taxes. Management believes we have adequately provided for obligations that would result from these legal and tax proceedings where it is probable that we will pay some amounts and the amounts can be reasonably estimated. In some cases, however, it is too early to predict a final outcome. Management believes that the ultimate resolution of these matters will not have a material effect on our financial position, results of operations or cash flows.

Item 1A. Risk Factors

We operate in an environment that involves a number of risks and uncertainties. The risks and uncertainties described in our 2011 Form 10-K are not the only risks and uncertainties that we face. Additional risks and uncertainties that presently are not considered material or are not known to us, and therefore are not mentioned herein, may impair our business operations. If any of the risks described in our 2011 Form 10-K actually occur, our business, operating results and financial position could be adversely affected. There has not been a material change to the risk factors as set forth in our 2011 Form 10-K.

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER REPURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased [1]	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
April 1 to April 30, 2012	—	$—	—	—
May 1 to May 31, 2012	—	—	—	—
June 1 to June 30, 2012	1,634	3.31	—	—
Total	1,634	3.31	—	—

[1] Consists of shares withheld from delivery upon settlement of the vesting portion of a restricted stock unit award made granted to Bruce M. Cazenave, our Chief Executive Officer. We will withhold from the settlement of each monthly vesting portion of the award the number of shares sufficient to satisfy Mr. Cazenave's tax withholding obligation incident to such vesting, unless Mr. Cazenave should first elect to satisfy the tax obligation by cash payment to us. We do not have any publicly announced equity securities repurchase plans or programs.

Item 6. Exhibits

The following exhibits are filed herewith.

Exhibit No.	Description
31.1	Certification of Principal Executive Officer and Acting Principal Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of Principal Executive Officer and Acting Principal Financial Officer pursuant to Rule 13a-14(b) of the Securities and Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial statements from Nautilus, Inc.'s quarterly report on Form 10-Q for the three and six months ended June 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets (unaudited), (ii) Condensed Consolidated Statements of Operations (unaudited), (iii) Condensed Consolidated Statements of Comprehensive Income (Loss) (unaudited), (iv) Condensed Consolidated Statements of Cash Flows (unaudited) and (v) Notes to Condensed Consolidated Financial Statements (unaudited). Information is furnished and not filed, and is not incorporated by reference in any registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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* Indicates management contract, compensatory agreement or arrangement in which the Company's directors or executive officers may participate.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NAUTILUS, INC.

Date: August 8, 2012

By: /S/ Bruce M. Cazenave
Bruce M. Cazenave
Chief Executive Officer
(Principal Executive Officer, Acting Principal Financial Officer and Acting Principal Accounting Officer)