

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 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 SEPTEMBER 30, 2006

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: 000-25867

NAUTILUS, INC.

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of
incorporation or organization)

94-3002667
(I.R.S. Employer
Identification No.)

**16400 S.E. Nautilus Drive
Vancouver, Washington 98683**
(Address of principal executive offices, including zip code)

(360) 859-2900
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

Large Accelerated Filer ☒ Accelerated Filer ☐ Non-Accelerated Filer ☐

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

Number of shares of issuer's common stock outstanding as of November 2, 2006: 31,472,886

NAUTILUS, INC.
TABLE OF CONTENTS

| | <u>Page</u> |
|---|-------------|
| PART I. FINANCIAL INFORMATION | |
| Item 1. Financial Statements (Unaudited) | 3 |
| Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations | 16 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 24 |
| Item 4. Controls and Procedures | 25 |
| PART II. OTHER INFORMATION | |
| Item 1. Legal Proceedings | 26 |
| Item 1A. Risk Factors | 27 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 27 |
| Item 6. Exhibits | 27 |
| Signatures | 28 |
| Exhibit Index | 29 |

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

NAUTILUS, INC.
CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands)

| | September 30, 2006 | December 31, 2005 |
|--|-----------------------|----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 3,404 | \$ 7,984 |
| Trade receivables (net of allowance for doubtful accounts of \$3,544 and \$4,085 at September 30, 2006 and December 31, 2005, respectively) | 120,901 | 116,908 |
| Inventories | 69,546 | 96,084 |
| Prepaid expenses and other current assets | 8,002 | 8,369 |
| Short-term notes receivable | 2,556 | 2,496 |
| Assets held for sale | 1,742 | 6,115 |
| Deferred tax assets | 5,633 | 7,235 |
| Total current assets | 211,784 | 245,191 |
| PROPERTY, PLANT AND EQUIPMENT (at cost, net of accumulated depreciation of \$48,026 and \$43,802 at September 30, 2006 and December 31, 2005, respectively) | 54,374 | 59,320 |
| GOODWILL | 65,064 | 64,404 |
| INTANGIBLE AND OTHER ASSETS, net | 50,353 | 44,371 |
| TOTAL ASSETS | \$ 381,575 | \$ 413,286 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Trade payables | \$ 49,704 | \$ 61,132 |
| Accrued liabilities | 25,388 | 29,097 |
| Short-term borrowings | 35,000 | 40,147 |
| Income taxes payable | 1,843 | 3,810 |
| Customer deposits | 2,084 | 3,327 |
| Current portion of long-term debt | 178 | 707 |
| Total current liabilities | 114,197 | 138,220 |
| LONG TERM DEBT | 4,245 | 5,610 |
| NONCURRENT DEFERRED TAX LIABILITIES | 16,917 | 16,990 |
| COMMITMENTS AND CONTINGENCIES (Note 11) | | |
| STOCKHOLDERS' EQUITY: | | |
| Common stock – no par value, 75,000 shares authorized; 31,473 and 32,780 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively | 405 | 3,549 |
| Unearned stock compensation | — | (1,947) |
| Retained earnings | 241,719 | 248,123 |
| Accumulated other comprehensive income | 4,092 | 2,741 |
| Total stockholders' equity | 246,216 | 252,466 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 381,575 | \$ 413,286 |

See notes to consolidated financial statements.

NAUTILUS, INC.
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited, in thousands, except per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------------|-------------------------------------|------------|------------------------------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| NET SALES | \$ 159,583 | \$ 163,308 | \$ 482,185 | \$ 449,277 |
| COST OF SALES | 87,493 | 91,022 | 270,192 | 242,164 |
| Gross profit | 72,090 | 72,286 | 211,993 | 207,113 |
| OPERATING EXPENSES: | | | | |
| Selling and marketing | 42,621 | 44,526 | 137,887 | 129,425 |
| General and administrative | 14,507 | 11,146 | 40,399 | 34,567 |
| Research and development | 2,521 | 2,856 | 8,321 | 8,768 |
| Royalties | 1,296 | 1,297 | 3,991 | 3,952 |
| Total operating expenses | 60,945 | 59,825 | 190,598 | 176,712 |
| OPERATING INCOME | 11,145 | 12,461 | 21,395 | 30,401 |
| OTHER INCOME (EXPENSE): | | | | |
| Interest income (expense), net | (537) | 145 | (1,152) | 1,460 |
| Other income (expense), net | (2) | 31 | 1,220 | 542 |
| Total other income (expense) | (539) | 176 | 68 | 2,002 |
| INCOME BEFORE INCOME TAXES | 10,606 | 12,637 | 21,463 | 32,403 |
| INCOME TAX EXPENSE | 1,230 | 4,366 | 5,215 | 11,373 |
| NET INCOME | \$ 9,376 | \$ 8,271 | \$ 16,248 | \$ 21,030 |
| EARNINGS PER SHARE: | | | | |
| BASIC | \$ 0.29 | \$ 0.25 | \$ 0.50 | \$ 0.63 |
| DILUTED | \$ 0.29 | \$ 0.24 | \$ 0.50 | \$ 0.62 |
| WEIGHTED AVERAGE SHARES OUTSTANDING: | | | | |
| BASIC | 32,138 | 33,549 | 32,577 | 33,367 |
| DILUTED | 32,240 | 34,365 | 32,732 | 34,090 |

See notes to consolidated financial statements.

NAUTILUS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
NINE MONTHS ENDED SEPTEMBER 30, 2006 AND YEAR ENDED DECEMBER 31, 2005
(In Thousands, Except Share Data)

| | <u>Common Stock</u> | | <u>Unearned Stock Compensation</u> | <u>Retained Earnings</u> | <u>Accumulated Other Comprehensive Income</u> | <u>Total</u> |
|---|---------------------|---------------|--|------------------------------|---|------------------|
| | <u>Shares</u> | <u>Amount</u> | | | | |
| BALANCES, January 1, 2005 | 33,147,758 | \$ 10,682 | \$ (1,204) | \$ 238,474 | \$ 4,084 | \$252,036 |
| Net income | — | — | — | 23,000 | — | 23,000 |
| Foreign currency translation adjustment | — | — | — | — | (1,343) | (1,343) |
| Comprehensive income | | | | | | 21,657 |
| Dividends paid | — | — | — | (13,351) | — | (13,351) |
| Unearned stock compensation | — | 1,106 | (1,106) | — | — | — |
| Amortization of unearned stock compensation | — | — | 363 | — | — | 363 |
| Options exercised | 462,553 | 5,609 | — | — | — | 5,609 |
| Stock repurchased | (830,700) | (15,636) | — | — | — | (15,636) |
| Tax benefit of exercise of nonqualified options | — | 1,788 | — | — | — | 1,788 |
| BALANCES, DECEMBER 31, 2005 | 32,779,611 | 3,549 | (1,947) | 248,123 | 2,741 | 252,466 |
| Net income | — | — | — | 16,248 | — | 16,248 |
| Foreign currency translation adjustment | — | — | — | — | 1,351 | 1,351 |
| Comprehensive income | | | | | | 17,599 |
| Dividends paid | — | — | — | (9,760) | — | (9,760) |
| Stock repurchased | (1,344,200) | (3,761) | — | (12,892) | — | (16,653) |
| Unearned stock compensation | — | (1,947) | 1,947 | — | — | — |
| Stock-based compensation | — | 2,044 | — | — | — | 2,044 |
| Options exercised | 37,100 | 484 | — | — | — | 484 |
| Tax benefit of exercise of nonqualified options | — | 36 | — | — | — | 36 |
| BALANCES, SEPTEMBER 30, 2006 | <u>31,472,511</u> | <u>\$ 405</u> | <u>\$ —</u> | <u>\$241,719</u> | <u>\$ 4,092</u> | <u>\$246,216</u> |

See notes to consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------------|
| | 2006 | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 16,248 | \$ 21,030 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 12,815 | 11,066 |
| Amortization of unearned stock compensation | — | 255 |
| Stock-based compensation | 2,044 | — |
| Amortization of discount on long-term debt | — | 12 |
| Loss on sale of property, plant and equipment | 109 | 15 |
| Tax benefit from exercise of nonqualified options | — | 1,942 |
| Excess tax benefit from exercise of employee stock options | (36) | — |
| Deferred income taxes | 1,182 | 2,032 |
| Foreign currency transaction gain | (1,115) | — |
| Changes in assets and liabilities: | | |
| Trade receivables | (2,338) | 8,935 |
| Inventories | 27,559 | (21,035) |
| Prepaid expenses and other current assets | 370 | (7,064) |
| Trade payables | (12,678) | (617) |
| Accrued liabilities | (4,072) | (2,812) |
| Income taxes payable | (1,907) | (7,651) |
| Customer deposits | (1,523) | 542 |
| Net cash provided by operating activities | <u>36,658</u> | <u>6,650</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property, plant and equipment | (8,372) | (23,210) |
| Proceeds from sale of property, plant and equipment, and assets held for sale | 6,064 | 2,972 |
| Net increase in intangible and other assets | (7,501) | (306) |
| Acquisition, net of cash acquired | — | (73,688) |
| Purchases of short-term investments | — | (49,352) |
| Proceeds from maturities of short-term investments | — | 134,671 |
| Net increase (decrease) in notes receivable | (60) | 107 |
| Net cash used in investing activities | <u>(9,869)</u> | <u>(8,806)</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Cash dividends paid on common stock | (9,760) | (10,010) |
| Proceeds from exercise of stock options | 484 | 5,565 |
| Excess tax benefit from exercise of employee stock options | 36 | — |
| Stock repurchases | (16,653) | (4,580) |
| Net reduction in short-term borrowings | (5,147) | — |
| Principal payments on long-term debt | (1,900) | (89) |
| Net cash used in financing activities | <u>(32,940)</u> | <u>(9,114)</u> |
| Net Effect of Foreign Currency Exchange Rate Changes | <u>1,571</u> | <u>(566)</u> |
| Net Decrease in Cash and Cash Equivalents | <u>(4,580)</u> | <u>(11,836)</u> |
| Cash and Cash Equivalents, beginning of period | <u>7,984</u> | <u>19,266</u> |
| Cash and Cash Equivalents, end of period | <u>\$ 3,404</u> | <u>\$ 7,430</u> |
| Supplemental Disclosures: | | |
| Cash paid for interest | <u>\$ 1,479</u> | <u>\$ 55</u> |
| Cash paid for income taxes | <u>\$ 6,685</u> | <u>\$ 14,461</u> |
| Supplemental Disclosure of Other Non-cash Investing and Financing Activities: | | |
| Promissory notes issued or assumed in business acquisitions | <u>\$ —</u> | <u>\$ 6,854</u> |

See notes to consolidated financial statements.

NAUTILUS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. BASIS OF PRESENTATION

Nautilus, Inc. is referred to as “we,” “us,” “our” or “Company” in this report. The accompanying consolidated financial statements relate to Nautilus, Inc. and its subsidiaries as of September 30, 2006 and for the three and nine month periods ended September 30, 2006 and 2005. The consolidated financial statements of the Company include the accounts of Nautilus, Inc. and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2005.

The financial information included herein reflects all adjustments (consisting of normal recurring adjustments), which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year.

Use of Accounting Estimates

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 and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Our significant estimates relate to revenue recognition, stock-based compensation, warranty reserves, legal reserves, sales returns and discounts, the allowance for doubtful accounts, inventory valuation, intangible asset valuation, and income taxes.

New Accounting Pronouncements

In September 2006, the staff of the Securities and Exchange Commission (“SEC”) issued Staff Accounting Bulletin (“SAB”) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (“SAB 108”). In SAB 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the Company’s financial statements and the related financial statement disclosures. The Company will adopt SAB 108 in December 2006 and is currently evaluating the impact that the adoption will have on the Company’s results of operations, cash flows or financial position.

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standard (“SFAS”) No. 157, *Fair Value Measurements* (“SFAS 157”). This statement defines fair value, establishes a framework for measuring fair value in U.S. GAAP, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2006. The Company is currently evaluating the impact that the adoption will have on the Company’s results of operations, cash flows or financial position.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”). FIN 48 provides a two-step approach for recognizing and measuring tax benefits and requires companies to make disclosures about uncertainties in their income tax position, including a detailed rollforward of tax benefits taken that do not qualify for financial statement recognition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that the adoption will have on the Company’s results of operations, cash flows or financial position.

2. STOCK BASED COMPENSATION

2005 Long Term Incentive Plan

In 2005, the Company’s shareholders approved the Company’s 2005 Long Term Incentive Plan (the “Plan”). The Plan permits flexibility in types of awards, and specific terms of awards, which allow future awards to be based on then-current objectives for aligning compensation with increasing long-term shareholder value. The aggregate number of shares of common stock authorized for issuance as awards under the Plan is 4,000,000, plus any shares of common stock that were previously reserved for issuance under the Company’s Stock Option Plan and were not subject to grant on June 6, 2005 or as to which the option award is forfeited on or after June 6, 2005. The maximum aggregate number of shares of common stock subject to stock options, stock appreciation rights, restricted stock or stock unit awards which may be granted to any one participant in any one year under the Plan is 1,000,000. The aggregate number of shares available for issuance under the Plan is reduced by two shares for each share delivered in settlement of any stock appreciation rights, restricted stock, stock unit or performance unit award, and one share for each share delivered in settlement of a stock option award.

Adoption of SFAS 123(R)

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* (“SFAS 123(R)”) for its share-based compensation plan using the modified prospective transition method. The Company previously accounted for the plan under the recognition and measurement principles of Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB 25” or “Opinion 25”) and related interpretations and disclosure requirements established by SFAS 123, *Accounting for Stock-Based Compensation*, and SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*. In March 2005, the SEC issued SAB No. 107, *Share-Based Payment* (“SAB 107”), relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Under APB 25, no expense was recorded in the income statement for the Company’s stock options granted at fair market value. The pro forma effect on income for stock options was instead disclosed in a footnote to the financial statements. Expense was recorded in the income statement for equity awards granted below fair market value on the date of grant.

Under SFAS 123(R), the Company recognizes compensation expense from share-based payments over the requisite service periods of the individual grants, which generally equal the vesting periods. Consistent with prior years, the fair value of each equity award is estimated at the date of grant using the Black-Scholes-Merton option pricing model which requires extensive use of accounting judgment, including estimates of the expected volatility of the Company’s common stock price over the expected term, the dividend yield, expected term option holders will retain their vested awards before exercising them, and the number of awards that will be forfeited prior to the completion of their vesting requirements. Application of alternative assumptions could produce significantly different estimates of the fair value of equity awards and consequently the related amounts of compensation cost recognized in the Consolidated Statements of Income.

The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to its equity awards for the periods prior to adoption of SFAS 123(R):

| <i>(in thousands, except per share amounts)</i> | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|--|--|---|
| Net income, as reported | \$ 8,271 | \$ 21,030 |
| Add: Stock-based employee compensation expense included in reported net income, net of tax | 55 | 165 |
| Deduct: Stock-based employee compensation expense determined under fair value based method, net of tax | (664) | (1,837) |
| Net income, pro forma | \$ 7,662 | \$ 19,358 |
| Basic earnings per share: | | |
| As reported | \$ 0.25 | \$ 0.63 |
| Pro forma | \$ 0.23 | \$ 0.58 |
| Diluted earnings per share: | | |
| As reported | \$ 0.24 | \$ 0.62 |
| Pro forma | \$ 0.22 | \$ 0.57 |

As a result of adopting SFAS 123(R), the Company’s income before income taxes and net income for the three months ended September 30, 2006 are \$0.7 million and \$0.6 million lower, respectively, than if it had continued to account for share-based compensation under Opinion 25. The Company’s income before income taxes and net income for the nine months ended September 30, 2006 are \$2.0 million and \$1.5 million lower, respectively, than if it had continued to account for share-based compensation under Opinion 25. The Company’s basic and diluted earnings per share for the three and nine months ended September 30, 2006 are \$0.02 and \$0.06, respectively, lower than if it had continued to account for share-based compensation under APB 25. The Company did not capitalize any of its share-based compensation costs in any of the periods.

Stock Options

Stock option awards are granted with an exercise price equal to the market price of the Company’s stock on the date prior to the award grant date, generally vest based on four years of continuous service and have a seven year contractual term.

[Table of Contents](#)

A summary of the Company's stock option plan activity for the three months ended September 30, 2006 is as follows:

| <i>(in thousands, except exercise price)</i> | Total Shares | Weighted- Average Exercise Price | Weighted- Average Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|--|-------------------------|---|--|--|
| Outstanding at June 30, 2006 | 2,702 | \$ 16.63 | | |
| Granted | 4 | 13.06 | | |
| Forfeited or canceled | (39) | 18.74 | | |
| Expired | (19) | 28.03 | | |
| Exercised | (13) | 10.49 | | \$ 39 |
| Outstanding at September 30, 2006 | <u>2,635</u> | <u>\$ 16.54</u> | <u>6.75</u> | <u>\$ 2,671</u> |

A summary of the Company's stock option plan activity for the nine months ended September 30, 2006 is as follows:

| <i>(in thousands, except exercise price)</i> | Total Shares | Weighted- Average Exercise Price | Weighted- Average Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|--|-------------------------|---|--|--|
| Outstanding at December 31, 2005 | 2,277 | \$ 17.39 | | |
| Granted | 645 | 15.63 | | |
| Forfeited or canceled | (123) | 19.82 | | |
| Expired | (127) | 24.96 | | |
| Exercised | (37) | 13.06 | | \$ 135 |
| Outstanding at September 30, 2006 | <u>2,635</u> | <u>\$ 16.54</u> | <u>6.75</u> | <u>\$ 2,671</u> |
| Exercisable at September 30, 2006 | <u>938</u> | <u>\$ 16.78</u> | <u>6.27</u> | <u>\$ 1,386</u> |

The fair value of the Company's equity awards was estimated utilizing the following assumptions:

| | Three months ended September 30, 2006 | Nine months ended September 30, 2006 |
|-------------------------|--|---|
| Expected life (years) | 4.75 | 4.75 |
| Risk-free interest rate | 4.8% | 4.8% |
| Expected dividend yield | 3.1% | 2.6% |
| Expected volatility | 44% | 44% |

Expected life represents the period that the Company's equity awards are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the equity awards and vesting schedules. Risk-free interest rate is based on the implied U.S. Treasury zero coupon yield curve in effect in the month of grant. Expected dividend yield is calculated based on the authorization by the Company's Board of Directors of the payment of the 2006 quarterly dividends in the amount of \$0.10 per share. Expected volatility utilized in the model is calculated using daily historical volatility of the Company's stock price. When estimating forfeitures, the Company considers terminations as well as anticipated retirements based on an analysis of historical data.

Performance Units

In December 2005, the Company granted performance unit awards to members of its executive team. The performance unit awards vest if the Company meets earnings targets set by the Compensation Committee of the Board of Directors. The fair value of the performance units is based on the closing market price of the Company's common stock on the date preceding the grant date and is amortized over the estimated requisite service period when it becomes probable that the performance targets are expected to be met. The amount of stock-based compensation expense is based on the number of performance unit awards ultimately expected to vest, and therefore has been reduced for estimated forfeitures.

[Table of Contents](#)

At September 30, 2006, there was approximately \$2.9 million of total unrecognized stock-based compensation costs related to performance units with the intrinsic value of approximately \$2.4 million. None of the performance units were vested at September 30, 2006. There were no performance units in the comparable period of fiscal 2005. The Company did not record any compensation expense related to the performance unit awards in the three and nine month periods ended September 30, 2006. A summary of the Company's performance units activity for the three months ended September 30, 2006 is as follows:

| <i>(in thousands, except fair value amounts)</i> | Performance Units | Weighted Average Grant Date Fair Value |
|--|-------------------|--|
| Outstanding at June 30, 2006 | 156 | \$ 15.15 - \$17.70 |
| Granted | 18 | 12.52 |
| Forfeited or canceled | — | — |
| Expired | — | — |
| Exercised | — | — |
| Outstanding at September 30, 2006 | 174 | \$ 12.52 - \$ 17.70 |

A summary of the Company's performance units activity for the nine months ended September 30, 2006 is as follows:

| <i>(in thousands, except fair value amounts)</i> | Performance Units | Weighted Average Grant Date Fair Value |
|--|-------------------|--|
| Outstanding at December 31, 2005 | 125 | \$ 17.70 |
| Granted | 49 | 12.52 -15.15 |
| Forfeited or canceled | — | — |
| Expired | — | — |
| Exercised | — | — |
| Outstanding at September 30, 2006 | 174 | \$12.52 - \$ 17.70 |

3. INVENTORIES

Inventories consisted of the following:

| <i>(in thousands)</i> | September 30, 2006 | December 31, 2005 |
|-----------------------|--------------------|-------------------|
| Finished goods | \$ 49,029 | \$ 69,178 |
| Work-in-process | 1,431 | 1,368 |
| Parts and components | 19,086 | 25,538 |
| Inventories | \$ 69,546 | \$ 96,084 |

Inventories are stated at the lower of standard cost or market. The Company evaluates the need for inventory valuation adjustments associated with obsolete, slow-moving and not saleable inventory by reviewing current transactions and forecasted product demand on a quarterly basis.

4. INTANGIBLE AND OTHER ASSETS

Intangible assets, exclusive of goodwill, consisted of the following:

| <i>(in thousands)</i> | Estimated Useful Life (in years) | September 30, 2006 | December 31, 2005 |
|-----------------------------|----------------------------------|--------------------|-------------------|
| Intangible assets: | | | |
| Indefinite life trademarks | N/A | \$ 37,310 | \$ 30,465 |
| Definite life trademarks | 20 | — | 6,800 |
| Patents | 1 to 17 | 7,336 | 1,597 |
| Customer base | 8 | 3,400 | 3,400 |
| Developed technology | 4 | 2,500 | 2,500 |
| Non-compete agreements | 3 | 1,722 | 1,647 |
| Total intangible assets | | 52,268 | 46,409 |
| Accumulated amortization | | (4,746) | (3,233) |
| Intangible assets, net | | 47,522 | 43,176 |
| Other assets | | 2,831 | 1,195 |
| Intangible and other assets | | \$ 50,353 | \$ 44,371 |

[Table of Contents](#)

Identifiable intangible assets such as license agreements, patents, and trademarks are recorded at cost, or when acquired as part of a business combination, at estimated fair value and are amortized over a period they provide the Company with economic benefit, or using the straight-line method over their estimated useful life. The amortization expense for the next five full succeeding years is estimated at \$2.3 million, \$1.9 million, \$1.4 million, \$1.1 million, and \$1.1 million per year.

5. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

| <i>(in thousands)</i> | September 30, 2006 | December 31, 2005 |
|--------------------------|-----------------------|----------------------|
| Accrued warranty expense | \$ 8,258 | \$ 10,210 |
| Payroll | 5,794 | 8,457 |
| Sales return reserve | 1,555 | 1,049 |
| Royalty reserve | 1,255 | 1,685 |
| Other | 8,526 | 7,696 |
| Accrued liabilities* | <u>\$ 25,388</u> | <u>\$ 29,097</u> |

* Other accrued liabilities consist primarily of finance fees, commissions, accrued advertising and marketing fees, reserve for product liability, and miscellaneous accruals.

Warranty reserve activity for the nine months ended September 30, 2006 and 2005 was as follows:

| <i>(in thousands)</i> | Balance at Beginning of Period | Charged to Costs and Expenses | Deductions* | Balance at End of Period |
|-----------------------|--------------------------------------|-------------------------------------|-------------|--------------------------------|
| 2006 | \$ 10,210 | \$ 5,831 | \$ 7,783 | \$ 8,258 |
| 2005 | \$ 7,537 | \$ 6,442 | \$ 5,617 | \$ 8,362 |

* Deductions represent warranty claims paid out in the form of service costs and/or product replacements.

Warranty costs are estimated based on the Company's historical experience and are charged to cost of sales. Beginning in 2006, the Company has been able to offset its warranty costs by recovering a portion of such costs from its suppliers.

6. LINE OF CREDIT AND OTHER DEBT

In November 2005, the Company entered into an unsecured credit agreement with two domestic lending institutions. In August 2006, the Company amended its credit agreement. The agreement, as amended, provides for a revolving credit facility for a maximum commitment of \$65 million, includes revolving loans, letters of credit and swing loans, and expires on November 17, 2010. Under this credit facility, borrowings bear interest based at either the Prime Rate, Federal Funds Effective Rate or Eurodollar rates plus the applicable margin for either Base Rate Loans or Eurodollar Loans based upon the Company's consolidated leverage ratio. The credit facility has a default rate of two percent in excess of the rate otherwise applicable and provides for a facility fee at the annual rate equal to the applicable Facility Fee Rate in effect on the payment date. The facility fee is based on the average daily total commitment amount in effect during the quarter and is payable quarterly. At September 30, 2006, the borrowing limit under the credit facility was \$65 million of which \$23.5 million was available. The interest rate on the amount of borrowings outstanding at September 30, 2006 ranged between 5.990% and 6.025%. The interest rates ranged between 5.025% and 5.275% on the amount of borrowings outstanding at December 31, 2005. At September 30, 2006, the Company had \$6.5 million in standby letters of credit primarily with Asian vendors which reduced the balance available under the credit facility.

Under the terms of the credit facility, the Company may use proceeds for working capital and other general corporate purposes, including acquisitions. The terms of the credit facility also allow the use of funds for the repurchase of shares of the Company's common stock in an aggregate amount not to exceed \$30 million until the fixed charge coverage ratio is equal to or greater than 1.20 to 1.00. The credit facility, as amended, contains certain financial and non-financial covenants with which the Company was in compliance at September 30, 2006.

As part of its plan to expand its borrowing capacity to \$125 million, the Company entered into a \$25 million unsecured revolving credit agreement (the "Facility") with a lender in October 2006. The Facility expires on December 30, 2006. The Facility is intended for general corporate purposes, including working capital, stock repurchases, and permitted acquisitions. The Facility provides for either Base Rate or Eurodollar Rate loans. Base Rate loans bear interest at the higher of the Federal Funds Rate plus $\frac{1}{2}$ of 1.0% or the Prime Rate; Eurodollar loans bear interest at the Eurodollar Rate plus 1.00%. The Facility includes a commitment fee of 0.25% per annum for the unused portion of the commitment and contains certain financial and non-financial covenants which include but are not limited to a leverage ratio.

[Table of Contents](#)

In 2005, the Company issued a \$1.5 million non-interest bearing promissory note (\$1.3 million, net of imputed interest) as part of the purchase price of the Belko Canada acquisition payable in full in May 2008. At June 30, 2006, the Company reached an agreement with the noteholder to settle the entire amount of the note in fiscal 2006. The Company paid off the remaining balance of the note in August of 2006.

As part of the acquisition of Pearl Izumi, the Company became obligated on two non-interest bearing notes of \$4.4 million and \$0.9 million, net of imputed interest. The \$4.4 million note requires payments of \$0.3 million in February 2006, and \$0.15 million per quarter beginning March 2007 through December 2016. The \$0.9 million note requires payments of \$0.15 million per quarter beginning September 2005 through December 2006.

7. COMPREHENSIVE INCOME

Accounts of the Company's foreign operations are measured using the local currency as the functional currency. These accounts are then translated into U.S. dollars using the current rate method with translation gains and losses accumulated as the comprehensive income component of stockholders' equity, except for gains or losses from intercompany transactions which are recorded in the Consolidated Statement of Income.

Comprehensive income was as follows:

| (in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net income | \$ 9,376 | \$ 8,271 | \$16,248 | \$21,030 |
| Foreign currency translation adjustments | 300 | 226 | 1,351 | (1,041) |
| Comprehensive income | <u>\$ 9,676</u> | <u>\$ 8,497</u> | <u>\$17,599</u> | <u>\$19,989</u> |

8. EARNINGS PER SHARE

The calculation of the number of outstanding shares is as follows:

| (in thousands, except per share amounts) | Three Months Ended September 30, 2006 | | | Three Months Ended September 30, 2005 | | |
|--|--|--------------|---------------------|--|------------|---------------------|
| | Income | Shares | Per Share Amount | Income | Shares | Per Share Amount |
| Basic EPS: | | | | | | |
| Net income | \$9,376 | 32,138 | \$ 0.29 | \$8,271 | 33,549 | \$ 0.25 |
| Effect of dilutive securities: | | | | | | |
| Stock options | — | 102 | 0.00 | — | 816 | (0.01) |
| Diluted EPS: | | | | | | |
| Net income | \$9,376 | 32,240 | \$ 0.29 | \$8,271 | 34,365 | \$ 0.24 |
| Antidilutive stock options * | | <u>1,864</u> | | | <u>250</u> | |

| (in thousands, except per share amounts) | Nine Months Ended September 30, 2006 | | | Nine Months Ended September 30, 2005 | | |
|--|---|--------------|---------------------|---|------------|---------------------|
| | Income | Shares | Per Share Amount | Income | Shares | Per Share Amount |
| Basic EPS: | | | | | | |
| Net income | \$16,248 | 32,577 | \$ 0.50 | \$21,030 | 33,367 | \$ 0.63 |
| Effect of dilutive securities: | | | | | | |
| Stock options | — | 155 | 0.00 | — | 723 | (0.01) |
| Diluted EPS: | | | | | | |
| Net income | \$16,248 | 32,732 | \$ 0.50 | \$21,030 | 34,090 | \$ 0.62 |
| Antidilutive stock options * | | <u>1,818</u> | | | <u>263</u> | |

* Stock options not included in the calculation of diluted earnings per share for each respective period because they would be antidilutive.

9. STOCK REPURCHASE PROGRAM

In March 2005, the Company's Board of Directors authorized the repurchase of up to \$100 million of the Company's common stock in open-market transactions at times and in such amounts as management deems appropriate depending on market conditions and other factors. The authorization expires on March 31, 2008 unless extended by the Board of Directors. The repurchase program does not obligate the Company to acquire any specific number of shares or acquire shares over any specified period of time. During the three and nine months ended September 30, 2006, the Company acquired 1,344,200 shares of common stock at an average price of \$12.42 per share for a total cost of \$16.7 million. During 2005, the Company acquired 830,700 shares of common stock at an average price of \$18.82 per share for a total cost of \$15.6 million.

10. INCOME TAXES

The Company's effective tax rates for the three and nine months ended September 30, 2006 were 11.6% and 24.3%, respectively. The income tax provision for the three months ended September 30, 2006 includes a discrete \$3.0 million net benefit related to the reduction of tax contingency reserves resulting from determination that certain statutory periods for the assessment of additional state income tax are now closed, and a discrete \$0.2 million net increase related to adjustments of the 2005 tax provision to the final filed tax returns. The Company's effective tax rates for the three and nine months ended September 30, 2005 were 34.5% and 35.1%, respectively.

11. COMMITMENTS AND CONTINGENCIES

Legal Matters

We are involved in various claims, lawsuits and other proceedings from time to time. Such litigation involves uncertainty as to possible losses we may ultimately realize when one or more future events occur or fail to occur. We accrue and charge to income estimated losses from contingencies when it is probable that a liability had been incurred and the amount of loss can be reasonably estimated. Differences between estimates recorded and actual amounts determined in subsequent periods are treated as changes in accounting estimates. The Company estimates the probability of losses on legal contingencies based on the advice of internal and external counsels, outcomes from similar litigation, the status of the lawsuits (including settlement initiatives), legislative developments, and other factors. Due to numerous variables associated with these judgments and assumptions, both the precision and reliability of the resulting estimates of the related loss contingencies are subject to substantial uncertainties. We regularly monitor our estimated exposure to these contingencies and, as additional information becomes known, may change our estimates significantly. A significant change in our estimates, or a result that materially differs from our estimates, could have a significant impact on our financial position, results of operations and cash flows.

In November 2005, the Company proceeded to trial in Salt Lake City, Utah in a case filed by ICON Health & Fitness, Inc. ("ICON") claiming false advertising involving the Company's advertising and promotion going back to 1987 for certain elements of its Bowflex home gyms and claiming trademark infringement for the name placed on a treadmill belt sold in 2002. On November 15, 2005, the jury returned a verdict in favor of ICON in the amount of \$7.8 million which the Court subsequently increased to \$8.1 million. By an order dated April 21, 2006, the Court refused to modify the amount of the jury verdict. The Company has filed a notice of appeal of this judgment and has posted the necessary bond with the Court for the appeal. The Company, based on discussion with its legal counsel, believes the verdict is inconsistent with the law and the evidence presented at trial. Further, the Company believes that the evidence does not support the damage award and thus the likelihood of loss is neither probable nor is the amount of potential loss estimable. Therefore, no accrual has been recorded by the Company.

In December 2002, the Company filed suit against ICON in the Federal District Court, Western District of Washington (the "District Court") alleging infringement by ICON of the Company's Bowflex patents and trademarks. The Company sought injunctive relief, monetary damages and its fees and costs. In October 2003, the District Court dismissed the patent infringement claims. The Company appealed the District Court's decision to the United States Court of Appeals for the Federal Circuit (the "Appeals Court") and in November 2003, the Appeals Court overruled the District Court and reinstated the patent infringement claims. In May 2005, the District Court again dismissed the patent infringement case against ICON. The Company appealed this case to the Appeals Court, which issued an order in August 2006 affirming the ruling of the District Court dismissing the patent infringement case.

In July 2003, the District Court ruled in favor of the Company on a motion for preliminary injunction on the issue of trademark infringement and entered an order barring ICON from using the trademark "CrossBow" on any exercise equipment. In its ruling, the District Court concluded that the Company showed "a probability of success on the merits and irreparable injury" on its trademark infringement claim. In August 2003, the Appeals Court granted ICON a temporary stay regarding the motion for a preliminary injunction, which enjoined ICON from using the trademark "CrossBow." This stay allowed ICON to continue using the trademark "CrossBow" until a decision was issued by the Appeals Court. In June 2004, the Appeals Court issued its decision

upholding the issuance of an injunction and preventing ICON from selling exercise equipment using the trademark “CrossBow” pending trial on the trademark issue. A trial date has been set for February 2007 in the District Court on this claim.

In October 2006, the Company filed a complaint in the Superior Court for Clark County, Washington against Gately’s LLC (the “defendant”) seeking damages in the amount of \$5.1 million plus interest, attorney’s fees and costs, for collection of outstanding accounts receivable for product purchased by the defendant. No trial date has been set in this matter.

There have been no other significant subsequent developments relating to the commitments and contingencies reported in the Company’s most recent Annual Report on Form 10-K.

In addition to the matters described above, from time to time the Company is subject to litigation, claims and assessments that arise in the ordinary course of business, including disputes that may arise from intellectual property related matters. Many of our legal matters are covered in whole or in part by insurance. Management believes that any liability resulting from such matters will not have a material adverse effect on the Company’s financial position, results of operations, or cash flows.

Guarantees

From time to time, the Company arranges for commercial leases or other financing sources with third parties to enable certain of its commercial customers to purchase the Company’s commercial products. While most of these financing arrangements are without recourse, in certain cases the Company provides a guarantee or other recourse provisions to the independent finance company of all or a portion of the lease payments in order to facilitate the sale of the commercial products. In such situations, the Company ensures that the transaction between the independent leasing company and the commercial customer represents a sales-type lease. The Company monitors the payment status of the lessee under these arrangements and provides a reserve under SFAS No. 5, *Accounting for Contingencies*, in situations when collection of the lease payments is not probable. At September 30, 2006 and December 31, 2005, the maximum contingent liability under all recourse and guarantee provisions was approximately \$2.2 million and \$4.1 million, respectively. At September 30, 2006, lease terms on outstanding commercial customer financing arrangements were between 3 and 5 years. A reserve for estimated losses under recourse provisions of approximately \$0.1 million was recorded based on historical loss experience and is included in accrued expenses at both September 30, 2006 and December 31, 2005. In accordance with FASB Interpretation No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, the Company has also recorded a liability and corresponding reduction of revenue for the estimated fair value of the Company’s guarantees issued during those periods. The fair value of the guarantees was determined based on the estimated risk premium a bank or similar institution would require in order to extend financing to a customer in the absence of a third-party guarantee. This liability is being reduced over the life of each respective guarantee. In most cases if the Company is required to fulfill its obligations under the guarantee, it has the right to repossess the products from the commercial customer. It is not practical to estimate the amount of proceeds that would be generated from the sale of these assets in such situations.

The Company has an agreement with a financing company to provide second tier financing for its consumers. Under normal circumstances, funding for this reserve comes from a percentage of each sale held back by the financing company. In the event that the financing company experiences higher consumer default rates than specified under our contract, the Company will be required to pay an additional amount to the financing company. At September 30, 2006, the Company accrued approximately \$0.6 million for this liability.

At September 30, 2006, the Company also had approximately \$6.5 million in outstanding commercial letters of credit expiring between December 2006 and January 2007.

12. REPORTABLE SEGMENTS

The Company’s operating segments are evidence of the structure of the Company’s internal organization and are organized to allow focus on specific business opportunities in the Company’s worldwide market place. The Company’s three business segments are Fitness Equipment Business, International Equipment Business, and Fitness Apparel Business.

The Fitness Equipment Business is responsible for the design, production, marketing and selling of branded fitness equipment sold under the Nautilus, Bowflex, Schwinn Fitness and Stairmaster brand names and is responsible for servicing customers within the Americas, which includes the United States, Mexico, Canada and South America.

The International Equipment Business is responsible for the marketing and selling of branded fitness equipment sold under the Nautilus, Bowflex, Schwinn Fitness and Stairmaster brand names and is responsible for servicing customers outside of the Americas.

[Table of Contents](#)

The Fitness Apparel Business is responsible for the design, production, marketing and selling of branded fitness apparel, footwear and accessory products sold primarily under the Pearl Izumi brand in both domestic and international markets.

The three business segments are supported by teams that provide services to support the entire entity including finance and reporting, legal, human resources and other centralized functions. Management does not allocate expenses from the centralized functions to the business segments. As a result, the business segments operating results are reviewed based on revenue and gross profit.

Net sales from external customers for the Company's consolidated operations were as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------|-------------------------------------|-------------------|------------------------------------|-------------------|
| | 2006 | 2005 | 2006 | 2005 |
| <i>(in thousands)</i> | | | | |
| Fitness Equipment Business | \$ 128,257 | \$ 134,013 | \$ 389,176 | \$ 395,057 |
| International Equipment Business | 14,584 | 14,160 | 43,002 | 39,085 |
| Fitness Apparel Business | 16,742 | 15,135 | 50,007 | 15,135 |
| Net Sales | <u>\$ 159,583</u> | <u>\$ 163,308</u> | <u>\$ 482,185</u> | <u>\$ 449,277</u> |

Gross profit from external customers for the Company's consolidated operations was as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------|-------------------------------------|-----------------|------------------------------------|-------------------|
| | 2006 | 2005 | 2006 | 2005 |
| <i>(in thousands)</i> | | | | |
| Fitness Equipment Business | \$61,687 | \$61,647 | \$ 179,621 | \$ 189,186 |
| International Equipment Business | 2,994 | 3,615 | 10,473 | 10,903 |
| Fitness Apparel Business | 7,409 | 7,024 | 21,899 | 7,024 |
| Gross Profit | <u>\$72,090</u> | <u>\$72,286</u> | <u>\$ 211,993</u> | <u>\$ 207,113</u> |

Assets from the Company's three operating segments were as follows:

| | September 30, 2006 | December 31, 2005 |
|----------------------------------|-----------------------|----------------------|
| <i>(in thousands)</i> | | |
| Fitness Equipment Business | \$ 262,648 | \$ 304,033 |
| International Equipment Business | 32,274 | 31,034 |
| Fitness Apparel Business | 86,653 | 78,219 |
| | <u>\$ 381,575</u> | <u>\$ 413,286</u> |

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

FORWARD-LOOKING STATEMENTS

Certain statements contained in this Form 10-Q, including, without limitation, statements containing the words “could,” “may,” “will,” “should,” “plan,” “believes,” “anticipates,” “estimates,” “predicts,” “expects,” “projections,” “potential,” “continue,” and words of similar import, constitute “forward-looking statements.” Investors are cautioned that all forward-looking statements involve risks and uncertainties, and various factors could cause actual results to differ materially from those in the forward-looking statements. From time to time and in this Form 10-Q, we may make forward-looking statements relating to our financial performance, including the following:

- Anticipated revenues, expenses and gross margins
- Seasonal patterns
- Expense as a percentage of revenue
- Anticipated earnings
- New product introductions, and
- Future capital expenditures.

Numerous factors could affect our actual results, including the following:

- The availability of media time and fluctuating advertising rates
- A decline in consumer spending due to unfavorable economic conditions including high fuel and energy costs, as well as increasing interest rates
- Our ability to effectively develop, manufacture, market and sell future products
- Our ability to get foreign sourced products through customs in a timely manner
- Our ability to effectively identify and negotiate any future strategic acquisitions
- Our ability to integrate any acquired businesses into our operations
- Our ability to adequately protect our intellectual property
- Introduction of lower priced competing products
- Unpredictable events and circumstances relating to our international operations, including our use of foreign manufacturers
- Unpredictable changes in exchange rates of foreign currencies and the market cost of key commodities such as steel
- Government regulatory action, and
- Our ability to retain key employees.

We describe certain of these and other key risk factors elsewhere in more detail in this Form 10-Q and in our most recent Annual Report on Form 10-K. Although we believe the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements. Except to the extent required by the federal securities laws, we undertake no obligation to update publicly any forward-looking statements to reflect new information, events, or circumstances after the date of this Form 10-Q or to reflect the occurrence of unanticipated events.

This Management's Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) should be read in conjunction with our Interim Consolidated Financial Statements and related notes included elsewhere in this report as well as with the MD&A in our most recent Annual Report on Form 10-K. We believe that period-to-period comparisons of our operating results are not necessarily indicative of future performance. You should consider our prospects in light of the risks, expenses and difficulties frequently encountered by companies that operate in evolving markets. We may not be able to successfully address these risks and difficulties and, consequently, we cannot assure you of any future growth or profitability.

OVERVIEW

Nautilus, Inc. (“we,” “us,” “our” or “Company”) is a leading marketer, developer and manufacturer of branded health and fitness products sold under well-known names such as Nautilus, Bowflex, Schwinn Fitness, StairMaster and Pearl Izumi. Our products are distributed through diversified direct, retail and commercial sales channels, both domestically and internationally. We market and sell a variety of branded products that are targeted at specific locations where people shop or exercise. Nautilus, StairMaster and Pearl Izumi brands are most commonly marketed through the commercial and high-end specialty retail markets, while the Bowflex and

Schwinn Fitness branded products are marketed primarily through retail and direct sales channels. Our product marketing includes direct response marketing utilizing a combination of television commercials, infomercials, response mailings, the Internet, catalog, and inbound/outbound call centers to sell our products directly to customers. It also includes a sales force and dealer network marketing to retail organizations, health clubs, government agencies, hotels, corporate fitness centers, colleges, universities and assisted living facilities worldwide.

Summary of the Third Quarter 2006 Results

Net sales for the third quarter of 2006 were \$159.6 million, compared to \$163.3 million in the same quarter of 2005, a decrease of \$3.7 million or 2.3%. The decrease is primarily the result of greater visibility provided by our new information system allowing us to better analyze our sales and margin information by customer, channel, brand and product. As a result, we have restructured some of our relationships with existing customers and discontinued less profitable product offerings to improve profitability. Additionally, seasonal purchase patterns by retailers with more purchases moving into the last quarter of the current year further contributed to a decline in net sales. Gross profit margin increased to 45.2% in the third quarter of 2006 compared to 44.3% in the same quarter of 2005 as a result of continuing improvements in our operational and manufacturing efficiency, our ability to reduce warranty costs by recovering a portion of such costs from our suppliers, and reducing cost of our sourced products. Quarterly operating income declined to \$11.1 million or 7.0% of net sales compared to \$12.5 million or 7.7% of net sales in the third quarter of 2005. During the third quarter of 2006, the Company recorded a \$3.0 million reduction of tax contingency reserves as a result of closing of certain statutory periods and \$0.7 million of equity compensation expense; there were no similar items in the corresponding quarter of 2005. Diluted earnings per share for the quarter were 29 cents, compared to 24 cents a year ago.

CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS

The preparation of financial statements in conformity with U.S. GAAP requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements. As described by the Securities and Exchange Commission, critical accounting estimates and assumptions are those that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on the financial condition or operating performance of the company. There were no changes to our critical accounting estimates and assumptions in the three and nine month periods ended September 30, 2006. Refer to our most recent Annual Report on Form 10-K for a complete description of our critical accounting estimates and assumptions.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005 AND 2006

The following tables present certain consolidated financial data as a percentage of net sales and statement of income data comparing results for the three months ended September 30, 2006 and 2005:

Statement of Income Data (In thousands)

| | Three Months Ended September 30, | | | | | |
|--------------------------------|----------------------------------|-------------------|-----------------|-------------------|-----------------|-------------|
| | 2006 | % of net sales | 2005 | % of net sales | \$ change | % change |
| Net sales | \$ 159,583 | 100.0% | \$ 163,308 | 100.0% | \$(3,725) | (2.3%) |
| Cost of sales | 87,493 | 54.8% | 91,022 | 55.7% | (3,529) | (3.9%) |
| Gross profit | 72,090 | 45.2% | 72,286 | 44.3% | (196) | (0.3%) |
| Operating expenses: | | | | | | |
| Selling and marketing | 42,621 | 26.7% | 44,526 | 27.3% | (1,905) | (4.3%) |
| General and administrative | 14,507 | 9.1% | 11,146 | 6.8% | 3,361 | 30.2% |
| Research and development | 2,521 | 1.6% | 2,856 | 1.7% | (335) | (11.7%) |
| Royalties | 1,296 | 0.8% | 1,297 | 0.8% | (1) | (0.1%) |
| Total operating expenses | 60,945 | 38.2% | 59,825 | 36.6% | 1,120 | 1.9% |
| Operating income | 11,145 | 7.0% | 12,461 | 7.7% | (1,316) | (10.6%) |
| Other Income (Expense): | | | | | | |
| Interest income (expense), net | (537) | (0.3%) | 145 | 0.1% | (682) | (470.3%) |
| Other income (expense), net | (2) | 0.0% | 31 | 0.0% | (33) | (106.5%) |
| Total other income (expense) | (539) | (0.3%) | 176 | 0.1% | (715) | (406.3%) |
| Income before income taxes | 10,606 | 6.7% | 12,637 | 7.8% | (2,031) | (16.1%) |
| Income tax expense | 1,230 | 0.8% | 4,366 | 2.7% | (3,136) | (71.8%) |
| Net income | <u>\$ 9,376</u> | 5.9% | <u>\$ 8,271</u> | 5.1% | <u>\$ 1,105</u> | 13.4% |

Net Sales

Fitness Equipment Business

Total net sales for the Fitness Equipment Business were \$128.3 million in the third quarter of 2006 compared to \$134.0 million in the same period of 2005, a decrease of \$5.7 million or 4.3%. The decrease is the result of our strategy to improve profitability by refining or eliminating certain of our customer relationships, slower sales during the quarter as a result of seasonal purchase patterns by retailers with more purchases moving into the last quarter of the current year, discontinuation of less profitable product offerings, and decreased advertising.

Net sales from the commercial channel were \$17.9 million in the third quarter of 2006 compared to \$18.2 million in the same period of 2005. Commercial sales include sales to commercial dealers, health clubs, hotels and living complexes. The decrease in commercial net sales is primarily due to price increases and renegotiation of less profitable volume terms with our dealers to increase profitability.

Net sales from the specialty retail channel were \$15.9 million in the third quarter of 2006 compared to \$17.8 million in the same period of 2005, a decrease of \$1.9 million or 10.7%. Specialty retail sales include sales to fitness retail stores and independent bicycle dealers that typically sell health club-quality equipment to the end consumer for home and small business use. The decrease in specialty net sales is primarily due to slower sales during the quarter as a result of seasonal purchase patterns by retailers with more purchases moving into the last quarter of the current year.

Net sales from the retail channel, which include sales to sporting good stores, warehouse clubs, and department stores, were \$27.1 million in the third quarter of 2006 compared to \$29.7 in the same period of 2005, a decrease of \$2.6 million or 8.8%. The decrease in retail net sales is primarily due to our strategy to discontinue less profitable product offerings and refining or elimination of some customer relationships to improve profitability. The overall decrease in net sales was slightly offset by additional net sales due to launching the Bowflex Blaze product during the quarter.

Net sales from the direct channel were \$67.1 million in the third quarter of 2006 compared to \$68.3 million in the same period of 2005, a decrease of \$1.2 million or 1.8%. The direct channel includes internet sales, catalog sales and sales from direct response advertising. During the current quarter, we increased our media support for our new generation of Bowflex home gyms, the Bowflex Revolution, which was launched in July of 2005, and decreased the amount of advertising spent on our rod based home gyms.

[Table of Contents](#)

International Equipment Business

Net sales from the International Equipment Business were \$14.6 million in the third quarter of 2006 compared to \$14.2 million in the same period of 2005, an increase of \$0.4 million or 2.8%. The International Equipment Business represents sales outside of the Americas and includes primarily commercial sales, with increasing retail and initial direct marketing sales. The increase in net sales is due to expansion of the commercial and retail channels in Germany and the commercial channel in Italy.

Fitness Apparel Business

Net sales from the Fitness Apparel Business were \$16.7 million in the third quarter of 2006 compared to \$15.1 million in the same period of 2005, an increase of \$1.6 million or 10.6%. The Fitness Apparel Business was created in July 2005 with the Company's acquisition of Pearl Izumi. The Fitness Apparel Business sells high quality fitness apparel and footwear for cyclists, runners and fitness enthusiasts. The revenue stream of the Fitness Apparel Business is generally seasonal with the first and third quarters having the highest sales and the second and fourth quarters having lower sales. Much of this is related to the timing of when our customers purchase inventory to stock their shelves. The increase in net sales is primarily due to strong sales of the core Pearl Izumi cycling and running products with domestic net sales increasing approximately \$0.5 million, and international direct and distributor net sales contributing approximately \$0.6 million and \$0.3 million, respectively.

Gross Profit

As a result of lower sales, total gross profit was \$72.1 million in the third quarter of 2006 compared to \$72.3 million in the same period of 2005, a decrease of \$0.2 million or 0.3%. As a percentage of net sales, gross profit margins increased to 45.2% in the third quarter of 2006 compared to 44.3% in the comparable period of 2005. The increase is the result of increased visibility provided by our new information system which allows us to better analyze our relationships with existing customers resulting in sales to more profitable customers. Additionally, we have been able to offset our warranty costs by recovering a portion of such costs from our suppliers. Further, we realized cost reductions for our products sourced internationally.

Fitness Equipment Business

Gross profit for the Fitness Equipment Business remained unchanged at \$61.7 million in the third quarter of 2006 compared to \$61.6 million in the same period of 2005. As a percentage of net sales, gross profit margins increased to 48.1% in the third quarter of 2006 compared to 46.0% in the comparable period of 2005, an increase of 2.1%. The increase in the gross profit margin is attributable to our ability to reduce warranty costs by recovering a portion of such costs from our suppliers. We have also realized cost reductions for our products sourced internationally which were offset by a continuing increase in freight expenses due to high fuel prices.

International Equipment Business

Gross profit for the International Equipment Business was \$3.0 million in the third quarter of 2006 compared to \$3.6 million in the same period of 2005, a decrease of \$0.6 million or 16.7%. As a percentage of net sales, gross profit margin was 20.5% in the third quarter of 2006 compared to 25.4% in the comparable period of 2005. The decrease in gross profit is the result of clearing out older cardio products at discounted prices.

Fitness Apparel Business

Gross profit for the Fitness Apparel Business was \$7.4 million in the third quarter of 2006 compared to \$7.0 million in the same period of 2005, an increase of \$0.4 million or 5.7%. As a percentage of net sales, gross profit margin decreased to 44.3% in the third quarter of 2006 compared to 46.4% in the comparable period of 2005, a decrease of 2.1%. The decrease in the profit margin is due to the mix of products offered by the Fitness Apparel Business and a larger portion of sales coming from the international direct and distributor markets which have lower profit margins.

[Table of Contents](#)

Operating Expenses

Selling and Marketing

Selling and marketing expenses were \$42.6 million in the third quarter of 2006 compared to \$44.5 million in the same period of 2005, a decrease of \$1.9 million or 4.3%. The decrease is primarily due to a reduction of discretionary amounts spent on marketing costs.

General and Administrative

General and administrative expenses were \$14.5 million in the third quarter of 2006 compared to \$11.1 million in the same period of 2005, an increase of \$3.4 million or 30.2%. As a percentage of net sales, general and administrative expenses were 9.1% in the third quarter of 2006 compared to 6.8% in the same period of 2005. The increase is primarily due to expenses relating to our new ERP system that was implemented in the third quarter of 2005, legal costs, additional depreciation and rent for our new corporate headquarters which we occupied late in the third quarter of 2005, and stock-based compensation expense resulting from the adoption of SFAS 123(R).

Research and Development

Research and development expenses were \$2.5 million in the third quarter of 2006 compared to \$2.9 million in the same period of 2005, a decrease of \$0.3 million or 11.7%. As a percentage of net sales, research and development expenses were 1.6% in the third quarter of 2006 compared to 1.7% in the same period of 2005. The slight decrease is due to a reduced headcount as we aligned our research and development to support our current pace of product innovation.

Royalties

Royalty expenses were \$1.3 million in the third quarter of both 2006 and 2005.

Interest income (expense), net

Net interest expense increased to \$0.5 million in the third quarter of 2006 compared to interest income of \$0.1 million in the same period of 2005. The increase in interest expense is due to short-term borrowings outstanding during the third quarter of 2006. The Company did not have such borrowings in the comparable period of 2005.

Income Tax Expense

Income tax expense was approximately \$1.2 million in the third quarter of 2006 compared to \$4.4 million in the same period of 2005, a decrease of \$3.1 million or 71.8%. Our effective tax rate for the third quarter of 2006 was 11.6% compared to 34.5% in the same period of 2005. The decrease in the effective tax rate is primarily due to a \$3.0 million reduction of tax contingency reserves resulting from our determination that certain statutory periods for the assessment of additional state income tax are now closed.

RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005

The following tables present certain consolidated financial data as a percentage of net sales and statement of income data comparing results for the nine months ended 2006 and 2005:

Statement of Income Data (In thousands)

| | Nine Months Ended September 30, | | | | | |
|--------------------------------|---------------------------------|-------------------|-----------|-------------------|------------|-------------|
| | 2006 | % of net sales | 2005 | % of net sales | \$ change | % change |
| Net sales | \$482,185 | 100.0% | \$449,277 | 100.0% | \$ 32,908 | 7.3% |
| Cost of sales | 270,192 | 56.0% | 242,164 | 53.9% | 28,028 | 11.6% |
| Gross profit | 211,993 | 44.0% | 207,113 | 46.1% | 4,880 | 2.4% |
| Operating expenses: | | | | | | |
| Selling and marketing | 137,887 | 28.6% | 129,425 | 28.8% | 8,462 | 6.5% |
| General and administrative | 40,399 | 8.4% | 34,567 | 7.7% | 5,832 | 16.9% |
| Research and development | 8,321 | 1.7% | 8,768 | 2.0% | (447) | (5.1%) |
| Royalties | 3,991 | 0.8% | 3,952 | 0.9% | 39 | 1.0% |
| Total operating expenses | 190,598 | 39.5% | 176,712 | 39.4% | 13,886 | 7.9% |
| Operating income | 21,395 | 4.4% | 30,401 | 6.7% | (9,006) | (29.6%) |
| Other income (expense): | | | | | | |
| Interest income (expense), net | (1,152) | (0.2%) | 1,460 | 0.3% | (2,612) | (178.9%) |
| Other income, net | 1,220 | 0.3% | 542 | 0.1% | 678 | 125.1% |
| Total other income (expense) | 68 | 0.1% | 2,002 | 0.4% | (1,934) | (96.6%) |
| Income before income taxes | 21,463 | 4.5% | 32,403 | 7.1% | (10,940) | (33.8%) |
| Income tax expense | 5,215 | 1.1% | 11,373 | 2.5% | (6,158) | (54.1%) |
| Net income | \$ 16,248 | 3.4% | \$ 21,030 | 4.6% | \$ (4,782) | (22.7%) |

Net Sales

Net sales were \$482.2 million for the first nine months of 2006 compared to \$449.3 million in the same period of 2005, an increase of \$32.9 million or 7.3%. The increase is attributable to the acquisition of the Fitness Apparel Business in the third quarter of 2005 which contributed approximately \$50.0 million of net sales in the first nine month period ended September 30, 2006 compared to \$15.1 million in the same period of 2005.

Fitness Equipment Business

Net sales for the Fitness Equipment Business were \$389.2 million for the first nine months of 2006 compared to \$395.1 million in the same period of 2005, a decrease of \$5.9 million or 1.5% primarily due to lower net sales in the direct channel and discontinuation of less profitable product offerings.

Net sales from the commercial channel were \$52.1 million for the first nine months of 2006 compared to \$53.1 million for the same period of 2005, a decrease of \$1.0 million or 1.9%. The decrease in net sales is the result of greater visibility provided by our new information system which allows us to refine our relationships with existing customers and to identify less profitable product offerings which we discontinued to improve profitability.

Net sales from the specialty retail channel were \$53.7 million for the first nine months of 2006 compared to \$52.8 million for the same period of 2005, an increase of \$0.9 million or 1.7%. The increase in net sales is primarily due to gaining additional customers and expanding the number of products offered at existing dealers.

Retail net sales were \$72.2 million for the first nine months of 2006 compared to \$66.8 million for the same period of 2005, an increase of \$5.4 million or 8.1%. The increase is due to gaining additional customers, introduction of new product offerings within our Schwinn Fitness line of cardio equipment, and launching the Bowflex Blaze product in the third quarter of 2006.

Net sales from the direct channel were \$211.0 million for the first nine months of 2006 compared to \$222.3 million for the same period of 2005, a decrease of \$11.3 million or 5.1%. The decrease is due to a combination of reduced advertising in the second quarter of 2006 as a result of increased competition for media space, lower conversion rates as consumer confidence was negatively affected by higher interest rates and fuel prices, and a decrease in sales of our Bowflex rod based technology home gyms as a result of the introduction of a new generation of Bowflex home gyms, the Bowflex Revolution.

[Table of Contents](#)

International Equipment Business

Net sales from the International Equipment Business were \$43.0 million for the first nine months of 2006 compared to \$39.1 million for the same period of 2005, an increase of \$3.9 million or 10.0%. The increase is due to net sales from the addition of new retail distributors, including expansion of our commercial and retail channels in China, and increased sales in Sweden, Germany, India, Russia and the Benelux countries.

Fitness Apparel Business

Net sales from the Fitness Apparel Business were \$50.0 million for the first nine months of 2006 compared to \$15.1 million in the same period of 2005, an increase of \$34.9 million. The Fitness Apparel Business was created in July 2005 with the Company's acquisition of Pearl Izumi.

Gross Profit

Gross profit was \$212.0 million for the first nine months of 2006 compared to \$207.1 million in the same period of 2005, an increase of \$4.9 million or 2.4%. The increase is primarily attributable to the full integration of the Fitness Apparel Business acquired in the third quarter of 2005. As a percentage of net sales, gross profit margin decreased to 44.0% in the first nine months of 2006 compared to 46.1% in the comparable period of 2005. The decrease is a result of lower direct channel sales which generally have a higher margin than sales in our other channels, and the addition of the Fitness Apparel Business which had a gross profit margin of 43.8% for the first nine months of 2006.

Fitness Equipment Business

Gross profit for the Fitness Equipment Business was \$179.6 million for the first nine months of 2006 compared to \$189.2 million for the same period of 2005, a decrease of \$9.6 million or 5.1%. As a percentage of net sales, the gross profit margin was 46.1% in the first nine months of 2006 compared to 47.9% in the comparable period of 2005. The decrease in the gross profit margin as a percent of net sales is primarily due to changing channel and product mix and increased freight costs experienced in the first nine months of the current year, offset by reduced warranty costs as a result of recovering a portion of such costs from suppliers and reducing the cost of our sourced products. In addition, the gross profit margin decreased as a result of lower margins realized in the direct channel and the higher margin direct channel representing a smaller percentage of total sales. The direct channel represented approximately 54.2% of net sales during the first nine months of 2006 compared to 56.3% of net sales in the same period of the prior year.

International Equipment Business

Gross profit for the International Equipment Business was \$10.5 million for the first nine months of 2006 compared to \$10.9 million for the same period of 2005, a decrease of \$0.4 million or 3.7%. As a percentage of net sales, the gross profit margin was 24.4% in the first nine months of 2006 compared to 27.9% for the same period of 2005. The decrease in the profit margin is a result of competitive pressures in Europe, increases in freight costs, and clearing out both our older cardio products at discounted prices.

Fitness Apparel Business

Gross profit for the Fitness Apparel Business was \$21.9 million for the first nine months of 2006 with a gross profit margin of 43.8% compared to \$7.0 million and 46.4%, respectively, during the same period of 2005. The Fitness Apparel Business was acquired in the third quarter of 2005. The decrease in the profit margin is due to the mix of products offered by the Fitness Apparel Business and a larger portion of sales coming from the international direct and distributor markets which have lower profit margins.

Operating Expenses

Selling and Marketing

Selling and marketing expenses were \$137.9 million for the first nine months of 2006 compared to \$129.4 million for the same period of 2005, an increase of \$8.5 million or 6.5%. The increase is primarily due to including operating results of two acquisitions made in 2005.

General and Administrative

General and administrative expenses were \$40.4 million for the first nine months of 2006 compared to \$34.6 million for the same period of 2005, an increase of \$5.8 million or 16.9%. As a percentage of net sales, general and administrative expenses were 8.4% in the first nine months of 2006 compared to 7.7% in the same period of 2005. The increase is due to inclusion of expenses of our

[Table of Contents](#)

acquired businesses in 2005, expenses relating to our new ERP system that was implemented in the third quarter of 2005, legal costs, additional depreciation and rent for our new corporate headquarters which we occupied late in the third quarter of 2005, and stock-based compensation expense resulting from the adoption of SFAS 123(R).

Research and Development

Research and development expenses were approximately \$8.3 million for the first nine months of 2006 compared to approximately \$8.8 million for the same period of 2005, a decrease of approximately \$0.4 million or 5.1%. The slight decrease is due to a reduced headcount as we aligned our research and development to support our current pace of product innovation.

Royalties

Royalty expenses remained unchanged for the first nine months of 2006 and 2005 at \$4.0 million in each of the periods.

Interest and other income (expense), net

Net interest expense increased to \$1.2 million in the first nine months of 2006 compared to net interest income of \$1.5 million in the same period of 2005. The increase in expense is due to an average balance of short-term borrowings outstanding during 2006; the Company was in a cash investment position during the same period of 2005.

Net other income increased to \$1.2 million in the first nine months of 2006 from \$0.5 million in the comparable period of 2005. The increase is due to additional foreign currency gains realized by the Company in the second quarter of 2006.

Income Tax Expense

Income tax expense was approximately \$5.2 million for the first nine months of 2006 compared to \$11.4 million in the same period of 2005, a decrease of \$6.2 million or 54.1%. Our effective tax rate for the first nine months of 2006 was 24.3% compared to 35.1% in 2005. The decrease in the effective tax rate is primarily due to a \$3.0 million reduction of tax contingency reserves resulting from our determination that certain statutory periods for the assessment of additional state income tax are now closed. Including this and an additional expected tax reserve reversal of \$0.8 million in the fourth quarter, we expect our 2006 effective tax rate be 28.5%, returning to 37% in fiscal 2007.

LIQUIDITY AND CAPITAL RESOURCES

During the first nine months of 2006, our operating activities generated \$36.7 million in net cash compared to \$6.7 million in the same period of the prior year. The improvement from the prior year was primarily the result of a decrease in inventories as the Company focused on improving its forecasting and distribution processes.

Net cash used in investing activities was approximately \$9.9 million in the first nine months of 2006 compared to \$8.8 million in the same period of 2005. Capital expenditures were approximately \$8.4 million in the first nine months of 2006 compared to \$23.2 million in the same period of 2005. Capital expenditures during the first nine months of 2006 consisted of manufacturing equipment, website development costs to support our innovative product offerings, and computer equipment to maintain and expand current information systems for future growth. We have also purchased an intellectual property package for \$5.8 million. Further, the Company collected \$6.1 million from the sale of our former headquarters building located in Vancouver, Washington.

Net cash used in financing activities was \$32.9 million in the first nine months of 2006 compared to \$9.1 million in the same period of the prior year. The increase was primarily due to the Company's stock repurchases of \$16.7 million and paying down its short and long-term borrowings by \$7.0 million.

We believe our existing cash and cash equivalents, cash generated from operations and borrowings available under our credit facilities will be sufficient to meet our capital requirements in the foreseeable future.

OFF-BALANCE SHEET ARRANGEMENTS

From time to time, we arrange for leases or other financing sources with third parties to enable certain of our commercial customers to purchase our commercial products. While most of these financings are without recourse, in certain cases we may offer a guarantee or other recourse provisions. The purpose of these guarantees is to increase our selling opportunities to commercial customers that would not otherwise be able to obtain affordable financing to purchase our commercial products. At September 30, 2006 and December 31, 2005, the maximum contingent liability under all recourse provisions was approximately \$2.2 million and \$4.1 million, respectively.

[Table of Contents](#)

In addition, the Company has an agreement with a financing company to provide second tier financing for consumers. Refer to Note 11 of the Notes to Consolidated Financial Statements for further discussion of the accounting treatment for these arrangements.

INFLATION AND PRICE CHANGES

Although we cannot accurately anticipate the effect of inflation on our operations, we do not believe that inflation has had, or is likely in the foreseeable future to have, a material adverse effect on our financial position, results of operations or cash flows. However, increases in inflation over historical levels or uncertainty in the general economy could decrease discretionary consumer spending for products like ours.

During both 2006 and 2005, we experienced increases in transportation costs as a result of increases in the price for fuel. To the extent these costs continue to increase, our gross margins in 2006 may continue to be negatively impacted. Additionally, during 2006 and 2005, the Company implemented transportation surcharges passing some of these cost increases to the end consumer.

SEASONALITY

In general, based on historic trends, we expect our sales from fitness equipment products both domestic and international to vary seasonally with net sales typically strongest in the fourth quarter, followed by the third and first quarters, and weakest in the second quarter. Our analysis shows such factors as the broadcast of national network season finales and seasonal weather patterns influence television viewership and cause our television commercials on national cable television to be less effective in the second quarter than in other periods of the year. In addition, during the spring and summer consumers tend to do more activities outside including exercise, which impacts sales of fitness equipment that is used indoors. Sales from our fitness apparel products are strongest in the first and third quarters and weakest during the fourth quarter. We expect the fluctuation in our net sales between our highest and lowest quarters to be between 40% and 70%.

NEW ACCOUNTING PRONOUNCEMENTS

For a description of the new accounting standards that affect us, refer to Note 1 to our Consolidated Financial Statements included under Part I, Item 1 of this Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in our reported market risks since the filing of our 2005 Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 16, 2006.

We hold our cash and cash equivalents primarily in bank deposits and in liquid debt instruments with maturity dates of less than one year. We are subject to concentration of credit risk as bank deposits may exceed federally insured limits. Additionally, there is risk of loss of the entire principal with any debt instrument we invest in. To reduce risk of loss, we limit our exposure to any individual debt issuer and require certain minimum ratings for debt instruments that we purchase.

FOREIGN EXCHANGE RISK

We are exposed to foreign exchange risk from currency fluctuations, mainly in Canada and Europe, due to sourcing of products in U.S. Dollars and selling of products primarily in Canadian Dollars, Swiss Franks and Euros, respectively. Given the relative size of our current foreign operations, we have chosen not to enter into foreign currency hedges.

INTEREST RATE RISK

We are exposed to market risk for changes in interest rates related to our credit agreements. The credit agreements are at variable interest rates and, at September 30, 2006, we had outstanding borrowings under the credit facility of \$35 million. Due to the short-term nature of these borrowings, management believes that any reasonably possible near-term changes in related interest rates would not have a material impact on the Company's financial position, results of operations, or cash flows.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management has evaluated, under the supervision and with the participation of our Chairman, Chief Executive Officer and President, and Chief Financial Officer, Treasurer and Secretary, the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”), as amended) as of the end of the period covered by this quarterly report on Form 10-Q pursuant to Rule 13a-15(b) and 15d-15(b) under the Exchange Act. Based on this evaluation, our Chairman, Chief Executive Officer and President, and Chief Financial Officer, Treasurer and Secretary, concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective at the reasonable assurance level that information required to be disclosed in our Exchange Act reports is: (1) recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and (2) accumulated and communicated to our management, including our Chairman, Chief Executive Officer and President, and Chief Financial Officer, Treasurer and Secretary, as appropriate to allow timely decisions regarding required disclosure. Management does not expect that our disclosure controls and procedures will prevent or detect all errors and fraud. Any control system, no matter how well designed and operated, is based on certain assumptions and can provide only reasonable, not absolute assurance, that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected.

Changes in Internal Controls

As reported in the Company’s Annual Report on Form 10-K for the year ended December 31, 2005, management identified a material weakness in the Company’s controls for testing of and training for the enterprise resource planning (“ERP”) system. In addition, management also determined that efforts to mitigate the impact from the lack of testing and training for the implementation of the ERP system resulted in an additional material weakness from insufficient resources being devoted to controls over analyzing and recording contingencies. During the first nine months of 2006, the Company took action to correct the material weaknesses in internal control over financial reporting by:

- Identifying and correcting data migration issues;
- Providing additional training on the effective and efficient use of the ERP system to ensure data accuracy;
- Enhancing system reporting from the ERP system;
- Providing additional training to staff responsible for determining the financial impact of each contingency;
- Enhancing the review process and responsibility for review of accounting estimates and contingencies; and
- Implementing an additional level of review for all significant accounting estimates by the Vice President of Finance, Fitness Equipment Business.

Management believes it has made considerable progress in its efforts to remediate the material weaknesses since December 31, 2005. As on-going remediation continues, the Company is focusing its training and education efforts so that operating effectiveness can be demonstrated over a period of time that is sufficient to conclude that the material weaknesses have been remediated.

Except for the items identified above, there have been no other changes in the Company’s internal control over financial reporting during the most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are involved in various claims, lawsuits and other proceedings from time to time. Such litigation involves uncertainty as to possible losses we may ultimately realize when one or more future events occur or fail to occur. We accrue and charge to income estimated losses from contingencies when it is probable that a liability had been incurred and the amount of loss can be reasonably estimated. Differences between estimates recorded and actual amounts determined in subsequent periods are treated as changes in accounting estimates. The Company estimates the probability of losses on legal contingencies based on the advice of internal and external counsels, outcomes from similar litigation, the status of the lawsuits (including settlement initiatives), legislative developments, and other factors. Due to numerous variables associated with these judgments and assumptions, both the precision and reliability of the resulting estimates of the related loss contingencies are subject to substantial uncertainties. We regularly monitor our estimated exposure to these contingencies and, as additional information becomes known, may change our estimates significantly. A significant change in our estimates, or a result that materially differs from our estimates, could have a significant impact on our financial position, results of operations and cash flows.

In November 2005, the Company proceeded to trial in Salt Lake City, Utah in a case filed by ICON Health & Fitness, Inc. (“ICON”) claiming false advertising involving the Company’s advertising and promotion going back to 1987 for certain elements of its Bowflex home gyms and claiming trademark infringement for the name placed on a treadmill belt sold in 2002. On November 15, 2005, the jury returned a verdict in favor of ICON in the amount of \$7.8 million which the Court subsequently increased to \$8.1 million. By an order dated April 21, 2006, the Court refused to modify the amount of the jury verdict. The Company has filed a notice of appeal of this judgment and has posted the necessary bond with the Court for the appeal. The Company, based on discussion with its legal counsel, believes the verdict is inconsistent with the law and the evidence presented at trial. Further, the Company believes that the evidence does not support the damage award and thus the likelihood of loss is neither probable nor is the amount of potential loss estimable. Therefore, no accrual has been recorded by the Company.

In December 2002, the Company filed suit against ICON in the Federal District Court, Western District of Washington (the “District Court”) alleging infringement by ICON of the Company’s Bowflex patents and trademarks. The Company sought injunctive relief, monetary damages and its fees and costs. In October 2003, the District Court dismissed the patent infringement claims. The Company appealed the District Court’s decision to the United States Court of Appeals for the Federal Circuit (the “Appeals Court”) and in November 2003, the Appeals Court overruled the District Court and reinstated the patent infringement claims. In May 2005, the District Court again dismissed the patent infringement case against ICON. The Company appealed this case to the Appeals Court, which issued an order in August 2006 affirming the ruling of the District Court dismissing the patent infringement case.

In July 2003, the District Court ruled in favor of the Company on a motion for preliminary injunction on the issue of trademark infringement and entered an order barring ICON from using the trademark “CrossBow” on any exercise equipment. In its ruling, the District Court concluded that the Company showed “a probability of success on the merits and irreparable injury” on its trademark infringement claim. In August 2003, the Appeals Court granted ICON a temporary stay regarding the motion for a preliminary injunction, which enjoined ICON from using the trademark “CrossBow.” This stay allowed ICON to continue using the trademark “CrossBow” until a decision was issued by the Appeals Court. In June 2004, the Appeals Court issued its decision upholding the issuance of an injunction and preventing ICON from selling exercise equipment using the trademark “CrossBow” pending trial on the trademark issue. A trial date has been set for February 2007 in the District Court on this claim.

In October 2006, the Company filed a complaint in the Superior Court for Clark County, Washington against Gately’s LLC (the “defendant”) seeking damages in the amount of \$5.1 million plus interest, attorney’s fees and costs, for collection of outstanding accounts receivable for product purchased by the defendant. No trial date has been set in this matter.

There have been no other significant subsequent developments relating to the commitments and contingencies reported in the Company’s most recent Annual Report on Form 10-K.

In addition to the matters described above, from time to time the Company is subject to litigation, claims and assessments that arise in the ordinary course of business, including disputes that may arise from intellectual property related matters. Many of our legal matters are covered in whole or in part by insurance. Management believes that any liability resulting from such matters will not have a material adverse effect on the Company’s financial position, results of operations, or cash flows.

[Table of Contents](#)

Item 1A. **Risk Factors**

There have been no material changes to the risk factors identified in our annual report on Form 10-K for the year-ended December 31, 2005.

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

Registrant's Purchases of Equity Securities:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|-------------------------------------|---------------------------------|---|---|
| July 1, 2006 to July 31, 2006 | — | \$ — | — | \$ 84,364,000 |
| August 1, 2006 to August 31, 2006 | 1,300,700 | 12.43 | 1,300,700 | 68,241,000 |
| September 1, 2006 to September 30, 2006 | 43,500 | 12.20 | 43,500 | 67,710,000 |
| Total | <u>1,344,200</u> | <u>\$ 12.42</u> | <u>1,344,200</u> | <u>\$ 67,710,000</u> |

- (1) In March 2005, the Company's Board of Directors authorized the repurchase of up to \$100 million of the Company's common stock in open-market transactions, at times and in such amounts as management deems appropriate, depending on market conditions and other factors. The authorization expires on March 31, 2008, unless extended by the Board of Directors. The repurchase program does not obligate the Company to acquire any specific number of shares or acquire shares over any specified period of time.

Item 6. **Exhibits**

The following exhibits are filed herewith.

| Exhibit No. | Description |
|-------------|--|
| 10.1 | Summary of Performance Unit Award - Incorporated by reference to the Company's Current Report on Form 8-K, as filed with the Commission on August 3, 2006. |
| 10.2 | First Amendment to Nautilus, Inc. 2005 Long Term Incentive Plan |
| 31.1 | Certification of Principal Executive Officer pursuant to Rule 13a-14 (a) of the Securities Exchange Act of 1934, as amended |
| 31.2 | Certification of 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 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 |

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.

November 8, 2006
Date

By: /s/ Gregory C. Hammann
Greggory C. Hammann, Chairman, Chief Executive
Officer and President (Principal Executive Officer)

November 8, 2006
Date

By: /s/ William D. Meadowcroft
William D. Meadowcroft, Chief Financial Officer,
Treasurer and Secretary (Principal Financial Officer)

EXHIBIT INDEX

| Exhibit No. | Description |
|--------------------|--|
| 10.1 | Summary of Performance Unit Award - Incorporated by reference to the Company's Current Report on Form 8-K, as filed with the Commission on August 3, 2006. |
| 10.2 | First Amendment to Nautilus, Inc. 2005 Long Term Incentive Plan |
| 31.1 | Certification of Principal Executive Officer pursuant to Rule 13a-14 (a) of the Securities Exchange Act of 1934, as amended |
| 31.2 | Certification of 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 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 |

**First Amendment to Nautilus, Inc. 2005 Long Term Incentive Plan,
as adopted and approved by the Board of Directors of Nautilus, Inc. on October 30, 2006**

Section 12(b) of the Nautilus, Inc. 2005 Long Term Incentive Plan is hereby amended to provide in its entirety as follows:

- “(b) *If the outstanding Shares or other securities of Nautilus, or both, for which the Award is then exercisable or as to which the Award is to be settled shall at any time be changed or exchanged by declaration of a stock dividend, stock split, combination of shares, extraordinary dividend of cash and/or assets, recapitalization, reorganization or any similar event affecting the Shares or other securities of Nautilus, the Committee shall appropriately and equitably adjust the number and kind of Shares or other securities which are subject to this Plan or subject to any Awards theretofore granted, and the exercise or settlement prices of such Awards, so as to maintain the proportionate number of Shares or other securities without changing the aggregate exercise or settlement price.*”

CERTIFICATION

I, Gregory C. Hammann, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Nautilus, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 8, 2006

Date

By: /s/ Gregory C. Hammann

Greggory C. Hammann, Chairman, Chief Executive Officer and
President (Principal Executive Officer)

CERTIFICATION

I, William D. Meadowcroft, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Nautilus, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 8, 2006

Date

By: /s/ William D. Meadowcroft

William D. Meadowcroft, Chief Financial Officer,
Secretary and Treasurer (Principal Financial Officer)

Certification
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
(Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code)

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), the undersigned officer of Nautilus, Inc., a Washington corporation (the “Company”), does hereby certify that:

To my knowledge, the Quarterly Report on Form 10-Q for the period ended June 30, 2006 (the “Form 10-Q”) of the Company fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

November 8, 2006
Date

By: /s/ Gregory C. Hammann
Greggory C. Hammann, Chairman, Chief Executive Officer and President
(Principal Executive Officer)

To my knowledge, the Quarterly Report on Form 10-Q for the period ended June 30, 2006 (the “Form 10-Q”) of the Company fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

November 8, 2006
Date

By: /s/ William D. Meadowcroft
William D. Meadowcroft, Chief Financial Officer,
Secretary and Treasurer (Principal Financial Officer)