UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549
FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Year Ended December 31, 2001

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 000-25867

DIRECT FOCUS, INC.
(Exact name of registrant as specified in its charter)

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|---|---|
| WASHINGTON<br>(State or other jurisdiction of incorporation or organization) | 94-3002667<br>(I.R.S. Employer Identification No.) |
| 1400 NE 136TH AVENUE, VANCOUVER, WA<br>(Address of principal executive offices) | 98684<br>(Zip Code) |

Registrant's telephone number, including area code: 360-694-7722

Securities registered pursuant to Section 12(b) of the Act: NONE
Securities registered pursuant to Section 12(g) of the Act:
COMMON STOCK, WITHOUT PAR VALUE

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K. |_|

The aggregate market value of the voting stock held by non-affiliates of the Registrant is $1,047,236,796 as of March 1, 2002 based upon the last sales price as reported by the Nasdaq National Market System.

The number of shares outstanding of the Registrant's Common Stock as of March 1, 2002 was 35,012,932 shares.

DOCUMENTS INCORPORATED BY REFERENCE

The Registrant has incorporated by reference into Part III of this Form 10-K portions of its Proxy Statement for its 2002 Annual Meeting of Stockholders.

DIRECT FOCUS, INC.
2001 FORM 10-K ANNUAL REPORT
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PART I

FORWARD-LOOKING STATEMENTS

CERTAIN STATEMENTS CONTAINED IN THIS ANNUAL REPORT ON FORM 10-K, INCLUDING, WITHOUT LIMITATION, STATEMENTS CONTAINING THE WORDS "COULD," "MAY," "WILL," "SHOULD," "PLAN," "BELIEVES," "ANTICIPATES," "ESTIMATES," "PREDICTS," "EXPECTS," "PROJECTIONS," "POTENTIAL" OR "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-K, 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:

- OUR RELIANCE ON A LIMITED PRODUCT LINE;
- EXPIRATION OF IMPORTANT PATENTS;
- OUR ABILITY TO EFFECTIVELY DEVELOP, MARKET, AND SELL FUTURE PRODUCTS;
- GROWTH MANAGEMENT CHALLENGES, INCLUDING THE GROWTH RESULTING FROM THE ACQUISITION OF THE ASSETS OF THE FITNESS DIVISION OF SCHWINN/GT CORP. IN SEPTEMBER 2001, AND THE ACQUISITION OF THE ASSETS OF STAIRMASTER IN FEBRUARY 2002;
- OUR ABILITY TO INTEGRATE THE STAIRMASTER BUSINESS, AND ANY OTHER ACQUIRED BUSINESSES INTO OUR OPERATIONS;
- A DECLINE IN CONSUMER SPENDING DUE TO UNFAVORABLE ECONOMIC CONDITIONS;
- THE AVAILABILITY OF MEDIA TIME AND FLUCTUATING ADVERTISING RATES;
- OUR RELIANCE ON THE CONSUMER FINANCE MARKET;
- OUR ABILITY TO ADEQUATELY PROTECT OUR INTELLECTUAL PROPERTY;
- OUR RELIANCE ON THIRD-PARTY MANUFACTURERS; AND
- GOVERNMENT REGULATORY ACTION.

WE DESCRIBE CERTAIN OF THESE AND OTHER KEY RISK FACTORS ELSEWHERE IN MORE DETAIL IN THIS 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. 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-K OR TO REFLECT THE OCCURRENCE OF UNANTICIPATED EVENTS.

ITEM 1. BUSINESS
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INTRODUCTION

Direct Focus, Inc. is a leading marketer, developer and manufacturer of branded health and fitness products sold under such well-known names as Nautilus, Bowflex, Schwinn Fitness and StairMaster. We market and sell our Bowflex and Nautilus Sleep Systems products through our direct-marketing channel utilizing an effective combination of television commercials, infomercials, response mailings, the Internet, and inbound/outbound call centers. We market and sell our Nautilus, Schwinn Fitness, StairMaster and Quinton commercial fitness equipment through our sales force and selected dealers to health clubs, government agencies, hotels, corporate fitness centers, colleges, universities and assisted living facilities. We also market a complete line of consumer fitness equipment, also sold under the Nautilus, Schwinn Fitness, Trimline, and StairMaster brands, through a network of specialty dealers, distributors and retailers worldwide.

We have experienced rapid growth, with sales increasing from $133.1 million in 1999 to $363.9 million in 2001, representing a compound annual growth rate of over 65%. This increase was primarily the result of organic growth in the sales of existing Nautilus and Bowflex product lines. In addition, we significantly expanded our market through extensions of existing product lines in new channels and the strategic acquisition of Schwinn Fitness and StairMaster. We have grown net income from $20.3 million in 1999 to $66.6 million in 2001, representing a compound annual growth rate of over 81%.

Our success to-date, based on sales growth, profitability and cash flow, has been driven primarily by the expansion of our Bowflex and Nautilus Sleep Systems product lines in the growing, direct-to-consumer distribution channel. We believe that we have been able to capture premium price points as a result of our high quality, innovative products and direct sales to end customers. We intend to continue driving our growth through our ability to identify, fulfill and increase customer demand for health and fitness products.

Through our extensive experience in direct marketing health and fitness products to consumers, we have developed a creative and highly disciplined sales and marketing program. Over the past 9 years, we have spent over $164 million in television advertising for our direct products. Core to our strategy is the continuous improvement of our direct marketing process by challenging and refining all aspects of our marketing and selling cycle. This improvement has been accomplished in large part by our ability to gain relatively instantaneous customer feedback from our advertisements. All customer inquiries are carefully monitored and analyzed through our state-of-the-art inbound and outbound call center utilizing a customized automated database and its statistical applications. As a result, we have been able to predict with a historically high degree of accuracy the inquiries of our marketing programs and their subsequent conversion into sales. This highly refined marketing program, combined with our media purchasing power, has created an effective and cost efficient means for driving consumer demand.

Our success has been enhanced by our continuing expansion into the commercial and retail channels of the fitness industry. To expand sales and market share in these channels, we acquired substantially all of the assets of Nautilus International, Inc. ("Nautilus") in January 1999, the fitness division of Schwinn/GT Corp. and its affiliates ("Schwinn Fitness") in September 2001, and StairMaster Sports/Medical, Inc. ("StairMaster") in February 2002. These acquisitions have enabled us to considerably expand our portfolio of leading brands, product lines, channels of distribution, product development and the size of our customer base. Through our purchase of Schwinn Fitness and

StairMaster, we believe that we have made significant progress in diversifying our product line and expanding our presence internationally. We now offer a comprehensive line of cardiovascular and weight resistance products in the retail and commercial fitness industry. Our retail and commercial product lines include home gyms, free weight equipment, treadmills, indoor cycling equipment, steppers and ellipticals. As a result of our acquisitions, we have also added operations in Switzerland, Germany and England, a sales office in Japan, and a worldwide network of distributors.

We believe that our Company possesses distinct competitive advantages as it builds towards its goal of being a complete provider of products to the health and fitness industry. We continue to develop a portfolio of highly recognized and trusted fitness brands. These brands are utilized, in concert with tailored product development, to meet the differing customer demands of each distribution channel: direct, commercial and retail. In addition, we have realized, and believe that we will continue to realize, significant synergies by leveraging our brands, marketing resources, and research and development capabilities across all three distribution channels. We believe the health and fitness industry's fragmentation of manufacturers and distribution channels lends itself to the execution of this strategy.

For a discussion of financial information about our two business segments, direct products and commercial/retail products, see Note 2 of the Notes to Consolidated Financial Statements.

Direct Focus was incorporated in California in 1986 and became a Washington corporation in 1993. Our principal executive offices are located at 1400 NE 136th Avenue, Vancouver, Washington 98684, and our telephone number is (360) 694-7722. We maintain our corporate web site at www.directfocusinc.com. None of the information on this web site or our other web sites is part of this Form 10-K.

As used in this Form 10-K, the terms "we," "our," "us," "Direct Focus" and "Company" refer to Direct Focus, Inc. and its subsidiaries. The names Nautilus(R), Bowflex(R), Bowflex Power-Pro(R), Motivator(R), Versatrainer(R), Power Rod(R), Direct Focus(R), Instant Comfort(R), Nautilus Sleep Systems(R), Airdyne(R), Fitness Advisor(R), StairMaster(R), and Trimline(R) are registered trademarks of Direct Focus, Inc.

The consolidated financial statements of the Company include Direct Focus, Inc., Nautilus HPS, Inc., Nautilus, Inc., DFI Properties, LLC, BFI Advertising, Inc., DFI Sales, Inc., DFI Leaseco, LLC, Nautilus Fitness Products, Inc., Nautilus/Schwinn Fitness Group, Inc., DF Hebb Industries, Inc., Schwinn Fitness International SA, Schwinn Holdings International SA, and Schwinn Fitness SA. All intercompany transactions have been eliminated in the preparation of the consolidated financial statements. While StairMaster is discussed throughout this document due to its significance to our business strategy, its financial results are not included in our financial statements as it was acquired subsequent to year end 2001.

LONG-TERM STRATEGY

Our long-term strategy is to build a complete health and fitness company offering high quality, premium-branded products enabling health conscious consumers to maintain active lifestyles. We intend to do this by:

- Utilizing our positioning and capabilities in the direct marketing channel to launch new, innovative products;
- Capitalizing on the synergy and growth opportunities from acquisitions;

- Continuing to capture premium price points and accelerate demand by researching and developing high quality, branded products that better meet the needs of our customers and retailers; and
- Expanding our international opportunities by leveraging our recently acquired network of international distributors and operations.

## INDUSTRY OVERVIEW

### CONSUMER TRENDS

We believe that our organic growth has benefited from a number of demographic and market trends that we expect will continue, including:

- Growing consumer awareness of positive benefits of good nutrition and fitness;
- Expanding media attention on health and fitness;
- An aging population that is maintaining a more active lifestyle;
- Continued attention to appearance and weight by consumers, which is expected to increase as the "baby-boomers" pass through their 40's;
- High healthcare costs that are focusing more attention on preventative practices including an increase in the number of corporate fitness programs and wellness centers;
- Expansion of the market for sophisticated high-quality fitness equipment due to consumers' continued demand for higher levels of efficiency in their workout regimes; and
- The continued growth of direct to consumer marketing, which is estimated to exceed $1.0 trillion in annual sales in the United States in 2002.

We believe these consumer trends bode well for our future growth prospects. Just as the "baby boomers," those Americans born between 1946 and 1964, started the modern fitness movement, they will continue to be a driving force as they age. We believe baby boomers will use more of their increasing leisure time for exercise and more of their disposable income for fitness equipment purchases as they strive to counter the effects of aging.

### TRENDS IN FITNESS EQUIPMENT

We market our Nautilus, Bowflex, Schwinn Fitness and StairMaster equipment in the United States, as well as internationally. According to the Sporting Goods Manufacturing Association ("SGMA"), United States consumers were projected to spend $16.6 billion on sports equipment in 2001. Based on a study performed by the SGMA, U.S. consumers spent roughly $5.8 billion specifically on home fitness equipment in 2000.

Due to a difficult economic climate and the fact that sports equipment may be considered as discretionary spending, the market experienced a difficult year in 2001. According to the SGMA, the sports equipment market in the U.S. is expected to have declined 4.5% in 2001. However, the exercise equipment market is expected to have only declined 3.6%.

The SGMA expects the overall sports equipment market to continue to contract a further 0.7% in 2002; however, they are projecting a quick recovery for fitness equipment and expect the category to grow 4.0% in 2002 to return to 2000 levels.

Research from the National Sporting Goods Association ("NSGA") indicates that Americans are not only exercising more but are also exercising more with fitness equipment. Surveys performed by the NSGA indicate that the percentage of U.S. consumers above the age of seven who participated in exercise with fitness equipment rose from 35.3% in 1990 to 44.8% in 2000. In addition, the SGMA estimates that a number of Americans using strength equipment and cardiovascular equipment increased 5.4% and 3.5% annually, respectively, from 1990 to 2000. A significant component of this growth is attributable to the aging "baby-boomer" generation.

The commercial market has benefited from continued strength and increase in health club memberships. Health club memberships have grown an average of 5.0% annually for the past 13 years, according to the SGMA. The SGMA estimates that there were 32.8 million health club memberships at the end of 2000.

The worldwide travel industry has recognized that providing travelers with the fitness equipment required to maintain their regular exercise and fitness programs while away from home enhances customer satisfaction. Fitness facilities have become important factors in attracting and retaining hotel guests.

The international markets represent a strong opportunity for growth, driven by the continued fitness boom across Europe and the increasing focus on fitness and healthy lifestyles by more affluent consumers in Asia and Latin America. In fact, according to the International Health, Racquet and Sportsclub Association ("IHRSA"), there are approximately 19,500 health clubs in Europe, 7,800 in Latin America and 4,800 in the Asia/Australia market, compared to approximately 17,800 clubs in the U.S. We believe demand for U.S. products will increase, as foreign consumers increasingly demand the reliability, service and innovative designs provided by U.S. suppliers such as Nautilus, Schwinn Fitness, and StairMaster.

### TRENDS IN SLEEP PRODUCTS

The United States mattress market is large and dominated by four major manufacturers whose primary focus is the conventional innerspring mattress. According to the International Sleep Products Association ("ISPA"), United States mattress and foundation sales totaled 39.5 million units shipped in 2000, representing a 2.2 percent increase from 1999. Total dollar value of these wholesale shipments reached $4.6 billion in 2000, a 5.4% increase from 1999. We believe this equates to over $7.6 billion in retail sales. The ISPA estimates that innerspring mattresses accounted for approximately 90% of total domestic mattress sales in 2000. The ISPA also believes that less than 6% of all mattress sales are made through direct marketing channels. According to the ISPA, the bedding industry has enjoyed years of uninterrupted growth, which has led to increased competition and retail outlet consolidation. Queen-sized mattresses, which became the largest selling segment in 1998, continued to top the U.S. market in 2000, capturing 33.1% of the market.

## DIRECT BUSINESS SEGMENT

### DIRECT TO CONSUMER MARKETING

We market and sell our Bowflex and Nautilus Sleep Systems products through our direct-marketing channel utilizing an effective combination of television commercials, infomercials, response mailings, the Internet, and inbound/outbound call centers. The direct to consumer distribution channel involves sales of our range of products directly to the consumer. This is derived almost entirely from television advertisements, including both commercials and infomercials. By selling directly to the end consumer, we are able to target premium price points paid by end consumers, eliminating all other parties from the supply chain. Our ability to capture the entire gross margin has consistently produced a high financial return on time and money invested. The size of the direct market is also substantial. Through our advertising initiatives, we estimate that we currently target 70 million homes. Success within this distribution channel is almost entirely dependent on the ability to capture target demographics. By using over 1,000 different 800 numbers, we are able to measure exactly which ads our customers are responding to, and we have built a comprehensive database that enables us to scientifically adapt marketing strategies to better target customers. Historically, we have been able to predict, with a good degree of accuracy, inquiries to specific advertisements and the resulting sales. We continue to believe that this will serve as a key differentiating factor and enable us to maintain a competitive advantage within this channel.

We conduct direct to consumer marketing through a combination of 60-second "spot" television commercials and 30-minute television "infomercials." To date, we have been highly successful with what we refer to as a "two-step" marketing approach. Our two-step approach focuses first on generating consumer interest in our products and requests for product information, which is achieved primarily through the use of spot commercials and infomercials. The second step focuses on converting inquiries into sales, which we accomplish through a combination of response mailings and outbound telemarketing to potential customers who have made initial inquiries based on our first step advertising efforts. We have found that second quarter influences on television viewership, such as the broadcast of national network season finales and seasonal weather factors, cause our spot television commercials on national cable television to be marginally less effective in the second quarter than in other periods of the year.

ADVERTISING

SPOT COMMERCIALS AND INFOMERCIALS. Spot television commercials are a key element of the marketing strategy for all of our direct-marketed consumer products. For direct-marketed products that may require further explanation and demonstration, television infomercials are an important additional marketing tool. We have developed a variety of spot commercials and infomercials for our Bowflex product line and several commercials and marketing videos for our Nautilus Sleep Systems product line. We expect to use spot commercials and, where appropriate, infomercials to market consumer products that we determine are appropriate for the direct-marketing channel.

When we begin marketing a new product, we typically test and refine our marketing concepts and selling practices while advertising the product in spot television commercials. Production costs for these commercials can range from $50,000 to $150,000. Based on market research and viewer response to our spot commercials, we may produce additional spot commercials and, if appropriate for the product, an infomercial. Production costs for infomercials can range from $150,000 to $500,000. Generally, we attempt to film several infomercial and commercial concepts at the same time in order to maximize production efficiencies. From this footage we can then develop several varieties of spot commercials and infomercials and introduce and refine them over time. We typically generate our own scripts for spot commercials and utilize outside writers to assist with infomercial scripts on an as-needed basis. Typically, we contract with outside production companies to produce our spot commercials and infomercials.

We test spot commercials and infomercials on a variety of cable television networks that have a history of generating favorable responses for our existing products. Our initial objective is to determine the product's marketing appeal and evaluate creative or product modifications that may be appropriate. If these initial tests are successful, we then air the spot commercials and infomercials on an accelerating schedule of additional cable networks.

MEDIA BUYING. An important component of our direct marketing success is our ability to purchase quality media time at an affordable price. The cost of airing spot commercials and infomercials varies significantly, depending on the network, time slot and, for spot commercials, programming. Each spot commercial costs between $25 and $25,000 to air, and each infomercial costs between $600 and $55,000 to air. We currently purchase the majority of our media time on cable networks, through which we reach more than 70 million homes.

We do not currently purchase media time under long-term contracts. Instead, we book most of our spot commercial time on a quarterly basis and most of our infomercial time on a monthly or quarterly basis, as networks make time available. Networks typically allow us to cancel booked time with two weeks advance notice, which enables us to adjust our advertising schedule if our statistical tracking indicates that a particular network or time slot is no longer cost effective. Generally, we can increase or decrease the frequency of our spot commercial and infomercial airings at almost any time.

INTERNET. We expect the Internet to continue as an increasingly important part of our direct- marketing strategy. For example, we are promoting our web sites in spot commercials and infomercials in an effort to further stimulate electronic product inquiries and eCommerce transactions. We presently advertise our products on third-party web sites on a limited basis. Our site is loaded with informative customer testimonials and allows consumers to view our video online and obtain more information about our products. We currently operate two direct marketing-oriented web sites. The first, www.bowflex.com, focuses on our Bowflex line of home exercise equipment. The second, www.nautilussleepsystems.com, focuses on our Nautilus Sleep Systems. In an effort to expand and enhance our web presence, we have added dedicated web site development and management personnel.

OPTIMAL USE OF DIRECT MARKETING DATABASE

Since 1994, when we initially started testing our target markets, we have consistently invested significant resources in order to build a comprehensive direct marketing database. Our database has allowed us to monitor customer responses and effectively utilize information to adapt our marketing strategy to better target such customers. We track the success of each of our spot commercials and infomercials by determining how many viewers respond to each airing of a spot commercial or infomercial. We accumulate this information in a database that we use to evaluate the cost-effectiveness of available media time. In addition, we believe the database enables us to predict with reasonable accuracy how many product sales and inquiries will result from each spot commercial and infomercial that we air. We also believe we can effectively track changing viewer patterns and adjust our advertising accordingly.

CONVERSION OF DIRECT-MARKETED PRODUCT INQUIRIES INTO SALES

CUSTOMER SERVICE CALL CENTER AND ORDER PROCESSING. We operate our own customer service call center in Vancouver, Washington, which operates 18-23 hours per day and receives and processes all infomercial-generated and customer service-related inquiries regarding our Bowflex and Nautilus Sleep Systems products. We have developed a skill-based call routing system that automatically routes each incoming call to the most highly qualified inside sales agent or customer service representative available. The appropriate representative then answers product questions, pro-actively educates the potential customer about the benefits of our product line, promotes financing through our third-party private label credit card, and typically up sells the benefits of higher priced models in our product line. This sophisticated system allows us to better utilize our agents, prioritize call types and improve customer service.

We employ two large telemarketing companies to receive and process information requests generated by our spot television advertising 24 hours per day. The telemarketing agents for these companies only collect names, addresses and other basic information from callers and do not sell or promote our products.

INTERNET. We use television spot commercials and infomercials to lead consumers to our web sites, as we believe that consumers who visit our web sites are more inclined to purchase our products. Our ongoing Internet-related goals include improving the capabilities of our Bowflex and Nautilus Sleep System web sites. In 1999, we used our web sites to generate interest in our products but limited the information we provided to potential customers in an effort to induce them to initiate a telephone inquiry. In 2000, we believe we achieved a balance between our goals of finalizing sales and capturing consumer information by strategically designing our web pages and carefully analyzing web page hits, conversion rates, average sales prices and inquiry counts, which we continued to enhance in 2001. Our eCommerce sales are an increasingly important component of our direct sales channel and have grown from 8% to 19% to 22% of direct sales for 1999, 2000 and 2001, respectively.

RESPONSE MAILINGS. We forward a "fulfillment kit" in response to each inquiry regarding our direct-marketed products. Each kit contains detailed literature that describes the product line and available accessories, a marketing video that demonstrates and highlights the key features of our premium product in the line, and additional information about how to purchase the product. If a potential customer does not respond within a certain time period, we proceed with additional follow-up mailings that convey a different marketing message and typically offer certain inducements to encourage a sale. The specific marketing message and offer at each stage will vary, based on what our statistical tracking indicates is most likely to trigger a sale.

CONSUMER FINANCE PROGRAMS. We believe that convenient consumer financing is an important tool in our direct marketing sales efforts and induces many of our customers to make purchases when they otherwise would not. Currently, we offer "zero-down" financing to approved customers on all sales of our Bowflex Products and Nautilus Sleep Systems. We arrange this financing through a consumer finance company pursuant to a non-recourse consumer financing agreement. Under this arrangement, our customer service representatives can obtain financing approval in a few minutes over the telephone and, if a customer is approved, immediately ship the ordered product without the need for cumbersome paperwork. The consumer finance company pays us promptly after submission of the required documentation and subsequently sends to each approved customer a Direct Focus private label credit card that can be used for future purchases of our products. There were approximately 220,000 active private label cards with aggregate available credit of approximately $118 million outstanding as of December 31, 2001. During 2001, over 41% of our net sales were financed in this manner, and we believe this program will continue to be an effective marketing tool.

## DIRECT PRODUCTS

### BOWFLEX HOME FITNESS EQUIPMENT

We introduced the first Bowflex home exercise machine in 1986, and since then have implemented several improvements to its design and functionality. We now offer four different Bowflex machines and nine different models. The key feature of each Bowflex machine is our patented "Power Rod" resistance technology. Each Power Rod is made of a solid polymer material that provides progressive resistance in both the concentric and eccentric movements of an exercise. When combined with a bilateral cable pulley system, the machines provide excellent range and direction of motion for a large variety of strength-building exercises. Although Bowflex equipment continues to be our most successful product, due to our product diversification efforts, sales of our Bowflex products, as a percentage of our total sales, have decreased to 74% in 2001 from 80% and 83% in 1999 and 2000, respectively.

We currently offer the following Bowflex machines:

- The Ultimate, introduced in late 2001, is our newest product in the Bowflex line. The Ultimate is available in one model that offers over 80 different strength building exercises in one compact, foldable, and portable design and comes with a 310-pound resistance pack that can be upgraded to 410 pounds. We have also incorporated an integrated adjustable pulley system feature to allow a user to adjust the range of motion of many basic exercises to increase workout results. Prices currently range from $1,999 to $2,098, depending on the available resistance upgrade.

- The Power Pro, introduced in 1993, is our best selling product. The Power Pro is available in four different models: the basic Power Pro, the XT, the XTL and the XTLU. Each model offers over 60 different strength building exercises in one compact, foldable and portable design and comes with a 210-pound resistance pack that can be upgraded to 410 pounds. We have also incorporated an aerobic rowing exercise feature into the Power Pro. Prices currently range from $999 to $1,597, depending on the model and add-on features.

- The Motivator, introduced in 1996, is our entry-level strength training line. It is available in three different models: the basic Motivator, the XT and the XTL. Each model offers over 40 different strength building exercises in one compact, foldable design and comes standard with a 210-pound resistance pack that can be upgraded to 410 pounds. Prices currently range from $699 to $1,049, depending on the model and add-on features.

- The Versatrainer by Bowflex, introduced in 1988, is specifically designed to accommodate wheelchair-bound users. The Versatrainer's key advantage is that it permits users to exercise while remaining in their wheelchair, which offers enhanced independence and esteem. The Versatrainer can be found in many major rehabilitation hospitals, universities and institutions. The Versatrainer is currently priced at $1,699.

NAUTILUS SLEEP SYSTEMS

In December 1999, we began marketing a line of premium air sleep systems, which we have named the "Nautilus Sleep Systems." The key feature of each Nautilus Sleep System is its variable firmness support chamber, an air chamber within each air sleep system that can be electronically adjusted to regulate firmness. All queen and larger sleep systems in our Signature, Premier and Ultimate Series are equipped with dual air chambers that enable users to maintain different firmness settings on each side of the bed. We believe that variable firmness and other comfort-oriented features of our Nautilus Sleep Systems favorably differentiate them from conventional innerspring mattresses.

We currently offer four models of our Nautilus Sleep System:

- The Ultimate Series is our top-of-the-line Nautilus Sleep System. It features dual patent-pending, interlocking variable support chambers that permit users to maintain separate firmness settings on each side of the sleep system. The interlocking chambers regulate airflow and pressure to more effectively maintain support when a user changes position. The Ultimate Series comes with removable wool blend and silk blend pillow top sleeping surfaces, which permits users to easily convert to a "tight top" surface when they desire extra firmness. The Ultimate Series also has an upgraded comfort layer of visco-elastic foam that conforms to a user's body. The Ultimate Series is available in seven sizes and currently ranges in price from $1,399.99 for a twin to $1,999.99 for a California king, excluding foundation.

- The Premier Series features dual patent-pending, interlocking variable support chambers that permit users to maintain separate firmness settings on each side of the sleep system. The interlocking chambers regulate airflow and pressure to more effectively maintain support when a user changes position. The Premier Series comes with a removable wool blend pillow top sleeping surface, which permits users to easily convert to a "tight top" surface when they desire extra firmness. The Premier Series is available in seven sizes and currently ranges in price from $799.99 for a twin to $1,399.99 for a California king, excluding foundation.

- The Signature Series is designed to appeal to consumers who desire the flexibility of dual variable firmness support chambers, but at a more affordable price. Our customers can choose between a tight top or pillow-top sleeping surface over a one and one-half inch convoluted foam comfort layer. The Signature Series is available in seven sizes and currently ranges in price from $499.99 for a twin to $1,099.99 for a California king, excluding foundation.

- The Basic Series is our entry-level Nautilus Sleep System, which features a single, head-to-toe variable firmness support chamber and a traditional tight-top sleeping surface over a one and one-half inch thick convoluted foam comfort layer. The Basic Series is available in five sizes and currently ranges in price from $349.99 for a twin to $799.99 for a California king, excluding foundation.

We offer foundations that are specifically designed to support and enhance the performance of our Nautilus Sleep Systems. We advise consumers to use our foundations because conventional box springs tend to sag and wear over time, causing a sleep system to eventually mirror the worn box spring. The majority of our Nautilus Sleep System customers order a complete sleep system, which includes both a mattress and a foundation. Our foundations currently range in price from $199 for a twin to $399 for a California king.

### CHAMPION NUTRITION

In May 2001, we entered into a financing agreement with Champion Nutrition ("Champion") and its primary shareholder. Champion is a privately held manufacturer of nutritional supplements. We began selling Champion's product line through our direct sales channel in June 2001. We package these products as kits and sell them to our Bowflex customers as add-on items. Under the terms of the agreement, we have an option to buy the stock of Champion for $6 million through October 2002.

## COMMERCIAL/RETAIL BUSINESS SEGMENT

### COMMERCIAL/RETAIL SALES AND MARKETING

We market and sell our Nautilus, Schwinn Fitness, StairMaster, Quinton and Trimline commercial fitness equipment through our sales force and selected dealers to health clubs, government agencies, hotels, corporate fitness centers, colleges, universities and assisted living facilities. Our commercial direct sales force is focused on strengthening the market position of our existing Nautilus, Schwinn Fitness, and StairMaster commercial product lines, which we sell principally to health clubs, large hotels, assisted living facilities and the government. Additionally, as we continue to broaden our product line with products like Nautilus Nitro commercial equipment, our direct sales force will target new market segments and, if successful, broaden our customer base. Internationally, we market and sell our Nautilus, Schwinn Fitness, and StairMaster commercial fitness products through a worldwide network of independent distributors and our foreign operations.

We also market a complete line of consumer fitness equipment, under the Nautilus, Schwinn Fitness, and StairMaster brands, through a dealer network of more than 1,200 dealers, specialty retailers and specialty stores worldwide. As part of our acquisition of Schwinn Fitness, we have added an experienced management team to oversee the sales and marketing operations of our retail products business.

In general, sales of commercial/retail fitness equipment and accessories are seasonal. Typically, sales are higher in the first and fourth quarters with considerable weakness experienced in the second quarter. We believe the principle reason for this trend is the commercial and retail fitness industry's preparation for the impact of New Year's fitness resolutions and seasonal weather patterns related to colder winter months.

### COMMERCIAL EQUIPMENT

We currently offer the following Nautilus, Schwinn Fitness, and StairMaster equipment for the commercial market:

NAUTILUS SELECTORIZED EQUIPMENT. The Nautilus 2ST line of commercial strength equipment offers 27 high quality, technologically advanced strength building machines, each of which is specially designed to focus on a particular strength building exercise, such as leg presses, bench presses, super pullovers, hip abductors and adductors and leg curls. In addition, we offer a line of specially designed Nautilus 2ST equipment that we market principally to medical therapy and rehabilitation clinics. The key component of each Nautilus 2ST machine is either its "cam" or a four-bar linkage mechanism, which builds and releases resistance as a user moves through an exercise. The resistance is at its minimum during the initial and final stages of an exercise, and at its maximum in the middle of an exercise. The cam or four-bar linkage mechanism is designed to accommodate and maximize the benefits associated with the motion required for that machine. Other features are convergent and divergent upper body compound movements, four-bar linkages that produce functional movement, Kevlar belt drive, selectorized one pound add-on weight system, seat accessible weight stacks, low friction bearings and pulleys, hydraulic seat adjustments, machine-mounted instructional placards, tethered magnetic weight pins, powder coat finish, and quick release shields.

The Nautilus NITRO line, introduced in late 2000, is a complete line of compact selectorized machines. It is ideal for clubs and other facilities where floor space is limited. Nautilus NITRO features super-smooth belt drives, patented four-bar linkage, classic full range variable resistance cams and converging axis movements. Each Nautilus NITRO machine features 2" by 4" bent steel frames and 5-pound increment weight adjustments. In addition, EZ Glide seat adjustments make Nautilus NITRO easily adaptable to a variety of sizes, tastes, and exercise movements.

NAUTILUS FREE WEIGHT EQUIPMENT. In 1999, we introduced a line of Nautilus free weight equipment with new innovations in design and engineering intended to help club owners better serve their customers. The product line offers a sleeker look, tougher components and increased versatility. This new free weight gear can be coupled with the Nautilus selectorized equipment circuit to give facility managers a complete strength gym to serve all strength fitness tastes.

SCHWINN FITNESS INDOOR CYCLING EQUIPMENT. Our line of Schwinn Fitness indoor cycling products are used as part of a cycling-based exercise program that is popular among health clubs worldwide, and offer adjustable resistance, heavy-duty flywheels, plush seats and Schwinn's high-quality construction methods.

STAIRMASTER. StairMaster introduced the world's first stairclimber in 1983. Its full product line now includes stairclimbers, treadmills, exercise bikes, and Crossrobics. These products feature ergonomic designs, comfortable and user-friendly controls and smoothly performing equipment. StairMaster treadmills are built to commercial standards with long lasting decks, belts and motors. StairMaster treadmills feature large running surfaces, various workout programs and offers speeds of up to 12 miles per hour. Crossrobics machines allow individuals to engage in both strength training and cardiovascular training at the same time.

RETAIL EQUIPMENT AND ACCESSORIES

Nautilus retail equipment includes a wide variety of products for the retail consumer in the following categories:

- Fitness Accessories - a full line of fitness accessories, such as weight belts, jump ropes and ankle weights distributed to specialty fitness retailers and the sporting goods industry. The current line includes over fifty products.

- Gyms - Nautilus gyms are designed to give a complete, total body workout, and are built with the same commitment to quality and biomechanical function as our commercial equipment. Our gyms allow the consumer to perform a wide variety of exercises such as chest press, shoulder press, lat pulls, tricep extensions, leg work and more.

- o Free Weights and Benches - allow gym-quality exercises with adjustable workout benches, free weight systems, dumbbell racks, weight trees and more.

- o Weights - commercial quality barbells and dumbbells for personal use. Constructed of durable chrome and iron, many of these sets are packaged in a convenient storage case allowing easy organization of plates and bars.

- o Apparel - Nautilus hats, shirts, t-shirts and other apparel are all made with high quality materials and workmanship.

Schwinn Fitness offers a wide variety of retail products in the following categories:

- o Treadmills - Schwinn Fitness offers a wide variety of treadmills for use in the home. All are made in the USA and feature high power motors and quality electronics.

- o Stationary Bikes - Schwinn Fitness' line of stationary bikes includes both upright and recumbent style exercise bikes with features including self-generating computers with various exercise programs and computer-controlled resistance.

- o Steppers - Schwinn Fitness' steppers feature independent stepping action, and certain models feature computer-controlled exercise programs.

- o Wind - Schwinn Fitness' line of wind resistance exercise equipment uses fans to create resistance that increases with workout intensity. The line includes the Airdyne exercise bike and other products using wind resistance for upper body and full body workouts.

- o Strength Equipment - Schwinn Fitness' strength equipment includes multi-station weight machines with models for both home and institutional use.

- o Elliptical - Schwinn Fitness' elliptical trainers provide a low-impact natural motion workout and feature self-generating computers with multiple exercise programs.

StairMaster offers high-end products in the following categories:

- o Stairclimbers - StairMaster is the market leader in stairclimbers. These products provide superior cardiovascular workouts and condition major lower-body muscle groups with less impact than conventional aerobic machines.

- o Stationary Bikes - StairMaster offers both an upright and recumbent stationary exercise bike for home use. These products feature cordless operation and variable resistance workouts.

## NEW PRODUCT DEVELOPMENT AND INNOVATION

We continue to emphasize the expansion and diversification of our product development capabilities in health and fitness products. New product development is a focal point of our company. We develop new products either from internally generated ideas or by acquiring or licensing patented technology from outside inventors and then enhancing the technology.

In recent years, successful new product introductions and extensions have included the Nautilus Sleep Systems, the Nitro commercial line of strength equipment, and new Nautilus selectorized home gym and free weight equipment.

Our research and development competencies have been augmented through the acquisition of Schwinn Fitness and StairMaster. Schwinn Fitness possesses advanced design development and testing expertise and a state-of-the-art prototype and test facility. Schwinn Fitness has successfully developed and grown many new product categories, including both indoor group cycling and wind resistance machines sold under the Airdyne brand name. The acquisition of StairMaster has brought additional capabilities and product development in the stepper and stair climbing categories. StairMaster is widely credited with creating and growing these categories.

Our additional research and development resources have allowed us to become fully integrated in the product development process, allowing us to take a new product from the beginning of feasibility studies straight through to production and continuing product review. This integration allows us a greater degree of control over the new product process, which will allow us to generate a higher quality product, increase our speed to market, and control our costs.

For new direct-marketed products, we look for high-quality, high margin, and proprietary consumer products. In addition, these products should have the potential for mass consumer appeal, particularly among members of the "baby-boom" generation, who are accustomed to watching television and, in general, are likely to have higher disposable income.

For commercial/retail fitness products, we gather and evaluate ideas from various areas, including existing and potential customers, sales and marketing, manufacturing and engineering, and we determine which ideas will be incorporated into existing products or will serve as the basis for new products. Based on these ideas, we design new or enhanced products, develop prototypes, test and modify products, develop a manufacturing plan, and finally bring products to market. The Company evaluates, designs, and develops each new or enhanced product, taking into consideration our marketing requirements, target price points, gross margin requirements and manufacturing constraints. In addition, each new or enhanced product must maintain the Nautilus, Schwinn Fitness, and StairMaster standard of quality and reputation for excellence.

Research and development expense was $716,240, $1,186,216, and $2,229,242 for 1999, 2000, and 2001, respectively.

## COMPETITION

### DIRECT PRODUCTS SEGMENT

BOWFLEX. The market for our Bowflex products is highly competitive. Our competitors frequently introduce new and/or improved products, often accompanied by major advertising and promotional programs. We believe the principal competitive factors affecting this portion of our business are price, quality, brand name recognition, product innovation and customer service.

We compete directly with a large number of companies that manufacture, market and distribute home fitness equipment. We also compete with the many health clubs that offer exercise and recreational facilities and, indirectly, with outdoor fitness, sporting goods and other recreational products. Our principal direct competitors include ICON Health & Fitness (through its Health Rider, NordicTrak, Image, ProForm, Weider and Weslo brands), Precor and Total Gym. Some of our competitors have greater financial and marketing resources, which may give them and their products an advantage in the marketplace.

We believe our Bowflex line of home exercise equipment is competitive within the market for home fitness equipment based on product design, quality and performance and that our direct marketing activities are effective in distinguishing our products from the competition.

NAUTILUS SLEEP SYSTEMS. The sleep products industry is also highly competitive, as evidenced by the wide range of products available to consumers, such as innerspring mattresses, waterbeds, futons and other air-supported mattresses. We believe market participants compete primarily on the basis of price, product quality and durability, brand name recognition, innovative features, warranties and return policies.

We believe our most significant competition is the conventional mattress industry, which is dominated by four large, well-recognized manufacturers: Sealy (which also owns the Stearns & Foster brand name), Serta, Simmons and Spring Air. Although we believe our Nautilus Sleep Systems offer consumers an appealing alternative to conventional mattresses, many of these conventional manufacturers, including Sealy, Serta, Simmons and Spring Air, possess significantly greater financial, marketing and manufacturing resources and have better brand name recognition.

In addition to the conventional mattress manufacturers, several manufacturers currently offer beds with firmness technology similar to our Nautilus Sleep Systems. We believe the largest manufacturer in this niche market is Select Comfort. Select Comfort offers its sleep systems through retail stores and engages in a significant amount of direct marketing, including infomercials, targeted mailings, print, radio and television advertising. Select Comfort has an established brand name supported by marketing and manufacturing resources. Select Comfort also has significantly greater experience in marketing and distributing sleep systems. We believe the market for sleep systems is large enough for both companies to be successful and that our Nautilus Sleep Systems possess features that will enable us to compete effectively. However, the intense competition in the mattress industry, both from conventional mattress manufacturers and Select Comfort, may adversely affect our efforts to market and sell our sleep systems and, consequently, may adversely affect our financial performance.

COMMERCIAL/RETAIL SEGMENT PRODUCTS

COMMERCIAL FITNESS EQUIPMENT. The market for commercial fitness equipment is highly competitive. Our Nautilus, Schwinn Fitness, and StairMaster products compete against the products of numerous other commercial fitness equipment companies, including Life Fitness, Cybex, Star Trac and Precor. We believe the key competitive factors in this industry include price, product quality and durability, diversity of features, financing options and warranties. Some of our competitors have greater financial resources, significantly more experience in the fitness industry, and more extensive experience manufacturing their products.

RETAIL FITNESS EQUIPMENT. The market for retail fitness equipment is extremely competitive. Our Nautilus, Schwinn Fitness, and StairMaster retail products compete against the products of numerous domestic retail fitness equipment companies including ICON Health & Fitness (marketing products under the brand names Weslo, Health Rider, Weider, NordicTrak and ProForm), Star Trac, Life Fitness, Cybex, Fitness Quest, Bollinger Industries, and Precor. The Company's products also indirectly compete with outdoor fitness, sporting goods and other recreational products. We believe the key competitive factors in the retail fitness equipment industry include price, product quality, brand name recognition, customer service and the ability to create and develop new, innovative products. In addition, there are no significant technological, manufacturing or marketing barriers to entry into the fitness equipment markets in which we compete, even though like many companies in the industry, we have sought and received patent and trademark protection in an effort to protect our competitive position.

We believe that our combination of high-quality products, recognized brand names, multiple distribution channels, and dependable customer service gives us the ability to compete in our current markets.

MANUFACTURING AND DISTRIBUTION

Our primary manufacturing and distribution objectives for all of our products are to maintain product quality, reduce and control costs, maximize production flexibility and improve delivery speed. We use computerized inventory management systems to forecast our manufacturing requirements.

Our Nautilus commercial fitness manufacturing operations are located in Virginia. These operations are vertically integrated and include such functions as metal fabrication, powder coating, upholstery and vacuum-formed plastics processes. By managing our own manufacturing operations, we can control the quality of our Nautilus commercial products, while offering commercial customers greater color specification flexibility.

Our manufacturing operations also include a plant in Texas for Schwinn Fitness and Trimline consumer treadmills and a plant in Oklahoma for StairMaster products. By manufacturing these products in our own facilities, we ensure the highest quality control standards.

The main components of our Bowflex products, the Power Rods, are exclusively produced in our facilities to protect our manufacturing trade secrets and to ensure the highest quality control standards. In addition, we use outside suppliers to manufacture many of our components and finished parts for our direct and retail products. Whenever possible, we attempt to use at least two suppliers to manufacture each product component in order to improve flexibility.

Domestically, we inspect, package, and ship our products from our facilities in Washington, Virginia, Illinois, Texas, and Nevada. We rely primarily on United Parcel Service (UPS) to deliver our Bowflex and our Nautilus Sleep Systems products. We distribute our Nautilus, Schwinn Fitness retail equipment and accessories, and StairMaster retail and commercial fitness equipment from our Illinois and Oklahoma facilities using various commercial truck lines. We distribute Nautilus commercial fitness equipment from our Virginia warehouse facilities directly to customers primarily through our truck fleet. This method of distribution allows us to effectively control the set-up and inspection of equipment at the end-user's facilities.

For international sales, we have distributors in over 50 countries, and we inspect, package and ship our products from leased facilities in Switzerland, the United Kingdom, and Germany. We also lease, on a month-to-month basis, flexible warehouse space in multiple countries in Asia and Europe devoted to international distribution of Schwinn Fitness products.

INTELLECTUAL PROPERTY

Protecting our intellectual property is an important factor in maintaining our competitive position in the fitness and mattress industries. If we do not, or are unable to, adequately protect our intellectual property, our sales and profitability could be adversely affected. Accordingly, we have taken the following protective measures:

- We hold 17 United States patents and have applied for three additional United States patents with respect to our Nautilus products;
- We hold 20 United States patents and have 25 applications pending internationally with respect to our Schwinn Fitness products;
- We hold four patents relating to our Bowflex home fitness equipment;
- We have applied for one patent relating to our Nautilus Sleep Systems;
- We have obtained United States trademark protection for various names associated with our products, including "Bowflex," "Nautilus," "Power Rod," "Bowflex Power Pro," "Motivator," "Versatrainer," "Schwinn," "Airdyne," and "Fitness Advisor";
- We have applied for United States trademark protection for the names "Direct Focus," "Instant Comfort" and various other names and slogans associated with our products;
- We have registered the name "Bowflex" in Canada and the European Community, and have registered or applied to register the "Nautilus" trademark in approximately 30 foreign countries;
- We have obtained trademark protection for the "look" of our Bowflex Power Rods; and
- We hold eight United States copyright registrations relating to our Nautilus products.

Each federally registered trademark is renewable indefinitely if the mark is still in use at the time of renewal. We are not aware of any material claims of infringement or other challenges to our right to use our marks.

EMPLOYEES

As of December 31, 2001, we employed 825 full-time employees, including 4 executive officers and 15 part-time employees. None of our employees are subject to any collective bargaining agreement.

## ITEM 2. PROPERTIES

Our corporate headquarters is located in Vancouver, Washington. It is a Company-owned 90,000 square foot facility that serves as a warehouse, production, distribution and administrative facility. We also lease a 17,000 square foot facility in Vancouver, which we use as our customer call center. We lease this property pursuant to an operating lease that expires April 30, 2002, which is subject to an optional extension period. We plan to move our entire Vancouver operation to our headquarters building in 2002.

Our Nautilus commercial operations and our East Coast distribution centers for our direct-segment products are located in Independence, Virginia. The following Company-owned facilities are part of 54 acres of commercial real property, which were acquired in 1999 with the acquisition of Nautilus:

- A 124,000 square foot building devoted to fabrication, finishing, assembly, plastics, upholstery, warehousing and shipping;
- A 100,000 square foot building devoted to fabrication and Bowflex warehousing and shipping;
- A 27,000 square foot building that houses our Nautilus engineering, prototyping, customer service and administrative operations; and

- A 9,000 square foot administrative and product display building.

In 2001, we purchased a 29,500 square foot building in Independence devoted to used commercial equipment sales and warehousing. In addition to the purchase, we leased, with the option to buy, an 86,000 square foot building in Independence to serve as our East Coast distribution center for Nautilus Sleep System products. We purchased this building in January 2002 for approximately $600,000.

We also have a distribution center in Las Vegas, Nevada. We originally leased 93,000 square feet, for which the lease expires November 30, 2002. We distribute direct segment products from this facility. In 2001, we leased an additional 40,000 square feet of space adjacent to the original facility to be devoted as the West Coast distribution center for Nautilus retail fitness equipment. The lease for the additional space expired January 31, 2002. Nautilus retail fitness products are now distributed from our facility in Bolingbrook, Illinois.

In 2000, we purchased approximately 19.5 acres of land in Las Vegas for $1.1 million. We may build a distribution, warehouse and administrative facility on the land.

Additional facilities occupied in 2001 through the acquisition of Schwinn Fitness are as follows:

- A leased 139,000 square foot building in Bolingbrook devoted to Schwinn and Nautilus Fitness product warehousing and distribution;
- An owned 62,000 square foot building in Tyler, Texas devoted to manufacturing and distribution of treadmills;
- A leased 40,000 square foot building in Boulder that serves as the Schwinn and Nautilus Fitness warehouse, production, testing, distribution and administrative facility;
- 3,800 square feet of leased office space in Boulder devoted to research and development administration;
- A leased 11,280 square foot building in Freibourg, Switzerland devoted to international distribution; and
- A leased 6,300 square foot building in Givisiez, Switzerland devoted to international sales and administration.

In addition to the acquired facilities, we lease, on a month-to-month basis, flexible warehouse space in multiple countries in Asia and Europe devoted to international distribution of Schwinn Fitness products.

On March 1, 2002, we purchased an 85,000 square foot building in Boulder for $6 million. This facility will be used for Schwinn Fitness corporate offices, warehouse storage, production, testing, and distribution. The new building will replace the leased facilities in Boulder described above.

Our acquisition of StairMaster in 2002 added leased facilities in Tulsa, Oklahoma; Bothell, Washington; Milton Keynes, England; and Bergisch Gladbach, Germany.

In general, our properties are well maintained, adequate and suitable for their purposes, and we believe these properties will meet our operational needs for the foreseeable future. If we require additional warehouse or office space, we believe we will be able to obtain such space on commercially reasonable terms.

## ITEM 3. LEGAL PROCEEDINGS

In the normal course of business, the Company is a party to various legal claims, actions and complaints. Although it is not possible to predict with certainty whether the Company will ultimately be successful in any of these legal matters, or what the impact might be, the Company believes that disposition of these matters will not have a material adverse effect on the Company's financial position, results of operations or cash flows.

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our stockholders during the quarter ended December 31, 2001.

# PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

### MARKET PRICE OF OUR COMMON STOCK

Since May 4, 1999, our common stock has been listed for trading exclusively on The Nasdaq National Market System under the symbol DFXI. The following table summarizes the high and low closing prices for each period indicated, adjusted to reflect the three-for-two stock splits effective August 2000, January 2001 and August 2001:

| | HIGH | LOW |
|---|---|---|
| 2000 | | |
| Quarter 1........... | $ 8.89 | $ 6.45 |
| Quarter 2........... | 14.52 | 7.97 |
| Quarter 3........... | 18.11 | 12.11 |
| Quarter 4........... | 20.67 | 14.14 |
| 2001 | | |
| Quarter 1........... | 21.42 | 12.39 |
| Quarter 2........... | 31.67 | 15.97 |
| Quarter 3........... | 33.34 | 17.11 |
| Quarter 4........... | $ 31.46 | $ 19.95 |

As of March 1, 2002, 35,012,932 shares of our common stock were issued and outstanding and held by 14,611 beneficial shareholders.

Payment of any future dividends is at the discretion of our board of directors, which considers various factors, such as our financial condition, operating results, current and anticipated cash needs and expansion plans. Our credit lines do not restrict the payment of dividends. To date, we have never declared or paid any cash dividends on our common stock and we do not presently intend to declare any cash dividends in the near future. Instead, we intend to retain and direct any future earnings to fund our anticipated expansion and growth.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data presented below for each year in the five-year period ended December 31, 2001 have been derived from our audited financial statements. The data presented below should be read in conjunction with our financial statements and notes thereto and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

| IN THOUSANDS (EXCEPT PER SHARE AMOUNTS) | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| STATEMENT OF OPERATIONS DATA | | | | | |
| Net sales | $ 21,546 | $ 63,171 | $ 133,079 | $ 223,927 | $ 363,862 |
| Cost of sales | 6,774 | 18,316 | 46,483 | 75,573 | 140,699 |
| Gross profit | 14,772 | 44,855 | 86,596 | 148,354 | 223,164 |
| Operating expenses: | | | | | |
| Selling and marketing | 9,600 | 22,643 | 44,630 | 73,510 | 99,814 |
| General and administrative | 975 | 1,701 | 4,237 | 8,804 | 15,574 |
| Royalties | 581 | 1,623 | 2,897 | 4,979 | 7,363 |
| Litigation settlement | - | - | 4,000 | - | - |
| Total operating expenses | 11,156 | 25,967 | 55,764 | 87,293 | 122,751 |
| Operating income | 3,616 | 18,888 | 30,832 | 61,061 | 100,413 |
| Other income (expense): | | | | | |
| Interest income | 119 | 527 | 1,003 | 3,632 | 4,024 |
| Other-net | (88) | (228) | 3 | 347 | 381 |
| Total other income | 31 | 305 | 1,006 | 3,979 | 4,405 |
| Income before income taxes | 3,647 | 19,193 | 31,838 | 65,040 | 104,818 |
| Income tax expense | 1,226 | 6,708 | 11,495 | 23,414 | 38,235 |
| Net income | $ 2,421 | $ 12,485 | $ 20,343 | $ 41,626 | $ 66,583 |
| Basic earnings per share * | $ 0.08 | $ 0.39 | $ 0.59 | $ 1.18 | $ 1.89 |
| Diluted earnings per share* | $ 0.07 | $ 0.38 | $ 0.58 | $ 1.15 | $ 1.85 |
| Basic shares outstanding * | 30,330 | 31,511 | 34,309 | 35,288 | 35,184 |
| Diluted shares outstanding * | 32,099 | 32,825 | 35,185 | 35,997 | 35,966 |
| BALANCE SHEET DATA | | | | | |
| Cash and short-term investments | $ 4,790 | $ 18,911 | $ 35,703 | $ 77,181 | $ 51,709 |
| Working capital | 4,100 | 15,682 | 38,209 | 72,520 | 84,366 |
| Total assets | 7,922 | 24,373 | 67,310 | 117,126 | 193,904 |
| Stockholders' equity | 4,592 | 17,651 | 53,031 | 92,867 | 147,414 |

*Reflects the three-for-two stock splits effective August 2000, January 2001 and August 2001

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CRITICAL ACCOUNTING POLICIES

We have identified the most critical accounting principles upon which our financial status depends. We determined the critical principles by considering accounting policies that involve the most complex or subjective decisions or assessments. We identified our most critical accounting policies to be those related to warranty reserves, sales return reserves, and the allowance for doubtful accounts.

### WARRANTY RESERVES

The costs for product warranties included in our warranty reserve are for the cost to manufacture (raw materials, labor and overhead) or purchase warranty parts from our suppliers and the cost to ship those parts to our customers. In addition, the cost of a technician to install a warranted part on our manufactured commercial equipment is also included.

The warranty reserve is based on past historical experience with each product. A warranty reserve is established for new products based on historical experience with similar products, adjusted for any technological advances in manufacturing or materials used. Thorough testing of new products in the development stage helps to identify and correct potential warranty issues prior to manufacturing. Continuing quality control efforts during manufacturing limit our exposure to warranty claims. We track all warranty claims by part and reason for claim in order to identify any potential warranty trends.

If our quality control efforts were to fail in detecting a fault in one of our products, we could experience increased warranty claims resulting in increasing the warranty reserve, which could have a significant impact on current and future financial position, results of operations and cash flows.

### SALES RETURN RESERVES

The sales return reserve is based on past historical experience of product returns during the trial period in which a customer can return a product for the full purchase price, less shipping and handling. The trial period for Bowflex products is 45 days and, for our Nautilus Sleep Systems, 90 days. Trial periods are not offered on our other product lines. We track all product returns in order to identify any potential customer satisfaction trends. Our return reserve may be sensitive to a change in our customers' ability to pay during the trial period due to unforeseen economic circumstances and to different product introductions that might fulfill the customers' needs at a perceived better value. In such cases, we could experience increased sales returns resulting in increasing the return reserve, which could have a significant impact on current and future financial position, results of operations and cash flows.

### ALLOWANCE FOR DOUBTFUL ACCOUNTS

The allowance for doubtful accounts reserve is based on past historical experience adjusted for any known uncollectible amounts. We periodically review the creditworthiness of our customers to help ensure collectability. Our allowance is sensitive to changes in our customer's ability to pay due to unforeseen changes in the economy, including the bankruptcy of a major customer, our efforts to actively pursue collections, and increases in chargebacks. Any major change in the aforementioned factors may result in increasing the allowance for doubtful accounts, which could have a significant impact on current and future financial position, results of operations and cash flows.

## RESULTS OF OPERATIONS

This discussion and analysis should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report.

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 experiencing rapid growth and, in particular, rapidly growing companies that operate in evolving markets. We may not be able to successfully address these risks and difficulties. Although we have experienced net sales growth in recent years, our net sales growth may not continue, and we cannot assure you of any future growth or profitability.

The following table presents certain financial data as a percentage of net sales:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 1999 | 2000 | 2001 |
| STATEMENT OF OPERATIONS DATA | | | |
| Net sales........................ | 100.0% | 100.0% | 100.0% |
| Cost of sales.................... | 34.9 | 33.7 | 38.7 |
| Gross profit..................... | 65.1 | 66.3 | 61.3 |
| Operating expenses | | | |
| Selling and marketing........ | 33.5 | 32.8 | 27.4 |
| General and administrative... | 3.2 | 3.9 | 4.3 |
| Royalties.................... | 2.2 | 2.2 | 2.0 |
| Litigation settlement........ | 3.0 | - | - |
| Total operating expenses......... | 41.9 | 38.9 | 33.7 |
| Operating income................. | 23.2 | 27.4 | 27.6 |
| Other income..................... | 0.7 | 1.6 | 1.2 |
| Income before income taxes....... | 23.9 | 29.0 | 28.8 |
| Income tax expense............... | 8.6 | 10.5 | 10.5 |
| Net income....................... | 15.3% | 18.6% | 18.3% |

COMPARISON OF THE YEARS ENDED DECEMBER 31, 2001 AND DECEMBER 31, 2000

NET SALES

Net sales grew by 62.5% to $363.9 million in 2001 from $223.9 million in 2000. Sales were driven by the growth in our direct-marketing business and the continued expansion into the commercial and retail market segments. In 2001, we capitalized on favorable advertising costs and availability to increase the consumer awareness of our Bowflex and Nautilus Sleep System product lines. Meanwhile, we have continued to expand our market share in the commercial and retail products segment, where we have grown the Nautilus brand and successfully integrated the acquisition of the Schwinn Fitness business.

Sales in our direct segment are comprised primarily of sales of our Bowflex product line; however, as the Nautilus Sleep Systems product line continues to grow, it is also becoming an increasingly important component of our direct business. Sales within our direct products segment were $292.5 million in 2001, an increase of 47.7% over the prior year. Our direct segment accounted for 80.4% of our aggregate net sales in 2001, down from 88.5% in 2000, as we continued our strategy of diversification into the commercial and retail products segments.

Sales within our commercial and retail products segment were $71.3 million in 2001, an increase of 176.2% over 2000. Our commercial and retail segment now accounts for 19.6% of our net sales, up from 11.5% in 2000 as we continued to execute our strategy of expanding our presence, product lines and brands across all our channels and especially within the commercial and retail products segment. In 2002, with a full year of results from Schwinn and with the acquisition of StairMaster, we expect our commercial and retail segment to continue to grow as a percentage of our net sales.

Our direct-marketing business is largely dependent upon national cable television advertising. We have found that second quarter influences on television viewership, such as the broadcast of national network season finales and seasonal weather factors, cause our spot television commercials on national cable television to be marginally less effective in the second quarter than in other periods of the year. We believe that sales within our commercial and retail products segment will be considerably lower in the second quarter of the year compared to the other quarters. Our strongest commercial/retail products quarter should be the fourth quarter, followed by the first and third quarters. We believe the principle reason for this trend is the commercial and retail fitness industry's preparation for the impact of New Year's fitness resolutions and seasonal weather patterns related to colder winter months.

GROSS PROFIT

Gross profits continued to be strong, growing 50.4% to $223.2 million in 2001, from $148.4 million in the same period a year ago. However, due to our product diversification strategy, which has increased sales in the commercial and retail segment and due to the inherent lower margins in that segment, our overall gross profit margin decreased 5.0% to 61.3% in 2001, from 66.3% in 2000. We expect this trend to continue as we further expand in the commercial and retail segments of the market.

The gross profit margin within our direct products segment was 69.8% in 2001 and 70.2% in 2000. Gross margins on our Bowflex product line continue to be very strong. We also outsource all non-proprietary manufacturing through established overseas production. The decrease in gross margins within our commercial and retail products segment to 26.4% in 2001, compared with 36.2% in 2000, was largely due to the Schwinn Fitness acquisition and higher research and development expenditures for the Nautilus retail fitness products. Schwinn's manufactured treadmill inventory was subject to purchase accounting guidelines that required step-up basis adjustments, negatively affecting our gross profit margins. Research and development costs increased 83.3% to $2.2 million in 2001 from $1.2 million in 2000.

OPERATING EXPENSES

SELLING AND MARKETING

Selling and marketing expenses grew to $99.8 million in 2001 from $73.5 million in the same period a year ago, an increase of 35.8%. This increase in selling and marketing expenses resulted primarily from the expansion of our direct marketing campaign for Bowflex products and Nautilus Sleep Systems and variable costs associated with our sales growth.

As a percentage of net sales, overall selling and marketing expenses decreased to 27.4% in 2001 from 32.8% in 2000. The decrease was a result of our planned product diversification efforts leading to a higher proportion of commercial and retail product sales. We benefited from the increased availability of advertising time and the reduction of advertising rates due to the dramatic reduction of dot.com media spending coupled with the economic downturn. Selling and marketing expenses within our direct products segment were 31.3% of net sales in 2001, compared to 33.9% in 2000. Overall, we expect that our selling and marketing expenses will increase in real dollar terms, but not as a percentage of net sales, as we continue to expand our Bowflex and Nautilus Sleep Systems direct-marketing campaign and expand our product diversification efforts in the commercial and retail segment.

GENERAL AND ADMINISTRATIVE

General and administrative expenses grew to $15.6 million in 2001 from $8.8 million in 2000, an increase of 76.9%. Our direct-marketing business accounted for $4.0 million of the increase, due primarily to increased staffing and infrastructure expenses necessary to support our growth. Our commercial and retail operations accounted for the remaining increase primarily due to our product diversification strategy. As a percentage of net sales, general and administrative expenses increased to 4.3% in 2001 from 3.9% in 2000. We believe that our general and administrative expenses will increase in future periods in real dollar terms, and increase marginally as a percentage of sales.

ROYALTY

Royalty expense grew to $7.4 million in 2001 from $5.0 million in 2000, an increase of 47.9%. Both our direct and commercial/retail segments have several royalty agreements. The increase in our royalty expenses is primarily attributable to the increased sales of our Bowflex products, along with sales of other products under royalty agreements which have been added as part of our diversification strategy. Our royalty expenses will increase if sales of our Bowflex products continue to increase and as we sell recently acquired products which have royalty agreements associated with them.

OTHER INCOME

In 2001, other income was $4.4 million compared to $4.0 million for 2000. The small increase resulted primarily from an increase in interest earned on invested cash and cash equivalents due to the effect of higher invested cash amounts offset by considerable interest rate cuts by the Federal Reserve Bank in 2001. Interest income should be lower in future periods due to the lower rate environment and the use of cash to acquire Schwinn Fitness and StairMaster.

INCOME TAX EXPENSE

Income tax expense increased by $14.8 million for 2001 primarily due to the growth in our income before taxes. The increase in our effective tax rate from 36.0% in 2000 to 36.5% in 2001 is due to state income tax issues relating to our commercial and retail business. We expect our income tax expense to increase in line with our growth in income before taxes.

NET INCOME

For the reasons discussed above, net income grew to $66.6 million in 2001 from $41.6 million in 2000, an increase of 60.0%. Not only were we able to maintain a higher sales growth rate, but we also complemented that with a control on our expenses, which grew only marginally as a percentage of sales from 2000. Higher sales, coupled with controlling our expenses, translated into strong net income growth in 2001.

COMPARISON OF THE YEARS ENDED DECEMBER 31, 2000 AND DECEMBER 31, 1999

NET SALES

Net sales in 2000 grew by 68.3% to $223.9 million from $133.1 million in 1999. Our Bowflex line of products continued to exhibit strong growth and was the primary reason for the strong sales growth in 2000. This was also enhanced by the full integration of Nautilus within our business. New products provided momentum to our sales, primarily in the direct products segment through the Nautilus Sleep

Systems, as well as in the commercial and retail products segment due to the addition of Nautilus Nitro commercial equipment and a line of Nautilus-branded retail products and home gyms.

Sales within our direct business segment increased substantially by 75.3% over prior year levels and accounted for $198.1 million, or 88.5% of our net sales in 2000, compared with $113.0 million or 84.9% in 1999 of our net sales.

Net sales within our commercial and retail products segment also continued to show growth, increased by 28.6% over 1999 and accounted for $25.8 million, or 11.5% of our net sales in 2000 as we embarked on expanding our market share and reach in this segment of the market.

GROSS PROFIT

Gross profit grew 71.3% to $148.4 million in 2000, from $86.6 million in 1999. Our gross profit margin increased 1.2% to 66.3% in 2000, from 65.1% in 1999. This increase was mainly attributable to the growth of direct product sales due to the launch of the Nautilus Sleep System and the growth in Bowflex revenues enhanced by strong eCommerce sales. The margin within our direct products segment was 70.2% in 2000, while there was a 36.2% margin within our commercial and retail products segment for 2000.

OPERATING EXPENSES

SELLING AND MARKETING

Selling and marketing expenses grew to $73.5 million in 2000 from $44.6 million in 1999, an increase of 64.7%. This increase in selling and marketing expenses resulted primarily from the continued expansion of our direct marketing campaign for Bowflex products and Nautilus Sleep Systems and variable costs associated with our sales growth.

As a percentage of net sales, selling and marketing expenses decreased by 0.7% in 2000 to 32.8%, compared to 33.5% in 1999. Selling and marketing expenses within our direct products segment were 33.9% of net sales in 2000 compared to 35.2% in 1999. Selling and marketing expenses within our commercial and retail business traditionally have been a lower percentage of net sales than we have experienced in direct marketing and were $6.4 million in 2000 compared with $5.1 million in 1999.

GENERAL AND ADMINISTRATIVE

General and administrative expenses grew to $8.8 million in 2000 from $4.2 million in 1999, an increase of 107.8%. As a percentage of net sales, general and administrative expenses increased to 3.9% in 2000 from 3.2% in 1999. Our direct products segment accounted for $4.0 million of the increase in general and administrative expenses, due primarily to increased staffing and infrastructure expenses necessitated by our continued growth and the implementation of our information systems. Commercial and retail operations accounted for the remaining increase of $0.6 million.

ROYALTY

Royalty expense grew to $5.0 million in 2000 from $2.9 million in 1999, an increase of 71.9%. The increase in our royalty expense is attributable to increased sales of our Bowflex products in 2000, plus new royalty agreements related to our product diversification strategy.

OTHER INCOME

In 2000, other income increased to $4.0 million from $1.0 million in 1999. The $3.0 million increase resulted primarily from interest earned on invested cash and cash equivalents.

INCOME TAX EXPENSE

Income tax expense increased by $11.9 million in 2000 compared to 1999.

NET INCOME

For the reasons discussed above, net income increased 104.6 % to $41.6 million in 2000 compared to $20.3 million in 1999. As a percentage of net sales, our net income was markedly higher in 2000 at 18.6%, compared with 15.3% in 1999.

QUARTERLY RESULTS OF OPERATIONS

The following table presents our operating results for each of the eight quarters in the period ended December 31, 2001. The information for each of these quarters is unaudited and has been prepared on the same basis as the audited financial statements appearing elsewhere in this Annual Report on Form 10-K. In the opinion of management, all necessary adjustments, consisting only of normal recurring adjustments, have been included to present fairly the unaudited quarterly results when read together with our audited financial statements and the related notes. These operating results are not necessarily indicative of the results of any future period. Given our acquisition strategy, we expect heightened seasonality in our business. We expect sales in the second quarter to be weakest while the first and fourth quarter should be our strongest. The fourth quarter should be stronger than the first quarter.

| | QUARTER ENDED (In thousands, except per share) | | | | |
|---|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 | Total |
| Fiscal 2001: | | | | | |
| Net sales | $ 74,855 | $ 75,010 | $ 88,702 | $125,295 | $ 363,862 |
| Gross profit | 49,551 | 49,237 | 55,691 | 68,685 | 223,164 |
| Operating income | 21,534 | 21,532 | 25,196 | 32,151 | 100,413 |
| Net income | 14,739 | 14,550 | 16,764 | 20,530 | 66,583 |
| Earnings per share | | | | | |
| Basic * | .41 | .41 | .48 | .59 | 1.89 |
| Diluted * | .41 | .40 | .46 | .57 | 1.85 |
| Fiscal 2000: | | | | | |
| Net sales | $ 47,333 | $ 48,132 | $ 57,834 | $ 70,628 | $ 223,927 |
| Gross profit | 32,149 | 31,190 | 39,063 | 45,952 | 148,354 |
| Operating income | 13,359 | 11,814 | 16,261 | 19,625 | 61,060 |
| Net income | 8,918 | 8,167 | 11,082 | 13,459 | 41,626 |
| Earnings per share | | | | | |
| Basic * | .25 | .23 | .31 | .39 | 1.18 |
| Diluted * | .25 | .23 | .31 | .37 | 1.15 |

* Reflects the three-for-two stock splits effective August 2000, January 2001 and August 2001.

## LIQUIDITY AND CAPITAL RESOURCES

Historically, we have financed our growth and acquisitions primarily from cash generated by our operating activities. During 2001, our operating activities generated approximately $66.9 million in net cash, which contributed to an aggregate $35.6 million balance in cash and cash equivalents and $16.1 million of short-term investments, compared with $52.8 million and $20.8 million net cash generated by our operating activities in 2000 and 1999, respectively.

Net cash used in our investing activities increased substantially in 2001 to $94.3 million, from $8.7 million in 2000 and $18.6 million in 1999. This was primarily due to the acquisition of Schwinn Fitness and net purchase of short-term investments.

Net cash used in financing activities increased to $14.0 million from $2.6 million in 2000, compared with net cash generated from financing activities in 1999 of $14.5 million. In 1999, cash was largely generated by our public offering in the United States, while increased use of funds for stock repurchases during 2001 resulted in the increase in net cash used. In January 2001, our Board of Directors authorized management to repurchase up to $20 million of the Company's common stock in open-market transactions, with the terms of the purchases to be determined by management based on market conditions. In 2001, the Company used $16.3 million of the authorized $20 million to repurchase shares. A $10 million repurchase program was approved in October 2001 by the Board of Directors and the remaining balance of the $20 million repurchase program was terminated. As of January 31, 2002, the $10 million repurchase authorization had expired unused.

Despite the drop in the balance of cash and cash equivalents from $77.2 million as of December 31, 2000 to $35.6 million as of December 31, 2001, our cash flow position remains very strong. The decrease last year was primarily due to the $69.8 million paid to acquire Schwinn Fitness, the purchase of short-term investments of $16.1 million, and the repurchase of $16.3 million of the Company's stock, part of which was offset by cash generated from operations.

Our working capital needs have increased marginally as we continue to implement our growth strategy. Working capital in 2001, 2000 and 1999 was $84.4 million, $72.5 million and $38.2 million, respectively. We anticipate that our working capital requirements will increase going forward as a result of us growing our commercial and retail segment through our acquisition strategy and internal growth. We also expect to materially increase our cash expenditures on spot commercials and infomercials as we expand the direct marketing campaigns for our Bowflex products and Nautilus Sleep Systems.

We maintain a $10 million line of credit with US Bank National Association. The line of credit is secured by certain assets and contains two financial covenants. As of the date of this filing, we are in compliance with the covenants applicable to the line of credit and there is no outstanding balance under the line.

As of December 31, 2001, the Company had no contractual capital obligations or commercial commitments other than operating leases, which are described in Note 8 of the Notes to Consolidated Financial Statements.

On February 8, 2002, the Company paid approximately $26.1 million to acquire StairMaster Sports/Medical Products, Inc., as described in Note 17 of the Notes to consolidated Financial Statements. The Company used cash generated from operations to finance the acquisition.

We believe our existing cash balances, combined with our line of credit, will be sufficient to meet our capital requirements for at least the next 12 months.

## INFLATION AND PRICE INCREASES

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 results of operations, cash flows or our financial position. However, increases in inflation over historical levels or uncertainty in the general economy could decrease discretionary consumer spending for products like ours. Very little of our revenue growth is attributable to price increases.

## RISKS AND UNCERTAINTIES

While management is optimistic about the Company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating our growth outlook.

### A SIGNIFICANT DECLINE IN CONSUMER INTEREST IN BOWFLEX PRODUCTS WOULD SHARPLY DIMINISH OUR SALES AND PROFITABILITY.

Our financial performance depends significantly on sales of our Bowflex line of home fitness equipment. During 2001, approximately 68% of our net sales were attributable to our Bowflex products. Accordingly, any significant decline in consumer interest in our Bowflex products could significantly reduce our sales and profitability. Sales of our Bowflex line could significantly decline if, for example, a competing product were effectively marketed and resulted in significant consumer purchases or if the market demand for our Bowflex line were to become saturated. Although we are working to diversify our revenue base, we anticipate that sales of our Bowflex product line will continue to account for a substantial portion of our net sales for the foreseeable future.

### OUR SALES COULD DECLINE SIGNIFICANTLY UPON THE EXPIRATION OF THE PRINCIPAL PATENT ON OUR BOWFLEX POWER RODS ON APRIL 27, 2004.

Although our Bowflex trademark is protected as long as we continuously use the trademark, the patent on our Bowflex Power Rods, a key component of our Bowflex products, expires on April 27, 2004. This patent expiration could trigger the introduction of similar products by competitors and result in a significant decline in our sales and revenues.

### NEW PRODUCT DEVELOPMENT IS AN ESSENTIAL COMPONENT OF OUR GROWTH STRATEGY; AN INABILITY TO SUCCESSFULLY DEVELOP NEW PRODUCTS COULD NEGATIVELY IMPACT OUR FUTURE PROFITABILITY.

Our future success depends on our ability to develop or acquire the rights to, and then effectively market and sell, new products that create and respond to new and evolving consumer demands. Accordingly, our net sales and profitability may be harmed if we are unable to develop, or acquire the rights to, new and different products that satisfy our marketing criteria. In addition, any new products that we market may not generate sufficient net sales or profits to recoup their development or acquisition cost.

We also may not be able to successfully acquire intellectual property rights or potentially prevent others from claiming that we have violated their proprietary right when we launch new products. We could incur substantial costs in defending against such claims, even if they are without basis, and we could become subject to judgments requiring us to pay substantial damages.

WE ARE A RAPIDLY GROWING COMPANY; OUR FAILURE TO PROPERLY MANAGE GROWTH MAY ADVERSELY AFFECT OUR FINANCIAL PERFORMANCE.

We have grown significantly in recent years, with an increase in net sales from $9.2 million in 1996 to $363.9 million in 2001. Our organic growth has been complemented by acquisitions of Schwinn Fitness in September 2001 and StairMaster in February 2002. Our rapid growth and recent acquisitions may strain our management team, production facilities, information systems and other resources. In addition, we may be unable to effectively allocate our existing and future resources to our various businesses while maintaining our focus on our core competencies. We cannot assure you that we will succeed in effectively managing our existing operations or our anticipated growth, which could adversely affect our financial performance.

IF WE ARE UNABLE TO EFFECTIVELY INTEGRATE NEWLY ACQUIRED BUSINESSES, SUCH AS STAIRMASTER, INTO OUR OPERATIONS, WE MAY NOT ACHIEVE ANTICIPATED REVENUE, EARNINGS AND BUSINESS SYNERGIES.

We face significant challenges in integrating acquired businesses, including recently acquired StairMaster, into our operations, particularly with respect to corporate cultures and management teams. Failure to successfully effect the integration could adversely impact the revenue, earnings and business synergies we expect from the acquisition. In addition, the process of integrating acquired businesses may be disruptive to our operations and may cause an interruption of, or a loss of momentum in, our core business.

Our future integration efforts may be jeopardized, and our actual return on investment from such acquisitions may be lower than anticipated, as a result of various factors, including the following:

- Challenges in the successful integration of the products, services or personnel of the acquired business into our operations;

- Loss of employees or customers that are key to the acquired business;

- Time and money spent by our management team focusing on the integration, which could distract it from our core operations;

- Our potential lack of experience in markets of the acquired businesses;

- Possible inconsistencies in standards, controls, procedures and policies among the combined companies and the need to implement our company financial, accounting, information and other systems; and

- The need to coordinate geographically diverse operations.

UNFAVORABLE ECONOMIC CONDITIONS COULD CAUSE A DECLINE IN CONSUMER SPENDING AND ACCORDINGLY HINDER OUR PRODUCT SALES.

The success of each of our products depends substantially on the amount of discretionary funds available to consumers and their purchasing preferences. Economic and political uncertainties could continue to adversely impact the U.S. and international economic environment. Although our revenues have not been adversely impacted by the current economic slowdown to date, a continued decline in economic conditions could further depress consumer spending, especially discretionary spending for premium priced products like ours. These poor economic conditions could in turn lead to substantial decreases in our sales and revenues.

A SIGNIFICANT DECLINE IN AVAILABILITY OF MEDIA TIME AND A MARKED INCREASE IN ADVERTISING RATES MAY HINDER OUR ABILITY TO EFFECTIVELY MARKET OUR PRODUCTS AND MAY REDUCE PROFITABILITY.

We depend primarily on 60-second "spot" television commercials and 30-minute television "infomercials" to market and sell our direct-marketed products. Consequently, a marked increase in the price we must pay for our preferred media time or a reduction in its availability may adversely impact our financial performance.

WE DEPEND ON A SINGLE CONSUMER FINANCE COMPANY TO PROVIDE FINANCING PACKAGES TO OUR CUSTOMERS; A DETERIORATION OF THE CONSUMER FINANCE MARKET OR FAILURE BY THE FINANCE COMPANY TO PROVIDE FINANCING TO OUR CUSTOMERS COULD NEGATIVELY IMPACT SALES OF OUR DIRECT-MARKETED PRODUCTS.

In purchasing our products, approximately 41% of our direct-marketed customers utilize convenient financing packages provided by an independent finance company. We believe that convenient consumer financing is an important tool in our direct marketing efforts and induces many of our customers to make purchases when they otherwise would not. We facilitate the availability of convenient financing to our customers in order to increase our sales. Consumers may be less likely to purchase our products if the consumer finance market were to deteriorate so that financing is less available or less convenient to our customers. In addition, we currently utilize the services of a single consumer finance company. Although we believe we could enter into similar arrangements with other provides if needed, a failure by the current provider to adequately service our customers could temporarily disrupt sales.

OUR FAILURE OR INABILITY TO PROTECT OUR INTELLECTUAL PROPERTY COULD SIGNIFICANTLY HARM OUR COMPETITIVE POSITION.

Protecting our intellectual property is an essential factor in maintaining our competitive position in the fitness and health industries. If we do not or are unable to adequately protect our intellectual property, our sales and profitability could be adversely affected. We currently hold a number of patents and trademarks and have several patent and trademark applications pending. However, our efforts to protect our proprietary rights may be inadequate and applicable laws provide only limited protection.

A DETERIORATION IN PRODUCT QUALITY OR INCREASE IN PRODUCT LIABILITY COULD ADVERSELY AFFECT OUR BUSINESS.

We rely on third party manufacturers for a significant portion of our product components and we may not be able to consistently control the quality of such components. Any material increase in the quantity of products returned by our customers for purchase-price refunds could adversely affect revenues. In addition, we are subject to potential product liability claims if our products injure, or allegedly injure, our customers or other users. Our financial performance could be affected if our warranty reserves are inadequate to cover warranty claims on our products. We could become liable for significant monetary damages if our product liability insurance coverage and reserves fail to cover future product liability claims.

GOVERNMENT REGULATORY ACTIONS COULD DISRUPT OUR DIRECT MARKETING EFFORTS AND PRODUCT SALES.

Various federal, state and local government authorities, including the Federal Trade Commission and the Consumer Products Safety Commission, regulate our direct marketing efforts and products. Our sales and profitability could be significantly harmed if any of these authorities commence a regulatory enforcement action that interrupts our direct marketing efforts or results in a product recall.

RECENT ACCOUNTING PRONOUNCEMENTS

On January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, which establishes accounting and reporting standards for derivative instruments and hedging activities requiring that all derivatives be recognized in the balance sheet and measured at fair value. The adoption of SFAS No. 133 did not have a material effect on the Company's financial position, results of operations or cash flows.

The Company adopted SFAS No. 141, "Business Combinations," effective July 1, 2001. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting.

In June 2001, the Financial Accounting Standards Board issued SFAS No. 142, "Goodwill and Other Intangible Assets." The statement requires discontinuing the amortization of goodwill and other intangible assets with indefinite useful lives. Instead, these assets are to be tested periodically for impairment and written down to their fair market value as necessary. The Company adopted the provisions of this statement effective September 20, 2001 as a result of the Schwinn Fitness acquisition, the effect of which is to not amortize the goodwill recorded as part of this acquisition but to annually test it for impairment.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," addresses accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." SFAS No. 144 establishes a single accounting model for long-lived assets to be disposed of by sale and expands on the guidance provided by SFAS No. 121 with respect to cash flow estimations. SFAS No. 144 becomes effective for the Company's fiscal year beginning January 1, 2002. The Company is evaluating SFAS No. 144 and has not yet determined the impact of adoption on its financial position or results of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have primarily invested cash with banks and in liquid debt instruments purchased with maturity dates of less than one year. Our bank deposits may exceed federally insured limits and there is risk of loss of the entire principal with any debt instrument. To reduce risk of loss, we limit our exposure to any one debt issuer and require certain minimum ratings for debt instruments that we purchase.

FOREIGN EXCHANGE RISK

The Company is exposed to foreign exchange risk to the extent of fluctuations in the Euro, the Swiss Franc, German Mark and the British Pound. Based on the relative size of the Company's foreign operations, management believes that its exposure to foreign exchange risk is not material and that any possible near-term changes in the related exchange rates would not have a material impact on the Company's financial position, results of operations or cash flows.

INTEREST RATE RISK

The Company has financed its growth through cash generated from operations. At December 31, 2001, the Company had no outstanding borrowings and was not subject to any interest rate risk.

The Company invests in liquid debt instruments purchased with maturity dates of less than one year. Due to the short-term nature of those investments, management believes that any possible near-term changes in related interest rates would have not have a material impact on the Company's financial position, results of operations, or cash flows.

## ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY FINANCIAL DATA

# INDEPENDENT AUDITORS' REPORT

Board of Directors and Stockholders
of Direct Focus, Inc.:

We have audited the accompanying consolidated balance sheets of Direct Focus, Inc. and subsidiaries as of December 31, 2000 and 2001, and the related consolidated statements of income, stockholders' equity and comprehensive income, and of cash flows for each of the three years in the period ended December 31, 2001. Our audits also included the financial statement schedule at Item 14. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Direct Focus, Inc. and subsidiaries at December 31, 2000 and 2001 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

DELOITTE & TOUCHE LLP
Portland, Oregon
January 21, 2002 (February 8, 2002 as to Note 17)

DIRECT FOCUS, INC.
CONSOLIDATED BALANCE SHEETS

| | December 31, 2000 | December 31, 2001 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 77,181,064 | $ 35,638,944 |
| Short-term investments, at amortized cost | -- | 16,069,691 |
| Trade receivables (less allowance for doubtful accounts of: $352,279 and $2,064,139 in 2000 and 2001) | 4,941,286 | 24,858,295 |
| Inventories, net | 12,653,117 | 45,516,207 |
| Prepaid expenses and other current assets | 591,453 | 2,006,623 |
| Notes receivable | -- | 2,671,838 |
| Current deferred tax asset | 950,363 | 1,425,190 |
| Total current assets | 96,317,283 | 128,186,788 |
| PROPERTY, PLANT AND EQUIPMENT, NET | 16,668,884 | 25,228,130 |
| OTHER ASSETS | 4,140,277 | 40,489,574 |
| TOTAL ASSETS | $ 117,126,444 | $ 193,904,492 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Trade payables | $ 12,335,776 | $ 25,255,352 |
| Accrued liabilities | 5,344,225 | 10,888,442 |
| Income taxes payable | 2,542,967 | 4,792,170 |
| Royalty payable to stockholders | 1,481,886 | 1,885,186 |
| Customer deposits | 2,092,611 | 999,759 |
| Total current liabilities | 23,797,465 | 43,820,909 |
| LONG-TERM DEFERRED TAX LIABILITY | 462,004 | 2,669,540 |
| COMMITMENTS AND CONTINGENCIES (Notes 8 and 15) | | |
| STOCKHOLDERS' EQUITY: | | |
| Common stock - authorized, 75,000,000 shares of no par value; issued and outstanding, 2000: 35,317,773 shares, 2001: 34,954,790 shares | 16,812,476 | 4,900,241 |
| Retained earnings | 76,054,499 | 142,637,163 |
| Accumulated other comprehensive loss | -- | (123,361) |
| Total stockholders' equity | 92,866,975 | 147,414,043 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 117,126,444 | $ 193,904,492 |

See notes to consolidated financial statements.

DIRECT FOCUS, INC.
CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 1999, 2000, AND 2001

| | 1999 | 2000 | 2001 |
|---|---|---|---|
| NET SALES | $133,078,513 | $223,927,365 | $363,862,384 |
| COST OF SALES | 46,482,613 | 75,573,619 | 140,698,578 |
| Gross profit | 86,595,900 | 148,353,746 | 223,163,806 |
| OPERATING EXPENSES: | | | |
| Selling and marketing | 44,629,825 | 73,509,675 | 99,813,812 |
| General and administrative | 4,236,804 | 8,804,446 | 15,573,667 |
| Royalties | 2,897,278 | 4,979,287 | 7,363,067 |
| Litigation settlement | 4,000,000 | - | - |
| Total operating expenses | 55,763,907 | 87,293,408 | 122,750,546 |
| OPERATING INCOME | 30,831,993 | 61,060,338 | 100,413,260 |
| OTHER INCOME (EXPENSE): | | | |
| Interest income | 1,003,586 | 3,631,993 | 4,024,095 |
| Other, net | 2,737 | 347,175 | 380,623 |
| Total other income, net | 1,006,323 | 3,979,168 | 4,404,718 |
| INCOME BEFORE INCOME TAXES | 31,838,316 | 65,039,506 | 104,817,978 |
| INCOME TAX EXPENSE | 11,495,425 | 23,413,412 | 38,235,314 |
| NET INCOME | $ 20,342,891 | $ 41,626,094 | $ 66,582,664 |
| BASIC EARNINGS PER SHARE | $ 0.59 | $ 1.18 | $ 1.89 |
| DILUTED EARNINGS PER SHARE | $ 0.58 | $ 1.15 | $ 1.85 |
| Basic shares outstanding | 34,308,957 | 35,287,604 | 35,183,632 |
| Diluted shares outstanding | 35,185,077 | 35,997,366 | 35,966,038 |

See notes to consolidated financial statements.

DIRECT FOCUS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 1999, 2000, AND 2001

| | Common Stock Shares | Common Stock Amount | Retained Earning | Accumulated Other Comprehensive Loss | Total |
|---|---|---|---|---|---|
| BALANCES, JANUARY 1, 1999 | 31,888,767 | $ 3,565,628 | $ 14,085,514 | $ - | $ 17,651,142 |
| Net income | - | - | 20,342,891 | - | 20,342,891 |
| Public offering | 3,290,625 | 17,937,691 | - | - | 17,937,691 |
| Options exercised | 782,411 | 300,482 | - | - | 300,482 |
| Stock repurchased | (712,800) | (3,698,793) | - | - | (3,698,793) |
| Tax benefit of exercise of nonqualified Options | - | 497,412 | - | - | 497,412 |
| BALANCES, DECEMBER 31, 1999 | 35,249,003 | 18,602,420 | 34,428,405 | - | 53,030,825 |
| Net income | - | - | 41,626,094 | - | 41,626,094 |
| Options exercised | 486,302 | 622,236 | - | - | 622,236 |
| Stock repurchased | (417,531) | (3,252,043) | - | - | (3,252,043) |
| Tax benefit of exercise of nonqualified Options | - | 839,863 | - | - | 839,863 |
| BALANCES, DECEMBER 31, 2000 | 35,317,773 | 16,812,476 | 76,054,499 | - | 92,866,975 |
| Net income | - | - | 66,582,664 | - | 66,582,664 |
| Cumulative translation adjustment | - | - | - | (123,361) | (123,361) |
| Comprehensive income | | | | | 66,459,303 |
| Shares issued | 11,213 | 250,000 | - | - | 250,000 |
| Options exercised | 567,563 | 2,270,226 | - | - | 2,270,226 |
| Stock repurchased | (941,759) | (16,309,486) | - | - | (16,309,486) |
| Tax benefit of exercise of nonqualified Options | - | 1,877,025 | - | - | 1,877,025 |
| BALANCES, DECEMBER 31, 2001 | 34,954,790 | $ 4,900,241 | $ 142,637,163 | $ (123,361) | $ 147,414,043 |

See notes to consolidated financial statements

DIRECT FOCUS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 1999, 2000, AND 2001

| | 1999 | 2000 | 2001 |
|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | $ 20,342,891 | $ 41,626,094 | $ 66,582,664 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 1,183,412 | 2,874,101 | 3,620,954 |
| Loss on equipment disposal | 1,262 | 4,504 | 212,713 |
| Tax benefit of exercise of nonqualified options | 497,412 | 839,863 | 1,877,025 |
| Deferred income taxes | (484,448) | 144,945 | 1,732,709 |
| Changes in assets and liabilities, net of the effect of acquisitions: | | | |
| Trade receivables | (1,519,116) | (197,073) | (10,107,949) |
| Inventories | (3,448,750) | (3,485,563) | (14,005,616) |
| Prepaid expenses and other current assets | (1,377,336) | 1,272,498 | (481,841) |
| Trade payables | 2,001,235 | 6,464,407 | 12,013,031 |
| Income taxes payable | 1,672,461 | 365,731 | 2,145,862 |
| Accrued liabilities and royalty payable to Stockholders | 988,414 | 1,881,008 | 4,379,916 |
| Customer deposits | 948,811 | 994,863 | (1,092,852) |
| Net cash provided by operating activities | 20,806,248 | 52,785,378 | 66,876,616 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Additions to property, plant and equipment | (1,929,137) | (8,761,526) | (5,716,348) |
| Proceeds from sale of property, plant and equip | 159,238 | 97,067 | 3,000 |
| Additions to other assets | (167,935) | (13,505) | 41,976 |
| Acquisition cost of Nautilus | (16,615,012) | -- | -- |
| Acquisition cost of Schwinn | -- | -- | (69,843,214) |
| Purchase of short-term investments | -- | -- | (37,132,771) |
| Proceeds from sales and maturities of short-term investments | -- | -- | 21,063,080 |
| Issuance of notes receivable | -- | -- | (2,671,838) |
| Net cash used in investing activities | (18,552,846) | (8,677,964) | (94,256,115) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Proceeds from public offering | 17,937,691 | -- | -- |
| Funds used for stock repurchase | (3,698,793) | (3,252,043) | (16,309,486) |
| Proceeds from exercise of stock options | 300,482 | 622,236 | 2,270,226 |
| Net cash provided by (used in) financing activities | 14,539,380 | (2,629,807) | (14,039,260) |
| Effect of exchange rate changes | -- | -- | (123,361) |

| | | | |
|---|---|---|---|
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 16,792,782 | 41,477,607 | (41,542,120) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 18,910,675 | 35,703,457 | 77,181,064 |
| CASH AND CASH EQUIVALENTS, END OF YEAR | $ 35,703,457 | $ 77,181,064 | $ 35,638,944 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | | |
| Cash paid for income taxes | 9,835,000 | 21,907,800 | 32,400,000 |
| Supplemental disclosure of other non-cash investing activities: | | | |
| Champion purchase option paid by stock | -- | -- | 250,000 |

See notes to consolidated financial statements

DIRECT FOCUS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
THREE YEARS ENDED DECEMBER 31, 2001

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

Direct Focus Inc. (the "Company," a Washington corporation) is a leading marketer, developer and manufacturer of branded health and fitness products sold under such well-known brands as Nautilus, Bowflex, Schwinn and StairMaster. These products are distributed through well established direct to consumer, commercial and retail channels. Our consumer and commercial fitness equipment products include a full line of cardiovascular and weight resistance products such as home gyms, free weight equipment, treadmills, stationary bikes, steppers and ellipticals. Our healthy lifestyle products also include a line of advanced sleep systems and nutritional products. As a result of the acquisition of the Fitness Division of Schwinn/GT Corp. ("Schwinn Fitness") in September 2001, the Company incorporated the Nautilus/Schwinn Fitness Group, Inc., DF Hebb Industries, Inc., Schwinn Fitness International SA, Schwinn Holdings International SA, and Schwinn Fitness SA, which include commercial and retail cardio fitness equipment and accessories, into the commercial/retail segment of the business.

CONSOLIDATION

The consolidated financial statements of the Company include Direct Focus, Inc., Nautilus HPS, Inc., Nautilus, Inc., DFI Properties, LLC, BFI Advertising, Inc., DFI Sales, Inc., Nautilus/Schwinn Fitness Group, Inc., DF Hebb Industries, Inc., Schwinn Fitness International SA, Schwinn Holdings International SA, Schwinn Fitness SA and Nautilus Fitness Products, Inc. All inter-company transactions have been eliminated in the preparation of the consolidated financial statements.

The accounts of foreign operations are measured using the local currency as the functional currency. These accounts are translated into U.S. dollars using exchange rates in effect at year-end for assets and liabilities and the average exchange rate during the period for the results of operations. Translation adjustments are accumulated as a separate component of equity and comprehensive income.

USE OF ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. The most significant estimates included in the preparation of the financial statements are related to warranty reserves, sales return reserves, and allowance for doubtful accounts.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash on hand, cash deposited with banks and financial institutions and highly liquid debt instruments purchased with maturity dates of three months or less at the date of acquisition. The Company maintains its cash in bank deposit accounts, which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

SHORT-TERM INVESTMENTS

Debt securities with original maturities greater than three months and remaining maturities less than one year are classified as short-term investments. Short-term investments in debt securities are classified as held-to-maturity and valued at amortized cost with gains and losses recognized upon the sale of the security.

INVENTORIES

Inventories are stated at the lower of average cost or market.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets.

Management reviews the investment in long-lived assets for possible impairment whenever events or circumstances indicate the carrying amount of an asset may not be recoverable. There have been no such events or circumstances in each of the three years in the period ended December 31, 2001. If there were an indication of impairment, management would prepare an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows were less than the carrying amount of the assets, an impairment loss would be recognized to write down the assets to their estimated fair value.

OTHER ASSETS

Other assets consist of license agreements, patents and trademarks and goodwill. Amortization is computed using the straight-line method over estimated useful lives of three to twenty years. Accumulated amortization was $510,374 and $833,565 at December 31, 2000 and 2001, respectively.

In June 2001, the Financial Accounting Standards Board issued SFAS No. 142, "Goodwill and Other Intangible Assets." The statement requires discontinuing the amortization of goodwill and other intangible assets with indefinite useful lives. Instead, these assets are to be tested periodically for impairment and written down to their far market value as necessary. The Company adopted the provisions of this statement effective September 20, 2001 as a result of the Schwinn acquisition, the effect of which is to not amortize the goodwill recorded as part of this acquisition but to annually test it for impairment.

REVENUE RECOGNITION

For all of the Company's products, except Nautilus commercial equipment, revenue from product sales is recognized at the time of shipment. Revenue is recognized upon installation for the Nautilus commercial equipment if the Company is responsible for installation.

WARRANTY COSTS

The Company's warranty policy provides for coverage for defects in material and workmanship. Warranty periods on the Company's products range from two years to limited lifetime on the Bowflex lines of fitness products and twenty years on sleep systems. The Nautilus commercial line of fitness products includes a lifetime warranty on the structural frame, welded moving parts and weight stacks, a 120-day warranty on upholstery and padded items, and a one-year warranty on all other parts. The Nautilus and Schwinn Fitness commercial and retail line of fitness products includes lifetime warranty on the frame and structural parts, a six month to three year warranty on parts, labor, electronics, upholstery, grips and cables, and a five year warranty on motors. Warranty costs are estimated based on the Company's experience and are charged to cost of sales as sales are recognized or as such estimates change.

RESEARCH AND DEVELOPMENT

Internal research and development costs are expensed as incurred and included in cost of sales. Third party research and development costs are expensed when the contracted work has been performed. Research and development expense was $716,240, $1,186,216 and $2,229,242 for 1999, 2000 and 2001, respectively.

ADVERTISING

The Company expenses all advertising costs as incurred. Advertising expense was $27,698,564, $47,264,904, and $63,581,847 for 1999, 2000, and 2001, respectively.

INCOME TAXES

Deferred income tax assets and liabilities are computed annually for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to periods in which the differences are expected to affect taxable income. A valuation allowance is established when necessary to reduce deferred tax assets to the amount more likely than not to be realized. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities.

STOCK-BASED COMPENSATION

The Company continues to measure compensation expense for its stock-based employee compensation plans using the method prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees." The Company provides pro forma disclosures of net income and earnings per share as if the method prescribed by SFAS No. 123, "Accounting for Stock-Based Compensation," had been applied in measuring compensation expense. See Note 9.

COMPREHENSIVE INCOME

Comprehensive income is defined as net income as adjusted for changes to equity resulting from events other than net income or transactions related to an entity's capital structure. Comprehensive income equals net income for the years ended December 31, 1999 and 2000.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount of the Company's cash and cash equivalents, short-term investments, trade receivables, trade payables, royalty payable to stockholders, and accrued liabilities approximates their estimated fair values due to the short-term maturities of those financial instruments.

RECENT ACCOUNTING PRONOUNCEMENTS

On January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, which establishes accounting and reporting standards for derivative instruments and hedging activities requiring that all derivatives be recognized in the balance sheet and measured at fair value. The adoption of SFAS No. 133 did not have a material effect on the Company's financial position, results of operations or cash flows.

The Company adopted SFAS No. 141, "Business Combinations," effective July 1, 2001. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting.

In June 2001, the Financial Accounting Standards Board issued SFAS No. 142, "Goodwill and Other Intangible Assets." The statement requires discontinuing the amortization of goodwill and other intangible assets with indefinite useful lives. Instead, these assets are to be tested periodically for impairment and written down to their fair market value as necessary. The Company adopted the provisions of this statement effective September 20, 2001 as a result of the Schwinn acquisition, the effect of which is to not amortize the goodwill recorded as part of this acquisition but to annually test it for impairment.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," addresses accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." SFAS No. 144 establishes a single accounting model for long-lived assets to be disposed of by sale and expands on the guidance provided by SFAS No. 121 with respect to cash flow estimations. SFAS No. 144 becomes effective for the Company's fiscal year beginning January 1, 2002. The Company is evaluating SFAS No. 144 and has not yet determined the impact of adoption on its financial position or results of operations.

RECLASSIFICATIONS

Certain amounts from 1999 and 2000 have been reclassified to conform to the 2001 presentation.

2. OPERATING SEGMENTS

The Company's operating segments include its direct products segment that includes all products marketed directly to consumers through a variety of direct marketing channels. The Bowflex line of fitness equipment and the Nautilus Sleep Systems are the principal products in the Company's direct products segment. The other operating segment is the commercial and retail products segment, which includes products and operations that are not direct marketed to consumers. Products in this segment include Nautilus and Schwinn commercial and retail fitness equipment and accessories. Accounting policies used by the segments are the same as those disclosed in Note 1.

The following table presents information about the Company's two operating segments (in thousands):

| | Direct Products | Commercial and Retail Products | Total |
|---|---|---|---|
| YEAR ENDED DECEMBER 31, 2001 | | | |
| Revenues from external customers | $ 292,539 | $ 71,323 | $ 363,862 |
| Interest income | 3,980 | 44 | 4,024 |
| Depreciation and amortization expense | 2,256 | 1,365 | 3,621 |
| Income tax expense | 36,166 | 2,069 | 38,235 |
| Segment net income | 62,908 | 3,675 | 66,583 |

| | | | |
|---|---|---|---|
| Segment assets | 87,264 | 106,640 | 193,904 |
| Additions to property, plant and equipment | 5,266 | 450 | 5,716 |
| YEAR ENDED DECEMBER 31, 2000 | | | |
| Revenues from external customers | $ 198,107 | $ 25,820 | $ 223,927 |
| Interest income | 3,630 | 2 | 3,632 |
| Depreciation and amortization expense | 2,068 | 806 | 2,874 |
| Income tax expense | 22,883 | 530 | 23,413 |
| Segment net income | 40,684 | 942 | 41,626 |
| Segment assets | 95,815 | 21,311 | 117,126 |
| Additions to property, plant and equipment | 8,237 | 525 | 8,762 |
| YEAR ENDED DECEMBER 31, 1999 | | | |
| Revenues from external customers | $ 113,004 | $ 20,075 | $ 133,079 |
| Interest income | 1,002 | 2 | 1,004 |
| Depreciation and amortization expense | 565 | 618 | 1,183 |
| Income tax expense | 11,084 | 411 | 11,495 |
| Segment net income | 19,715 | 628 | 20,343 |
| Segment assets | 47,753 | 19,557 | 67,310 |
| Additions to property, plant and equipment | 1,379 | 550 | 1,929 |

3. ACQUISITION OF SCHWINN

Effective September 20, 2001, the Company acquired the accounts receivable, inventories, fixed assets, certain intangible assets and all assets and liabilities of the foreign subsidiaries of the Fitness Division ("Schwinn Fitness") of Schwinn/GT Corp. and its affiliates for a cash purchase price of approximately $69.8 million, including acquisition costs of $ 4.2 million. Schwinn Fitness was acquired through a bankruptcy auction in the United States Bankruptcy Court for the District of Colorado, which auction was completed on September 12, 2001. The Company's bid for Schwinn Fitness was submitted as part of a $151 million bid with Pacific Cycle, LLC, which was awarded the right to purchase Schwinn/GT Corp.'s cycling division through the Chapter 11 proceeding. Schwinn/GT Corp. filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code on July 16, 2001.

The acquired assets include plant, equipment and other property used to manufacture, assemble, distribute and sell fitness equipment, including treadmills, upright stationary bicycles, recumbent stationary bicycles, elliptical machines and stair-climbing machines. The Company intends to continue to use the acquired assets for these purposes.

The purchase price for Schwinn Fitness was determined in the court auction. The Company's bid was formulated on the basis of historical and projected financial performance, which resulted in goodwill that has been recorded in the Commercial/Retail segment along with the acquired assets and liabilities. The Company financed the acquisition from cash-on-hand. In accordance with the Asset Purchase Agreement by and among the Company and Schwinn, the purchase price based on the formula set forth in the Asset Purchase Agreement was finalized in January 2002.

The Company has determined that the intangible asset associated with the Schwinn Fitness acquisition (a trademark valued at $6.8 million) has an indefinite useful life. However, as the expected use and cash flows from the trademark is expected to be approximately 20 years, the Company will amortize the trademark using the straight-line method over this period. The Company will evaluate the remaining useful life of the trademark that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization or if the asset should be tested for impairment.

The total cost of the acquisition has been allocated to the assets acquired and liabilities assumed as follows:

| | |
|---|---|
| Trade receivables | $ 9,809,060 |
| Inventories | 18,857,474 |
| Prepaid and other current assets | 933,329 |
| Property, plant and equipment | 6,356,374 |
| Other assets | 39,479 |
| Trademark | 6,800,000 |
| Goodwill | 29,624,985 |
| Liabilities assumed | (2,577,487) |
| Total acquisition cost | $ 69,843,214 |

The results and operations subsequent to the date of acquisition are included in the consolidated statements of the Company.

The unaudited pro forma financial information below for the year ended December 31, 2001 and 2000 were prepared as if the transaction had occurred at the beginning of the respective year (in thousands, except per share data):

| | YEAR ENDED DECEMBER 31, | |
|---|---|---|
| | 2000 | 2001 |
| Revenue | $ 322,199 | $ 429,186 |
| Net income | 49,566 | 66,838 |
| Basic earnings per share | 1.41 | 1.90 |
| Diluted earnings per share | 1.38 | 1.86 |

The unaudited pro forma financial information is not necessarily indicative of what actual results would have been had the transaction occurred at the beginning of the respective year, nor does it purport to indicate the results of future operations of the Company.

4. INVENTORIES

Inventories at December 31 consisted of the following:

| | 2000 | 2001 |
|---|---|---|
| Finished goods | $ 8,093,919 | $ 34,861,800 |
| Work in process | 1,160,647 | 1,148,066 |
| Parts and components | 3,398,551 | 9,506,341 |
| Total inventories | $ 12,653,117 | $ 45,516,207 |

5. PROPERTY, PLANT AND EQUIPMENT

Details of property, plant and equipment are summarized as follows at December 31:

| | Estimated Useful Life (in years) | 2000 | 2001 |
|---|---|---|---|
| Land | N/A | $ 1,718,495 | $ 1,779,795 |
| Buildings and improvements | 31.5 | 9,636,774 | 11,785,435 |
| Computer equipment | 2-5 | 5,179,365 | 10,088,243 |
| Production equipment | 5 | 2,778,679 | 6,567,368 |
| Furniture and fixtures | 5 | 915,040 | 1,463,741 |
| Automobiles | 7 | 53,000 | 348,825 |
| Total property, plant and equipment | | 20,281,353 | 32,033,407 |
| Accumulated depreciation | | (3,612,469) | (6,805,277) |
| Property, plant and equipment, net | | $ 16,668,884 | $ 25,228,130 |

6. OTHER ASSETS

Details of other assets are summarized as follows at December 31:

| | 2000 | 2001 |
|---|---|---|
| Trademarks and patents | $ 4,594,927 | $ 11,394,928 |
| Goodwill | - | 29,624,985 |
| Other assets | 55,724 | 303,226 |
| Total other assets | 4,650,651 | 41,323,139 |
| Accumulated amortization | (510,374) | (833,565) |
| Other assets, net | $ 4,140,277 | $ 40,489,574 |

The goodwill is part of our commercial/retail segment.

7. ACCRUED LIABILITIES

Accrued liabilities consisted of the following at December 31:

| | 2000 | 2001 |
|---|---|---|
| Accrued payroll | $ 3,178,847 | $ 4,852,398 |
| Accrued warranty expense | 447,194 | 2,413,267 |
| Sales return reserve | 1,307,000 | 2,100,000 |
| Accrued other | 411,184 | 1,522,777 |
| Total accrued liabilities | $ 5,344,225 | $ 10,888,442 |

## 8. COMMITMENTS AND CONTINGENCIES

### LINES OF CREDIT

The Company has a line of credit for $10 million with a bank. The line is secured by the Company's general assets, and interest is payable on outstanding borrowings under the line at the bank's prime rate (4.5% at December 31, 2001). There were no outstanding borrowings on the line of credit at December 31, 2001.

### OPERATING LEASES

The Company leases its Vancouver, Washington call center facility under an operating lease, which expires April 30, 2002. We plan to move our entire Vancouver operation to our headquarters building in 2002.

Since December 1999, the Company has leased a distribution center in Las Vegas, Nevada to service the Southwestern United States. This operating lease expires November 30, 2002.

Nautilus HPS, Inc. leases trucks and trailers and other equipment used in the Nautilus commercial business. These leases expire over various terms through December 2002.

Leased facilities were acquired in 2001 due to the acquisition of the Fitness Division of Schwinn/GT Corp. We lease sales and administrative office space in various properties in Boulder, Colorado. All but one of these leases are month-to-month with no defined future commitment. Due to the purchase of the new 85,000 square foot facility on March 1, 2002, for $6 million, all previous Boulder facility leases will be canceled. The only exception is the 40,000 square foot facility that carries a lease term through November 30, 2003, which we intend to sublease through the remaining lease term once we move into the new facility. We also lease manufacturing and distribution facilities in Bolingbrook, Illinois, and Tyler, Texas. Additionally, we lease sales and administrative office space in Givisiez, Switzerland and warehouse space in Fribourg, Switzerland. These leases expire over various terms through November 30, 2003.

In addition to the acquired facilities, the Fitness Division leases, on a month-to-month basis flexible warehouse space in multiple countries in Asia and Europe devoted to international distribution.

In general, our properties are well maintained, adequate and suitable for their purposes, and we believe these properties will meet our operational needs for the foreseeable future. If we require additional warehouse or office space, we believe we will be able to obtain such space on commercially reasonable terms.

Rent expense under all leases was $664,922 in 1999, $473,920 in 2000, and $937,078 in 2001.

### OBLIGATIONS

Future minimum lease payments under the operating leases for the years ending December 31 are as follows:

| | |
|---|---|
| 2002 | $ 1,151,528 |
| 2003 | 527,461 |
| Total minimum lease payments | $ 1,678,989 |

9. STOCK OPTIONS

The Company's stock-based compensation plan was adopted in June 1995. The Company can issue both nonqualified stock options to the Company's officers, directors and employees, and incentive stock options to the Company's employees. The plan was amended in June 2000 so the Company may grant options for up to 7,958,118 shares of common stock. At December 31, 2001, 2,377,954 shares are available for future issuance under the plan. The plan is administered by the Company's Board of Directors which determines the terms and conditions of the various grants awarded under these plans. Stock options granted generally have an exercise price equal to the closing market price of the Company's stock on the day before the date of grant, and vesting periods vary by option granted, generally no longer than four years. If compensation cost on stock options granted under these plans had been determined based on the fair value of the options consistent with that described in SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below for the years ended December 31, 1999, 2000 and 2001.

| | 1999 | 2000 | 2001 |
|---|---|---|---|
| Net income, as reported .................... | $ 20,342,891 | $ 41,626,094 | $ 66,582,664 |
| Net income, pro forma ...................... | 19,958,204 | 40,500,561 | 64,340,210 |
| Basic earnings per share, as reported ....... | $ 0.59 | $ 1.18 | $ 1.89 |
| Basic earnings per share, pro forma ......... | $ 0.58 | $ 1.15 | $ 1.83 |
| Diluted earnings per share, as reported ..... | $ 0.58 | $ 1.15 | $ 1.85 |
| Diluted earnings per share, pro forma ....... | $ 0.57 | $ 1.13 | $ 1.79 |

The pro forma amounts may not be indicative of the effects on reported net income for future years due to the effect of options vesting over a period of years and the granting of stock compensation awards in future years.

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for the grants in 1999, 2000 and 2001:

| | 1999 | 2000 | 2001 |
|---|---|---|---|
| Granted option vesting | All as scheduled | All as scheduled | All as scheduled |
| Dividend yield | None | None | None |
| Risk-free interest rate | 6.4% | 5.0% | 4.4% |
| Expected volatility | 60% | 51% | 67% |
| Expected option lives | 5 years | 5 years | 5 years |
| Weighted-average fair value of options granted | $2,000,003 | $4,564,198 | $8,128,933 |

A summary of the status of the Company's stock option plans as of December 31, 1999, 2000 and 2001, and changes during the years ended on those dates is presented below.

| | 1999 Shares | 1999 Weighted Average Exercise Price | 2000 Shares | 2000 Weighted Average Exercise Price | 2001 Shares | 2001 Weighted Average Exercise Price |
|---|---|---|---|---|---|---|
| Outstanding at beginning of year ................ | 1,858,337 | $ .71 | 1,576,596 | $ 2.67 | 1,694,195 | $ 8.59 |
| Granted ......................................... | 572,670 | 5.99 | 805,275 | 12.43 | 691,650 | 19.50 |
| Forfeited or cancelled .......................... | (72,001) | 3.17 | (201,375) | 5.98 | (91,901) | 16.73 |
| Exercised ....................................... | (782,410) | 0.39 | (486,301) | 1.28 | (567,563) | 4.00 |
| Outstanding at end of year ...................... | 1,576,596 | $ 2.67 | 1,694,195 | $ 8.59 | 1,726,381 | $ 12.79 |
| Options exercisable at end of year ............. | 723,945 | | 648,507 | | 540,345 | |

The following table summarizes information about stock options outstanding as of December 31, 2001:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| RANGE OF EXERCISE PRICES | Number Outstanding | Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number of Shares Exercisable | Weighted Average Exercise Price |
| $0.24 - $6.98 | 585,060 | 2.2 | $ 4.51 | 417,442 | $ 3.75 |
| $13.56 - $13.78 | 691,921 | 3.7 | 13.64 | 102,653 | 13.56 |
| $16.06 - $23.02 | 279,900 | 4.3 | 20.63 | 20,250 | 16.06 |
| $24.28 - $30.42 | 169,500 | 4.7 | 25.01 | - | - |
| $0.24 - $30.42 | 1,726,381 | 3.4 | $12.79 | 540,345 | $ 6.07 |

10. INCOME TAXES

The Company realizes income tax benefits as a result of the exercise of non-qualified stock options and the exercise and subsequent sale of certain incentive stock options (disqualifying dispositions). For financial statement purposes, any reduction in income tax obligations as a result of these tax benefits is credited to common stock.

The provision for (benefit from) income taxes consists of the following for the three years ended December 31, 2001:

| | 1999 | 2000 | 2001 |
|---|---|---|---|
| Current: | | | |
| Federal ...................... | $ 11,634,863 | $ 22,535,917 | $ 34,516,381 |
| State ........................ | 345,010 | 732,550 | 1,986,224 |
| Total current .......... | 11,979,873 | 23,268,467 | 36,502,605 |
| Deferred: | | | |
| Federal ...................... | (484,448) | 144,945 | 1,706,171 |
| State ........................ | -- | -- | 26,538 |
| Total deferred ......... | (484,448) | 144,945 | 1,732,709 |
| Total Provision ............... | $ 11,495,425 | $ 23,413,412 | $ 38,235,314 |

The components of the net deferred tax asset (liability) at December 31, 2000 and 2001 are as follows:

| | 2000 | 2001 |
|---|---|---|
| Current: | | |
| Assets: | | |
| Accrued vacation | $ 132,725 | $ 166,249 |
| Allowance for doubtful accounts | 94,742 | 112,005 |
| Inventory reserve | 148,959 | 166,239 |
| Uniform capitalization | 102,882 | 87,886 |
| Accrued reserves | 560,927 | 1,128,180 |
| Customer deposits | 52,128 | -- |
| Other | -- | 124,975 |
| Liabilities: | | |
| Prepaid advertising | -- | (210,137) |
| Other prepaids | (142,000) | (150,207) |
| Net current deferred tax asset | $ 950,363 | $ 1,425,190 |
| Noncurrent | | |
| Liabilities: | | |
| Depreciation | (462,004) | $(2,669,540) |
| Net long-term deferred tax liability | $ (462,004) | $(2,669,540) |

A reconciliation of the statutory income tax rate with the Company's effective income tax rate is as follows:

| | 2000 | 2001 |
|---|---|---|
| Federal | 35.00% | 35.00% |
| State | 1.13% | 1.89% |
| Other | (.13)% | (.41)% |
| Total | 36.00% | 36.48% |

11. EARNINGS PER SHARE

The per share amounts are based on the weighted average number of basic and dilutive common equivalent shares assumed to be outstanding during the period of computation. Net income for the calculation of both basic and diluted earnings per share is the same for all periods.

The calculation of weighted average outstanding shares is as follows:

| | Average Shares | | |
|---|---|---|---|
| | 1999 | 2000 | 2001 |
| Basic shares outstanding | 34,308,957 | 35,287,604 | 35,183,632 |
| Dilutive effect of stock options | 876,120 | 709,762 | 782,406 |
| Diluted shares outstanding | 35,185,077 | 35,997,366 | 35,966,038 |

12. STOCK REPURCHASE PROGRAM

Four times during fiscal 2000, the Board of Directors authorized the expenditure of up to $8 million to purchase shares of Direct Focus, Inc. common stock in open market transactions. During the year ended December 31, 2000, the Company repurchased a total of 417,531 shares of common stock in open market transactions for an aggregate purchase price of $3.3 million. All authorizations had expired at December 31, 2000.

Three times during fiscal 2001, the Board of Directors authorized the expenditure of up to $20 million to purchase shares of Direct Focus, Inc. common stock in open market transactions. In October 2001, the Board of Directors authorized a $10 million repurchase program extending through January 31, 2002 and the remaining balance of the $20 million repurchase program was terminated. During the year ended December 31, 2001, the Company repurchased a total of 941,759 shares of common stock in open market transactions for an aggregate purchase price of $16.3 million.

13. STOCK SPLITS

On June 26, 2000, the Board of Directors approved a three-for-two stock split in the form of a share dividend, payable to the Company's stockholders of record as of July 31, 2000. Shares resulting from the split were distributed by the transfer agent on August 14, 2000. On December 8, 2000, the Board of Directors approved another three-for-two stock split payable to Company stockholders of record as of January 2, 2001 with a payment date of January 15, 2001. On July 13, 2001, the Board of Directors approved another three-for-two stock split in the form of a share dividend, payable August 13, 2001 to the Company's stockholders of record as of August 2, 2001. All share and per-share numbers contained herein reflect these stock splits.

14. RELATED-PARTY TRANSACTIONS

The Company incurred royalty expense under an agreement with a stockholder of the Company of $2,815,116 in 1999, $4,837,212 in 2000, and $6,786,211 in 2001, of which $1,481,886 and $1,885,186 was payable at December 31, 2000 and 2001, respectively. In addition to the royalty agreement, the stockholder has separately negotiated an agreement dated June 18, 1992, when the Company was privately held, between the stockholder and the Company's Chief Executive Officer and a former Director of the Company, whereby the stockholder agreed to pay each twenty percent of the royalty amount paid to him.

15. LITIGATION SETTLEMENT

On July 17, 1999, the Company reached an agreement with a competitor to settle pending litigation. As a result of the settlement, the Company took a one-time, after-tax charge of $2.6 million in the second quarter of fiscal 1999. The Company made an $8 million cash payment to the competitor, of which $4 million was paid by insurance. This settlement did not affect the ongoing direct marketing campaign for the Company's Bowflex home fitness equipment.

Additionally, in the normal course of business, the Company is a party to various other legal claims, actions and complaints. Although it is not possible to predict with certainty whether the Company will ultimately be successful in any of these legal matters, or what the impact might be, the Company believes that disposition of these matters will not have a material adverse effect on the Company's financial position, results of operations or cash flows.

16. EMPLOYEE BENEFIT PLAN

The Company adopted a 401(k) profit sharing plan in 1999 covering all employees over the age of 18. The plan was amended in 2000 to allow for immediate eligibility in the plan. Each participant in the 401(k) plan may contribute up to 20% of eligible compensation during any calendar year, subject to certain limitations. The 401(k) plan provides for Company matching contributions of up to 50% of the first 6% of eligible contributions made by participants who have one year of service. In addition, the Company may make discretionary contributions. Employees are 100% vested in the matching and discretionary contributions after four years of service. Expense for the plan was $103,793, $134,669, and $224,806 for the years ended December 31, 1999, 2000, and 2001, respectively.

17. ACQUISITION OF STAIRMASTER

Effective February 8, 2002, the Company acquired the accounts receivable, inventories, fixed assets, certain intangible assets and all assets and liabilities of the foreign subsidiaries of StairMaster Sports/Medical, Inc. ("StairMaster") and its affiliates for a cash purchase price of approximately $26.1 million, including acquisition costs. StairMaster was acquired through a bankruptcy auction in the United States Bankruptcy Court for the Western District of Washington, which auction was completed on January 17, 2002.

The acquired assets include property, plant, equipment and other property used to manufacture, assemble, distribute and sell fitness equipment, including steppers, stepmills, treadmills and exercise bicycles. The Company intends to continue to use the acquired assets for these purposes.

The purchase price for StairMaster was determined in the court auction. The Company's bid was formulated on the basis of historical and projected financial performance. The Company financed the acquisition from cash-on-hand. In accordance with the Asset Purchase Agreement by and among the Company and StairMaster, the purchase price based on the formula set forth in the Asset Purchase Agreement should be finalized in the second quarter of 2002.

The Company has determined that the intangible asset associated with the StairMaster acquisition (a trademark valued at $6.2 million) has an indefinite useful life and thus will not be amortized. The Company will evaluate the remaining useful life of the trademark each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization or if the asset should be tested for impairment.

The total cost of the acquisition has preliminarily been allocated to the assets acquired and liabilities assumed as follows:

| | |
|---|---|
| Trade receivables | $ 8,421,618 |
| Inventories | 6,689,414 |
| Property, plant and equipment | 5,250,079 |
| Other assets | 309,887 |
| Trademark | 6,200,000 |
| Goodwill | 2,438,792 |
| Liabilities assumed | (3,252,010) |
| Total acquisition cost | $ 26,057,780 |

The unaudited pro forma financial information below for the year ended December 31, 2001 and 2000 were prepared as if the transaction had occurred on January 1, 2000 (in thousands, except per share data):

| | YEAR ENDED DECEMBER 31, | |
|---|---|---|
| | 2000 | 2001 |
| Revenue | $310,801 | $433,366 |
| Net income | 43,802 | 41,624 |
| Basic earnings per share | 1.24 | 1.18 |
| Diluted earnings per share | 1.22 | 1.16 |

The unaudited pro forma financial information is not necessarily indicative of what actual results would have been had the transaction occurred at the beginning of the respective year, nor does it purport to indicate the results of future operations of the Company.

## ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

# PART III

## ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this item is included under the captions "ELECTION OF DIRECTORS," "EXECUTIVE OFFICERS" and "SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE," respectively, in the Company's Proxy Statement for its 2002 Annual Meeting of Stockholders and is incorporated herein by reference.

## ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is included under the caption "EXECUTIVE COMPENSATION" in the Company's Proxy Statement for its 2002 Annual Meeting of Stockholders and is incorporated herein by reference.

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this item is included under the caption "SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT" in the Company's Proxy Statement for its 2002 Annual Meeting of Stockholders and is incorporated herein by reference.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is included under the caption "CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS" in the Company's Proxy Statement for its 2002 Annual Meeting of Stockholders and is incorporated herein by reference.

PART IV

## ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(A)(1) FINANCIAL STATEMENTS

See the Consolidated Financial Statements in Item 8.

(A)(2) FINANCIAL STATEMENT SCHEDULE

DIRECT FOCUS, INC.
Schedule II
Valuation and Qualifying Accounts
Three years ended December 31, 2001
(in thousands)

| Description | Balance at Beginning of Period | Charged to Costs and Expenses | Deductions | Balance at End of Period |
|---|---|---|---|---|
| Allowance for doubtful accounts: | | | | |
| 1999 | 40,000 | 264,727 | - | 304,727 |
| 2000 | 304,727 | 47,552 | - | 352,279 |
| 2001 | 352,279 | 1,711,860 | - | 2,064,139 |
| Inventory reserves | | | | |
| 1999 | 50,000 | 255,951 | - | 305,951 |
| 2000 | 305,951 | 254,128 | - | 560,079 |
| 2001 | 560,079 | 1,060,392 | - | 1,620,471 |
| Sales returns and allowances: | | | | |
| 1999 | 600,704 | 186,217 | - | 786,921 |
| 2000 | 786,921 | 520,079 | - | 1,307,000 |
| 2001 | 1,307,000 | 793,000 | - | 2,100,000 |

All other financial statement schedules have been omitted since they are not required, not applicable, or the information is included in the consolidated financial statements or notes thereto.

(A)(3) EXHIBIT INDEX

The following exhibits are filed herewith and this list is intended to constitute the exhibit index:

| EXHIBIT NO. | |
|---|---|
| 2.1 | Asset Purchase Agreement by and between Direct Focus, Inc. and Schwinn GT Corp., dated September 6, 2001, and purchase price - Incorporated by reference to Exhibits 2.1 and 2.3(a) of the Company's Form 8-K, as filed with the Securities and Exchange Commission (the "Commission") on October 4, 2001, and Exhibits 99.1 - 99.9 of the Company's Form 8-K/A, as filed with the Commission on December 3, 2001. |

| | |
|---|---|
| 2.2 | Asset Purchase Agreement by and between Direct Focus and StairMaster Sports/Medical Products, Inc., dated January 17, 2002 - Incorporated by reference to Exhibit 2.1 of the company's Form 8-K, as filed with the Commission on February 8, 2002. |
| 2.3 | Amendment to the Asset Purchase Agreement by and between Direct Focus and StairMaster Sports/Medical Products, Inc., dated February 7, 2002 - Incorporated by reference to Exhibit 2.2 of the Company's Form 8-K, as filed with the Commission on February 8, 2002. |
| 3.1 | Articles of Incorporation, as Amended - Incorporated by reference to Exhibits 3.1, 3.2 and 3.3 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999. |
| 3.2 | Amendment to Articles of Incorporation - Incorporated by reference to Exhibit 3 to the Company's Quarterly Report on Form 10-Q for the three months ended June 30, 2000, as filed with the Commission on August 10, 2000. |
| 3.3 | Amendment to Articles of Incorporation, dated September 25, 2000. |
| 3.4 | Amended and Restated Bylaws - Incorporated by reference to Exhibit 3.4 of Amendment No. 2 to the Company's Registration Statement on Form S-1, as filed with the Commission on April 30, 1999. |
| 10.1 | Direct Focus, Inc. Stock Option Plan, as amended - Incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999. |
| 10.2 | Amendment to Direct Focus, Inc. Stock Option Plan - Incorporated by reference to Exhibit 10 to the Company's Quarterly Report on Form 10-Q for the three months ended June 30, 2000, as filed with the Commission on August 10, 2000. |
| 10.3 | Royalty Agreement, dated as of April 9, 1988, between Bow-Flex of America, Inc. and Tessema D. Shifferaw - Incorporated by reference to Exhibit 10.9 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999. |
| 10.4 | Royalty Payment Agreement, dated as of June 18, 1992, between Tessema D. Shifferaw, Brian R. Cook and R.E. "Sandy" Wheeler - Incorporated by reference to Exhibit 10.10 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999. |
| 10.5 | First Amended and Restated Merchant Agreement dated as of January 27, 1999, between Direct Focus, Inc. and Household Bank (SB), N.A. - Incorporated by reference to Exhibit 10.11 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999. |
| 10.6 | Second Amended and Restated Merchant Agreement dated February 23, 2000, between Direct Focus, Inc. and Household Bank (SB), N.A. |
| 10.7 | Trademark License Agreement by and between Pacific Direct, LLC, Nautilus, Inc., and Schwinn Acquisition, LLC - Incorporated by reference to Exhibit 2.1 of the Company's Quarterly Report on Form 10-Q for the nine months ended September 30, 2001, as filed with the Commission on November 14, 2001. |

| | |
|---|---|
| 10.8 | Business Loan Agreement, dated June 15, 2001, by and between Direct Focus, Inc. and U.S. Bank National Association. |
| 21 | Subsidiaries of Direct Focus, Inc. |
| 23 | Consent of Deloitte & Touche LLP. |
| 24.1 | Power of Attorney for Kirkland C. Aly. |
| 24.2 | Power of Attorney for C. Rowland Hanson. |
| 24.3 | Power of Attorney for Frederick T. Hull. |
| 24.4 | Power of Attorney for Paul F. Little. |
| 24.5 | Power of Attorney for James M. Weber. |

(B) REPORTS ON FORM 8-K

The following reports on Form 8-K were filed during the quarter ended December 31, 2001:

- Form 8-K related to the acquisition of Schwinn Fitness filed on October 4, 2001.
- Form 8-K/A related to the acquisition of Schwinn Fitness filed on December 3, 2001.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: March 26, 2002

DIRECT FOCUS, INC.

By /s/ Brian R. Cook

Brian R. Cook, Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 26, 2002:

| Signature | Title |
| --- | --- |
| /s/ Brian R. Cook<br>Brian R. Cook | Chairman and Chief Executive Officer (Principal Executive Officer) |
| /s/ Rod W. Rice<br>Rod W. Rice | Chief Financial Officer and Secretary (Principal Financial and Accounting Officer) |
| *<br>Kirkland C. Aly | Director |
| *<br>C. Rowland Hanson | Director |
| *<br>Frederick T. Hull | Director |
| *<br>Paul F. Little | Director |
| /s/ Randal R. Potter<br>Randal R. Potter | Director |
| *<br>James M. Weber | Director |
| * By: /s/ Rod W. Rice<br>Rod W. Rice<br>ATTORNEY-IN-FACT | March 26, 2002 |

EXHIBIT 3.3

# ARTICLES OF AMENDMENT
# TO ARTICLES OF INCORPORATION
# OF
# DIRECT FOCUS, INC.

Pursuant to RCW 23B.10.060 of the Washington Business Corporation Act, the undersigned corporation hereby submits the following amendment to the corporation's Articles of Incorporation:

1. The name of the corporation is Direct Focus, Inc.

2. The text of the amendment as adopted is as follows:

ARTICLE IV
CAPITAL STOCK

4.1 THE CORPORATION SHALL HAVE AUTHORITY TO ISSUE IN THE AGGREGATE SEVENTY FIVE MILLION (75,000,000) SHARES OF COMMON STOCK.

3. The amendment does not provide for an exchange, reclassification, or cancellation of issued shares.

4. The date of adoption of such amendment by the Board of Directors was July 25, 2000.

5. The amendment was adopted by the Board of Directors solely to change the number of authorized shares in proportion to a three-for-two stock dividend. Pursuant to RCW 23B.10.020(4), shareholder action is not required in connection with the amendment.

DATED this 25th day of September, 2000

DIRECT FOCUS, INC.

By: /s/ Brian R. Cook
------------------------------
Brian R. Cook

EXHIBIT 10.14

# BUSINESS LOAN AGREEMENT

BORROWER: DIRECT FOCUS, INC.
2200 N.E. 65TH AVENUE
VANCOUVER, WA 98661

LENDER: U.S. BANK NATIONAL ASSOCIATION
CORPORATE BANKING DIVISION
PL-7 COMMERCIAL LOAN SERVICE WEST
555 S.W. OAK
PORTLAND, OR 97204

THIS BUSINESS LOAN AGREEMENT BETWEEN DIRECT FOCUS, INC. ("BORROWER") AND U.S. BANK NATIONAL ASSOCIATION ("LENDER") IS MADE AND EXECUTED ON THE FOLLOWING TERMS AND CONDITIONS. BORROWER HAS RECEIVED PRIOR COMMERCIAL LOANS FROM LENDER OR HAS APPLIED TO LENDER FOR A COMMERCIAL LOAN OR LOANS AND OTHER FINANCIAL ACCOMMODATIONS, INCLUDING THOSE WHICH MAY BE DESCRIBED ON ANY EXHIBIT OR SCHEDULE ATTACHED TO THIS AGREEMENT. ALL SUCH LOANS AND FINANCIAL ACCOMMODATIONS, TOGETHER WITH ALL FUTURE LOANS AND FINANCIAL ACCOMMODATIONS FROM LENDER TO BORROWER, ARE REFERRED TO IN THIS AGREEMENT INDIVIDUAL AS THE "LOAN" AND COLLECTIVELY AS THE "LOANS." BORROWER UNDERSTANDS AND AGREES THAT: (A) IN GRANTING, RENEWING, OR EXTENDING ANY LOAN, LENDER IS RELYING UPON BORROWER'S REPRESENTATIONS, WARRANTIES, AND AGREEMENTS, AS SET FORTH IN THIS AGREEMENT: (B) THE GRANTING, RENEWING, OR EXTENDING OF ANY LOAN BY LENDER AT ALL TIMES SHALL BE SUBJECT TO LENDER'S SOLE JUDGMENT AND DISCRETION; AND (C) ALL SUCH LOANS SHALL BE AND SHALL REMAIN SUBJECT TO THE FOLLOWING TERMS AND CONDITIONS OF THIS AGREEMENT.

TERM. This Agreement shall be effective as of June 15, 2001, and shall continue thereafter until all indebtedness of Borrower to lender has been performed in full and the parties terminate this Agreement in writing.

DEFINITIONS. The following words shall have the following meanings when used in this Agreement. Terms not otherwise defined in this agreement shall have the meanings attributed to such terms in the Uniform Commercial Code. All references to dollar amounts shall mean amounts in lawful money of the United States of America.

AGREEMENT. The word "Agreement" means this Business Loan Agreement, as this Business Loan Agreement may be amended or modified from time to time, together with all exhibits and schedules attached to this Business Loan Agreement from time to time.

BORROWER. The word "Borrower" means DIRECT FOCUS, INC. The word "Borrower" also includes, as applicable, all subsidiaries and affiliates of Borrower as provided below in the paragraph titled "Subsidiaries and Affiliates."

CERCLA. The word "CERCLA" means the Comprehensive Environmental Response, Compensation, and liability Act of 1980, as amended.

CASH FLOW. The words "Cash Flow" mean net income after taxes, and exclusive of extraordinary gains and income, plus depreciation and amortization.

COLLATERAL. The word "Collateral" means and includes without limitation all property and assets granted as collateral security for a Loan, whether real or personal property, whether granted directly or indirectly, whether granted now or in the future, and whether granted in the form of a security interest, mortgage, deed

of trust, assignment, pledge, chattel mortgage, chattel trust, factor's lien, equipment trust, conditional sale, trust receipt, lien, charge, lien or title retention contract, lease or consignment intended as a security device, or any other security or lien interest whatsoever, whether created by law, contract, or otherwise.

DEBT. The word "Debt" means all of Borrower's liabilities excluding Subordinated Debt.

ERISA. The word "ERISA" means the Employee Retirement Income Security Act of 1974, as amended.

EVENT OF DEFAULT. The words "Event of Default" mean and include without limitation any of the Events of Default set forth below in the section titled "EVENTS OF DEFAULT."

GRANTOR. The word "Grantor" means and includes without limitation each and all of the persons or entities granting a Security Interest in any Collateral for the Indebtedness, including without limitation all Borrowers granting such a Security Interest.

GUARANTOR. The word "Guarantor" means and includes without imitation each and all of the guarantors, sureties, and accommodation parties in connection with any Indebtedness.

INDEBTEDNESS. The word "Indebtedness" means and includes without limitation all Loans, together with all other obligations, debts and liabilities of Borrower to Lender, or any one or more of them, as well as all claims by Lender against Borrower, or any one or more of them; whether now or hereafter existing, voluntary or involuntary, due or not due, absolute or contingent, liquidated or unliquidated; whether

Borrower may be liable individually or jointly with others; whether Borrower may be obligated as a Guarantor, surety, or otherwise; whether recovery upon such Indebtedness may be or hereafter may become barred by any statue of limitations; and whether such Indebtedness may be or hereafter may become otherwise unenforceable.

LENDER. The word "Lender" means U.S. Bank National Association, its successors and assigns.

LIQUID ASSETS. The words "Liquid  Assets" mean  Borrower's cash on hand plus Borrower's readily marketable securities.

LOAN. The word "Loan" or "Loans" means and includes without limitation any and all commercial loans and financial accommodations from Lender to Borrower, whether nor or hereafter existing, and however evidenced, including without limitation those loans and financial accommodations described here in or described on any exhibit or schedule attached to this Agreement from time to time.

NOTE. The word "Note" means and includes without limitation Borrower's promissory note or notes, if any, evidencing Borrower's Loan obligations in favor of Lender, as well as any substitute, replacement or refinancing note or notes therefore.

PERMITTED LIENS. The words "Permitted Liens" mean; (a) liens and security interests securing Indebtedness owed by Borrower to lender; (b) liens for taxes, assessments, or similar charges either not yet due or being contested in good faith; (c) liens of materialmen, mechanics, warehousemen, or carriers, or other like liens arising in the ordinary course of business and security obligations which are not yet delinquent; (d) purchase money liens or purchase money security interests upon or in any property acquired or held by Borrower in the ordinary course of business to security Indebtedness outstanding on the date of this Agreement or permitted to be incurred under the paragraph of this agreement titled "Indebtedness and Liens"; (e) liens and security interests which, as of the date of this Agreement, have been disclosed to and approved by the Lender in writing; and (f) those liens and security interests which in the aggregate constitute an immaterial and insignificant monetary amount with respect to the net value of Borrower's assets.

RELATED DOCUMENTS. The words "Related Documents" mean and include without limitation all promissory notes, credit agreements, loan agreements, environmental agreements, guaranties, security agreements, mortgages, deeds of trust, and all other instruments, agreements and documents, whether now or hereafter existing, executed in connection with the Indebtedness.

SECURITY AGREEMENT. The words "Security Agreement" mean and include without limitation any agreements, promises, covenants, arrangements, understandings or other agreements, whether created by law, contract, or otherwise, evidencing, governing, representing, or creating a Security Interest.

SECURITY INTEREST. The words "Security Interest" mean and include without limitation any type of collateral security, whether in the form of a lien, charge, mortgage, deed of trust, assignment, pledge, chattel mortgage, chattel trust, factor's lien, equipment trust, conditional sale, trust receipt, lien or title retention contract, lease or consignment intended as a security device, or any other security or lien interest whatsoever, whether created by law, contract or otherwise.

SARA. The word "SARA" means the Superfund Amendments and Reauthorization Act of 1986 as now or hereafter amended.

SUBORDINATED DEBT. The words "Subordinated Debt" mean indebtedness and liabilities of Borrower which have been subordinated by written agreement to indebtedness owed by Borrower to Lender in form and substance acceptable to Lender.

TANGIBLE NET WORTH. The words "Tangible Net Worth" mean Borrower's total assets excluding all intangible assets (i.e., goodwill, trademarks, patents, copyrights, organizational expenses, and similar intangible items, but including leaseholds and leasehold improvements) less total Debt.

WORKING CAPITAL. The words "Working Capital" mean Borrower's current assets, excluding prepaid expenses, less Borrower's current liabilities.

CONDITIONS PRECEDENT TO EACH ADVANCE. Lender's obligation to make the initial Loan Advance and each subsequent Loan Advance under this Agreement shall be subject to the fulfillment to Lender's satisfaction of all of the conditions set forth in this Agreement and in the Related Documents.

LOAN DOCUMENTS. Borrower shall provide to lender in form satisfactory to Lender the following documents for the Loan: (a) the Note; (b) Security Agreements granting to lender security interests in the Collateral; (c) Financing Statements perfecting lender's Security Interests; (d) evidence of insurance as required below; and (d) any other documents required under this Agreement or by lender or its counsel.

BORROWER'S AUTHORIZATION. Borrower shall have provided in form and substance satisfactory to lender properly certified resolutions, duly authorizing the execution and delivery of this Agreement, the Note and the Related Documents, and such other authorizations and other documents and instruments as Lender or its counsel, in their sole discretion, may require.

PAYMENT OF FEES AND EXPENSES. Borrower shall have paid to Lender all fees, charges, and other expenses which are then due and payable as specified in this Agreement or any Related Document.

REPRESENTATIONS AND WARRANTIES. The representations and warranties set forth in this agreement, in the Related Documents, and in any document or certificate delivered to Lender under this Agreement are true and correct.

NO EVENT OF DEFAULT. There shall not exist at the time of any advance a condition which would constitute of Event of Default under this Agreement.

REPRESENTATIONS AND WARRANTIES. Borrower represents and warrants to lender, as of the date of this Agreement, as of the date of each disbursement of Loan proceeds, as of the date of any renewal, extension or modification of any Loan, and at all times any Indebtedness exists:

ORGANIZATION. Borrower is a corporation which is duly organized, validly existing, and in good standing under the laws of the state of Borrower's incorporation and is validly existing and in good standing in all states in which Borrower is doing business. Borrower has the full power and authority to own its properties and to transact the business in which it is presently engaged or presently proposes to engage. Borrower also is duly qualified as a foreign corporation and is in good standing in all states in which the failure to so qualify would have a material adverse effect on its businesses or financial condition.

AUTHORIZATION. The execution, delivery, and performance of this Agreement and all Related Documents by Borrower, to the extent to be executed, delivered or performed by Borrower, have been duly authorized by all necessary action by Borrower; do not require the consent or approval of any other person, regulatory authority or governmental body; and do not conflict with, result in a violation of, or constitute a default under (a) any provision or its articles of incorporation or organization, or bylaws, or any agreement or other instrument binding upon Borrower or (b) any law, governmental regulation, court decree, or order applicable to Borrower.

FINANCIAL INFORMATION. Each financial statement of Borrower supplied to lender truly and completely disclosed Borrower's financial condition as of the date of the statement, and there has been no material adverse change in Borrower's financial condition subsequent to the date of the most recent financial statement supplied to Lender. Borrower has no material contingent obligations except as disclosed in such financial statements.

LEGAL EFFECT. This Agreement constitutes, and any instrument or agreement required hereunder to be given by Borrower when delivered will constitute legal, valid and binding obligations of Borrower enforceable against Borrower in accordance with their respective terms.

PROPERTIES. Except as contemplated by this Agreement or as previously disclosed in Borrower's financial statements or in writing to Lender and as accepted by Lender, and except for property tax liens for taxes not presently due and payable, Borrower owns and has good title to all of Borrower's properties free and clear of all Security Interests, and has not executed any security documents or financial statements relating to such properties. All of Borrower's properties are titled in Borrower's legal name, and Borrower has not used, or filed a financial statement under, any other name for at least the last five (5) years.

HAZARDOUS SUBSTANCES. The terms "hazardous waste," "hazardous substance," "disposal," "release," and "threatened release," as used in this Agreement, shall have the same meanings as set forth in the "CERCLA," "SARA," and the Hazardous Materials Transportation Act, 49 U.S.C. Section 1801, et seq., the Resource Conservation and Recovery Act, 42 U.S.C. Section 6901, et seq., or other applicable state or Federal laws, rules or regulations adopted pursuant to any of the foregoing or intended to protect human health or the environment "Environmental Laws"). Except as disclosed to and acknowledged by Lender in writing Borrower represents and warrants that: (a) During the period of Borrower's ownership of the properties, there has been no use, generation, manufacture, storage, treatment, disposal, release or threatened release of any hazardous waste or substance by any person on, under, about or from any of the properties; (b) Borrower has no knowledge of, or reason to believe that there has been (i) any use, generation, manufacture, storage, treatment, disposal, release, or threatened release of any hazardous waste or substance on, under, about or from the properties b any prior owners or occupants of any of the properties, or (ii) any actual or threatened litigation or claims of any kind by any person relating to such matters; and (c) Neither Borrower nor any tenant, contractor, agent or other authorized user of any of the properties shall use, generate, manufacture, store, treat, dispose of, or release any hazardous waste or substance on, under, about or from any of the properties, and any such activity shall be conducted in compliance with all applicable federal, state, and local laws, regulations, and ordinances, including without limitation Environmental Laws. Borrower authorizes Lender and its agents to enter upon the properties to make such inspections and tests as Lender may deem appropriate to determine compliance of the properties with this section of the Agreement. Any inspections or tests made by Lender shall be at Borrower's expense and for lender's purposes only and shall not be construed to create any responsibility or liability on the part of Lender to Borrower or to any other person. The representations and warranties contained herein are based on Borrower's due diligence in investigating the properties for hazardous waste and hazardous substances. Borrower hereby: (a) releases and waives any future claims against Lender for indemnity or contribution in the event Borrower becomes liable for cleanup or other costs under any such laws, and (b) agrees to indemnify and hold harmless Lender against any and all claims, losses, liabilities, damages, penalties, and expenses which Lender may directly or indirectly sustain or suffer resulting from a breach of this section of the Agreement or as a consequence of any use, generation, manufacture, storage, disposal, release or threatened release of a hazardous waste or substance on the properties or as a result of a violation of any Environmental Laws. The provisions of this section of the Agreement, including the obligation to indemnify, shall survive the payment of the Indebtedness and the termination or expiration of this agreement and shall not be effective by Lender's acquisition of any interest in any of the properties, whether by foreclosure or otherwise.

LITIGATION AND CLAIMS. No litigation, claim, investigation, administrative proceeding or similar action (including those for unpaid taxes) against Borrower is pending or threatened, and no other event has occurred which may materially adversely affect Borrower's financial condition or properties, other than litigation, claims, or other events, if any, that have been disclosed to and acknowledged by Lender in writing.

TAXES. To the best of Borrower's knowledge, all tax returns and reports of Borrower that are or were required to be filed, have been filed, and all taxes, assessments and other governmental charges have been paid in full, except those presently being or to be contested by Borrower in good faith in the ordinary course of business and for which adequate reserves have been provided.

LIEN PRIORITY. Unless otherwise previously disclosed to lender in writing, Borrower has not entered into or granted any Security Agreements, or permitted the filing or attachment of any Security Interests on or affecting any of the Collateral directly or indirectly securing repayment of Borrower's Loan and Note, that would be prior or that may in any way be superior to Lender's Security Interests and rights in and to such Collateral.

BINDING EFFECT. This Agreement, the Note, all Security Agreements directly or indirectly securing repayment of Borrower's Loan and Note and all of the Related Documents are binding upon Borrower, as well as upon Borrower's successors, representatives and assigns, and are legally enforceable in accordance with their respective terms.

COMMERCIAL PURPOSES. Borrower intends to use the Loan proceeds solely for business or commercial related purposes.

EMPLOYEE BENEFIT PLANS. Each employee benefit plan as to which Borrower may have any liability complies in all material respects with all applicable requirements of law and regulations, and (i) no Reportable Event or Prohibited Transaction (as defined in ERISA) has occurred with respect to any such plan; (ii) Borrower has not withdrawn from any such plan or initiated steps to do so; (iii) no steps have been taken to terminate any such plan; and (iv) there are no unfounded liabilities other than those previously disclosed to Lender in writing.

LOCATION OF BORROWER'S OFFICES AND RECORDS. Borrower's place of business, or Borrower's chief executive office, if Borrower has more than one place of business, is located at 2200 N.E. 65th Avenue, Vancouver, Washington 98661. Unless Borrower has designated otherwise in writing, this location is also the office or offices where Borrower keeps its records concerning the Collateral.

INFORMATION. All information heretofore or contemporaneously herewith furnished by Borrower to Lender for the purposes of or in connection with this Agreement or any transaction contemplated hereby is, and all information hereafter furnished by or on behalf of Borrower to Lender will be, true and accurate in every material respect on the date as of which such information is dated or certified; and none of such information is or will be incomplete by omitting to state any material fact necessary to make such information not misleading.

SURVIVAL OF REPRESENTATIONS AND WARRANTIES. Borrower understands and agrees that Lender, without independent investigation, is relying upon the above representations and warranties in extending Loan Advances to Borrower. Borrower further agrees that the foregoing representations and warranties shall be continuing in nature and shall remain in full force and effect until such time as Borrower's Indebtedness shall be paid in full, or until this Agreement shall be terminated in the manner provided above, whichever is the last to occur.

AFFIRMATIVE COVENANTS. Borrower covenants and agrees with Lender that, while this Agreement is in effect, Borrower will:

LITIGATION. Promptly inform Lender in writing of (a) all material adverse changes in Borrower's financial condition, and (b) all existing and all threatened litigation, claims, investigations, administrative proceedings or similar actions affecting Borrower or any Guarantor which could materially affect the financial condition of Borrower or the financial condition of any Guarantor.

Financial Records. MAINTAIN ITS BOOKS AND RECORDS IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, APPLIED ON A CONSISTENT BASIS, AND PERMIT LENDER TO EXAMINE AND AUDIT BORROWER'S BOOKS AND RECORDS AND HAVE ITS MANAGEMENT MEET WITH LENDER AT ALL REASONABLE TIMES.

Financial Statements. FURNISH LENDER WITH, AS SOON AS AVAILABLE, BUT IN NO EVENT LATER THAN NINETY (90) DAYS AFTER THE END OF EACH FISCAL YEAR (A) BORROWER'S BALANCE SHEET AND INCOME STATEMENT FOR THE YEAR ENDED, AUDITED BY A CERTIFIED PUBLIC ACCOUNTANT SATISFACTORY TO LENDER AND (B) A COPY OF BORROWER'S 10K FILED WITH THE S.E.C.; AND AS SOON AS AVAILABLE, BUT IN NO EVENT LATER THAN FORTY-FIVE (45) DAYS AFTER THE END OF EACH FISCAL QUARTER, (A) BORROWER'S BALANCE SHEET AND PROFIT AND LOSS STATEMENT FOR THE PERIOD ENDED, PREPARED AND CERTIFIED AS CORRECT TO THE BEST KNOWLEDGE AND BELIEF BY BORROWER'S CHIEF FINANCIAL OFFICER OR OTHER OFFICER OR PERSON ACCEPTABLE TO LENDER AND (B) A COPY OF BORROWER'S 10Q FILED WITH THE S.E.C. ALL FINANCIAL REPORTS REQUIRED TO BE PROVIDED UNDER THIS AGREEMENT SHALL BE PREPARED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, APPLIED ON A CONSISTENT BASIS, AND CERTIFIED BY BORROWER AS BEING TRUE AND CORRECT.

Additional Information. FURNISH SUCH ADDITIONAL INFORMATION AND STATEMENTS, LISTS OF ASSETS AND LIABILITIES, AGINGS OF RECEIVABLES AND PAYABLES, INVENTORY SCHEDULES, BUDGETS, FORECASTS, TAX RETURNS, AND OTHER REPORTS WITH RESPECT TO BORROWER'S FINANCIAL CONDITION AND BUSINESS OPERATIONS AS LENDER MAY REQUEST FROM TIME TO TIME.

Financial Covenants and Ratios. Comply with the following covenants and ratios:

Net Worth Ratio. MAINTAIN A RATIO OF TOTAL LIABILITIES TO TANGIBLE NET WORTH OF LESS THAN 1.25 to 1.00.

Current Ratio. MAINTAIN A RATIO OF CURRENT ASSETS TO CURRENT LIABILITIES IN EXCESS OF 2.00 to 1.00.

THE FOLLOWING PROVISIONS SHALL APPLY FOR PURPOSES OF DETERMINING COMPLIANCE WITH THE FOREGOING FINANCIAL COVENANTS AND RATIOS: Compliance with the foregoing ratios/amounts shall be determined by calculating the ratios/amounts as of the end of each quarter. EXCEPT AS PROVIDED ABOVE, ALL COMPUTATIONS MADE TO DETERMINE COMPLIANCE WITH THE REQUIREMENTS CONTAINED IN THIS PARAGRAPH SHALL BE MADE IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, APPLIED ON A CONSISTENT BASIS, AND CERTIFIED BY BORROWER AS BEING TRUE AND CORRECT.

Insurance. MAINTAIN FIRE AND OTHER RISK INSURANCE, PUBLIC LIABILITY INSURANCE, AND SUCH OTHER INSURANCE AS LENDER MAY REQUIRE WITH RESPECT TO BORROWER'S PROPERTIES AND OPERATIONS, IN FORM, AMOUNTS, COVERAGES, AND WITH INSURANCE COMPANIES REASONABLY ACCEPTABLE TO LENDER. BORROWER, UPON REQUEST OF LENDER, WILL DELIVER TO LENDER FROM TIME TO TIME THE POLICIES OR CERTIFICATES

OF INSURANCE IN FORM SATISFACTORY TO LENDER, INCLUDING STIPULATIONS THAT COVERAGES WILL NOT BE CANCELLED OR DIMINISHED WITHOUT AT LEAST TEN (10) DAYS' PRIOR WRITTEN NOTICE TO LENDER. EACH INSURANCE POLICY ALSO SHALL INCLUDE AN ENDORSEMENT PROVIDING THAT COVERAGE IN FAVOR OF LENDER WILL NOT BE IMPAIRED IN ANY WAY BY ANY ACT, OMISSION OR DEFAULT OF BORROWER OR ANY OTHER PERSON. IN CONNECTION WITH ALL POLICIES COVERING ASSETS IN WHICH LENDER HOLDS OR IS OFFERED A SECURITY INTEREST FOR THE LOANS, BORROWER WILL PROVIDE LENDER WITH SUCH LOSS PAYABLE OR OTHER ENDORSEMENTS AS LENDER MAY REQUIRE.

Insurance Reports. FURNISH TO LENDER, UPON REQUEST OF LENDER, REPORTS ON EACH EXISTING INSURANCE POLICY SHOWING SUCH INFORMATION AS LENDER MAY REASONABLY REQUEST, INCLUDING WITHOUT LIMITATION, THE FOLLOWING: (A) THE NAME OF THE INSURER; (B) THE RISKS INSURED; (C) THE AMOUNT OF THE POLICY; (D) THE PROPERTIES INSURED; (E) THE THEN CURRENT PROPERTY VALUES ON THE BASIS OF WHICH INSURANCE HAS BEEN OBTAINED, AND THE MANNER OF DETERMINING THOSE VALUES; AND (F) THE EXPIRATION DATE OF THE POLICY.

Other Agreements. COMPLY WITH ALL TERMS AND CONDITIONS OF ALL OTHER AGREEMENTS, WHETHER NOW OR HEREAFTER EXISTING, BETWEEN BORROWER AND ANY OTHER PARTY AND NOTIFY LENDER IMMEDIATELY IN WRITING OF ANY DEFAULT IN CONNECTION WITH ANY OTHER SUCH AGREEMENTS.

Loan Fees and Charges. IN ADDITION TO ALL OTHER AGREED UPON FEES AND CHARGES, PAY THE FOLLOWING: Borrower agrees to pay Lender, prior to or contemporaneously with the initial advance of Loan proceeds, a nonrefundable loan fee in the amount of .25% of the Loan amount per annum, payable quarterly in arrears, standby letters of credit at 1.0% per annum per letter of credit amount (minimum of $250.00) due upon issuance of letter of credit, and commercial letters of credit at U.S. Bank's published rates and charges.

Loan Proceeds. USE ALL LOAN PROCEEDS SOLELY FOR THE BORROWER'S BUSINESS OPERATIONS, UNLESS SPECIFICALLY CONSENTED TO THE CONTRARY BY LENDER IN WRITING.

Taxes, Charges and Liens. PAY AND DISCHARGE WHEN DUE ALL OF ITS INDEBTEDNESS AND OBLIGATIONS, INCLUDING WITHOUT LIMITATION ALL ASSESSMENTS, TAXES, GOVERNMENTAL CHARGES, LEVIES AND LIENS OF EVERY KIND AND NATURE, IMPOSED UPON BORROWER OR ITS PROPERTIES, INCOME OR PROFITS, PRIOR TO THE DATE ON WHICH PENALTIES WOULD ATTACH, AND ALL LAWFUL CLAIMS THAT, IF UNPAID, MIGHT BECOME A LIEN OR CHARGE UPON ANY OF BORROWER'S PROPERTIES, INCOME, OR PROFITS. PROVIDED HOWEVER, BORROWER WILL NOT BE REQUIRED TO PAY AND DISCHARGE ANY SUCH ASSESSMENT, TAX, CHARGE, LEVY, LIEN OR CLAIM SO LONG AS (A) THE LEGALITY OF THE SAME SHALL BE CONTESTED IN GOOD FAITH BY APPROPRIATE PROCEEDINGS, AND (B) BORROWER SHALL HAVE ESTABLISHED ON ITS BOOKS ADEQUATE RESERVES WITH RESPECT TO SUCH CONTESTED ASSESSMENT, TAX, CHARGE, LEVY, LIEN, OR CLAIM IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRACTICES. BORROWER, UPON DEMAND OF LENDER, WILL FURNISH TO LENDER EVIDENCE OF PAYMENT OF THE ASSESSMENTS, TAXES, CHARGES, LEVIES, LIENS AND CLAIMS, AND WILL AUTHORIZE THE APPROPRIATE GOVERNMENTAL OFFICIAL TO DELIVER TO LENDER AT ANY TIME A WRITTEN STATEMENT OF ANY ASSESSMENTS, TAXES, CHARGES, LEVIES, LIENS AND CLAIMS AGAINST BORROWER'S PROPERTIES, INCOME, OR PROFITS.

Performance. PERFORM AND COMPLY WITH ALL TERMS, CONDITIONS, AND PROVISIONS SET FORTH IN THIS AGREEMENT AND IN THE RELATED DOCUMENTS IN A TIMELY MANNER, AND PROMPTLY NOTIFY LENDER IF BORROWER LEARNS OF THE OCCURRENCE OF ANY EVENT WHICH CONSTITUTES AN EVENT OF DEFAULT UNDER THIS AGREEMENT OR UNDER ANY OF THE RELATED DOCUMENTS.

Operations. MAINTAIN EXECUTIVE AND MANAGEMENT PERSONNEL WITH SUBSTANTIALLY THE SAME QUALIFICATIONS AND EXPERIENCE AS THE PRESENT EXECUTIVE AND MANAGEMENT PERSONNEL; PROVIDE WRITTEN NOTICE TO LENDER OF ANY CHANGE IN EXECUTIVE AND MANAGEMENT PERSONNEL; CONDUCT ITS BUSINESS AFFAIRS IN A REASONABLE AND PRUDENT MANNER AND IN COMPLIANCE WITH ALL APPLICABLE FEDERAL, STATE AND MUNICIPAL LAWS, ORDINANCES, RULES AND REGULATIONS RESPECTING ITS PROPERTIES, CHARTERS, BUSINESSES AND OPERATIONS, INCLUDING WITHOUT LIMITATION, COMPLIANCE WITH THE

AMERICANS WITH DISABILITIES ACT AND WITH ALL MINIMUM FUNDING STANDARDS AND OTHER REQUIREMENTS OF ERISA AND OTHER LAWS APPLICABLE TO BORROWER'S EMPLOYEE BENEFIT PLANS.

Inspection. PERMIT EMPLOYEES OR AGENTS OF LENDER AT ANY REASONABLE TIME TO INSPECT AY AND ALL COLLATERAL FOR THE LOAN OR LOANS AND BORROWER'S OTHER PROPERTIES AND TO EXAMINE OR AUDIT BORROWER'S BOOKS, ACCOUNTS, AND RECORDS AND TO MAKE COPIES AND MEMORANDA OF BORROWER'S BOOKS, ACCOUNTS, AND RECORDS. IF BORROWER NOW, OR AT ANY TIME HEREAFTER, MAINTAINS ANY RECORDS (INCLUDING WITHOUT LIMITATION COMPUTER GENERATED RECORDS AND COMPUTER SOFTWARE PROGRAMS FOR THE GENERATION OF SUCH RECORDS) IN THE POSSESSION OF A THIRD PARTY, BORROWER, UPON REQUEST OF LENDER, SHALL NOTIFY SUCH PARTY TO PERMIT LENDER FREE ACCESS TO SUCH RECORDS AT ALL REASONABLE TIMES AND TO PROVIDE LENDER WITH COPIES OF ANY RECORDS IT MAY REQUEST, ALL AT BORROWER'S EXPENSE.

Compliance Certificate. UNLESS WAIVED IN WRITING BY LENDER, PROVIDE LENDER WITH AT LEAST QUARTERLY, DUE WITHIN SIXTY (60) DAYS OF QUARTER END AND AT THE TIME OF EACH DISBURSEMENT OF LOAN PROCEEDS WITH A CERTIFICATE EXECUTED BY BORROWER'S CHIEF FINANCIAL OFFICER, OR OTHER OFFICER OR PERSON ACCEPTABLE TO LENDER, CERTIFYING THAT THE REPRESENTATIONS AND WARRANTIES SET FORTH IN THIS AGREEMENT ARE TRUE AND CORRECT AS OF THE DATE OF THE CERTIFICATE AND FURTHER CERTIFYING THAT, AS OF THE DATE OF THE CERTIFICATE, NO EVENT OF DEFAULT EXISTS UNDER THIS AGREEMENT.

Environmental Compliance and Reports. BORROWER SHALL COMPLY IN ALL RESPECTS WITH ALL ENVIRONMENTAL PROTECTION FEDERAL, STATE AND LOCAL LAWS, STATUES, REGULATIONS AND ORDINANCES; NOT CAUSE OR PERMIT TO EXIST, AS A RESULT OF AN INTENTIONAL OR UNINTENTIONAL ACTION OR OMISSION ON ITS PART OR ON THE PART OF ANY THIRD PARTY, ON PROPERTY OWNED AND/OR OCCUPIED BY BORROWER, ANY ENVIRONMENTAL ACTIVITY WHERE DAMAGE MAY RESULT TO THE ENVIRONMENT, UNLESS SUCH ENVIRONMENTAL ACTIVITY IS PURSUANT TO AND IN COMPLIANCE WITH THE CONDITIONS OF A PERMIT ISSUED BY THE APPROPRIATE FEDERAL, STATE OR LOCAL GOVERNMENTAL AUTHORIZES; SHALL FURNISH TO LENDER PROMPTLY AND IN ANY EVENT WITHIN THIRTY (30) DAYS AFTER RECEIPT THEREOF A COPY OF ANY NOTICE, SUMMONS, LIEN, CITATION, DIRECTIVE, LETTER OR OTHER COMMUNICATION FROM ANY GOVERNMENTAL AGENCY OR INSTRUMENTALITY CONCERNING ANY INTENTIONAL OR UNINTENTIONAL ACTION OR OMISSION ON BORROWER'S PART IN CONNECTION WITH ANY ENVIRONMENTAL ACTIVITY WHETHER OR NOT THERE IS DAMAGE TO THE ENVIRONMENT AND/OR OTHER NATURAL RESOURCES.

Additional Assurances. MAKE, EXECUTE AND DELIVER TO LENDER SUCH PROMISSORY NOTES, MORTGAGES, DEEDS OF TRUST, SECURITY AGREEMENTS, FINANCING STATEMENTS, INSTRUMENTS, DOCUMENTS AND OTHER AGREEMENTS AS LENDER OR ITS ATTORNEYS MAY REASONABLY REQUEST TO EVIDENCE AND SECURE THE LOANS AND TO PERFECT ALL SECURITY INTERESTS.

NEGATIVE COVENANTS. Borrower covenants and agrees with Lender that while this Agreement is in effect, Borrower shall not, without the prior written consent of Lender:

CAPITAL EXPENDITURES. Make or contract to make capital expenditures, including leasehold improvements, in any fiscal year in excess of $20,000,000.00 or incur liability for rentals of property (including both real and personal property) in an amount which, together with capital expenditures, shall in any fiscal year exceed such sum.

INDEBTEDNESS AND LIENS. Sell with recourse any of Borrower's accounts, except to Lender.

CONTINUITY OF OPERATIONS. (a) Engage in any business activities substantially different than those in which Borrower is presently engaged, (b) cease all operations, liquidate, transfer, or consolidate with any other entity, change ownership, dissolve or transfer or sell Collateral out of the ordinary course of business.

LOANS, ACQUISITIONS AND GUARANTIES. (a) Loan, invest in or advance money or assets, (b) purchase, create or acquire any interest in any other enterprise or entity, or (c) incur any obligation as surety or guarantor other than in the ordinary course of business.

CESSATION OF ADVANCES. If Lender has made any commitment to make any Loan to Borrower, whether under this Agreement or under any other agreement, Lender shall have no obligation to make Loan Advances or to disburse Loan proceeds if: (a) Borrower or any Guarantor is in default under the terms of this Agreement or any of the Related Documents or any other agreement that Borrower or any Guarantor has with Lender; (b) Borrower or any Guarantor becomes insolvent, files a petition in bankruptcy or similar proceedings, or is adjudged a bankrupt; (c) there occurs a material adverse change in Borrower's financial condition, in the financial condition of any Guarantor, or in the value of any Collateral securing any Loan; (d) any Guarantor seeks, claims or otherwise attempts to limit, modify or revoke such Guarantor's guaranty of the Loan or any other loan with Lender; or (e) Lender in good faith deems itself insecure, even though no Event of Default shall have occurred.

ACCESS LAWS. Without limiting the generality of any provision of this Agreement requiring Borrower to comply with applicable laws, rules, and regulations, Borrower agrees that it will, at all times, comply with applicable laws relating to disabled access including, but not limited to, all applicable titles of the Americans with Disabilities Act of 1990.

ADDITIONAL DEFINITIONS.

CURRENT ASSETS. The words "Current Assets" mean Borrower's cash on hand plus Borrower's receivables plus inventory.

CURRENT LIABILITIES. The words "Current Liabilities" mean all Borrower's notes payable plus borrower's accounts payable plus Borrower's income taxes payable plus Borrower's accruals plus Borrower's current portion of long-term debt.

CURRENT RATIO. The words "Current Ratio" mean Borrower's total Current Assets divided by Borrower's total Current Liabilities.

OUT OF DEBT PERIOD. Borrower agrees with Lender that Borrower shall rest the Line of Credit Facility with no outstanding principal balance (not including outstanding standby letters of credit) for a minimum of thirty (30) consecutive days during the term of the loan.

RIGHT OF SETOFF. Borrower grants to Lender a contractual security interest in, and hereby assigns, conveys, delivers, pledges and transfers to Lender all Borrower's right, title and interest in and to Borrower's accounts with Lender (whether checking, savings, or some other account), including, without limitation, all accounts held jointly with someone else and all accounts Borrower may open in the future, excluding however all IRA and Keogh accounts, and all trust accounts for which the grant of a security interest would be prohibited by law. Borrower authorizes Lender, to the extent permitted by applicable law, to charge or setoff all sums owing on the Indebtedness against any and all such accounts.

EVENTS OF DEFAULT. Each of the following shall constitute of Event of Default under this Agreement:

DEFAULT ON INDEBTEDNESS. Failure of Borrower to make any payment when due on the Loans.

OTHER DEFAULTS. Failure of Borrower or any Grantor to comply with or to perform when due any other term, obligation, covenant or condition contained in this Agreement or in any of the Related Documents, or failure of Borrower to comply with or to perform any other term obligation, covenant or condition contained in any other agreement between Lender and Borrower.

DEFAULT IN FAVOR OF THIRD PARTIES. Should Borrower or any Grantor default under any loan, extension of credit, security agreement, purchase or sales agreement, or any other agreement, in favor of any other creditor of person that may materially affect any of Borrower's property or Borrower's or any Grantor's ability to repay the Loans or perform their respective obligations under this Agreement or any of the Related Documents.

FALSE STATEMENTS. Any warranty, representation or statement made or furnished to Lender by or on behalf of Borrower or any Grantor under this Agreement or the Related Documents is false or misleading in any material respect at the time made or furnished, or becomes false or misleading at any time thereafter.

DEFECTIVE COLLATERAL. This Agreement or any of the Related Documents ceases to be in full force and effect (including failure of any Security Agreement to create a valid and perfected Security Interest) at ay time and for any reason.

INSOLVENCY. The dissolution or termination of Borrower's existence as a going business, the insolvency of Borrower, the appointment of a receiver for any part of Borrower's property, any assignment for the benefit of creditors, any type of creditor workout, or the commencement of any proceeding under any bankruptcy or insolvency laws by or against Borrower.

CREDITOR OR FORFEITURE PROCEEDINGS. Commencement of foreclosure or forfeiture proceedings, whether by judicial proceeding, self-help, repossession or any other method, by any creditor of Borrower, any creditor of any Grantor against any collateral securing the Indebtedness, or by any governmental agency. This includes a garnishment, attachment, or levy on or of any of Borrower's deposit accounts with Lender.

EVENTS AFFECTING GUARANTOR. Any of the preceding events occurs with respect to any Guarantor of any of the Indebtedness or any Guarantor dies or becomes incompetent, or revokes or disputes the validity of, or liability under, any Guaranty of the Indebtedness.

ADVERSE CHANGE. A material adverse change occurs in Borrower's financial condition, or Lender believes the prospect of payment or performance of the Indebtedness is impaired.

EFFECT OF AN EVENT OF DEFAULT. If any Event of Default shall occur, except where otherwise provided in this Agreement or the Related Documents, all commitments and obligations of Lender under this Agreement or the Related Documents or any other agreement immediately will terminate (including any obligation to make Loan Advances or disbursements), and, at Lender's option, all Indebtedness immediately will become due and payable, all without notice of any kind to Borrower, except that in the case of an Event of Default on the type described in the "Insolvency" subsection above, such acceleration shall be automatic and not optional. In addition, Lender shall have all the rights and remedies provided in the Related Documents or available at law, in equity, or otherwise. Except as may be prohibited by applicable law, all of lender's rights and remedies shall be cumulative and may be exercised singularly or concurrently. Election by Lender to pursue any remedy shall not exclude pursuit of any other remedy, and an election to make expenditures or to take action to perform an obligation of Borrower or of any Grantor shall not affect Lender's right to declare a default and to exercise its rights and remedies.

MISCELLANEOUS PROVISIONS. The following miscellaneous provisions are a part of this Agreement:

AMENDMENTS. This Agreement, together with any Related Documents, constitutes the entire understanding and agreement of the parties as to the matters set forth in this Agreement. No alteration of or amendment to this agreement shall be effective unless given in writing and signed by the party or parties sought to be charged or bound by the alteration or amendment.

Applicable Law. This agreement has been delivered to Lender and accepted by Lender in the State of Oregon. If there is a lawsuit, Borrower agrees upon Lender's request to submit to the jurisdiction of the courts of Multnomah County, the State of Oregon. Lender and Borrower hereby waive the right to any jury trial in any action, proceeding, or counterclaim brought by either Lender or Borrower against the other. This Agreement shall be governed by and construed in accordance with the laws of the State of Oregon.

CAPTION HEADINGS. Caption headings in this Agreement are for convenience purposes only and are not to be used to interpret or define the provisions of this Agreement.

CONSENT TO LOAN PARTICIPATION. Borrower agrees and consents to Lender's sale or transfer, whether now or later, of one or more participation interests in the Loans to one or more purchasers, whether related or unrelated to Lender. Lender may provide, without any limitation whatsoever, to any one or more purchasers, or potential purchasers, any information or knowledge Lender may have about Borrower or about any other matter relating to the Loan, and Borrower hereby waives any rights to privacy it may have with respect to such matters. Borrower additionally waives any and all notices of sale of participation interests, as well as all notices of any repurchaser of such participation interests. Borrower also agrees that the purchasers of ay such participation interests will be considered as the absolute owners of such interests in the Loans and will have all the rights granted under the participation agreement or agreements governing the sale of such participation interests. Borrower further waives all rights of offset or counterclaim that it may have now or later against Lender or against any purchaser of such a participation interest and unconditionally agrees that either Lender or such purchaser may enforce Borrower's obligation under the Loans irrespective of the failure or insolvency of any holder of any interest in the Loans. Borrower further agrees that the purchaser of any such participation interests may enforce its interests irrespective of any personal claims or defenses that Borrower may have against Lender.

COSTS AND EXPENSES. Borrower agrees to pay upon demand all of Lender's expenses, including without limitation attorneys' fees, incurred in connection with the enforcement, modification and collection of this Agreement or in connection with the Loans made pursuant to this Agreement. Lender may pay someone else to help collect the Loans and to enforce this Agreement, and Borrower will pay that amount. This includes, subject to any limits under applicable law, Lender's attorneys' fees and Lender's legal expenses, whether or not there is a lawsuit, including attorneys' fees for bankruptcy proceedings (including efforts to modify or vacate any automatic stay or injunction), appeals, and any anticipated post-judgment collection services. Borrower also will pay any court costs, in addition to all other sums provided by law.

NOTICES. All notices required to be given under this Agreement shall be given in writing, may be sent by telefacsimile (unless otherwise required by law), and shall be effective when actually delivered or when deposited with a nationally recognized overnight courier or deposited in the United States mail, first class, postage prepaid, addressed to the party to whom the notice is to be given at the address shown above. Any party may change its address for notices under this Agreement by giving formal written notice to the other parties, specifying that the purpose of the notice is to change the party's address. To the extent permitted by applicable law, if there is more than one Borrower, notice to any Borrower will constitute notice to all Borrowers. For notice purposes, Borrowers will keep Lender informed at all times of Borrower's current address(es).

SEVERABILITY. If a court of competent jurisdiction finds any provision of this Agreement to be invalid or unenforceable as to any person or circumstance, such finding shall not render that provision invalid or unenforceable as to any other persons or circumstances. If feasible, any such offending provision shall be deemed to be modified to be within the limits of enforceability or validity; however, if the offending provision cannot be so modified, it shall be stricken and all other provisions of this Agreement in all other respects shall remain valid and enforceable.

SUBSIDIARIES AND AFFILIATES OF BORROWER. To the extent the context of any provisions of this Agreement makes it appropriate, including without limitation any representation, warranty or covenant, the word "Borrower" as used herein shall include all subsidiaries and affiliates of Borrower. Notwithstanding the foregoing however, under no circumstances shall this Agreement be construed to require Lender to make any Loan or other financial accommodation to any subsidiary or affiliate of Borrower.

SUCCESSORS AND ASSIGNS. All covenants and agreements contained by or on behalf of Borrower shall bind its successors and assigns and shall inure to the benefit of Lender, its successors and assigns. Borrower shall not, however, have the right to assign its rights under this Agreement or any interest therein, without the prior written consent of Lender.

SURVIVAL. All warranties, representations, and covenants made by Borrower in this Agreement or in any certificate or other instrument delivered by Borrower to Lender under this Agreement shall be considered to have been relied upon by Lender and will survive the making of the Loan and delivery to Lender of the Related Documents, regardless of any investigation made by Lender or on Lender's behalf.

WAIVER. Lender shall not be deemed to have waived any rights under this Agreement unless such waiver is given in writing and signed by Lender. No delay or omission on the part of Lender in exercising any right shall operate as a waiver of such right or any other right. A waiver by Lender of a provision of this Agreement shall not prejudice or constitute a waiver of Lender's right otherwise to demand strict compliance with that provision or any other provision of this agreement. No prior waiver by Lender, nor any course of dealing between Lender and Borrower, or between Lender and any Grantor, shall constitute a waiver of any of Lender's rights or of any obligations of Borrower or of any Grantor as to any future transactions. Whenever the consent of Lender is required under this Agreement, the granting of such consent by Lender in any instance shall not constitute continuing consent in subsequent instances where such consent is required, and in all cases such consent may be granted or withheld in the sold discretion of Lender.

UNDER OREGON LAW, MOST AGREEMENTS PROMISES AND COMMITMENTS MADCE BY US (LENDER) AFTER OCTOBER 3, 1989 CONCERNING LOANS AND OTHER CREDIT EXTENSIONS WHICH ARE NOT FOR PERSONAL, FAMILY OR HOUSEHOLD PURPOSES OR SECURED SOLELY BY THE BORROWER'S RESIDENCE MUST BE IN WRITING, EXPRESS CONSIDERATION AND BE SIGNED BY US TO BE ENFORCEABLE.

BORROWER ACKNOWLEDGES HAVING READ ALL OF THE PROVISIONS OF THIS BUSINESS LOAN AGREEMENT, AND BORROWER AGREES TO ITS TERMS. THIS AGREEMENT IS DATED AS OF MAY 15, 2001.

BORROWER:
DIRECT FOCUS, INC.

X___________________________________

LENDER:
U.S. BANK NATIONAL ASSOCIATION

BY: ________________________________
AUTHORIZED OFFICER

EXHIBIT 21

# SUBSIDIARIES OF DIRECT FOCUS, INC.

Nautilus Fitness Products, Inc., a Washington corporation
Nautilus Human Performance Systems, Inc., a Virginia corporation
Nautilus, Inc., a Washington corporation
Direct Focus Sales Corporation, a Washington corporation
DFI Properties, LLC, a Virginia limited liability company
BFI Advertising, Inc., a Washington corporation
DFI Leaseco, LLC, a Washington limited liability company
Nautilus/Schwinn Fitness Group, Inc., a Colorado corporation
DF Hebb Industries, Inc., a Texas corporation
Schwinn Fitness International, a Swiss corporation
Schwinn Fitness SA, a Swiss corporation
StairMaster Health and Fitness Products, Inc., a Washington corporation
StairMaster Sports/Medical Products (U.K.), a United Kingdom corporation
StairMaster Sports/Medical Products GmbH, a German corporation

EXHIBIT 23

# INDEPENDENT AUDITORS' CONSENT

We consent to the incorporation by reference in Registration Statement Nos. 333-79643 and 333-46936 of Direct Focus, Inc. on Form S-8 of our report dated January 21, 2002 (February 8, 2002, as to Note 17), appearing in the Annual Report on Form 10-K of Direct Focus, Inc. for the year ended December 31, 2001.

DELOITTE & TOUCHE LLP
Portland, Oregon
March 26, 2002

EXHIBIT 24.1

# POWER OF ATTORNEY

## KIRKLAND C. ALY

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, Kirkland C. Aly, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2001, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 25th day of March, 2002.

Signature:

/s/ Kirkland C. Aly

Kirkland C. Aly

EXHIBIT 24.2

# POWER OF ATTORNEY

## C. ROWLAND HANSON

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, C. Rowland Hanson, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2001, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 25th day of March, 2002.

Signature:

/s/ C. Rowland Hanson

C. Rowland Hanson

EXHIBIT 24.3

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POWER OF ATTORNEY

FREDERICK T. HULL

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, Frederick T. Hull, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2001, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 25th day of March, 2002.

Signature:

/s/ Frederick T. Hull

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Frederick T. Hull

EXHIBIT 24.4

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POWER OF ATTORNEY

PAUL F. LITTLE

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, Paul F. Little, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2001, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 25th day of March, 2002.

Signature:

/s/ Paul F. Little

Paul F. Little

EXHIBIT 24.5

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# POWER OF ATTORNEY

JAMES M. WEBER

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, James M. Weber, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2001, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 25th day of March, 2002.

Signature:

/s/ James M. Weber

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James M. Weber