MEDIFAST INC
Form 10-Q
May 10, 2007

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

FORM 10-Q

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

For the quarterly period ended March 31, 2007

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number 0-23016

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

Delaware	**13-3714405**
(State or other jurisdiction of organization)	**(I.R.S. employer identification no.)**

11445 Cronhill Drive
Owings Mills, MD 21117
Telephone Number (410) 581-8042

Indicate by checkmark 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 o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by checkmark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at May 8, 2007
Common stock, $.001 par value per share	13,668,998 shares

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MEDIFAST, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2007 (Unaudited)	December 31, 2006 (Audited)
ASSETS		
Current assets:		
Cash	$ 1,857,000	$ 1,085,000
Accounts receivable-net of allowance for doubtful accounts of $100,000	525,000	448,000
Inventory	8,707,000	8,255,000
Investment securities	1,414,000	1,540,000
Deferred compensation	798,000	673,000
Prepaid expenses and other current assets	3,483,000	2,599,000
Note receivable - current	174,000	174,000
Deferred tax asset	92,000	90,000
Total Current Assets	**17,050,000**	**14,864,000**
Property, plant and equipment - net	14,575,000	14,020,000
Trademarks and intangibles - net	6,301,000	6,274,000
Deferred tax asset, net of current portion	418,000	367,000
Note receivable, net of current portion	1,314,000	1,355,000
Other assets	53,000	47,000
TOTAL ASSETS	**$ 39,711,000**	**$ 36,927,000**
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 3,615,000	$ 2,913,000
Income taxes payable	689,000	535,000
Line of credit	1,906,000	1,256,000
Current maturities of long-term debt	528,000	548,000
Total current liabilities	**6,738,000**	**5,252,000**
Long-term debt, net of current portion	3,392,000	3,509,000
Total Liabilities	**10,130,000**	**8,761,000**
Stockholders' Equity:		
Common stock; par value $.001 per share; 20,000,000 authorized; 13,668,998 and 13,631,898 shares issued and outstanding, respectively	14,000	14,000
Additional paid-in capital	26,752,000	26,629,000
Accumulated other comprehensive income	348,000	334,000
Retained Earnings	7,653,000	6,231,000
	34,767,000	**33,208,000**
Less: cost of 274,184 and 210,902 shares of common stock in treasury	(1,994,000)	(1,686,000)
Less: unearned compensation	(3,192,000)	(3,356,000)

Total Stockholders' Equity		**29,581,000**		**28,166,000**
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	**$**	**39,711,000**	**$**	**36,927,000**

See accompanying notes to condensed consolidated financial statement.

MEDIFAST, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended March 31,	
	2007 (Unaudited)	**2006** (Unaudited)
Revenue	$ 20,089,000	$ 19,183,000
Cost of sales	5,058,000	4,778,000
Gross Profit	**15,031,000**	**14,405,000**
Selling, general, and administration	12,792,000	11,318,000
Income from operations	2,239,000	3,087,000
Other income/(expense)		
Interest expense	(95,000)	(89,000)
Loss on Sale of Consumers Choice Systems	-	(323,000)
Stock compensation expense	(241,000)	(33,000)
Interest income	33,000	98,000
Other expense	51,000	79,000
	(252,000)	(268,000)
Net income before provision for income taxes	**1,987,000**	**2,819,000**
Provision for income tax (expense)	(565,000)	(1,125,000)
Net income	**1,422,000**	**1,694,000**
Basic earnings per share	$ 0.11	$ 0.13
Diluted earnings per share	$ 0.10	$ 0.13
Weighted average shares outstanding -		
Basic	12,899,543	12,965,518
Diluted	13,690,788	13,474,411

See accompanying notes to condensed consolidated financial statements.

MEDIFAST, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,	
	2007	2006
	(Unaudited)	(Unaudited)
Cash flows from operating activities:		
Net income	$ 1,422,000	$ 1,694,000
Adjustments to reconcile net income to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	702,000	759,000
Realized (gain) loss on investment securities	32,000	(19,000)
Loss on sale of Consumer Choice Systems	-	323,000
Common stock issued for services	21,000	33,000
Stock options vested during period	77,000	18,000
Excess tax benefits from shared-based payment arrangements	30,000	(6,000)
Vesting of unearned compensation	164,000	15,000
Net change in other comprehensive (loss) income	14,000	(55,000)
Deferred income taxes	(53,000)	(262,000)
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	(76,000)	79,000
(Increase) decrease in inventory	(452,000)	46,000
(Increase) decrease in prepaid expenses & other current assets	(885,000)	835,000
(Increase) in deferred compensation	(125,000)	(102,000)
Decrease in other assets	(6,000)	(1,000)
Increase in accounts payable and accrued expenses	701,000	652,000
(Decrease) in deferred tax liability	-	(191,000)
Increase (decrease) in income taxes payable	154,000	(416,000)
Net cash provided by operating activities	1,720,000	3,402,000
Cash Flow from Investing Activities:		
(Purchase) sale of investment securities, net	97,000	(44,000)
(Purchase) of property and equipment	(1,044,000)	(763,000)
(Purchase) of intangible assets	(240,000)	(150,000)
Net cash (used in) investing activities	(1,187,000)	(957,000)
Cash Flow from Financing Activities:		
Issuance of common stock, options and warrants	24,000	13,000
(Repayment) of long-term debt, net	(137,000)	(155,000)
Increase in line of credit	650,000	-
Decrease in note receivable	41,000	-
Excess tax benefits from share-based payment arrangements	(30,000)	6,000
(Purchase) of treasury stock	(309,000)	-
Net cash provided by (used in) financing activities	239,000	(136,000)
NET INCREASE IN CASH AND CASH EQUIVALENTS	772,000	2,309,000
Cash and cash equivalents - beginning of the period	1,085,000	1,484,000

Cash and cash equivalents - end of period	$	1,857,000	$	3,793,000
Supplemental disclosure of cash flow information:				
Interest paid	$	95,000	$	89,000
Income taxes	$	464,000	$	1,231,000
Supplemental disclosure of non cash activity:				
Common stock issued to executives over 6-year vesting period	$	-	$	3,373,000
Common shares issued for options and warrants	$	-	$	384,000
Options vested during period	$	77,000	$	18,000
Common stock issued for services	$	21,000	$	33,000
Line of credit converted to long-term debt	$	-	$	369,000

See accompanying notes to condensed consolidated financial statements.

MEDIFAST, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT.)

	Three Months Ended March 31,	
	2007	2006
	(Unaudited)	(Unaudited)
Supplemental disclosure of non cash activity:		
Sale of Consumer Choice Systems		
Inventory	$ -	$ 358,000
Accounts Receivable	-	131,000
Intangible assets, net	-	1,337,000
Note receivable	-	(1,503,000)
Loss on sale of Consumer Choice Systems	-	(323,000)
	$ -	$ -

See accompanying notes to condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements

General

1. Basis of Presentation

The condensed unaudited interim consolidated financial statements included herein have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. The condensed consolidated financial statements and notes are presented as permitted on Form 10-Q and do not contain information included in the Company's annual statements and notes. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. It is suggested that these condensed consolidated financial statements be read in conjunction with the December 31, 2006 audited consolidated financial statements and the accompanying notes thereto. While management believes the procedures followed in preparing these condensed consolidated financial statements are reasonable, the accuracy of the amounts are in some respects dependent upon the facts that will exist, and procedures that will be accomplished by the Company later in the year.

These condensed unaudited consolidated financial statements reflect all adjustments, including normal recurring adjustments, which, in the opinion of management, are necessary to present fairly the operations and cash flows for the period presented.

2. Presentation of Financial Statements

The Company's condensed consolidated financial statements include the accounts of Medifast, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

3. Inventories

Inventories consist principally of finished packaged foods, packaging and raw materials held in either the Company's manufacturing facility and distribution warehouse. Inventories are valued with cost determined using the first-in, first-out (FIFO) method.

4. Goodwill and Other Intangible Assets

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement No. 142 "Goodwill and Other Intangible Assets". This statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets". It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This Statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. On January 17, 2006, the Company sold its goodwill balance of $893,500 when the Consumer Choice Systems division was sold.

The Company has intangible assets, which include: customer lists, non-compete agreements, trademarks and patents. The non-compete agreements are being amortized over the legal life of the agreements ranging between 3 to 7 years. The customer lists are being amortized over a period ranging between 5 to 10 years based on management's best estimate of the expected benefits to be consumed or otherwise used up. Trademarks and patents are regularly reviewed to determine whether the facts and circumstances exist to indicate that the useful life is shorter than originally

estimated or the carrying amount of the assets may not be recoverable. The Company assesses the recoverability of its trademarks and patents by comparing the projected discounted net cash flows associated with the related asset, over their remaining lives, in comparison to their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets.

	As of March 31, 2007		As of December 31, 2006	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Customer lists	$ 6,566,000	$ 1,817,000	$ 6,346,000	$ 1,635,000
Non-compete agreements	840,000	840,000	840,000	840,000
Trademarks and patents	1,726,000	174,000	1,707,000	143,000
Total	$ 9,132,000	$ 2,831,000	$ 8,893,000	$ 2,618,000

Amortization expense for the three months ended March 31, 2007 and 2006 was as follows:

	2007	2006
Customer lists	$ 182,000	419,000
Non-compete agreements	-	97,000
Trademarks and patents	31,000	20,000
Total Trademarks and Intangibles	$ 213,000	$ 536,000

Amortization expense is included in selling, general and administrative expenses.

5. Fixed Assets

Fixed assets are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the related assets, which are generally three to seven years. Leasehold improvements and equipment under capital leases are amortized on a straight-line basis over the lesser of the estimated useful life of the asset or the related lease terms. Expenditures for repairs and maintenance are charged to expense as incurred, while major renewals and improvements are capitalized.

6. Note Receivable

Medifast realized a $1,503,000 note receivable as a result of the sale of Consumer Choice Systems on January 17, 2006 to a former board member. The note has a 10-year term with imputed interest of 4% collateralized by 50,000 shares of Medifast stock and all the assets of Consumer Choice Systems. The amount of principal to be collected over each of the next 5 years is $183,000 per year with the remaining amount collectible thereafter of $495,000.

7. Income Per Common Share

Basic income per share is calculated by dividing net income by the weighted average number of outstanding common shares during the year. Basic income per share excludes any dilutive effects of options, warrants and other stock-based compensation.

8. 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 periods. Actual results could differ from those estimates.

9. Share Based Payments

Stock-Based Compensation

Effective December 31, 2005, the Company adopted the provisions of Financial Accounting Standards Board Statement of Financial Accounting Standard ("SFAS") No. 123(R), "Share-Based Payments," which establishes the accounting for employee stock-based awards. Under the provisions of SFAS No.123(R), stock-based compensation is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the requisite employee service period (generally the vesting period of the grant). The Company adopted SFAS No. 123(R) using the modified prospective method and, as a result, periods prior to December 31, 2005 have not been restated. The Company recognized stock-based compensation for awards issued under the Company's stock option plans in other income/expenses included in the Condensed Consolidated Statement of Operations. Additionally, no modifications were made to outstanding stock options prior to the adoption of SFAS No. 123(R), and no cumulative adjustments were recorded in the Company's financial statements.

Prior to December 31, 2005, the Company accounted for stock-based compensation in accordance with provisions of Accounting Principles Board Opinion No. 25 ("APB No. 25"), "Accounting for Stock Issued to Employees," and related interpretations. Under APB No. 25, compensation cost was recognized based on the difference, if any, on the date of grant between the fair value of the Company's stock and the amount an employee must pay to acquire the stock. The Company grants stock options at an exercise price equal to 100% of the market price on the date of grant. Accordingly, no compensation expense was recognized for the stock option grants in periods prior to the adoption of SFAS No. 123(R).

Unearned compensation represents shares issued to executives that will be vested over a 5-6 year period. These shares will be amortized over the vesting period in accordance with FASB 123(R). The expense related to the vesting of unearned compensation was $77,000 and $18,000 at March 31, 2007 and March 31, 2006, respectively.

SFAS No. 123(R) requires disclosure of pro-forma information for periods prior to the adoption. The pro-forma disclosures are based on the fair value of awards at the grant date, amortized to expense over the service period. The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation", for the period prior to the adoption of SFAS No. 123(R), and the actual effect on net income and earnings per share for the period after the adoption of SFAS No. 123(R).

	Three Months Ended	
	03/31/07	03/31/06
Net income, as reported	$ 1,422,000	$ 1,694,000
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	77,000	11,000
	(77,000)	(11,000)

Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects				
Net income, pro forma	$	1,422,000	$	1,694,000
Earning per share:				
Basic, as reported	$	0.11	$	0.13
Basic, pro forma	$	0.11	$	0.13
Diluted, as reported	$	0.10	$	0.13
Diluted, pro forma	$	0.10	$	0.13

For the purpose of the above table, the fair value of each option granted is estimated as of the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended	
	March 31, 2007	March 31, 2006
Dividend yield	0.0%	0.0%
Expected volatility	0.70	0.70
Risk-free interest rate	4.70%	4.5%
Expected life in years	1-5	1-5

The following summarizes the stock option activity for the Three Months ended March 31, 2007:

	March 31, 2007		
	Shares	Weighted Average Exercise Price	Weighted Average Contractual Term (Years)
Outstanding, December 31, 2006	321,579	3.76	
Options granted			
Options reinstated			
Options exercised	(27,500)	0.89	
Options forfeited or expired			
Outstanding March 31, 2007	294,079	4.16	3.01
Options exercisable, March 31, 2007	204,077	2.75	2.63
Options available for grant at end of year	928,421		

10. Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, “Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140.” SFAS No. 155 resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, “Application of Statement 133 to Beneficial Interests in Securitized Financial Assets,” and permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interests in securitized financial assets to

identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of the first fiscal year that begins after September 15, 2006. This standard did not have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140." SFAS No. 156 requires an entity to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract under a transfer of the servicer's financial assets that meets the requirements for sale accounting, a transfer of the servicer's financial assets to a qualified special-purpose entity in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale or trading securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and an acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer or its consolidated affiliates. Additionally, SFAS No. 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, permits an entity to choose either the use of an amortization or fair value method for subsequent measurements, permits at initial adoption a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights and requires separate presentation of servicing assets and liabilities subsequently measured at fair value and additional disclosures for all separately recognized servicing assets and liabilities. SFAS No. 156 is effective for transactions entered into after the beginning of the first fiscal year that begins after September 15, 2006. This standard did not have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements, ("FAS 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The adoption of FAS 157 is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

The FASB also issued in September 2006 Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans — an amendment of FASB Statement No. 87, 88, 106 and 132(R), ("FAS 158") . This Standard requires recognition of the funded status of a benefit plan in the statement of financial position. The Standard also requires recognition in other comprehensive income certain gains and losses that arise during the period but are deferred under pension accounting rules, as well as modifies the timing of reporting and adds certain disclosures. FAS 158 provides recognition and disclosure elements to be effective as of the end of the fiscal year after December 15, 2006 and measurement elements to be effective for fiscal years ending after December 15, 2008. The Company has not yet analyzed the impact FAS 158 will have on its financial condition, results of operations, cash flows or disclosures.

In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 108, "Quantifying Misstatements." SAB 108 provides interpretative guidance on how public companies quantify financial statement misstatements. There have been two common approaches used to quantify such errors. Under an income statement approach, the "roll-over" method, the error is quantified as the amount by which the current year income statement is misstated. Alternatively, under a balance sheet approach, the "iron curtain" method, the error is quantified as the cumulative amount by which the current year balance sheet is misstated. In SAB 108, the SEC established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company's financial statements and the related financial statement disclosures. This model is commonly referred to as a "dual approach" because it requires quantification of errors under both the roll-over and iron curtain methods. SAB 108 is effective for the first fiscal year ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on the Company's consolidated financial position and results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 is not expected to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

11. Revenue Recognition

Revenue is recognized for product sales upon shipment and passing of risk to the customer and when estimates of discounts, rebates, promotional adjustments, price adjustments, returns, and other potential adjustments are reasonably determinable, collection is reasonably assured and the Company has no further performance obligations. These estimates are presented in the financial statements as reductions to net revenues and accounts receivable. Estimated sales returns, allowances and discounts are provided for.

Outbound shipping charges to customers and outbound shipping-related costs are netted and included in "cost of sales."

Returns - Consistent with industry practice, the Company maintains a return policy that allows its customers to return product within a specified period (30 days). Because the period of payment generally approximates the period revenue was originally recognized, refunds are recorded as a reduction of revenue when paid. The Company's estimate for

returns is based upon its historical experience with actual returns. While such experience has allowed for reasonable estimation in the past, history may not always be an accurate indicator of future returns. The Company continually monitors its estimates for returns and makes adjustments when it believes that actual product returns may differ from the established accruals.

Management Discussion and Analysis of
Financial Condition and Results of Operations

Except for the historical information contained herein, this Report on Form 10-Q contains certain forward-looking statements that involve substantial risks and uncertainties. When used in this Report, the words "anticipate," "believe," "estimate," "expect" and similar expressions, as they relate to Medifast, Inc. or its management, are intended to identify such forward-looking statements. The Company's actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. Accordingly, there is no assurance that the results in the forward-looking statements will be achieved.

General
Three Months Ended March 31, 2007 and March 31, 2006

Revenue: Revenue increased to $20.1 million for the first three months of 2007 as compared to $19.2 million for the first three months of 2006, an increase of $900,000 or 5%. The direct marketing sales channel accounted for 60% of total revenue, Take Shape for Life 30%, doctors 5%, and clinics 5%. As compared to the first three months of 2006, the direct response sales channel revenue increased by 4%. Direct response is normally fueled primarily by consumer advertising, however, in the first quarter of 2006 it was also fueled largely by a substantial editorial placement in a major consumer publication at no cost to the Company. Take Shape for Life sales, which are fueled by person-to-person recruiting and support increased by 6% year-over-year. The Company's clinic division which began operating under the Medifast Weight Control Center name in late 2006, increased sales by 21% as compared to the first quarter of 2006.

Throughout the fourth quarter of 2006, the Company expanded the direct response marketing department to evaluate and analyze the past year's media effectiveness and to more effectively spend the Company's increased advertising budget in 2007. In the fourth quarter of 2006, the Company analyzed the past years overall campaign metrics such as response rates, closing rates and media costs in order to improve on these metrics moving forward. The first quarter of 2007 was largely spent applying knowledge gained from this analysis to utilize the most effective aspects of the 2006 advertising campaigns. This was done to both show the improvements in the campaigns execution, while also utilizing the first quarter to create new advertising campaigns that were launched at the end of the first quarter and will continue to roll out with larger spend throughout the remainder of 2007. This strategy, led to improved month-to-month return on advertising dollars throughout the first quarter of 2007. As compared to our 2006 advertising campaign, the 2007 campaign includes new 60 second TV commercials, long-form television infomercials, an expanded presence on the web, and new creative for our print and radio advertisements. The Company anticipates the quarterly advertising budget to increase throughout the second and third quarter of 2007. In the first quarter of 2007, the Company spent $4.3 million on direct response marketing.

The Take Shape for Life network grew 6% year-over-year as the Company continues focusing on providing tools to help the network recruit additional health coaches. The Company made substantial investment in 2006 to provide the health coaches with a comprehensive business tool that will drive recruiting within the Organization as well as lead to a higher lifetime value of customers and health coaches. In Q1 of 2007, the Take Shape for Life Network was in the beginning stages of recruiting growth and this will remain a focus throughout the remainder of 2007.

Medifast Weight Control Centers are currently operating in 10 locations in Texas and Florida. In Q1 of 2007, the Clinics realized sales growth of 21% compared to Q1 of 2006. Additional clinics will be opened in Florida and Texas throughout Q2 and Q3. This model will be available for franchise opportunities toward the end of the second quarter.

Throughout the fourth quarter of 2006 and the first quarter of 2007, the Company has continued to invest in the executive expertise necessary to drive the Medifast direct response and Take Shape for Life models, which represent

90% of the total business revenue, along with the Information Technology infrastructure expertise to support both of these hi-tech business models. The hiring of Richard Zeeb, VP of Direct Response Marketing, Rodman Heckman, EVP Take Shape for Life, and John Hamilton, Chief Information Officer, who each have extensive years of specific industry experience has provided the Company the expertise needed in each of these critical areas. The timing of these hires did not allow them to have their full potential impact on the business in the first quarter of 2007, however, we expect based on current Company trends and these individuals industry histories, that the Company will recognize significant improvements in their division's effectiveness in both the short and long term.

Costs and Expenses: Cost of revenue increased $280,000 to $5.1 million in the first three months of 2007 from $4.8 million in 2006. As a percentage of sales, gross margin remained at approximately 75% for the first quarter of 2007 and 2006.

Other Income/Expense: Stock compensation expense for the first three months of 2006 was $241,000 as compared to $33,000 in 2006. This expense represents the vesting of share-based compensation to key executives over five and six year terms. The Company has reviewed unvested options and concluded that the effects of FASB 123R are immaterial.

Income taxes**:** For the first three months of 2007, we recorded $565,000 in income tax expense, which represents an annual effective rate of 28%. For the first three months of 2006, we recorded income tax expense of $1.1 million which reflected an estimated annual effective tax rate of 39%. The Company anticipates a tax rate of approximately 36-38% in 2007.

Net income: Net income was $1.4 million in the first three months of 2007 as compared to $1.7 million in the first three months of 2006, which reflected a decrease of $300,000 or 18%.

Seasonality

The Company's weight management products and programs have historically been subject to seasonality. Traditionally the holiday season in November/December of each year is considered poor for diet control products and services. January and February generally show increases in sales, as these months are considered the commencement of the "diet season." In 2007, seasonality has not been a significant factor. This is largely due to the increase in the consumer's awareness of the overall health and nutritional benefits accompanied with the use of the Company's product line. As consumers continue to increase their association of nutritional weight loss programs with overall health, seasonality will continue to decrease.

Inflation

To date, inflation has not had a material effect on the Company's business.

Item 5. Other Information

Litigation**:**

There was no material pending or threatened litigation as of 3/31/07.

Earnings Per Share: The Company follows the provisions of Statement of Financial Accounting Standards No. 128, "Earnings Per Share." The calculation of basic and diluted earnings per share ("EPS") is reflected on the accompanying Consolidated Statement of Operations.

Code of Ethics: In September 2002, the Company implemented a Code of Ethics by which directors, officers and employees commit and undertake to personal and corporate growth, dedicate themselves to excellence, integrity and responsiveness to the marketplace, and work together to enhance the value of the Company for the shareholders, vendors, and customers.

Trading Policy: In March 2003, the Company implemented a Trading Policy whereby if a director, officer or employee has material non-public information relating to the Company, neither that person nor any related person may buy or sell securities of the Company or engage in any other action to take advantage of, or pass on to others, that information. Additionally, on October 16, 2006 the Board of Directors approved an updated trading policy in which insiders may purchase or sell MED securities if such purchase or sale is made 7 days after or 14 days before an earnings announcement to include the 10-K or 10-Q in order to insure that investors have available the same information necessary to make investment decisions as insiders.

Internal Control Policy: As of March 31, 2007, the Company's management, with the participation of the Chief Executive Officer and Chief Financial Officer, performed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the design and operation of these disclosure controls and procedures were effective as of the end of the period covered by this report. In connection with this evaluation, no change in the Company's internal control over financial reporting was identified that occurred during the period covered by this report that has materially affected, or is reasonably likely to affect the

Company's internal control over financial reporting.

Forward Looking Statements: Some of the information presented in this quarterly report constitutes forward-looking statements within the meaning of the private Securities Litigation Reform Act of 1995. Statements that are not historical facts, including statements about management's expectations for fiscal year 2003 and beyond, are forward-looking statements and involve various risks and uncertainties. Although the Company believes that its expectations are based on reasonable assumptions within the bounds of its knowledge, there can be no assurance that actual results will not differ materially from the Company's expectations. The Company cautions investors not to place undue reliance on forward-looking statements which speak only to management's experience on this data.

Index to Exhibits

Exhibit Number	Description of Exhibit
31.1	Certification of Chief Executive Officer pursuant to Item 601(b)(31) of Regulation S-K, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Item 601(b)(31) of Regulation S-K, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002