1. Nature of Business and Significant Accounting Policies

Nature of Business

Relìv International, Inc. (the Company) produces a proprietary line of nutritional supplements addressing basic nutrition, specific wellness needs, weight management, and sports nutrition. These products are sold by subsidiaries of the Company to a sales force of independent distributors and licensees of the Company that sell products directly to consumers. The Company and its subsidiaries sell products to distributors throughout the United States and in Australia, Canada, New Zealand, Mexico, the United Kingdom/Ireland, Germany, the Philippines, Malaysia, and Singapore.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its foreign and domestic subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Inventories

Inventories are valued at the lower of cost or market. Product cost includes raw materials, labor, and overhead costs and is accounted for using the first-in, first-out basis. On a periodic basis, the Company reviews its inventory levels, as compared to future demand requirements and the shelf life of the various products. Based on this review, the Company records inventory write-downs when necessary.

Property, Plant, and Equipment

Property, plant, and equipment are stated on the cost basis. Depreciation is computed using the straight-line or an accelerated method over the useful life of the related assets, including assets recorded under capital leases. Generally, computer equipment and software are depreciated over 5 years, office equipment and machinery over 7 years, and real property over 39 years.

Foreign Currency Translation

All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statements of income amounts have been translated using the average exchange rate for the year. The gains and losses resulting from the changes in exchange rates from year to year have been reported in other comprehensive loss. The foreign currency translation adjustment is the only component of accumulated other comprehensive loss. Foreign currency translation adjustments exclude income tax expense (benefit) given that the Company's investments in non-U.S. subsidiaries are deemed to be reinvested for an indefinite period of time. The transaction losses/(gains) were $268,436, ($99,628), and ($63,273) for 2005, 2004, and 2003, respectively.

Revenue Recognition

The Company receives payment by credit card, personal check, or guaranteed funds for orders from independent distributors and makes related commission payments in the following month. The net sales price is the suggested retail price less the distributor discount of 20 percent to 40 percent of such suggested retail price. Sales revenue and commission expenses are recorded when the merchandise is shipped, as this is the point title and risk of loss pass. In accordance with EITF 01-09, the Company presents distributor royalty and commission expense as an operating expense, rather than a reduction to net sales, as these payments are not made to the purchasing distributor.

Actual and estimated returns are classified as a reduction of net sales. The Company estimates and accrues a reserve for product returns based on the Company's return policy and historical experience. The Company records shipping and handling revenue as a component of sales and records shipping and handling costs as a component of cost of products sold.

Income Taxes

The provision for income taxes is computed using the liability method. The primary differences between financial statement and taxable income result from financial statement accruals and reserves and differences between depreciation for book and tax purposes.

Basic and Diluted Earnings per Share

Basic earnings per common share are computed using the weighted average number of common shares outstanding during the year. Diluted earnings per common share are computed using the weighted average number of common shares and potential dilutive common shares that were outstanding during the period. Potential dilutive common shares consist of outstanding stock options, outstanding stock warrants, and convertible preferred stock. See Note 7 for additional information regarding earnings per share.

Stock-Based Compensation

The Company has a stock option plan for employees and eligible directors allowing for incentive and non-qualified stock options, which are described more fully in Note 6. Effective January 1, 2003, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure," which allows the Company to continue to account for stock option plans under the intrinsic value method in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and related Interpretations. Accordingly, no stock-based employee compensation cost is reflected in net income, as all options granted under the Company's current or prior plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

Pursuant to the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, pro forma net income and earnings per share are presented in the table below as if compensation cost for stock options was determined as of the grant date under the fair value method:

Year ended December 31	2005	2004	2003
Basic:			
Net income available to common shareholders, as reported	$7,521,416	$5,374,397	$4,340,678
Deduct: total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects	1,645,036	52,125	194,507
Pro forma net income available to common shareholders	$5,876,380	$5,322,272	$4,146,171
Diluted:			
Net income available to common shareholders, as reported	$7,521,416	$5,386,689	$4,397,440
Deduct: total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects	1,645,036	52,125	194,507
Pro forma net income available to common shareholders	$5,876,380	$5,334,564	$4,202,933
Earnings per share:			
Basic—as reported	$0.47	$0.34	$0.29
Basic—pro forma	$0.37	$0.34	$0.28
Diluted—as reported	$0.46	$0.31	$0.26
Diluted—pro forma	$0.36	$0.31	$0.25

The Company accounts for options granted to non-employees and warrants granted to distributors under the fair value approach required by EITF 96-18, "Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods, or Services."

The compensation expense associated with the fair value of the options calculated for the years ended December 31, 2005, 2004 and 2003, is not necessarily representative of the potential effects on reported net income in future years. The fair value of each option grant is estimated on the date of the grant by use of the Black-Scholes option pricing model.

Advertising

Costs of sales aids and promotional materials are capitalized as inventories. All other advertising and promotional costs are expensed when incurred. The Company recorded $52,000, $64,000, and $35,000 of advertising expense in 2005, 2004, and 2003, respectively.

Research and Development Expenses

Research and development expenses which are charged to selling, general, and administrative expenses as incurred were $558,000, $525,000, and $493,000 in 2005, 2004, and 2003, respectively.

Cash Equivalents

The Company's policy is to consider demand deposits and short-term investments with a maturity of three months or less when purchased as cash equivalents.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

New Accounting Pronouncements

Share-Based Payments

In December 2004, the FASB issued SFAS No. 123 (R), "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock Based Compensation," and supersedes APB No. 25. Among other items, SFAS No. 123 (R) eliminates the use of APB No. 25 and the intrinsic value method of accounting and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements.

The effective date of SFAS No. 123 (R) for the company is the first annual reporting period beginning after June 15, 2005. SFAS No. 123 (R) permits companies to adopt its requirements using either a "modified prospective" method or a "modified retrospective" method. Under the "modified prospective" method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS No. 123 (R) for all share-based payments granted after that date and based on the requirements of SFAS No. 123 for all unvested awards granted prior to the effective date of SFAS No. 123 (R).

The Company adopted SFAS No. 123 (R) beginning on January 1, 2006 using the modified prospective method. This change in accounting is not expected to materially impact our financial position. However, because the Company currently accounts for share-based payments to the Company's employees using the intrinsic value method, the Company's results of operations have not included the recognition of compensation expense for the issuance of stock option awards. Had the Company applied the fair-value criteria established by SFAS No. 123 (R) to previous stock option grants, the impact to the Company's results of operations would have approximated the impact of applying SFAS No. 123, which was a reduction to net income of approximately $1,645,000 in 2005, $52,000 in 2004, and $195,000 in 2003. The impact of applying SFAS No. 123 to previous stock option grants is further summarized above. The Company expects the recognition of compensation expense for stock options previously issued, unvested and outstanding at December 31, 2005 to reduce fiscal year 2006 net earnings by approximately $63,000.

SFAS No. 123 (R) also requires the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options.

Inventory Costs

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs,” which clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The provisions of SFAS No. 151 apply prospectively and are effective for inventory costs incurred after January 1, 2006. While the Company believes that SFAS No. 151 will not have a material effect on its consolidated financial position and results of operations, the impact of adopting these new rules is dependent on events that could occur in future periods, and cannot be determined until the event occurs in future periods.

Income Taxes

On December 21, 2004, the FASB issued two FSP’s regarding the accounting implications of the American Jobs Creation Act of 2004. FSP No. 109-1, “Application of FASB Statement No. 109 ‘Accounting for Income Taxes’ to the Tax Deduction on Qualified Production Activities Provided by the American Job Creation Act of 2004” is effective for fiscal year 2005 and is described in Note 11. FSP No. 109-2, “Accounting and Disclosure Guidance for the Foreign Provision within the American Jobs Creation Act of 2004” became effective in fiscal year 2004 and is also described in Note 11.

Reclassifications

Certain reclassifications have been made to the 2004 and 2003 financial statements to conform to the 2005 presentation.

2. Property, Plant, and Equipment

Property, plant, and equipment at December 31, 2005 and 2004, consist of the following:

	2005	2004
Land	$ 829,222	$ 829,222
Building	9,553,311	9,027,577
Machinery and equipment	4,736,274	4,926,048
Office equipment	1,400,544	1,092,285
Computer equipment and software	2,536,415	2,719,065
	19,055,766	18,594,197
Less accumulated depreciation and amortization	8,915,325	8,626,048
	$10,140,441	$ 9,968,149

3. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses at December 31, 2005 and 2004, consist of the following:

	2005	2004
Trade payables	$ 3,165,871	$ 3,155,071
Distributors' commissions	3,578,405	3,561,110
Sales taxes	518,870	493,571
Interest expense	31,000	18,000
Payroll and payroll taxes	864,624	598,321
	$ 8,158,770	$ 7,826,073

4. Short-Term Borrowings

In June 2005, the Company entered into a new $15 million revolving line of credit facility with the Company’s primary lender. This new facility replaced the Company’s previous operating line of credit that had a maximum borrowing limit of $1 million. The new facility expires in April 2007, and any advances accrue interest at a variable interest rate based on LIBOR. The new facility includes covenants to maintain total stockholders’ equity of not less than $10.5 million, and that the borrowings under the facility shall not exceed EBITDA by a ratio

of 3.5:1. A commitment fee in an amount equal to 0.25% per year is payable quarterly on the average daily-unused portion of the revolver. At December 31, 2005, the Company had not utilized any of the new revolving line of credit facility and was in compliance with the minimum stockholders' equity covenant.

5. Long-Term Debt

Long-term debt at December 31, 2005 and 2004, consists of the following:

	2005	2004
Term loan payable in monthly installments of $24,955, (plus interest at prime); secured by land and building (net book value of $5,701,000 at December 31, 2004); balance due paid June 2005	$ —	$ 3,627,413
Promissory note payable to a former officer/director payable in annual installments, interest payable quarterly at 4% per annum (see Note 15)	3,100,000	—
Notes payable — primarily vehicle loans	27,309	56,173
	3,127,309	3,683,586
Less current maturities	916,244	325,895
	$ 2,211,065	$ 3,357,691

Principal maturities of long-term debt at December 31, 2005 are as follows:

2006	$ 916,244
2007	911,065
2008	1,300,000
	$3,127,309

6. Stockholders' Equity

Stock Split

The Board of Directors declared a five-for-four stock split on September 4, 2003. The dividends were paid on November 14, 2003, to stockholders of record on October 29, 2003. Average shares outstanding, all per share amounts, and stock option and warrant data included in the accompanying consolidated financial statements and notes are based on the increased number of shares as restated for the stock split.

Stock Options

The Company sponsors a stock option plan (the "2003 Plan") allowing for incentive stock options and non-qualified stock options to be granted to employees and eligible directors. The plan has been approved by the stockholders of the Company. The 2003 Plan provides that 1,000,000 shares may be issued under the plan at an option price not less than the fair market value of the stock at the time the option is granted. The 2003 Plan expires on March 20, 2013. The options vest pursuant to the schedule set forth for the plan. In 2005, the Company issued grants of 543,000 shares under the 2003 Plan. The 2005 option grants were fully vested in the year of grant. As of December 31, 2005, 457,000 shares remain available for grant under the 2003 Plan.

The Company grants stock options for a fixed number of shares to directors and employees with an exercise price equal to the fair value of the shares at the time of the grant. Accordingly, the Company has not recognized compensation expense for its stock option grants.

For the purposes of the pro forma disclosures in Note 1, the estimated fair value of the options is recognized as compensation expense over the options' vesting period. The fair value of the options granted in 2005 were estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions: risk-free interest rates ranging from 4.02% to 4.31%; dividend yield ranging from 0.55% to 0.80%; volatility factor of the expected price of the Company's stock ranging from 0.448 to 0.516; and a weighted average expected life of 7.0 years. The weighted average fair value of options granted during 2005 was $4.19 per share.

There were no options granted during the years ended December 31, 2004, 2003, and 2002. As of December 31, 2005, there exist unexercised stock options from grants made in 2001 under a prior stock option plan. The fair value of options granted in 2001 were estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions: risk-free interest rates ranging from 3.07% to 4.78%; dividend yield of zero; volatility factor of the expected price of the Company's stock of 0.729; and a weighted average expected life of 4.51 years. The weighted average fair value of options granted during 2001 was $0.42 per share.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility.

A summary of the Company's stock option activity and related information for the years ended December 31 follows:

	2005		2004		2003	
	Options	Weighted Avg. Exercise Price	Options	Weighted Avg. Exercise Price	Options	Weighted Avg. Exercise Price
Outstanding beginning of the year	985,114	$0.73	2,413,433	$0.91	2,897,171	$0.94
Granted	543,000	7.97	—		—	
Exercised	(710,286)	0.72	(1,428,319)	1.04	(483,738)	1.08
Forfeited	(4,754)	0.71	—		—	
Outstanding at end of year	813,074	$5.57	985,114	$0.73	2,413,433	$0.91
Exercisable at end of year	684,354		727,676		2,034,671	

As of December 31, 2005:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Avg. Remaining Life	Weighted Avg. Exercise Price	Number Exercisable	Weighted Avg. Exercise Price
$0.71–$0.78	270,074	0.53	$0.74	141,354	$0.71
$7.92–$8.68	543,000	9.05	$7.97	543,000	$7.97
$0.71–$8.68	813,074	6.22	$5.57	684,354	$6.47

Of the options exercised in 2005, 523,344 shares were paid with 44,960 mature shares of Company stock, owned six months or greater. In 2004, options for 1,183,438 shares were paid with 157,656 mature shares. In 2003, options for 202,248 shares were paid with 42,332 mature shares. These shares tendered as payment were valued at the fair market price on the date of exercise.

Distributor Stock Purchase Plan

In November 1998, the Company established a Distributor Stock Purchase Plan. The plan allows distributors who have reached the "Ambassador" status the opportunity to allocate up to 10% of their monthly compensation into the plan to be used to purchase the Company's common stock at the current market value. The plan also states that at the end of each year, the Company will grant warrants to purchase additional shares of the Company's common stock based on the number of shares purchased by the distributors under the plan during the year. The warrant exercise price will equal the market price for the Company's common stock at the date of issuance. The warrants issued shall be in the amount of 25% of the total shares purchased under the plan during the year. This plan commenced in January 1999, and a total of 25,303, 22,959 and 27,279 warrants were issued during the years ended December 31, 2005, 2004, and 2003, respectively. The warrants are fully vested upon grant. The weighted average fair values of warrants granted during 2005, 2004, and 2003 were $4.04, $2.94 and $2.33 per share, respectively.

The Company records expense under the fair value method of SFAS No. 123 for warrants granted to distributors. The adoption of SFAS No. 123(R) is not expected to significantly impact the accounting treatment of warrants granted under the plan. Total expense recorded for these warrants was $66,674, $77,367, and $90,068 in 2005, 2004, and 2003, respectively. The fair value of the warrants was estimated at the date of grant using a Black-Scholes option pricing model with the following assumptions:

Year ended December 31	2005	2004	2003
Expected warrant life (years)	2.5	2.5	2.5
Risk-free weighted average interest rate	4.37%	3.08%	1.84%
Stock price volatility	0.448	0.516	0.743
Dividend yield	0.6%	0.8%	0.0%

A summary of the Company's warrant activity and related information for the years ended December 31 follows:

	2005		2004		2003	
	Warrants	Weighted Avg. Exercise Price	Warrants	Weighted Avg. Exercise Price	Warrants	Weighted Avg. Exercise Price
Outstanding beginning of the year	76,852	$ 5.70	137,957	$ 2.51	162,679	$ 1.56
Granted	25,303	13.18	22,959	8.94	27,279	5.12
Exercised	(35,347)	3.94	(83,675)	1.35	(52,001)	0.92
Forfeited	(89)	3.73	(389)	0.84	—	
Outstanding at end of year	66,719	$ 9.47	76,852	$ 5.70	137,957	$ 2.51
Exercisable at end of year	66,719		76,852		113,899	

As of December 31, 2005:

	Warrants Outstanding			Warrants Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Avg. Remaining Life	Weighted Avg. Exercise Price	Number Exercisable	Weighted Avg. Exercise Price
$5.12	18,829	1.00	$ 5.12	18,829	$ 5.12
$8.94	22,587	2.00	8.94	22,587	8.94
$13.18	25,303	3.00	13.18	25,303	13.18
$5.12–$13.18	66,719	2.10	$ 9.47	66,719	$ 9.47

Sale of Preferred Stock

On March 31, 2003, the Company sold an aggregate of 150,000 shares of preferred stock to three executive officers/directors. The "Series A Preferred Stock" ("Preferred Stock"), was designated by the Company's Board of Directors out of the 3,000,000 previously authorized shares of $0.001 par value preferred stock. Each of the preferred stockholders purchased 50,000 shares of Preferred Stock for $500,000 ($10.00 per share).

The preferred stockholders were entitled to receive dividends at an annual rate of 6% of the shares' purchase price. These dividends accrued on a daily basis and were payable quarterly when declared by the Company's Board of Directors. All dividends on shares of Preferred Stock were cumulative.

In August 2003, the Company redeemed 17,500 shares from each executive officer/director for a total redemption of 52,500 shares at a value of $525,000. In February 2004, the Company redeemed an additional 15,000 shares from each executive officer/director for a total redemption of 45,000 shares at a value of $450,000. In April 2004, the Company redeemed the remaining 17,500 shares from each officer/director for a total redemption of 52,500 shares at a value of $525,000.

7. Earnings per Share

The following table sets forth the computation of basic and diluted earnings per share:

Year ended December 31	2005	2004	2003
Numerator:			
Numerator for basic and diluted earnings per share — net income available to common shareholders	$7,521,416	$5,374,397	$4,340,678
Effect of convertible preferred stock:			
Dividends on preferred stock	—	12,292	56,762
Numerator for diluted earnings per share	$7,521,416	$5,386,689	$4,397,440
Denominator:			
Denominator for basic earnings per share — weighted average shares	15,885,000	15,662,000	14,969,000
Effect of convertible preferred stock and dilutive securities:			
Convertible preferred stock	—	52,000	237,000
Employee stock options and warrants	503,000	1,423,000	1,500,000
Denominator for diluted earnings per share — adjusted weighted average shares	16,388,000	17,137,000	16,706,000
Basic earnings per share	$0.47	$0.34	$0.29
Diluted earnings per share	$0.46	$0.31	$0.26

8. Leases

The Company leases certain manufacturing, storage, office facilities, equipment, and automobiles. These leases have varying terms, and certain leases have renewal and/or purchase options. Future minimum payments under non-cancelable leases with initial or remaining terms in excess of one year consist of the following at December 31, 2005:

2006	$ 65,785
2007	64,679
2008	28,388
2009	19,416
2010	8,090
	$186,358

Rent expense for all operating leases was $57,632, $75,529, and $161,792 for the years ended December 31, 2005, 2004, and 2003, respectively.

9. Fair Value of Financial Instruments

The carrying values and fair values of the Company's financial instruments are approximately as follows:

	2005		2004	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	$5,654,000	$5,654,000	$10,152,000	$10,152,000
Long-term debt, including current maturities	3,127,000	3,077,000	3,684,000	3,686,000

The carrying amount of cash equivalents approximates fair value because of the short maturity of those instruments. The fair value of long-term debt and capital lease obligations is estimated based on the current rates offered to the Company for debt of the same remaining maturities.

10. Derivative Financial Instruments

The Company has various transactions with its foreign subsidiaries that are denominated in U.S. dollars and are subject to foreign currency exchange risk on these transactions.

The Company uses foreign currency exchange contracts to reduce its exposure to fluctuations in foreign exchange rates. The Company bases these contracts on the amount of cash flows that it expects to be remitted to the United States from its foreign operations and does not use such derivative financial instruments for trading or speculative purposes. The Company accounts for these contracts as free standing derivatives, such that gains or losses on the fair market value of these forward exchange contracts as of the balance sheet dates are recorded as other income and expense in the consolidated statements of income.

At December 31, 2005, the Company held forward exchange contracts totaling $978,000 with maturities through December 2006. All such contracts were denominated in Canadian dollars. The aggregate accrued loss on these contracts was $59,000 and $101,000 as of December 31, 2005 and 2004, respectively. The increase (decrease) in the aggregate accrued loss on these contracts was ($42,000), $55,000, and $46,000 for the years ended December 31, 2005, 2004, and 2003, respectively.

11. Income Taxes

The components of income before income taxes are as follows:

Year ended December 31	2005	2004	2003
United States	$15,186,474	$9,548,384	$7,731,363
Foreign	(2,687,058)	(540,695)	(431,923)
	$12,499,416	$9,007,689	$7,299,440

The components of the provision for income taxes are as follows:

Year ended December 31	2005	2004	2003
Current:			
Federal	$4,594,000	$2,963,000	$2,657,000
State	705,000	392,000	351,000
Foreign	45,000	44,000	(26,000)
Total current	5,344,000	3,399,000	3,034,000
Deferred:			
Federal	(327,000)	138,000	(88,000)
State	(39,000)	18,000	(12,000)
Foreign	—	66,000	(32,000)
Total deferred	(366,000)	222,000	(132,000)
	$4,978,000	$3,621,000	$2,902,000

The provision for income taxes is different from the amounts computed by applying the United States federal statutory income tax rate of 34%. The reasons for these differences are as follows:

Year ended December 31	2005	2004	2003
Income taxes at U.S. statutory rate	$4,250,000	$3,063,000	$2,482,000
State income taxes, net of federal benefit	666,000	410,000	339,000
Effect of foreign losses without an income tax benefit	50,000	126,000	58,000
Foreign corporate income taxes	45,000	45,000	—
Executive life insurance expense	33,000	8,000	(8,000)
Meals and entertainment	41,000	40,000	37,000
Extraterritorial income exclusion	(33,000)	(68,000)	—
Qualified production activities income – American Jobs Creation Act	(73,000)	—	—
Other	(1,000)	(3,000)	(6,000)
	$4,978,000	$3,621,000	$2,902,000

The Company's effective tax rate is based on expected income, statutory tax rates and tax planning opportunities available to the Company in the various jurisdictions in which the Company operates. Significant judgment is required in determining the Company's effective tax rate and in evaluating its tax positions. In evaluating the exposure associated with various filing positions, the Company estimates reserves for probable exposures, which are adjusted quarterly in light of changing facts and circumstances, such as the progress of tax audits, case law and emerging legislation.

The components of the deferred tax assets and liabilities, and the related tax effects of each temporary difference at December 31, 2005 and 2004, are as follows:

	2005	2004
Deferred tax assets:		
Product refund reserve	$ 145,000	$ 99,000
Inventory obsolescence reserve	60,000	2,000
Vacation accrual	21,000	20,000
Compensation expense for warrants granted	42,000	37,000
Organization costs	70,000	54,000
Deferred compensation	406,000	352,000
Miscellaneous accrued expenses	39,430	25,430
Foreign net operating loss carryforwards	1,813,000	1,328,000
Valuation allowance	(1,764,000)	(1,125,000)
	832,430	792,430
Deferred tax liabilities:		
Depreciation	469,000	641,000
Inventories	—	154,000
Net deferred tax assets (liabilities)	$ 363,430	$ (2,570)

The Company has a deferred tax asset of $1,813,000, as of December 31, 2005, and $1,328,000 as of December 31, 2004, relating to foreign net operating loss carryforwards. The Company has recorded a valuation allowance to the extent that it is more likely than not that some portion of this asset will not be realized before it expires beginning in 2006.

On October 22, 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. In December 2004, the FASB issued Staff Position No. 109-1, "Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004," ("FSP No. 109-1"). FSP No. 109-1 provides accounting guidance for companies that will be eligible for a tax deduction resulting from "qualified production activities income" as defined in the Act. For 2005, the application of FSP No. 109-1 provided a tax benefit of approximately $73,000 and reduced the company's effective tax rate approximately 0.6%.

Another provision of the Act provides for a special one-time tax deduction of 85% of certain repatriated foreign earnings. In December 2004, the FASB issued Staff Position No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004," ("FSP No. 109-2"). The Company did not take advantage of this special provision. Through December 31, 2005, the Company has not recorded a provision for income taxes on the earnings of its foreign subsidiaries because such earnings are intended to be permanently reinvested outside the U.S. The cumulative amount of unremitted earnings on which the Company has not recognized United States income tax was $238,000 at December 31, 2005.

12. License Agreement

The Company has a license agreement with the individual who developed several of the Company's products. This agreement provides the Company with the exclusive worldwide license to manufacture and sell all products created by the licensor and requires monthly royalty payments of 5% of net sales, with a minimum payment of $10,000 and a maximum payment of $22,000. The royalty payments terminated upon the death of the licensor, which occurred in February 2003. However, under the terms of the license agreement, the Company has the right to continue to use the name and likeness of the licensor in connection with marketing the related products for an annual fee of $10,000 for the duration of the agreement. As a result, the amounts of the expense in the years ended December 31, 2005, 2004, and 2003, were $10,000, $10,000, and $54,000, respectively. The license agreement expired in April 2005.

13. Employee Benefit Plans

The Company sponsors a 401(k) employee savings plan which covers substantially all employees. Employees can contribute up to 15% of their gross income to the plan, and the Company matches 75% of the employee's contribution. Company contributions under the 401(k) plan totaled $384,000, $337,000, and $288,000 in 2005, 2004, and 2003, respectively.

14. Incentive Compensation Plans

In July 2001, the Board of Directors approved an incentive compensation plan effective for fiscal years beginning with 2001. Under the plan, the Company established a bonus pool payable on a semi-annual basis equal to 25% of the net income of the Company. Bonuses are payable on all profits, but only if the net income for each six-month period exceeds $250,000. The bonus pool is allocated to executives according to a specified formula, with a portion allocated to a middle management group determined by the Executive Committee of the Board of Directors. The Company expensed a total of $2,141,500, $1,580,000, and $1,309,500 to the participants of the bonus pool for 2005, 2004, and 2003, respectively.

The Company sponsors a Supplemental Executive Retirement Plan (SERP) to allow certain executives to defer a portion of their annual salary and bonus into a grantor trust. A grantor trust was established to hold the assets of the SERP. The Company funds the grantor trust by paying the amount deferred by the participant into the trust at the time of deferral. Investment earnings and losses accrue to the benefit or detriment of the participants. The SERP also provides for a discretionary matching contribution by the Company not to exceed 100% of the participant's annual contribution. In 2005, 2004, and 2003, the Company did not provide a match. The participants fully vest in the deferred compensation three years from the date they enter the SERP. The participants are not eligible to receive distribution under the SERP until retirement, death, or disability of the participant.

15. Related Party Transactions

An officer/director of the Company is a principal in a law firm which provides legal services to the Company. During the years ended December 31, 2005, 2004, and 2003, the Company incurred consulting fees to the officer/director and legal fees to his firm totaling approximately $429,000, $410,000, and $372,000, respectively.

In January 2004, the Company purchased a total of 116,564 shares of the Company's common stock from three officer/directors and one director. The total cost of the purchases was $607,178, for a weighted average purchase price of $5.21 per share. In April 2004, the Company purchased a total of 75,000 shares of the Company's common stock from two officer/directors. The total cost of the purchases was $686,802, for a weighted average purchase price of $9.16 per share. The price per share was based on a discount from the market price per share at the time of purchase in order to approximate the dilutive impact of their shares on the open market.

In March 2005, the Company entered into a stock redemption agreement with an officer/director and his spouse (collectively "Seller"). Under the stock redemption agreement, the Company issued promissory notes ("Notes") totaling $4,050,000 to the Seller in exchange for 450,000 shares of the Company's common stock ($9.00 per

share) owned by the Seller. Subsequently, in 2005, the Company made principal payments on the Notes totaling $950,000 resulting in a December 31, 2005 outstanding balance due on the Notes of $3,100,000. Additional principal payments of $900,000 are each due on March 31, 2006 and 2007, respectively, with a final principal payment of $1,300,000 due on January 15, 2008. Interest, at 4% per annum, accrues on the outstanding balance of the Notes and is payable quarterly.

In March 2005 and May 2005, the Company purchased a total of 574,201 shares of the Company's common stock from three officer/directors and one former officer. The total cost of the purchases was $5,435,313, for a weighted average purchase price of $9.47 per share. The price per share was based on a discount from the market price per share at the time of purchase in order to approximate the dilutive impact of their shares on the open market.

16. Subsequent Event

On February 21, 2006, the Company filed a registration statement on Form S-3 with the Securities and Exchange Commission relating to an underwritten public offering of 2,000,000 shares of its common stock. The Company proposes to issue 1,200,000 shares of its common stock and the remaining 800,000 shares are proposed to be offered by selling stockholders. In connection with the offering, some of the selling stockholders expect to grant the underwriters a 30-day option to purchase up to 300,000 additional shares of Company stock to cover over-allotments, if any.

The Company intends to use the net proceeds from the offering for the repayment of debt and for general corporate purposes, including working capital, continued domestic and international growth, and for possible product acquisitions. The Company will not receive any proceeds from the sale of common stock by the selling stockholders.

17. Segment Information

Description of Products and Services by Segment

The Company operates in one reportable segment, a network marketing segment consisting of seven operating units that sell nutritional and dietary products to a sales force of independent distributors that sell the products directly to customers. These operating units are based on geographic regions.

Geographic area data for the years ended December 31, 2005, 2004, and 2003, follows:

	2005	2004	2003
Net sales to external customers			
United States	$102,549,244	$83,873,430	$65,832,045
Australia/New Zealand	2,215,465	2,542,695	2,059,928
Canada	1,667,555	1,750,704	1,255,836
Mexico	1,607,473	2,634,394	3,338,071
United Kingdom	846,273	545,534	475,319
Malaysia/Singapore	2,031,045	2,770,664	579,988
Philippines	2,328,178	2,865,012	3,418,536
Germany	319,931	—	—
Total net sales	$113,565,164	$96,982,433	$76,959,723
Assets by area			
United States	$20,920,384	$25,315,646	$18,738,771
Australia/New Zealand	670,787	754,089	865,823
Canada	176,760	221,160	252,443
Mexico	1,323,482	1,834,229	2,300,299
United Kingdom	195,399	273,408	247,740
Malaysia/Singapore	1,414,909	1,716,929	1,353,677
Philippines	764,471	881,206	922,163
Germany	515,231	—	—
Total consolidated assets	$25,981,423	$30,996,667	$24,680,916

The Company classifies its sales into three categories of products. Net sales by product category data for the years ended December 31, 2005, 2004, and 2003, follow:

	2005	2004	2003
Net sales by product category			
Nutritional supplements	$ 99,254,075	$83,982,424	$66,597,426
Skin care products	1,131,012	1,229,187	1,056,133
Sales aids and other	13,180,077	11,770,822	9,306,164
Total net sales	$113,565,164	$96,982,433	$76,959,723

18. Quarterly Financial Data (Unaudited)

(In thousands, except per share amounts)	First	Second	Third	Fourth
2005				
Net sales	$28,979	$28,546	$28,555	$27,485
Gross profit	24,036	23,835	23,681	22,749
Net income	2,063	1,979	1,668	1,811
Preferred dividends	—	—	—	—
Net income available to common shareholders	2,063	1,979	1,668	1,811
Earnings per share:				
Basic	0.13	0.12	0.11	0.11
Diluted	$ 0.12	$ 0.12	$ 0.11	$ 0.11
2004				
Net sales	$23,478	$23,891	$24,172	$25,441
Gross profit	19,624	19,891	20,032	20,772
Net income	1,642	1,201	1,264	1,280
Preferred dividends	12	—	—	—
Net income available to common shareholders	1,629	1,201	1,264	1,280
Earnings per share:				
Basic	0.11	0.08	0.08	0.07
Diluted	$ 0.10	$ 0.07	$ 0.07	$ 0.07