

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

**FORM 10-K**

**ANNUAL REPORT**  
**pursuant to Section 13 or 15(d)**  
**of the Securities Exchange Act of 1934**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2009**

**000-15701**  
(Commission file number)

**NATURAL ALTERNATIVES INTERNATIONAL, INC.**  
(Exact name of registrant as specified in its charter)

**Delaware**  
(State of incorporation)

**84-1007839**  
(IRS Employer Identification No.)

**1185 Linda Vista Drive**  
**San Marcos, California 92078**  
(Address of principal executive offices)

**(760) 744-7340**  
(Registrant's telephone number)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of exchange on which registered
Common Stock, \$0.01 par value per share	Nasdaq Global Market

Securities registered pursuant to Section 12(g) of the Act:

**None**

Indicate by check mark if Natural Alternatives International, Inc. (NAI) is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933.  Yes  No

Indicate by check mark if NAI is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934.  Yes  No

Indicate by check mark whether NAI (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 NAI was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether NAI has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that NAI was required to submit and post such files).  Yes  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 NAI'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.

Indicate by check mark whether NAI is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

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

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

The aggregate market value of NAI's common stock held by non-affiliates of NAI as of the last business day of NAI's most recently completed second fiscal quarter (December 31, 2008) was approximately \$34,218,523 (based on the closing sale price of \$6.10 reported by Nasdaq on December 31, 2008). For this purpose, all of NAI's officers and directors and their affiliates were assumed to be affiliates of NAI.

As of September 25, 2009, 7,068,793 shares of NAI's common stock were outstanding, net of 180,941 treasury shares.

**DOCUMENTS INCORPORATED BY REFERENCE**

Part III (Items 10, 11, 12, 13 and 14) of this Form 10-K incorporates by reference portions of NAI's definitive proxy statement for its Annual Meeting of Stockholders to be held November 30, 2009, to be filed on or before October 28, 2009.

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### SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS

Certain statements in this report, including information incorporated by reference, are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements reflect current views about future events and financial performance based on certain assumptions. They include opinions, forecasts, intentions, plans, goals, projections, guidance, expectations, beliefs or other statements that are not statements of historical fact. Words such as “may,” “will,” “should,” “could,” “would,” “expects,” “plans,” “believes,” “anticipates,” “intends,” “estimates,” “approximates,” “predicts,” or “projects,” or the negative or other variation of such words, and similar expressions may identify a statement as a forward-looking statement. Any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, our goals, strategies, focus and plans, and other characterizations of future events or circumstances, including statements expressing general optimism about future operating results, are forward-looking statements. Forward-looking statements in this report may include statements about:

- future financial and operating results, including projections of net sales, revenue, income or loss, net income or loss per share, profit margins, expenditures, liquidity, goodwill valuation and other financial items;
- our ability to develop relationships with new customers and maintain or improve existing customer relationships;
- development of new products, brands and marketing strategies;
- the effect of the discontinuance of Dr. Cherry’s television program and our ability to develop a new marketing plan for, and to sustain, our Pathway to Healing® product line;
- distribution channels, product sales and performance, and timing of product shipments;
- inventories and the adequacy and intended use of our facilities;
- current or future customer orders;
- the impact on our business and results of operations and variations in quarterly net sales from cost reduction programs, seasonal and other factors;
- management’s goals and plans for future operations;
- our ability to improve operational efficiencies, manage costs and business risks and improve or maintain profitability;
- growth, expansion, diversification, acquisition, divestment and consolidation strategies, the success of such strategies, and the benefits we believe can be derived from such strategies;
- personnel;
- the outcome of regulatory, tax and litigation matters;
- sources and availability of raw materials;
- operations outside the United States;
- the adequacy of reserves and allowances;
- overall industry and market performance;
- competition and competitive advantages resulting from our quality commitment;
- current and future economic and political conditions;
- the impact of accounting pronouncements; and
- other assumptions described in this report underlying or relating to any forward-looking statements.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements. Forward-looking statements are subject to certain events, risks, and uncertainties that may be outside of our control. When considering forward-looking statements, you should carefully review the risks, uncertainties and other cautionary statements in this report as they identify certain important factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements. These factors include, among others, the risks described under Item 1A of Part I and elsewhere in this report, as well as in other reports and documents we file with the United States Securities and Exchange Commission (SEC).

## PART I

### ITEM 1. BUSINESS

#### General

Our vision is to enrich the world through the best of nutrition.

We are a leading formulator, manufacturer and marketer of nutritional supplements and provide strategic partnering services to our customers. Our comprehensive partnership approach offers a wide range of innovative nutritional products and services to our clients including: scientific research, clinical studies, proprietary ingredients, customer-specific nutritional product formulation, product testing and evaluation, marketing management and support, packaging and delivery system design, regulatory review and international product registration assistance.

As our primary business activity, we provide private label contract manufacturing services to companies that market and distribute vitamins, minerals, herbs, and other nutritional supplements, as well as other health care products, to consumers both within and outside the United States. Additionally, we develop, manufacture and market our own branded products under the Pathway to Healing® product line, which is aimed at restoring, maintaining and improving health.

#### History

Originally founded in 1980, Natural Alternatives International, Inc. reorganized as a Delaware corporation in 1989. Our principal executive offices are located at 1185 Linda Vista Drive, San Marcos, California, 92078.

On January 22, 1999, Natural Alternatives International Europe S.A. (NAIE) was formed as our wholly owned subsidiary, based in Manno, Switzerland. In September 1999, NAIE opened its manufacturing facility to provide manufacturing capability in encapsulation and tablets, finished goods packaging, quality control laboratory testing, warehousing, distribution and administration.

On December 5, 2005, we acquired Real Health Laboratories, Inc. (RHL), which primarily marketed branded nutritional supplements. RHL's operations included in-house creative, supply chain management and call center and fulfillment activities. On August 4, 2008, we sold certain assets related to RHL's catalog and internet business conducted under the name "As We Change®" to Miles Kimball Company for a cash purchase price of \$2.3 million. On July 31, 2009, we sold substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business to PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for a purchase price of \$500,000, with the potential to receive an additional \$500,000 from the buyers as a conditional earn-out if certain profitability criteria are met. Following the sale of substantially all of the assets of RHL on July 31, 2009, we changed the name of RHL to Disposition Company, Inc. The financial information presented in this report has been reclassified to reflect the legacy RHL business as discontinued operations.

Unless the context requires otherwise, all references in this report to the "Company," "NAI," "we," "our," and "us" refer to Natural Alternatives International, Inc. and, as applicable, NAIE and our other wholly owned subsidiary.

#### Overview of our Facilities and Operations

Our U.S.-based operations are located in San Marcos and Vista, California and include manufacturing and distribution, sales and marketing, in-house formulation, laboratory and other research and development services. Our manufacturing facilities were recertified on June 3, 2009 by the Therapeutic Goods Administration (TGA) of Australia after its audit of our Good Manufacturing Practices (GMP). TGA evaluates new therapeutic products, prepares standards, develops testing methods and conducts testing programs to ensure that products are high in quality, safe and effective. The TGA also conducts a range of assessment and monitoring activities including audits of the manufacturing practices of companies who export and sell products to Australia. TGA certification enables us to manufacture products for export into countries that have signed the Pharmaceutical Inspection Convention, which include most European countries as well as several Pacific Rim countries. TGA certifications are generally reviewed every eighteen months.

Our California facilities also have been awarded GMP registration annually by NSF International (NSF) through the NSF Dietary Supplements Certification Program since October 2002 and received "GMP for Sport" NSF Certified registration on February 16, 2009. GMP requirements are regulatory standards and guidelines establishing necessary processes, procedures and documentation for manufacturers in an effort to assure the products produced by that manufacturer have the identity, strength, composition, quality and purity they are represented to possess.

NAIE also operates a manufacturing, warehousing, packaging and distribution facility in Manno, Switzerland. In January 2004, NAIE obtained a pharmaceutical license to process pharmaceuticals for packaging, importation, export and sale within Switzerland and other countries from the Swissmedic Authority of Bern, Switzerland. In March 2007, following the expansion of NAIE's manufacturing facilities to include powder filling capabilities, NAIE obtained an additional pharmaceutical license from the

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Swissmedic Authority certifying NAIE's expanded facilities conform to GMP. We believe these licenses and NAIE's manufacturing capabilities help strengthen our relationships with existing customers and can improve our ability to develop relationships with new customers. The licenses are valid until February 2014.

In addition to our operations in the United States and Switzerland, we have a part-time representative in Japan who provides a range of services to our customers currently present in or seeking to expand into the Japanese market and other markets in the Pacific Rim. These services include regulatory and marketing assistance along with guidance and support in adapting products to these markets.

### **Business Strategy**

Our goals are to achieve long-term growth and profitability and to diversify our sales base. To accomplish these goals, we have sought and intend to continue to seek to:

- leverage our state of the art, certified facilities to increase the value of the goods and services we provide to our highly valued private label contract manufacturing customers and assist in developing relationships with additional quality oriented customers;
- provide strategic partnering services to our private label contract manufacturing customers, including, but not limited to, customized product formulation, clinical studies, regulatory assistance and product registration in foreign markets;
- develop and grow our own line of branded products primarily through direct-to-consumer channels;
- commercialize our licensed patent estate through contract manufacturing, royalty and sub-license agreements; and
- improve operational efficiencies and manage costs and business risks to improve profitability.

Overall, we believe there is an opportunity to enhance consumer confidence in the quality of our nutritional supplements and their adherence to label claims through the education provided by direct sales and direct-to-consumer marketing programs. We believe our GMP and TGA certified manufacturing operations, science based product formulations, peer-reviewed clinical studies and regulatory expertise provide us with a sustainable competitive advantage by providing our customers with a high degree of confidence in the products we manufacture.

While today's consumer may have access to a variety of information, we believe many consumers remain uneducated about nutrition and nutritional supplementation, uncertain about the relevance or reliability of the information they have or are confused about conflicting claims or information, which we believe creates a significant opportunity for the direct sales marketing channel. The direct sales marketing channel has proved, and we believe will continue to prove, to be a highly effective method for marketing high quality nutritional supplements as associates or other personalities educate consumers on the benefits of science based nutritional supplements. Our largest customers operate in the direct sales marketing channel. Thus, the majority of our business has been fueled primarily by the effectiveness of our customers in this marketing channel.

With the acquisition of RHL in 2005, we expanded our branded products segment to include the legacy RHL business, which included the internet and catalog business "As We Change®" (AWC) and certain branded products primarily marketed through mass retail, with distribution to Food, Drug and Mass Market (FDM) retailers, as well as NAI's branded products primarily sold directly to consumers under the Pathway to Healing® product line. During the fourth quarter of fiscal 2008, however, we undertook a careful review of our branded products portfolio and operations and decided to narrow our branded products focus and developed and approved a plan to sell the legacy RHL business in an effort to enhance stockholder value, improve working capital and enable us to focus on our core contract manufacturing business. As of July 31, 2009, we had sold substantially all of the assets of RHL.

Following the completion of the sale of substantially all of the assets of RHL, our branded products segment consists primarily of the products sold under our Pathway to Healing product line. During fiscal 2009, we revamped our website for this product line and increased our direct-to-consumer marketing and advertising efforts. During fiscal 2010, we intend to further increase our marketing and advertising efforts with respect to our Pathway to Healing product line and continue to evaluate alternative sales growth initiatives to support the product line.

In the third quarter of fiscal 2009, we took steps to further commercialize our licensed patent estate and entered into a sublicense agreement with Compound Solutions, Inc. (CSI) under which we agreed to grant a sublicense of certain of our licensed patent and trademark rights to customers of CSI who purchase the material Beta-Alanine™ from CSI. The sublicense will allow CSI's customers to manufacture, offer for sale and/or sell products incorporating, using or made in accordance with our licensed patent and trademark rights. We will receive a sublicense fee from CSI that will vary based on the amount of net sales of Beta-Alanine sold by CSI and CSI's related costs.

We believe our comprehensive approach to customer service is unique within our industry. We believe this approach, together with our commitment to high quality, innovative products and investment in our continuing branded products, will provide the means to implement our strategies and achieve our goals. There can be no assurance, however, that we will successfully implement any of our business strategies or that we will increase or diversify our sales, develop and grow our branded products segment, successfully commercialize our licensed patent estate or improve our overall financial results.

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**Products, Principal Markets and Methods of Distribution**

Our primary business activity is to provide private label contract manufacturing services to companies that market and distribute vitamins, minerals, herbs, and other nutritional supplements, as well as other health care products, to consumers both within and outside the United States. Our private label contract manufacturing customers include companies that market nutritional supplements through direct sales marketing channels, direct response television and retail stores. We manufacture products in a variety of forms, including capsules, tablets, chewable wafers and powders to accommodate a variety of consumer preferences.

We provide strategic partnering services to our private label contract manufacturing customers, including the following:

- customized product formulation;
- clinical studies;
- manufacturing;
- marketing support;
- international regulatory and label law compliance;
- international product registration; and
- packaging in multiple formats and labeling design.

Additionally, we develop, manufacture and market our own branded products and work with a nationally recognized physician to develop brand name products that reflect his individual approach to restoring, maintaining or improving health. These products are currently sold through print media and internet distribution channels.

For the last two fiscal years ended June 30, our net sales were derived from the following (dollars in thousands):

	2009		2008	
	\$	%	\$	%
Private Label Contract Manufacturing	\$71,242	93	\$77,850	84
Branded Products	2,677	3	3,905	4
Discontinued Operations (legacy RHL business)	2,913	4	11,276	12
Total Net Sales	<u>\$76,832</u>	<u>100</u>	<u>\$93,031</u>	<u>100</u>

**Research and Development**

We are committed to quality research and development. We focus on the development of new science based products and the improvement of existing products. We periodically test and validate our products to help ensure their stability, potency, efficacy and safety. We maintain quality control procedures to verify that our products comply with applicable specifications and standards established by the United States Food and Drug Administration (FDA) and other regulatory agencies. We also direct and participate in clinical research studies, often in collaboration with scientists and research institutions, to validate the benefits of a product and provide scientific support for product claims and marketing initiatives. We believe our commitment to research and development, as well as our facilities and strategic alliances with our suppliers and customers, allow us to effectively identify, develop and market high-quality and innovative products.

As part of the services we provide to our private label contract manufacturing customers, we may perform, but are not required to perform, certain research and development activities related to the development or improvement of their products. While our customers typically do not pay directly for this service, the cost of this service is included as a component of the price we charge to manufacture and deliver their products. Research and development costs, which include costs associated with international regulatory compliance services we provide to our customers, are expensed as incurred.

Our research and development expenses for the last two fiscal years ended June 30 were \$1.2 million for 2009 and \$2.0 million for 2008.

**Sources and Availability of Raw Materials**

We use raw materials in our operations including powders, excipients, empty capsules, and components for packaging and distributing our finished products. We test the raw materials we buy to ensure their quality, purity and potency before we use them in our products. We typically buy raw materials in bulk from qualified vendors located both within and outside the United States. During fiscal 2009, Mannatech, Incorporated accounted for 13% of our total raw material purchases. We did not experience any significant shortages or difficulties obtaining adequate supplies of raw materials during fiscal 2009 and we do not anticipate any significant

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shortages or difficulties in the near term. During fiscal 2008 and early fiscal 2009, however, we experienced increases in various product raw material costs, transportation costs and the cost of petroleum based raw materials and packaging supplies used in our business, which were associated with higher oil and fuel costs. We currently believe petroleum related raw material and product cost pricing pressures have stabilized and will remain relatively constant throughout fiscal 2010.

### **Major Customers**

NSA International, Inc. has been our largest customer over the past several years. During the fiscal year ended June 30, 2009, NSA International, Inc. accounted for approximately 49% of our net sales from continuing operations. Our second largest customer was Mannatech, Incorporated, which accounted for approximately 30% of our net sales from continuing operations during fiscal 2009. Both of these customers are private label contract manufacturing customers. No other customer accounted for 10% or more of our net sales during fiscal 2009. We continue to focus on obtaining new private label contract manufacturing customers and growing our remaining branded products to reduce the risks associated with deriving a significant portion of our sales from a limited number of customers.

### **Competition**

We compete with other manufacturers, distributors and marketers of vitamins, minerals, herbs, and other nutritional supplements both within and outside the United States. The nutritional supplement industry is highly fragmented and competition for the sale of nutritional supplements comes from many sources. These products are sold primarily through retailers (drug store chains, supermarkets, and mass market discount retailers), health and natural food stores, and direct sales channels (mail order, network marketing and e-marketing companies). The products we produce for our private label contract manufacturing customers may compete with our own branded products, although we believe such competition is limited.

We believe private label contract manufacturing competition in our industry is based on, among other things, customized services offered, product quality and safety, innovation, price and customer service. We believe we compete favorably with other companies because of our ability to provide comprehensive turnkey solutions for customers, our certified manufacturing operations and our commitment to quality and safety through our research and development activities.

Our future competitive position for both private label contract manufacturing and branded products will likely depend on, but not be limited to, the following:

- the continued acceptance of our products by our customers and consumers;
- our ability to continue to develop high quality, innovative products;
- our ability to attract and retain qualified personnel;
- the effect of any future governmental regulations on our products and business;
- the results of, and publicity from, product safety and performance studies performed by governments and other research institutions;
- the continued growth of the global nutrition industry; and
- our ability to respond to changes within the industry and consumer demand, financially and otherwise.

The nutritional supplement industry is highly competitive and we expect the level of competition to remain high over the near term. We do not believe it is possible to accurately estimate the total number or size of our competitors. The nutritional supplement industry has undergone consolidation in the recent past and we expect that trend to continue in the near term.

### **Government Regulation**

Our business is subject to varying degrees of regulation by a number of government authorities in the United States, including the FDA, the Federal Trade Commission (FTC), the Consumer Product Safety Commission, the United States Department of Agriculture, and the Environmental Protection Agency. Various agencies of the states and localities in which we operate and in which our products are sold also regulate our business, such as the California Department of Health Services, Food and Drug Branch. The areas of our business that these and other authorities regulate include, among others:

- product claims and advertising;
- product labels;
- product ingredients; and
- how we manufacture, package, distribute, import, export, sell and store our products.

The FDA, in particular, regulates the formulation, manufacturing, packaging, storage, labeling, promotion, distribution and sale of vitamin and other nutritional supplements in the United States, while the FTC regulates marketing and advertising claims. In August 2007, a new rule issued by the FDA went into effect requiring companies that manufacture, package, label, distribute or hold

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nutritional supplements to meet certain GMPs to ensure such products are of the quality specified and are properly packaged and labeled. Companies have up to three years to comply with the new requirements depending on the size of the company. In our case, given the current number of our employees, we were required to comply with the new requirements by June 25, 2009. We are committed to meeting or exceeding the standards set by the FDA and believe we are currently operating within the FDA mandated GMPs.

The FDA also regulates the labeling and marketing of dietary supplements and nutritional products, including:

- the identification of dietary supplements or nutritional products and their nutrition and ingredient labeling;
- requirements related to the wording used for claims about nutrients, health claims, and statements of nutritional support;
- labeling requirements for dietary supplements or nutritional products for which “high potency” and “antioxidant” claims are made;
- notification procedures for statements on dietary supplements or nutritional products; and
- premarket notification procedures for new dietary ingredients in nutritional supplements.

The Dietary Supplement Health and Education Act of 1994 (DSHEA) revised the provisions of the Federal Food, Drug and Cosmetic Act concerning the composition and labeling of dietary supplements and defined dietary supplements to include vitamins, minerals, herbs, amino acids and other dietary substances used to supplement diets. DSHEA generally provides a regulatory framework to help ensure safe, quality dietary supplements and the dissemination of accurate information about such products. The FDA is generally prohibited from regulating active ingredients in dietary supplements as drugs unless product claims, such as claims that a product may heal, mitigate, cure or prevent an illness, disease or malady, trigger drug status.

In December 2006, the Dietary Supplement and Nonprescription Drug Consumer Protection Act was passed, which further revised the provisions of the Federal Food, Drug and Cosmetic Act. Under the act, manufacturers, packers or distributors whose name appears on the product label of a dietary supplement or nonprescription drug are required to include contact information on the product label for consumers to use in reporting adverse events associated with the product’s use and to notify the FDA of any serious adverse event report within 15 business days of receiving such report. Events reported to the FDA would not be considered an admission from a company that its product caused or contributed to the reported event. The act became effective in December 2007. We are committed to meeting or exceeding the provisions of this act on a timely basis.

We are also subject to a variety of other regulations in the United States, including those relating to bioterrorism, taxes, labor and employment, import and export, the environment and intellectual property.

Our operations outside the United States are similarly regulated by various agencies and entities in the countries in which we operate and in which our products are sold. The regulations of these countries may conflict with those in the United States and may vary from country to country. The sale of our products in certain European countries is subject to the rules and regulations of the European Union, which may be interpreted differently among the countries within the European Union. In markets outside the United States, we may be required to obtain approvals, licenses or certifications from a country’s ministry of health or comparable agency before we begin operations or the marketing of products in that country. Approvals or licenses may be conditioned on reformulation of our products for a particular market or may be unavailable for certain products or product ingredients. These regulations may limit our ability to enter certain markets outside the United States.

### **Intellectual Property**

*Trademarks.* We have developed and use registered trademarks in our business, particularly relating to corporate, brand and product names. We own 23 trademark registrations, including 12 incontestable registrations, in the United States and have one trademark application pending with the United States Patent and Trademark Office. Federal registration of a trademark affords the owner nationwide exclusive trademark rights in the registered mark and the ability to prevent others from using the same or similar marks. However, to the extent a common law user has made prior use of the mark in connection with similar goods or services in a particular geographic area, the nationwide rights conferred by federal registration would be subject to that geographic area.

We have one trademark registered with the Japanese Patent and Trademark Office and intend to register additional trademarks in foreign countries where our products are or may be sold in the future. We also claim common law ownership and protection of certain unregistered trademarks and service marks. Trademark rights are based on use of a mark. Common law use of a mark offers protection of a mark within the particular geographic area in which it is used. We believe our registered and unregistered trademarks constitute valuable assets, adding to the recognition of our products and services in the marketplace. These and other proprietary rights have been and will continue to be important in enabling us to compete.

*Trade Secrets.* We own certain intellectual property, including trade secrets we seek to protect, in part, through confidentiality agreements with employees and other parties. Although we regard our proprietary technology, trade secrets, trademarks and similar intellectual property as critical to our success, we rely on a combination of trade secrets, contract, patent, copyright and trademark law to establish and protect the rights in our products and technology. In addition, the laws of certain foreign countries may not protect our intellectual property rights to the same extent as the laws of the United States.



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*Patents and Patent Licenses.* We own certain United States patents. In addition, we have an exclusive worldwide license to five certain United States patents, and each patent's corresponding foreign patent application. The license continues until the expiration of the patents covered by the license and requires us to make certain royalty payments to the licensors. We are currently involved in research and development of products employing the licensed inventions. These patents relate to the ingredient formerly known as "Oxford Factor." We are currently selling this ingredient to a customer for use in a limited market under the name Beta-Alanine™, and in March 2009 entered into an agreement to sublicense with CSI under which we agreed to grant a sublicense of the licensed inventions to customers of CSI who purchase the material Beta-Alanine from CSI. The sublicense will allow CSI's customers to manufacture, offer for sale and/or sell products incorporating, using or made in accordance with the licensed inventions. We will receive a sublicense fee from CSI that will vary based on the amount of net sales of Beta-Alanine sold by CSI and CSI's related costs. We also have a nonexclusive worldwide license to five certain United States patents and are currently involved in the research and development of products employing the licensed inventions.

*Other Intellectual Property.* We have license agreements with Dr. Cherry and his ministries pursuant to which we have the right to use the names, likenesses, styles, personas and certain other intellectual property and attributes of Dr. Cherry to market and distribute nutritional and dietary supplements and related products and materials, including the Pathway to Healing product line. The license agreements require the payment of certain royalties based on net sales. The licenses are in effect until December 31, 2010, and automatically extend for successive one (1) year periods unless terminated by either party at least 120 days before the expiration of the then current term.

### **Employees**

As of June 30, 2009, from continuing operations we employed 156 full-time employees in the United States, two of whom held executive management positions. Of the remaining full-time employees, 31 were employed in research, laboratory and quality control, six in sales and marketing, and 117 in manufacturing and administration. From time to time we use temporary personnel to help us meet short-term operating requirements. These positions typically are in manufacturing and manufacturing support. As of June 30, 2009, we had 12 temporary personnel.

As of June 30, 2009, NAIE employed an additional 24 full-time employees. Most of these positions were in the areas of manufacturing and manufacturing support.

As of June 30, 2009, we also employed one additional full-time employee as part of our legacy RHL business classified as discontinued operations.

Our employees are not represented by a collective bargaining agreement and we have not experienced any work stoppages as a result of labor disputes. We believe our relationship with our employees is good.

### **Seasonality**

Although we believe there is no material impact on our business or results of operations from seasonal factors, we have experienced and expect to continue to experience variations in quarterly net sales due to the timing of private label contract manufacturing orders.

### **Financial Information about Our Business Segments and Geographic Areas**

Our operations are comprised of two reportable segments:

- Private label contract manufacturing, in which we primarily provide manufacturing services to companies that market and distribute nutritional supplements and other health care products; and
- Branded products, in which we market and distribute branded nutritional supplements through direct-to-consumer marketing programs, and under which we develop, manufacture and market our own products and work with a nationally recognized physician to develop brand name products that reflect his individual approach to restoring, maintaining or improving health. These products are currently sold through print media and the internet.

Our private label contract manufacturing products are sold both in the United States and in markets outside the United States, including Europe, Australia and Asia. The primary market outside the United States is Europe. Our branded products are only sold in the United States.

For additional financial information, including financial information about our business segment and geographic areas, please see the consolidated financial statements and accompanying notes to the consolidated financial statements included under Item 8 of this report.

Our activities in markets outside the United States are subject to political, economic and other risks in the countries in which our products are sold and in which we operate. For more information about these and other risks, please see Item 1A in this report.

**ITEM 1A. RISK FACTORS**

*You should carefully review and consider the risks described below, as well as the other information in this report and in other reports and documents we file with the SEC when evaluating our business and future prospects. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties, not presently known to us, or that we currently see as immaterial, may also occur. If any of the following risks or any additional risks and uncertainties actually occur, our business, financial condition and results of operations could be seriously harmed. In that event, the market price of our common stock could decline and you could lose all or a portion of the value of your investment in our common stock. You should not draw any inference as to the magnitude of any particular risk from its position in the following discussion.*

***Because we derive a significant portion of our revenues from a limited number of customers, our revenues would be adversely affected by the loss of a major customer or a significant change in its business, personnel or the timing or amount of its orders.***

We have in the past and expect to continue to derive a significant portion of our revenues from a relatively limited number of customers. During the fiscal year ended June 30, 2009, sales to one customer, NSA International, Inc., were approximately 49% of our total net sales from continuing operations. Our second largest customer was Mannatech, Incorporated, which accounted for approximately 30% of our net sales from continuing operations during fiscal 2009. The loss of one of these customers or other major customers, a significant decrease in sales or the growth rate of sales to these customers, or a significant change in their business or personnel, would materially affect our financial condition and results of operations. Furthermore, the timing of our customers' orders is impacted by, among others, their marketing programs, supply chain management, entry into new markets and new product introductions, all of which are outside of our control. All of these attributes have had and will have a significant impact on our business.

***Our future growth and stability depends, in part, on our ability to diversify our sales. Our efforts to establish new sales from existing customers and new customers and develop and grow our branded products could require significant initial investments, which may or may not result in higher sales and improved financial results.***

Our business strategy depends in large part on our ability to develop new product sales from current and new customer relationships. These activities often require a significant up-front investment including, among others, customized formulations, regulatory compliance, product registrations, package design, product testing, pilot production runs, and the build up of initial inventory. In addition, we may incur increased marketing and advertising costs to the extent we seek to develop and grow our branded products. We may experience significant delays from the time we increase our operating expenses and make investments in inventory until the time we generate net sales from new products or customers, and it is possible that we may never generate any revenue from new products or customers after incurring such expenditures. If we incur significant expenses and investments in inventory that we are not able to recover, and we are not able to compensate for those expenses, our operating results could be adversely affected.

***We may, in the future, pursue acquisitions of other companies that, if not successful, could adversely affect our business, financial condition and results of operations.***

In the future, we may pursue acquisitions of companies that we believe could complement or expand our business, augment our market coverage, provide us with important relationships or otherwise offer us growth opportunities. Acquisitions involve numerous risks, including:

- potential difficulties related to integrating the products, personnel and operations of the acquired company;
- failure to operate as a combined organization utilizing common information and communication systems, operating procedures, financial controls and human resources practices;
- diverting management's attention from the normal daily operations of the business;
- entering markets in which we have no or limited prior direct experience and where competitors in such markets have stronger market positions;
- potential loss of key employees of the acquired company;
- potential inability to achieve cost savings and other potential benefits expected from the acquisition;
- an uncertain sales and earnings stream from the acquired company; and
- potential impairment charges, which may be significant, against goodwill and purchased intangible assets acquired in the acquisition due to changes in conditions and circumstances that occur after the acquisition, many of which may be outside of our control.

There can be no assurance that acquisitions that we may pursue will be successful. If we pursue an acquisition but are not successful in completing it, or if we complete an acquisition but are not successful in integrating the acquired company's employees, products or operations successfully, our business, financial position or results of operations could be adversely affected.

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*We are required to assess the value of goodwill annually for potential impairment, which requires, among others, significant management judgment to forecast future operating results used in the determination. In the fourth quarter of fiscal 2007, we recorded a \$7.0 million non-cash, goodwill impairment charge and in the third quarter of fiscal 2009 we recorded an additional impairment charge of \$1.8 million and may, in the future, be required to recognize additional impairment charges, which could be significant, against goodwill and purchased intangible assets due to changes in conditions and circumstances, many of which may be outside of our control.*

Following the acquisition of RHL on December 5, 2005, we recorded approximately \$7.5 million of goodwill. In the fourth quarter of fiscal 2007, we recorded a \$7.0 million non-cash, goodwill impairment charge as a result of our annual testing of goodwill. In the third quarter of fiscal 2009, we determined the current book value of RHL's net assets exceeded the fair value by approximately \$1.8 million and recorded an impairment charge for this amount. There can be no assurance that an additional non-cash impairment charge will not be required. Any such additional charge could have a negative effect on our results of operations but would not impact our cash flows or cash position.

*Our operating results will vary. We have experienced a decline in net sales and incurred losses in recent years and there is no guarantee that our sales will improve or that we will earn a profit in future years. Fluctuations in our operating results may adversely affect the share price of our common stock.*

Our net sales and income from continuing operations declined during fiscal 2009 as compared to fiscal 2008 and there can be no assurance that our net sales will improve in the near term, or that we will earn a profit in any given year. We have experienced net losses in the past, including fiscal years 2009 and 2008, and may incur losses in the future. Our operating results will fluctuate from year to year and/or from quarter to quarter due to various factors including differences related to the timing of revenues and expenses for financial reporting purposes and other factors described in this report. At times, these fluctuations may be significant. We currently anticipate generating positive net income during the first quarter of fiscal 2010, although there is no assurance we will be able to do so. Fluctuations in our operating results may adversely affect the share price of our common stock.

*A significant or prolonged economic downturn, such as the one the global economy has recent experienced, could have, and recently has had, a material adverse effect on our results of operations.*

Our results of operations are affected by the level of business activity of our customers, which in turn is affected by the level of consumer demand for their products. A significant or prolonged economic downturn may adversely affect the disposable income of many consumers and may lower demand for the products we produce for our private label contract manufacturing customers, as well as our branded products. During fiscal 2009, the decline in economic conditions in the United States and the various foreign markets in which our customers operate negatively impacted our customers' businesses and our operations. A continued or further decline in consumer demand and the level of business activity of our customers due to economic conditions could have a material adverse effect on our revenues and profit margins.

*Because our direct-to-consumer sales rely on the marketability of key personalities, the inability of a key personality to perform his or her role or the existence of negative publicity surrounding a key personality may adversely affect our revenues.*

Direct-to-consumer products may be marketed with a key personality through a variety of distribution channels. The inability or failure of a key personality to fulfill his or her role, or the ineffectiveness of a key personality as a spokesperson for a product, a reduction in the exposure of a key personality due to the discontinuance of a marketing program or otherwise or negative publicity about a key personality may adversely affect the sales of our product associated with that personality and could affect the sale of other products. A decline in sales would negatively affect our results of operations and financial condition.

*Our industry is highly competitive and we may be unable to compete effectively. Increased competition could adversely affect our financial condition.*

The market for our products is highly competitive. Many of our competitors are substantially larger and have greater financial resources and broader name recognition than we do. Our larger competitors may be able to devote greater resources to research and development, marketing and other activities that could provide them with a competitive advantage. Our market has relatively low entry barriers and is highly sensitive to the introduction of new products that may rapidly capture a significant market share. Increased competition could result in price reductions, reduced gross profit margins or loss of market share, any of which could have a material adverse effect on our financial condition and results of operations. There can be no assurance that we will be able to compete in this intensely competitive environment.

*We may not be able to raise additional capital or obtain additional financing if needed.*

Our cash from operations may not be sufficient to meet our working capital needs and/or to implement our business strategies. Additionally, there can be no assurance that our existing line of credit will be sufficient to meet our working capital needs. Furthermore, if we fail to maintain certain loan covenants we may no longer have access to the credit line. During fiscal 2009, we

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failed to meet certain of our loan covenants under our credit facility. While in each case our lender agreed to waive its default rights resulting from these covenant violations, there is no guarantee that the lender will continue to do so if we do not meet future covenant requirements. The credit line terminates in November 2010.

At any given time it may be difficult for companies to raise capital due to a variety of factors, some of which may be outside a company's control, including a tightening of credit markets, overall poor performance of stock markets, and/or an economic slowdown in the United States or other countries. Thus, there is no assurance we would be able to raise additional capital if needed. To the extent we do raise additional capital the ownership position of existing stockholders could be diluted. Similarly, there can be no assurance that additional financing will be available if needed or that it will be available on favorable terms. Under the terms of our credit facility, there are limits on our ability to create, incur or assume additional indebtedness without the approval of our lender.

Recent economic conditions have made it more difficult for companies to raise capital and obtain financing. Our inability to raise additional capital or to obtain additional financing if needed would negatively affect our ability to implement our business strategies and meet our goals. This, in turn, would adversely affect our financial condition and results of operations.

***The failure of our suppliers to supply quality materials in sufficient quantities, at a favorable price, and in a timely fashion could adversely affect the results of our operations.***

We buy our raw materials from a limited number of suppliers. During fiscal 2009, approximately 13% of our total raw material purchases were from one supplier. The loss of any of our major suppliers or of a supplier that provides any hard to obtain materials could adversely affect our business operations. Although we believe that we could establish alternate sources for most of our raw materials, any delay in locating and establishing relationships with other sources could result in product shortages, with a resulting loss of sales and customers. In certain situations we may be required to alter our products or to substitute different materials from alternative sources.

We rely solely on one supplier to process certain raw materials that we use in the product line of our largest customer. The loss of or unexpected interruption in this service would materially adversely affect our results of operations and financial condition.

A shortage of raw materials or an unexpected interruption of supply could also result in higher prices for those materials. During fiscal 2008 and early fiscal 2009, we experienced increases in various product raw material costs, transportation costs and the cost of petroleum based raw materials and packaging supplies used in our business, which were associated with higher oil and fuel costs. We currently believe petroleum related raw material and product cost pricing pressures have stabilized and will remain relatively constant throughout fiscal 2010, although there is no assurance this will occur. Although we may be able to raise our prices in response to significant increases in the cost of raw materials, we may not be able to raise prices sufficiently or quickly enough to offset the negative effects of the cost increases on our results of operations.

There can be no assurance that suppliers will provide the quality raw materials needed by us in the quantities requested or at a price we are willing to pay. Because we do not control the actual production of these raw materials, we are also subject to delays caused by interruption in production of materials based on conditions outside of our control, including weather, transportation interruptions, strikes and natural disasters or other catastrophic events.

***Our business is subject to the effects of adverse publicity, which could negatively affect our sales and revenues.***

Our business can be affected by adverse publicity or negative public perception about our industry, our competitors, our customers, or our business generally. This adverse publicity may include publicity about the nutritional supplements industry generally, the efficacy, safety and quality of nutritional supplements and other health care products or ingredients in general or our products or ingredients specifically, and regulatory investigations, regardless of whether these investigations involve us or the business practices or products of our competitors, or our customers. During the second and third quarters of fiscal 2008, our Mannatech contract manufacturing sales were adversely impacted due to certain negative publicity and heightened litigation and regulatory activities that affected Mannatech's domestic recruiting efforts and corresponding consumer sales. There can be no assurance that we will be able to reestablish our prior sales levels with Mannatech, and there can be no assurance that we will be able to avoid any adverse publicity or negative public perception in the future. Any adverse publicity or negative public perception will likely have a material adverse effect on our business, financial condition and results of operations. Our business, financial condition and results of operations also could be adversely affected if any of our products or any similar products distributed by other companies are alleged to be or are proved to be harmful to consumers or to have unanticipated health consequences.

***We could be exposed to product liability claims or other litigation, which may be costly and could materially adversely affect our operations.***

We could face financial liability due to product liability claims if the use of our products results in significant loss or injury. Additionally, the manufacture and sale of our products involves the risk of injury to consumers from tampering by unauthorized third parties or product contamination. We could be exposed to future product liability claims that, among others: our products contain contaminants; we provide consumers with inadequate instructions about product use; or we provide inadequate warning about side effects or interactions of our products with other substances. Even if we were to prevail in any such claims, the cost of negotiations, settlement and litigation could be significant.

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We maintain product liability insurance coverage, including primary product liability and excess liability coverage. The cost of this coverage has increased dramatically in recent years, while the availability of adequate insurance coverage has decreased. While we currently expect to be able to continue our product liability insurance, there can be no assurance that we will in fact be able to continue such insurance coverage, that our insurance will be adequate to cover any liability we may incur, or that our insurance will continue to be available at an economically reasonable cost.

Additionally, it is possible that one or more of our insurers could exclude from our coverage certain ingredients used in our products. In such event, we may have to stop using those ingredients or rely on indemnification or similar arrangements with our customers who wish to continue to include those ingredients in their products. A substantial increase in our product liability risk or the loss of customers or product lines could have a material adverse effect on our results of operations and financial condition.

***If we or our private label contract manufacturing customers expand into additional markets outside the United States or our or their sales in markets outside the United States increase, our business would become increasingly subject to political, economic, regulatory and other risks in those markets, which could adversely affect our business.***

Our future growth may depend, in part, on our ability and the ability of our private label contract manufacturing customers to expand into additional markets outside the United States or to improve sales in markets outside the United States. There can be no assurance that we or our customers will be able to expand in existing markets outside the United States, enter new markets on a timely basis, or that new markets outside the United States will be profitable. There are significant regulatory and legal barriers in markets outside the United States that must be overcome. We will be subject to the burden of complying with a wide variety of national and local laws, including multiple and possibly overlapping and conflicting laws. We also may experience difficulties adapting to new cultures, business customs and legal systems. Our sales and operations outside the United States are subject to political, economic and social uncertainties including, among others:

- changes and limits in import and export controls;
- increases in custom duties and tariffs;
- changes in government regulations and laws;
- coordination of geographically separated locations;
- absence in some jurisdictions of effective laws to protect our intellectual property rights;
- changes in currency exchange rates;
- economic and political instability; and
- currency transfer and other restrictions and regulations that may limit our ability to sell certain products or repatriate profits to the United States.

Any changes related to these and other factors could adversely affect our business, profitability and growth prospects. If we or our customers expand into additional markets outside the United States or improve sales in markets outside the United States, these and other risks associated with operations outside the United States are likely to increase.

***Our products and manufacturing activities are subject to extensive government regulation, which could limit or prevent the sale of our products in some markets and could increase our costs.***

The manufacturing, packaging, labeling, advertising, promotion, distribution, and sale of our products are subject to regulation by numerous national and local governmental agencies in the United States and in other countries. Failure to comply with governmental regulations may result in, among other things, injunctions, product withdrawals, recalls, product seizures, fines, and criminal prosecutions. Any action of this type by a governmental agency could materially adversely affect our ability to successfully market our products. In addition, if the governmental agency has reason to believe the law is being violated (for example, if it believes we do not possess adequate substantiation for product claims), it can initiate an enforcement action. Governmental agency enforcement could result in orders requiring, among other things, limits on advertising, consumer redress, divestiture of assets, rescission of contracts, and such other relief as may be deemed necessary. Violation of these orders could result in substantial financial or other penalties. Any action by the governmental agency could materially adversely affect our ability and our customers' ability to successfully market those products.

In markets outside the United States, before commencing operations or marketing our products, we may be required to obtain approvals, licenses, or certifications from a country's ministry of health or comparable agency. Approvals or licensing may be conditioned on reformulation of products or may be unavailable with respect to certain products or product ingredients. We must also comply with product labeling and packaging regulations that vary from country to country. Furthermore, the regulations of these countries may conflict with those in the United States and with each other. The sale of our products in certain European countries is

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subject to the rules and regulations of the European Union, which may be interpreted differently among the countries within the European Union. The cost of complying with these various and potentially conflicting regulations can be substantial and can adversely affect our results of operations.

We cannot predict the nature of any future laws, regulations, interpretations, or applications, nor can we determine what effect additional governmental regulations, when and if adopted, would have on our business. They could include requirements for the reformulation of certain products to meet new standards, the recall or discontinuance of certain products, additional record keeping, expanded or different labeling, and additional scientific substantiation. Any or all of these requirements could have a material adverse effect on our operations.

***If we are unable to attract and retain qualified management personnel, our business will suffer.***

Our executive officers and other management personnel are primarily responsible for our day-to-day operations. We believe our success depends largely on our ability to attract, maintain and motivate highly qualified management personnel. Competition for qualified individuals can be intense, and we may not be able to hire additional qualified personnel in a timely manner and on reasonable terms. Our inability to retain a skilled professional management team could adversely affect our ability to successfully execute our business strategies and achieve our goals.

***Our manufacturing and third party fulfillment and call center activities are subject to certain risks.***

We manufacture the vast majority of our products at our manufacturing facility in California. As a result, we are dependent on the uninterrupted and efficient operation of these facilities. Our manufacturing operations are subject to power failures, blackouts, the breakdown, failure or substandard performance of equipment, the improper installation or operation of equipment, natural or other disasters, and the need to comply with the requirements or directives of governmental agencies, including the FDA. In addition, we may in the future determine to expand or relocate our facilities, which may result in slow downs or delays in our operations. While we have implemented and are evaluating various emergency, contingency and disaster recovery plans and maintain business interruption insurance, there can be no assurance that the occurrence of these or any other operational problems at our facilities in California or at NAIE's facility in Switzerland would not have a material adverse effect on our business, financial condition and results of operations. Furthermore, there can be no assurance that our contingency plans will prove to be adequate or successful if needed or that our insurance will continue to be available at a reasonable cost or, if available, will be adequate to cover any losses that we may incur from an interruption in our manufacturing and distribution operations.

As a result of our decision to sell the legacy RHL business, we initiated an operational consolidation program during the first quarter of fiscal 2009. This program included outsourcing our branded products fulfillment and call center activities. The operation of the third party service provider's facilities is subject to the interruption and similar risks described above for our facilities and there can be no assurance that these interruptions or any other operational problem at such third party's facilities would not have a material adverse effect on our business, financial condition and results of operations.

***We may be unable to protect our intellectual property rights or may inadvertently infringe on the intellectual property rights of others.***

We possess and may possess in the future certain proprietary technology, trade secrets, trademarks, trade names, licenses and similar intellectual property. There can be no assurance that we will be able to protect our intellectual property adequately. In addition, the laws of certain foreign countries may not protect our intellectual property rights to the same extent as the laws of the United States. Litigation in the United States or abroad may be necessary to enforce our intellectual property rights, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement. This litigation, even if successful, could result in substantial costs and diversion of resources and could have a material adverse effect on our business, results of operation and financial condition. If any such claims are asserted against us, we may seek to obtain a license under the third party's intellectual property rights. There can be no assurance, however, that a license would be available on terms acceptable or favorable to us, if at all.

***Collectively, our officers and directors own a significant amount of our common stock, giving them influence over corporate transactions and other matters and potentially limiting the influence of other stockholders on important policy and management issues.***

Our officers and directors, together with their families and affiliates, beneficially owned approximately 19% of our outstanding shares of common stock as of June 30, 2009, including approximately 18% of our outstanding shares of common stock beneficially owned by Mark LeDoux, our Chief Executive Officer and the Chairman of the Board, and his family and affiliates. As a result, our officers and directors, and in particular Mr. LeDoux, could influence such business matters as the election of directors and approval of significant corporate transactions.

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Various transactions could be delayed, deferred or prevented without the approval of stockholders, including:

- transactions resulting in a change in control;
- mergers and acquisitions;
- tender offers;
- election of directors; and
- proxy contests.

There can be no assurance that conflicts of interest will not arise with respect to the officers and directors who own shares of our common stock or that conflicts will be resolved in a manner favorable to us or our other stockholders.

***If our information technology system fails, our operations could suffer.***

Our business depends to a large extent on our information technology infrastructure to effectively manage and operate many of our key business functions, including order processing, customer service, product manufacturing and distribution, cash receipts and payments and financial reporting. A long term failure or impairment of any of our information technology systems could adversely affect our ability to conduct day-to-day business.

***If certain provisions of our Certificate of Incorporation, Bylaws and Delaware law are triggered, the future price investors might be willing to pay for our common stock could be limited.***

Certain provisions in our Certificate of Incorporation, Bylaws and Delaware corporate law help discourage unsolicited proposals to acquire our business, even if the proposal would benefit our stockholders. Our Board of Directors is authorized, without stockholder approval, to issue up to 500,000 shares of preferred stock having such rights, preferences, and privileges, including voting rights, as the Board of Directors designates. The rights of our common stockholders will be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future. Any or all of these provisions could delay, deter or prevent a takeover of our company and could limit the price investors are willing to pay for our common stock.

***Our stock price could fluctuate significantly.***

Stock prices in general have been historically volatile and ours is no different. The trading price of our stock may fluctuate in response to the following, as well as other, factors:

- broad market fluctuations and general economic and/or political conditions;
- fluctuations in our financial results;
- relatively low trading volumes;
- future offerings of our common stock or other securities;
- the general condition of the nutritional supplement product industries;
- increased competition;
- regulatory action;
- adverse publicity;
- manipulative or illegal trading practices by third parties; and
- product and other public announcements.

The stock market has historically experienced significant price and volume fluctuations. There can be no assurance that an active market in our stock will continue to exist or that the price of our common stock will not decline. Our future operating results may be below the expectations of securities analysts and investors. If this were to occur, the price of our common stock would likely decline, perhaps substantially.

From time to time our shares may be listed for trading on one or more foreign exchanges, with or without our prior knowledge or consent. Certain foreign exchanges may have less stringent listing requirements, rules and enforcement procedures than the Nasdaq Global Market or other markets in the United States, which may increase the potential for manipulative trading practices to occur. These practices, or the perception by investors that such practices could occur, may increase the volatility of our stock price or result in a decline in our stock price, which in some cases could be significant.

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**ITEM 2. PROPERTIES**

This table summarizes our facilities as of June 30, 2009. We believe our facilities are adequate to meet our operating requirements for the foreseeable future.

<u>Location</u>	<u>Nature of Use</u>	<u>Square Feet</u>	<u>How Held</u>	<u>Lease Expiration Date</u>
San Marcos, CA USA	NAI corporate headquarters and branded products operations	29,500	Owned	N/A
Vista, CA USA <sup>(1)</sup>	Manufacturing, warehousing, packaging and distribution <sup>(3)</sup>	162,000	Leased	March 2014
Manno, Switzerland <sup>(2)</sup>	Manufacturing, warehousing, packaging and distribution	46,000	Leased	December 2015

- (1) This facility is used by NAI primarily for its private label contract manufacturing segment.
- (2) This facility is used by NAIE, our wholly owned Swiss subsidiary, in connection with our private label contract manufacturing segment. NAIE sublets approximately 3,000 square feet to a third party pursuant to a sublease that terminates on December 31, 2009.
- (3) We use approximately 93,000 square feet for production, 60,000 square feet for warehousing and 9,000 square feet for administrative functions.

**ITEM 3. LEGAL PROCEEDINGS**

From time to time, we become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to product liability, employment, intellectual property, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. While unfavorable outcomes are possible, based on available information, we generally do not believe the resolution of these matters will result in a material adverse effect on our business, consolidated financial condition, or results of operation. However, a settlement payment or unfavorable outcome could adversely impact our results of operation. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes that we do not expect.

As of September 25, 2009, neither NAI nor its subsidiaries were a party to any material pending legal proceeding nor was any of their property the subject of any material pending legal proceeding.

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

We did not submit any matters to our stockholders for a vote during the fourth quarter ended June 30, 2009.



**PART II**

**ITEM 5. MARKET FOR OUR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

**Market Information**

Our common stock trades on the Nasdaq Global Market under the symbol "NAIL." Below are the high and low closing prices of our common stock as reported on the Nasdaq Global Market for each quarter of the fiscal years ended June 30, 2009 and 2008:

	Fiscal 2009		Fiscal 2008	
	High	Low	High	Low
First Quarter	\$8.00	\$7.00	\$7.71	\$5.81
Second Quarter	\$7.55	\$5.70	\$8.68	\$6.09
Third Quarter	\$6.19	\$5.78	\$9.18	\$8.41
Fourth Quarter	\$6.75	\$5.84	\$9.00	\$6.51

**Holders**

As of September 22, 2009, there were approximately 316 stockholders of record of our common stock.

**Dividends**

We have never paid a dividend on our common stock and we do not intend to pay a dividend in the foreseeable future. Our current policy is to retain all earnings to help provide funds for future growth. Additionally, under the terms of our credit facility, we are precluded from paying a dividend.

**Recent Sales of Unregistered Securities**

During the fiscal year ended June 30, 2009, we did not sell any unregistered securities.

**Repurchases**

During the fourth quarter of the fiscal year ended June 30, 2009, we did not repurchase any shares of our common stock, nor were any repurchases made on our behalf.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**

The following discussion and analysis is intended to help you understand our financial condition and results of operations as of June 30, 2009 and 2008 and for each of the last two fiscal years then ended. You should read the following discussion and analysis together with our audited consolidated financial statements and the notes to the consolidated financial statements included under Item 8 in this report. Our future financial condition and results of operations will vary from our historical financial condition and results of operations described below based on a variety of factors. You should carefully review the risks described under Item 1A and elsewhere in this report, which identify certain important factors that could cause our future financial condition and results of operations to vary.

### **Executive Overview**

*The following overview does not address all of the matters covered in the other sections of this Item 7 or other items in this report or contain all of the information that may be important to our stockholders or the investing public. This overview should be read in conjunction with the other sections of this Item 7 and this report.*

Our primary business activity is providing private label contract manufacturing services to companies that market and distribute vitamins, minerals, herbs and other nutritional supplements, as well as other health care products, to consumers both within and outside the United States. Historically, our revenue has been largely dependent on sales to one or two private label contract manufacturing customers and subject to variations in the timing of such customers' orders, which in turn is impacted by such customers' internal marketing programs, supply chain management, entry into new markets and new product introductions, as well as general economic conditions.

A cornerstone of our business strategy is to achieve long-term growth and profitability and to diversify our sales base. We have sought and expect to continue to seek to diversify our sales by developing relationships with additional, quality-oriented, private label contract manufacturing customers, developing and growing our own line of branded products and commercializing our licensed patent estate through contract manufacturing, royalty and sub-license agreements.

In an effort to enhance stockholder value, improve working capital and enable us to focus on our core contract manufacturing business, during the fourth quarter of fiscal 2008 we developed a plan to narrow our branded products focus and portfolio and to sell our legacy RHL business. On August 4, 2008 RHL sold certain assets related to its catalog and internet business conducted under the name "As We Change®" to Miles Kimball Company for a cash purchase price of \$2.3 million. We recorded a loss of \$226,000 as a result of this sale and recognized \$221,000 in severance and related payroll costs during fiscal 2009.

On July 31, 2009, we sold substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business to PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for a cash purchase price of \$500,000. As additional compensation, RHL may receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. The financial information presented in this report has been reclassified to reflect the legacy RHL business as discontinued operations.

As a result of our decision to sell the legacy RHL business, we initiated an operational consolidation program during the first quarter of fiscal 2009 that transitioned the remaining branded products business operations to our corporate offices. This operational consolidation program was substantially complete as of September 30, 2008 and resulted in a charge to discontinued operations of \$823,000 in severance and other business related exit costs during fiscal 2009.

During fiscal 2009, our net sales from continuing operations were 9.6% lower than in fiscal 2008. Private label contract manufacturing sales declined 8.5% due primarily to lower volumes of existing products in existing markets sold to our two largest customers. This decline was partially offset by an increase in sales to other customers. Net sales from our branded products declined 31.4% in fiscal 2009 as compared to fiscal 2008 due to the continued softening of our Pathway to Healing® product line.

Revenue concentration to our two largest private label contract manufacturing customers as a percentage of our total sales from continuing operations remained flat at 79% for both fiscal 2009 and fiscal 2008. We expect our contract manufacturing revenue concentration percentage for our two largest customers to remain constant or increase marginally during fiscal 2010.

Beginning in fiscal 2008 and continuing through fiscal 2009, we invested substantial time and incurred substantial costs associated with hiring and training new quality assurance and other manufacturing support personnel, increased testing activity, and documentation and validation processes related to our GMPs compliance programs. These additional expenses negatively impacted our operating income from continuing operations during fiscal 2008 and fiscal 2009. Although the cost of GMP compliance is significant, we believe the majority of our implementation investment costs have been incurred. Going forward, our commitment to quality and our steadfast support of the FDA mandated GMPs makes us well positioned to operate within the higher standards of the FDA's GMPs and we believe differentiates us from our competitors.

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During the early part of fiscal 2009, the continued decline in economic conditions in the United States and the various foreign markets we service negatively impacted our customers' businesses and our operations. As a result, during the second quarter of fiscal 2009 we implemented a cost reduction program that resulted in the elimination of certain personnel and business activities. This program resulted in a charge to our continuing operations of \$558,000 during the second quarter of fiscal 2009. During the second half of fiscal 2009, our cost reduction program resulted in a savings of \$3.0 million compared to the cost structure in the comparable prior year period. We expect our cost reduction program to further reduce our operating overhead costs in fiscal 2010 by approximately \$3.5 million as compared to fiscal 2009.

Following the completion of the sale of substantially all of the assets of RHL, our branded products segment consists primarily of the products sold under our Pathway to Healing® product line. Beginning in April 2007, Dr. Cherry ceased airing his weekly television program, which had served as the primary customer acquisition vehicle in marketing the Pathway to Healing® product line. While sales of the product line have been primarily generated by continuity orders from long-standing repeat customers, the loss of the television program has had a negative impact on our ability to acquire new customers and retain existing customers. During fiscal 2009 we revamped our Dr. Cherry website and increased our direct-to-consumer marketing and advertising efforts. These activities helped reduce the decline in our Dr. Cherry sales volumes during the second half of fiscal 2009. During fiscal 2010 we intend to further increase our Dr. Cherry marketing and advertising efforts and continue working with Dr. Cherry to evaluate alternative sales growth initiatives to support the product line.

During fiscal 2010, we plan to continue to focus on:

- Leveraging our state of the art, certified facilities to increase the value of the goods and services we provide to our highly valued private label contract manufacturing customers, and assist us in developing relationships with additional quality oriented customers;
- Implementing focused initiatives to grow our Pathway to Healing® product line;
- Commercializing our licensed patent estate through contract manufacturing, royalties and sub-license agreements and protecting our proprietary rights; and
- Improving operational efficiencies and managing costs and business risks to improve profitability

### **Critical Accounting Policies and Estimates**

Our consolidated financial statements included under Item 8 in this report have been prepared in accordance with United States generally accepted accounting principles (GAAP). Our significant accounting policies are described in the notes to our consolidated financial statements. The preparation of financial statements in accordance with GAAP requires that we make estimates and assumptions that affect the amounts reported in our financial statements and their accompanying notes. We have identified certain policies that we believe are important to the portrayal of our financial condition and results of operations. These policies require the application of significant judgment by our management. We base our estimates on our historical experience, industry standards, and various other assumptions that we believe are reasonable under the circumstances. Actual results could differ from these estimates under different assumptions or conditions. An adverse effect on our financial condition, changes in financial condition, and results of operations could occur if circumstances change that alter the various assumptions or conditions used in such estimates or assumptions. Our critical accounting policies include those listed below.

#### *Goodwill and Intangible Asset Valuation*

The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired. Goodwill and intangible assets deemed to have indefinite lives are not amortized, but are subject to annual impairment tests. The amounts and useful lives assigned to other intangible assets impact future amortization. Determining the fair values and useful lives of intangible assets requires the use of estimates and the exercise of judgment. While there are a number of different generally accepted valuation methods to estimate the value of intangible assets acquired, we primarily use the discounted cash flow method and relief-from-royalty method. These methods require significant management judgment to forecast the future operating results used in the analysis. In addition, other significant estimates are required such as residual growth rates and discount factors. The estimates we use to value and amortize intangible assets are consistent with the plans and estimates that we use to manage our business and are based on available historical information and industry estimates and averages. These judgments can significantly affect our net operating results.

We are required to assess goodwill impairment annually using the methodology prescribed by Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). SFAS 142 requires that goodwill be tested for impairment at the reporting unit level on an annual basis or more frequently if we believe indicators of impairment exist. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units and determining the fair value of each reporting unit. Goodwill impairment is determined using a two-step process. The first step of the goodwill impairment test is used to identify potential impairment by comparing the fair value of a reporting unit with the net book value (or carrying amount), including goodwill. If the fair value of the reporting unit exceeds the carrying amount, goodwill of the reporting unit is considered not impaired and the second step of the

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impairment test is unnecessary. If the carrying amount of the reporting unit exceeds the fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. The second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination, accordingly the fair value of the reporting unit is allocated to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit. We have selected April 1 as the annual date to test for impairment.

Determining the fair value of the reporting unit under the first step of the goodwill impairment test and determining the fair value of individual assets and liabilities of a reporting unit under the second step of the goodwill impairment test is judgmental in nature and often involves the use of significant estimates and assumptions. These estimates and assumptions could have a significant impact on whether or not an impairment charge is recognized and also the magnitude of any such charge. Estimates of fair value are primarily determined using discounted cash flows and market comparisons. These approaches use significant estimates and assumptions, including projection and timing of future cash flows, discount rates reflecting the risk inherent in future cash flows, perpetual growth rates, determination of appropriate market comparables, and determination of whether a premium or discount should be applied to comparables. It is reasonably possible that the plans and estimates used to value these assets may be incorrect. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges.

During the third quarter of fiscal 2009, RHL's wholesale operation experienced a decline in sales activity from one of its largest customers as a result of the discontinuance of certain RHL product lines. Historically these product sales represented a significant portion of RHL's overall annual sales to this customer. Additionally, during this same period, we received feedback from multiple parties related to their preliminary interest in acquiring the remaining assets of RHL. Due in part to the expected decline in future RHL sales as noted above and the current depressed worldwide economic conditions, the preliminary purchase price valuations provided by these third parties provided us with an indication that an impairment of the RHL net asset carrying values may exist.

In accordance with SFAS 142 and SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144) we performed an analysis that compared the fair value of RHL's net assets as indicated by the third party purchase price valuations noted above to the current carrying amounts to determine if an impairment of value was evident. As a result of this analysis, we determined that as of the related measurement date the book value of RHL's net assets exceeded the fair value by approximately \$1.8 million and recorded an impairment charge for this amount to discontinued operations during the third quarter of fiscal 2009. Based on the required analysis performed as of the annual test date, no additional impairment losses were recorded in the fourth quarter of fiscal 2009.

### *Impairment of Assets*

In accordance with the provisions of SFAS 144, our policy is to evaluate whether there has been a permanent impairment in the value of long-lived assets and certain identifiable intangibles when certain events have taken place that indicate the remaining unamortized balance may not be recoverable. When factors indicate that the intangible assets should be evaluated for possible impairment, we use an estimate of related undiscounted cash flows. Factors considered in the valuation include current operating results, trends and anticipated undiscounted future cash flows. No additional impairment losses were recorded in the fourth quarter of fiscal 2009.

### *Revenue Recognition*

We recognize revenue in accordance with the SEC's Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements* (SAB 104), SFAS No. 48, *Revenue Recognition When Right of Return Exists* (SFAS 48), and Emerging Issues Task Force (EITF) Abstract No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)* (EITF 01-09). SAB 104 requires four basic criteria be met before revenue can be recognized: 1) there is evidence that an arrangement exists; 2) delivery has occurred; 3) the fee is fixed or determinable; and 4) collectability is reasonably assured. SFAS 48 states that revenue from sales transactions where the buyer has the right to return the product shall be recognized at the time of sale only if (1) the seller's price to the buyer is substantially fixed or determinable at the date of sale; (2) the buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product; (3) the buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product; (4) the buyer acquiring the product for resale has economic substance apart from that provided by the seller; (5) the seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer; and (6) the amount of future returns can be reasonably estimated. We recognize revenue upon determination that all criteria for revenue recognition have been met. The criteria are usually met at the time title passes to the customer, which usually occurs upon shipment. Revenue from shipments where title passes upon delivery is deferred until the shipment has been delivered.

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We record reductions to gross revenue for estimated returns of private label contract manufacturing products and branded products. The estimated returns are based on the trailing six months of private label contract manufacturing gross sales and our historical experience for both private label contract manufacturing and branded product returns. However, the estimate for product returns does not reflect the impact of a large product recall resulting from product nonconformance or other factors as such events are not predictable nor is the related economic impact estimable.

As part of the services we provide to our private label contract manufacturing customers, we may perform, but are not required to perform, certain research and development activities related to the development or improvement of their products. While our customers typically do not pay directly for this service, the cost of this service is included as a component of the price we charge to manufacture and deliver their products. These costs are recorded in selling, general and administrative expenses.

### *Inventory Reserve*

We operate primarily as a private label contract manufacturer that builds products based upon anticipated demand or following receipt of customer specific purchase orders. From time to time, we build inventory for private label contract manufacturing customers under a specific purchase order with delivery dates that may subsequently be rescheduled or canceled at the customer's request. We value inventory at the lower of cost or market on an item-by-item basis and establish reserves equal to all or a portion of the related inventory to reflect situations in which the cost of the inventory is not expected to be recovered. This requires us to make estimates regarding the market value of our inventory, including an assessment for excess and obsolete inventory. Once we establish an inventory reserve amount in a fiscal period, the reduced inventory value is maintained until the inventory is sold or otherwise disposed of. In evaluating whether inventory is stated at the lower of cost or market, management considers such factors as the amount of inventory on hand, the estimated time required to sell such inventory, the remaining shelf life and efficacy, the foreseeable demand within a specified time horizon and current and expected market conditions. Based on this evaluation, we record adjustments to cost of goods sold to adjust inventory to its net realizable value. These adjustments are estimates, which could vary significantly, either favorably or unfavorably, from actual requirements if future economic conditions, customer demand or other factors differ from expectations.

### *Accounting for Income Taxes*

On July 1, 2007, we adopted the provisions of the Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense. Upon adoption of FIN 48 on July 1, 2007, we did not record any interest or penalties.

As of June 30, 2009 and 2008, we have not recorded any FIN 48 tax liabilities.

We estimate income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure, together with assessing temporary differences resulting from differing treatment of items, such as property and equipment depreciation, for tax and financial reporting purposes. Actual income taxes could vary from these estimates due to future changes in income tax law or results from final tax examination reviews.

We record valuation allowances to reduce our deferred tax assets to an amount that we believe is more likely than not to be realized. We consider estimated future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance. If we determine we will not realize all or part of our deferred tax assets in the future, we will record an adjustment to the carrying value of the deferred tax asset, which would be reflected as income tax expense. Conversely, if we determine we will realize a deferred tax asset, which currently has a valuation allowance, we will reverse the valuation allowance, which would be reflected as an income tax benefit.

During fiscal 2009, we recorded a valuation allowance against deferred income tax assets of \$1.8 million, representing the amount of our deferred income tax assets in excess of our deferred income tax liabilities. We recorded the valuation allowance because management was unable to conclude, in light of the cumulative loss we have realized related to our US-based operations for the three year period ended June 30, 2009, that realization of the net deferred income tax asset was more likely than not. The valuation allowance recorded during the fiscal 2009 primarily related to fiscal 2009 net operating loss carry forwards and changes in other deferred tax items recognized during fiscal 2009. As a result of the recognition of these valuation adjustments, we have a \$1.8 million net deferred tax asset offset by a valuation allowance of \$1.8 million resulting in a net deferred tax asset of \$0 as of June 30, 2009. This valuation allowance did not have any affect on the tax expense and related liability recorded for operating income recognized by NAIE during the year ended June 30, 2009.

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Additionally, we have not recorded U.S. income tax expense for NAIE's retained earnings that we have declared as indefinitely reinvested offshore, thus reducing our overall income tax expense. The earnings designated as indefinitely reinvested in NAIE are based on the actual deployment of such earnings in NAIE's assets and our expectations of the future cash needs of NAIE and NAI. Income tax laws also are a factor in determining the amount of foreign earnings to be indefinitely reinvested offshore.

We carefully review several factors that influence the ultimate disposition of NAIE's retained earnings declared as reinvested offshore, and apply stringent standards to overcome the presumption of repatriation. Despite this approach, because the determination involves our future plans and expectations of future events, the possibility exists that amounts declared as indefinitely reinvested offshore may ultimately be repatriated. For instance, NAI's actual cash needs may exceed our current expectations or NAIE's actual cash needs may be less than our current expectations. Additionally, changes may occur in tax laws and/or accounting standards that could change our determination of the status of NAIE's retained earnings. This would result in additional income tax expense in the fiscal year in which we determine that amounts are no longer indefinitely reinvested offshore.

On an interim basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision in accordance with the anticipated annual rate. As the fiscal year progresses, we refine our estimate based upon actual events and earnings by jurisdiction during the year. This continual estimation process periodically results in a change to our expected effective tax rate for the fiscal year. When this occurs, we adjust the income tax provision during the quarter in which the change in estimate occurs so that the year-to-date provision equals the expected annual rate.

We establish reserves based on management's assessment of exposure for certain positions taken in previously filed tax returns that may become payable upon audit by tax authorities. The tax reserves are analyzed at least annually, generally in the fourth quarter of each year, and adjustments are made as events occur that warrant adjustments to the reserve.

### *Derivative Financial Instruments*

We may use derivative financial instruments in the management of our foreign currency exchange risk inherent in our forecasted transactions denominated in Euros. We may hedge our foreign currency exposures by entering into offsetting forward exchange contracts and currency options. To the extent we use derivative financial instruments, we account for them using the deferral method under Financial Accounting Standard 133, *Accounting for Derivatives and Related Hedging Activity* (FAS 133), when such instruments are intended to hedge identifiable, firm foreign currency commitments or anticipated transactions and are designated as, and effective as, hedges. Foreign exchange exposures arising from certain transactions that do not meet the criteria for the deferral method are marked-to-market.

We recognize any unrealized gains and losses associated with derivative instruments in income in the period in which the underlying hedged transaction is realized. In the event the derivative instrument is deemed ineffective we would recognize the resulting gain or loss in income at that time. As of June 30, 2009, we did not have any derivative financial instruments.

### *Allowance for Doubtful Accounts*

We maintain an allowance for doubtful accounts to reflect our estimate of current and past due receivable balances that may not be collected. The allowance for doubtful accounts is based upon our assessment of the collectability of specific customer accounts, the aging of accounts receivable and our history of bad debts. We believe that the allowance for doubtful accounts is adequate to cover anticipated losses in the receivable balance under current conditions. However, significant deterioration in the financial condition of our customers, resulting in an impairment of their ability to make payments, could materially change these expectations and an additional allowance may be required.

### *Defined Benefit Pension Plan*

We sponsor a defined benefit pension plan. Effective June 21, 1999, we adopted an amendment to freeze benefit accruals to the participants. The plan obligation and related assets of the plan are presented in the notes to the consolidated financial statements. Plan assets, which consist primarily of marketable equity and debt instruments, are valued based upon third party market quotations. Independent actuaries, through the use of a number of assumptions, determine plan obligation and annual pension expense. Key assumptions in measuring the plan obligation include the discount rate and estimated future return on plan assets. In determining the discount rate, we use an average long-term bond yield. Asset returns are based on the historical returns of multiple asset classes to develop a risk free rate of return and risk premiums for each asset class. The overall rate for each asset class was developed by combining a long-term inflation component, the risk free rate of return and the associated risk premium. A weighted average rate is developed based on the overall rates and the plan's asset allocation.

We have discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors and the Audit Committee has reviewed our disclosure relating to these policies.

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**Results of Operations**

The following table sets forth selected consolidated operating results for each of the last two fiscal years, presented as a percentage of net sales (dollars in thousands).

	Fiscal Year Ended				Increase (Decrease)	
	June 30, 2009		June 30, 2008			
Private label contract manufacturing	\$71,242	96%	\$77,850	95%	\$(6,608)	(8)%
Branded products	2,677	4%	3,905	5%	(1,228)	(31)%
Total net sales	73,919	100%	81,755	100%	(7,836)	(10)%
Cost of goods sold	64,514	87%	68,843	84%	(4,329)	(6)%
Gross profit	9,405	13%	12,912	16%	(3,507)	(27)%
Selling, general & administrative expenses	9,008	12%	11,838	14%	(2,830)	(24)%
Operating income from continuing operations	397	1%	1,074	1%	(677)	(63)%
Other expenses (income), net	524	1%	(102)	(0)%	(626)	(614)%
(Loss) income from continuing operations before income taxes	(127)	0%	1,176	1%	(1,303)	(111)%
Income tax expense	93	0%	264	0%	(171)	(65)%
(Loss) income from continuing operations	(220)	(0)%	912	1%	(1,132)	(124)%
Loss from discontinued operations, net of tax	(3,860)	(5)%	(1,283)	(2)%	(2,577)	(201)%
Net loss	<u>\$ (4,080)</u>	<u>(6)%</u>	<u>\$ (371)</u>	<u>(0)%</u>	<u>\$(3,709)</u>	<u>(1,000)%</u>

**Fiscal 2009 Compared to Fiscal 2008**

The percentage decrease in private label contract manufacturing net sales was primarily attributed to the following:

	Percentage Change
NSA International, Inc. (NSA)	(5) <sup>(1)</sup>
Mannatech, Incorporated	(7) <sup>(1)</sup>
Other customers	4 <sup>(2)</sup>
Total	<u>(8)</u>

<sup>1</sup> A decrease in net sales resulted primarily from the impact of the current economic conditions and unfavorable foreign currency fluctuations.

<sup>2</sup> An increase in net sales to other customers was primarily due to increased sales from several of our existing customers along with increased sales from a new customer and income related to a sub-license agreement for the distribution of Beta-Alanine.

Net sales from our continuing branded products segment decreased 31.4% during fiscal 2009 due primarily to the continued softening of the Pathway to Healing product line following the cessation of Dr. Cherry's weekly television program in April 2007, which had served as the primary acquisition vehicle in marketing the Pathway to Healing® product line.

Gross profit margin from continuing operations decreased 3.1 percentage points primarily due to the following:

	Percentage Change
Shift in sales mix	(2.5)
Changes in overhead expenses	(1.6)
Incremental direct and indirect labor	0.9
Branded products operations	0.4
Cost reduction program (severance)	(0.3)
Total	<u>(3.1)</u>

Private label contract manufacturing gross profit margin declined 2.5 percentage points to 11.2% in fiscal 2009 compared to 13.7% in fiscal 2008. The decrease in gross profit as a percentage of sales was primarily due to higher per unit private label manufacturing costs associated with lower production levels, increased product testing costs associated with new product offerings and system and process validation costs related to improving our existing processes and implementing newly required GMPs. These expenses were partially offset by lower direct and indirect labor costs associated with our cost reduction programs. Additionally, during fiscal 2009 we experienced an unfavorable sales mix shift to lower margin product sales as compared to the prior year along with unfavorable currency exchange rates associated with our international sales.

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Branded products gross profit margin decreased 3.1 percentage points to 53.8% in fiscal 2009 from 56.9% in fiscal 2008 due primarily to increased material and shipping costs as a percentage of sales.

Selling, general and administrative expenses from continuing operations decreased \$2.8 million, or 24% during fiscal 2009. The decrease from the comparable fiscal year was attributed to a reduction in selling, general and administrative expenses primarily from our branded products business totaling \$900,000 associated with our operational consolidation, and a \$1.9 million decrease in operating costs from our domestic contract manufacturing operation as a result of our cost reduction programs implemented during the fiscal year ended June 30, 2009.

Other income, net decreased \$626,000 primarily due to \$656,000 in unfavorable foreign currency exchange losses due to the weakening of the Euro and the related impact on the translation of Euro denominated cash and receivables and \$45,000 in other income amounts. These amounts were partially offset by a \$75,000 reduction in interest expense due to lower borrowings and interest rates during the current fiscal year.

Our income tax expense of \$93,000 for the year ended June 30, 2009 was the result of \$180,000 in tax expense from our foreign subsidiary at a statutory tax rate of 20% and \$87,000 in net tax benefit from our US-based operations related primarily to annual tax return versus tax provision reconciliation adjustments. As a result of our deferred tax asset valuation, we did not record any income tax benefit during the year ended June 30, 2009 against our year-to-date US-based losses from operations.

### **Net Loss from Discontinued Operations**

In an effort to enhance stockholder value, improve working capital and enable us to focus on our core contract manufacturing business, during the fourth quarter of fiscal 2008 we undertook a careful review of our branded products portfolio and operations. As a result, we decided to narrow our branded products focus and portfolio and developed a plan to do so, which included a decision to sell our legacy RHL business. On August 4, 2008, RHL sold certain assets related to its catalog and internet business conducted under the name "As We Change®" to Miles Kimball Company for a cash purchase price of \$2.3 million. We recorded a loss of \$226,000 as a result of this sale and recognized \$221,000 in severance and related payroll costs during fiscal 2009.

On July 29, 2009, we entered into an Asset Purchase Agreement with PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for the sale of substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business. The sale closed on July 31, 2009 for a cash purchase price of \$500,000. As additional compensation, RHL may receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. NAI provided a guarantee of RHL's indemnity obligations under the Asset Purchase Agreement, which potential liability is capped at the amount of the purchase price paid by the buyers to RHL. RHL has agreed to provide certain transition services and support to the buyers for a period of up to six months and will receive an amount equal to \$9,000 per month for such services.

As a result of our decision to sell the legacy RHL business, we initiated an operational consolidation program during the first quarter of fiscal 2009 that transitioned the remaining branded products business operations to our corporate offices. This operational consolidation program was substantially complete as of September 30, 2008 and resulted in a charge to discontinued operations of \$823,000 in severance and other business related exit costs during the year ended June 30, 2009.

As the plan to dispose of the legacy RHL business met the criteria of SFAS 144, the current and prior periods presented in this report have been reclassified to reflect the legacy RHL business as discontinued operations.

For fiscal 2009, net loss from discontinued operations was \$3.9 million or \$0.55 per basic share and included a \$1.8 million impairment charge. For fiscal 2008, net loss from discontinued operations was \$1.3 million, or \$0.18 per basic share.

### **Liquidity and Capital Resources**

Our primary sources of liquidity and capital resources are cash flows provided by operating activities and the availability of borrowings under our credit facility. Net cash provided by operating activities was \$4.9 million in fiscal 2009 compared to net cash provided by operating activities of \$2.7 million in fiscal 2008.

At June 30, 2009, changes in accounts receivable, consisting primarily of amounts due from our private label contract manufacturing customers, provided \$706,000 in cash during fiscal 2009 compared to \$1.5 million of cash used in the prior year. Cash provided by accounts receivable in fiscal 2009 was due to the increase in shipments during the fourth quarter of 2008 as compared to the comparable period in fiscal 2009 and the timing of collections. Days sales outstanding from continuing operations was 30 days during fiscal 2009 compared to 25 days in fiscal 2008. The increase in days sales outstanding was primarily due to timing of shipments.



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At June 30, 2009, changes in inventory provided \$4.8 million in cash during fiscal 2009 compared to \$788,000 of cash used in fiscal 2008. The decrease in inventory at June 30, 2009 was primarily related to declining sales demand and management's efforts to reduce our working capital investment in inventory.

Approximately \$810,000 of our operating cash flow was generated by NAIE in fiscal 2009. In June 2005, we repatriated \$2.0 million of NAIE retained earnings under the American Jobs Creation Act. As of June 30, 2009, NAIE's undistributed retained earnings are considered indefinitely reinvested.

Cash used in investing activities in fiscal 2009 was \$3.0 million compared to \$1.4 million in fiscal 2008. Capital expenditures were \$4.5 million in fiscal 2009 compared to \$1.4 million in fiscal 2008. Capital expenditures for both years were primarily for manufacturing equipment in our Vista, California and Manno, Switzerland facilities.

Our consolidated debt decreased to \$1.3 million at June 30, 2009 from \$2.7 million at June 30, 2008 primarily due to net payments of \$1.5 million to our term loan balances during fiscal 2009.

We have a bank credit facility of \$8.8 million as of June 30, 2009, comprised of a \$7.5 million working capital line of credit and \$1.3 million in outstanding term loans. The working capital line of credit is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has a fluctuating or fixed interest rate as elected by NAI from time to time and described in more detail below, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. As of June 30, 2009, the outstanding balances on the term loans consisted of a \$226,000, 15 year term loan due June 2011, secured by our San Marcos building, at an interest rate of 8.25%; a \$521,000, 10 year term loan due May 2014 with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; and a \$520,000, four year term loan due December 2009, secured by equipment, at an interest rate of LIBOR plus 2.10%. Monthly payments on the term loans are approximately \$122,000 plus interest. As of June 30, 2009 and June 30, 2008, our working capital line of credit balance was zero.

On January 24, 2007, we amended our credit facility to extend the maturity date for the working capital line of credit from November 1, 2007 to November 1, 2008, and maintain the ratio of total liabilities/tangible net worth covenant at 1.25/1.0 for the remainder of the term of the credit facility.

On December 18, 2007, we further amended our credit facility to (i) extend the maturity date for the working capital line of credit from November 1, 2008 to November 1, 2009; (ii) reduce the maximum principal amount available under the working capital line of credit from \$12.0 million to \$7.5 million; (iii) reduce the maximum borrowings against inventory from \$6.0 million to \$3.75 million, provided any such borrowings do not at any time exceed eligible accounts receivable; and (iv) extend the availability of the Foreign Exchange Facility from November 1, 2007 to November 1, 2008 and the allowable contract term thereunder from November 1, 2008 to November 1, 2009.

On December 29, 2008, we again amended our credit facility to (i) extend the maturity date for the working capital line of credit from November 1, 2009 to November 1, 2010; (ii) modify the interest rate payable on the line of credit from a rate equal to the Prime Rate or LIBOR plus 1.75%, as elected by NAI from time to time, to a rate equal to either a fluctuating rate per annum equal to 2.75% to 3.75% above the Daily One Month LIBOR Rate in effect from time to time or a fixed rate per annum equal to 2.50% to 3.50% above LIBOR, as elected by NAI from time to time, in each case with the percentage above the applicable LIBOR determined based on NAI's fixed charge coverage ratio; (iii) modify the fiscal year end net income requirement for fiscal 2009 from net income after taxes of not less than \$750,000 to a net loss not to exceed \$2,500,000; (iv) modify the fixed charge coverage ratio for the quarter ended March 31, 2009 from not less than 1.25 to 1.0 to not less than 0.50 to 1.0; and (v) eliminate the fixed charge coverage ratio and net income requirements that would have applied to the second quarter of fiscal 2009. In consideration of such amendments, NAI paid a \$25,000 amendment fee to the lender.

On July 14, 2009, we completed certain additional amendments to our credit facility, effective June 1, 2009, to (i) modify the interest rate payable on the line of credit from a rate equal to either a fluctuating rate per annum equal to 2.75% to 3.75% above the Daily One Month LIBOR Rate in effect from time to time or a fixed rate per annum equal to 2.50% to 3.50% above LIBOR, to a rate equal to either a fluctuating rate per annum equal to 2.75% to 4.25% above the Daily Three Month LIBOR Rate in effect from time to time or a fixed rate per annum equal to 2.50% to 4.00% above LIBOR, as elected by NAI from time to time, in each case with the percentage above the applicable LIBOR determined based on NAI's fixed charge coverage ratio; (ii) modify the annual fee payable to the lender from 0.25% to 1.00% of the maximum available line of credit amount to 0.25% to 1.50% of the maximum available line of credit amount with the percentage determined based on NAI's fixed charge coverage ratio; (iii) modify the borrowing limitation under the line of credit from an aggregate of 85% of NAI's eligible accounts receivable plus 50% of the value of NAI's eligible inventory to an aggregate of 85% of NAI's eligible accounts receivable plus 30% of the value of NAI's eligible raw materials inventory plus 40% of the value of NAI's eligible finished goods inventory; (iv) extend the availability of the foreign exchange facility to November 1, 2010; (v) modify the fiscal year end net income requirement for fiscal 2009 from a net loss not to exceed \$2,500,000 to a net loss not to exceed \$5,000,000; (vi) modify the quarterly net income requirement from net income not less than \$1.00 to net income not less than \$250,000 for the quarter ended June 30, 2009; and (iv) modify the fixed charge coverage ratio for the quarter ended June 30, 2009 from not less than 1.25 to 1.0 to not less than -1.95 to 1.0.

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On June 30, 2009, we were in compliance with all loan debt covenants.

On September 22, 2006, NAIE, our wholly owned subsidiary, entered into a credit facility to provide it with a credit line of up to CHF 1.3 million, or approximately \$1.2 million, which is the initial maximum aggregate amount that can be outstanding at any one time under the credit facility. This maximum amount was reduced by CHF 160,000, or approximately \$147,000, as of December 31, 2007, and was reduced an additional CHF 160,000, or approximately \$147,000, as of December 31, 2008, and will be reduced by an additional CHF 160,000 at the end of each succeeding calendar year. On February 19, 2007, NAIE amended its credit facility to provide that the maximum aggregate amount that may be outstanding under the facility cannot be reduced below CHF 500,000, or approximately \$461,000. As of June 30, 2009, there was no outstanding balance under the credit facility.

Under its credit facility, NAIE may draw amounts either as current account loan credits to its current or future bank accounts or as fixed loans with a maximum term of 24 months. Current account loans will bear interest at the rate of 5% per annum. Fixed loans will bear interest at a rate determined by the parties based on current market conditions and must be repaid pursuant to a repayment schedule established by the parties at the time of the loan. If a fixed loan is repaid early at NAIE's election or in connection with the termination of the credit facility, NAIE will be charged a pre-payment penalty equal to 0.1% of the principal amount of the fixed loan or CHF 1,000 (approximately \$921), whichever is greater. The bank reserves the right to refuse individual requests for an advance under the credit facility, although its exercise of such right will not have the effect of terminating the credit facility as a whole.

As of June 30, 2009, we had \$4.0 million in cash and cash equivalents, a \$699,000 certificate of deposit and \$5.2 million available under our line of credit. We believe our available cash, cash equivalents and potential cash flows from operations will be sufficient to fund our current working capital needs, capital expenditures and debt payments through at least the next 12 months.

### **Off-Balance Sheet Arrangements**

As of June 30, 2009, we did not have any significant off-balance sheet debt nor did we have any transactions, arrangements, obligations (including contingent obligations) or other relationships with any unconsolidated entities or other persons that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses material to investors.

### **Inflation**

During fiscal 2008 and early fiscal 2009, we experienced increases in various product raw material costs, transportation costs and the cost of petroleum based raw materials and packaging supplies used in our business, which were associated with higher oil and fuel costs. We currently believe petroleum related raw material and product cost pricing pressures have stabilized and will remain relatively constant throughout fiscal 2010, although there is no assurance this will occur. We do not believe current inflation rates will have a material impact on our future operations or profitability.

### **Recent Accounting Pronouncements**

A discussion of recent accounting pronouncements is included under Note A in the notes to our consolidated financial statements included under Item 8 of this report.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders  
Natural Alternatives International, Inc.

We have audited the accompanying consolidated balance sheets of Natural Alternatives International, Inc. as of June 30, 2009 and 2008, and the related consolidated statements of operations and comprehensive loss, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Natural Alternatives International, Inc. at June 30, 2009 and 2008, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

San Diego, California  
September 25, 2009

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**Natural Alternatives International, Inc.**  
**Consolidated Balance Sheets**  
**As of June 30**  
**(Dollars in thousands, except share and per share data)**

	2009	2008
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 3,995	\$ 3,518
Certificate of deposit	699	—
Accounts receivable - less allowance for doubtful accounts of \$27 at June 30, 2009 and \$17 at June 30, 2008	5,685	6,401
Inventories, net	9,320	14,135
Income tax receivable	2	1,354
Prepays and other current assets	1,259	1,223
Assets of discontinued operations	1,187	6,299
Total current assets	<u>22,147</u>	<u>32,930</u>
Property and equipment, net	14,133	12,823
Other noncurrent assets, net	159	160
Total assets	<u>\$36,439</u>	<u>\$45,913</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 4,327	\$ 7,245
Accrued liabilities	1,001	1,048
Accrued compensation and employee benefits	1,164	1,332
Income taxes payable	490	409
Current portion of long-term debt	669	2,730
Liabilities of discontinued operations	599	1,724
Total current liabilities	8,250	14,488
Long-term debt, less current portion	598	—
Deferred income taxes	—	61
Deferred rent	1,054	1,164
Long-term pension liability	505	198
Total liabilities	<u>10,407</u>	<u>15,911</u>
Commitments and contingencies		
Stockholders' equity:		
Preferred stock; \$.01 par value; 500,000 shares authorized; none issued or outstanding	—	—
Common stock; \$.01 par value; 20,000,000 shares authorized at June 30, 2009 and June 30, 2008, issued and outstanding 7,249,734 at June 30, 2009 and 7,210,937 at June 30, 2008	71	71
Additional paid-in capital	18,899	18,485
Accumulated other comprehensive loss	(565)	(261)
Retained earnings	8,726	12,806
Treasury stock, at cost, 180,941 shares at June 30, 2009 and June 30, 2008	(1,099)	(1,099)
Total stockholders' equity	<u>26,032</u>	<u>30,002</u>
Total liabilities and stockholders' equity	<u>\$36,439</u>	<u>\$45,913</u>

*See accompanying notes to consolidated financial statements.*

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**Natural Alternatives International, Inc.**  
**Consolidated Statements Of Operations And Comprehensive Income (Loss)**  
**For the Years Ended June 30**  
**(Dollars in thousands, except share and per share data)**

	2009	2008
Net sales	\$ 73,919	\$ 81,755
Cost of goods sold	<u>64,514</u>	<u>68,843</u>
Gross profit	9,405	12,912
Selling, general & administrative expenses	<u>9,008</u>	<u>11,838</u>
Operating income from continuing operations	397	1,074
Other (expense) income:		
Interest income	14	20
Interest expense	(210)	(286)
Foreign exchange (loss) gain	(360)	296
Other, net	<u>32</u>	<u>72</u>
	<u>(524)</u>	<u>102</u>
(Loss) income from continuing operations before income taxes	(127)	1,176
Provision for income taxes	<u>93</u>	<u>264</u>
(Loss) income from continuing operations	(220)	912
Loss from discontinued operations, net of tax	<u>(3,860)</u>	<u>(1,283)</u>
Net loss	<u>\$ (4,080)</u>	<u>\$ (371)</u>
Unrealized gain resulting from change in fair value of derivative instruments, net of tax	—	39
Change in minimum pension liability, net of tax	<u>(304)</u>	<u>(116)</u>
Comprehensive loss	<u>\$ (4,384)</u>	<u>\$ (448)</u>
Net (loss) income per common share:		
Basic:		
Continuing operations	\$ (0.03)	\$ 0.13
Discontinued operations	<u>(0.55)</u>	<u>(0.18)</u>
Net loss	<u>\$ (0.58)</u>	<u>\$ (0.05)</u>
Diluted:		
Continuing operations	\$ (0.03)	\$ 0.13
Discontinued operations	<u>(0.55)</u>	<u>(0.18)</u>
Net loss	<u>\$ (0.58)</u>	<u>\$ (0.05)</u>
Weighted average common shares outstanding:		
Basic	7,055,952	6,982,852
Diluted	7,055,952	7,037,682

*See accompanying notes to consolidated financial statements.*

**Natural Alternatives International, Inc.**  
**Consolidated Statements Of Stockholders' Equity**  
**For the Years Ended June 30**  
**(Dollars in thousands)**

	Common Stock		Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total
	Shares	Amount					
Balance, June 30, 2007	7,001,230	\$ 69	\$ 17,335	\$ 13,177	\$ (375)	\$ (184)	\$ 30,022
Issuance of common stock for employee stock purchase plan and stock option exercises	209,707	2	531	—	—	—	533
Compensation expense related to stock options and employee stock purchase plan	—	—	425	—	—	—	425
Repurchase of common stock	—	—	—	—	(724)	—	(724)
Tax benefit from exercise of stock options	—	—	194	—	—	—	194
Unrealized gain resulting from change in fair value of derivative instruments, net of tax	—	—	—	—	—	39	39
Change in minimum pension liability, net of tax	—	—	—	—	—	(116)	(116)
Net loss	—	—	—	(371)	—	—	(371)
Balance, June 30, 2008	7,210,937	71	18,485	12,806	(1,099)	(261)	30,002
Issuance of common stock for employee stock purchase plan and stock option exercises	38,797	—	—	—	—	—	—
Compensation expense related to stock options and employee stock purchase plan	—	—	325	—	—	—	325
Tax benefit from exercise of stock options	—	—	89	—	—	—	89
Change in minimum pension liability, net of tax	—	—	—	—	—	(304)	(304)
Net loss	—	—	—	(4,080)	—	—	(4,080)
Balance, June 30, 2009	7,249,734	\$ 71	\$ 18,899	\$ 8,726	\$ (1,099)	\$ (565)	\$ 26,032

*See accompanying notes to consolidated financial statements.*

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**Natural Alternatives International, Inc.**  
**Consolidated Statements Of Cash Flows**  
**For the Years Ended June 30**  
**(Dollars in thousands)**

	2009	2008
<b>Cash flows from operating activities</b>		
(Loss) income before discontinued operations	\$ (220)	\$ 912
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Provision for uncollectible accounts receivable	10	2
Depreciation and amortization	3,143	2,960
Non-cash equipment impairment charge	—	74
Tax benefit from exercise of stock options	(89)	(194)
Deferred income taxes	(61)	1,144
Non-cash compensation	325	425
Pension benefit (expense), net of contributions	3	(72)
Loss on disposal of assets	39	—
Changes in operating assets and liabilities:		
Accounts receivable	706	(1,461)
Inventories	4,815	(788)
Other assets	(35)	(205)
Accounts payable and accrued liabilities	(3,075)	1,312
Income taxes payable	1,522	(475)
Accrued compensation and employee benefits	(168)	94
Net cash provided by operating activities from continuing operations	6,915	3,728
Net cash (used) provided by operating activities from discontinued operations	(2,028)	(1,040)
Net cash provided by operating activities	<u>4,887</u>	<u>2,688</u>
<b>Cash flows from investing activities</b>		
Capital expenditures	(4,530)	(1,372)
Proceeds from sale of property & equipment	38	—
Purchase of certificate of deposit	(699)	—
Net cash used in investing activities from continuing operations	(5,191)	(1,372)
Net cash provided by (used in) investing activities from discontinued operations, including proceeds from the sale of As We Change®	2,155	(44)
Net cash used in investing activities	<u>(3,036)</u>	<u>(1,416)</u>
<b>Cash flows from financing activities</b>		
Payments on long-term debt	(1,463)	(1,852)
Issuance of common stock	—	533
Repurchase of common stock	—	(724)
Tax benefit from exercise of stock options	89	194
Net cash used in financing activities	<u>(1,374)</u>	<u>(1,849)</u>
Net increase (decrease) in cash and cash equivalents	477	(577)
Cash and cash equivalents at beginning of year	<u>3,518</u>	<u>4,095</u>
Cash and cash equivalents at end of year	<u>\$ 3,995</u>	<u>\$ 3,518</u>
<b>Supplemental disclosures of cash flow information</b>		
Cash paid during the year for:		
Taxes	\$ 109	\$ 419
Interest	\$ 267	\$ 360
Disclosure of non-cash activities:		
Net unrealized gains resulting from change in fair value of derivative instruments	\$ —	\$ 39
Change in minimum pension liability, net of tax	\$ 304	\$ 116

*See accompanying notes to consolidated financial statements.*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### A. Organization and Summary of Significant Accounting Policies

#### Organization

We provide private label contract manufacturing services to companies that market and distribute vitamins, minerals, herbs, and other nutritional supplements, as well as other health care products, to consumers both within and outside the United States. We also develop, manufacture and market our own products.

#### Subsidiaries

On January 22, 1999, Natural Alternatives International Europe S.A. (NAIE) was formed as our wholly owned subsidiary, based in Manno, Switzerland. In September 1999, NAIE opened its manufacturing facility to provide manufacturing capability in encapsulation and tablets, finished goods packaging, quality control laboratory testing, warehousing, distribution and administration.

On December 5, 2005, we acquired Real Health Laboratories, Inc. (RHL), which primarily marketed branded nutritional supplements. RHL's operations included in-house creative, supply chain management and call center and fulfillment activities. During the fourth quarter of fiscal 2008, we undertook a careful review of our branded products portfolio and operations. As a result of this review, we decided to narrow our branded products focus and portfolio. On August 4, 2008, we sold certain assets related to RHL's catalog and internet business conducted under the name "As We Change<sup>®</sup>" and on July 31, 2009, we sold substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business. As a result, the current and prior periods presented in this report have been reclassified to reflect the originally acquired RHL operations as discontinued operations, pursuant to SFAS 144.

#### Principles of Consolidation

The consolidated financial statements include the accounts of Natural Alternatives International, Inc. (NAI) and our wholly owned subsidiary, NAIE. All significant intercompany accounts and transactions have been eliminated. The functional currency of NAIE, our foreign subsidiary, is the United States dollar. The financial statements of NAIE have been translated at either current or historical exchange rates, as appropriate, with gains and losses included in the consolidated statements of operations.

#### Reclassification

Certain prior year amounts have been reclassified to conform with the current year's presentation. Such reclassifications had no effect on net (loss) income.

#### Subsequent Events Evaluation

The Company evaluated all events or transactions that occurred after June 30, 2009 up through September 25, 2009, the date these financial statements were issued.

#### Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations: Applying the Acquisition Method* ("SFAS No. 141R"). SFAS No. 141R retains the fundamental requirements of SFAS No. 141, *Business Combinations*, but provides additional guidance on applying the acquisition method when accounting for similar economic events. It establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141R was a joint effort between the FASB and the International Accounting Standards Board to promote global standards by improving the accounting and financial reporting of business combinations. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company will be required to adopt this standard effective July 1, 2009. We will assess the impact of SFAS No. 141R if and when a future acquisition occurs.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* ("FSP No. 142-3"). FSP No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS No. 142"). The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141 (revised 2007), *Business Combinations*, and other GAAP. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We do not expect the adoption of FSP No. 142-3 to have a material impact on our results of operations, financial position or cash flows.

In April 2009, the FASB issued the following new accounting standards: (i) FSP FAS 157-4, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed* (FSP FAS 157-4), which provides guidelines for making fair value measurements more consistent with the principles presented in SFAS 157. FSP FAS 157-4 provides additional authoritative guidance in determining whether a market is active or inactive, and whether a transaction is distressed, is applicable to all assets and liabilities (financial and nonfinancial) and will require enhanced disclosures; (ii) FSP FAS 115-2, FAS 124-2 and EITF 99-20-2, *Recognition and*



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*Presentation of Other-Than-Temporary Impairments, which is applicable to debt securities and provides additional guidance to provide greater clarity about the credit and noncredit component of an other-than-temporary impairment event and to more effectively communicate when an other-than-temporary impairment event has occurred; and (iii) FSP FAS 107-1 and Accounting Principles Board (APB) Opinion No. 28-1, Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1 and APB 28-1), which amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments in interim as well as in annual financial statements and also amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in all interim financial statements. The Company adopted each of these standards effective June 15, 2009. The adoption of these standards did not have a material impact on the Company's consolidated financial statements.*

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (SFAS 165), which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The Company is required to adopt SFAS 165 prospectively to both interim and annual financial periods ending after June 15, 2009. The adoption of SFAS 165 has not resulted in a change in the Company's practices. The Company adopted these standards effective June 15, 2009. The adoption of these standards did not have a material impact on the Company's consolidated financial statements.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*, a replacement of FASB Statement No. 162 (FAS 168), which will become the source of authoritative U.S. GAAP recognized by the FASB to be applied to nongovernmental entities. On its effective date, FAS 168 will supersede all then-existing non-SEC accounting and reporting standards. FAS 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company believes adoption of FAS 168 will not have a material impact on its consolidated financial statements.

### **Cash and Cash Equivalents**

We consider all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

### **Investments**

We apply SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to its investments. We invest excess cash balances primarily in certificates of deposit and money market accounts with strong credit ratings. All securities have a maturity of less than one year as of June 30, 2009. Realized gains and losses would be calculated on the specific identification method and recorded as interest income. As of June 30, 2009, we had a certificate of deposit investment in the amount of \$699,000 and no gains and losses were realized for the year ended June 30, 2009.

### **Fair Value of Financial Instruments**

Our financial statements include the following financial instruments: cash and cash equivalents, short-term investments, accounts payable, and accrued expenses. We believe the carrying amounts of these assets and liabilities in the financial statements approximate the fair values of these financial instruments at June 30, 2009. We adopted the provisions of SFAS No. 157, *Fair Value Measurements* (SFAS 157), effective July 1, 2008, for its financial assets and liabilities. In February 2008, the FASB issued FSP No. 157-2, *Effective Date of SFAS 157*, which delayed the effective date of SFAS 157 until July 1, 2009, with respect to the fair value measurement requirements for non-financial assets and liabilities that are not re-measured on a recurring basis (at least annually). Therefore, we adopted the provisions of SFAS 157 only with respect to financial assets and liabilities, as well as any other assets and liabilities carried at fair value. Under this standard, fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date.

SFAS No. 157 establishes a three-level hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions about the inputs that market participants would use in pricing the asset or liability and are developed based on the best information available in the circumstances.

The fair value hierarchy is broken down into three levels based on the source of inputs. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. We classify cash, cash equivalents, and marketable securities balances as a Level 1 asset. Fair values determined by Level 2 inputs are based on quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active and models for which all significant inputs are observable or can be corroborated, either directly or indirectly by observable market data. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. These include certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs. As of June 30, 2009, we did not have any financial assets or liabilities classified as Level 2 or 3.

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We do not currently expect the application of the fair value framework established by SFAS No. 157 to non-financial assets and liabilities measured on a nonrecurring basis to have a material impact on its financial statements. However, we will continue to assess the potential effects of SFAS 157 as additional guidance becomes available. On July 1, 2008, we also adopted the provisions of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159), which allows an entity to voluntarily choose to measure many financial instruments and certain other items at fair value. SFAS No. 159 allows the Company to recognize the unrealized gains and losses on items for which the fair value option was elected in earnings at each subsequent reporting date. We have chosen not to elect the fair value option for any items that are not already required to be measured at fair value in accordance with GAAP.

### **Accounts Receivable**

We perform ongoing credit evaluations of our customers and adjust credit limits based on payment history and customer credit-worthiness. An allowance for estimated doubtful accounts is maintained based on historical experience and identified customer credit issues. We monitor collections regularly and adjust the allowance for doubtful accounts as necessary to recognize any changes in credit exposure. Upon conclusion that a receivable is uncollectible, we record the respective amount as a charge against allowance for doubtful accounts.

### **Inventories**

Our inventories are recorded at the lower of cost (first-in, first-out) or market (net realizable value). Such costs include raw materials, labor and manufacturing overhead.

### **Property and Equipment**

We state property and equipment at cost. Depreciation of property and equipment is provided using the straight-line method over their estimated useful lives, generally ranging from 1 to 39 years. We amortize leasehold improvements using the straight-line method over the shorter of the life of the improvement or the term of the lease. Maintenance and repairs are expensed as incurred. Significant expenditures that increase economic useful lives are capitalized.

### **Impairment of Long-Lived Assets**

SFAS 144 addresses financial accounting and reporting for the impairment of long-lived assets (excluding goodwill) and for long-lived assets to be disposed of. However, SFAS 144 retains the fundamental provisions of SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* for recognition and measurement of the impairment of long-lived assets to be held and used.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. We report assets to be disposed of at the lower of the carrying amount or fair value less costs to sell.

### **Goodwill and Other Intangible Assets**

Under SFAS 142, goodwill and other intangible assets with indefinite useful lives are not amortized, but are reviewed annually for impairment or more frequently if impairment indicators arise. Separable intangible assets that have finite lives are amortized over their useful lives. Under SFAS 142, goodwill and other intangible assets with indefinite useful lives resulting from acquisitions are not amortized.

### **Derivative Financial Instruments**

We may use derivative financial instruments in the management of our foreign currency exchange risk inherent in our forecasted transactions denominated in Euros. We may hedge our foreign currency exposures by entering into offsetting forward exchange contracts and currency options. To the extent we use derivative financial instruments, we account for them using the deferral method under FAS 133, when such instruments are intended to hedge identifiable, firm foreign currency commitments or anticipated transactions and are designated as, and effective as, hedges. Foreign exchange exposures arising from certain transactions that do not meet the criteria for the deferral method are marked-to-market.

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We recognize any unrealized gains and losses associated with derivative instruments in income in the period in which the underlying hedged transaction is realized. In the event the derivative instrument is deemed ineffective we would recognize the resulting gain or loss in income at that time. As of June 30, 2009, we did not have any derivative financial instruments.

### **Revenue Recognition**

We recognize revenue in accordance with SAB 104, SFAS 48 and EITF 01-09. SAB 104 requires that four basic criteria be met before revenue can be recognized: 1) there is evidence that an arrangement exists; 2) delivery has occurred; 3) the fee is fixed or determinable; and 4) collectability is reasonably assured. SFAS 48 states that revenue from sales transactions where the buyer has the right to return the product shall be recognized at the time of sale only if (1) the seller's price to the buyer is substantially fixed or determinable at the date of sale; (2) the buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product; (3) the buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product; (4) the buyer acquiring the product for resale has economic substance apart from that provided by the seller; (5) the seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer; and (6) the amount of future returns can be reasonably estimated. We recognize revenue upon determination that all criteria for revenue recognition have been met. The criteria are usually met at the time title passes to the customer, which usually occurs upon shipment. Revenue from shipments where title passes upon delivery is deferred until the shipment has been delivered.

We record reductions to gross revenue for estimated returns of private label contract manufacturing products and branded products. The estimated returns are based on the trailing six months of private label contract manufacturing gross sales and our historical experience for both private label contract manufacturing and branded product returns. However, the estimate for product returns does not reflect the impact of a large product recall resulting from product nonconformance or other factors as such events are not predictable nor is the related economic impact estimable.

### **Cost of Goods Sold**

Cost of goods sold includes raw material, labor and manufacturing overhead.

### **Shipping and Handling Costs**

In accordance with EITF No. 00-10, *Accounting for Shipping and Handling Fees and Costs*, we include fees earned on the shipment of our products to customers in sales and include costs incurred on the shipment of product to customers in costs of goods sold.

### **Research and Development Costs**

As part of the services we provide to our private label contract manufacturing customers, we may perform, but are not obligated to perform, certain research and development activities related to the development or improvement of their products. While our customers typically do not pay directly for this service, the cost of this service is included as a component of the price we charge to manufacture and deliver their products.

Research and development costs are expensed when incurred. Our research and development expenses for the last two fiscal years ended June 30 were \$1.2 million for 2009 and \$2.0 million for 2008. These costs are included in selling, general and administrative expenses.

### **Advertising Costs**

We expense the production costs of advertising the first time the advertising takes place. We incurred and expensed advertising costs in continuing operations in the amount of \$118,000 during the fiscal year ended June 30, 2009 and \$290,000 during fiscal 2008. These costs were included in selling, general and administrative expenses in the accompanying statements of operations.

### **Income Taxes**

We account for income taxes using the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates, for each of the jurisdictions in which we operate, expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations in the period that includes the enactment date.

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On July 1, 2007 we adopted the provisions of the FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense. Upon adoption of FIN 48 on July 1, 2007, we did not record any interest or penalties.

As of June 30, 2009 and 2008, we have not recorded any FIN 48 tax liabilities.

We are subject to taxation in the United States, Switzerland and various state jurisdictions. Our tax years for the fiscal year ended June 30, 2006 and forward are subject to examination by the United States and state tax authorities and our tax years for the fiscal year ended June 30, 2007 and forward are subject to examination by the Switzerland tax authorities.

We do not record U.S. income tax expense for NAIE's retained earnings that are declared as indefinitely reinvested offshore, thus reducing our overall income tax expense. The amount of earnings designated as indefinitely reinvested in NAIE is based on the actual deployment of such earnings in NAIE's assets and our expectations of the future cash needs of our U.S. and foreign entities. Income tax laws are also a factor in determining the amount of foreign earnings to be indefinitely reinvested offshore.

It is our policy to establish reserves based on management's assessment of exposure for certain positions taken in previously filed tax returns that may become payable upon audit by tax authorities. The tax reserves are analyzed at least annually, generally in the fourth quarter of each year, and adjustments are made as events occur that warrant adjustments to the reserve.

### Stock-Based Compensation

We have an equity incentive plan under which we have granted nonqualified and incentive stock options to employees, non-employee directors and consultants. We also had an employee stock purchase plan, that was terminated effective as of June 30, 2009. The Company accounts for share-based employee compensation plans under the fair value recognition and measurement provisions of SFAS No. 123(revised), Share-Based Payment (SFAS No. 123R). SFAS No. 123R requires the recognition of compensation expense, using a fair-value based method, for costs related to all share-based payments including stock options. Pursuant to SFAS No. 123R, compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the requisite service period. SFAS No. 123R also requires the cash flows resulting from the tax benefits due to tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows.

We estimated the fair value of the stock option awards at the date of grant and employee stock purchase plan shares at the beginning of the offering period using the Black-Scholes option valuation model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions. Black-Scholes uses assumptions related to volatility, the risk-free interest rate, the dividend yield (which is assumed to be zero, as we have not paid any cash dividends) and employee exercise behavior. Expected volatilities used in the model are based mainly on the historical volatility of our stock price. The risk-free interest rate is derived from the U.S. Treasury yield curve in effect in the period of grant. The expected life of the fiscal 2009 grants is derived from historical experience.

The per share fair value of options granted in connection with stock option plans and rights granted in connection with the employee stock purchase plan reported below has been estimated at the date of grant or beginning of the offering period, as applicable, with the following weighted average assumptions:

	Employee Stock Options		Employee Stock Purchase Plan	
	Fiscal Years Ended June 30,		Fiscal Years Ended June 30,	
	2009	2008	2009	2008
Expected life (years)	4.0	4.0	0.5	0.5
Risk-free interest rate	2.53 – 3.45%	2.8 – 4.37%	0.28 – 3.32%	3.3 – 4.9%
Volatility	34%	39%	33%	31%
Dividend yield	0%	0%	0%	0%
Weighted average fair value	\$ 1.80	\$ 2.60	\$ 0.63	\$ 0.68

For purposes of these disclosures, we have amortized the estimated fair value of our stock option awards to expense over the options' vesting periods and of our employee stock purchase plan shares to expense over the offering period.

The aggregate intrinsic value of awards outstanding as of June 30, 2009 was \$277,000. The aggregate intrinsic value of awards exercisable as of June 30, 2009 was \$277,000. In addition, the aggregate intrinsic value of awards exercised was \$255,000 during fiscal 2009 and \$923,000 during fiscal 2008. The total remaining unrecognized compensation cost related to unvested awards amounted to \$577,000 at June 30, 2009 and is expected to be recognized over the next 3.0 years. The weighted average remaining requisite service period of the unvested awards was 1.8 years. The total fair value of shares vested during the fiscal year ended June 30, 2009 was \$419,000. The total fair value of shares vested during the fiscal year ended June 30, 2008 was \$332,000.

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[Table of Contents](#)**Use of Estimates**

Our management has made a number of estimates and assumptions relating to the reporting of assets and liabilities, revenue and expenses, and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with GAAP. Actual results could differ from those estimates.

**Net Loss per Common Share**

We compute net loss per common share in accordance with SFAS No. 128, *Earnings Per Share* (SFAS 128). SFAS 128 requires the presentation of basic income per common share, using the weighted average number of common shares outstanding during the period, and diluted income per common share, using the additional dilutive effect of all dilutive securities. The dilutive impact of stock options account for the additional weighted average shares of common stock outstanding for our diluted net loss per common share computation. We calculated basic and diluted net loss per common share as follows (amounts in thousands, except per share data):

	For the Years Ended June 30,	
	2009	2008
<b>Numerator</b>		
Net loss	\$ (4,080)	\$ (371)
<b>Denominator</b>		
Basic weighted average common shares outstanding	7,056	6,983
Dilutive effect of stock options	—	55
Diluted weighted average common shares outstanding	<u>7,056</u>	<u>7,038</u>
Basic net loss per common share	<u>\$ (0.58)</u>	<u>\$ (0.05)</u>
Diluted net loss per common share	<u>\$ (0.58)</u>	<u>\$ (0.05)</u>

Shares related to stock options of 715,000 for the fiscal year ended June 30, 2009 and 708,000 for fiscal 2008, were excluded from the calculation of diluted net loss per common share, as the effect of their inclusion would be anti-dilutive.

**Concentrations of Credit Risk**

Financial instruments that subject us to concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. We place our cash and cash equivalents with highly rated financial institutions. Credit risk with respect to receivables is concentrated with our two largest customers, whose receivable balances collectively represented 77% of gross accounts receivable at June 30, 2009 and 84% at June 30, 2008. Concentrations of credit risk related to the remaining accounts receivable balances are limited due to the number of customers comprising our remaining customer base.

**B. Discontinued Operations**

In an effort to enhance stockholder value, improve working capital and enable us to focus on our core contract manufacturing business, during the fourth quarter of fiscal 2008 we undertook a careful review of our branded products portfolio and operations. As a result, we decided to narrow our branded products focus and portfolio and developed a plan to do so, which included a decision to sell our legacy RHL business. On August 4, 2008, RHL sold certain assets related to its catalog and internet business conducted under the name "As We Change®" to Miles Kimball Company for a cash purchase price of \$2.3 million. We recorded a loss of \$226,000 as a result of this sale and recognized \$221,000 in severance and related payroll costs during fiscal 2009.

On July 29, 2009, we entered into an Asset Purchase Agreement with PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for the sale of substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business. The sale closed on July 31, 2009 for a cash purchase price of \$500,000. As additional compensation, RHL may receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. NAI provided a guarantee of RHL's indemnity obligations under the Asset Purchase Agreement, which potential liability is capped at the amount of the purchase price paid by the buyers to RHL. RHL has agreed to provide certain transition services and support to the buyers for a period of up to six months and will receive an amount equal to \$9,000 per month for such services.

As a result of our decision to sell the legacy RHL business, we initiated an operational consolidation program during the first quarter of fiscal 2009 that transitioned the remaining branded products business operations to our corporate offices. This operational consolidation program was substantially complete as of September 30, 2008 and resulted in a charge to discontinued operations of \$823,000 in severance and other business related exit costs during the year ended June 30, 2009.

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As the plan to dispose of the legacy RHL business met the criteria of SFAS 144, the current and prior periods presented in this report have been reclassified to reflect the legacy RHL business as discontinued operations.

During the third quarter of fiscal 2009, RHL's wholesale operation experienced a decline in sales activity from one of its largest customers as a result of the discontinuance of certain RHL product lines. Historically these product sales represented a significant portion of RHL's overall annual sales to this customer. Additionally, during this same period we received feedback from multiple parties related to their preliminary interest in acquiring the then remaining RHL operations. Due in part to the expected decline in future RHL sales as noted above and the current depressed worldwide economic conditions, the preliminary purchase price valuations provided by these third parties provided us with an indication that an impairment of the RHL net asset carrying values may exist.

In accordance with SFAS 142 and SFAS 144 we performed an analysis that compared the fair value of RHL's net assets as indicated by the third party purchase price valuations noted above to the current carrying amounts to determine if an impairment of value was evident. As a result of this analysis, we determined that as of the related measurement date the book value of RHL's net assets exceeded the fair value by approximately \$1.8 million and recorded an impairment charge for this amount to discontinued operations during the third quarter of fiscal 2009.

The following table presents the activity and the reserve balances related to the restructuring programs described above for the year ended June 30, 2009 (in thousands):

	Balance at June 30, 2008	Charges to Expense	Cash Payments	Balance at June 30, 2009
Employee termination costs	\$ —	\$ 936	\$ (917)	\$ 19
Lease liabilities and related facility closure costs	—	108	(93)	15
<b>Total</b>	<b>\$ —</b>	<b>\$ 1,044</b>	<b>\$(1,010)</b>	<b>\$ 34</b>
Accrued restructuring charges:				
Current portion – continuing operations				\$ 7
Discontinued operations				27
<b>Total</b>				<b>\$ 34</b>

The following table summarizes the results of the legacy RHL business at June 30 (dollars in thousands):

	2009	2008
Net sales	\$ 2,913	\$11,276
Cost of goods sold and operating expenses	3,648	13,119
Restructuring expenses	1,044	—
Intangible impairment charges	1,804	—
Loss on sale of As We Change®	226	—
Other expense	51	63
Loss before income taxes	(3,860)	(1,906)
Income tax benefit	—	(623)
<b>Loss from discontinued operations</b>	<b>\$(3,860)</b>	<b>\$(1,283)</b>

Assets and liabilities of the legacy RHL business included in the consolidated balance sheets are summarized as follows at June 30 (dollars in thousands):

	2009	2008
<b>Assets</b>		
Cash	\$ 144	\$ 575
Accounts receivable, net	510	349
Inventory, net	286	805
Other current assets	39	204
Plant and equipment, net	—	351
Goodwill and intangible assets	208	4,015
<b>Total assets</b>	<b>\$1,187</b>	<b>\$6,299</b>
<b>Liabilities</b>		
Accounts payable	\$ —	\$ 678
Accrued liabilities	599	1,046
<b>Total liabilities</b>	<b>599</b>	<b>1,724</b>
<b>Net assets of discontinued operations</b>	<b>\$ 588</b>	<b>\$4,575</b>

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[Table of Contents](#)**C. Inventories**

Inventories, net, consisted of the following at June 30 (dollars in thousands):

	<u>2009</u>	<u>2008</u>
Raw materials	\$6,368	\$10,428
Work in progress	1,445	2,517
Finished goods	2,287	1,997
Reserve	(780)	(807)
	<u>\$9,320</u>	<u>\$14,135</u>

**D. Property and Equipment**

Property and equipment consisted of the following at June 30 (dollars in thousands):

	<b>Depreciable Life In Years</b>	<u>2009</u>	<u>2008</u>
Land	NA	\$ 393	\$ 393
Building and building improvements	7 – 39	2,679	2,723
Machinery and equipment	3 – 12	23,681	19,963
Office equipment and furniture	3 – 5	3,419	3,774
Vehicles	3	204	204
Leasehold improvements	1 – 15	10,067	10,283
Total property and equipment		40,443	37,340
Less: accumulated depreciation and amortization		(26,310)	(24,517)
Property and equipment, net		<u>\$ 14,133</u>	<u>\$ 12,823</u>

**E. Goodwill and Purchased Intangibles**

All previously reported goodwill and intangibles balances were related to our legacy RHL business and have been reclassified as discontinued operations in accordance with SFAS 144.

**F. Debt**

We have a bank credit facility of \$8.8 million as of June 30, 2009, comprised of a \$7.5 million working capital line of credit and \$1.3 million in outstanding term loans. The working capital line of credit is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has a fluctuating or fixed interest rate as elected by NAI from time to time and described in more detail below, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. As of June 30, 2009, the outstanding balances on the term loans consisted of a \$226,000, 15 year term loan due June 2011, secured by our San Marcos building, at an interest rate of 8.25%; a \$521,000, 10 year term loan due May 2014 with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; and a \$520,000, four year term loan due December 2009, secured by equipment, at an interest rate of LIBOR plus 2.10%. Monthly payments on the term loans are approximately \$122,000 plus interest. As of June 30, 2009 and June 30, 2008, our working capital line of credit balance was zero.

On January 24, 2007, we amended our credit facility to extend the maturity date for the working capital line of credit from November 1, 2007 to November 1, 2008, and maintain the ratio of total liabilities/tangible net worth covenant at 1.25/1.0 for the remainder of the term of the credit facility.

On December 18, 2007, we further amended our credit facility to (i) extend the maturity date for the working capital line of credit from November 1, 2008 to November 1, 2009; (ii) reduce the maximum principal amount available under the working capital line of credit from \$12.0 million to \$7.5 million; (iii) reduce the maximum borrowings against inventory from \$6.0 million to \$3.75 million, provided any such borrowings do not at any time exceed eligible accounts receivable; and (iv) extend the availability of the Foreign Exchange Facility from November 1, 2007 to November 1, 2008 and the allowable contract term thereunder from November 1, 2008 to November 1, 2009.

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On December 29, 2008, we again amended our credit facility to (i) extend the maturity date for the working capital line of credit from November 1, 2009 to November 1, 2010; (ii) modify the interest rate payable on the line of credit from a rate equal to the Prime Rate or LIBOR plus 1.75%, as elected by NAI from time to time, to a rate equal to either a fluctuating rate per annum equal to 2.75% to 3.75% above the Daily One Month LIBOR Rate in effect from time to time or a fixed rate per annum equal to 2.50% to 3.50% above LIBOR, as elected by NAI from time to time, in each case with the percentage above the applicable LIBOR determined based on NAI's fixed charge coverage ratio; (iii) modify the fiscal year end net income requirement for fiscal 2009 from net income after taxes of not less than \$750,000 to a net loss not to exceed \$2,500,000; (iv) modify the fixed charge coverage ratio for the quarter ended March 31, 2009 from not less than 1.25 to 1.0 to not less than 0.50 to 1.0; and (v) eliminate the fixed charge coverage ratio and net income requirements that would have applied to the second quarter of fiscal 2009. In consideration of such amendments, NAI paid a \$25,000 amendment fee to the lender.

On July 14, 2009, we completed certain additional amendments to our credit facility, effective June 1, 2009, to (i) modify the interest rate payable on the line of credit from a rate equal to either a fluctuating rate per annum equal to 2.75% to 3.75% above the Daily One Month LIBOR Rate in effect from time to time or a fixed rate per annum equal to 2.50% to 3.50% above LIBOR, to a rate equal to either a fluctuating rate per annum equal to 2.75% to 4.25% above the Daily Three Month LIBOR Rate in effect from time to time or a fixed rate per annum equal to 2.50% to 4.00% above LIBOR, as elected by NAI from time to time, in each case with the percentage above the applicable LIBOR determined based on NAI's fixed charge coverage ratio; (ii) modify the annual fee payable to the lender from 0.25% to 1.00% of the maximum available line of credit amount to 0.25% to 1.50% of the maximum available line of credit amount with the percentage determined based on NAI's fixed charge coverage ratio; (iii) modify the borrowing limitation under the line of credit from an aggregate of 85% of NAI's eligible accounts receivable plus 50% of the value of NAI's eligible inventory to an aggregate of 85% of NAI's eligible accounts receivable plus 30% of the value of NAI's eligible raw materials inventory plus 40% of the value of NAI's eligible finished goods inventory; (iv) extend the availability of the foreign exchange facility to November 1, 2010; (v) modify the fiscal year end net income requirement for fiscal 2009 from a net loss not to exceed \$2,500,000 to a net loss not to exceed \$5,000,000; (vi) modify the quarterly net income requirement from net income not less than \$1.00 to net income not less than \$250,000 for the quarter ended June 30, 2009; and (iv) modify the fixed charge coverage ratio for the quarter ended June 30, 2009 from not less than 1.25 to 1.0 to not less than 1.0 to 1.0.

On June 30, 2009, we were in compliance with all loan debt covenants.

On September 22, 2006, NAIE, our wholly owned subsidiary, entered into a credit facility to provide it with a credit line of up to CHF 1.3 million, or approximately \$1.2 million, which is the initial maximum aggregate amount that can be outstanding at any one time under the credit facility. This maximum amount was reduced by CHF 160,000, or approximately \$147,000, as of December 31, 2007, and was reduced an additional CHF 160,000, or approximately \$147,000, as of December 31, 2008, and will be reduced by an additional CHF 160,000 at the end of each succeeding calendar year. On February 19, 2007, NAIE amended its credit facility to provide that the maximum aggregate amount that may be outstanding under the facility cannot be reduced below CHF 500,000, or approximately \$461,000. As of June 30, 2009, there was no outstanding balance under the credit facility.

Under its credit facility, NAIE may draw amounts either as current account loan credits to its current or future bank accounts or as fixed loans with a maximum term of 24 months. Current account loans will bear interest at the rate of 5% per annum. Fixed loans will bear interest at a rate determined by the parties based on current market conditions and must be repaid pursuant to a repayment schedule established by the parties at the time of the loan. If a fixed loan is repaid early at NAIE's election or in connection with the termination of the credit facility, NAIE will be charged a pre-payment penalty equal to 0.1% of the principal amount of the fixed loan or CHF 1,000 (approximately \$921), whichever is greater. The bank reserves the right to refuse individual requests for an advance under the credit facility, although its exercise of such right will not have the effect of terminating the credit facility as a whole.

The composite interest rate on all of our outstanding debt was 6.94% at June 30, 2009 and 7.44% at June 30, 2008.

Aggregate amounts of long-term debt contractual maturities as of June 30, 2009 were as follows (dollars in thousands):

2010	\$ 669
2011	146
2012	35
2013	35
2014	382
Thereafter	—
	<u>\$1,267</u>



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**G. Income Taxes**

During fiscal 2009, we recorded a valuation allowance against deferred income tax assets of \$1.8 million, representing the amount of our deferred income tax assets in excess of our deferred income tax liabilities. We recorded the valuation allowance because management was unable to conclude, in light of the cumulative loss we have realized related to our US-based operations for the three year period ended June 30, 2009, that realization of the net deferred income tax asset was more likely than not. The valuation allowance recorded during fiscal 2009 primarily related to fiscal 2009 net operating loss carry forwards and changes in other deferred tax items recognized during fiscal 2009. As a result of the recognition of these valuation adjustments, we have a \$1.8 million net deferred tax asset offset by a valuation allowance of \$1.8 million resulting in a net deferred tax asset of \$0 as of June 30, 2009. This valuation allowance did not have any affect on the tax expense and related liability recorded for operating income recognized by NAIE during the year ended June 30, 2009.

The provision for income taxes for the years ended June 30 consisted of the following (dollars in thousands):

	2009	2008
<b>Current:</b>		
Federal	\$ 81	\$(293)
State	(168)	2
Foreign	180	295
	<u>93</u>	<u>4</u>
<b>Deferred:</b>		
Federal	(550)	99
State	(100)	(33)
Valuation allowance	650	—
	<u>—</u>	<u>66</u>
Stock option benefit recorded to additional paid in capital	—	194
Provision for income taxes	<u>\$ 93</u>	<u>\$ 264</u>

Net deferred tax assets and deferred tax liabilities as of June 30 were as follows (dollars in thousands):

	2009	2008
<b>Deferred tax assets:</b>		
Allowance for doubtful accounts	\$ 30	\$ 5
Accrued vacation expense	143	222
Tax credit carry forward	39	3
Allowance for inventories	277	347
Stock-base compensation	287	204
Pension liability	302	181
Other, net	479	431
Deferred rent	203	283
Accumulated depreciation and amortization	40	—
Net operating loss carry forward	305	153
Total gross deferred tax assets	\$ 2,105	\$ 1,829
<b>Deferred tax liabilities:</b>		
Prepaid expenses	(272)	(286)
Accumulated depreciation and amortization	(83)	(1,604)
Deferred tax liabilities	<u>(355)</u>	<u>(1,890)</u>
Valuation allowance	(1,750)	—
Net deferred tax assets	<u>\$ —</u>	<u>\$ (61)</u>

At June 30, 2009, we had federal tax net operating loss carry forwards of approximately \$327,000. The federal tax loss carry forwards will begin to expire in 2028, unless previously utilized. At June 30, 2009, we had state tax net operating loss carry forwards of approximately \$3.3 million. The state tax loss carry forwards will begin to expire in 2016, unless previously utilized. Included in these amounts are federal and state net operating losses of approximately \$236,000 attributable to stock option deductions of which the tax benefit will be credited to equity when realized.

At June 30, 2009, we had federal R&D credit carry forwards of approximately \$35,000. The federal R&D credit carry forwards will begin to expire in 2027, unless previously utilized. At June 30, 2009, we had state R&D credit carry forwards of approximately \$6,000. The state R&D credits carry forward indefinitely until utilized.

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NAIE's effective tax rate for Swiss federal, cantonal and communal taxes is approximately 20%. NAIE had net income of \$719,000 for the fiscal year ended June 30, 2009. Undistributed earnings of NAIE amounted to approximately \$6.3 million at June 30, 2009. These earnings are considered to be indefinitely reinvested and, accordingly, no provision for U.S. federal taxes has been provided thereon.

A reconciliation of income taxes computed by applying the statutory federal income tax rate of 34% to net income before income taxes for the year ended June 30 is as follows (dollars in thousands):

	<u>2009</u>	<u>2008</u>
Income taxes computed at statutory federal income tax rate	\$ (43)	\$ 400
State income taxes, net of federal income tax expense	(111)	(5)
Expenses not deductible for tax purposes	45	75
Foreign tax rate differential	(126)	(207)
Return to provision – difference	(52)	2
Change in valuation allowance, net	379	—
Other	1	(1)
Income taxes as reported	<u>\$ 93</u>	<u>\$ 264</u>
Effective tax rate	<u>(73.2)%</u>	<u>22.5%</u>

### **H. Employee Benefit Plans**

We have a profit sharing plan pursuant to Section 401(k) of the Internal Revenue Code of 1986, as amended (the "Code"), whereby participants may contribute a percentage of compensation not in excess of the maximum allowed under the Code. All employees with six months of continuous employment are eligible to participate in the plan. Effective January 1, 2004, the plan was amended to require that we match 100% of the first 3% and 50% of the next 2% of a participant's compensation contributed to the plan. Effective January 1, 2009, we elected to temporarily discontinue the company match program. The total contributions under the plan charged to continuing operations totaled \$153,000 for the fiscal year ended June 30, 2009 and \$266,000 for fiscal 2008.

We have a "Cafeteria Plan" pursuant to Section 125 of the Code, whereby health care benefits are provided for active employees through insurance companies. Substantially all active full-time employees are eligible for these benefits. We recognize the cost of providing these benefits by expensing the annual premiums, which are based on benefits paid during the year. The premiums expensed to continuing operations for these benefits totaled \$864,000 for the fiscal year ended June 30, 2009 and \$968,000 for fiscal 2008.

In December 1999, we adopted an employee stock purchase plan that initially provided for the issuance of up to 150,000 shares of our common stock. Beginning July 1, 2004, the number of shares available for purchase under the plan has increased by 25,000 each year on July 1. The plan was intended to qualify under Section 423 of the Code and was for the benefit of qualifying employees. Under the terms of the plan, participating employees could have up to 15% of their compensation withheld through payroll deductions to purchase shares of our common stock at 85% of the closing sale price for the stock as quoted on the Nasdaq Global Market on either the first or last trading day in the offering period, whichever was lower. As of June 30, 2009, 183,037 shares of common stock were issued pursuant to this plan. Effective June 30, 2009 the employee stock purchase plan was discontinued.

We sponsor a defined benefit pension plan, which provides retirement benefits to employees based generally on years of service and compensation during the last five years before retirement. Effective June 21, 1999, we adopted an amendment to freeze benefit accruals to the participants. We contribute an amount not less than the minimum funding requirements of the Employee Retirement Income Security Act of 1974 nor more than the maximum tax-deductible amount.

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**Disclosure of Funded Status**

The following table sets forth the defined benefit pension plan's funded status and amount recognized in our consolidated balance sheets at June 30 (dollars in thousands):

	<u>2009</u>	<u>2008</u>
<b>Change in Benefit Obligation</b>		
Benefit obligation at beginning of year	\$1,439	\$1,549
Interest cost	79	80
Actuarial (gain) loss	15	12
Benefits paid	—	(202)
Benefit obligation at end of year	<u>\$1,533</u>	<u>\$1,439</u>
<b>Change in Plan Assets</b>		
Fair value of plan assets at beginning of year	\$1,240	\$1,473
Actual return on plan assets	(213)	(81)
Employer contributions	—	50
Benefits paid	—	(202)
Fair value of plan assets at end of year	<u>\$1,027</u>	<u>\$1,240</u>
<b>Reconciliation of Funded Status</b>		
Benefit obligation in excess of fair value of plan assets	\$ (505)	\$ (198)
Unrecognized net actuarial loss	758	454
Net amount recognized	<u>\$ 253</u>	<u>\$ 256</u>
<b>Additional Minimum Liability Disclosures</b>		
Accrued benefit liability	\$ (505)	\$ (198)

The weighted-average rates used for the years ended June 30 in determining the projected benefit obligations for the defined benefit pension plan were as follows:

	<u>2009</u>	<u>2008</u>
Discount rate	5.50%	5.50%
Compensation increase rate	N/A	N/A

**Net Periodic Benefit Cost**

The components included in the defined benefit pension plan's net periodic benefit income for the fiscal years ended June 30 were as follows (dollars in thousands):

	<u>2009</u>	<u>2008</u>
Interest cost	\$ 78	\$ 80
Expected return on plan assets	(103)	(111)
Recognized actuarial loss	28	10
Net periodic benefit expense (income)	<u>\$ 3</u>	<u>\$ (21)</u>

We expect to contribute \$50,000 to our defined benefit pension plan in fiscal 2010.

The following benefit payments are expected to be paid:

2010	\$ 13
2011	20
2012	24
2013	24
2014	40
2015-2019	398
	<u>\$519</u>

The weighted-average rates used for the years ended June 30 in determining the defined benefit pension plan's net pension costs, were as follows:

	<u>2009</u>	<u>2008</u>
Discount rate	5.50%	5.50%
Expected long-term rate of return	8.00%	8.00%
Compensation increase rate	N/A	N/A

Our expected rate of return is determined based on a methodology that considers historical returns of multiple classes analyzed to develop a risk free real rate of return and risk premiums for each asset class. The overall rate for each asset class was developed by combining a long-term inflation component, the risk free real rate of return, and the associated risk premium. A weighted average rate was developed based on those overall rates and the target asset allocation of the plan.

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Our defined benefit pension plan's weighted average asset allocation at June 30 and weighted average target allocation were as follows:

	<u>2009</u>	<u>2008</u>	<u>Target Allocation</u>
Equity securities	65%	57%	60%
Debt securities	32%	40%	40%
Cash and money market funds	3%	3%	0%
	<u>100%</u>	<u>100%</u>	<u>100%</u>

The underlying basis of the investment strategy of our defined benefit pension plan is to ensure that pension funds are available to meet the plan's benefit obligations when they are due. Our investment strategy is a long-term risk controlled approach using diversified investment options with relatively minimal exposure to volatile investment options like derivatives.

### **I. Stockholders' Equity**

#### **Treasury Stock**

On June 29, 2007, the independent members of the Board of Directors approved the repurchase of 100,000 shares of our common stock from Mark LeDoux, our Chief Executive Officer and the Chairman of the Board, his wife, their family limited partnership and related children's trust, conditioned on a purchase price equal to a 10% discount from the closing price on such date. The repurchase was completed on July 6, 2007 at a total cost of \$650,000.

#### **Stock Option Plans**

On December 6, 1999, our stockholders approved the adoption of the 1999 Omnibus Equity Incentive Plan (the "1999 Plan"). As of June 30, 2009, a total of 2.5 million shares of common stock are reserved under the 1999 Plan for issuance to our directors, officers, other employees, and consultants. Under the terms of the 1999 Plan, the aggregate number of shares of common stock that may be awarded is automatically increased on January 1<sup>st</sup> of each year by a number equal to the lesser of 2.5% of the total number of common shares then outstanding or 100,000 shares. The 1999 Plan has increased by 100,000 common shares on January 1 of each year from 2000 through 2009.

Grants under the 1999 Plan can be either incentive stock options or nonqualified stock options. Options granted under the 1999 Plan have either a five or a ten-year term.

Stock option activity for the two years ended June 30, 2009 was as follows:

	<u>1999 Plan</u>	<u>Weighted Average Exercise Price</u>
Outstanding at June 30, 2007	1,237,395	\$ 6.45
Exercised	(276,595)	\$ 3.93
Forfeited	(48,000)	\$ 8.24
Granted	225,000	\$ 9.04
Outstanding at June 30, 2008	1,137,800	\$ 7.50
Exercised	(184,600)	\$ 5.31
Forfeited	(363,258)	\$ 7.68
Granted	125,000	\$ 7.38
Outstanding at June 30, 2009	<u>714,942</u>	\$ 7.96
Weighted-average remaining contractual life in years	3.14	
Available for grant at June 30, 2009	<u>717,910</u>	

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The following is a further breakdown of the options outstanding at June 30, 2009:

Range of Exercise Prices	Number Outstanding	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$2.00 - \$2.81	54,000	\$ 2.19	54,000	\$ 2.19
\$3.70 - \$3.70	10,000	\$ 3.70	10,000	\$ 3.70
\$6.66 - \$7.93	288,942	\$ 7.47	114,492	\$ 7.44
\$8.05 - \$10.19	362,000	\$ 9.33	241,550	\$ 9.22
\$2.00 - \$10.47	<u>714,942</u>	\$ 7.96	<u>420,042</u>	\$ 7.70
Weighted-average remaining contractual life in years	3.14		2.48	

### J. Restructuring Costs

During the year ended June 30, 2009, the continued decline in economic conditions in the United States and the various foreign markets we service negatively impacted our customers' businesses and our operations. As a result, during the second quarter of fiscal 2009 we implemented a cost reduction program that resulted in the elimination of certain personnel and business activities. The cost reduction program is expected to reduce the financial impact of the anticipated reduction in future sales. This program resulted in a charge to our continuing operations of \$558,000 in severance from a reduction in force during the second quarter of fiscal 2009. All payments related to this cost reduction program are expected to be completed within the next twelve months.

The following table presents the activity and the reserve balance related to this restructuring program for the year ended June 30, 2009 (in thousands):

	Balance at June 30, 2008	Charges to Expense	Adjustments	Cash Payments	Balance at June 30, 2009
Employee termination costs recorded to cost of goods sold	\$ —	\$ 187	\$ (25)	\$ (162)	\$ —
Employee termination costs recorded to selling, general & administrative expenses	—	371	(17)	(278)	76
Total	<u>\$ —</u>	<u>\$ 558</u>	<u>\$ (42)</u>	<u>\$ (440)</u>	<u>\$ 76</u>

### K. Commitments

We lease a total of 162,000 square feet at our manufacturing facility in Visa, California from an unaffiliated third party under a non-cancelable operating lease that expires in March 2014.

NAIE leases facility space in Manno, Switzerland. The leased space totals approximately 46,000 square feet. We primarily use the facilities for manufacturing, packaging, warehousing and distributing nutritional supplement products for the European marketplace. The lease expires in December 2015.

On March 28, 2007, we entered into an agreement to sublet approximately 3,000 square feet at our Manno, Switzerland facility. The sublease expires December 31, 2009 and provides for monthly rental income equal to our rental expense for the space.

Minimum rental commitments (exclusive of property tax, insurance and maintenance) under all non-cancelable operating leases with initial or remaining lease terms in excess of one year, including the lease agreements referred to above, are set forth below as of June 30, 2009 (dollars in thousands):

	2010	2011	2012	2013	2014	There-after	Total
Gross minimum rental commitments	\$2,351	\$2,390	\$2,430	\$2,471	\$2,141	\$1,587	\$13,370
Sublease income commitments	(23)	—	—	—	—	—	(23)
	<u>\$2,328</u>	<u>\$2,390</u>	<u>\$2,430</u>	<u>\$2,471</u>	<u>\$2,141</u>	<u>\$1,587</u>	<u>\$13,347</u>

Rental expense from continuing operations totaled \$2.1 million for the fiscal year ended June 30, 2009 and \$2.2 million for fiscal 2008. Rental expense was offset by sublease rental income in the amount of \$47,000 in fiscal 2009 and \$53,000 in fiscal 2008.

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[Table of Contents](#)**L. Foreign Currency Instruments**

On January 18, 2007, we purchased three option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The three options expired monthly beginning August 2007 and ending October 2007. The option contracts had a notional amount of \$1.9 million, a weighted average strike price of \$1.24, and a purchase price of \$12,000. The risk of loss associated with the options was limited to the purchase price paid for the option contracts.

On April 3, 2007, we purchased three option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The three options expired monthly beginning November 2007 and ending January 2008. The option contracts had a notional amount of \$1.9 million, a weighted average strike price of \$1.29, and a purchase price of \$18,000. The risk of loss associated with the options was limited to the purchase price paid for the option contracts.

On August 14, 2007, we purchased three option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The three options expired monthly beginning February 2008 and ending April 2008. The option contracts had a notional amount of \$1.9 million, a weighted average strike price of \$1.29, and a purchase price of \$10,000. The risk of loss associated with the options was limited to the purchase price paid for the option contracts.

On September 7, 2007, we purchased three option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The three options expired monthly beginning May 2008 and ending July 2008. The option contracts had a notional amount of \$1.9 million, a weighted average strike price of \$1.29, and a purchase price of \$12,000. The risk of loss associated with the options was limited to the purchase price paid for the option contracts.

For the fiscal years ended June 30, 2009 and 2008, approximately \$0 and \$68,000 was charged to income for option contracts expiring during the year. As of June 30, 2009, we did not have any outstanding derivative financial instruments.

**M. Economic Dependency**

We had substantial net sales from continuing operations to certain customers during the fiscal years ended June 30 shown in the following table. The loss of any of these customers, or a significant decline in sales or the growth rate of sales to these customers could have a material adverse impact on our net sales and net income from continuing operations. Net sales from continuing operations to any one customer representing 10% or more of the respective year's total net sales for the two years ended June 30 were as follows (dollars in thousands):

	2009		2008	
	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales
Customer 1	\$ 36,295	49%	\$ 39,927	49%
Customer 2	22,278	30%	27,821	34%
	<u>\$ 58,573</u>	<u>79%</u>	<u>\$ 67,748</u>	<u>83%</u>

Accounts receivable from these customers totaled \$4.4 million at June 30, 2009 and \$5.4 million at June 30, 2008.

We buy certain products from a limited number of raw material suppliers. The loss of any of these suppliers could have a material adverse impact on our net sales and net income. During fiscal 2009, approximately 13% of our total raw material purchases were from one supplier. We did not have any accounts payable due to this supplier at June 30, 2009. No other supplier comprised 10% or more of our raw material purchases for the year ended June 30, 2009. During fiscal 2008, approximately 31% of our total raw material purchases were from two suppliers. Accounts payable to these suppliers were \$437,000 at June 30, 2008. No other supplier comprised 10% or more of our raw material purchases for the year ended June 30, 2008.

**N. Contingencies**

From time to time, we become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to product liability, employment, intellectual property, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. While unfavorable outcomes are possible, based on available information, we generally do not believe the resolution of these matters will result in a material adverse effect on our business, consolidated financial condition, or results of operation. However, a settlement payment or unfavorable outcome could adversely impact our results of operation. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes that we do not expect.

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As of September 25, 2009, neither NAI nor its subsidiaries were a party to any material pending legal proceeding nor was any of their property the subject of any material pending legal proceeding.

On July 31, 2009 RHL sold substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business to PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for a cash purchase price of \$500,000. As additional compensation, RHL may receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. NAI provided a guarantee of RHL's indemnity obligations under the asset purchase agreement, which potential liability is capped at the amount of the purchase price paid by the buyers to RHL.

### **O. Segment Information**

Our business consists of two segments, as defined by SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, identified as private label contract manufacturing, which primarily provides private label contract manufacturing services to companies that market and distribute nutritional supplements and other health care products, and branded products, which markets and distributes branded nutritional supplements.

In an effort to enhance stockholder value, improve working capital and enable us to focus on our core contract manufacturing business, during the fourth quarter of fiscal 2008 we developed a plan to narrow our branded products focus and portfolio and to sell our legacy RHL business. On August 4, 2008, RHL sold certain assets related to its catalog and internet business conducted under the name "As We Change®" to Miles Kimball Company for a cash purchase price of \$2.3 million. We recorded a loss of \$226,000 as a result of this sale and recognized \$221,000 in severance and related payroll costs during fiscal 2009.

On July 31, 2009, we sold substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business to PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for a cash purchase price of \$500,000. As additional compensation, RHL may receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. The financial information presented in this report has been reclassified to reflect the legacy RHL business as discontinued operations.

Following the completion of the sale of substantially all of the assets of RHL, our branded products segment consists primarily of the products sold under our Pathway to Healing product line.

We evaluate performance based on a number of factors. The primary performance measures for each segment are net sales and income or loss from operations before corporate allocations. Operating income or loss for each segment does not include corporate general and administrative expenses, interest expense and other miscellaneous income and expense items. Corporate general and administrative expenses include, but are not limited to: human resources, legal, finance, information technology, and other corporate level related expenses, which are not allocated to either segment. The accounting policies of our segments are the same as those described in the summary of significant accounting policies in Note A.

Our operating results by business segment for the years ended June 30 were as follows (dollars in thousands):

	<u>2009</u>	<u>2008</u>
<b>Net Sales</b>		
Private label contract manufacturing	\$71,242	\$77,850
Branded products	<u>2,677</u>	<u>3,905</u>
	<u>\$73,919</u>	<u>\$81,755</u>
	<u>2009</u>	<u>2008</u>
<b>Operating Income from Continuing Operations</b>		
Private label contract manufacturing	\$ 6,201	\$ 8,166
Branded products	<u>499</u>	<u>400</u>
Income from operations of reportable segments	6,700	8,566
Corporate expenses not allocated to segments	<u>(6,303)</u>	<u>(7,492)</u>
	<u>\$ 397</u>	<u>\$ 1,074</u>

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	2009
<b>Total Assets</b>	
Private label contract manufacturing	\$34,774
Branded products	478
	<u>\$35,252</u>

Our private label contract manufacturing products are sold both in the United States and in markets outside the United States, including Europe, Australia and Asia. Our primary market outside the United States is Europe. Our branded products are only sold in the United States.

Net sales by geographic region, based upon the customers' location, for the two years ended June 30 were as follows (dollars in thousands):

	2009	2008
United States	\$49,221	\$57,597
Markets outside the United States	24,698	24,158
Total net sales	<u>\$73,919</u>	<u>\$81,755</u>

Products manufactured by NAIE accounted for 54% of net sales in markets outside the United States in fiscal 2009 and 52% in fiscal 2008. No products manufactured by NAIE were sold in the United States during the fiscal years ended June 30, 2009 and 2008.

Assets and capital expenditures by geographic region, based on the location of the company or subsidiary at which they were located or made, for the two years ended June 30 were as follows (dollars in thousands):

	Long-Lived Assets	Total Assets	Capital Expenditures
<b>2009</b>			
United States	\$ 11,991	\$27,106	\$ 3,579
Europe	2,301	8,146	951
	<u>\$ 14,292</u>	<u>\$35,252</u>	<u>\$ 4,530</u>
<b>2008</b>			
United States	\$ 11,202	\$32,179	\$ 1,232
Europe	1,781	7,435	140
	<u>\$ 12,983</u>	<u>\$39,614</u>	<u>\$ 1,372</u>

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

None.

### ITEM 9A. CONTROLS AND PROCEDURES

#### (a) Evaluation of Disclosure Controls and Procedures

We maintain certain disclosure controls and procedures as defined under the Securities Exchange Act of 1934. They are designed to help ensure that material information is: (1) gathered and communicated to our management, including our principal executive and financial officers, in a manner that allows for timely decisions regarding required disclosures; and (2) recorded, processed, summarized, reported and filed with the SEC as required under the Securities Exchange Act of 1934 and within the time periods specified by the SEC.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2009. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective for their intended purpose described above as of June 30, 2009.

#### (b) Management's Annual Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, and for performing an assessment of the effectiveness of internal control over financial reporting as of June 30, 2009. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's board



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of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management performed an assessment of the effectiveness of the Company's internal control over financial reporting as of June 30, 2009 based upon criteria in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, management believes that the Company's internal control over financial reporting was effective as of June 30, 2009 based on those criteria issued by COSO.

This report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent registered public accounting firm pursuant to temporary rules of the SEC that permit the Company to provide only management's report in this report.

**(c) Changes in Internal Control Over Financial Reporting**

There were no changes to our internal control over financial reporting during the fourth quarter ended June 30, 2009 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

Effective as of September 11, 2009, our Board of Directors determined to terminate our Management Cash Incentive Plan.

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information for this item is incorporated by reference to the sections "Our Board of Directors," "Our Executive Officers," "Section 16(a) Beneficial Ownership Reporting Compliance," and "Code of Ethics" in our definitive proxy statement for our Annual Meeting of Stockholders to be held on November 30, 2009, to be filed on or before October 28, 2009.

**ITEM 11. EXECUTIVE COMPENSATION**

The information for this item is incorporated by reference to the sections "Director Compensation" and "Executive Officer Compensation" in our definitive proxy statement for our Annual Meeting of Stockholders to be held on November 30, 2009, to be filed on or before October 28, 2009.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information for this item is incorporated by reference to the sections "Stock Holdings of Certain Owners and Management" and "Securities Authorized for Issuance Under Equity Compensation Plans" in our definitive proxy statement for our Annual Meeting of Stockholders to be held on November 30, 2009, to be filed on or before October 28, 2009.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information for this item is incorporated by reference to the sections "Certain Relationships and Related Transactions" and "Our Board of Directors – Independence" in our definitive proxy statement for our Annual Meeting of Stockholders to be held on November 30, 2009, to be filed on or before October 28, 2009.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information for this item is incorporated by reference to the sections "Audit Fees," "Audit-Related Fees," "Tax Fees," "All Other Fees" and "Pre-Approval Policies and Procedures" in our definitive proxy statement for our Annual Meeting of Stockholders to be held on November 30, 2009, to be filed on or before October 28, 2009.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

The following documents are filed as part of this report:

- (1) Financial Statements. The financial statements listed below are included under Item 8 of this report:
  - Consolidated Balance Sheets as of June 30, 2009 and 2008;
  - Consolidated Statements of Operations and Comprehensive Income (Loss) for the years ended June 30, 2009 and 2008;
  - Consolidated Statements of Stockholders' Equity for the years ended June 30, 2009 and 2008;
  - Consolidated Statements of Cash Flows for the years ended June 30, 2009 and 2008; and
  - Notes to Consolidate Financial Statements.
- (2) Exhibits. The following exhibit index shows those exhibits filed with this report and those incorporated by reference:

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description</b>	<b>Incorporated By Reference To</b>
3(i)	Amended and Restated Certificate of Incorporation of Natural Alternatives International, Inc. filed with the Delaware Secretary of State on January 14, 2005	Exhibit 3(i) of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005
3(ii)	Amended and Restated By-laws of Natural Alternatives International, Inc. dated as of February 9, 2009	Exhibit 3(ii) of NAI's Current Report on Form 8-K dated February 9, 2009, filed with the commission on February 13, 2009
4(i)	Form of NAI's Common Stock Certificate	Exhibit 4(i) of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.1	1999 Omnibus Equity Incentive Plan as adopted effective May 10, 1999, amended effective January 30, 2004, and further amended effective December 3, 2004*	Exhibit 10.1 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005
10.2	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and Mark A. LeDoux*	Exhibit 10.6 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.3	Amended and Restated Exclusive License Agreement effective as of September 1, 2004 by and among NAI and Dr. Reginald B. Cherry	Exhibit 10.11 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.4	Exclusive License Agreement effective as of September 1, 2004 by and among NAI and Reginald B. Cherry Ministries, Inc.	Exhibit 10.12 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.5	First Amendment to Exclusive License Agreement effective as of December 10, 2004 by and among NAI and Reginald B. Cherry Ministries, Inc.	Exhibit 10.3 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005
10.6	Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company (lease reference date June 12, 2003)	Exhibit 10.10 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003, filed with the commission on November 5, 2003
10.7	Credit Agreement dated as of May 1, 2004 by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.11 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2004, filed with the commission on May 17, 2004
10.8	First Amendment to Credit Agreement dated as of February 1, 2005 by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.1 of NAI's Current Report on Form 8-K dated February 1, 2005, filed with the commission on February 7, 2005
10.9	Form of Indemnification Agreement entered into between NAI and each of its directors	Exhibit 10.15 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.10	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated May 9, 2005 (English translation)	Exhibit 10.19 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, filed with the commission on May 13, 2005

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10.11	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated July 25, 2003 (English translation)	Exhibit 10.19 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.12	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated June 8, 2004 (English translation)	Exhibit 10.20 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.13	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated February 7, 2005 (English translation)	Exhibit 10.21 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.14	License Agreement effective as of April 28, 1997 by and among Roger Harris, Mark Dunnett and NAI	Exhibit 10.22 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.15	Amendment to License Agreement effective as of March 17, 2001 by and among Roger Harris, Mark Dunnett and NAI	Exhibit 10.23 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.16	Amendment effective as of September 15, 2005 to Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated May 9, 2005 (English translation)	Exhibit 10.24 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005, filed with the commission on November 4, 2005
10.17	Promissory Note made by NAI for the benefit of Wells Fargo Equipment Finance, Inc. in the amount of \$3,800,000	Exhibit 10.5 of NAI's Current Report on Form 8-K dated December 5, 2005, filed with the commission on December 9, 2005
10.18	Second Amendment to Credit Agreement dated as of December 1, 2005 by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.30 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006
10.19	Exclusive License Agreement by and between NAI and Richard Linchitz, M.D. effective as of August 23, 2005	Exhibit 10.32 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006
10.20	First Amendment to Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company, effective December 21, 2004	Exhibit 10.34 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006
10.21	Second Amendment to Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company, effective January 13, 2006	Exhibit 10.35 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006
10.22	Third Amendment to Credit Agreement dated as of March 15, 2006 by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.35 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006, filed with the commission on May 9, 2006
10.23	Loan Agreement between NAIE and Credit Suisse dated as of September 22, 2006, including general conditions (portions of the Loan Agreement have been omitted pursuant to a request for confidential treatment)	Exhibit 10.36 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2006, filed with the commission on November 1, 2006
10.24	Fourth Amendment to Credit Agreement dated as of November 1, 2006, and entered into on January 24, 2007, by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.37 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2006, filed with the commission on January 30, 2007

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10.25	Sublease Contract for facilities in Manno, Switzerland, between NAIE and Vertime SA effective as of April 1, 2007 (portions of the Sublease Contract have been omitted pursuant to a request for confidential treatment) (English translation)	Exhibit 10.39 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006, filed with the commission on May 14, 2007
10.26	Second Amendment to License Agreement Amending The First Amendment Dated March 17, 2001 to License Agreement Dated April 28, 1997 by and among Roger Harris, Mark Dunnett and NAI dated as of March 26, 2007	Exhibit 10.40 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007, filed with the commission on May 14, 2007
10.27	First Amendment to Loan Agreement between NAIE and Credit Suisse dated as of February 19, 2007	Exhibit 10.41 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007, filed with the commission on May 14, 2007
10.28	Consulting Agreement effective as of July 1, 2007, by and between Dr. John A. Wise and NAI	Exhibit 10.44 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2007, filed with the commission on October 15, 2007.
10.29	Fifth Amendment to Credit Agreement dated as of November 1, 2007, and entered into on December 18, 2007, by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.40 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2007, filed with the commission on February 8, 2008
10.30	Employment Agreement effective as of February 11, 2008, by and between NAI and Kenneth Wolf*	Exhibit 10.1 of NAI's Current Report on Form 8-K dated February 11, 2008, filed with the commission on February 14, 2008
10.31	Asset Purchase Agreement by and between RHL and Miles Kimball Company dated August 4, 2008	Exhibit 10.1 of NAI's Current Report on Form 8-K dated August 4, 2008, filed with the commission on August 8, 2008
10.32	Revolving Line of Credit Note made by NAI for the benefit of Wells Fargo Bank, National Association in the amount of \$7,500,000 (with Addendum)	Exhibit 10.40 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009
10.33	Sixth Amendment to Credit Agreement dated as of November 1, 2008, by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.41 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009
10.34	Separation Agreement and General Release of Claims by and between Disposition Company, Inc. (fka Real Health Laboratories, Inc.) and John Dullea effective as of December 26, 2008	Exhibit 10.42 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009
10.35	Separation Agreement and General Release of Claims by and between NAI and Randell Weaver effective as of March 13, 2009	Exhibit 10.43 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009
10.36	Agreement to Sublicense by and between NAI and Compound Solutions, Inc. dated as of March 3, 2009	Exhibit 10.44 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009
10.37	Separation Agreement and General Release of Claims by and between NAI and Alvin McCurdy effective as of July 9, 2009	Filed herewith
10.38	Seventh Amendment to Credit Agreement dated as of June 1, 2009, by and between NAI and Wells Fargo Bank, National Association	Filed herewith

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10.39	First Modification to Promissory Note dated as of June 1, 2009, by and between NAI and Wells Fargo Bank, National Association (with Amended and Restated Addendum)	Filed herewith
10.40	Third Amendment to License Agreement by and among Roger Harris, Mark Dunnett, Kenny Johansson and NAI effective as of March 3, 2009	Filed herewith
10.41	Asset Purchase Agreement by and among NAI, Disposition Company, Inc. (fka Real Health Laboratories, Inc.), PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. dated July 29, 2009	Exhibit 10.1 of NAI's Current Report on Form 8-K dated July 29, 2009, filed with the commission on August 4, 2009
21	Subsidiaries of the Company	Filed herewith
23.1	Consent of Independent Registered Public Accounting Firm	Filed herewith
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer	Filed herewith
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer	Filed herewith
32	Section 1350 Certification	Filed herewith

\* Indicates management contract or compensatory plan or arrangement.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Natural Alternatives International, Inc., the registrant, has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: September 25, 2009

NATURAL ALTERNATIVES INTERNATIONAL, INC.

By: /s/ Mark A. LeDoux  
Mark A. LeDoux, 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 Natural Alternatives International, Inc., in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Mark A. LeDoux</u> (Mark A. LeDoux)	Chief Executive Officer and Chairman of the Board of Directors (principal executive officer)	September 25, 2009
<u>/s/ Ken Wolf</u> (Ken Wolf)	Chief Financial Officer (principal financial officer and principal accounting officer)	September 25, 2009
<u>/s/ Joe E. Davis</u> (Joe E. Davis)	Director	September 25, 2009
<u>/s/ Alan G. Dunn</u> (Alan G. Dunn)	Director	September 25, 2009
<u>/s/ Alan J. Lane</u> (Alan J. Lane)	Director	September 25, 2009
<u>/s/ Lee G. Weldon</u> (Lee G. Weldon)	Director	September 25, 2009

**SEPARATION AGREEMENT AND GENERAL RELEASE OF CLAIMS**

This Separation Agreement and General Release of Claims ("Agreement") is entered into by and between Alvin McCurdy ("Former Employee") and Natural Alternatives International, Inc., a Delaware corporation ("Company").

**RECITALS**

A. Former Employee's employment with the Company terminated effective on June 30, 2009 ("Date of Termination").

B. Former Employee and Company desire to settle and compromise any and all possible claims between them arising out of their relationship to date, including Former Employee's employment with the Company, and the termination of Former Employee's employment with the Company, and to provide for a general release of any and all claims relating to Former Employee's employment and its termination. In particular, and without limiting the generality of the foregoing, Former Employee and Company are each parties to an Employment Agreement dated November 20, 2006, as amended June 28, 2008 (the "Employment Agreement"), and desire to settle and compromise any and all claims of Former Employee pursuant to the Employment Agreement.

NOW, THEREFORE, incorporating the above recitals, and for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

**AGREEMENT**

1. Separation Payment by Company. In consideration of Former Employee's promises and covenants contained in this Agreement:

(a) The Company agrees to pay Former Employee the gross sum of fifty-six thousand two hundred fifty and zero/100 dollars (\$56,250.00), less all applicable withholdings and deductions, which amount represents a severance benefit in the amount of three (3) months' base salary. Twenty-eight thousand one hundred twenty-five and zero/100 dollars (\$28,125.00) of such severance benefit will be paid by the Company to Former Employee within ten (10) business days after the Effective Date (as hereinafter defined) and the balance of the severance benefit will be paid by the Company to Former Employee on a bi-weekly basis over the three (3) month period following the Effective Date, with the first such payment to be processed with the next regularly scheduled Company payroll after the Effective Date. Former Employee acknowledges and agrees he has received payment for all unused, accrued vacation pay, as well as all salary to which he was entitled through the Date of Termination, less all applicable withholdings and deductions.

(b) Former Employee shall be entitled to receive continuing group health insurance coverage pursuant to COBRA and, should Former Employee elect to continue group health insurance coverage pursuant to COBRA, the Company will, following the Effective Date, pay the premiums for such continuation coverage for a period of three (3) months in the amount of one thousand nine hundred three and sixty-three/100 dollars (\$1,903.63) per month for a total of five thousand seven hundred one and eighty-nine/100 dollars (\$5,701.89).



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(c) Former Employee acknowledges and agrees that (i) the amounts set forth above represent additional payments to Former Employee, over and above all compensation (including salary, wages, bonuses, or benefits) to which Former Employee would otherwise be entitled due to Former Employee's employment with the Company and but for Former Employee's execution of this Agreement, Former Employee would not otherwise be entitled to such payments; and (ii) the payments set forth in Sections 1(a) and 1(b) represent the total consideration due to Former Employee from the Company under this Agreement.

2. Release.

(a) Former Employee does hereby unconditionally, irrevocably and absolutely release and forever discharge the Company, and its subsidiaries and affiliates, and its and their respective past and present directors, officers, employees, representatives, agents, attorneys, stockholders, insurers, successors and/or assigns (hereinafter individually a "Released Party" and collectively, the "Released Parties"), from any and all losses, liabilities, claims, demands, causes of action, or suits of any type, whether in law and/or in equity, related directly or indirectly or in any way in connection with any transaction, affairs or occurrences between them to date, including, but not limited to, Former Employee's employment with the Company and the termination of said employment. Former Employee agrees and understands the release given by Former Employee to the Released Parties in this Agreement applies, without limitation, to all wage claims, tort and/or contract claims, common law claims, claims for wrongful termination and/or retaliatory discharge, and claims arising under the Age Discrimination in Employment Act, the Older Workers' Benefit Protection Act, the Civil Rights Act of 1964 (Title VII), the Civil Rights Act of 1991, Section 1981, the Americans with Disabilities Act, the Rehabilitation Act of 1973, the Equal Pay Act, the California Fair Employment and Housing Act, the Unruh and Ralph Civil Rights Act, the Fair Labor Standards Act, the Worker Adjustment and Retraining Notification Act, the Family and Medical Leave Act, the Employee Retirement and Income Security Act, the California Labor Code, the California Worker Adjustment and Retraining Notification Act, all as amended, any and all federal, state or local laws, regulations, statutes or ordinances governing discrimination and/or harassment in employment, and the California Business and Professions Code. This release does not extend to any matters that may not be released in this manner as a matter of law.

(b) Former Employee warrants, represents, acknowledges and agrees that Former Employee has not filed or otherwise cooperated in the authorization of the filing of any complaints, charges, or lawsuits against any Released Party with any governmental agency or court. If such a complaint, charge or lawsuit has been filed on Former Employee's behalf or is filed in the future, Former Employee hereby waives, releases and discharges any right to recover thereunder from any Released Party.

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### 3. Confidentiality.

(a) Former Employee agrees that all matters relative to this Agreement shall remain confidential. Accordingly, Former Employee hereby agrees that Former Employee shall not discuss, disclose or reveal to any other persons, entities or organizations, whether within or outside of the Company, with the exception of Former Employee's legal counsel, financial, tax and business advisors, and such other persons as may be reasonably necessary for the management of the Former Employee's affairs, the terms, amounts and conditions of settlement and of this Agreement. Notwithstanding the above, Former Employee acknowledges that Company may be required to disclose certain terms, aspects or conditions of this Agreement and/or Former Employee's termination of employment in Company's public filings made with the United States Securities and Exchange Commission and Former Employee hereby expressly consents to any such required disclosures.

(b) Former Employee shall not make, issue, disseminate, publish, print or announce any news release, public statement or announcement with respect to these matters, or any aspect thereof, the reasons therefore and the terms or amounts of this Agreement.

4. Return of Documents and Equipment. Former Employee represents that Former Employee has returned to the Company all Company Property (as such term is defined in that certain Confidential Information and Invention Assignment Agreement, Covenant of Exclusivity and Covenant Not To Compete by and between Former Employee and Company). In the event Former Employee has not returned all Company Property, Former Employee agrees to reimburse the Company for any reasonable expenses it incurs in an effort to have such property returned. These reasonable expenses include attorneys' fees and costs.

### 5. Civil Code Section 1542 Waiver.

(a) Former Employee expressly accepts and assumes the risk that if facts with respect to matters covered by this Agreement are found hereafter to be other than or different from the facts now believed or assumed to be true, this Agreement shall nevertheless remain effective. It is understood and agreed that this Agreement shall constitute a general release and shall be effective as a full and final accord and satisfaction and as a bar to all actions, causes of action, costs, expenses, attorneys' fees, damages, claims and liabilities whatsoever, whether or not now known, suspected, claimed or concealed pertaining to the released claims. Former Employee acknowledges that Former Employee is familiar with California Civil Code §1542, which provides and reads as follows:

**“A general release does not extend to claims which the creditor does not know of or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor.”**

(b) Former Employee expressly waives and relinquishes any and all rights or benefits which Former Employee may have under, or which may be conferred upon Former Employee by the provisions of California Civil Code §1542, as well as any other similar state or federal statute or common law principle, to the fullest extent that Former Employee may lawfully waive such rights or benefits pertaining to the released claims.

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6. Right to Consult Legal Counsel; Review Period.

(a) Former Employee is aware of and acknowledges the following: (i) Former Employee has the right, at Former Employee's expense, to consult with an attorney before signing this Agreement, has been advised in writing to do so, and has done so to the extent desired; (ii) Former Employee has twenty-one (21) days from the date of Former Employee's receipt of this Agreement to review and consider this Agreement, and Former Employee may use as much of this twenty-one (21) day period as Former Employee wishes before signing; (iii) for a period of seven (7) days following the execution of this Agreement, Former Employee may revoke this Agreement by delivering a written notice specifically stating Former Employee's desire to revoke this Agreement to the Company c/o Ken Wolf, Natural Alternatives International, Inc., 1185 Linda Vista Drive, San Marcos, California 92078, which notice must be received by the Company not later than midnight on the seventh day following execution of this Agreement by Former Employee, and this Agreement shall not become effective or enforceable until the revocation period has expired; and (iv) this Agreement shall become effective eight (8) days after it is signed by Former Employee and the Company (provided it is not revoked), and in the event the parties do not sign on the same date, this Agreement shall become effective at 12:01 a.m. on the eighth day after the date it is signed by Former Employee ("Effective Date"). Former Employee shall, promptly upon signing this Agreement, deliver the executed original of the Agreement to the Company to the attention of Ken Wolf.

(b) In the event Former Employee elects to execute this Agreement before the end of the twenty-one (21) day review period provided to Former Employee and thereby waive the remainder of the twenty-one (21) day review period, Former Employee does so knowingly and voluntarily, and Former Employee acknowledges and represents that the Company has not in any way coerced Former Employee to do so or otherwise threatened to withdraw or alter the Company's offer of severance pay set forth in this Agreement before the expiration of such twenty-one (21) day period.

7. Entire Agreement. The parties declare and represent that, with the exception of the Mutual Agreement to Mediate and Arbitrate Claims and the Confidential Information and Invention Assignment Agreement, Covenant of Exclusivity and Covenant Not to Compete each entered into by and between the Company and Former Employee effective as of November 20, 2006 (collectively, the "Prior Agreements"), no promise, inducement or agreement not herein expressed has been made to them and that this Agreement, together with the Prior Agreements, contain the entire agreement between and among the parties with respect to the subject matter hereof, and that the terms of this Agreement are contractual and not a mere recital. This Agreement supersedes any and all other agreements, either oral or in writing, between the parties with respect to the subject matter hereof with the exception of the Prior Agreements.

8. Applicable Law. This Agreement is entered into in the State of California. The validity, interpretation, and performance of this Agreement shall be construed and interpreted according to the laws of the State of California.

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9. Agreement as Defense. This Agreement may be pleaded as a full and complete defense and may be used as the basis for an injunction against any action, suit or proceeding which may be prosecuted, instituted or attempted by either party in breach thereof.

10. Severability. If any provision of this Agreement, or part thereof, is held invalid, void or voidable as against public policy or otherwise, the invalidity shall not affect other provisions, or parts thereof, which may be given effect without the invalid provision or part. To this extent, the provisions, and parts thereof, of this Agreement are declared to be severable.

11. No Admission of Liability. It is understood that this Agreement is not an admission of any liability by any person, firm, association or corporation.

12. Counterparts. This Agreement may be executed in counterparts, each of which will be deemed an original copy of this Agreement and all of which, when taken together, will be deemed to constitute one and the same agreement. The exchange of copies of this Agreement and of signature pages by facsimile transmission shall constitute effective execution and delivery of this Agreement as to the parties and may be used in lieu of the original Agreement for all purposes. Signatures of the parties transmitted by facsimile shall be deemed to be their original signatures for all purposes.

13. Representation of No Assignment. The parties represent and warrant that they have not heretofore assigned, transferred, subrogated or purported to assign, transfer or subrogate any claim released herein to any person or entity.

14. Cooperation. The parties hereto agree that, for their respective selves, heirs, executors and assigns, they will abide by this Agreement, the terms of which are meant to be contractual, and further agree that they will do such acts and prepare, execute and deliver such documents as may reasonably be required in order to carry out the objectives of this Agreement.

15. Arbitration. Any dispute arising out of or relating to this Agreement shall be resolved pursuant to that certain Mutual Agreement to Mediate and Arbitrate Claims made and entered into effective as of November 20, 2006, by and between the Company and Former Employee.

17. Legal Representation; Independent Counsel. The law firm of K&L Gates LLP has prepared this Agreement on behalf of the Company based on the Company's instructions. K&L Gates LLP does not represent any other party to this Agreement. In executing this Agreement, Former Employee represents that Former Employee has neither requested nor been given legal advice or counsel by K&L Gates LLP or any of its attorneys. Former Employee is aware of Former Employee's right to obtain separate legal counsel with respect to the negotiation and execution of this Agreement and acknowledges that K&L Gates LLP has recommended that Former Employee retain Former Employee's own counsel for such purpose. Former Employee further acknowledges that Former Employee (i) has read and understands this Agreement; (ii) has had the opportunity to retain separate counsel in connection with the negotiation and execution of this Agreement; and (iii) has relied on the advice of separate counsel with respect to this Agreement or made the conscious decision not to retain counsel in connection with the negotiation and execution of this Agreement.

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18. Further Acknowledgements. Each party represents and acknowledges that it is not being influenced by any statement made by or on behalf of the other party to this Agreement. Former Employee and the Company have relied and are relying solely upon his, her or its own judgment, belief and knowledge of the nature, extent, effect and consequences relating to this Agreement and/or upon the advice of their own legal counsel concerning the consequences of this Agreement.

*[Signatures on following page.]*

**THIS AGREEMENT AFFECTS YOUR RIGHTS. BEFORE SIGNING THIS AGREEMENT, PLEASE MAKE SURE THAT YOU HAVE READ IT CAREFULLY. YOU ARE INVITED AND ADVISED TO CONSULT WITH AN ATTORNEY BEFORE YOU SIGN IT. IN EXCHANGE FOR THE SEVERANCE PAY OFFERED BY THE COMPANY, YOU ARE AGREEING TO WAIVE CERTAIN IMPORTANT RIGHTS.**

IN WITNESS WHEREOF, the undersigned have executed this Agreement on the date(s) shown below.

FORMER EMPLOYEE

/s/ Alvin McCurdy  
Alvin McCurdy

Dated: July 1, 2009

Executed in: Anaheim, California  
(City)

COMPANY

Natural Alternatives International, Inc.,  
a Delaware corporation

By: /s/ Kenneth Wolf  
(Signature)

Printed Name: Kenneth Wolf

Title: CFO

Dated: July 6, 2009

Executed in: San Marcos, California  
(City)

SEVENTH AMENDMENT TO CREDIT AGREEMENT

THIS AMENDMENT TO CREDIT AGREEMENT (this "Amendment") is entered into as of June 1, 2009, by and between NATURAL ALTERNATIVES INTERNATIONAL, INC., a Delaware corporation ("Borrower"), and WELLS FARGO BANK, NATIONAL ASSOCIATION ("Bank").

RECITALS

WHEREAS, Borrower is currently indebted to Bank pursuant to the terms and conditions of that certain Credit Agreement between Borrower and Bank dated as of May 1, 2004, as amended from time to time ("Credit Agreement").

WHEREAS, Bank and Borrower have agreed to certain changes in the terms and conditions set forth in the Credit Agreement and have agreed to amend the Credit Agreement to reflect said changes.

NOW, THEREFORE, for valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree that the Credit Agreement shall be amended as follows:

1. The first sentence of Section 1.1.(b) is hereby deleted in its entirety, and the following substituted therefor:

"Outstanding borrowings under the Line of Credit, to a maximum of the principal amount set forth above, shall not at any time exceed an aggregate of eighty-five percent (85%) of Borrower's eligible accounts receivable, plus, thirty percent (30%) of the value of Borrower's eligible raw materials inventory, plus forty percent (40%) of the value of Borrower's eligible finished goods inventory (exclusive of work in process and inventory which is obsolete, unsaleable or damaged), with value defined as the lower of cost or market value, provided however, that outstanding borrowings against inventory shall not at any time exceed an aggregate of Three Million Seven Hundred Fifty Thousand Dollars (\$3,750,000.00); and provided further, that outstanding borrowings against such inventory shall not at any time exceed eligible accounts receivable."

2. Section 1.4.(a) is hereby deleted in its entirety, and the following substituted therefor:

"(a) Foreign Exchange Facility. Subject to the terms and conditions of this Agreement, Bank hereby agrees to make available to Borrower a facility (the "Foreign Exchange Facility") under which Bank, from time to time up to and including November 1, 2010, will enter into foreign exchange contracts for the account of Borrower for the purchase and/or sale by

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Borrower in United States dollars of foreign currencies designated by Borrower; provided however, that the contract limit shall not at any time exceed an aggregate of One Million Eight Hundred Thousand United States Dollars (US\$1,800,000.00). No foreign exchange contract shall be executed for a term which extends beyond November 1, 2010. Borrower shall have a "Delivery Limit" under the Foreign Exchange Facility not to exceed at any time the aggregate principal amount of Zero United States Dollars (US\$0.00) with PVD ("Payment versus Delivery") which will require Borrower to provide funds before the currency is delivered and this will eliminate the 1 or 2 business day settlement period and mitigate settlement risk. All foreign exchange transactions shall be subject to the additional terms of a Foreign Exchange Agreement dated as of May 1, 2004 ("Foreign Exchange Agreement"), all terms of which are incorporated herein by this reference."

3. Section 4.3 (d) is hereby deleted in its entirety, and the following substituted therefor:

"(d) not later than 15 days after and as of the end of each month, an inventory collateral report, Borrowing Base Certificate, an aged listing of accounts receivable and accounts payable, and a reconciliation accounts; not later than 15 days after and as of the 15th and last day of each month, semi-monthly collateral report if Borrower elects to use 35% concentration allowance for Mannatech, Inc. and a new account debtor acceptable to Bank, and not later than 30 days after and as of the end of each May and November, a list of the names, addresses and contact phone numbers of all Borrower's account debtors;"

4. Sections 4.9.(c) and (d) are hereby deleted in their entirety, and the following substituted therefor:

"(c) Net income after tax for the fiscal quarter ending June 30, 2009 not less than \$250,000.00 and for each fiscal quarter thereafter not less than \$1.00; Net loss for the fiscal year ending June 30, 2009 not to exceed \$5,000,000.00 and thereafter net income after tax not less than \$750,000.00 on an annual basis, determined as of each fiscal year.

(d) Fixed Charge Coverage Ratio not less than -1.95 to 1.00 as of June 30, 2009, and not less than 1.25 to 1.00 as of each fiscal quarter end thereafter, determined on a rolling 4-quarter basis, with "Fixed Charge Coverage Ratio" defined as the aggregate of net profit after taxes plus depreciation expense, amortization expense and net contributions, divided by the aggregate of the current maturity of long-term debt and capitalized lease payments."



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5. Section 5.9. is hereby deleted in its entirety, and the following substituted therefor

“SECTION 5.9. PLEDGE OF ASSETS. Mortgage, pledge, grant or permit to exist a security interest in, or lien upon, all or any portion of Borrower’s assets now owned or hereafter acquired, except any of the foregoing in favor of Bank or which is existing as of, and disclosed to Bank in writing prior to, the date hereof, and liens to the extent they secure the debt permitted under Section 5.4 hereof.”

6. Section 7.4. is hereby deleted in its entirety, and the following substituted therefor:

“7.4 SUCCESSORS, ASSIGNMENT. This Agreement shall be binding upon and inure to the benefit of the heirs, executors, administrators, legal representatives, successors and assigns of the parties; provided however, that Borrower may not assign or transfer its interest hereunder without Bank’s prior written consent, Bank reserves the right to sell, assign, transfer, negotiate or grant participations in all or any part of, or any interest in, Bank’s rights and benefits under each of the Loan Documents. In connection therewith, Bank may disclose all documents and information which Bank now has or may hereafter acquire relating to any credit subject hereto, Borrower or its business, or any collateral required hereunder.”

7. Except as specifically provided herein, all terms and conditions of the Credit Agreement remain in full force and effect, without waiver or modification. All terms defined in the Credit Agreement shall have the same meaning when used in this Amendment. This Amendment and the Credit Agreement shall be read together, as one document.

8. Borrower hereby remakes all representations and warranties contained in the Credit Agreement and reaffirms all covenants set forth therein. Borrower further certifies that as of the date of this Amendment there exists no Event of Default as defined in the Credit Agreement, nor any condition, act or event which with the giving of notice or the passage of time or both would constitute any such Event of Default.

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IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be executed as of the day and year first written above.

NATURAL ALTERNATIVES INTERNATIONAL, INC.

WELLS FARGO BANK, NATIONAL ASSOCIATION

By: /s/ Mark A. LeDoux

By: /s/ Bernie Palmer

Title: CEO

Bernie Palmer  
Vice President

By: /s/ Kenneth Wolf

Title: CFO

## FIRST MODIFICATION TO PROMISSORY NOTE

THIS MODIFICATION TO PROMISSORY NOTE (this "Modification") is entered into as of June 1, 2009, by and between NATURAL ALTERNATIVES INTERNATIONAL, INC. ("Borrower"), and WELLS FARGO BANK, NATIONAL ASSOCIATION ("Bank").

RECITALS

WHEREAS, Borrower is currently indebted to Bank pursuant to the terms and conditions of that certain Revolving Line of Credit Note in the maximum principal amount of \$7,500,000.00, executed by Borrower and payable to the order of Bank, dated as of November 1, 2008 (the "Note"), which Note is subject to the terms and conditions of a loan agreement between Borrower and Bank dated as of May 1, 2004, as amended from time to time (the "Loan Agreement"), which Note incorporates the terms of an Addendum to Promissory Note dated as of the same date (the "Addendum").

WHEREAS, Bank and Borrower have agreed to certain changes in the terms and conditions set forth in the Note, and have agreed to modify the Note to reflect said changes.

NOW, THEREFORE, for valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree that the Note shall be modified as follows:

1. Paragraph (b) under the section "DEFINITIONS" is hereby deleted in its entirety and the following substituted therefor:

"(b) Daily Three Month LIBOR" means, for any day, the rate of interest equal to LIBOR then in effect for delivery for a three (3) month period."

2. Paragraph (d)(i)(B) under the section "DEFINITIONS" is hereby deleted in its entirety and the following substituted therefor.

"(B) for the purpose of calculating effective rates of interest for loans making reference to the Daily Three Month LIBOR Rate, as the Inter-Bank Market Offered Rate in effect for time to time for delivery of funds for three (3) months in amounts approximately equal to the principal amount of such loans."

3. Paragraph (a) under the section "INTEREST" is hereby deleted in its entirety and the following substituted therefor:

"(a) Interest. The outstanding principal balance of this Note shall bear interest (computed on the basis of a 360-day year, actual days elapsed) either (i) at a fluctuating rate per annum determined by Bank to be two and three-quarters percent (2.75%) above the Daily Three Month LIBOR Rate in effect from time to time, or (ii) at a fixed rate per annum determined by Bank to be two and one-half percent (2.50%) above LIBOR in effect on the first day of the applicable Fixed Rate Term. When interest is determined in relation to the Daily Three Month LIBOR Rate, each change in the interest rate shall become effective each Business Day that the Bank determines that the Daily Three Month LIBOR Rate has changed. Bank is hereby authorized to

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note the date, principal amount and interest rate applicable thereto and any payments made thereon on Bank's books and records (either manually or by electronic entry) and/or on any schedule attached to this Note, which notations shall be prima facie evidence of the accuracy of the information noted."

4. Paragraph (b) under the section "INTEREST" is hereby deleted in its entirety and the following substituted therefor:

"(b) Selection of Interest Rate Options. At any time any portion of this Note bears interest determined in relation to LIBOR for a Fixed Rate Term, it may be continued by Borrower at the end of the Fixed Rate Term applicable thereto so that all or a portion thereof bears interest determined in relation to the Daily Three Month LIBOR Rate or to LIBOR for a new Fixed Rate Term designated by Borrower. At any time any portion of this Note bears interest determined in relation to the Daily Three Month LIBOR Rate, Borrower may at any time convert all or a portion thereof so that it bears interest determined in relation to LIBOR for a Fixed Rate Term designated by Borrower. At such time as Borrower requests an advance hereunder or wishes to select an interest rate determined in relation to the Daily Three Month LIBOR Rate or a Fixed Rate Term for all or a portion of the outstanding principal balance hereof, and at the end of each Fixed Rate Term, Borrower shall give Bank notice specifying: (i) the interest rate option selected by Borrower; (ii) the principal amount subject thereto; and (iii) for each LIBOR selection for a Fixed Rate Term, the length of the applicable Fixed Rate Term. Any such notice may be given by telephone (or such other electronic method as Bank may permit) so long as, with respect to each LIBOR selection for a Fixed Rate Term, (A) if requested by Bank, Borrower provides to Bank written confirmation thereof not later than three (3) Business Days after such notice is given, and (B) such notice is given to Bank prior to 10:00 a.m. on the first day of the Fixed Rate Term, or at a later time during any Business Day if Bank, at its sole option but without obligation to do so, accepts Borrower's notice and quotes a fixed rate to Borrower. If Borrower does not immediately accept a fixed rate when quoted by Bank, the quoted rate shall expire and any subsequent LIBOR request from Borrower shall be subject to a redetermination by Bank of the applicable fixed rate. If no specific designation of interest is made at the time any advance is requested hereunder or at the end of any Fixed Rate Term, Borrower shall be deemed to have made a Daily Three Month LIBOR Rate interest selection for such advance or the principal amount to which such Fixed Rate Term applied."

5. Paragraph (c) under the section "BORROWING AND REPAYMENT" is hereby deleted in its entirety and the following substituted therefor:

"(c) Application of Payments. Each payment made on this Note shall be credited first, to any interest then due and second, to the outstanding principal balance hereof. All payments credited to principal shall be applied first, to the outstanding principal balance of this Note which bears interest determined in relation to the Daily Three Month LIBOR Rate, if any, and second, to the outstanding principal balance of this Note which bears interest determined in relation to LIBOR, with such payments applied to the oldest Fixed Rate Term first."

6. Paragraph (a) under the section "PREPAYMENT" is hereby deleted in its entirety and the following substituted therefor;

"(a) Daily Three Month LIBOR Rate. Borrower may prepay principal on any portion of this Note which bears interest determined in relation to the Daily Three Month LIBOR Rate at any time, in any amount and without penalty."

7. The last paragraph under the section "PREPAYMENT" is hereby deleted in its entirety and the following substituted therefor:

"Borrower acknowledges that prepayment of such amount may result in Bank incurring additional costs, expenses and/or liabilities, and that it is difficult to ascertain the full extent of such costs, expenses and/or liabilities. Borrower, therefore, agrees to pay the above-described prepayment fee and agrees that said amount represents a reasonable estimate of the prepayment costs, expenses and/or liabilities of Bank. If Borrower fails to pay any prepayment fee when due, the amount of such prepayment fee shall thereafter bear interest until paid at a rate per annum two percent (2.0%) above the Daily Three Month LIBOR Rate in effect from time to time (computed on the basis of a 360-day year, actual days elapsed)."

8. The Addendum to Promissory Note attached amends and restates in its entirety the prior Addendum.

9. Except as expressly set forth herein, all terms and conditions of the Note remain in full force and effect, without waiver or modification. All terms defined in the Note or the Loan Agreement shall have the same meaning when used in this Modification. This Modification and the Note shall be read together, as one document.

10. Borrower certifies that as of the date of this Modification there exists no Event of Default under the Note, nor any condition, act or event which with the giving of notice or the passage of time or both would constitute any such Event of Default.

IN WITNESS WHEREOF, the parties hereto have caused this Modification to be executed as of the day and year first written above.

NATURAL ALTERNATIVES  
INTERNATIONAL, INC.

By: /s/ Mark A. LeDoux  
Title: CEO

By: /s/ Kenneth Wolf  
Title: CFO

WELLS FARGO BANK,  
NATIONAL ASSOCIATION

By: /s/ Bernie Palmer  
Bernie Palmer  
Vice President

AMENDED AND RESTATED  
ADDENDUM TO PROMISSORY NOTE  
(LIBOR PRICING ADJUSTMENTS)

THIS AMENDED AND RESTATED ADDENDUM dated as of June 1, 2009 is attached to and made a part of that certain promissory note executed by NATURAL ALTERNATIVES INTERNATIONAL, INC. ("Borrower") and payable to WELLS FARGO BANK, NATIONAL ASSOCIATION ("Bank"), or order, dated as of November 1, 2008 in the principal amount of Seven Million Five Hundred Thousand Dollars (\$7,500,000.00), as amended (the "Note"). The Amended and Restated Addendum to Promissory Note (LIBOR Pricing Adjustments) amends and restates in its entirety the prior Addendum to Promissory Note (LIBOR Pricing Adjustments).

The following provisions are hereby incorporated into the Note to reflect the interest rate adjustments agreed to by Bank and Borrower:

INTEREST RATE ADJUSTMENTS:

(a) Initial LIBOR Margin. The initial interest rates applicable to this Note shall be the rates set forth in the "Interest" paragraph herein.

(b) LIBOR Rate Adjustments. Bank shall adjust the (a) annual fee, and (b) the LIBOR margin used to determine the rate of interest applicable to Daily Three Month LIBOR or the LIBOR option selected by Borrower under this Note on a quarterly basis, commencing with Borrower's fiscal quarter ending June 30, 2009, if required to reflect a change in Borrower's ratio of Fixed Charge Coverage Ratio (as defined in the Credit Agreement referenced herein), in accordance with the following grid:

<u>Fixed Charge Coverage Ratio</u>	<u>Applicable LIBOR Margin</u>	<u>Applicable Daily Three Month LIBOR Margin</u>	<u>Annual Fee Margin</u>
2.5 to 1.0 or greater	2.50%	2.75%	0.25%
at least 1.75 to 1.00 but less than 2.5 to 1.0	3.00%	3.25%	0.50%
at least 1.25 to 1.00 but less 1.75 to 1.00	3.50%	3.75%	1.00%
less 1.25 to 1.00	4.00%	4.25%	1.50%

Each such adjustment shall be effective on the first Business Day of Borrower's fiscal quarter following the quarter during which Bank receives and reviews Borrower's most current fiscal quarter-end financial statements in accordance with any requirements established by Bank for the preparation and delivery thereof.

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IN WITNESS WHEREOF, this Addendum has been executed as of the date hereof. NATURAL ALTERNATIVES INTERNATIONAL, INC.

By: /s/ Mark A. LeDoux  
Title: CEO

By: /s/ Kenneth Wolf  
Title: CFO

**THIRD AMENDMENT TO LICENSE AGREEMENT**

This Third Amendment ("Amendment") to the License Agreement by and among Roger Harris, Mark Dunnett and Kenny Johansson (collectively, the "LICENSOR") and Natural Alternatives International, Inc., a Delaware corporation ("LICENSEE"), effective as of April 28, 1997, as amended by that certain Amendment to License Agreement dated March 17, 2001, and as further amended by that certain Second Amendment to License Agreement dated March 26, 2007 (collectively, the "Agreement"), is made and entered into effective as of March 3, 2009 ("Effective Date"). Unless otherwise defined herein, capitalized terms shall have the meanings given them in the Agreement.

1. Section 4.3 is hereby amended in its entirety to read as follows:

"4.3 **Sublicensee Royalties.** LICENSOR acknowledges and agrees that LICENSEE may:

- 4.3.1 Enter into certain manufacturing or similar agreements with one or more third parties pursuant to which LICENSEE agrees to grant a sublicense of the rights granted to LICENSEE under this Agreement to such third party in accordance with Section 2.2 of this Agreement in exchange for the right of LICENSEE to manufacture and/or package any Licensed Products developed by such third party pursuant to such sublicense. In such event, LICENSEE agrees to pay LICENSOR a royalty at the rates set forth in Section 4.2; provided, however, that for such purpose "Net Receipts" shall mean the gross invoice amount billed by LICENSEE to such third party and received by LICENSEE for such manufacturing and/or packaging services less shipping and storage costs, the cost of any required governmental authorizations and outside laboratory testing, research costs and returns, discounts, allowances and rebates.
- 4.3.2 Enter into agreements with one or more third party suppliers or distributors of raw materials used in Licensed Products pursuant to which LICENSEE agrees to grant a sublicense of the rights granted to LICENSEE under this Agreement to such third party's customers in accordance with Section 2.2 of this Agreement in consideration for the payment of certain sublicense fees to LICENSEE by such third party supplier or distributor. In such event, LICENSEE agrees to pay LICENSOR a royalty at the rates set forth in Section 4.2; provided, however, that for such purpose "Net Receipts" shall mean the aggregate gross sales price charged by such third party supplier or distributor to its customers for the sale and purchase of such raw materials less all applicable cash discounts, sales discounts and returns.



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4.3.3 Enter into sublicense or similar agreements in accordance with Section 2.2 of this Agreement other than of the type described in Sections 4.3.1 and 4.3.2 and from any royalties actually received by LICENSEE from such sublicensees for Transfers of Licensed Products, LICENSEE shall pay LICENSOR an amount equal to 50% of the sum that LICENSEE would otherwise have paid in royalties under Section 4.2 if LICENSEE had directly made such Transfers.

2. Section 4.4 of the Agreement is hereby deleted in its entirety.

3. The introductory paragraph and signature page to the Agreement are hereby amended to include Kenny Johansson as a "LICENSOR."

In connection with the foregoing, each party to the Agreement hereby acknowledges and agrees as follows:

- (a) Mr. Johansson, together with Messrs. Harris and Dunnett, is, and was at all times during the term of the Agreement, an owner of the Licensed Rights.
- (b) Despite the foregoing and the fact that LICENSOR represented to LICENSEE in the Agreement that it was the sole owner of the Licensed Rights, Mr. Johansson was inadvertently omitted as a party to the Agreement.
- (c) Messrs. Harris and Dunnett each represents to LICENSEE that, at all times during the term of the Agreement, they have (i) honored Mr. Johansson's rights as an owner of the Licensed Rights, (ii) considered Mr. Johansson to be a party to the Agreement, and (iii) have distributed to Mr. Johansson one-third (1/3) of all royalties paid to LICENSOR pursuant to the Agreement.
- (d) Mr. Johansson represents to LICENSEE that, at all times during the term of the Agreement, Mr. Johansson has (i) been treated as an owner of the Licensed Rights and (ii) considered himself to be a party to the Agreement.

4. Section 4.5 of the Agreement is hereby amended to add the following at the end of such section:

"Notwithstanding anything herein to the contrary, LICENSEE, at its election, may elect to pay any royalty payment due LICENSOR hereunder by paying one-third (1/3) of such royalty payment directly to each of Roger Harris, Mark Dunnett and Kenny Johansson or to such other person or entity as Roger Harris, Mark Dunnett or Kenny Johansson may instruct LICENSEE as to their respective portion of any royalty payment."

5. Except as set forth herein, all other terms and conditions of the Agreement shall remain in full force and effect.

*[Signatures on next page]*

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IN WITNESS WHEREOF, the undersigned have executed this Amendment as of the Effective Date.

LICENSOR

/s/ Roger Harris

\_\_\_\_\_  
Roger Harris

/s/ Mark Dunnett

\_\_\_\_\_  
Mark Dunnett

/s/ Kenny Johansson

\_\_\_\_\_  
Kenny Johansson

LICENSEE

Natural Alternatives International, Inc.,  
a Delaware corporation

/s/ Mark A. LeDoux

\_\_\_\_\_  
Mark A. LeDoux, Chief Executive Officer

**List of Subsidiaries of  
Natural Alternatives International, Inc., a Delaware corporation**

<b>Name of Subsidiary</b>	<b>State or other Jurisdiction of Incorporation or Organization</b>
Natural Alternatives International Europe S.A.	Switzerland
Transformative Health Products, Inc.	Delaware, USA
Disposition Company, Inc.	California, USA

**Consent of Independent Registered Public Accounting Firm**

We consent to the incorporation by reference in the Registration Statements:

1. Form S-8 No. 333-154160, pertaining to the 1999 Omnibus Equity Incentive Plan and the 1999 Employee Stock Purchase Plan.
2. Form S-8 No. 333-140185, pertaining to the 1999 Omnibus Equity Incentive Plan and the 1999 Employee Stock Purchase Plan.
3. Form S-3 No. 333-132191, as amended, and related prospectus, pertaining to the registration of 510,000 shares of Natural Alternatives International, Inc. Common Stock,
4. Form S-8 No. 333-131968, pertaining to the 1999 Omnibus Equity Incentive Plan and the 1999 Employee Stock Purchase Plan,
5. Form S-8 No. 333-32828, pertaining to the 1999 Omnibus Equity Incentive Plan, the 1999 Employee Stock Purchase Plan, and the Two Outstanding Non-Employee Director Option Agreements outside of any plan,
6. Form S-8 No. 333-117020, pertaining to the 1999 Omnibus Equity Incentive Plan

of our report dated September 25, 2009, with respect to the consolidated financial statements of Natural Alternatives International, Inc. included in its Annual Report (Form 10-K) for the year ended June 30, 2009.

/s/ Ernst & Young LLP

San Diego, California  
September 25, 2009

**Certification of Chief Executive Officer  
Pursuant to  
Rule 13a-14(a)/15d-14(a)**

I, Mark A. LeDoux, Chief Executive Officer of Natural Alternatives International, Inc., certify that:

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

Date: September 25, 2009

/s/ Mark A. LeDoux  
\_\_\_\_\_  
Mark A. LeDoux, Chief Executive Officer

**Certification of Chief Financial Officer  
Pursuant to  
Rule 13a-14(a)/15d-14(a)**

I, Ken Wolf, Chief Financial Officer of Natural Alternatives International, Inc., certify that:

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

Date: September 25, 2009

/s/ Ken Wolf

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Ken Wolf, Chief Financial Officer

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

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), each of the undersigned officers of Natural Alternatives International, Inc., a Delaware corporation, does hereby certify, to such officer's knowledge, that the Annual Report on Form 10-K for the fiscal year ended June 30, 2009 of Natural Alternatives International, Inc. fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) and that information contained in such report fairly presents, in all material respects, the financial condition and results of operations of Natural Alternatives International, Inc.

Date: September 25, 2009

/s/ Mark A. LeDoux

Mark A. LeDoux, Chief Executive Officer

Date: September 25, 2009

/s/ Ken Wolf

Ken Wolf, Chief Financial Officer

The foregoing certification is furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and is not being filed as part of the Form 10-K or as a separate disclosure document.