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

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**FORM 10-K**

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

**FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

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

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**NATURAL ALTERNATIVES INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

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**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:**  
None

**Securities registered pursuant to Section 12(g) of the Act:**  
**Common Stock, \$0.01 par value per share**

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Indicate by check mark whether Natural Alternatives International, Inc. (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 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 an accelerated filer (as defined in Rule 12b-2 of the Act).  Yes  No

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, 2004) was approximately \$41,243,757 (based on the closing sale price of \$9.23 reported by Nasdaq on December 31, 2004). For this purpose, all of NAI's officers and directors and their affiliates were assumed to be affiliates of NAI.

As of September 8, 2005, 6,032,367 shares of NAI's common stock were outstanding, net of 61,000 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 December 2, 2005, to be filed on or before October 28, 2005.

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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, net income per share, profit margins, expenditures, liquidity and other financial items;
- inventories and the adequacy and intended use of our facilities;
- the adequacy of reserves and allowances;
- sources and availability of raw materials;
- personnel;
- operations outside the United States;
- overall industry and market performance;
- competition;
- current and future economic and political conditions;
- development of new products, brands and marketing strategies;
- distribution channels and product sales and performance;
- growth, expansion and acquisition strategies;
- the outcome of regulatory, tax and litigation matters;
- our ability to develop relationships with new customers and maintain or improve existing customer relationships;
- the impact of accounting pronouncements;
- management’s goals and plans for future operations; 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 7 and elsewhere in this report, as well as in other reports and documents we file with the SEC.

## PART I

### ITEM 1. BUSINESS

#### Overview

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

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, under our direct-to-consumer marketing program, we develop, manufacture and market our own products and work with nationally recognized physicians to develop brand name products that reflect their individual approaches to restoring, maintaining or improving health.

Our U.S.-based manufacturing facilities are located in Vista, California. These facilities were recertified in June 2005 by the Therapeutic Goods Administration (“TGA”) of Australia after their 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.

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.

Natural Alternatives International Europe S.A. (NAIE), our wholly owned subsidiary existing under the laws of Switzerland, 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. We believe the license can help improve our ability to develop relationships with new customers. The license is valid until January 2009.

In addition to our operations in the United States and Switzerland, we have a full-time representative in Japan who provides a range of services to our customers 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.

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

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**Business Strategy**

Our goals are to increase and diversify our net sales while improving our overall financial results. To achieve these goals, we intend to:

- capitalize on the strength of our existing customer relationships through new product introductions;
- develop new customer relationships both within and outside the United States;
- continue to develop new products, marketing strategies and brands within our direct-to-consumer marketing programs, which we believe could improve our operating margins over the long term due to generally higher gross margins than those derived from products sold to private label contract manufacturing customers;
- improve brand awareness;
- further diversify by entering new markets outside the United States and/or expanding our presence in existing markets;
- strengthen our offering of customized services including product formulation, clinical studies, regulatory assistance and product registration;
- evaluate acquisition opportunities; and
- improve efficiencies and manage costs.

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 certified manufacturing operations, science based product formulation, clinical studies and regulatory expertise provide us with a sustainable competitive advantage by providing our customers with a high degree of confidence in our products.

We believe the lack of relevant and reliable consumer education about nutrition and nutritional supplementation combined with the duplication of brands and products in the retail sales channel create 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. We believe this education process can lead to premium product pricing and avoid competing with brands of inferior quality and lower pricing in other distribution channels. Our two largest customers operate in the direct sales marketing channel. Thus, our growth has been fueled by the effectiveness of this marketing channel.

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 the leadership of our experienced management team, 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 net sales or improve our overall financial results.

**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.

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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
- package and labeling design.

Additionally, under our direct-to-consumer marketing program, we develop, manufacture and market our own products. Under the direct-to-consumer marketing program, we work with nationally recognized physicians to develop brand name products that reflect their individual approaches to restoring, maintaining or improving health. Direct-to-consumer marketing program products are sold through a variety of distribution channels including television programs, print media and the internet.

We believe the direct-to-consumer marketing program can be an effective method for marketing our high quality nutritional supplements. In March 2000, we launched Dr. Cherry's Pathway to Healing™ product line. As of June 30, 2005, the product line included nineteen condition specific, custom formulated products. The products are primarily marketed through a weekly television program.

For the last three fiscal years, net sales from our private label contract manufacturing and direct-to-consumer marketing program were as follows (dollars in thousands):

	Fiscal 2005	Fiscal 2004	Fiscal 2003
Private Label Contract Manufacturing	\$ 83,382	\$68,493	\$ 45,768
Direct-to-Consumer Marketing Program	8,110	10,041	10,194
<b>Total Net Sales</b>	<b>\$91,492</b>	<b>\$ 78,534</b>	<b>\$55,962</b>

### 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 Food and Drug Administration 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 research and development team of experienced personnel, 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 three fiscal years ended June 30 were \$3.5 million for 2005, \$2.8 million for 2004 and \$1.7 million for 2003.

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### **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 typically buy raw materials in bulk from a limited number of qualified vendors located both within and outside the United States. During fiscal 2005, Carrington Laboratories Incorporated was our largest supplier, accounting for 35% of our total raw material purchases.

We test the raw materials we buy to ensure their quality, purity and potency before we use them in our products. During the fiscal year ended June 30, 2005, we did not experience any significant shortages or difficulties obtaining adequate supplies of raw materials and we do not anticipate any significant shortages or difficulties in the near term.

### **Major Customers**

NSA International, Inc. has been our largest customer over the past several years. During the fiscal year ended June 30, 2005, NSA International, Inc. accounted for approximately 40% of our net sales. Our second largest customer was Mannatech, Incorporated, which accounted for approximately 39% of our net sales during fiscal 2005. Both NSA International, Inc. and Mannatech, Incorporated are private label contract manufacturing customers. No other customer accounted for 10% or more of our net sales during fiscal 2005. Our sales and marketing team is focused on obtaining new private label contract manufacturing customers and developing new direct-to-consumer marketing programs to reduce the risks associated with deriving a significant portion of our net sales from a limited number of customers.

### **Competition**

We compete with other manufacturers and distributors 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 direct-to-consumer products, although we believe such competition is limited.

We believe 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 turn key solutions for customers, our certified manufacturing operations and our commitment to quality and safety through our research and development activities. Our future position in the industry 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 number or size of our competitors. The 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 United States Food and Drug Administration (FDA), the Federal Trade Commission (FTC), the Consumer Product Safety Commission, the United States Department of Agriculture, and the Environmental

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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. The FDA issued a final rule called “Statements Made for Dietary Supplements Concerning the Effect of the Product on the Structure or Function of the Body,” which includes regulations requiring companies, their suppliers and manufacturers to meet GMP in the preparation, packaging, storage and shipment of their products. The FDA also published a Notice of Advance Rule Making for Good Manufacturing Practices that would require manufacturing of dietary supplements to follow GMP. While the final regulations are subject to revision, we are committed to meeting or exceeding the standards set by the FDA.

The FDA has also issued regulations governing the labeling and marketing of dietary supplements and nutritional products. They include:

- 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.

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 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 and product names. We own 21 trademark registrations in the United States and have six trademark applications pending with the United States Patent and Trademark Office. Federal registration of a trademark enables the registered owner of the mark to bar the unauthorized use of the registered mark in connection with a similar product in the same channels of trade by any third party anywhere in the United States, regardless of whether the registered owner has ever used the trademark in the area where the unauthorized use occurs.



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We have filed applications and own trademark registrations and intend to register additional trademarks in foreign countries where products are or may be sold in the future. We have one trademark application filed with the Japan Trademark Office.

We also claim ownership and protection of certain product names, unregistered trademarks and service marks under common law. Common law trademark rights do not provide the same level of protection afforded by registration of a trademark. In addition, common law trademark rights are limited to the geographic area in which the trademark is actually used. We believe these trademarks, whether registered or claimed under common law, constitute valuable assets, adding to our recognition and the marketing of our products and that these 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 that 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 our 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.

*Patents and Patent Licenses.* We own certain United States patents. In addition, we have licensed exclusive worldwide rights to four certain United States patents, and each patent's corresponding foreign patent application, and 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 of Beta-Alanine™.

### **Backlogs**

Our backlog was approximately \$16.0 million at September 2, 2005 and \$15.8 million at September 2, 2004. Our sales are made primarily pursuant to standard purchase orders for the delivery of products. Quantities of our products to be delivered and delivery schedules are frequently revised to reflect changes in our customers' needs. Customer orders generally can be cancelled or rescheduled without significant penalty to the customer. For these reasons, our backlog as of any particular date is not representative of actual sales for any succeeding period, and therefore, we believe that backlog is not necessarily a good indicator of future revenue.

### **Working Capital Practices**

We manufacture products following receipt of customer specific purchase orders and as a result our inventory primarily consists of raw materials and work in process. Our raw material purchases are made primarily pursuant to standard purchase orders for the delivery of raw materials based upon anticipated demand. Customer specific delivery requirements combined with raw material lead times impact the amount of inventory on hand at any given time. We typically purchase raw materials on 30-day payment terms. Discounts are taken periodically for early payment.

Sales are typically made based upon 30-day terms. A 2% discount is provided to customers that pay within 10 days of invoice date.

### **Employees**

As of June 30, 2005, we employed 208 full-time employees in the United States, six of whom held executive management positions. Of the remaining full-time employees, 32 were employed in research, laboratory and quality control, 11 in sales and marketing, and 159 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, 2005, we had 50 temporary personnel.

As of June 30, 2005, NAIE employed 25 full-time employees. Most of these positions are in the areas of manufacturing and manufacturing support.

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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**

We believe there is no material impact on our business or results of operations from seasonal factors.

**Financial Information about Our Business Segment and Geographic Areas**

Our business consists of one industry segment, the development, manufacturing, marketing and distribution of nutritional supplements. Our products are sold both within the United States and in markets outside the United States, including Europe, Australia and Japan. Our primary market outside the United States is Europe.

For the last three fiscal years, net sales by geographic region were as follows (dollars in thousands):

	Fiscal 2005	Fiscal 2004	Fiscal 2003
Net Sales			
United States	\$ 67,784	\$ 56,350	\$ 41,838
Markets Outside the United States	23,708	22,184	14,124
Total Net Sales	\$91,492	\$ 78,534	\$55,962

The allocation of net sales between the United States and markets outside the United States is based on the location of the customers. Products manufactured by NAIE accounted for 46% of net sales in markets outside the United States in fiscal 2005, 42% in fiscal 2004 and 51% in fiscal 2003. No products manufactured by NAIE were sold in the United States during the last three fiscal years.

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.

As we continue to expand into markets outside the United States, we will become increasingly subject to political, economic and other risks in the countries in which the products are sold and in which we operate. For more information about these and other risks, please see Items 7 and 7A in this report.

**ITEM 2. PROPERTIES**

This table summarizes our facilities as of June 30, 2005. We believe our facilities are adequate to meet our operating requirements for the foreseeable future.

Location	Nature of Use	Square Feet	How Held	Lease Expiration Date <sup>(2)</sup>
San Marcos, CA USA	Corporate headquarters	49,000	Owned/leased <sup>(4)</sup>	Various <sup>(4)</sup>
Vista, CA USA	Manufacturing, warehousing, packaging and distribution <sup>(3)</sup>	162,000	Leased	March 2014
Manno, Switzerland <sup>(1)</sup>	Manufacturing, warehousing, packaging and distribution	38,000	Leased	December 2015

(1) This facility is used by NAIE, our Swiss subsidiary.

(2) We expect to renew our leases in the normal course of business.

(3) We use approximately 93,000 square feet for production; 60,000 square feet for warehousing and 9,000 square feet for administrative functions.

(4) We own approximately 29,500 square feet and lease the remaining space with various expiration dates through 2007.

**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, including that discussed below, 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, including that discussed below, could change in the future and we could have unfavorable outcomes that we do not expect.

On February 10, 2005, a complaint was filed against NAI on behalf of Novogen Research Pty. Ltd. in the United States District Court, Southern District of New York alleging a cause of action for patent infringement of a Novogen patent by products manufactured by NAI. The parties are attempting to resolve the matter in an out-of-court settlement but if we are unable to do so we intend to vigorously defend the action.

As of September 8, 2005, other than as set forth above, 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, 2005.

## 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 National Market under the symbol "NAII." Below are the high and low closing prices of our common stock as reported on the Nasdaq National Market for each quarter of the fiscal years ended June 30, 2005 and 2004:

	Fiscal 2005		Fiscal 2004	
	High	Low	High	Low
First Quarter	\$ 9.65	\$ 6.32	\$ 5.47	\$4.68
Second Quarter	\$11.46	\$ 7.88	\$ 6.41	\$ 4.70
Third Quarter	\$ 9.85	\$ 6.37	\$ 9.60	\$6.20
Fourth Quarter	\$ 8.21	\$6.75	\$13.80	\$7.27

In addition to the Nasdaq National Market, our shares are also listed for trading on the Berlin-Bremen Stock Exchange, the Frankfurt Stock Exchange, and the XETRA Stock Exchange, each of which is a foreign exchange located in Germany. We are not aware of any other exchanges on which our shares are traded.

#### Holdings

As of September 8, 2005, there were approximately 360 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, 2005, we did not sell any unregistered securities.

#### Repurchases

During fiscal 2005, we did not repurchase any shares of our common stock, nor were any repurchases made on our behalf.

### ITEM 6. SELECTED FINANCIAL DATA

The following tables contain certain financial information about NAI, including its subsidiaries. When you review this information, you should keep in mind that it is historical. Our future financial condition and results of operations will vary based on a variety of factors. You should carefully review the following information together with the information on risks under Item 7 and elsewhere in this report, and our consolidated financial statements included in this report under Item 8.

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**Annual Financial Data**

	Annual Financial Information for Years Ended June 30 (Amounts in thousands, except per share amounts)				
	2005	2004	2003	2002	2001
Net sales	\$ 91,492	\$ 78,534	\$ 55,962	\$ 50,037	\$ 42,158
Cost of goods sold	73,095	59,964	42,781	39,068	33,970
Gross profit	18,397	18,570	13,181	10,969	8,188
Selling, general & administrative expenses	14,605	15,188	12,012	10,684	8,848
Loss on impairment of intangible assets acquired	—	—	—	—	1,544
Income (loss) from operations	3,792	3,382	1,169	285	(2,204)
Other income (expense):					
Interest income	21	24	57	16	92
Interest expense	(280)	(274)	(252)	(665)	(755)
Foreign exchange gain (loss)	(137)	57	12	(68)	15
Proceeds from vitamin antitrust litigation	—	—	225	3,410	298
Other, net	13	(165)	(59)	259	35
Total other income (expense)	(383)	(358)	(17)	2,952	(315)
Income (loss) before income taxes	3,409	3,024	1,152	3,237	(2,519)
Provision for (benefit from) income taxes	1,210	24	47	(642)	2,370
Net income (loss)	\$ 2,199	\$ 3,000	\$ 1,105	\$ 3,879	\$ (4,889)
Net income (loss) per common share:					
Basic	\$ 0.37	\$ 0.51	\$ 0.19	\$ 0.67	\$ (0.85)
Diluted	\$ 0.34	\$ 0.48	\$ 0.18	\$ 0.67	\$ (0.85)
Weighted average common shares:					
Basic	5,949	5,843	5,809	5,788	5,770
Diluted	6,465	6,304	6,021	5,798	5,770
Balance sheet data at end of period:					
Total assets	\$ 44,138	\$ 42,468	\$ 30,724	\$ 27,510	\$ 25,068
Working capital	\$ 14,398	\$ 17,468	\$ 12,321	\$ 8,725	\$ 5,045
Long-term debt and capital lease obligations, net of current portion	\$ 2,979	\$ 3,841	\$ 2,386	\$ 1,576	\$ 3,567
Total stockholders' equity	\$ 26,917	\$ 24,128	\$ 20,777	\$ 19,608	\$ 15,604

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**Quarterly Financial Data - Unaudited**

Quarterly Financial Information for Fiscal 2005 and Fiscal 2004  
(Amounts in thousands, except per share amounts)

	Fiscal 2005				Fiscal 2004			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Net sales	\$ 24,730	\$ 22,490	\$ 21,545	\$ 22,727	\$ 23,350	\$ 21,268	\$ 17,195	\$ 16,721
Cost of goods sold	20,456	18,277	16,953	17,409	17,874	16,215	13,300	12,575
Gross profit	4,274	4,213	4,592	5,318	5,476	5,053	3,895	4,146
Selling, general & administrative expenses	3,433	3,538	3,710	3,924	4,279	4,047	3,346	3,516
Income from operations	841	675	882	1,394	1,197	1,006	549	630
Other income (expense):								
Interest income	6	5	6	4	3	3	9	9
Interest expense	(89)	(86)	(54)	(51)	(111)	(69)	(51)	(43)
Foreign exchange gain (loss)	(115)	(188)	168	(2)	(38)	(50)	130	15
Other, net	(3)	(8)	25	(1)	(96)	(22)	(25)	(22)
Total other income (expense)	(201)	(277)	145	(50)	(242)	(138)	63	(41)
Income before income taxes	640	398	1,027	1,344	955	868	612	589
Provision for (benefit from) income taxes	355	121	242	492	(47)	13	36	22
Net income	\$ 285	\$ 277	\$ 785	\$ 852	\$ 1,002	\$ 855	\$ 576	\$ 567
Net income per common share:								
Basic	\$ 0.05	\$ 0.05	\$ 0.13	\$ 0.14	\$ 0.17	\$ 0.15	\$ 0.10	\$ 0.10
Diluted	\$ 0.04	\$ 0.04	\$ 0.12	\$ 0.13	\$ 0.15	\$ 0.13	\$ 0.09	\$ 0.09
Weighted average common shares:								
Basic	5,982	5,958	5,929	5,924	5,881	5,849	5,822	5,821
Diluted	6,414	6,421	6,572	6,448	6,606	6,335	6,162	6,107

## 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 for the last three fiscal years ended June 30, 2005. 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. You should carefully review the risks described under this Item 7 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.*

Major business developments of fiscal 2005 included the following:

- Completed our fourth year of net sales and operating income growth. Achieved record-breaking net sales in fiscal 2005.
- Net sales to our two largest customers grew 32% and comprised 79% of total net sales in fiscal 2005.
- Gross profit margin declined to 20.1% in fiscal 2005 from 23.6%. Sales from powder products in fiscal 2005 increased to 31% of our total net sales compared to 20% last year. Powder products typically include higher material cost as a percentage of selling price as compared to capsule or tablet products, contributing to a lower gross profit margin.
- Achieved a \$385,000 improvement in income before income taxes over last year despite incurring increased regulatory costs of \$706,000 related to the TGA certification review of our U.S.-based manufacturing facilities and \$323,000 related to public company compliance matters.
- We extended our relationship with one of our largest customers, NSA International, Inc.
- Obtained GMP recertification by the TGA for our recently expanded U.S.-based manufacturing facilities.
- Funded \$7.7 million of capital expenditures from available cash on hand and reduced our outstanding debt by \$832,000, or 18%. The capital expenditures were invested primarily in the build out of our Vista, California facility, which included the acquisition of additional manufacturing equipment.

Our focus for fiscal 2006 includes the following:

- Leverage our new facility and TGA recertification to:
  - Increase the value of the goods and services we provide to our highly valued customers; and
  - Assist us in developing relationships with additional quality oriented customers;
- Implement focused initiatives to market our own branded products through new distribution channels;
- Improve operational efficiency and manage costs and business risks to improve profitability; and
- Identify and evaluate acquisition opportunities that could increase product lines, expand distribution channels, enhance manufacturing capabilities or reduce risks associated with a variety of factors.

Looking forward, we expect to continue our trend of annual revenue growth. We anticipate quarterly revenue fluctuations due to, among other things, the timing of customer orders that are impacted by marketing programs, supply chain management, entry into new markets and new product introductions.

We also expect our long-term trend of growth in annual operating income to continue, however; there may be periodic quarterly declines in operating income due to revenue fluctuations, regulatory compliance costs and investments in new marketing, brand development and channel diversification initiatives. Regulatory compliance costs related to our TGA recertification are largely complete. We anticipate the reduction in regulatory compliance costs to be offset by incremental costs for implementing focused initiatives to establish our own branded products through new distribution channels.

## **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.

### *Revenue Recognition*

We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (SAB 101). SAB 101 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) collectibility is reasonably assured. 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.

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.

Additionally, we record reductions to gross revenue for estimated returns of private label contract manufacturing products and direct-to-consumer products. The estimated returns are based upon the trailing six months of private label contract manufacturing gross sales and our historical experience for both private label contract manufacturing and direct-to-consumer 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.

### *Inventory Reserve*

We operate primarily as a private label contract manufacturer that builds products following receipt of customer specific purchase orders. As a result, we have limited realization risk in finished goods and work-in-process inventories. Our inventory reserve primarily relates to, but is not necessarily limited to, realization risk for raw materials. Our estimate to reduce inventory to net realizable value is based upon expiration of the raw materials' efficacy, foreseeable demand of raw materials, market conditions and specific factors that arise from time to time related to regulatory and other factors. The reserve level reflects our historical experience. If demand and/or market conditions are less favorable than we estimate, additional inventory reserves may be required.

### *Accounting for Income Taxes*

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 that 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



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would be reflected as income tax expense. Conversely, if we determine that we will realize a deferred tax asset, which currently has a valuation allowance, we would reverse the valuation allowance, which would be reflected as income tax benefit.

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 upon 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 are also 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 overcoming 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 conclusion about the status of NAIE's retained earnings. This would result in additional income tax expense in the fiscal year 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 continually 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.

It is our policy to establish reserves based upon 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 which warrant adjustments to the reserve.

#### *Derivative Financial Instruments*

We 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. We account for derivative financial instruments using the deferral method under FAS 133, "Accounting for Derivatives and Related Hedging Activity," 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 or sold prior to maturity, we would recognize the resulting gain or loss in income at that time.

#### *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 collectibility 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 additional allowance may be required.

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*Defined benefit pension plan*

The plan obligation and related assets of the defined benefit pension 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 upon 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.

**Results of Operations**

The results of operations for the fiscal years ended June 30 were as follows (dollars in thousands, except per share amounts):

	2005	2004	Percent Change (2005- 2004)	2003	Percent Change (2004- 2003)
Private label contract manufacturing	\$ 83,382	\$ 68,493	22%	\$ 45,768	50%
Direct-to-consumer marketing program	8,110	10,041	(19)%	10,194	(2)%
<b>Total net sales</b>	<b>91,492</b>	<b>78,534</b>	<b>16%</b>	<b>55,962</b>	<b>40%</b>
Cost of goods sold	73,095	59,964	22%	42,781	40%
<b>Gross profit</b>	<b>18,397</b>	<b>18,570</b>	<b>(1)%</b>	<b>13,181</b>	<b>41%</b>
Gross profit %	20.1%	23.6%		23.6%	
Selling, general & administrative expenses	14,605	15,188	(4)%	12,012	26%
% of net sales	16.0%	19.3%		21.5%	
Other expenses, net	383	358	7%	17	2006%
<b>Income before income taxes</b>	<b>3,409</b>	<b>3,024</b>	<b>13%</b>	<b>1,152</b>	<b>163%</b>
% of net sales	3.7%	3.9%		2.1%	
<b>Net income</b>	<b>\$ 2,199</b>	<b>\$ 3,000</b>	<b>(27)%</b>	<b>\$ 1,105</b>	<b>171%</b>
% of net sales	2.4%	3.8%		2.0%	
Diluted net income per common share	\$ 0.34	\$ 0.48	(29)%	\$ 0.18	167%

**Fiscal 2005 Compared to Fiscal 2004**

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

Strengthening of the Euro against the U.S dollar	1%
NSA International, Inc. net sales growth	8%
Mannatech, Incorporated net sales growth	17%
Discontinuation of two customer relationships	(7)%
Other customers net sales growth	3%
<b>Total</b>	<b>22%</b>

- Net sales growth from NSA International, Inc over the prior year resulted primarily from higher volumes of established products in existing markets.
- Net sales growth from Mannatech, Incorporated over the prior year resulted primarily from the following:
  - Higher volumes of established products in existing markets contributed 16 percentage points; and
  - Introduction of existing products into new markets contributed one percentage point.
- We discontinued relationships with two of our customers due to the disproportionate risks related to inventory levels and accounts receivable required to continue serving these customers.

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- The remaining increase in private label contract manufacturing net sales was from growth in sales to newer customers, partially offset by decreased volumes with existing customers.

The increase in our private label contract manufacturing net sales was partially offset by the decrease in our direct-to-consumer net sales. This decrease was a continuation of the decline in sales for the Dr. Cherry Pathway to Healing™ product line due to our prior reduction in media spending investment in new television markets for the product line and a reduction in new customer acquisitions from our primary television market. We market our Dr. Cherry Pathway to Healing™ product line primarily through weekly television programming. During the third quarter we completed what we believe are improvements to the content and style of several of the programs. The new programming was introduced in the beginning of April 2005. The initial impact of the new programming appears to be positive as fourth quarter net sales improved 5% over the third quarter of fiscal 2005. In addition, we terminated the Chopra Center Essentials™ product line in June 2005.

Gross profit margin decreased to 20.1% in fiscal 2005 from 23.6%, or 3.5 percentage points, from fiscal 2004. The decrease in gross profit margin was primarily due to the following:

	<u>Percentage Points</u>
Shift in sales mix	(4.0)
Incremental inventory reserves	(0.5)
Incremental overhead expenses	(0.6)
Reduction in royalties paid to third parties	0.6
Reduction in direct and indirect labor	1.0
	<hr/>
Total	(3.5)
	<hr/>

- The shift in sales mix resulted from selling higher volumes of established powder products to one of our largest customers. Powder products typically include higher material cost as a percentage of selling price compared to capsule or tablet products, resulting in lower gross profit margins;
- Overhead expenses as a percentage of net sales increased 0.6 percentage points or \$1.6 million, from the prior year primarily due to the following:
  - Incremental outsourced lab testing of \$756,000 in conjunction with the preparation for our TGA audit; and
  - Incremental rent and maintenance expense of \$545,000 related to our facility expansion in Vista, California.
- Reduction in direct-to-consumer marketing program royalties resulted from lower net sales; and
- Reduction in direct and indirect labor was primarily due to improved operational efficiencies and fixed cost leverage.

Selling, general and administrative expenses decreased \$583,000, or 4%, from the prior year primarily attributable to the following:

- Incremental Sarbanes-Oxley (SOX) compliance costs of \$323,000.
- Incremental costs of \$706,000 due to increased regulatory certification requirements to improve service to our customers selling products in international markets.
- Incremental personnel costs of \$844,000 primarily due to changes in personnel to strengthen quality assurance, regulatory compliance, product formulation and sales and marketing.
- Incremental non-cash charge of \$131,000 associated with the acceleration of vesting of all outstanding and unvested stock options.
- Reduced clinical study costs of \$398,000 as a result of lowering our level of participation in certain clinical studies.
- Reduced compensation costs under our Management Cash Incentive Plan of \$1.2 million.
- Reduced direct-to-consumer marketing brand development spending of \$324,000 and call center costs of \$411,000 associated with lower direct-to-consumer net sales.

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Other expense, net, increased \$25,000 over the prior year primarily attributable to the following:

- Net loss associated with derivative financial instruments to manage our foreign currency exchange risks of \$109,000.
- Incremental net loss on translation of Euro denominated cash and receivables of \$28,000.
- A gain of \$47,000 on the sale of a previously written-off investment.
- Fiscal 2004 included a \$61,000 charge in conjunction with refinancing our credit facility in May 2004. The charge related to a prepayment penalty and the write-off of capitalized issuance costs.

Our effective tax rate for fiscal 2005 was 35.5% compared to 1% in fiscal 2004. The increase in our effective rate is primarily attributable to the reduction in our valuation allowance on our net deferred tax assets in the prior year. Income taxes for fiscal 2005 differed from statutory rates primarily due to our Swiss federal and cantonal income tax holiday and the utilization of certain federal and state tax credits. Our Swiss tax holiday ended on June 30, 2005. We anticipate NAIE's effective tax rate for Swiss federal, cantonal and communal taxes will be approximately 23% in fiscal 2006 compared to our fiscal 2005 effective rate of 5%.

During the fourth quarter of fiscal 2005 we repatriated \$2.0 million of NAIE's foreign earnings under the American Jobs Creation Act (the "Act"), which was signed into law by the President on October 22, 2004. The Act creates a temporary incentive for U.S. multinational corporations to repatriate accumulated income earned outside the U.S. by providing an 85% dividend received deduction for certain dividends from controlled foreign corporations. The \$2.0 million repatriation resulted in an increase of \$232,000 in our tax provision for fiscal 2005. NAIE's repatriated foreign earnings previously had been designated as permanently reinvested and the remaining undistributed retained earnings continue to be designated as such subsequent to the one-time repatriation.

### **Fiscal 2004 Compared to Fiscal 2003**

Consolidated private label contract manufacturing net sales for the fiscal year ended June 30, 2004, increased \$22.7 million, or 50%, over the prior year. Changes in currency exchange rates, namely the strengthening of the Euro, contributed \$1.1 million dollars, or 2%, of this growth. Excluding the impact of changes in currency exchange rates, the remaining increase was due primarily to additional net sales of \$14.1 million, or 31%, to our two largest customers. Net sales to our largest customer increased \$6.0 million due to higher volumes of established products in existing markets. Net sales to our second largest customer increased \$3.7 million from new products in existing markets and \$4.4 million from established products in existing markets. Additionally, net sales increased \$4.9 million from net sales to new customers and \$3.4 million due to incremental volumes sold to customers obtained in the fourth quarter of fiscal 2003.

The Dr. Cherry Pathway to Healing™ product line comprised 100% of our direct-to-consumer net sales for the fiscal years ended June 30, 2004 and 2003. Direct-to-consumer net sales remained consistent due to a reduction in our media spending investment in new television markets for the Dr. Cherry Pathway to Healing™ product line, as the investment did not produce what we considered to be adequate results. Additionally, we experienced a reduction in new customer acquisitions from our primary television market, while the average order value remained consistent. We have identified opportunities to improve the content and style of the television programs and anticipate introducing the upgraded television programs in the third quarter of fiscal 2005.

Gross profit margin remained consistent despite a 1.4 percentage point increase in material cost as a percentage of net sales, due to a 1.5 percentage point decrease in labor and overhead as a percentage of net sales.

Our material cost as a percentage of net sales was 54.4% (\$42.7 million) for fiscal 2004 and 53.0% (\$29.6 million) in the prior year. The increase in material cost as a percentage of net sales was primarily due to an increase in inventory reserves of \$854,000 for specific inventory realization risks and \$111,000 for products as a result of terminating the Jennifer O'Neill Signature Line™ brand. The inventory allowance as a percentage of gross inventory at June 30, 2004 remained consistent with June 30, 2003. Additionally, 0.5 percentage points of the increase related to a shift in our sales mix to higher volume, lower margin products in fiscal 2004. Our labor and overhead expenses as a percentage of net sales were 22.0% (\$17.2 million) for fiscal 2004 compared to 23.5% (\$13.1 million) in the prior year. The decrease in labor and overhead as a percentage of net sales was primarily due to improved leverage of fixed costs on higher net sales.

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In June 2004, we began the build out of tenant improvements for approximately 46,000 square feet at our Vista facility. We anticipate the build out will be completed by the end of our second quarter in fiscal 2005. We anticipate being able to initiate production activities in the third quarter of fiscal 2005. If we are unable to complete the build out and transition our operating activities as planned, we could experience a disruption in our manufacturing capabilities and incur additional costs to fulfill customer orders.

Selling, general and administrative expenses as a percentage of net sales decreased 2.2 percentage points in fiscal 2004 compared to fiscal 2003. In absolute dollars, however, selling, general and administrative expenses increased \$3.2 million in fiscal 2004. The increase was primarily attributable to compensation payments under our fiscal 2004 Management Incentive Plan of \$1.2 million, higher property, product liability and general liability insurance costs of \$457,000 and research and development initiatives of \$948,000.

During fiscal 2004, we made significant investments in our research and development initiatives primarily in the areas of clinical studies, regulatory assistance and personnel. Clinical studies increased \$168,000 over the prior year primarily for efficacy validation of products in production and development stages. Regulatory related costs increased \$381,000 over the prior year for services provided to current and prospective customers for international product registration, international and domestic product compliance and other services. Personnel costs increased \$369,000 over the prior year to strengthen our team in the areas of regulatory and product formulation along with the hiring of our new Vice President of Science and Technology.

Other expense increased over the prior year primarily due to a \$61,000 charge in conjunction with refinancing our credit facility in May 2004. The charge related to a prepayment penalty and the write off of capitalized issuance costs and is included in interest expense in our consolidated statements of income. Additionally, we received proceeds from the settlement of claims associated with the vitamin antitrust litigation of \$225,000 in fiscal 2003.

At June 30, 2004, we reduced our valuation allowance on our deferred tax assets based on historical operating profits. The effective tax rate for fiscal 2004 was 1% compared to 4% in fiscal 2003. NAIE operates under a five-year Swiss federal and cantonal income tax holiday that ends June 30, 2005. Following the expiration of our tax holiday, we anticipate NAIE's effective tax rate for Swiss federal, cantonal and communal taxes will be approximately 23% compared to our current effective rate of approximately 5%.

Our net income was \$3.0 million (\$0.48 per diluted share) in fiscal 2004 and \$1.1 million (\$0.18 per diluted share) in fiscal 2003. Excluding the effect of the litigation settlement proceeds of \$225,000 in the prior year, net income increased \$2.1 million compared to \$880,000 (\$0.15 per diluted 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 \$2.5 million in fiscal 2005, compared to \$3.3 million in fiscal 2004 and \$3.3 million in fiscal 2003. Our operating cash flow in fiscal 2005 was impacted by the following:

- Net income of \$2.2 million;
- Receipt of \$960,000 from our landlord to fund tenant improvements; and
- Payments of \$1.6 million under our fiscal 2004 Management Cash Incentive Plan.

Approximately \$1.0 million of our operating cash flow was generated by NAIE in fiscal 2005. In June 2005, we repatriated \$2.0 million of NAIE retained earnings under the American Jobs Creation Act. As of June 30, 2005, NAIE's undistributed retained earnings are considered indefinitely reinvested.

Cash used in investing activities in fiscal 2005 was \$7.7 million compared to \$3.3 million in fiscal 2004 and \$779,000 in fiscal 2003. Capital expenditures were \$7.7 million in fiscal 2005 compared to \$3.3 million in fiscal 2004 and \$977,000 in fiscal 2003. Fiscal 2005 capital expenditures were primarily for the expansion of our Vista, California production facility, which included the acquisition of additional manufacturing equipment. The expanded facility should help us improve operational efficiency, increase manufacturing capacity and reduce business risk. On February 1, 2005, we amended our credit facility to increase the limitation on our capital expenditures for the fiscal year ended June 30, 2005 from \$6.5 million to \$8.0 million. All other terms and conditions of our credit facility remain in full force and effect. Capital expenditures included \$960,000 of tenant improvements that were funded by landlord allowances.

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Our consolidated debt decreased to \$3.8 million at June 30, 2005 from \$4.7 million at June 30, 2004. Our \$12.0 million credit facility is comprised of an \$8.0 million working capital line of credit and \$4.0 million in term loans. The working capital line of credit expires in November 2006, is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has an interest rate of Prime Rate or LIBOR plus 1.75%, as elected by the Company from time to time, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. The term loans consist of a \$700,000 ten year term loan with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; a \$1.8 million four year term loan, secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, at an interest rate of LIBOR plus 2.10%; and a \$1.5 million five year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%. Monthly payments on the term loans are approximately \$63,000 plus interest. As of June 30, 2005, we had \$7.7 million available under the working capital line of credit, net of a \$270,000 outstanding letter of credit issued to our landlord. Under our credit facility, we may not create, incur or assume additional indebtedness without the approval of our lender.

On May 13, 2005, we purchased seven 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 seven options expire monthly beginning June 2005 and ending December 2005. The option contracts had a notional amount of \$4.2 million, a weighted average strike price of \$1.19, and a purchase price of \$21,000. The risk of loss associated with the options is limited to premium amounts paid for the option contracts. As of June 30, 2005, we had not exercised any of the options and one of the options had expired.

On July 7, 2005, we purchased 12 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 12 options expire monthly beginning January 2006 and ending December 2006. The option contracts had a notional amount of \$7.0 million, a weighted average strike price of \$1.16, and a purchase price of \$152,000. The risk of loss associated with the options is limited to premium amounts paid for the option contracts.

There are no other derivative financial instruments at June 30, 2005.

As of June 30, 2005, we had \$1.9 million in cash and cash equivalents. We plan on funding our current working capital needs, capital expenditures and debt payments using available cash, cash flow from operations and our credit facility.

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

We do not have any off-balance sheet debt nor do we have any transactions, arrangements, obligations (including contingent obligations) or other relationships with any unconsolidated entities or other persons that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses.

### **Contractual Obligations**

This table summarizes our known contractual obligations and commercial commitments at June 30, 2005 (dollars in thousands).

Contractual Obligations	Payments Due By Period				
	Total	Less Than 1 Year	1 – 3 Years	3 – 5 Years	More Than 5 Years
Long-Term Debt	\$ 3,840	\$ 861	\$ 1,783	\$ 596	\$ 600
Operating Leases	18,605	1,872	3,856	3,916	8,961
<b>Total Obligations</b>	<b>\$ 22,445</b>	<b>\$ 2,733</b>	<b>\$ 5,639</b>	<b>\$ 4,512</b>	<b>\$ 9,561</b>

### **Inflation**

We do not believe that inflation or changing prices have had a material impact on our historical operations or profitability.

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### Recent Accounting Pronouncements

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, "Inventory Costs, an amendment of APB No. 43, Chapter 4" (SFAS 151). SFAS 151 clarifies that abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are required to be recognized as current period charges. The provisions of SFAS 151 are effective for our fiscal year beginning July 1, 2006. We do not expect that the adoption of SFAS 151 will have a material impact on our consolidated financial position or results of operations.

On December 16, 2004, the FASB finalized SFAS 123R, "Share Based Payment" (SFAS 123R), which will be effective for our interim and annual reporting periods beginning after June 15, 2005. SFAS 123R will require that we expense stock options and employee stock purchase plan shares using a binomial lattice valuation model that the FASB believes is capable of more fully reflecting certain characteristics of employee stock options. The effect of expensing stock options and employee stock purchase plan shares on our reported results of operations using the Black-Scholes model is presented in the notes to our consolidated financial statements under Item 8 of this report.

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections" (SFAS 154). SFAS 154 replaces APB Opinion No. 20, "Accounting Changes" and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. SFAS 154 also provides that a correction of errors in previously issued financial statements should be termed a "restatement." The new standard is effective for accounting changes and correction of errors beginning July 1, 2005. We do not expect that the adoption of SFAS 154 will have a material impact on our consolidated financial position or results of operations.

### Risks

*You should carefully consider the risks described below, as well as the other information in this report, when evaluating our business and future prospects. If any of the following risks 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.*

***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 or personnel.***

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, 2005, sales to one customer, NSA International, Inc., were approximately 40% of our total net sales. Our second largest customer was Mannatech, Incorporated, which accounted for approximately 39% of our net sales. The loss of either 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. Based on press releases issued by Mannatech, Incorporated, Mannatech achieved record net sales in its fiscal year ended December 31, 2004 and in the first two quarters of its fiscal 2005. There can be no assurance that such results will continue. A significant decline in Mannatech's net sales or the growth rate of such sales could materially affect our financial condition and results of operations.

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

Our business strategy depends in large part on our ability to develop new products, marketing strategies, brands and 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, marketing and the build up of initial inventory. 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.

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***Our operating results will vary and there is no guarantee that we will earn a profit. Fluctuations in our operating results may adversely affect the share price of our common stock.***

While our net sales and income from operations have both improved during the past three fiscal years, there can be no assurance that they will continue to improve, or that we will earn a profit in any given year. We have experienced losses in the past and may incur losses in the future. Our operating results may fluctuate from year to year 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. Fluctuations in our operating results may adversely affect the share price of our common stock.

***A significant or prolonged economic downturn could have 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 for our direct-to-consumer products. A 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.***

For the fiscal year ended June 30, 2005, our direct-to-consumer products accounted for approximately 9% of our net sales. These products are 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 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. Although we obtained an \$8.0 million line of credit in May 2004, there can be no assurance that this line of credit will be sufficient to meet our needs. Furthermore, if we fail to maintain certain loan covenants we will no longer have access to the credit line. The credit line has a 2.5 year term and will terminate in November 2006. As a result, we may need to raise additional capital or obtain additional financing.

In recent years, it has been difficult for companies to raise capital due to a variety of factors including the overall poor performance of the stock markets and the economic slowdown in the United States and 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



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credit facility, we may not create, incur or assume additional indebtedness without the approval of our lender. 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 2005, Carrington Laboratories Incorporated was our largest supplier, accounting for 35% of our total raw material purchases. The loss of Carrington Laboratories Incorporated or other major supplier 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. 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, 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. 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.

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. There can be no assurance that product liability insurance will continue to be available at an economically reasonable cost or that our insurance will be adequate to cover any liability we may incur.

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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.

***As we continue to expand into markets outside the United States our business becomes increasingly subject to political and economic risks in those markets, which could adversely affect our business.***

Our future growth may depend, in part, on our ability to continue to expand into markets outside the United States. There can be no assurance that we will be able to expand our presence in our 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 we must 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. As we continue to expand into 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 subject to the rules and regulations of the European Union, which may be interpreted differently among the countries within the Union. The cost of complying with these various and potentially conflicting regulations can be substantial and can adversely affect our results of operations.

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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 activity is subject to certain risks.***

We currently 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 that facility. Our manufacturing operations are subject to power failures, 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 manufacturing facilities, which may result in slow downs or delays in our manufacturing operations. While we maintain business interruption insurance, there can be no assurance that the occurrence of these or any other operational problems at our facility 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 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.

***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, tradenames 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 25% of our outstanding shares of common stock as of June 30, 2005. As a result, our officers and directors could influence such business matters as the election of directors and approval of significant corporate transactions.

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.

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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 benefits 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 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.***

Our stock price has been volatile in recent years. The trading price of our stock could fluctuate in response to:

- broad market fluctuations and general economic conditions;
- fluctuations in our financial results;
- future offerings of our common stock or other securities;
- the general condition of the nutritional supplement industry;
- 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 Stock 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.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risk, which is the potential loss arising from adverse changes in market rates and prices, such as interest and foreign currency exchange rates. We generally do not enter into derivatives or other financial instruments for trading or speculative purposes. We may, however, enter into financial instruments to try to manage and reduce the impact of changes in foreign currency exchange rates. We cannot predict with any certainty our future exposure to fluctuations in interest and foreign currency exchange rates or other market risks or the impact, if any, such fluctuations may have on our future business, product pricing, consolidated financial condition, results of operations or cash flows. The actual impact of any fluctuations in interest or foreign currency exchange rates may differ significantly from those discussed below.

### **Interest Rates**

At June 30, 2005, we had fixed rate debt of \$602,000 and variable rate debt of approximately \$3.2 million. The interest rates on our variable rate debt range from LIBOR plus 1.75% to LIBOR plus 2.25%. As of June 30, 2005, the weighted average effective interest rate on our variable rate debt was 4.50%. An immediate one hundred basis point (1.0%) increase in the interest rates on our variable rate debt, holding other variables constant, would have increased our interest expense by \$48,000 for the fiscal year ended June 30, 2005. Interest rates have been at or near historic lows in recent years. There can be no guarantee that interest rates will not rise. Any increase in interest rates may adversely affect our results of operations and financial condition.

### **Foreign Currencies**

To the extent our business continues to expand outside the United States, an increasing share of our net sales and cost of sales will be transacted in currencies other than the United States dollar. Accounting practices require that our non-United States dollar-denominated transactions be converted to United States dollars for reporting purposes. Consequently, our reported net income may be significantly affected by fluctuations in currency exchange rates. When the United States dollar strengthens against currencies in which products are sold or weakens against currencies in which we incur costs, net sales and costs could be adversely affected.

Our main exchange rate exposures are with the Swiss Franc and the Euro against the United States dollar. This is due to NAIE's operations in Switzerland and the payment in Euros by our largest customer for finished goods. Additionally, we pay our NAIE employees and certain operating expenses in Swiss Francs. We may enter into forward exchange contracts, foreign currency borrowings and option contracts to hedge our foreign currency risk. Our goal in seeking to manage foreign currency risk is to provide reasonable certainty to the functional currency value of foreign currency cash flows and to help stabilize the value of non-United States dollar-denominated earnings.

On May 13, 2005, we purchased seven 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 seven options expire monthly beginning June 2005 and ending December 2005. The option contracts had a notional amount of \$4.2 million, a weighted average strike price of \$1.19, and a purchase price of \$21,000. The risk of loss associated with the options is limited to premium amounts paid for the option contracts. As of June 30, 2005, we had not exercised any of the options and one of the options had expired.

On July 7, 2005, we purchased 12 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 12 options expire monthly beginning January 2006 and ending December 2006. The option contracts had a notional amount of \$7.0 million, a weighted average strike price of \$1.16, and a purchase price of \$152,000. The risk of loss associated with the options is limited to premium amounts paid for the option contracts.

On June 30, 2005, the Swiss Franc closed at 1.28 to 1.00 United States dollar and the Euro closed at 0.83 to 1.00 United States dollar. A 10% adverse change to the exchange rates between the Swiss Franc and the Euro against the United States dollar, holding other variables constant, would have decreased our net income for the fiscal year ended June 30, 2005 by \$762,000.

**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, 2005 and 2004, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended June 30, 2005. Our audits also included the financial statement schedule listed in the index at Item 15(2). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule 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 audit 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, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended June 30, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Ernst & Young LLP

San Diego, California  
August 5, 2005

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

	2005	2004
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 1,916	\$ 7,495
Accounts receivable - less allowance for doubtful accounts of \$221 at June 30, 2005 and \$132 at June 30, 2004	10,834	8,889
Inventories, net	12,987	12,863
Deferred income taxes	421	1,010
Other current assets	1,012	633
	<u>27,170</u>	<u>30,890</u>
Property and equipment, net	16,507	11,380
Other assets:		
Deferred income taxes	276	—
Other noncurrent assets, net	185	198
	<u>461</u>	<u>198</u>
Total assets	<u>\$ 44,138</u>	<u>\$ 42,468</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 7,973	\$ 7,567
Accrued liabilities	1,923	2,078
Accrued compensation and employee benefits	1,351	2,626
Income taxes payable	664	320
Current portion of long-term debt	861	831
	<u>12,772</u>	<u>13,422</u>
Long-term debt, less current portion	2,979	3,841
Deferred income taxes	—	717
Deferred rent	1,264	220
Long-term pension liability	206	140
	<u>17,221</u>	<u>18,340</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, 2005 and 8,000,000 at June 30, 2004, issued and outstanding 6,064,467 at June 30, 2005 and 5,970,992 at June 30, 2004	61	60
Additional paid-in capital	11,494	10,864
Accumulated other comprehensive loss	(137)	(96)
Retained earnings	15,792	13,593
Treasury stock, at cost, 61,000 shares at June 30, 2005 and June 30, 2004	(293)	(293)
	<u>26,917</u>	<u>24,128</u>
Total liabilities and stockholders' equity	<u>\$ 44,138</u>	<u>\$ 42,468</u>

*See accompanying notes to consolidated financial statements.*

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

	2005	2004	2003
Net sales	\$ 91,492	\$ 78,534	\$ 55,962
Cost of goods sold	73,095	59,964	42,781
Gross profit	18,397	18,570	13,181
Selling, general & administrative expenses	14,605	15,188	12,012
Income from operations	3,792	3,382	1,169
Other income (expense):			
Interest income	21	24	57
Interest expense	(280)	(274)	(252)
Foreign exchange gain (loss)	(137)	57	12
Proceeds from vitamin antitrust litigation	—	—	225
Other, net	13	(165)	(59)
	(383)	(358)	(17)
Income before income taxes	3,409	3,024	1,152
Provision for income taxes	1,210	24	47
Net income	\$ 2,199	\$ 3,000	\$ 1,105
Unrealized gain resulting from change in fair value of derivative instruments, net of tax	8	—	—
Additional minimum pension liability, net of tax	(49)	(96)	—
Comprehensive income	\$ 2,158	\$ 2,904	\$ 1,105
Net income per common share:			
Basic	\$ 0.37	\$ 0.51	\$ 0.19
Diluted	\$ 0.34	\$ 0.48	\$ 0.18
Weighted average common shares outstanding:			
Basic shares	5,949,212	5,843,241	5,809,140
Diluted shares	6,464,714	6,304,167	6,021,155

*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, 2002	6,073,179	\$ 61	\$ 11,362	\$ 9,488	\$(1,303)	\$ —	\$ 19,608
Issuance of common stock for employee stock purchase plan and stock option exercises	14,353	—	33	—	—	—	33
Compensation expense related to stock options	—	—	31	—	—	—	31
Net income	—	—	—	1,105	—	—	1,105
Balance, June 30, 2003	6,087,532	61	11,426	10,593	(1,303)	—	20,777
Issuance of common stock for employee stock purchase plan and stock option exercises	94,860	1	327	—	—	—	328
Cancellation of treasury stock	(211,400)	(2)	(1,008)	—	1,010	—	—
Compensation expense related to stock options	—	—	119	—	—	—	119
Additional minimum pension liability, net of tax	—	—	—	—	—	(96)	(96)
Net income	—	—	—	3,000	—	—	3,000
Balance, June 30, 2004	5,970,992	60	10,864	13,593	(293)	(96)	24,128
Issuance of common stock for employee stock purchase plan and stock option exercises	93,475	1	427	—	—	—	428
Compensation expense related to stock options	—	—	72	—	—	—	72
Compensation expense related to the acceleration of stock options	—	—	131	—	—	—	131
Unrealized gain resulting from change in fair value of derivative instruments, net of tax	—	—	—	—	—	8	8
Additional minimum pension liability, net of tax	—	—	—	—	—	(49)	(49)
Net income	—	—	—	2,199	—	—	2,199
Balance, June 30, 2005	6,064,467	\$ 61	\$ 11,494	\$ 15,792	\$(293)	\$(137)	\$ 26,917

*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)**

	2005	2004	2003
<b>Cash flows from operating activities</b>			
Net income	\$ 2,199	\$ 3,000	\$ 1,105
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for uncollectible accounts receivable	89	105	(46)
Depreciation and amortization	2,559	2,676	2,477
Deferred income taxes	(404)	(293)	—
Non-cash compensation	203	119	31
Pension benefit (expense), net of contributions	17	(77)	(78)
Loss on disposal of assets	20	86	10
Changes in operating assets and liabilities:			
Accounts receivable	(2,034)	(3,326)	(2,086)
Inventories	(124)	(5,018)	26
Tax refund receivable	—	—	701
Other assets	(427)	71	(175)
Accounts payable and accrued liabilities	1,351	3,758	1,180
Income taxes payable	344	274	(85)
Accrued compensation and employee benefits	(1,275)	1,909	235
Net cash provided by operating activities	<u>2,518</u>	<u>3,284</u>	<u>3,295</u>
<b>Cash flows from investing activities</b>			
Proceeds from sale of property and equipment	—	—	109
Capital expenditures	(7,706)	(3,322)	(977)
Repayment of notes receivable	13	7	89
Net cash used in investing activities	<u>(7,693)</u>	<u>(3,315)</u>	<u>(779)</u>
<b>Cash flows from financing activities</b>			
Borrowings on long-term debt	—	4,055	2,500
Payments on long-term debt	(832)	(2,339)	(1,707)
Increase in restricted cash	—	—	1,500
Issuance of common stock	428	328	33
Net cash provided by (used in) financing activities	<u>(404)</u>	<u>2,044</u>	<u>2,326</u>
Net increase (decrease) in cash and cash equivalents	(5,579)	2,013	4,842
Cash and cash equivalents at beginning of year	7,495	5,482	640
Cash and cash equivalents at end of year	<u>\$ 1,916</u>	<u>\$ 7,495</u>	<u>\$ 5,482</u>
<b>Supplemental disclosures of cash flow information</b>			
Cash paid during the year for:			
Taxes	\$ 1,075	\$ 44	\$ —
Interest	\$ 280	\$ 243	\$ 252
Disclosure of non-cash activities:			
Treasury stock cancelled	\$ —	\$ 1,010	\$ —
Net unrealized gains resulting from change in fair value of derivative instruments	\$ 8	\$ —	\$ —
Additional minimum pension liability	\$ 49	\$ 96	\$ —

*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. We operate in a single segment, nutritional supplements.

#### International Subsidiary

On January 22, 1999, NAIE was formed as our wholly-owned subsidiary, based in Manno, Switzerland, which is adjacent to the city of Lugano. 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. Upon formation, NAIE obtained from the Swiss tax authorities a five-year Swiss federal and cantonal income tax holiday that ended June 30, 2005.

#### Principles of Consolidation

The consolidated financial statements include the accounts of NAI and our wholly-owned subsidiary, NAIE. All significant intercompany accounts and transactions have been eliminated. The functional currency of 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 income.

#### Cash and Cash Equivalents

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

#### 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

Long-lived assets and certain identifiable intangibles 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.

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**Revenue Recognition**

We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (SAB 101). SAB 101 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) collectibility is reasonably assured. 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.

Additionally, we record reductions to gross revenue for estimated returns of private label contract manufacturing products and direct-to-consumer products. The estimated returns are based upon the trailing six months of private label contract manufacturing gross sales and our historical experience for both private label contract manufacturing and direct-to-consumer product returns.

**Cost of Goods Sold**

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

**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 three fiscal years ended June 30 were \$3.5 million for 2005, \$2.8 million for 2004 and \$1.7 million for 2003.

**Advertising Costs**

We expense advertising costs as incurred. We incurred and expensed advertising costs in the amount of \$865,000 during the fiscal year ended June 30, 2005, \$1.3 million during fiscal 2004 and \$1.5 million during fiscal 2003. These costs are included in selling, general and administrative expenses in the accompanying statements of income.

**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 carryforwards. 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.

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 upon 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 upon 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 which warrant adjustments to the reserve.

**Stock-Based Compensation**

We have equity incentive plans under which we have granted nonqualified and incentive stock options to employees, non-employee directors and consultants. We also have an employee stock purchase plan. We account for stock-based awards to employees, including shares issued pursuant to the employee stock purchase plan, in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), and related interpretations. We have adopted the disclosure-only alternative of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), as amended by SFAS No. 148, "Accounting for Stock-Based Compensation –Transition and Disclosure" (SFAS 148).

Pro forma information regarding net income and net income per common share is required and has been determined as if we had accounted for our stock-based awards under the fair value method, instead of the guidelines provided by APB 25. 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, including expected life and stock price volatility. Because our options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect fair value estimates, in the opinion of management, the existing models do not necessarily provide a reliable single measure of the fair value of our stock option awards.

Effective April 27, 2005, our Board of Directors approved the acceleration of the vesting of all outstanding and unvested options held by directors, officers and other employees under our 1999 Omnibus Equity Incentive Plan. As a result of the acceleration, options to acquire 827,932 shares of our common stock, which otherwise would have vested over the next 36 months, became immediately exercisable. This action was taken to eliminate, to the extent permitted, the transition expense that we otherwise would incur in connection with the adoption of SFAS 123R. Included in the options to acquire 827,932 shares of our common stock were options to purchase 545,992 shares with exercise prices greater than our closing stock price on the date of acceleration. Under the accounting guidance of APB 25, the accelerated vesting resulted in a charge for stock-based compensation of approximately \$131,000, which was recognized in the fourth quarter of fiscal 2005. Additionally, our pro forma disclosure includes the effect of this accelerated vesting, as calculated under SFAS 123, of \$1.8 million which would have otherwise been recognized in our consolidated statements of operations over the next three fiscal years, upon the adoption of SFAS 123R in the first quarter of fiscal 2006.

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

	Employee Stock Options			Employee Stock Purchase Plans		
	Fiscal Years Ended June 30,			Fiscal Years Ended June 30,		
	2005	2004	2003	2005	2004	2003
Expected life (years)	4.0 – 8.0	4.0 – 8.0	4.0–6.0	0.5	0.5	0.5
Risk-free interest rate	3.4–3.8%	2.4–3.7%	4.0%	2.0%	1.0%	1.5%
Volatility	54%	64%	71%	54%	64%	71%
Dividend yield	0%	0%	0%	0%	0%	0%
Weighted average fair value	\$ 3.82	\$ 3.21	\$ 1.75	\$2.36	\$1.82	\$1.10

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For purposes of pro forma disclosures, we have amortized the estimated fair value of our stock option awards to expense over the options' vesting periods and the estimated fair value of our employee stock purchase plan shares over the offering period. Our pro forma information under SFAS 123 and SFAS 148 is as follows (dollars in thousands, except per share data):

	Fiscal Years Ended June 30,		
	2005	2004	2003
Net income - as reported	\$ 2,199	\$ 3,000	\$ 1,105
Plus: Reported stock-based compensation	203	119	31
Less: Fair value stock-based compensation	(2,658)	(718)	(299)
Net income (loss) - pro forma	\$ (256)	\$ 2,401	\$ 837
Reported basic net income per common share	\$ 0.37	\$ 0.51	\$ 0.19
Pro forma basic net income (loss) per common share	\$ (0.04)	\$ 0.41	\$ 0.14
Reported diluted net income per common share	\$ 0.34	\$ 0.48	\$ 0.18
Pro forma diluted net income (loss) per common share	\$ (0.04)	\$ 0.38	\$ 0.14

**Fair Value of Financial Instruments**

The carrying amounts of certain of our financial instruments, including cash and cash equivalents, accounts receivable, notes receivable, accounts payable, line of credit and notes payable approximate fair value due to the relatively short maturity of such instruments. The carrying amounts for long-term debt approximate fair value as the interest rates and terms are comparable to rates and terms that could be obtained currently for similar instruments.

**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 United States generally accepted accounting principles. Actual results could differ from those estimates.

**Net Income per Common Share**

We compute net income per common share in accordance with SFAS 128, "Earnings Per Share." This statement 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 income per common share computation. We calculated basic and diluted net income per common share as follows (amounts in thousands, except per share data):

	For the Years Ended June 30,		
	2005	2004	2003
<b>Numerator</b>			
Net income	\$ 2,199	\$ 3,000	\$ 1,105
<b>Denominator</b>			
Basic weighted average common shares outstanding	5,949	5,843	5,809
Dilutive effect of stock options	516	461	212
Diluted weighted average common shares outstanding	6,465	6,304	6,021
Basic net income per common share	\$ 0.37	\$ 0.51	\$ 0.19
Diluted net income per common share	\$ 0.34	\$ 0.48	\$ 0.18

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Shares related to stock options of 193,000 for the fiscal year ended June 30, 2005, 61,000 for fiscal 2004 and 74,000 for fiscal 2003, were excluded from the calculation of diluted net income 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 largest customers, whose receivable balances collectively represented 86% of gross accounts receivable at June 30, 2005 and 73% at June 30, 2004. 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. Inventories**

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

	2005	2004
Raw materials	\$ 8,068	\$ 7,915
Work in progress	3,230	3,066
Finished goods	1,689	1,882
	<u>\$12,987</u>	<u>\$12,863</u>

**C. Property and Equipment**

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

	Depreciable Life In Years	2005	2004
Land	NA	\$ 393	\$ 393
Building and building improvements	7 – 39	2,713	3,235
Machinery and equipment	3 – 12	18,470	17,345
Office equipment and furniture	3 – 5	3,280	4,038
Vehicles	3	204	204
Leasehold improvements	1 – 15	9,244	4,954
Total property and equipment		<u>34,304</u>	<u>30,169</u>
Less: accumulated depreciation and amortization		(17,797)	(18,789)
Property and equipment, net		<u>\$ 16,507</u>	<u>\$ 11,380</u>

**D. Debt**

We have a \$12.0 million credit facility with a bank. The facility is comprised of an \$8.0 million working capital line of credit and \$4.0 million in term loans. The working capital line of credit expires in November 2006, is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has an interest rate of Prime Rate or LIBOR plus 1.75%, as elected by the Company from time to time, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. The term loans consist of a \$700,000 ten year term loan with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; a \$1.8 million four year term loan, secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, at an interest rate of LIBOR plus 2.10%; and a \$1.5 million five year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%. Monthly payments on the term loans are approximately \$63,000 plus interest. As of June 30, 2005, the outstanding amount on the term loans was \$3.2 million and we did not have an outstanding balance on the working capital line of credit. As of June 30, 2005, we had \$7.7 million available under the line of credit, net of a \$270,000 outstanding letter of credit issued to our landlord.

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On February 1, 2005, we amended our credit facility with the bank to increase the limitation on our capital expenditures for the fiscal year ended June 30, 2005 from \$6.5 million to \$8.0 million. All other terms and conditions of our credit facility remain in full force and effect.

Additionally, we have a term loan agreement for \$1.1 million, secured by our San Marcos building, at an annual interest rate of 8.25%. The loan is due in June 2011 and provides for principal and interest payable in monthly installments of \$10,800. As of June 30, 2005, the outstanding amount on the loan was \$602,000.

The composite interest rate on all of our outstanding debt was 5.18% at June 30, 2005 and 5.44% at June 30, 2004.

Aggregate amounts of long-term debt maturities as of June 30, 2005 were as follows (dollars in thousands):

2006	\$ 861
2007	895
2008	888
2009	445
2010	151
Thereafter	600
	<u>3,840</u>

**E. Income Taxes**

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

	2005	2004	2003
<b>Current:</b>			
Federal	\$ 1,320	\$ 175	\$ —
State	94	3	—
Foreign	109	139	47
	<u>1,523</u>	<u>317</u>	<u>47</u>
<b>Deferred:</b>			
Federal	(398)	1,045	(372)
State	85	293	(163)
Change in valuation allowance	—	(1,631)	535
	<u>(313)</u>	<u>(293)</u>	<u>—</u>
<b>Provision for income taxes</b>	<u>\$ 1,210</u>	<u>\$ 24</u>	<u>\$ 47</u>

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

	2005	2004
<b>Deferred tax assets:</b>		
Allowance for doubtful accounts	\$ 85	\$ 48
Accrued vacation expense	189	156
Tax credit carryforward	99	128
Allowance for inventories	659	414
Other, net	93	—
Net operating loss carryforward	31	264
	<u>\$ 1,156</u>	<u>\$ 1,010</u>
<b>Deferred tax liabilities:</b>		
Accumulated depreciation and amortization	(459)	(717)
	<u>(459)</u>	<u>(717)</u>
<b>Net deferred tax assets</b>	<u>\$ 697</u>	<u>\$ 293</u>

At June 30, 2005, we had state tax net operating loss carryforwards of approximately \$530,000. The state tax loss carryforwards will begin to expire in 2007, unless previously utilized.





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NAIE obtained from the Swiss tax authorities a five-year Swiss federal and cantonal income tax holiday that ended June 30, 2005. Following the expiration of our tax holiday, we anticipate NAIE's effective tax rate for Swiss federal, cantonal and communal taxes will be approximately 23%. NAIE had net income of \$1.0 million for the fiscal year ended June 30, 2005.

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>2005</u>	<u>2004</u>	<u>2003</u>
Income taxes computed at statutory federal income tax rate	\$1,159	\$ 1,029	\$ 392
State income taxes, net of federal income tax expense	118	196	67
Increase (decrease) in valuation allowance	—	(1,631)	534
Expenses not deductible for tax purposes	53	69	12
Foreign tax holiday	(304)	(187)	(228)
Foreign tax withholding	101	—	—
Dividend tax	131	—	—
Prior year adjustments	—	305	(668)
Transfer pricing adjustment	—	264	—
Other	(48)	(21)	(62)
	<u>          </u>	<u>          </u>	<u>          </u>
Income taxes as reported	\$ 1,210	\$ 24	\$ 47
	<u>          </u>	<u>          </u>	<u>          </u>
Effective tax rate	35.5%	0.8%	4.1%
	<u>          </u>	<u>          </u>	<u>          </u>

**F. 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. We may make contributions to the plan at the discretion of our Board of Directors. Effective July 1, 2001, the plan was amended to require that we match one half of the first 6% of a participant's compensation contributed to 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. The total contributions under the plan charged to operations totaled \$315,000 for the fiscal year ended June 30, 2005, \$200,000 for fiscal 2004, and \$79,000 for fiscal 2003.

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 for these benefits totaled \$876,000 for the fiscal year ended June 30, 2005, \$697,000 for fiscal 2004, and \$492,000 for fiscal 2003.

In December 1999, we adopted an employee stock purchase plan that provides 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 will increase by 25,000 each year on July 1 until determined otherwise by the Board of Directors. The plan is intended to qualify under Section 423 of the Code and is for the benefit of qualifying employees. Under the terms of the plan, participating employees may 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 National Market on either the first or last trading day in the offering period, whichever is lower. As of June 30, 2005, 129,544 shares of common stock were issued pursuant to this plan.

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>2005</u>	<u>2004</u>
<b>Change in Benefit Obligation</b>		
Benefit obligation at beginning of year	\$ 1,286	\$ 1,102
Interest cost	73	72
Actuarial loss	139	118
Benefits paid	(10)	(6)
	<u>\$ 1,488</u>	<u>\$ 1,286</u>
<b>Change in Plan Assets</b>		
Fair value of plan assets at beginning of year	\$ 1,146	\$ 937
Actual return on plan assets	83	139
Employer contributions	63	76
Benefits paid	(10)	(6)
	<u>\$ 1,282</u>	<u>\$ 1,146</u>
<b>Reconciliation of Funded Status</b>		
Benefit obligation in excess of fair value of plan assets	\$ (206)	\$ (140)
Unrecognized net actuarial loss	241	96
	<u>\$ 35</u>	<u>\$ (44)</u>
<b>Additional Minimum Liability Disclosures</b>		
Accrued benefit liability	\$ (206)	\$ (140)

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>2005</u>	<u>2004</u>
Discount rate	5.50%	6.00%
Compensation increase rate	N/A	N/A

**Net Periodic Benefit Cost**

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

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Interest cost	\$ 73	\$ 72	\$ 67
Expected return on plan assets	(89)	(73)	(64)
	<u>\$ (16)</u>	<u>\$ (1)</u>	<u>\$ 3</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>2005</u>	<u>2004</u>	<u>2003</u>
Discount rate	6.00%	6.00%	6.50%
Expected long term rate of return	8.00%	8.00%	7.50%
Compensation increase rate	N/A	N/A	N/A

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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.

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

	2005	2004	Target Allocation
Equity securities	62%	61%	60%
Debt securities	30%	31%	32%
Real estate	8%	8%	8%
	100%	100%	100%

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 a relatively minimal exposure to volatile investment options like derivatives.

## G. Stockholders' Equity

### Treasury Stock

In January 1999, the Board of Directors approved a repurchase program of up to 500,000 shares of our common stock. This program was terminated by the Board of Directors in October 2002 after the repurchase of 272,400 shares. During March 2004, 211,400 shares of such repurchased common stock were cancelled and returned to the status of authorized but unissued shares of our common stock.

### Stock Option Plans

On December 6, 1999, our stockholders approved the adoption of the 1999 Omnibus Equity Incentive Plan (the "1999 Plan"). A total of 500,000 shares of common stock were initially 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, commencing January 1, 2000, 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 increased by 100,000 common shares on each of January 1, 2000, 2001, 2002, 2003, 2004 and 2005. In addition, at our Annual Meetings of Stockholders held on January 30, 2004 and December 31, 2004, our stockholders approved amendments to the 1999 Plan to increase the number of shares of common stock available under the 1999 Plan by an additional 500,000 shares, for a total increase of 1,000,000 shares.

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.

Effective April 27, 2005, our Board of Directors approved the acceleration of the vesting of all outstanding and unvested options held by directors, officers and other employees under our 1999 Omnibus Equity Incentive Plan. As a result of the acceleration, options to acquire 827,932 shares of our common stock, which otherwise would have vested over the next 36 months, became immediately exercisable. This action was taken to eliminate, to the extent permitted, the transition expense that we otherwise would incur in connection with the adoption of SFAS 123R. Included in the options to acquire 827,932 shares of our common stock were options to purchase 545,992 shares with exercise prices greater than our closing stock price on the date of acceleration. Under the accounting guidance of APB 25, the accelerated vesting resulted in a charge for stock-based compensation of approximately \$131,000, which was recognized in the fourth quarter of fiscal 2005.

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Stock option activity for the three years ending June 30, 2005 was as follows:

	1992 Incentive Plan	1998 Outside Director Plan	1999 Plan	Total All Plans	Weighted Average Exercise Price
Outstanding at June 30, 2002	85,000	20,000	421,800	526,800	3.58
Exercised	—	—	(6,199)	(6,199)	2.17
Forfeited	(85,000)	—	(135,401)	(220,401)	5.57
Granted	—	—	285,000	285,000	3.08
Outstanding at June 30, 2003	—	20,000	565,200	585,200	2.60
Exercised	—	(20,000)	(61,700)	(81,700)	3.40
Forfeited	—	—	(8,600)	(8,600)	5.61
Granted	—	—	774,800	774,800	6.26
Outstanding at June 30, 2004	—	—	1,269,700	1,269,700	4.76
Exercised	—	—	(49,945)	(49,945)	2.86
Forfeited	—	—	(20,955)	(20,955)	5.82
Granted	—	—	240,500	240,500	8.56
Outstanding at June 30, 2005	—	—	1,439,300	1,439,300	5.45
Exercisable at June 30, 2005	—	—	1,439,300	1,439,300	5.45
Weighted-average remaining contractual life in years Available for grant at June 30, 2005	—	—	3.71	3.71	
	—	—	536,752	536,752	

During fiscal 2002, we granted options to purchase 90,000 shares to employees at an exercise price below the fair market value of the stock on the grant date. During fiscal 2004, we granted options to purchase 150,000 shares to an employee at an exercise price below the fair market value of the stock on the grant date. We recorded approximately \$72,000 of compensation expense related to these option grants in fiscal 2005, \$63,000 in fiscal 2004 and \$31,000 in fiscal 2003. As a result of the acceleration of vesting of all outstanding and unvested options on April 27, 2005, we expensed the unamortized deferred compensation associated with these options.

Additionally, during fiscal 2004 we recorded \$56,000 of compensation expense related to options granted to a non-employee to purchase 15,000 shares.

The following is a further breakdown of the options outstanding at June 30, 2005:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$1.80 - \$2.03	166,800	4.64	\$ 1.97	166,800	\$ 1.97
\$2.04 - \$3.02	245,400	2.34	\$ 2.63	245,400	\$ 2.63
\$3.03 - \$5.21	310,000	3.49	\$ 4.96	310,000	\$ 4.96
\$5.22 - \$6.65	407,600	3.56	\$ 6.56	407,600	\$ 6.56
\$6.66 - \$10.47	309,500	4.71	\$ 8.58	309,500	\$ 8.58
<b>\$ 1.80 - \$10.47</b>	<b>1,439,300</b>	<b>3.71</b>	<b>\$ 5.45</b>	<b>1,439,300</b>	<b>\$ 5.45</b>

**H. Commitments**

We lease a total of 181,500 square feet of our manufacturing facilities from unaffiliated third parties under non-cancelable operating leases, including 162,000 square feet at our manufacturing facility in Vista, California and 19,500 square feet at our San Marcos, California facility. The leases on the San Marcos facility have various expiration dates through 2007. The lease on the Vista facility expires in March 2014.

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On February 25, 2004, we entered into an agreement to sublet 42,000 square feet at our Vista, California facility. The sublease was for a term of seven months that began on April 1, 2004, and provided for monthly rental income equal to our rental expense for the space. The sublease agreement ended October 31, 2004. The space is currently being used for warehousing.

As required under the terms of our Vista lease, on May 11, 2004, we provided a letter of credit in the amount of \$440,000 to the landlord. The amount of the letter of credit will be reduced by approximately 33% each year. On April 1, 2005, we reduced our outstanding amount to \$270,000.

NAIE leases facility space in Manno, Switzerland. The leased space totals approximately 38,000 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.

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, 2005 (dollars in thousands):

2006	\$ 1,872
2007	1,937
2008	1,919
2009	1,939
2010	1,977
Thereafter	8,961
	<hr/>
	\$18,605
	<hr/>

Rental expense totaled \$1.7 million for the fiscal year ended June 30, 2005, \$1.2 million for fiscal 2004, and \$947,000 for fiscal 2003. Rental expense was offset by sublease rental income in the amount of \$137,000 for fiscal 2005, \$68,000 in fiscal 2004 and zero in fiscal 2003.

#### **I. Foreign Currency Instruments**

On August 9, 2004, we purchased ten monthly participating forward contracts designated and effective as cash flow hedges against the foreign currency exchange risk inherent in our forecasted transactions denominated in Euros. The participating forward contracts consisted of ten put options providing protection if the exchange rate of the United States dollar to the Euro decreased below our contracted strike price of \$1.1892, and ten call options that offset the initial cost of the purchased put options. The call options obligated us to give up 50% of the foreign currency gain related to the forecasted transaction if the United States dollar/Euro exchange rate increased above our contracted strike price. The participating forward contracts had an initial notional amount of \$1.5 million and a weighted average strike price of \$1.1892. As of June 30, 2005, we had exercised all of the participating forward contracts.

On May 13, 2005, we purchased seven 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 seven options expire monthly beginning June 2005 and ending December 2005. The option contracts had a notional amount of \$4.2 million, a weighted average strike price of \$1.19, and a purchase price of \$21,000. The risk of loss associated with the options is limited to premium amounts paid for the option contracts. As of June 30, 2005, we had not exercised any of the options and one of the options had expired.

For the fiscal year ended June 30, 2005, approximately \$109,000 had been charged to income for option contracts outstanding during the year.

#### **J. Related Party Transactions**

During fiscal 1999, we made a 6% interest bearing loan of \$20,000 to our Chief Scientific Officer. The note and interest due were being paid in biweekly payments of \$550. The balance of the note, including accrued interest, was paid in full in September 2004.

## K. Economic Dependency

We had substantial net sales 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 net sales or the growth rate of net sales to these customers could have a material adverse impact on our net sales and net income. Net sales to any one customer representing 10% or more of the respective year's total net sales were as follows (dollars in thousands):

	2005		2004		2003	
	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales
Customer 1	\$ 36,991	40%	\$ 31,182	40%	\$ 24,119	43%
Customer 2	35,193	39%	23,464	30%	15,337	27%
	<u>\$ 72,184</u>	<u>79%</u>	<u>\$ 54,646</u>	<u>70%</u>	<u>\$ 39,456</u>	<u>70%</u>

Accounts receivable from these customers totaled \$9.5 million at June 30, 2005, and \$6.6 million at June 30, 2004.

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. Carrington Laboratories Incorporated comprised 35% of our total raw material purchases for the year ended June 30, 2005. Accounts payable to Carrington Laboratories Incorporated was \$660,000 at June 30, 2005. No other supplier comprised 10% or more of our raw material purchases for the year ended June 30, 2005.

## L. 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, including that discussed below, 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, including that discussed below, could change in the future and we could have unfavorable outcomes that we do not expect.

On February 10, 2005, a complaint was filed against NAI on behalf of Novogen Research Pty. Ltd. in the United States District Court, Southern District of New York alleging a cause of action for patent infringement of a Novogen patent by products manufactured by NAI. The parties are attempting to resolve the matter in an out-of-court settlement but if we are unable to do so we intend to vigorously defend the action.

We were a plaintiff in an anti-trust lawsuit against several manufacturers of vitamins and other raw materials that we purchased. Other similarly situated companies filed a number of similar lawsuits against some or all of the same manufacturers. Our lawsuit was consolidated with some of the others and captioned *In re: Vitamin Antitrust Litigation*. As of June 30, 2003, all of our claims under the vitamin antitrust litigation were settled. Settlement payments that we received of \$225,000 in fiscal 2003 and \$3.4 million in fiscal 2002 are included in proceeds from vitamin antitrust litigation in the accompanying statements of income for fiscal 2003 and 2002, as applicable.

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**M. Segment Information**

Our business consists of one segment, the development, manufacturing, marketing and distribution of nutritional supplements. Our products are sold both in the United States and in markets outside the United States, including Europe, Australia and Japan. Our primary market outside the United States is Europe.

Net sales by geographic region, based upon the customers' location, were as follows (dollars in thousands):

	Year Ended June 30		
	2005	2004	2003
United States	\$ 67,784	\$ 56,350	\$ 41,838
Markets Outside the United States	23,708	22,184	14,124
<b>Total Net Sales</b>	<b>\$91,492</b>	<b>\$ 78,534</b>	<b>\$55,962</b>

Products manufactured by NAIE accounted for 46% of net sales in markets outside the United States in fiscal 2005, 42% in fiscal 2004 and 51% in fiscal 2003.

No products manufactured by NAIE were sold in the United States during the fiscal years ended June 30, 2005, 2004 and 2003.

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

2005	Long-Lived Assets	Total Assets	Capital Expenditures
United States	\$ 17,144	\$ 40,470	\$ 7,397
Europe	1,053	3,668	309
	<b>\$ 18,197</b>	<b>\$ 44,138</b>	<b>\$ 7,706</b>
<b>2004</b>	<b>Long-Lived Assets</b>	<b>Total Assets</b>	<b>Capital Expenditures</b>
United States	\$ 10,833	\$38,625	\$ 3,138
Europe	1,135	3,843	184
	<b>\$11,968</b>	<b>\$ 42,468</b>	<b>\$ 3,322</b>
<b>2003</b>	<b>Long-Lived Assets</b>	<b>Total Assets</b>	<b>Capital Expenditures</b>
United States	\$ 9,996	\$26,724	\$ 755
Europe	1,362	4,000	222
	<b>\$ 11,358</b>	<b>\$ 30,724</b>	<b>\$ 977</b>



**SCHEDULE II****Natural Alternatives International, Inc.  
Valuation And Qualifying Accounts  
For The Years Ended June 30, 2005, 2004 and 2003**

(Dollars in thousands)

	<u>Balance at Beginning of Period</u>	<u>Provision</u>	<u>(Deductions)</u>	<u>Balance at End of Period</u>
Fiscal year ended June 30, 2005:				
Inventory reserves	\$ 1,113	\$ 1,529	\$ (827)	\$ 1,815
Allowance for doubtful accounts	\$ 132	\$ 101	\$ (12)	\$ 221
Fiscal year ended June 30, 2004:				
Inventory reserves	\$ 708	\$ 965	\$ (560)	\$ 1,113
Allowance for doubtful accounts	\$ 27	\$ 106	\$ (1)	\$ 132
Fiscal year ended June 30, 2003:				
Inventory reserves	\$ 1,467	\$ 19	\$ (778)	\$ 708
Allowance for doubtful accounts	\$ 105	\$ (46)	\$ (32)	\$ 27

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

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

We maintain certain disclosure controls and procedures. They are designed to help ensure that material information is: (1) gathered and communicated to our management, including our principal executive and financial officers, on a timely basis; and (2) recorded, processed, summarized, reported and filed with the SEC as required under the Securities Exchange Act of 1934.

Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2005. Based on their evaluation, they concluded that our disclosure controls and procedures were effective for their intended purpose described above. There were no changes to our internal controls during the fourth quarter ended June 30, 2005 that have materially affected, or that are reasonably likely to materially affect, our internal controls.

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS**

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 December 2, 2005, to be filed on or before October 28, 2005.

**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 December 2, 2005, to be filed on or before October 28, 2005.

**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 December 2, 2005, to be filed on or before October 28, 2005.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information for this item is incorporated by reference to the section “Certain Relationships and Related Transactions” in our definitive proxy statement for our Annual Meeting of Stockholders to be held on December 2, 2005, to be filed on or before October 28, 2005.

**ITEM 14. PRINCIPAL ACCOUNTING 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 December 2, 2005, to be filed on or before October 28, 2005.

**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, 2005 and 2004;
  - Consolidated Statements of Income and Comprehensive Income for the years ended June 30, 2005, 2004 and 2003;
  - Consolidated Statements of Stockholders' Equity for the years ended June 30, 2005, 2004 and 2003;
  - Consolidated Statements of Cash Flows for the years ended June 30, 2005, 2004 and 2003; and
  - Notes to Consolidated Financial Statements.
- (2) Financial Statement Schedule. The following financial statement schedule is included under Item 8 of this report:
  - Schedule II - Valuation and Qualifying Accounts for the years ended June 30, 2005, 2004 and 2003.
- (3) Exhibits. The following exhibit index shows those exhibits filed with this report and those incorporated by reference:

**EXHIBIT INDEX**

<u>Exhibit Number</u>	<u>Description</u>	<u>Incorporated By Reference To</u>
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)	By-laws of Natural Alternatives International, Inc. dated as of December 21, 1990	NAI's Registration Statement on Form S-1 (File No. 33-44292) filed with the commission on December 21, 1992
4(i)	Form of NAI's Common Stock Certificate	Filed herewith
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	1999 Employee Stock Purchase Plan as adopted effective October 18, 1999	Exhibit B of NAI's definitive Proxy Statement filed with the commission on October 21, 1999
10.3	Management Incentive Plan	Exhibit 10.3 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
10.4	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and Mark Zimmerman	Exhibit 10.4 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	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and Randell Weaver	Exhibit 10.5 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
10.6	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
10.7	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and John Wise	Exhibit 10.7 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
10.8	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and John Reaves	Exhibit 10.8 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
10.9	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and Timothy E. Belanger	Exhibit 10.9 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	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

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10.11	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
10.12	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
10.13	Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company dated October 27, 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
10.14	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
10.15	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
10.16	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
10.17	Amended and Restated Exclusive License Agreement effective as of February 5, 2003, by and among NAI, Chopra Enterprises, LLC, Deepak Chopra, M.D., and David Simon, M.D.	Exhibit 10.16 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
10.18	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
10.19	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated July 25, 2003 (English translation)	Filed herewith
10.20	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated June 8, 2004 (English translation)	Filed herewith
10.21	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated February 7, 2005 (English translation)	Filed herewith
10.22	License Agreement effective as of April 28, 1997 by and among Roger Harris, Mark Dunnett and NAI	Filed herewith
10.23	Amendment to License Agreement effective as of March 17, 2001 by and among Roger Harris, Mark Dunnett and NAI	Filed herewith
21	Subsidiaries of the Company	Filed herewith
23.1	Consent of Independent Registered Public Accounting Firm	Filed herewith

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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

**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 8, 2005

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>
/s/ Mark A. LeDoux _____ (Mark A. LeDoux)	Chief Executive Officer and Chairman of the Board of Directors (principal executive officer)	September 8, 2005
/s/ John R. Reaves _____ (John R. Reaves)	Chief Financial Officer (principal financial officer and principal accounting officer)	September 8, 2005
/s/ Joe E. Davis _____ (Joe E. Davis)	Director	September 8, 2005
/s/ Alan G. Dunn _____ (Alan G. Dunn)	Director	September 8, 2005
/s/ Alan J. Lane _____ (Alan J. Lane)	Director	September 8, 2005
/s/ Lee G. Weldon _____ (Lee G. Weldon)	Director	September 8, 2005

[face OF CERTIFICATE]

NUMBER

NAI

INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE

THIS CERTIFICATE IS TRANSFERABLE IN RIDGEFIELD PARK, NJ AND NEW YORK, NY

[LOGO]

NATURAL ALTERNATIVES INTERNATIONAL, INC.

AUTHORIZED CAPITAL 20,500,000 SHARES

20,000,000 COMMON SHARES, PAR VALUE \$.01 PER SHARE

500,000 PREFERRED SHARES, PAR VALUE \$.01 PER SHARE

SHARES

SEE REVERSE FOR CERTAIN DEFINITIONS

CUSIP 638842 30 2

THIS CERTIFIES THAT

Is The Record Holder Of

FULLY PAID AND NONASSESSABLE COMMON SHARES, \$.01 PAR VALUE PER SHARE OF NATURAL ALTERNATIVES INTERNATIONAL, INC.

transferable only on the books of the Company by the holder hereof in person or by duly authorized attorney upon surrender of this Certificate properly endorsed. This Certificate and the shares represented hereby are issued and shall be subject to all the provisions of the Certificate of Incorporation, to all of which the holder by acceptance hereby assents.

IN WITNESS WHEREOF, the Company has caused this Certificate to be signed in facsimile by its duly authorized officers and the facsimile seal of the Company to be duly affixed hereto.

This Certificate is not valid unless duly countersigned by the Transfer Agent and Registrar.

Dated

/sig/

RANDELL WEAVER, PRESIDENT

[SEAL]

/sig/

JOHN REAVES, CHIEF FINANCIAL OFFICER

COUNTERSIGNED AND REGISTERED:

MELLON INVESTOR SERVICES LLC  
TRANSFER AGENT AND REGISTRAR

BY

AUTHORIZED SIGNATURE

[REVERSE OF CERTIFICATE]

NATURAL ALTERNATIVES INTERNATIONAL, INC.

The following abbreviations, when used in the inscription on the face of this certificate, shall be construed as though they were written out in full according to applicable laws or regulations:

TEN COM - as tenants in common

TEN ENT - as tenants by the entireties

JT TEN - as joint tenants with right of survivorship and not as tenants in common

UNIF GIFT MIN ACT - (Cust) Custodian (Minor) under Uniform Gifts to Minors Act (State)



Additional abbreviations may also be used though not in the above list.

For Value Received, hereby sell, assign and transfer unto

PLEASE INSERT SOCIAL SECURITY OR OTHER IDENTIFYING NUMBER OF ASSIGNEE

PLEASE PRINT OR TYPEWRITE NAME AND ADDRESS, INCLUDING POSTAL ZIP CODE, OF ASSIGNEE(S)

Shares of capital stock represented by the within Certificate and do hereby irrevocably constitute and appoint

---

Attorney to transfer the said stock on the books of the within named Corporation with full power of substitution in the premises.

Dated

X

NOTE: The signature to this assignment must correspond with the name as written upon the face of the certificate in every particular, without alteration or enlargement or any change whatever.

Signature Guaranteed

By

THE SIGNATURE(S) SHOULD BE GUARANTEED BY AN ELIGIBLE GUARANTOR INSTITUTION (BANKS, STOCKBROKERS, SAVINGS AND LOAN ASSOCIATIONS AND CREDIT UNIONS WITH MEMBERSHIP IN AN APPROVED SIGNATURE GUARANTEE MEDALLION PROGRAM), PURSUANT TO S.E.C. RULE 17Ad-15.

Between

Mr. SILVIO TARCHINI - Manno, Centro Galleria 3, Via Cantonale (VAT # 352 809)

Further indicated as "owner" and

NAIE NATURAL ALTERNATIVES INTERNATIONAL EUROPE SA – Manno,

Centro Galleria 1, Via Cantonale (VAT # 462 163)

Further indicated as "NAIE" o "tenant", having Mr. Randy Lee Weaver as representative individual

Both parties enter the following

**LEASE CONTRACT**

- 1) Mr. SILVIO TARCHINI - Manno, leases to NAIE a comprehensive area of 2'769.86 sqm situated in the Galleria 1 building map 433, in Manno, at the ground and first floors, including the use of 12 outdoor parking places # 52,53,54,55,80,81,82,83,84,85,86,87 and 11 indoor parking places # 154,155,156,157,158,159,164,165,166,236,237.
- 2) The areas leased are referred in the attached map with numbers 4,5,7,11,12,13,15,16,17,22 and 31.
- 3) The tenant is allowed to use the areas as offices, laboratory, warehouse, production departments in compliance with the current pertinent regulations.
- 4) This contract is entered into and is effective as of August 1, 2003 and has a duration of 6 (six) years, i.e. until December 31, 2010.

Save if one of the parties will terminate the contract with a 6 (six)-month notice, the present contract will be automatically renewed for additional 5 (five) years at every renewed contract end date.

4a) In case the tenant would face the necessity to have his own plant erected and Mr. Tarchini would not be in a position to offer adequate space within his properties of Manno, Bioggio or Mendrisio, NAIE SA could terminate the lease contract for the end of the calendar year (December 31) upon a 12-month prior notification but anyhow not before December 31, 2005.

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4b) The present contract supersedes the previous ones dated March 29 1999, April 6 1999, April 12 1999, June 2 1999, August 23 1999, October 20 1999, July 27 2000, February 20 2001, May 31 2001, July 26 2002, March 26 2003.

#### **LEASE**

- 5) The yearly lease is fixed at Swiss fr. 460'000.- (four hundreds sixty thousands Swiss francs) VAT excluded, expenses included, to be paid in advance at every quarter i.e. January 1, April 1st, July 1<sup>st</sup> and October 1<sup>st</sup> of every calendar year.
- 6) In case of payment delay of the quarterly lease, a penalty of 7% might be applied. Delays in payment major than 1 month will lead to debt recovering legal procedure, being the present contract considered as a debt recognition by both parties, as per art. 83 LEF.
- 7) The lease guarantee is as stipulated in the former contracts i.e. deposit of Swiss fr. 45'103.70 to the Credit Suisse bank, account # 550557-10
- 8) Cancelled.
- 9) Cancelled.

#### **LEASE INDEXING**

- 10) The lease is index-linked on a yearly basis according to the national cost of living index (Re. index on September 1966 = 100), with one-month notice. Index at the contract starting date is 317.6. The first adjustment might be applied on August 1, 2004.
- 11) Expenses for power or any other type of energy used in the leased areas are charged to the tenant.
- 12) The lease includes the following expenses:
  - heating
  - cooling of the offices area
  - power for the common areas
  - city water in the common areas

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- sewage, water purifying
  - garden and accesses
  - snow ploughing
  - janitor and supervision
- 13) The owner will adequately insure the building against fire, whilst the tenant will insure his materials, assets and proprieties inside the leased areas against damages caused by fire, water, nature disasters etc...

#### **MODIFICATIONS INTO THE LEASED AREAS**

- 14) The tenant is allowed to modify the leased areas, at his own costs and according to his business necessities. Modifications require the owner's pre-approval upon receipt of a written request. The owner has the faculty to deny approval but only towards sound and valid reasons.
- 15) Upon lease contract termination, improvements as per caption 14) that are removable without causing damages can be taken off (no obligation to do so). If dismantlement would cause damages, improvements must be left as they are and will remain the property of the owner with no refunding to the tenant. If the tenant removes improvements the same, the areas must be left as they initially were.
- 16) All costs for power connections needed in the leased areas are charged to the tenant, including heating and cooling units, electrical installations, telephone.
- Studio Silvio Tarchini will authorize a company of its choice to execute whatever electrical work into the Galleria 1. For the telephone, both parties will undersign a separate contract. It is forbidden to by-pass the PABX main switchboard by means of any other connection for telephone and telefax. Parking signals, logos, signs will be placed by the company SPM S.A. and costs invoiced to the tenant. It is forbidden to place any sort of panel, commercial, logo without prior approval by the owner who may deny authorization only on the basis of sound and valid reasons.

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**SEVERABILITY**

17) Governing Law for any action concerning both parties respective obligations: Pretura di Lugano.

IN WITNESS WHEREOF, the parties have executed this contract as of the date below written

**The Owner :**

**SILVIO TARCHINI**  
**Manno**

Manno, July 25, 2003

**The Tenant :**

**NAIE NATURAL ALTERNATIVES INT. EUROPE SA**  
**Manno**

To the attention of Dr. Fausto Petrini

Manno, June 8, 2004

RE: Lease of area number 11 – Centro Galleria 1 - Manno

Dear Mr. Petrini,

As agreed with our Mr. Graziano Marra, we hereby confirm the lease of the captioned area, and specifically

Situation: Galleria 1 in Manno

Area: # 11 of 177.18 sqm, at the first floor –highlighted in yellow on the attached map

Use: Warehousing

Lease: 26,600 CHF (twenty six thousands and six hundreds Swiss fr.) per year, expenses included, VAT excluded.

Effective as of August 1, 2004

Duration: as to the terms of the current lease contract

Consignment: the areas is consigned as it is

For all other contractual aspects, reference is made to the current lease contract dated July 25, 2003.

Thank you for signing the present letter for acceptance and mailed to our offices.

With best regards,

**NAIE SA**  
**Manno**

**SILVIO TARCHINI**  
**Manno**

For acceptance

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To the attention of Dr. Fausto Petrini

Manno, February 7, 2005

RE: Lease of area number 7 – Centro Galleria 1 - Manno

Dear Mr. Petrini,

As agreed with our Mr. Graziano Marra, we hereby confirm the lease of the captioned area, and specifically

Situation: Galleria 1 in Manno

Area: # 7 of 28.19 sqm, at the first floor –highlighted in yellow on the attached map

Use: Warehousing

Lease: 4,200 CHF (four thousands and two hundreds Swiss francs) per year, expenses included, VAT excluded.

Effective as of March 1, 2005

Duration: as to the terms of the current lease contract

Consignment: the area is consigned as it is

Miscellaneous: Overhauling costs sustained to move the material property of the Hope Modellismo AG presently stored into the captioned area will be charged to NAIE SA

For all other contractual aspects, reference is made to the current lease contract dated July 25, 2003.

Thank you for signing the present letter for acceptance and mailed to our offices.

With best regards,

**NAIE SA**  
**Manno**

**SILVIO TARCHINI**  
**Manno**

For acceptance

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**LICENSE AGREEMENT**

This License Agreement is between Roger Harris and Mark Dunnett (collectively, "LICENSOR"), and Natural Alternatives International, Inc. ("LICENSEE"), and is made with reference to the following recitals:

**RECITALS**

- A. LICENSOR is the owner of the Patent Application identified below, and of the technology and materials described therein, along with rights in related technology and materials.
- B. LICENSEE, by letter agreement dated December \_\_, 1996, has agreed to pay LICENSOR £57,000 to conduct further research studies as to the efficacy of the technology and materials described below.
- C. LICENSEE desires to secure, and LICENSOR is willing to grant, a license to manufacture, use, sell, and offer for sale products coming within the scope of such patent or using such technology and materials, in accordance with the terms and conditions of this Agreement and in consideration for such research support.

**AGREEMENTS**

In consideration of the covenants and obligations set forth below, LICENSOR and LICENSEE agree as follows:

**1. DEFINITIONS**

- 1.1 **Agreement.** "Agreement" means this License Agreement.
- 1.2 **Biological Matter.** "Biological Matter" means the materials, substances, organisms, components, and products comprising Compound X, a substance used to enhance the work capacity of muscle, as further described in Appendix A.
- 1.3 **Derivative Matter.** "Derivative Matter" means any material, substance, organism, component, or product incorporating, derived from, developed from, based upon, or made from, the Biological Matter.
- 1.4 **Improvement.** "Improvement" means any alteration or modification of any Invention, but such that the altered or modified version comes within any claim of the Licensed Rights.
- 1.5 **Invention.** "Invention" means the structure, materials, design, concepts, techniques, and processes embodied in the Licensed Rights.
- 1.6 **Know-how.** "Know-How" means the technical information of LICENSOR relating to the Invention and Licensed Products, including all samples, sources of supply, documentation, and

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other similar tangible and intangible information and property in LICENSOR's possession or control useful in the manufacture, use, or sale of Licensed Products.

1.7 **Legal Action.** "Legal Action" means any legal or equitable suit, proceeding, action, or arbitration.

1.8 **Licensed Animal Field.** "Licensed Animal Field" means use of the Biological Matter and Derivative Matter to treat dogs, horses and camels.

1.9 **Licensed Field.** "Licensed Field" means use of the Biological Matter and Derivative Matter to treat humans and such other organisms as the Parties may agree from time to time, and includes the Licensed Animal Field.

1.10 **Licensed Rights.** "Licensed Rights" means all foreign and domestic patents or patent-like rights, including but not limited to a pending UK Patent Application, and all continuation and continuations-in-part applications, divisional applications, reissue patents, and extensions having a priority date based on such UK Patent Application, that cover or claim the use, manufacture, or sale of the Biological Matter and/or Derivative Matter.

1.11 **Licensed Products.** "Licensed Products" means any machine, manufacture, or composition of matter (1) made in accordance with or incorporating the teachings of any Invention and covered in whole or in part by any of the claims of the Licensed Rights, or (2) incorporating any Know-how, or (3) incorporating or made from Biological Matter and/or Derivative Matter.

1.12 **Manufacture.** "Manufacture" means make or have made.

1.13 **Net Receipts.** "Net Receipts" means the total amounts of money or other consideration received or earned by LICENSEE from all Transfers of Licensed Products, less the following amounts if itemized separately from the Transfer price: tax, duty, tariff, or other governmental charge on the making, having made, use, transportation, or Transfer of the Licensed Products.

1.14 **Parties, Party.** "Parties" means LICENSOR and LICENSEE, collectively. "Party" means either LICENSOR or LICENSEE.

1.15 **Territory.** "Territory" means the entire world.

1.16 **Transfer.** "Transfer" means any sale, lease, rental, or other commercial disposition, with or without consideration, to any party not related to LICENSEE.

## 2. LICENSE

2.1 **Grant.** Except as provided by ¶2.3 below, LICENSOR grants to LICENSEE, and LICENSEE accepts, an exclusive, non-transferrable license under the Licensed Rights and Know-how to Manufacture, use, offer for sale, and/or Transfer Licensed Products in the Territory for the Licensed Field, from the Effective Date of this Agreement (as defined in ¶9.16) to the end of the Term of this Agreement (as defined in ¶7.1).

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2.2 **Sublicenses.** LICENSEE shall have the right to sublicense the rights granted to LICENSEE under this Agreement to any other entity, other than a company related to LICENSEE. LICENSOR shall have the right of prior approval of any sublicense for the Licensed Animal Rights, which approval shall not be unreasonably withheld. If LICENSOR does not object in writing within 15 days after receiving a copy of a proposed sublicense, approval shall be deemed to have been given. LICENSEE agrees that every sublicense agreement shall contain a statement setting forth the date upon which LICENSEE's exclusive rights under this Agreement expire. LICENSEE agrees to forward to LICENSOR a copy of any and all fully executed sublicense agreements.

2.3 **Reservation of Rights to LICENSOR.** Notwithstanding any provision of this Agreement to the contrary, LICENSOR shall have the right under the Licensed Rights and Know-how to Manufacture, and use Licensed Products for LICENSOR's own use and consumption.

2.4 **Exploitation of the Licensed Rights.** LICENSEE shall use reasonable business efforts to exploit the Licensed Rights and Know-how to Manufacture, use, offer to sell, and Transfer Licensed Products.

2.5 **Permits.** LICENSEE shall be responsible for obtaining, at its cost, any permits, licenses, authorizations, or approvals required or necessary by any government or other entity (1) to Manufacture, use, offer to sell, or Transfer any Licensed Products, or (2) to enter into this Agreement.

2.6 **Marking Requirement.** LICENSEE agrees to mark Licensed Products made by or on behalf of LICENSEE with the patent number or numbers of the Licensed Rights. The notice shall be directly applied to the Licensed Products, or when, from the character of the Licensed Products this cannot be done, by fixing to the Licensed Products or their packaging a label containing a like notice.

2.7 **Trademarks and Corporate Name.** LICENSEE agrees that it will not, without LICENSOR's express written permission, (1) use any LICENSOR owned trade name, trademark, trade device, service mark, symbol, or other identification, or any abbreviation, contraction, or simulation thereof, or (2) represent (directly or indirectly) that any product or service of LICENSEE is a product or service of LICENSOR, or is made in accordance with or utilizes any materials, information, or documentation of LICENSOR. However, LICENSEE may mark Licensed Products with a notice that such products are made under a license from LICENSOR.

### 3. **OBLIGATIONS OF LICENSOR**

3.1 **Technical Assistance.** Within 30 days after execution of this Agreement, LICENSOR shall deliver the Transfer Package to LICENSEE. If LICENSEE requires technical assistance in manufacturing Licensed Products, LICENSOR agrees to supply such assistance at a time and place to be agreed upon.

4. **ROYALTIES & FEES**

4.1 **Patent Fees.** LICENSEE shall pay all costs and fees required to obtain the Licensed Rights and to maintain any domestic and foreign patents or patent-like rights. The Parties shall agree on each jurisdiction where counterpart patent applications are to be filed.

4.2 **Agreement for Royalties.** LICENSEE agrees to pay LICENSOR a royalty at the following rates:

4.2.1 A rate as set forth in Column A of the Table below on all Net Receipts from Transfers by LICENSEE of Licensed Products made or used in, or imported into, any part of the Territory where Licensed Rights are formally recognized by the relevant legal authorities.

4.2.2 In consideration of the license granted by this Agreement for LICENSOR’s Know-how and the delivery of the Transfer Package to LICENSEE, and solely during the Term of this Agreement, a rate as set forth in Column B of the Table below on all Net Receipts from Transfers by LICENSEE of Licensed Products made or used in, or imported into, any part of the Territory where Licensed Rights are not, or are no longer, formally recognized by the relevant legal authorities.

4.2.3 Only a single royalty shall be paid with respect to any Transfer of a unit of any Licensed Product. If multiple royalty rates could apply, the actual royalty rate shall be the first possible rate that could apply.

Licensed Products for:	A Transfers covered by Licensed Rights		B Transfers <i>not</i> covered by Licensed Rights	
	For annually cumulated ( <i>i.e.</i> , reset each year) Net Receipts (in <i>millions</i> of U.S. dollars) of:			
All purposes	<\$1	6.0%	<\$1	2.50%
	\$1 to \$2.5	5.0%	\$1 to \$2.5	2.25%
	\$2.5 to \$5	4.5%	\$2.5 to \$5	2.00%
	\$5 to \$10	4.0%	\$5 to \$10	1.75%
	>\$10	3.5%	>\$10	1.50%

4.3 **Sublicensee Royalties.** From any royalties actually received by LICENSEE from its 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.

4.4 **Sublicense Revenues.** With respect to sublicenses granted under this Agreement, LICENSEE shall pay to LICENSOR 50% of all fees and lump sum payments, including but not limited to technology access fees and license issue fees, but excluding royalties.

4.5 **Payment.** The royalty on the Transfer of each Licensed Product is earned on the earlier of (1) the day on which LICENSEE ships the Licensed Product to a distributor or customer, or (2)

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the day on which LICENSEE invoices the Licensed Product. Each royalty payment to LICENSOR must be paid within 30 days after the end of the calendar quarter in which the royalty is earned. Royalties earned on Licensed Products for which refunds, credits, or allowances are given or made by LICENSEE shall be credited against future royalties due to LICENSOR. Royalties shall be paid in U.S. dollars. For those Transfers of Licensed Products made by LICENSEE in other currencies, the Net Receipts shall be converted to U.S. dollars in accordance with the exchange rates published in the Wall Street Journal at the end of the respective royalty period.

**4.6 No Royalty Reductions.** LICENSEE's royalty obligations shall be exclusive of, and shall not be reduced or offset by, any charges now or hereafter imposed on the Manufacture, use, transportation, or Transfer of the Licensed Products, such as (1) shipping or insurance charges; (2) taxes of any nature (including, but not limited to, withholding taxes) imposed by any taxing jurisdiction within or outside of the United States; and/or (3) duties or tariffs. Such charges shall be borne by, and shall be the sole responsibility of, LICENSEE. LICENSOR shall, upon written request of LICENSEE, furnish to LICENSEE any applicable exemption or reduced rate withholding tax certificates provided that LICENSEE has provided blank copies of such exemption certificates to LICENSOR. LICENSEE shall further indemnify and hold LICENSOR harmless against any liability arising from the failure to make any deduction for any such charges.

**4.7 Statements.** With each royalty payment, LICENSEE must submit to LICENSOR a statement of: (1) the number of Transfers of Licensed Products from all sources during the applicable period, (2) the total of the Net Receipts during the applicable period, and (3) a clear computation of the royalty payment.

**4.8 Sublicensee Statements.** Once each year, LICENSEE shall forward to LICENSOR a copy of any reports received by LICENSEE from its sublicensees during the previous 12 month period reasonably necessary for conducting a royalty accounting of such sublicensees.

**4.9 Interest.** If any royalty, charge, or fee to be paid by LICENSEE under this Agreement becomes delinquent, it shall bear interest until paid in full with the interest. The interest will be compounded annually and will accrue at the lesser of (1) the highest annual rate allowed under applicable law at the time the outstanding amount becomes delinquent, or (2) 0.0005 multiplied by the outstanding amount per day of delinquency.

**4.10 Inspection.** LICENSEE agrees to keep or have kept separate and adequately detailed accounting records of all Transfers of Licensed Products, whether such Transfers are made by LICENSEE or by a sublicensee. Such accounting records shall be kept for a minimum of 2 years. During the term of this Agreement and for one year thereafter, LICENSOR or its agents have the right to inspect the relevant accounting records of LICENSEE and its sublicensees to verify the accuracy of the royalties paid or payable to LICENSOR. All inspected information shall be kept in confidence from third parties. LICENSOR must give at least 10 days' written notice to LICENSEE or its sublicensees before any inspection, and may not inspect more than twice in any 12 month period. All inspections must be during ordinary business hours, and shall be conducted so as to not unreasonably interfere with normal business activities. If any inspection discloses that the amount of royalties paid to LICENSOR is incorrect in either LICENSOR's or

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LICENSEE's favor, then any amount due to either Party must be paid within 10 days by the other Party. If LICENSOR's inspection demonstrates that the royalties paid for the period in question are less than 95% of the correct amount owing, LICENSEE shall be liable for LICENSOR's cost of inspection. Otherwise, LICENSOR must pay all of LICENSOR's costs for any inspection.

## 5. IMPROVEMENTS

5.1 **By LICENSEE.** If LICENSEE makes any Improvement to the Invention during the term of this Agreement, that Improvement shall be considered to be governed by the license granted by this Agreement for the Licensed Rights. In addition, LICENSEE agrees to grant back to LICENSOR a royalty free, paid-up, non-exclusive, world-wide, unrestricted license to use all such Improvements for research purposes.

5.2 **By LICENSOR.** If LICENSOR makes or acquires any Improvement to the Invention, LICENSOR shall promptly disclose the Improvement to LICENSEE, and that Improvement shall be considered to be governed by the license granted by this Agreement for the Licensed Rights.

5.3 **By LICENSOR.** If LICENSOR patents any Improvement to the Invention within 5 years after the Effective Date of this Agreement, LICENSOR shall promptly disclose any issued patent covering the Improvement to LICENSEE, and that patent shall be considered to be governed by the license granted by this Agreement for the Licensed Rights. LICENSEE shall not be obligated to pay to LICENSOR any additional royalty or fee for the Manufacture, use, Transfer, or practice of any such patented Improvement beyond the royalties provided for in Section 4 above with respect to Licensed Products.

5.4 **Rights to Biological & Derivative Matter.** Notwithstanding any contrary provision of this Agreement, LICENSOR shall own all rights (including intellectual property rights) to the Biological Matter and all Derivative Matter. LICENSEE shall assist LICENSOR in obtaining and/or maintaining patents and similar rights to any Derivative Matter developed by LICENSEE if LICENSOR, in its sole discretion, shall so request. LICENSEE shall sign all documents and do all other things necessary to obtain and/or maintain such rights, to assign them to LICENSOR, and to protect them against infringement by other entities. The obligations of this Paragraph are continuing and survive the termination or completion of this Agreement.

## 6. ENFORCEMENT OF PATENT RIGHTS

6.1 **Obligation to Enforce.** For as long as LICENSEE's license under the Licensed Rights is exclusive, LICENSEE has the obligation to pursue (by Legal Action or otherwise) infringers of the Licensed Rights if, within 180 days of each infringer being given notice or having knowledge of such infringement, LICENSEE has not been able to cause the infringer to cease infringement. LICENSEE shall promptly advise LICENSOR of all notices of infringement within such 180 day period, and of all other entities that LICENSEE believes are infringers. LICENSOR shall promptly advise LICENSEE of the same information that LICENSOR has obtained. LICENSEE is not required to proceed with Legal Action against any infringer that is selling less than 100 infringing units per year in the United States. Further, LICENSEE is only required to pursue one patent infringement Legal Action at any one time. However, LICENSEE shall notify LICENSOR of all known infringers selling less than 100 commercial units per year, and of any infringers that

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LICENSEE is not pursuing because of a pending Legal Action. If there is any disagreement between LICENSOR and LICENSEE as to whether or not infringement by a third party exists, either Party may submit the issue to arbitration in accordance with ¶9.1 below.

**6.2 Costs of Enforcement by LICENSEE.** All costs, disbursements, and expenses of any Legal Action brought by LICENSEE shall be borne by LICENSEE. LICENSEE shall advise LICENSOR of all such costs, disbursement, and expenses semiannually after commencement of each Legal Action. If any recovery or payment results from any such Legal Action, LICENSEE shall be reimbursed for all costs, disbursements, and expenses incurred by LICENSEE therein, and thereafter 10% of any remaining amount shall be paid to LICENSOR.

**6.3 Assistance by LICENSOR.** LICENSOR agrees to assist LICENSEE with respect to any Legal Action brought by LICENSEE relating to the enforcement of the Licensed Rights. LICENSOR shall be entitled to receive reimbursement of any reasonable out-of-pocket expenses incurred by it in rendering such assistance, and LICENSOR shall be kept currently advised of the status and activities of all such Legal Actions.

**6.4 LICENSOR's Option to Enforce.** LICENSOR shall have the option to pursue (by Legal Action or otherwise) infringers of the Licensed Rights against whom LICENSEE is not required to bring Legal Action under ¶6.1 above.

**6.5 Costs of Enforcement by LICENSOR.** All costs, disbursements, and expenses of any Legal Action brought by LICENSOR shall be borne by LICENSOR. If any recovery or payment results from any such Legal Action, LICENSOR shall retain all such recovery or payments.

**6.6 Assistance by LICENSEE.** LICENSEE agrees to assist LICENSOR with respect to any Legal Action brought by LICENSOR relating to the enforcement of the Licensed Rights. LICENSEE shall be entitled to receive reimbursement of any reasonable out-of-pocket expenses incurred by it in rendering such assistance, and LICENSEE shall be kept currently advised of the status and activities of all such Legal Actions.

## 7. TERM & TERMINATION

**7.1 Term.** The original Term of this Agreement shall be for 5 years from the Effective Date of this Agreement.

**7.2 Renewal.** This Agreement shall be renewed automatically for from year to year after the original Term, unless one Party gives written notice of termination to the other Party at least 60 days before the end of the original Term or of any one-year renewal term. The original Term and any extension Term shall be subject to early termination under the provisions of this Section.

**7.3 By Mutual Agreement.** The Parties may mutually agree in writing to terminate this Agreement, and all rights and licenses granted under this Agreement, at any time.

**7.4 Option at Default.** LICENSOR, at its option, may immediately terminate this Agreement and all rights and licenses granted under this Agreement if LICENSEE defaults in the performance of any material obligation and if the default has not been remedied within 30 days

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after written notice to LICENSEE describing the default. LICENSEE's failure to pay when due any amount payable under this Agreement shall constitute a default in the performance of a material obligation of this Agreement.

7.5 **Option at Financial Distress.** LICENSOR, at its option, may immediately terminate this Agreement and all rights and licenses granted under this Agreement (1) upon the liquidation or dissolution of LICENSEE, or (2) if LICENSEE ceases to be actively engaged in business or financially capable of fulfilling its obligations under this Agreement.

7.6 **Accrued Royalties Payable.** Within 30 days after any termination of this Agreement, LICENSEE must pay all royalties accrued up to the date of termination, and provide an accounting for the final period.

7.7 **Rights re Inventory.** Notwithstanding any contrary provision of this Agreement, LICENSEE shall have the right for a period of 90 days to dispose of any Licensed Products (including in-process products) in its possession or control at the date of termination. However, LICENSEE must make all royalty payments relating to such Licensed Products as are otherwise required by this Agreement. Within 30 days after any termination, LICENSEE shall provide LICENSOR with a report of LICENSEE's current inventory of Licensed Products as of the date of termination.

7.8 **No Obligation to Refund.** At no time shall LICENSOR be required to refund any money paid to LICENSOR under this Agreement.

## 8. REPRESENTATIONS AND DISCLAIMER OF WARRANTIES

8.1 **Representation re Ownership.** LICENSOR represents that it is the sole owner of the Licensed Rights, that LICENSOR has not granted any other entity any right or license under the Licensed Rights, and that LICENSOR has the right to grant the exclusive license given to LICENSEE by this Agreement.

8.2 **No Warranty re Usefulness.** LICENSOR makes no warranty or representation that LICENSEE can successfully use the Licensed Rights to make Licensed Products.

8.3 **No Warranty re Infringement.** LICENSEE acknowledges that this Agreement grants LICENSEE a limited license under the Licensed Rights, and that LICENSOR makes no representations that any Licensed Product will not infringe the intellectual property rights of any third party.

8.4 **DISCLAIMER OF WARRANTIES. LICENSOR DOES NOT WARRANT THAT THE Transfer Package IS SUFFICIENT TO MAKE, USE, OR SELL THE Licensed Products OR TO EXPLOIT THE Invention OR Know-how. LICENSOR MAKES NO WARRANTIES, EITHER EXPRESS OR IMPLIED, WITH RESPECT TO THE Transfer Package OR ANY Licensed Products DESCRIBED IN THIS AGREEMENT, OR AS TO THE QUALITY, PERFORMANCE, MERCHANTABILITY, OR FITNESS FOR ANY PURPOSE OF THE Transfer Package OR ANY Licensed Products.**



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**8.5 Exclusion and Limitation of Liability.** In no event shall LICENSOR be liable to LICENSEE or any third party for direct, indirect, consequential, incidental, or punitive damages, lost profits or lost savings, resulting from any defect in or use of any Licensed Product. In no event shall LICENSOR be liable to LICENSEE for indirect, consequential, incidental, or punitive damages, lost profits or lost savings, for any breach of this Agreement.

**8.6 Indemnification by LICENSEE.** LICENSEE agrees to indemnify, defend, and hold harmless LICENSOR, and each of its employees and agents, from and against any and all liabilities, costs, expenses, damages, losses, actions, causes of action, and the like arising from or relating to (directly or indirectly) any determination that LICENSOR is liable for any direct, indirect, consequential, incidental, or punitive damages, or lost profits or lost savings, resulting from any Manufacture, marketing, Transfers, or use of, or defect in, any Licensed Products. The indemnification required by this Paragraph shall include the payment of all attorneys' fees and other expenses (not limited to taxable costs) incurred in settling or defending any threatened or actual Legal Action.

**9. GENERAL TERMS AND CONDITIONS**

**9.1 Arbitration.** All disputes between the Parties concerning (1) the terms and conditions of this Agreement and involving less than \$50,000, or (2) enforcement of the Licensed Rights against third parties (but excluding any issue about the validity of the Licensed Rights), shall be subject to expedited binding arbitration outside of the American Arbitration Association ("AAA") before an attorney or expert who is knowledgeable and experienced in the patent field, and who is selected by mutual agreement of the Parties. A Party shall commence arbitration by delivering written notice to the other Party. If the Parties fail to agree on an arbitrator within 30 days after notice of a commencement of arbitration is delivered, arbitration shall be by the AAA, subject to the rules of the AAA then in effect, except that, in any case, the arbitrator shall provide for discovery in accordance with the Federal Rules of Civil Procedure and Federal Rules of Evidence for a period of 120 days following the selection of the arbitrator. Questions relating to such discovery shall be determined by the arbitrator. Until a determination is made in the arbitration, each Party shall share equally in the payment of the expenses of the arbitrator, and LICENSEE shall continue to pay to LICENSOR all royalties required by this Agreement. Judgment upon the award rendered in any arbitration may be entered in any court having jurisdiction of the matter.

**9.2 Attorneys' Fees.** If any arbitration, litigation, or other legal proceeding occurs between the Parties relating to this Agreement, the prevailing Party shall be entitled to recover (in addition to any other relief awarded or granted) its reasonable costs and expenses, including attorneys' fees, incurred in the proceeding.

**9.3 Relationship of the Parties.** This Agreement does not constitute a partnership agreement, nor does it create a joint venture or agency relationship between the Parties. Neither Party shall hold itself out contrary to the terms of this Paragraph. It is specifically understood that each Party is an independent contractor and shall not be considered an employee, agent, or consultant of the other Party. Neither Party shall be liable for the representations, acts, or omissions of the other Party contrary to the terms of this Agreement.

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9.4 **Notices.** Unless otherwise provided for in this Agreement, all notices or other communications required or permitted under this Agreement must be in writing and either personally delivered or sent in any fashion that provides written proof of actual delivery by a third party. The effective date of delivery shall be considered to be the next business day after actual delivery. Until written notice to the contrary is given, the addresses of the Parties are as shown on the signature page of this Agreement.

9.5 **Waiver and Amendment.** No waiver, amendment, or modification of any provision of this Agreement shall be effective unless in writing and signed by the Party against whom the waiver, amendment, or modification is sought to be enforced. No failure or delay by either Party in exercising any right, power, or remedy under this Agreement shall operate as a waiver of the right, power, or remedy. No waiver of any provision, condition, or breach of this Agreement shall be construed as a waiver of any other provision, condition, or breach.

9.6 **Assignment.** This Agreement is binding upon and inures to the benefit of the successors and assigns of the Parties. However, without the prior written consent of LICENSOR (which consent shall not be unreasonably withheld), LICENSEE may not assign or transfer its rights or obligations under this Agreement, whether by (1) assignment or contract, (2) transfer by operation of law, or (3) transfer of a majority ownership interest in LICENSEE to another party, or merger of its equity, assets, or operations with another party in a manner such that the other party succeeds or would succeed to LICENSEE's rights under this Agreement by operation of law or contract.

9.7 **No Third Party Rights.** Except as provided in ¶8.6 above with respect to agents and employees of LICENSOR, this Agreement is not for the benefit of any third party, and shall not be deemed to grant any right or remedy to any third party, whether or not referred to in this Agreement.

9.8 **Interpretation.** The section and paragraph headings of this Agreement are intended as a convenience only, and shall not be used to interpret its provisions. Where the context of this Agreement requires, singular terms shall be considered plural, and plural terms shall be considered singular.

9.9 **Ambiguities.** The Parties have reviewed this Agreement, and have either had this Agreement reviewed by legal counsel or declined to do so. Accordingly, no rule of preferential interpretation for the non-drafting party shall be applied to this Agreement.

9.10 **Severability.** If any provision of this Agreement is finally held by a court or arbitration panel of competent jurisdiction to be unlawful, the remaining provisions of this Agreement shall remain in full force and effect to the extent that the intent of the Parties can be enforced.

9.11 **Governing Law and Forum.** The validity, construction, and performance of this Agreement is governed by the laws of California. Suit or arbitration with respect to this Agreement may be brought only in California. The Parties agree to submit to personal jurisdiction in California.

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9.12 **Further Assurances.** The Parties agree to execute any and all agreements and documents in connection with this Agreement in order to complete and fulfill the terms of this Agreement. Where this Agreement provides that documents are to be signed and/or filed, such shall be done within a reasonable time after the signing of this Agreement.

9.13 **Signature Authority.** The persons executing this Agreement warrant that they have the right, power, legal capacity, and appropriate authority to enter into this Agreement on behalf of the Party for which they have signed below.

9.14 **Publicity.** The Parties shall be free to publicize the existence of this Agreement after the Effective Date of this Agreement. However, each Party shall use its best efforts not to disclose specific clauses (particularly those clauses relating to payment of license fees or royalties) to any third party during the term of this Agreement, except as required by law, or by governmental regulation, requirement or order, or as may be required to establish its rights under this Agreement.

9.15 **Counterparts.** For the convenience of the Parties, this Agreement may be executed in multiple counterparts. Each Party shall deliver to every other Party a signed original of the counterpart executed by such Party. Each Party's signature page to a counterpart may be appended to any other counterpart to produce a complete document with all signatures. Each executed counterpart shall be considered an original of one and the same agreement if each Party has executed at least one counterpart.

9.16 **Effective Date.** The Effective Date of this Agreement shall be the date by which all Parties have signed at least one counterpart of this Agreement.

9.17 **Entire Agreement.** This Agreement, including all referenced attachments, constitutes the complete and final agreement between the Parties, and supersedes all prior negotiations, agreements, and understandings between the Parties concerning its subject matter.

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**AGREED:**

LICENSOR

/s/ Roger Harris

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Roger Harris  
Inventor  
address: 4 Armstrong Close  
NewMarket  
Suffolk, UK, CB88HD

Date: 19/4/97

/s/ Mark Dunnett

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Mark Dunnett  
Inventor  
address: 78 Highwood Rd.  
Gazeley  
NewMarket, Suffolk, UK, CB88RJ

Date: 19/04/97

LICENSEE

Natural Alternatives International, Inc.  
1185 Linda Vista Drive  
San Marcos, CA 92069

/s/ Mark A. LeDoux

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Mark A. LeDoux  
CEO

Date: April 28, 1997

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**APPENDIX A**  
Description of Compound X

1. Beta-alanine
2. Beta-alanine and Creatine
3. Beta-alanine, Creatine and L-Histidine
4. Active derivatives of Beta-alanine or L-Histidine
5. Beta-alanine or L-Histidine as individual amino acids, components of Dipeptides, Oligopeptides or Polypeptides

## AMENDMENT TO LICENSE AGREEMENT

1. Roger Harris and Mark Dunnett (collectively, "LICENSOR"), AND natural Alternatives International, Inc. ("LICENSEE") entered into a License Agreement ("the Agreement") effective on April 28, 1997.
2. LICENSOR and LICENSEE would hereby like to amend that Agreement by extending the term for an additional five years.
3. Therefore, LICENSOR and LICENSEE hereby agree as follows:
  - a. Section 7.1 shall be deleted, and the following new Section 7.1 shall be substituted:

"**7.1 Term.** The term of this agreement shall be from its Effective Date until the last to expire patents included with Licensed Rights."
  - b. Section 7.2 shall be modified to delete entirely the following language: " , unless one Party gives written notice of termination to the other Part at least 60 days before the end of the original Term or of any one-year renewal term. The original Term and any extension Term shall be subject to early termination under the provisions of this Section."
  - c. A new Section 2.8 shall be added, as follows:

"**2.8 Right to Make Nonexclusive.** In the event that the aggregate royalties paid by LICENSEE to LICENSOR under Section 4.2 for Transfers made by LICENSEE during the tenth year of the Term of this agreement shall be less than \$200,000.00 LICENSOR shall have the right, which must be exercised within 90 days of LICENSOR's receipt of a payment and/or a statement for the fourth quarter of the tenth year, to convert the license granted to LICENSEE under Section 2 from exclusive to non-exclusive. However, LICENSEE shall have the right to augment the payment for the aforesaid fourth quarter to bring the payment for the tenth year up to the above-stated amount, in which case, LICENSOR shall not have this right to convert. For each additional year between the tenth and the fifteenth year, if the payment is not at least the aforesaid amount increased 20% for each additional year (calculated cumulatively), LICENSOR shall have the same right to convert unless, of course, LICENSEE augments the fourth quarter payment as set forth above. After the fifteenth year, the license shall remain exclusive for the remainder of its Term irrespective of the royalties paid. Any payments made under this Section 2.8 by LICENSEE to bring a quarterly payment up to the required amount shall be nonrefundable and shall not be credited against any future royalty obligations of LICENSEE.
  - d. In Section 9.1, line 2, delete the phrase "and involving less than \$50,000".

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e. Except as set forth above, the Agreement shall remain the same.

/s/ Roger Harris

Roger Harris

/s/ Mark Dunnett

Mark Dunnett

/s/ John Wise

Natural Alternatives, by Dr. John Wise

Date 3-17-01

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

<u>Name of Subsidiary</u>	<u>State or other Jurisdiction of Incorporation or Organization</u>
Natural Alternatives International Europe S.A.	Switzerland
Custom Nutrition, LLC	Delaware, USA
CellLife Pharmaceuticals International, Inc.	California, USA
Transformative Health Products, Inc.	Delaware, USA



**Consent of Independent Registered Public Accounting Firm**

We consent to the incorporation by reference in the Registration Statement (Form S-8 No. 33-73980) pertaining to the 1992 Incentive Stock Option Plan and the 1992 Nonqualified Stock Option Plan, in the Registration Statement (Form S-8 No. 333-00947) pertaining to the 1994 Nonqualified Stock Option Plan, in the Registration Statement (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, and the Registration Statement (Form S-8 No. 333-117020) pertaining to the 1999 Omnibus Equity Incentive Plan of our report dated August 5, 2005, with respect to the consolidated financial statements and schedule of Natural Alternatives International, Inc. included in its Annual Report (Form 10-K) for the year ended June 30, 2005.

/s/ Ernst & Young LLP

San Diego, California  
September 6, 2005

**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)) 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) 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
  - c) 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;
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 8, 2005

/s/ Mark A. LeDoux

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Mark A. LeDoux, Chief Executive Officer

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

I, John R. Reaves, 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)) 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) 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
  - c) 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;
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 8, 2005

/s/ John R. Reaves

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John R. Reaves, 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, 2005 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 8, 2005

/s/ Mark A. LeDoux

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Mark A. LeDoux, Chief Executive Officer

Date: September 8, 2005

/s/ John R. Reaves

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John R. Reaves, 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.