Forward-looking Statements

This annual report includes both historical and "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. We have based these forward-looking statements on our current expectations and projections about future results. Words such as "may," "should," "could," "would," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential," "continue," or similar words are intended to identify forward-looking statements, although not all forward-looking statements contain these words. Although we believe that our opinions and expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements, and our actual results may differ substantially from the views and expectations set forth in this annual report. We disclaim any intent or obligation to update any forward-looking statements after the date of this annual report to conform such statements to actual results or to changes in our opinions or expectations.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our financial statements and related notes included elsewhere in this Annual Report. The following discussion and analysis discusses the financial condition and results of our operations on a consolidated basis, unless otherwise indicated.

Overview

We are a developer, manufacturer and marketer of a proprietary line of nutritional supplements addressing basic nutrition, specific wellness needs, weight management and sports nutrition. We also offer a line of skin care products. We sell our products through an international network marketing system using independent distributors. Sales in the United States represented approximately 90.0% of worldwide net sales for the year ended December 31, 2006, compared to approximately 90.3% for the year ended December 31, 2005. Our international operations currently generate sales through distributor networks in Australia, Canada, Germany, Ireland, Malaysia, Mexico, New Zealand, the Philippines, Singapore and the United Kingdom. We also operate on a limited basis in Austria and the Netherlands from our German office.

We derive our revenues principally through product sales made by our global independent distributor base, which, as of December 31, 2006, consisted of approximately 64,960 distributors. Our sales can be affected by several factors, including our ability to attract new distributors and retain our existing distributor base, our ability to properly train and motivate our distributor base and our ability to develop new products and successfully maintain our current product line.

All of our sales to distributors outside the United States are made in the respective local currency; therefore, our earnings and cash flows are subject to fluctuations due to changes in foreign currency rates as compared to the U.S. dollar. As a result, exchange rate fluctuations may have an effect on sales and gross margins. Accounting practices require that our results from operations be converted to U.S. dollars for reporting purposes. Consequently, our reported earnings may be significantly affected by fluctuations in currency exchange rates, generally increasing with a weaker U.S. dollar and decreasing with a strengthening U.S. dollar. Products manufactured by us for sale to our foreign subsidiaries are transacted in U.S. dollars. From time to time, we enter into foreign exchange forward contracts to mitigate our foreign currency exchange risk.

Components of Net Sales and Expense

Product sales represent the actual product purchase price typically paid by our distributors, after giving effect to distributor allowances, which can range between 20% to 40% of suggested retail price, depending on the rank of a particular distributor. Handling and freight income represents the amounts billed to distributors for shipping costs. In previous years, in addition to the required disclosure of "net sales," we reported "sales at suggested retail," representing the gross sales amount reflected on our invoices to distributors before "distributor allowances." In the current year, we have reclassified the presentation of "net sales" by presenting "product sales" and "handling & freight income." Subsequent to this classification, net sales represent product sales and handling & freight income. We record net sales and the related commission expense when the merchandise is shipped.

Our primary expenses include cost of products sold, distributor royalties and commissions and selling, general and administrative expenses.

Cost of products sold primarily consists of expenses related to raw materials, labor, quality control and overhead directly associated with production of our products and sales materials, as well as shipping costs relating to the shipment of products to distributors, and duties and taxes associated with product exports. Cost of products sold is impacted by the cost of the ingredients used in our products, the cost of shipping the distributors' orders, along with our efficiency in managing the production of our products.

Distributor royalties and commissions are monthly payments made to Master Affiliates and above, based on products sold by Master Affiliates and above sponsored by such Master Affiliates or higher-level distributors. Based on our distributor agreements, these expenses typically approximate 23% of sales at suggested retail. Also, we include other sales leadership bonuses, such as Ambassador bonuses, in this line item. We generally expect total distributor royalties and commissions to approximate 40% of our net sales. Distributor royalties and commissions are directly related to the level of our sales and, absent any changes in our distributor compensation plan, should continue at comparable levels as a percentage of net sales as in recent periods.

Selling, general and administrative expenses include the compensation and benefits paid to our employees, all other selling expenses, marketing, promotional expenses, travel and other corporate administrative expenses. These other corporate administrative expenses include professional fees, depreciation and amortization, occupancy costs, communication costs and other similar operating expenses. Selling, general and administrative expenses can be affected by a number of factors, including staffing levels and the cost of providing competitive salaries and benefits; the amount we decide to invest in distributor training and motivational initiatives; the cost of regulatory compliance, such as the costs incurred to comply with the various provisions of the Sarbanes-Oxley Act of 2002; and other administrative costs.

Results of Operations

The following table sets forth selected results of our operations expressed as a percentage of net sales for the years ended December 31, 2006, 2005 and 2004. Our results of operations for the periods described below are not necessarily indicative of results of operations for future periods.

Year ended December 31,	2006	2005	2004
Net sales	100.0%	100.0%	100.0%
Costs and expenses:			
Cost of products sold	16.6	17.0	17.2
Distributor royalties and commissions	40.1	40.0	39.8
Selling, general and administrative	33.0	32.0	33.7
Income from operations	10.3	11.0	9.3
Interest income	0.6	0.2	0.1
Interest expense	-0.0	-0.3	-0.3
Other income	0.2	0.1	0.2
Income before income taxes	11.1	11.0	9.3
Provision for income taxes	4.4	4.4	3.7
Net income	6.7%	6.6%	5.6%

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

Net Sales. Sales in the United States grew by 3.2% in the year ended December 31, 2006 compared to 2005. During 2006, our international sales increased by 6.1% over the prior year, primarily the result of continued growth in our UK market due to the efforts of the local management, and growth in our Australia/New Zealand market as the result of the focused sales development efforts.

The following table summarizes net sales by geographic market ranked by the date we began operations in each market for the years ended December 31, 2006 and 2005.

Net Sales by Region	2006		2005		Change from	Change
(in thousands)	Amount	% of Sales	Amount	% of Sales	prior year	in %
United States	$ 105,784	90.0 %	$ 102,549	90.3 %	$ 3,235	3.2%
Australia/New Zealand	2,550	2.2	2,215	2.0	335	15.1
Canada	1,638	1.4	1,668	1.5	(30)	-1.8
Mexico	1,433	1.2	1,608	1.4	(175)	-10.9
United Kingdom/Ireland	1,235	1.1	846	0.7	389	46.0
Philippines	2,198	1.9	2,328	2.0	(130)	-5.6
Malaysia/Singapore	1,805	1.5	2,031	1.8	(226)	-11.1
Germany	824	0.7	320	0.3	504	157.5
Consolidated total	$ 117,467	100.0%	$ 113,565	100.0%	$ 3,902	3.4%

The following table sets forth, as of December 31, 2006 and 2005, the number of our active distributors and Master Affiliates and above. The total number of active distributors includes Master Affiliates and above. We define an active distributor as one that enrolls as a distributor or renews its distributorship during the prior twelve months. Master Affiliates and above are distributors that have attained the highest level of discount and are eligible for royalties generated by Master Affiliates and above in their downline organization. Growth in the number of active distributors and Master Affiliates and above is a key factor in continuing the growth of our business.

Active Distributors and Master Affiliates and Above by Region	2006		2005		Change in %	
	Distributors	Master Affiliates and Above	Distributors	Master Affiliates and Above	Distributors	Master Affiliates and Above
United States	52,880	16,580	52,040	15,840	1.6%	4.7%
Australia/New Zealand	2,460	300	2,410	250	2.1	20.0
Canada	1,170	180	1,210	210	-3.3	-14.3
Mexico	1,130	240	1,630	310	-30.7	-22.6
United Kingdom/Ireland	910	160	750	100	21.3	60.0
Philippines	3,430	370	4,070	490	-15.7	-24.5
Malaysia/Singapore	2,560	410	3,250	590	-21.2	-30.5
Germany	420	130	120	50	250.0	160.0
Consolidated total	64,960	18,370	65,480	17,840	-0.8%	3.0%

In the United States, the rate of sales growth was impacted by declining new distributor enrollments over the course of 2006. In 2006, approximately 20,390 new distributors were enrolled in the United States, as compared to approximately 23,030 in 2005. Distributor retention in the United States remained consistent at approximately 62.4% for 2006 compared to a rate of 62.9% for 2005. The number of distributors reaching Master Affiliate and above in the United States was similarly impacted in 2006. In 2006, approximately 7,600 distributors qualified as new Master Affiliates and 56.7% of the Master Affiliates and above as of December 31, 2005 requalified as Master Affiliates and above during 2006. This compares to approximately 8,120 new Master Affiliates and a requalification rate of 61.6% in 2005.

We continue to focus on initiatives to improve our new distributor enrollment rates, which we believe will lead to improved sales, and continue to emphasize the importance of new distributor enrollments in our distributor training. We believe that these initiatives are beginning to have a positive impact, as shown by the slight improvement in U.S. sales in the third and fourth quarters of 2006 compared to the prior-year quarters and new distributor enrollments in the fourth quarter of 2006 compared to the fourth quarter of 2005. We were featured in the June 2006 issue of *Success from Home* magazine, a publication targeted towards people who are considering starting their own business in the network marketing industry. We have encouraged our distributors to use this magazine as a tool to help them build their sales organizations. Also, at our international distributor conference in St. Louis in late July 2006, with nearly 6,000 distributors in attendance, we announced a special bonus program, called "Mega Bonus." Via the new "Mega Bonus" program, we will award more than $700,000 in bonuses at our international conference in August 2007. The bonuses will be awarded to the top 50 distributors in group sales volume between August 1, 2006 and July 31, 2007, with the first-place winner receiving $100,000.

During the year ended December 31, 2006, net sales in our international operations increased in aggregate by 6.1% to $11.7 million compared to $11.0 million for the year ended December 31, 2005. The increase in international sales occurred primarily in UK/Ireland, Australia/New Zealand, and Germany. In 2006, Germany had its first full year of business, with net sales of $824,000, compared to $320,000 from July through December, 2005. When net sales are converted using the 2005 exchange rate for both 2006 and 2005, international net sales increased 3.4% for 2006 compared to the prior year, as the U.S. dollar strengthened against the Australian and New Zealand dollars and the Mexican peso. All other currencies in which we conduct operations strengthened against the U.S. dollar, in particular the Philippine peso and Canadian dollar.

Net sales in the Australia/New Zealand market increased by 15.1% in 2006 compared to 2005. New distributor enrollments were 893 in 2006 compared to 725 in 2005. When net sales are converted using the 2005 exchange rate for both 2006 and 2005, net sales in this market increased by 16.8%. In 2006, we invested in sales development in that region by supporting leading U.S. distributors as part of a sustained plan to develop more activity in this and other foreign markets. In total, we invested approximately $500,000 in these additional sales development expenses across our foreign markets during 2006. The sales development efforts were successful in that they had a positive impact on net sales; however, the combined net loss for the Australia/New Zealand market was $224,000 in 2006, compared to a net loss of $115,000 in 2005.

Net sales in Canada decreased by 1.8% in 2006 compared to 2005. Just as in the United States, the decline in new distributor enrollments played a role in the decline in net sales. New distributor enrollments were 441 in 2006 compared to 489 in 2005. When measured in local currency, Canadian net sales decreased by 7.9% in 2006 compared to 2005. The net loss in Canada was $2,000 for 2006, compared to net income of $77,000 in 2005. In mid-2006, we hired a sales manager to focus on the Canadian market.

Net sales in Mexico decreased 10.9% in 2006 compared to 2005. New distributor enrollments were 682 in 2006 compared to 1,048 in 2005. When measured in local currency, 2006 net sales declined by 10.7%. For most of 2006, net sales continued to be impacted by the price increase and change in distributor qualification requirements, effective March 1, 2005, to make the Mexican business model consistent with the rest of our markets. In August 2006, we named a new national sales manager for our Reliv Mexico operations. Our sales director for the US/Hispanic market will also oversee sales in our Mexico market. The net loss in Mexico for 2006 was $285,000, compared to a net loss of $446,000 in 2005.

Net sales in the United Kingdom increased by 46.0% for 2006 compared to 2005, as the efforts of our general manager hired in 2005 in the UK continued to show positive results, coupled with added U.S. distributor leader support. When measured in local currency, net sales in the UK increased by 43.9% in 2006, compared to the prior year. New distributor enrollments were 624 in 2006 compared to 447 in 2005. However, the added staffing and sales development expenses continue to impact the profitability of this market. The net loss incurred in the UK was $507,000 in 2006, compared to a net loss of $421,000 in 2005.

Net sales in the Philippines declined by 5.6% in 2006 compared to the prior year. New distributor enrollments were 2,254 in 2006 compared to 2,993 in 2005. When measured in local currency, 2006 net sales declined by 11.9%. As in Mexico, net sales continue to be impacted by the changes to our distributor qualification requirements and increased prices in the Philippines effective February 2005. The net loss in the Philippines for 2006 was $127,000, compared to a net loss of $104,000 in 2005.

Net sales in the Malaysia/Singapore market decreased by approximately 11.1% in 2006 compared to the prior year. New distributor enrollments were 1,743 in 2006 compared to 2,546 in 2005. When measured in local currency, 2006 net sales declined by 14.1%. Net sales decreased in Malaysia/Singapore because our new distributor enrollments declined by nearly 31.5% during 2006 compared to 2005, and our active distributor count decreased by 21.2%. The combined net loss for Malaysia/Singapore for 2006 was $258,000, compared to a net loss of $392,000 in 2005. We have taken steps to reduce administrative expenses in this market by moving our offices into a smaller, less-costly facility and have reduced our presence in Singapore by consolidating our operations into the Malaysian office, with distribution via a public warehouse.

Net sales in Germany increased by 157% from $320,000 in 2005 to $824,000 in 2006, our first full year of operations. New distributor enrollments were 359 in 2006, compared to 120 during the portion of 2005 that we were open for business. We began operations in Germany in July 2005. The net loss in Germany for 2006 was $473,000.

Our Direct Select program is available for distributors and their retail customers to order products in less than case lots directly from us. In the United States during 2006, we processed a total of approximately 75,870 orders under this program at a suggested retail sales value of $8.8 million, compared to 76,000 orders, at a suggested retail value of $8.4 million during 2005. The average order size at a suggested retail value increased in 2006 to $116 compared to $111 during 2005.

Cost of Products Sold. Cost of products sold as a percentage of net sales decreased slightly to 16.6% for the year ended December 31, 2006 compared to 17.0% for the year ended December 31, 2005. Gross margins improved primarily due to margin improvements on our new formulation of Reliv Classic, which was introduced in mid-February 2006, along with improved material usage variances. Partially offsetting these improvements were higher distribution costs on distributors' orders due to fuel surcharges and other increased shipping charges.

Distributor Royalties and Commissions. Distributor royalties and commissions as a percentage of net sales increased slightly to 40.1% for the year ended December 31, 2006 compared to 40.0% for the same period in 2005. Due to the structure of

our distributor compensation plan, we do not expect to experience significant fluctuations in distributor royalties and commissions as a percentage of net sales.

Selling, General and Administrative Expenses. For 2006, selling, general and administrative, or SGA, expenses increased by $2.4 million compared to 2005. Additionally, SGA expenses as a percentage of net sales increased from 32.0% in 2005 to 33.0% in 2006.

Sales and marketing expenses represented approximately $1.8 million of the 2006 increase, including the increased international sales development expenses of $508,000, and increased promotional bonuses, such as the "Mega Bonus", of $482,000 and promotional trip expenses of $289,000 related to sales volume. Expenses for distributor conferences, such as our International Conference and regional conferences, increased by $200,000. Distribution and warehouse expenses increased by $202,000 due to higher wages and fringe benefit expenses. General and administrative expenses increased by approximately $383,000. Major components of the increase were an increase in salaries, bonuses, and fringe benefit expenses of $637,000 and an increase in business insurance expense of $215,000. Offsetting the increases were decreases in professional and consulting fees, legal, and accounting fees of $459,000.

Interest Income/Expense. Interest income increased to $693,000 for the year ended December 31, 2006, compared to $238,000 for the same period in 2005. Interest expense decreased to $50,000 for 2006 compared to $313,000 for 2005. The decrease is the result of a lower outstanding debt level during the year ended December 31, 2006, compared to 2005. In April 2006, we completed a public offering of our common stock, which yielded $11.9 million in net proceeds to us. A portion of the proceeds was used to pay off the remaining balance of $2.2 million on a note we entered into in March 2005 to purchase the shares of our common stock owned by a former officer/director and his wife. The increase in interest income is the result of the earnings on the remaining proceeds and higher interest rates compared to the prior year.

Income Taxes. We recorded income tax expense of $5.1 million for 2006, an effective rate of 39.3%. In 2005, we recorded income tax expense of $5.0 million, an effective rate of 39.8%. The lower effective rate in 2006 is the result of the benefit of tax-exempt interest income, coupled with the Federal excise tax credit available on telecommunications services.

Net Income. Our net income improved to $7.9 million ($0.48 per share basic and $0.47 per share diluted) for the year ended December 31, 2006 compared to $7.5 million ($0.47 per share basic and $0.46 per share diluted) for 2005. Profitability increased slightly commensurate with the increase in net sales in the United States, as discussed above, and the increase in interest income. Net income in the United States was $9.8 million in 2006, compared to $9.2 million in 2005. The net loss from international operations was $1.9 million in 2006, compared to a net loss of $1.7 million in 2005.

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

Net Sales. Sales in the United States grew by 22.3% in the year ended December 31, 2005 compared to 2004. During 2005, our international sales declined by 16.0% over the prior year, primarily the result of price increases and changes made to the distributor qualification requirements made in our Mexican and Philippine markets. Also contributing to the net sales increase during 2005 were sales from the introduction of our newest product, CardioSentials. Introduced in February 2005, net sales of this product were $3.9 million for the year ended December 31, 2005.

The following table summarizes net sales by geographic market for the years ended December 31, 2005 and 2004:

Net Sales by Region	2005		2004		Change from	Change
(in thousands)	Amount	% of Sales	Amount	% of Sales	prior year	in %
United States	$ 102,549	90.3%	$ 83,873	86.5%	$ 18,676	22.3%
Australia/New Zealand	2,215	2.0	2,543	2.6	(328)	-12.9
Canada	1,668	1.5	1,751	1.8	(83)	-4.7
Mexico	1,608	1.4	2,634	2.7	(1,026)	-39.0
United Kingdom/Ireland	846	0.7	545	0.6	301	55.2
Philippines	2,328	2.0	2,865	3.0	(537)	-18.7
Malaysia/Singapore	2,031	1.8	2,771	2.9	(740)	-26.7
Germany	320	0.3	—	—	320	—
Consolidated total	$ 113,565	100.0%	$ 96,982	100.0%	$ 16,583	17.1%

The following table sets forth the number of our active distributors and Master Affiliates and above, as of December 31, 2005 and 2004:

Active Distributors and Master Affiliates and Above by Region	2005 Distributors	2005 Master Affiliates and Above	2004 Distributors	2004 Master Affiliates and Above	Change in % Distributors	Change in % Master Affiliates and Above
United States	52,040	15,840	47,190	12,460	10.3%	26.8%
Australia/New Zealand	2,410	250	3,040	290	-20.7	-17.2
Canada	1,210	210	1,480	210	-18.2	0.0
Mexico	1,630	310	9,000	710	-81.9	-56.3
United Kingdom/Ireland	750	100	450	60	66.7	66.7
Philippines	4,070	490	6,760	650	-39.8	-24.6
Malaysia/Singapore	3,250	590	5,280	730	-38.4	-19.2
Germany	120	50	—	—	—	—
Consolidated total	65,480	17,840	73,200	15,110	-10.5%	17.8%

In the United States, new distributor enrollments, high retention and continued growth in the number of Master Affiliates and above continue to be key factors in our sales growth. In 2005, over 23,030 new distributors were enrolled in the United States, as compared to approximately 22,980 in 2004. Distributor retention in the United States was approximately 62.9% for 2005 compared to a rate of 57.7% for 2004. The number of distributors reaching Master Affiliate and above also continued to improve in the United States. In 2005, approximately 8,120 distributors qualified as new Master Affiliates and 61.6% of the Master Affiliates and above as of December 31, 2004 requalified as Master Affiliates and above during 2005. This compares to approximately 6,860 new Master Affiliates and a requalification rate of 61.2% in 2004.

During the year ended December 31, 2005, net sales in our international operations declined in aggregate by 16.0% to $11.0 million compared to $13.1 million for the year ended December 31, 2004. The decrease in international sales occurred primarily in Mexico, Malaysia/Singapore and the Philippines because of a change in our distributor qualification requirements, which resulted in a decrease in our number of distributors in those markets. When net sales are converted using the 2004 exchange rate for both 2004 and 2005, international net sales declined 18.1% for 2005 compared to the prior year, as the U.S. dollar weakened against every currency in which we conduct operations during 2005.

Net sales in the Australia/New Zealand market decreased by 12.9% in 2005 compared to 2004. New distributor enrollments were 725 in 2005 compared to 1,419 in 2004. When net sales are converted using the 2004 exchange rate for both 2004 and 2005, net sales in this market decreased by 15.6%. As a result of the decline in sales during the first half of 2005, the contract of the sales manager for that market was terminated during the second quarter of 2005, and we named a new sales manager in September 2005. The combined net loss for the Australia/New Zealand market was $115,000 in 2005, compared to a net loss of $132,000 in 2004.

Net sales in Canada decreased by 4.7% in 2005 compared to 2004. The decline in net sales was due in part to the decline in new distributor enrollments. New distributor enrollments were 489 in 2005 compared to 853 in 2004. When measured in local currency, Canadian net sales decreased by 11.1% in 2005 compared to 2004. Net income in Canada was $77,000 for 2005, compared to $249,000 in 2004.

Net sales in Mexico decreased 39.0% in 2005 compared to 2004. New distributor enrollments were 1,048 in 2005 compared to 7,904 in 2004. When measured in local currency, 2005 net sales declined by 41.3%. Net sales declined subsequent to a price increase and change in distributor qualification requirements, effective March 1, 2005, to make the Mexican business model consistent with the rest of our markets. The net loss in Mexico for 2005 was $446,000, compared to a net loss of $113,000 in 2004.

Net sales in the United Kingdom increased by 55.2% for 2005 compared to 2004, as the efforts of our new general manager and national sales manager in the UK began to show positive results. When measured in local currency, net sales in the UK increased by 56.3% in 2005, compared to the prior year. New distributor enrollments were 447 in 2005 compared to 193 in 2004. However, the added staffing and sales development expenses more than offset the gain in sales. The net loss incurred in the UK was $421,000 in 2005, compared to a net loss of $183,000 in 2004.

As in Mexico, we changed our distributor qualification requirements and increased prices in the Philippines effective February 2005. Net sales in the Philippines declined by 18.7% in 2005 compared to the prior year. New distributor enrollments were 2,993 in 2005 compared to 5,360 in 2004. When measured in local currency, 2005 net sales declined by 20.2%. The net loss in the Philippines for 2005 was $104,000, compared to a net loss of $164,000 in 2004.

Net sales in the Malaysia/Singapore market decreased by approximately 26.7% in 2005 compared to the prior year. New distributor enrollments were 2,546 in 2005 compared to 4,906 in 2004. In comparison to 2004, currency fluctuation in 2005 had a negligible effect on sales in this market. Net sales decreased in Malaysia/Singapore because our new distributor enrollments declined by nearly 48.1% during 2005 compared to 2004, and our active distributor count decreased by 38.4%. The decrease in new distributors in this market resulted from a change in our distributor qualification requirements. The combined net loss for Malaysia/Singapore for 2005 was $392,000, compared to a net loss of $170,000 in 2004.

We began operations in Germany in July 2005. We had net sales of approximately $320,000 during our first six months.

Our Direct Select program is available for distributors and their retail customers to order products in less than case lots directly from us. In the United States during 2005, we processed a total of approximately 76,000 orders under this program at a suggested retail sales value of $8.4 million, compared to 58,800 orders, at a suggested retail value of $6.2 million during 2004. The average order size at a suggested retail value increased in 2005 to $111 compared to $106 during 2004.

Cost of Products Sold. Cost of products sold as a percentage of net sales decreased slightly to 17.0% for the year ended December 31, 2005 compared to 17.2% for the year ended December 31, 2004. Raw material costs remained fairly stable throughout the year, and operating efficiencies gradually improved during 2005 subsequent to the installation of new production equipment during the third and fourth quarters of 2004.

Distributor Royalties and Commissions. Distributor royalties and commissions as a percentage of net sales increased slightly to 40.0% for the year ended December 31, 2005 compared to 39.8% for the same period in 2004. The increase was due to changes made during the first quarter of 2005 to the distributor compensation plan in the Philippines and Mexico, resulting in commission payments being made on the full suggested retail value of the products sold. With these changes, commission payments are now uniform throughout our domestic and international markets.

Selling, General and Administrative Expenses. For 2005, selling, general and administrative, or SGA, expenses increased by $3.6 million compared to 2004. However, SGA expenses as a percentage of net sales declined from 33.7% in 2004 to 32.0% in 2005.

Sales and marketing expenses represented approximately $1.9 million of the 2005 increase, including increased credit card fees due to the higher sales volume, and increased promotional bonuses and promotional trip expenses related to sales volume. General and administrative expenses increased by approximately $1.6 million, primarily in salaries and bonuses, fringe benefit expenses, travel expenses, professional service fees, and director's fees. These increases were offset by declines in certain areas. Legal fees decreased by $163,000, and accounting fees and related expenses decreased by $669,000 in 2005 compared to the prior year. The decrease in accounting fees and related expenses is due in part to our establishment of an internal audit department to supplement management's efforts related to documenting and assessing our internal controls. In the prior year, we incurred additional third party expenses with the adoption of the internal control documentation requirements of the Sarbanes-Oxley Act.

During 2005, we incurred SGA expenses of approximately $645,000 in our most recent market entry, Germany. We began operations in Germany on July 18, 2005.

Interest Expense. Interest expense increased to $313,000 for the year ended December 31, 2005 compared to $243,000 for 2004. The increase is the result of higher interest rates on the term loan on our headquarters facility, coupled with additional interest expense incurred on a note we entered into in March 2005 to purchase the shares of our common stock owned by a former officer/director and his wife. The interest rate on the term loan on our headquarters facility was a variable rate loan with interest equal to the prime rate. This loan was paid in full in June 2005. The note to purchase the stock owned by the former officer/director was for $3.5 million with an interest rate of 4.0% per year, of which $3.1 million was outstanding as of December 31, 2005. We also issued a note for $593,000 to the wife of the former officer and director, which was repaid immediately after its issuance.

Income Taxes. We recorded income tax expense of $5.0 million for 2005, an effective rate of 39.8%. In 2004, we recorded income tax expense of $3.6 million, an effective rate of 40.2%. The lower effective rate in 2005 is the result of the new Domestic Manufacturing Deduction, enacted by the American Jobs Creation Act of 2004, beginning with the 2005 tax year.

Net Income. Our net income improved to $7.5 million ($0.47 per share basic and $0.46 per share diluted) for the year ended December 31, 2005 compared to $5.4 million ($0.34 per share basic and $0.31 per share diluted) for 2004. Profitability continued to increase as net sales improved in the United States, as discussed above. Net income in the United States was $9.2 million in 2005, compared to $5.9 million in 2004. The net loss from international operations was $1.7 million in 2005, compared to a net loss of $513,000 in 2004.

Financial Condition, Liquidity and Capital Resources

We generated $9.0 million of net cash during 2006 from operating activities, $9.3 million was used in investing activities, and we generated $3.8 million in financing activities. This compares to $12.5 million of net cash provided by operating activities, $1.6 million used in investing activities, and $15.2 million used in financing activities in 2005. Cash and cash equivalents increased by $3.7 million to $9.3 million as of December 31, 2006 compared to December 31, 2005. We also have $7.9 million in short-term investments as of December 31, 2006.

Significant changes in working capital items consisted of a decrease in inventories of $897,000, a decrease in prepaid expenses and other current assets of $154,000, an increase in refundable income taxes of $260,000, and a decrease in income taxes payable of $822,000 in 2006. The decrease in inventory is a result of an effort to improve inventory turnover. The decrease in prepaid expenses/other current assets is due to the timing of deposits due on promotional trips due in 2006 compared to the prior year. The increase in refundable income taxes and the decrease in income taxes payable is the result of our income tax deposits being based on a higher projected pre-tax income for 2006 versus actual results.

Our net investing activities included $477,000, $1.6 million, and $1.8 million for capital expenditures in the years ended December 31, 2006, 2005 and 2004, respectively. Investing activities for 2006 also included a net purchase of $8.9 million in short and long-term investments. The short-term investments of $7.9 million are comprised of investment grade variable rate debt obligations issued by various state and municipal governments and certificates of deposit. Long-term investments of $1.0 million represent an investment as a limited partner in a private equity fund.

Financing activities in 2006 included $11.9 million in net proceeds from the common stock offering that closed in April 2006, $1.7 million in common stock dividends paid, $3.6 million in our treasury stock purchases, $317,000 in proceeds from options and warrants exercised and excess tax benefits from stock-based compensation, and $3.1 million of principal payments made on long-term borrowings. These payments paid off the balance of a promissory note for the purchase of common stock from a former officer/director and his wife that occurred in March 2005. The most significant financing activity in 2005 was $13.8 million in purchases of treasury stock. Of the $13.8 million in stock purchases, $9.7 million was paid in cash and notes were issued for the remaining $4.1 million. As of December 31, 2005, $3.1 million of the notes was outstanding. The majority of this treasury stock was purchased from a former officer, a former officer/director and his wife, and three of our current officers and/or directors. In March 2005, we announced that our board of directors had approved a stock repurchase plan of our common stock of up to $15 million over the next three years. Approximately $4.3 million of stock was purchased in the open market during 2005. In June 2005, we also paid the remaining balance of the long-term debt on our headquarters facility totaling approximately $3.5 million. In 2005, we also paid $1.2 million in common stock dividends and received $274,000 in proceeds from the exercise of options and warrants. In 2004, we paid $975,000 for the redemption of preferred stock, $12,000 in preferred stock dividends and $1.0 million in common stock dividends. We also used $1.3 million to purchase treasury stock and received $292,000 in proceeds from the exercise of options and warrants. In 2004, all treasury stock was purchased from related parties.

Stockholders' equity increased to $27.7 million at December 31, 2006 compared with $12.6 million at December 31, 2005. The increase is primarily due to the net proceeds of the stock offering of $11.9 million, our net income during 2006 of $7.9 million, less the treasury stock purchases and common stock dividends paid. Stockholders' equity also increased by $122,000 and $1.4 million as the result of the tax benefit from the exercise of nonqualified options and warrants during the years ended December 31, 2006 and 2005, respectively.

Our working capital balance was $16.2 million at December 31, 2006 compared to $4.0 million at December 31, 2005. The current ratio at December 31, 2006 was 2.9 compared to 1.4 at previous year-end.

On February 21, 2006, we filed a registration statement on Form S-3 with the Securities and Exchange Commission relating to an underwritten public offering of 2,000,000 shares of our common stock. On April 5, 2006, we commenced the public offering at a price of $11.25 per share. The public offering was completed on April 11, 2006 and consisted of 1,200,000 shares of common stock offered and sold by us and 800,000 shares of common stock offered and sold by selling stockholders. The selling stockholders were four of our directors and/or officers. The underwriters had a 30-day option to purchase up to 300,000 additional shares from certain of the selling stockholders to cover over-allotments, if any. This option was exercised for the full 300,000 shares and closed on May 9, 2006. We did not receive any proceeds from the sale of common stock by the selling stockholders.

We have used a portion of the proceeds from the offering for the repayment of debt. We intend to use the balance of net proceeds for general corporate purposes, including working capital, continued domestic and international growth, and for possible product acquisitions. Net proceeds to us from the offering, after reduction for the underwriters' fee and other offering expenses, were $11.9 million.

We also have a $5 million secured revolving credit facility with our primary lender that we entered into in June 2006. This facility replaces the previous agreement with a $15 million limit, and expires in April 2008, and any advances accrue interest at a variable interest rate based on LIBOR. The credit facility is secured by all of our assets. The facility includes covenants to maintain total stockholders' equity of not less than $10.5 million, and that the ratio of borrowings under the facility to EBITDA shall not exceed 3.5 to 1.0. At December 31, 2006, we had not utilized any of the revolving line of credit facility and were in compliance with the minimum stockholders' equity covenant.

Management believes that our internally generated funds and the borrowing capacity under the new revolving line of credit facility will be sufficient to meet working capital requirements for the remainder of 2007.

Contractual Obligations The table below presents our contractual obligations and commercial commitments as of December 31, 2006. This consists of our operating leases. For the operating leases, the amounts shown represent the future minimum payments under noncancelable leases with initial or remaining terms in excess of one year as of December 31, 2006.

(in thousands)	Less Than 1 year	1-3 years	3-5 years	More than 5 years	Total
Operating leases	51	51	—	—	102
Total Obligations	$ 51	$ 51	$ —	$ —	$ 102

Critical Accounting Policies Our financial statements are based on the selection and application of significant accounting policies, which require management to make significant estimates and assumptions. We believe that the following are some of the more critical judgment areas in the application of our accounting policies that currently affect our financial condition and results of operations.

Inventories Inventories are valued at the lower of cost or market. Product cost includes raw material, labor and overhead costs and is accounted for using the first-in, first-out basis. On a periodic basis, we review our inventory levels in each country for estimated obsolescence or unmarketable items, as compared to future demand requirements and the shelf life of the various products. Based on this review, we record inventory write-downs when costs exceed expected net realizable value. Historically, our estimates of our obsolete or unmarketable items have been materially accurate.

In 2006, we adopted SFAS No. 151, "Inventory Costs," ("SFAS 151") which clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as period charges, rather than as an inventory value. This standard also requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. Our pre-existing accounting policy for inventory valuation was generally consistent with this guidance, and therefore, the adoption of SFAS 151 did not have a significant impact on 2006 financial results.

Foreign Currency Translation All balance sheet accounts are translated using the exchange rates in effect at the balance sheet date. Statements of operations amounts are translated using the average exchange rate for the year-to-date periods. The gains and losses resulting from the changes in exchange rates during this interim period have been reported in other comprehensive loss. Foreign currency translation adjustments exclude income tax expense (benefit) given that our investments in non-U.S. subsidiaries are deemed to be reinvested for an indefinite period of time.

Legal Proceedings In the ordinary course of business, we are subject to various legal proceedings, including lawsuits and other claims related to labor, product and other matters. We are required to assess the likelihood of adverse judgments and outcomes to these matters as well as the range of potential loss. Such assessments are required to determine whether a loss contingency reserve is required under the provisions of SFAS No. 5, "Accounting for Contingencies," and to determine the amount of required reserves, if any. These assessments are subjective in nature. Management makes these assessments for each individual matter based on consultation with outside counsel and based on prior experience with similar claims. To the extent additional information becomes available or our strategies or assessments change, our estimates of potential liability for a given matter may change. Changes to estimates of liability would result in a corresponding additional charge or benefit recognized in the statement of operations in the period in which such changes become known. We recognize the costs associated with legal defense in the periods incurred. Accordingly, the future costs of defending claims are not included in our estimated liability.

Income Tax Matters We face challenges from domestic and foreign tax authorities regarding the amount of taxes due. These challenges include questions regarding the timing and amount of deductions and the allocation of income among various taxing jurisdictions. In evaluating the exposure associated with our various filing positions, we estimate reserves for probable exposures. Based on our evaluation of our tax positions, we believe we have appropriately accrued for probable exposures. To the extent we were to prevail in matters for which accruals have been established or be required to pay amounts in excess of our reserves, our effective tax rate in a given financial statement period may be materially impacted.

At December 31, 2006, we had deferred tax assets related to net operating loss carryforwards and other income tax credits with a tax value of $2.4 million. These net operating loss carryforwards have various expiration dates, depending on the country in which they occurred. A valuation allowance of $2.3 million has been established for a portion of these deferred tax assets based on projected future taxable income and the expiration dates of these carryforwards.

Newly Adopted Accounting Pronouncements On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123(R), "Share-Based Payments" ("SFAS No. 123(R)"). Prior to the adoption of SFAS No. 123(R), we had adopted the disclosure-only provisions of SFAS No. 123 and accounted for employee stock-based compensation under the intrinsic value method, and no expense related to stock options was recognized. We adopted the provisions of SFAS 123(R) using the modified prospective transition method. Under this method, our consolidated financial statements as of and for the year ended December

31, 2006 reflect the impact of SFAS 123(R), while the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). SFAS 123(R) amends SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits be reported as a financing cash flow rather than as an operating cash flow.

We used the Black-Scholes option pricing model to determine the fair value of stock options. As a result of adopting SFAS 123(R), we incurred employee stock-based compensation cost of $63,000, net of tax, for the year ended December 31, 2006. At December 31, 2006, we had no unrecognized compensation cost relating to stock options.

Accounting Pronouncements Not Yet Implemented In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN No. 48). FIN No. 48 prescribes a more likely than not threshold for financial statement presentation and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on de-recognition of income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. FIN No. 48 is effective for us as of January 1, 2007. We are currently evaluating the impact of FIN No. 48 on our consolidated financial statements.

Quantitative and Qualitative Disclosures Regarding Market Risk

Foreign Currency Risk Our earnings and cash flows are subject to fluctuations due to changes in foreign currency rates as we have several foreign subsidiaries and continue to explore expansion into other foreign countries. As a result, exchange rate fluctuations may have an effect on sales and gross margins. Accounting practices require that our results from operations be converted to U.S. dollars for reporting purposes. Consequently, our reported earnings in future periods may be significantly affected by fluctuations in currency exchange rates, generally increasing with a weaker U.S. dollar and decreasing with a strengthening U.S. dollar. Products manufactured by us for sale to our foreign subsidiaries are transacted in U.S. dollars.

Net sales outside of the United States represented 10.0%, 9.7%, and 13.5% of total net sales in 2006, 2005, and 2004, respectively. Our primary exposures to adverse currency fluctuations would result in an increase in the cost of goods sold, relative to foreign net sales, as the vast majority of the products sold are purchased from the parent company in the United States, with prices denominated in U.S. dollars. As of December 31, 2006, we had a net investment in our foreign subsidiaries of $3.8 million (in U.S. dollars).

We have performed a sensitivity analysis as of December 31, 2006 that measures the change in the results of our foreign operations arising from a hypothetical 10% adverse movement in the exchange rate of all of the currencies the Company presently has operations in. Using the results of operations for 2006 for our foreign operations as a basis for comparison, an adverse movement of 10% would create a potential reduction in our net income of less than $50,000 and reduce the value of the net investment in the foreign subsidiaries by $384,000.

From time to time, we enter into foreign exchange forward contracts with a financial institution to sell Canadian dollars in order to protect against currency exchange risk associated with expected future cash flows. We have accounted for these contracts as freestanding derivatives, such that gains or losses on the fair market value of these forward exchange contracts are recorded as other income and expense in the consolidated statements of operations. We began 2006 holding Canadian forward exchange contracts totaling $978,000 with maturities through December 31, 2006, and a related cumulative expense of $59,000. At December 31, 2006, due to consistency in the United States – Canadian dollar exchange rate and our Canadian cash flows, we elected to no longer hold any Canadian forward exchange contracts. As of December 31, 2006, we had no hedging instruments in place to offset exposure to any foreign currencies for the countries in which we do business.

Interest Rate Risk Our interest income is subject to interest rate risk. At December 31, 2006 we hold worldwide balances of cash, cash equivalents, and short-term investments totaling more than $17 million; a substantial portion of which is invested in U.S. based financial instruments. A significant portion of our U.S. held cash and cash equivalents balances earn overnight interest income at either the daily prevailing market rate or other short-term (30 days) variable rates. Our short-term investments consist of auction rate securities and other debt securities with interest rates that typically reset every 35 days or less and fixed-rate certificates of deposit with original maturities greater than 90 days but less than one year at date of purchase. Our primary objective of our interest income strategy is to preserve principal while maximizing yields, without significantly increasing risk. Utilizing an average fiscal year 2006 quarter-end balance comprised of U.S. held cash, cash equivalents, and short term investments, a hypothetical 1% change in interest rates could result in a change in our interest income of $112,000.

As noted above, our cash, cash equivalents, and short-term investments are generally invested in short-term variable rate financial instruments in which the interest rate resets every 35 days or less. As a result of these resetting variable rates, interest rates attributable to these investments typically approximate current market rates. Therefore, we believe our market risk to unrealized gains or losses on the carrying value of these investments is not significant.

We also are exposed to market risk in changes in commodity prices in some of the raw materials we purchase for our manufacturing needs. However, this presents a risk that would not have a material effect on our results of operations or financial condition.

Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. This evaluation included review of the documentation of controls, evaluation of the design effectiveness of controls, testing of the operation effectiveness of controls and a conclusion on this evaluation. Although there are inherent limitations in the effectiveness of any system of internal control over financial reporting, based on our evaluation, management has concluded our internal controls over financial reporting were effective as of December 31, 2006.

Ernst & Young LLP, an independent registered public accounting firm, has issued an attestation report on management's assessment of internal control over financial reporting as of December 31, 2006, which is included elsewhere in this annual report.