NATURAL HEALTH TRENDS CORP
Form 10-K
July 25, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from __________ to __________.

Commission file number: 0-26272

NATURAL HEALTH TRENDS CORP.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	59-2705336 (I.R.S. Employer Identification No.)
2050 Diplomat Drive Dallas, Texas (Address of principal executive offices)	75234 (Zip code)

Registrant s telephone number, including area code: (972) 241-4080

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

None

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

Common Stock, $0.001 par value

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer (as defined in Rule 405 of the Securities Act). Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No þ

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 registrant 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. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (see definitions of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act).

Large accelerated filer o Accelerated filer o Non-Accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the closing price of such common equity on June 30, 2005 as reported by the NASDAQ National Market on that date: $74,248,760

At April 28, 2006, the number of shares outstanding of the registrant s common stock was 8,199,933 shares.

Documents Incorporated by Reference

Certain information required for Part III of this report is incorporated by reference from the registrant s proxy statement for the 2006 annual meeting of the Company s shareholders to be held during the second quarter of 2006.

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FORWARD-LOOKING STATEMENTS

Certain statements contained in this report constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements included in this report, other than statements of historical facts, regarding our strategy, future operations, financial position, estimated revenues, projected costs, prospects, plans and objectives are forward-looking statements. When used in this report, the words believe, anticipate, intend , estimate, expect, project , could may , plan , predict , pursue , continue , feel and similar expressions are intended to identify forward-looking sta although not all forward-looking statements contain these identifying words.

We cannot guarantee future results, levels of activity, performance or achievements, and you should not place undue reliance on our forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including the risks described in Risk Factors, and elsewhere in this report. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or strategic investments. In addition, any forward-looking statements represent our expectation only as of the date of this report and should not be relied on as representing our expectations as of any subsequent date. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if our expectations change.

Although we believe that the expectations reflected in any of our forward-looking statements are reasonable, actual results could differ materially from those projected or assumed in any of our forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to change and to inherent risks and uncertainties, such as those disclosed in this report. Important factors that could cause our actual results, performance and achievements, or industry results to differ materially from estimates or projections contained in forward-looking statements include, among others, the following:

§ our relationship with our distributors;

§ our need to continually recruit new distributors;

§ our internal controls and accounting methods may require further modification;

§ adverse consequences from audit committee investigations or management changes;

§ regulatory matters governing our products and network marketing system;

§ regulatory matters pertaining to direct-selling laws, specifically in China;

§ our ability to recruit and maintain key management,

§ adverse publicity associated with our products or direct selling organizations;

§ product liability claims;

§ our reliance on outside manufacturers;

§ risks associated with operating internationally, including foreign exchange risks;

§ product concentration;

§ dependence on increased penetration of existing markets;

§ the competitive nature of our business; and

§ our ability to generate sufficient cash to operate and expand our business.

Market data and other statistical information used throughout this report is based on independent industry publications, government publications, reports by market research firms or other published independent sources and on our good faith estimates, which are derived from our review of internal surveys and independent sources. Although we believe that these sources are reliable, we have not independently verified the information and cannot guarantee its accuracy or completeness.

Additional factors that could cause actual results to differ materially from our forward-looking statements are set forth in this Annual Report on Form 10-K, including under the heading Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and in our financial statements and the related notes.

Forward-looking statements in this Annual Report on Form 10-K speak only as of the date hereof, and forward looking statements in documents attached are incorporated by reference speak only as of the date of those documents. The Company does not undertake any obligation to update or release any revisions to any forward-looking statement or to report any events or circumstances after the date hereof or to reflect the occurrence of unanticipated events, except as required by law. Unless otherwise noted, the terms we, our, us, Company, refer to Natural Health Trends Corp. and its subsidiaries.

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PART I

Item 1. BUSINESS

Overview of Business

Natural Health Trends Corp. (the Company) is an international direct-selling organization. We control subsidiaries that distribute products through two separate direct-selling businesses that promote health, wellness and vitality. Lexxus International, Inc., our wholly-owned subsidiary (Lexxus U.S.), and other Lexxus subsidiaries (collectively, Lexxus), sell certain personal care, wellness and quality of life products, which accounted for approximately 99% of our consolidated net revenues in 2005. eKaire.com, Inc. (eKaire), our wholly-owned subsidiary, distributes nutritional supplements aimed at general health and wellness.

Lexxus commenced operations in January 2001 and has experienced tremendous growth. As of December 31, 2005, it is conducting business in 15 countries through approximately 119,000 active distributors. These statistics do not include the countries and distributors of KGC Networks Pte Ltd. (KGC) as the Company sold its 51% interest in that subsidiary to the minority shareholder effective December 31, 2005 (see Recent Developments). eKaire has been in business since 2000 and is operating in four countries through approximately 3,000 active distributors. We consider a distributor active if he or she has placed at least one product order with us during the preceding year.

We seek to be a leader in the direct selling industry serving the health, wellness and lifestyle marketplace by driving our products into as many venues and into as many markets as possible through our direct selling marketing operations. Our objectives are to enrich the lives of the users of our products and enable our distributors to benefit financially from the sale of our products.

We maintain executive offices at 2050 Diplomat Drive, Dallas, Texas 75234 and our telephone number is (972) 241-4080. The Company s corporate filings can be viewed on its website located at www.naturalhealthtrendscorp.com. The information provided on our website should not be considered part of this report.

Recent Developments

On February 22, 2005, the Company s common stock began trading on The NASDAQ National Market under the ticker symbol BHIP . Prior to that time, the Company s common stock was quoted on the NASD over-the-counter bulletin board under the symbol NHTC and subsequently NHLC.OB .

During April 2005, the Company launched a new product line, Gourmet Coffee Café, which consists of coffee machines and the related coffee and tea pods, in the North American market. Since the launch, the Company has experienced a high rate of defects and product returns. As a result, the Company has delayed continued sales of our existing inventory of this product and approached the manufacturer for resolution. The manufacturer has agreed to repair all of the machines in our existing inventory and provide discounts on future purchases. The Company is currently planning to re-start the sale of the coffee machines in the second half of 2006.

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On June 1, 2005, the Company held its annual meeting of shareholders. At that time, the Company s reincorporation in the State of Delaware was approved by holders of a majority of the Company s shares of common stock outstanding. On June 29, 2005, the Company re-incorporated in the State of Delaware.

The Company entered into a settlement agreement (the Toyota Agreement) dated August 31, 2005 by and among Toyota Jidosha Kabushiki Kaisha (d/b/a Toyota Motor Corporation), Toyota Motor Sales, U.S.A., Inc. (collectively, the Toyota Entities) and Lexxus U.S., pursuant to which the Toyota Entities agreed to terminate their claims against the Company, and the Company agreed to discontinue use of the Lexxus name and mark and change the name of its Lexxus operations and domain names by June 1, 2006, and sell or otherwise dispose of all product inventory marked with the name Lexxus by December 1, 2006. It is anticipated that, by June 1, 2006, the Company will change the name of Lexxus U.S. to NHT Global, Inc. and the terms Lexxus and Lexxus International will be replaced in all other uses by the Company and its subsidiaries by the terms NHT Global or a variation that includes NHT or Natural Health Trends .

During September 2005, the Company reorganized its senior management team in connection with an investigation conducted by the Company s Audit Committee. Effective October 3, 2005, each of Mark Woodburn and Terry LaCore resigned as officers and members of the Company s Board of Directors due to their failure to cooperate with the Audit Committee s investigation. The investigation was initiated in August 2005 and included allegations of misconduct by Messrs. Woodburn and LaCore asserted by an unrelated third party arising out of a lawsuit involving Mr. LaCore and such unrelated third party. From October 3, 2005 through November 13, 2005, Messrs. Woodburn and LaCore were employed as the Company s Global Managing Director Operations and Global Managing Director Business Development, respectively.

Effective October 3, 2005, the Board of Directors of the Company appointed Robert H. Hesse, a member of the Company s Board of Directors since July 2004, as the Company s Interim Chief Executive Officer. The Company also created the Office of the Chief Executive, comprised of Mr. Hesse, Chris Sharng, the Company s Executive Vice President and Chief Financial Officer, and Richard S. Johnson, President of Natural Health Trends Japan, Inc. (NHT Japan). The Office of the Chief Executive was responsible for managing the day-to-day operations of the Company. Since Mr. Hesse was no longer considered to be an independent director, he resigned from the Company s Audit Committee in September 2005.

On November 10, 2005, an independent investigator retained by the Company s Audit Committee learned that an entity controlled by Messrs. Woodburn and LaCore received payments from an independent distributor of the Company s products during 2001 through August 2005. The Company believes that Messrs. Woodburn and LaCore received from such independent distributor a total of approximately $1.4 million and $1.1 million, respectively. The Company believes that the fees paid by the Company to such independent distributor were not in excess of the amounts due under the Company s regular distributor compensation plan. The Audit Committee s investigation is continuing (see Item 1A. Risk Factors).

Approximately $2.4 million of the funds paid by the independent distributor to Messrs. Woodburn and LaCore were paid at the direction of Messrs. Woodburn and LaCore to an entity that is partially owned by Mr. Woodburn s father and Randall A. Mason, a member of the Company s Board of Directors and former Chairman of the Company s Audit Committee. The funds were subsequently paid to an entity controlled by Messrs. Woodburn and LaCore at their direction. After investigation by the Audit Committee, the Board of Directors of the Company concluded that Mr. Mason was unaware that these payments were directed by Messrs. Woodburn and LaCore to an entity partially owned by him until uncovered by the Audit s Committee s independent investigator on November 10, 2005, and that Mr. Mason was not involved in any misconduct and received no pecuniary benefit from the payments made by the independent distributor. However, since payments were directed into an entity that is partially owned by Mr. Mason, he could no longer be considered independent in accordance with the rules of The NASDAQ Stock Market and under the federal securities laws. Therefore, effective November 11, 2005, Mr. Mason resigned as Chairman and a member of the Company s Audit Committee. Mr. Mason remained as a director.

On November 14, 2005, in light of the information learned by the Company s Audit Committee on November 10, 2005, the Company terminated the employment of each of Messrs. Woodburn and LaCore. No severance was paid by the Company to Messrs. Woodburn and LaCore and the Audit Committee is investigating claims or actions that the

Company may bring against them.

In addition, a loan made by the Company under the direction of Mr. Woodburn in the aggregate principal amount of $256,000 in February 2004 was previously recorded as a loan to a third party. On November 10, 2005, the Audit Committee investigator learned that the Company actually loaned the funds to an entity owned and controlled by the parents of Mr. Woodburn. The loan was repaid in full, partially by an entity controlled by a third party and partially by an entity controlled by Mr. Woodburn in December 2004.

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On December 7, 2005, the Board of Directors expanded to six members and Anthony B. Martino, Terrence M. Morris, and Colin J. O Brien were appointed to join Sir Brian Wolfson (Chairman), Randall A. Mason, and Robert H. Hesse as members of the Company s Board of Directors. At that time, the Board of Directors also appointed the following individuals as sole members of the following committees:

Audit Committee	Compensation Committee	Nominating Committee
Anthony B. Martino (Chairman)	Colin J. O Brien (Chairman)	Sir Brian Wolfson (Chairman)
Colin J. O Brien	Terrence M. Morris	Terrence M. Morris
Terrence M. Morris		

Effective December 31, 2005, the Company entered into a Stock Purchase Agreement with Bannks Foundation, a Lichtenstein foundation and owner of 49% of the common shares of KGC, a Singapore corporation, pursuant to which the Company sold to Bannks Foundation 51,000 common shares representing the Company s 51% of the outstanding shares of capital stock of KGC for a total cash purchase price of $350,000. KGC was a Company subsidiary through which the Company s Lexxus products were sold into a separate network of independent distributors located primarily in Russia and other Eastern European countries. In connection with the sale of its interest in KGC, the Company entered into a separate agreement with KGC providing for the payment to the Company of 24 equal monthly installments of approximately $169,000 each relating to inventories ordered and partially delivered, and the settlement of its outstanding inter-company receivable. The Company also agreed to continue to supply KGC with certain products for a period of at least 48 months. As a result of these transactions, the Company will no longer include the financial statements of KGC in its consolidated financial statements. The Company does not believe these transactions result in a discontinued operation as the Company will continue to supply KGC with a significant amount of product for the foreseeable future. Therefore, the 2005 results of KGC have been reported in results from operations.

On February 10, 2006, the Company entered into an Escrow Agreement (the Agreement) with Messrs. Woodburn and LaCore, the LaCore and Woodburn Partnership, an affiliate of Woodburn and LaCore, and Krage and Janvey LLP, as escrow agent (the Agent). Pursuant to the Agreement, (i) the Company agreed to issue and deposit with the Agent stock certificates in the name of the Agent representing an aggregate of 1,081,066 shares of the Company s common stock (the Escrowed Shares) and (ii) Woodburn and LaCore deposited with the Agent $1,206,000 in immediately available funds (the Cash Deposit). The Escrowed Shares are the shares of common stock issuable upon the cashless exercise of options issued in 2001 and 2002 to LaCore and the LaCore and Woodburn Partnership for 1,200,000 shares of common stock exercisable at $1.00 and $1.10 per share. The number of Escrow Shares is based upon the closing price of the Company s common stock on February 9, 2006 of $10.14 and the surrender of 118,934 option shares as payment of the aggregate exercise price of $1,206,000.

The Escrowed Shares were issued pursuant to Section 4(2) of the Securities Act of 1933, as amended, to the Agent upon receipt from the Agent of an irrevocable proxy (the Proxy) to the Company to vote the Escrowed Shares on all matters presented at meetings of stockholders or any written consent executed in lieu thereof. The parties have agreed that the Agent will hold the Escrowed Shares and the Cash Deposit until it receives (i) joint written instructions from the Company, Woodburn and LaCore, or (ii) a final non-appealable order from a court of competent jurisdiction. Each of the Company and Woodburn and LaCore has further agreed that all current and future rights, claims, defenses and causes of actions they have or may have against each other are preserved.

On March 10, 2006, the Company entered into a letter agreement dated March 1, 2006 with Robert H. Hesse, the Company s Interim Chief Executive Officer and a member of the Board of Directors. Pursuant to the letter agreement, Mr. Hesse has agreed to continue acting as the interim chief executive officer of the Company. In addition to continuing his base pay of $2,000 per day, the Company has agreed to pay Mr. Hesse a retention bonus equal to $300,000, of which $150,000 is due and payable upon executing the letter agreement and $150,000 is due within five days after satisfactory completion of Mr. Hesse s term as Interim Chief Executive Officer.

On March 16, 2006, Richard S. Johnson, the Company and NHT Japan amended Mr. Johnson s employment agreement effective as of February 1, 2006. As amended, the employment agreement is extended through January 31, 2009. Under the amended employment agreement, Mr. Johnson will continue to serve as President of NHT Japan and will provide advice and services to the Company, as requested. For health reasons, Mr. Johnson will reside in the U.S.

and is expected to work a reduced number of hours. He will be compensated by the Company under the amended employment agreement at the rate of $2,000 per day with a minimum of $16,000 per quarter (or $64,000 per year). Under the amended employment agreement, the Company will issue to Mr. Johnson options exercisable for 8,000 shares of the Company s common stock during each year of the term of the consulting agreement. The options shall be exercisable at a price equal to the fair market value of the shares of common stock on the date of grant and will be issued pursuant to the Company s 2002 Stock Plan. The Company has also agreed to reimburse Mr. Johnson for business related expenses.

On March 28, 2006, the Board of Directors and Mr. Hesse mutually agreed that Mr. Hesse had completed his assignment as the Interim Chief Executive Officer of the Company, effective immediately. In addition, as of March 28, 2006, the Board of Directors promoted Curtis E. Broome from President-Greater China and Southeast Asia to the position of President of NHT Global designate Mr. Broome to serve as the Company s principal executive officer on an interim basis. The Search Committee of the Board of Directors continues to conduct an active search for a chief executive officer.

Also effective March 28, 2006, the Board of Directors terminated the Office of the Chief Executive and formed an Executive Management Committee (the EMC) that consists of Mr. Broome, Mr. Sharng, and John Cavanaugh, the President of the Company s MarketVision subsidiary. Terrence M. Morris, a member of the Company s Board of Directors, will have the right to attend all meetings of the EMC and will liaise with the Board of Directors regarding matters addressed by the EMC. The EMC will manage the Company s day-to-day operations and will report directly to the Board of Directors. In the event that the Board of Directors determines that continued participation with the EMC would interfere with Mr. Morris exercise of independent judgment in carrying out his responsibilities as a director, Mr. Morris may be asked to refrain from participating in EMC matters in order to preserve his status as an independent director on the Board. As compensation for Mr. Morris additional tasks, a monthly payment of $4,000 has been approved by the Board of Directors.

Additionally, on March 28, 2006, Sir Brian Wolfson decided, for personal reasons, to resign as Chairman of the Board of Directors and will continue to serve as its Vice Chairman. In connection therewith, the Board of Directors appointed Randall A. Mason, a member of the Board of Directors since May 2003, as its Chairman.

On April 6, 2006, a mutual agreement was entered into with two members of the Company s Mexico management team, Oscar De la Mora and Jose Raul Villareal, terminating the employment of Messrs. De la Mora and Villareal and all employment agreements between them and affiliates of the Company. Messrs. De la Mora and Villareal may, in the future, serve as independent distributors for the Company and its affiliates.

On April 18, 2006, the Company received a letter from The NASDAQ Stock Market stating that the Company is not in compliance with Marketplace Rule 4310(c)(14), which obligates listed issuers to timely file those reports and other documents required to be filed with the Securities and Exchange Commission. On April 25, 2006, the Company requested a hearing with the NASDAQ Hearings Panel concerning the Company s failure to file its Form 10-K in a timely fashion. The Company received a hearing date of June 1, 2006 from NASDAQ. The Company has been advised that its shares of common stock will not be delisted prior to the date of the hearing.

On April 20, 2006, the Board of Directors accepted Mr. Broome s request to resign as the Company s interim principal executive officer and appointed Mr. Sharng as the interim principal executive officer.

On May 5, 2006, the Company paid $150,000 to Mr. Hesse as provided in the above letter agreement dated as of March 1, 2006, that was signed on March 10, 2006. Mr. Hesse has released the Company from all other obligations under that letter agreement and, effective May 5, 2006, resigned from the Company s Board of Directors.

Our Principal Products

We offer several Lexxus branded products, which principally include:

Skindulgence® is a skin care system that includes a 30-Minute Non-Surgical FaceLift as well as a spa collection for hands, feet and all-over body. The 30-Minute Non-Surgical FaceLife is designed to create a more youthful appearance by helping to tone and firm facial muscles, by helping to diminish fine lines and wrinkles and by helping to improve skin tone and color. The facelift masque is coupled with a cleanser and moisturizer.

Alura® is an intimacy enhancing cream for women.

Valura Xtreme is an intimacy enhancing herbal supplement for men that will be offered for sale in 2006 to replace the *Valura* product previously offered for sale.

Premium Noni Juice is a reconstituted morinda citrifolia fruit juice, made from organic noni puree. Noni is a fruit native in the Samoan Islands of the South Pacific. Marketed as a refreshing and energizing beverage, its natural flavor has been enhanced with white grape concentrate, concord grape concentrate, pineapple juice puree and other natural flavors.

LexLips is a lip enhancing gloss designed to create the effect of fuller lips and to help reduce fine lines and wrinkles around the mouth.

La Vie is an energy-boosting dietary supplement described as a non-alcoholic red wine.

180° Life System® - Carb Blocker is a weight management product.

Triotein is a lactose-free whey protein powder that provides amino acid substrates needed to stimulate the body s production of an anti-oxidant, intracellular glutathione peroxidase, in an effort to optimize the body s ability to heal itself.

Cluster Concentrate is a product created for increased and more efficient cell hydration.

We offer Kaire branded products, generally nutritional supplements, which are organized into several broad categories such as antioxidant support, immune support, bone & joint support, digestive and dietary support, weight management, OmegaKaire hemp products, Sakaira Spa with Moor Mud, Sakaira Skin & Hair Care, Kaire Essentials and ecoKaire Home Care. Among the products offered by eKaire, *Pycnogenol ®* , *Enzogenol* , *OptiMSM* , *OptiPure®*, *Phase2* & *ActivAloe* are trademarks of our suppliers.

Operations of the Business

Sourcing of Products

The Company s independent research consultants and the executive staff work with research and development personnel of our manufacturers to create product concepts and develop the product ideas into actual products. Each of the Company s three current major product lines *Skindulgence®*, *Alura®* and *Premium Noni Juice* - were originally conceived by our manufacturing vendors. The Company or its subsidiaries then enter into supply agreements with the vendors pursuant to which the Company obtains exclusive rights to sell the products under private labels (or trademarks) that are owned by the Company. Because our current main products all came to us originally as proposals from our vendors, we have incurred minimal out-of-pocket research and development costs through December 31, 2005.

The Company or its subsidiaries generally purchase finished goods from manufacturers and sells them to our distributors for their resale or personal consumption. Aloe Commodities International (for *Skindulgence®*), 40Js LLC (for *Alura®*) and Two Harbor Trading (for *Premium Noni Juice*) are the three most significant vendors, accounting for a majority of the Company s product purchases. The Company is required to purchase from 40Js LLC a minimum volume of 15 barrels of product per quarter to maintain the exclusivity and volume discount rights granted in the agreement. The terms of these agreements are between one and three years, with annual automatic renewal. We believe that, in the event we are unable to source products from these suppliers or the other suppliers of our other products, our revenue, income and cash flow could be adversely and materially impacted.

Marketing and Distribution

Lexxus and eKaire are set up as direct-selling companies using separate networks of distributors to sell products. Our distributors are independent full-time or part-time contractors who purchase products directly from our subsidiaries via the Internet for resale to retail consumers (other than in China) or for their own personal consumption. Purchasers of our products in China may purchase only for their own personal consumption and not for resale in China. The growth of a distributor s business depends largely upon their ability to recruit a down-line network of distributors and the popularity of our products in the marketplace.

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As of December 31, 2005, we had an active physical presence in eight (the U.S., Mexico, South Korea, Japan, Taiwan, China, Australia and Canada) of the top 15 direct-selling markets in the world. We experienced a 33% increase in active Lexxus distributors during 2005, following a 97% increase in active distributors in 2004 compared to the prior year (excluding KGC distributors). The following table represents the number of active distributors by market for both Lexxus and eKaire as of December 31.

	Year Ended December 31,		
	2003	2004	2005
United States	5,295	8,876	7,309
Canada	1,793	4,020	4,662
North America	7,088	12,896	11,971
Hong Kong	28,971	63,114	86,661
Taiwan	2,323	2,533	2,873
Greater China	31,294	65,647	89,534
Singapore	797	735	527
Philippines	1,139	2,799	341
Southeast Asia	1,936	3,534	868
Australia	214	374	710
New Zealand	34	32	75
Australia/NZ	248	406	785
Russia and Eastern Europe[1]	26,775	40,727	52,679
South Korea	3,510	4,780	6,257
Latin America	192	87	1,456
Central Europe		891	1,895
Japan		848	5,947
India	883	25	
Total Lexxus distributors	71,916	129,841	171,392
Less KGC[1]	(26,775)	(40,727)	(52,679)
Total Lexxus distributors without KGC	45,151	89,114	118,713
eKaire	4,671	3,656	3,008
Total distributors	49,822	92,770	121,721

We devoted much time and resources to pursue opening the Japanese, Mexican and Chinese markets in 2005. We commenced revenue generation in Mexico and Japan in the fourth quarter of 2005. We have submitted an application for a direct selling license in China in December 2005.

To become a Lexxus or eKaire distributor, a prospective distributor must agree to the terms and conditions of our distributor agreement (posted on our respective Lexxus or eKaire website). Lexxus distributors generally pay a nominal $100 annual enrollment fee. The distributor agreement sets forth our policies and procedures, and we may elect to terminate a distributor for non-compliance.

[1] The Company will no longer consolidate the operating results of KGC for periods beginning after December 31, 2005 as it sold its 51% equity interest to Bannks Foundation effective December 31, 2005.

We pay commissions to eligible Lexxus distributors based on sales by such distributors down-line distributors during a given commission period. To be eligible to receive commissions, distributors in some countries may be required to make nominal monthly purchases of products. We believe that the uniqueness and efficacy of our Lexxus products, combined with a high commission rate, creates a highly desirable business opportunity and work environment for our Lexxus distributors. See Working with Distributors.

Distributors generally place orders through their own Internet page and pay by credit card prior to shipment. Accordingly, we carry minimal accounts receivable and credit losses are historically minimal.

We regularly sponsor promotional meetings and participate in motivational training events in key cities around the world for Lexxus distributors. These events are designed to inform prospective and existing distributors about both existing and new product lines as well as selling techniques. Distributors typically share their direct selling experiences, their individual selling styles and their recruiting methods at these promotional or training events. Prospective distributors are educated about the structure, dynamics and benefits of the direct selling industry. We are continually developing or updating our marketing strategies and programs to motivate our distributors. These programs are designed to increase distributors monthly product sales and the recruiting of new distributors in their down-lines.

Management Information Systems

The Lexxus business uses our proprietary web-based MarketVision system to process orders and to communicate volume and commissions to distributors. KGC, a majority owned subsidiary until December 31, 2005, used a third-party service provider, Septuor Consulting, and its software for functionalities similar to those provided by MarketVision (see Recent Developments). The Kaire business uses a third-party software package, Infotrax, to calculate commissions and provide each independent distributor with a detailed monthly accounting of all sales and recruiting activity. These statements eliminate the need for substantial record keeping on behalf of the distributor.

Other than MarketVision, the Company has not automated and integrated other critical business processes such as inventory management and accounting. The Company began automating the financial reporting processes with Oracle s E-Business Suite in the fourth quarter of 2005 and expects to continue this process for the first half of 2006.

Corporate History

The Company s current business can be traced back to Kaire Neutraceutical Inc., a privately owned Colorado company involved in direct selling. Mr. Mark Woodburn was engaged by its investors as an advisor and subsequently became the President in 1999. Mr. Woodburn engaged Mr. Terry LaCore as a direct selling consultant to turn around the struggling business. Mr. Woodburn assisted with its acquisition of the Company, which was an inactive publicly traded entity originally incorporated in Florida in 1988, and reverse-merged Kaire Neutraceutical Inc. into the Company in 1999. In 2000, Kaire Neutraceutical Inc. was sold to certain private investors. Also in 2000, the Company was relocated to Dallas, Texas.

In January 2001, the Company with certain minority investors launched the Lexxus business in the U.S. The move was followed by a string of international expansions of the Lexxus business that significantly fueled the growth of the Company. On March 31, 2004, the Company acquired MarketVision Communications Corp. (MarketVision), the exclusive provider of the direct selling software used by our Lexxus businesses around the world since mid-2001. Effective June 29, 2005, the Company changed its state of incorporation from Florida to Delaware.

Geographic Locations

The Company operates in 15 countries. The Company s business is generally organized along geographic lines within the two different brands:

Lexxus has active physical presence in the following markets:

- North America (United States and Canada)
- Greater China (Hong Kong, Macau, Taiwan and China) and Southeast Asia (Singapore, the Philippines and Indonesia)
- Australia and New Zealand
- South Korea
- Japan
- Latin America (primarily Mexico)
- Slovenia

eKaire has active physical presence in the following markets:

- North America (United States and Canada)
- Australia and New Zealand

Natural Health Trends Corp. is headquartered and mainly staffed in Dallas, Texas.

MarketVision is staffed in Minneapolis, Minnesota.

Until December 31, 2005, the Company owned a 51% interest in KGC, which has a physical presence in Russia and Eastern Europe.

See Item 2. Properties for specific locations of our facilities.

Employees

At December 31, 2005, the combined total number of world-wide employees for our company was 222, of which the United States had 54 employees, Cayman Islands 1, Canada 11, Hong Kong and China 73, Taiwan 26, the Philippines 1, Singapore 4, Indonesia 5, South Korea 17, Mexico 9, Japan 15, and Australia 6. The number of employees is expected to increase in the coming year, especially in China, where we anticipate using employees rather than independent distributors to market and sell our products.

Seasonality

Our revenue has generally not been impacted by seasonality on any significant basis. From quarter to quarter, the Company is somewhat impacted by seasonal factors and trends such as major cultural events and vacation patterns. For example, most Asian markets celebrate their respective local New Year in the first quarter, which generally has a small negative impact on that quarter. We believe that direct selling in the United States and Europe is also generally negatively impacted during the month of August, which is in our third quarter, when many individuals, including our distributors, traditionally take time off for vacations.

Intellectual Property

Most of the Lexxus and eKaire products are packaged under a private label arrangement. We have applied for trademark registration for names, logos and various product names in several countries into which Lexxus and eKaire are doing business or considering expanding into. We currently have three trademark registrations in the United States. Our registered trademarks expire or become renewable in 2007 and 2008, and we rely on common law trademark rights to protect our unregistered trademarks. These common law trademark rights do not provide us with the same level of protection as afforded by a United States federal registration trademark. Common law trademark rights are limited to the geographic area in which the trademark is actually utilized, while a United States federal registration of a trademark enables the registrant to discontinue the unauthorized use of the trademark by a third party anywhere in the United States even if the registrant has never used the trademark in the geographic area where the trademark is

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being used, provided, however, that the unauthorized third party user has not, prior to the registration date, perfected its common law rights in the trademark within that geographic area.

In November 2001, the inventor of our *Alura*® product, from whom we have a license to distribute *Alura*®, was awarded a patent for the formulation of that product.

As a result of a settlement agreement with Toyota Motor Sales, U.S.A. (see Item 3. Legal Proceedings), it is anticipated that, by June 1, 2006, the Company will change the name of Lexxus International to NHT Global, Inc. and the terms Lexxus and Lexxus International will be replaced in all other uses by the Company and its subsidiaries by the terms NHT Global or a variation that includes NHT or Natural Health Trends . In connection with this name change, the Company anticipates applying for registration of rights in these names and related marks in various of the countries in which we do business.

In 2005, the Company implemented a foreign holding and operating company structure for our non-United States businesses, which involved the division of our United States and non-United States operations. As part of implementing this structure, the Company and some of its United States subsidiaries granted an exclusive license to some of the Company s non-United States subsidiaries to use outside of the United States all of their intangible property, including trademarks, trade secrets and other proprietary information. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Insurance

The Company currently carries general liability insurance in the amount of $1,000,000 per occurrence and $2,000,000 in the aggregate as well as customary cargo and other insurance coverage, including coverage for international subsidiaries. We do not carry product liability insurance, but may be covered by the insurance maintained by our principal suppliers. There can be no assurance, however, that product liability insurance would be available, and if available, that it would be sufficient to cover potential claims or that an adequate level of coverage would be available in the future at a reasonable cost, if at all. A successful product liability claim could have a material adverse effect on our business, financial condition and results of operations. In November 2004, Dorothy Porter filed a complaint against the Company for strict liability, breach of warranty and negligence in the U.S. District Court for the Southern District of Illinois, alleging that she sustained a brain hemorrhage after taking Formula One, an ephedra-containing product marketed by Kaire Neutraceutical Inc., a former subsidiary of the Company (see Item 3. Legal Proceedings).

Working with Distributors

<u>Sponsorship</u>

Sponsoring of new distributors creates multiple levels in the direct-selling structure of Lexxus. The persons that a distributor sponsors within the network are referred to as sponsored distributors. Persons newly recruited are assigned by distributors into network positions that can be under other distributors, thus they can be called down-line distributors. If down-line distributors also sponsor new distributors, they create additional levels within the structure, but their down-line distributors remain in the same down-line network as their original sponsoring distributor.

We rely on our distributors to recruit and sponsor new distributors. Our top up-line distributors tend to focus on building their network of down-line distributors. While we provide product samples, brochures and other sales materials, distributors are primarily responsible for recruiting and educating their new distributors with respect to products, the compensation plan and how to build a successful distributorship network.

Distributors are not required to sponsor other distributors as their down-line, and we do not pay any commissions for sponsoring new distributors. However, because of the financial incentives provided to those who succeed in building a distributor network that consumes and resells products, we believe that many of our distributors attempt, with varying degrees of effort and success, to sponsor additional distributors. Because they are seeking new opportunities for income, people are often attracted to become distributors after using our products or after attending introductory seminars. Once a person becomes a distributor, he or she is able to purchase products directly from us at wholesale prices via the Internet. The distributor is also entitled to sponsor other distributors in order to build a network of distributors and product users.

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Compensation Plans

Lexxus employs what is commonly referred to as a binary compensation plan. We believe that one of our key competitive advantages within the direct selling industry is our compensation plan for Lexxus distributors. Under the Lexxus compensation plan, distributors are paid weekly commissions in the distributor s home country, in their local currency, for product sold by that distributor s down-line distributor network across all geographic markets. Distributors are not paid commissions on purchases or sales of our products made directly by them, but instead earn a spread between the wholesale price to the distributor and the retail price received by the distributor. This seamless compensation plan enables a distributor located in one country to sponsor other distributors located in other countries where we are authorized to do business.

Currently, there are two fundamental ways in which Lexxus distributors can earn income:

Through retail markups on sales of products purchased by distributors at wholesale prices; and

Through a series of commissions paid on product purchases made by their down-line distributors.

Each of our products carries a specified number of sales volume points, also called bonus volume or BV . Commissions are based on total personal and group sales volume points per sales period. Sales volume points are essentially based upon a percentage of a product s wholesale cost. As the distributor s business expands from successfully sponsoring other distributors who in turn expand their own businesses by sponsoring other distributors, the distributor receives higher commissions from purchases made by an expanding down-line network. To be eligible to receive commissions, a distributor may be required to make nominal monthly purchases of our products. Certain of our subsidiaries do not require these nominal purchases for a distributor to be eligible to receive commissions. In determining commissions, the number of levels of down-line distributors included within the distributor s commissionable group increases as the number of distributorships directly below the distributor increases. Under our current compensation plan, commissions may be limited to 60% of sales. In some markets, commissions may be further limited. From time to time we make modifications and enhancements to our compensation plan to help motivate distributors, which can have an impact on distributor commissions. From time to time we also enter into agreements for business or market development, which may result in additional compensation to specific distributors.

Distributor Support

We are committed to providing a high level of support services tailored to the needs of our distributors in each marketplace we are serving. We attempt to meet the needs and build the loyalty of distributors by providing personalized distributor services and by maintaining a generous product return policy (see Product Warranties and Returns). Because many of our distributors are working on a part-time basis and have only a limited number of hours each week to concentrate on their business, we believe that maximizing a distributor s efforts by providing effective distributor support has been, and could continue to be, important to our success.

Through training meetings, annual conventions, web-based messages, distributor focus groups, regular telephone conference calls and other personal contacts with distributors, we seek to understand and satisfy the needs of our distributors. Via our websites, we provide product fulfillment and tracking services that result in user-friendly and timely product distribution. Most of our offices maintain meeting rooms, which our distributors may utilize for training and sponsoring activities.

To help maintain communication with our distributors, we offer the following support programs:

Teleconferences. Lexxus and eKaire hold teleconferences with company management and associate field leadership on various subjects such as technical product discussions, distributor organization building and management techniques.

Internet. We maintain our main website at www.naturalhealthtrendscorp.com. On this website, the user can read company news, learn more about various products, sign up to be a distributor, place orders, and track the fulfillment and delivery of their order.

Product Literature. We offer a variety of literature to distributors, including product catalogs, informational brochures, pamphlets and posters for individual products.

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Toll Free Access. eKaire offers a toll free number to place orders and to sponsor new distributors. Lexxus offers these services only through its websites. Both eKaire and Lexxus offer live consumer support where a customer service representative can address general questions or concerns.

Broadcast E-mail. Announcements about Lexxus and eKaire are sent via e-mail to all active distributors.

Technology and Internet Initiatives

We believe that the Internet has become increasingly important to our business as more consumers communicate online and purchase products over the Internet as opposed to traditional retail and direct sales channels. As a result, we have committed significant resources to our e-commerce capabilities and the abilities of our distributors to take advantage of the Internet. Substantially all of our sales have occurred via the Internet. eKaire has a personalized website for its distributors to purchase products via the Internet. Lexxus offers a global web page that allows a distributor to have a personalized website through which he or she can sell products in all of the countries in which we do business. Links to these websites can be found at our main website at www.naturalhealthtrendscorp.com. The information provided on these websites should not be considered part of this report.

Rules Affecting Distributors

Our distributor policies and procedures establish the rules that distributors must follow in each country. We also monitor distributor activity in an attempt to provide our distributors with a level playing field so that one distributor may not be disadvantaged by the activities of another. We require our distributors to present products and business opportunities in an ethical and professional manner. Distributors further agree that their presentations to customers must be consistent with, and limited to, the product claims and representations made in our literature.

We require that we produce or pre-approve all sales aids used by distributors such as videotapes, audiotapes, brochures and promotional clothing. Further, distributors may not use any form of media advertising to promote products unless it is pre-approved by the Company. Products may be promoted only by personal contact or by literature produced or approved by us. Distributors are not entitled to use our trademarks or other intellectual property without our prior consent.

Our compliance department reviews reports of alleged distributor misbehavior. If we determine that a distributor has violated our distributor policies or procedures, we may terminate the distributor s rights completely. Alternatively, we may impose sanctions, such as warnings, probation, withdrawal or denial of an award, suspension of privileges of the distributorship, fines, withholding commissions, until specified conditions are satisfied or other appropriate injunctive relief. Our distributors are independent contractors, not employees, and may act independently of us. Further, our distributors may resign or terminate their distributorship at any time without notice. See Item 1A Risk Factors Although Our Distributors Are Independent Contractors, Improper Distributor Actions That Violate Laws or Regulations Could Harm Our Business.

Government Regulations

Government Regulation of Direct Selling Activities

Direct selling activities are regulated by various federal, state and local governmental agencies in the United States and foreign countries. These laws and regulations are generally intended to prevent fraudulent or deceptive schemes often referred to as pyramid schemes, that compensate participants for recruiting additional participants irrespective of product sales, use high pressure recruiting methods and/or do not involve legitimate products. The laws and regulations in our current markets often:

- impose cancellation/product return, inventory buy backs and cooling off rights for consumers and distributors;
- require us or our distributors to register with governmental agencies;
- impose reporting requirements; and
- impose upon us requirements, such as requiring distributors to maintain levels of retail sales to qualify to receive commissions, to ensure that distributors are being compensated for sales of products and not for recruiting new distributors.

The laws and regulations governing direct selling are modified from time to time to address concern of regulators. For example, in South Korea, regulations were adopted that, among other things, restrict direct selling marketing companies from imposing certain personal sales quota to obtain or maintain distributorship or favorable compensation rates, modify product return requirements so that product must be returned within a shorter period of time, and require the companies to show sufficient insurance or guarantee to reimburse customers and/or distributors for cancelled or unfilled orders. We have had to make some modifications to our compensation plan and policies in order to be in compliance with all of these rules.

Based on research conducted in opening our existing markets, the nature and scope of inquiries from government regulatory authorities, and our history of operations in such markets to date, we believe that our methods of distribution are in compliance in all material respects with the laws and regulations relating to direct selling activities of the countries in which we currently operate. Many countries currently still have laws in place that would prohibit us from conducting business in such markets. There can be no assurance that we would be allowed to continue to conduct business in each of our existing markets that we currently service or any new market we may enter in the future.

Regulation of Our Products

Our products and related promotional and marketing activities are subject to extensive governmental regulation by numerous domestic and foreign governmental agencies and authorities, including the FDA, the FTC, the Consumer Product Safety Commission, the United States Department of Agriculture, state attorneys general and other state regulatory agencies, and similar government agencies in each country in which we operate. For example, in Taiwan, all medicated cosmetic and pharmaceutical products require registration. These regulations can limit our ability to import products into new markets and can delay introductions of new products into existing markets as we comply with the registration and approval process for our products.

During the fall of 2003, the customs agency of the government of South Korea brought a charge against LXK, Ltd. (LXK), the Company s wholly owned subsidiary operating in South Korea, with respect to the importation of the Company s *Alura*® product. The customs agency alleges that *Alura*® is not a cosmetic product, but rather should be categorized and imported as a pharmaceutical product. This allegation prevailed in a Seoul district court ruling in February 2005. In the verdict, the Company was fined and prohibited from marketing *Alura*®. The Company is currently appealing against the Seoul district court ruling. See Item 3. Legal Proceedings.

Some of our products are strictly regulated in certain markets in which we operate. These markets have varied regulations that apply to and distinguish nutritional health supplements from drugs or pharmaceutical products. For example, the FDA of the United States under the Federal Food, Drug and Cosmetic Act regulates our products. The Federal Food, Drug and Cosmetic Act has been amended several times with respect to nutritional supplements, most recently by the Nutrition Labeling and Education Act and the Dietary Supplement Health and Education Act. The Dietary Supplement Health and Education Act establishes rules for determining whether a product is a dietary supplement. Under this statute, dietary supplements are regulated more like foods than drugs, are not subject to the food additive provisions of the law, and are generally not required to obtain regulatory approval prior to being introduced to the market. None of this limits, however, the FDA s power to remove an unsafe substance from the market. In the event a product, or an ingredient in a product, is classified as a drug or pharmaceutical product in any market, we would generally not be able to distribute that product in that market through our distribution channel because of strict restrictions applicable to drug and pharmaceutical products.

Most of our existing major markets also regulate product claims and advertising regarding the types of claims and representations that can be made regarding the efficacy of products, particularly dietary supplements. Accordingly, these regulations can limit our ability and that of our distributors to inform consumers of the full benefits of our products. For example, in the United States, we are unable to make any claim that any of our nutritional supplements will diagnose, cure, mitigate, treat or prevent disease. The Dietary Supplement Health and Education Act permits only substantiated, truthful and non-misleading statements of nutritional support to be made in labeling, such as statements describing general well-being resulting from consumption of a dietary ingredient or the role of a nutrient or dietary ingredient in affecting or maintaining a structure or a function of the body. In addition, all product claims must be substantiated.

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Other Regulatory Issues

As a company incorporated in the United States and operating through subsidiaries in foreign jurisdictions, we are subject to foreign exchange control, various forms of withholding taxes and transfer pricing laws that regulate the flow of funds between our subsidiaries and us for product purchases, management services and contractual obligations such as the payment of distributor commissions.

Product Warranties and Returns

The Lexxus refund policies and procedures closely follow industry and country-specific standards, which vary greatly by country. For example, in the United States, the Direct Selling Association recommends that direct sellers permit returns during the twelve-month period following the sale, while in Hong Kong the standard return policy is 14 days following the sale. Our return policies have conformed to local laws or the recommendation of the local direct selling association. In most cases, distributors who timely return unopened product that is in resalable condition may receive a refund. The amount of the refund may be dependent on the country in which the sale occurred, the timeliness of the return, and any applicable re-stocking fee. Lexxus must be notified of the return in writing and such written requests would be considered a termination notice of the distributorship.

From time to time, we alter our return policy in response to special circumstances. For example, in April 2004, an investigative television program was aired in the People s Republic of China with respect to the operations of the Company s Hong Kong subsidiary and the Lexxus representative office located in Beijing. The television program made allegations that Lexxus s Hong Kong operations engaged in fraudulent activities and sold products without proper permits. In order to address the concerns of many independent distributors, Lexxus extended its existing 14-day return policy in Hong Kong to 180 days to allow distributors and customers who purchased products during the two-week period prior to, and the two-week period after, the airing of the television program to return purchased merchandise for a full refund. In October 2004, this special extended product return policy expired.

Our Industry

We are engaged in the direct selling industry, selling life-style enhancement products, cosmetics, personal care and nutritional supplements. Direct selling is also referred to as network marketing or multi-level marketing. This type of organizational structure and approach to marketing and sales has proven to be extremely successful for several other direct selling companies, particularly companies selling life-style-enhancement products, cosmetics and nutritional supplements, or selling other types of consumer products, such as Tupperware Corporation and Amway Corp. Generally, direct selling is based upon an organizational structure in which independent distributors of a company s products are compensated for sales made directly to consumers.

Lexxus distributors are compensated for sales generated by distributors they recruited and all subsequent distributors recruited by their down-line network of distributors. The experience of the direct selling industry has been that once a sizeable network of distributors is established, new and alternative products and services can be offered to those distributors for sale to consumers and additional distributors. The successful introduction of new products can dramatically increase sales and profits for both distributors and the direct selling marketing organization.

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Approximately 55 million individuals are now involved in direct selling worldwide and those involved in direct selling generate approximately $96 billion in annual sales around the world.

	Retail Sales (In Millions)	Number of Distributors (In Thousands)	Sales per Distributor
United States	$ 29,900	13,600	$ 2,199
Japan	23,000	2,000	11,500
South Korea	8,030	4,650	1,727
Brazil	3,921	1,539	2,548
Mexico	3,346	1,850	1,809
United Kingdom	3,032	520	5,831
Italy	2,979	272	10,952
Germany	2,875	206	13,956
Taiwan	2,000	3,877	516
France	1,718	170	10,106
Russia	1,268	2,305	550
Malaysia	1,400	3,000	467
Australia	1,083	700	1,547
Canada	1,000	898	1,114
Thailand	880	4,100	215
Argentina	662	683	969
Poland	644	585	1,101
Indonesia	625	5,427	115
Spain	623	136	4,581
Colombia	583	650	897
Other	6,308	7,798	809
Total	$ 95,877	54,966	1,744

Source: World Federation of Direct Selling Associations (www.wfdsa.org) as of March 8, 2006

Competition

We compete with a significant number of other retailers that are engaged in similar lines of business, including sellers of health-related products and other direct sellers such as Nu Skin Enterprises, Inc., USANA Health Sciences, Inc., Mannatech, Inc., Reliv International, Inc, and Herbalife, Ltd.. Many of the competitors have greater name recognition and financial resources than us as well as many more distributors. The direct selling channel tends to sell products at a higher price compared to traditional retailers, which poses a degree of competitive risk. There is no assurance that we would continue to compete effectively against retail stores, internet based retailers or other direct sellers.

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Item 1A. RISK FACTORS

Risks Related to Our Business

As A Network Marketing Company, We Rely On An Independent Sales Force and We Do Not Have Direct Control Over The Marketing Of Our Products.

We rely on non-employee, independent distributors to market and sell our products. We have a large number of distributors and a relatively small corporate staff to implement our marketing programs and to provide motivational support and training to our distributors. Directors may voluntarily terminate their agreements with us at any time, and there is typically significant turnover in our distributors from year to year. We anticipate using employees rather than independent distributors to market and sell our products in China.

Since We Cannot Exert The Same Level Of Influence Or Control Over Our Independent Distributors As We Could Were They Our Own Employees, Our Distributors Could Fail To Comply With Our Distributor Policies and Procedures, Which Could Result in Claims Against Us That Could Harm Our Financial Condition and Operating Results.

Our distributors are independent contractors and, accordingly, we are not in a position to directly provide the same direction, motivation and oversight as we would if distributors were our own employees. As a result, there can be no assurance that our distributors will participate in our marketing strategies or plans, accept our introduction of new products, or comply with our distributor policies and procedures. Extensive federal, state and local laws regulate our business, our products and our network marketing program. Because we have expanded into foreign countries, our policies and procedures for our independent distributors differ due to the different legal requirements of each country in which we do business. While we have implemented distributor policies and procedures designed to govern distributor conduct and to protect the goodwill associated with the Company s trademarks and tradenames, it can be difficult to enforce these policies and procedures because of the large number of distributors and their independent status given the size and diversity of our distributor force, we experience problems with distributors from time to time, especially with respect to our distributors in foreign markets. Distributors often desire to enter a market, before we have received approval to do business, to gain an advantage in the marketplace. Improper distributor activity in new geographic markets could result in adverse publicity and can be particularly harmful to our ability to ultimately enter these markets. Violations by our distributors of applicable law or of our policies and procedures in dealing with customers could reflect negatively on our products and operations, and harm our business reputation. In addition, it is possible that a court could hold us civilly or criminally accountable based on vicarious liability because of the actions of our independent distributors. If any of these events occur, the value of an investment in our common shares could be impaired.

Loss Of Key Personnel Could Adversely Affect Our Business.

Our future success depends to a significant degree on the skills, experience and efforts of our top management. In November 2005, the Company terminated the top two employees, Mark D. Woodburn, formerly the President, and Terry A. LaCore, formerly the Chief Executive Officer of Lexxus U.S., due to misconduct (see Item 1. Recent Developments). The loss of the services of these two individuals could have a material adverse effect on our business, results of operations and financial condition. We also depend on the ability of our executive officers and other members of senior management to work effectively as a team. We currently have an interim Chief Executive Officer, and the failure to identify and hire a permanent replacement, or the loss of one or more of our other executive officers or members of our senior management could have a material adverse effect on our business, results of operations and financial condition.

We May Be Unable To Protect Our Proprietary Technology Rights.

Our success depends to a significant degree upon the protection of our MarketVision software and other proprietary technology rights. We rely on trade secret, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. Moreover, the laws of some countries in which we market our products may afford little or no effective protection of our proprietary technology. The reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it. This could have a material adverse effect on our business, operating results and financial condition. If we resort to legal proceedings to enforce our intellectual property rights, the proceedings could be burdensome and expensive and could involve a high degree of risk.

Claims May Arise Against the Company From Unknown Oral Agreements and Misconduct of Former Officers and Directors.

We continue to investigate oral agreements and misconduct by Mr. Mark Woodburn, a former director and the former President of the Company, and Mr. Terry LaCore, a former director of the Company and the former Chief Executive Officer of the Company s subsidiary, Lexxus U.S. See Item 1. Recent Developments and Item 3. Legal Proceedings. There can be no assurance that all such oral agreements and misconduct have been discovered. Additional discoveries could lead to claims and proceedings against the Company, its subsidiaries and their officers and directors. We are not aware that the Company is the target of any governmental investigation or proceeding. However, if it is determined that any conduct by Messrs. Woodburn and LaCore violated any law, there can be no assurance that the Company or one or more of its subsidiaries would not be subjected to prosecution or adverse proceedings. Any such claims, prosecutions or other proceedings and the cost of their defense could have a material adverse impact on the reputation, business and financial condition of the Company.

Adverse Publicity Associated With Our Products, Ingredients or Network Marketing Program, or Those of Similar Companies, Could Harm Our Financial Condition and Operating Results.

Adverse publicity concerning any actual or claimed failure of our Company or our distributors to comply with applicable laws and regulations regarding product claims and advertising, good manufacturing practices, the regulation of our network marketing program, the licensing of our products for sale in our target markets or other aspects of our business, whether or not resulting in enforcement actions or the imposition of penalties, could have an adverse effect on the goodwill of our Company and could negatively affect our ability to attract, motivate and retain distributors, which would negatively impact our ability to generate revenue. We cannot ensure that all distributors will comply with applicable legal requirements relating to the advertising, labeling, licensing or distribution of our products.

In addition, our distributors and consumers perception of the safety and quality of our products and ingredients as well as similar products and ingredients distributed by other companies can be significantly influenced by national media attention, publicized scientific research or findings, widespread product liability claims and other publicity concerning our products or ingredients or similar products and ingredients distributed by other companies. Adverse publicity, whether or not accurate or resulting from consumers use or misuse of our products, that associates consumption of our products or ingredients or any similar products or ingredients with illness or other adverse effects, questions the benefits of our or similar products or claims that any such products are ineffective, inappropriately labeled or have inaccurate instructions as to their use, could negatively impact our reputation or the market demand for our products.

Network marketing systems such as ours are frequently subject to laws and regulations directed at ensuring that product sales are made to consumers of the products and that compensation, recognition, and advancement within the marketing organization are based on the sale of products rather than investment in the sponsoring company. We are subject to the risk that, in one or more of our present or future markets, our marketing system could be found not to comply with these laws and regulations or may be prohibited. Failure to comply with these laws and regulations or such a prohibition could have a material adverse effect on our business, financial condition, and results of operations. Further we may simply be prohibited from distributing products through a network-marketing channel in some foreign countries, or be forced to alter our compensation plan.

Our Failure To Maintain and Expand Our Distributor Relationships Could Adversely Affect Our Business.

We distribute our products through independent distributors, and we depend upon them directly for all of our sales. Accordingly, our success depends in significant part upon our ability to attract, retain and motivate a large base of distributors. Our direct selling organization is headed by a relatively small number of key distributors. The loss of a significant number of distributors, including any key distributors, could materially and adversely affect sales of our products and could impair our ability to attract new distributors. Moreover, the replacement of distributors could be difficult because, in our efforts to attract and retain distributors, we compete with other direct selling organizations, including but not limited to those in the personal care, cosmetic product and nutritional supplement industries. Our distributors may terminate their services with us at any time and, in fact, like most direct selling organizations, we have a high rate of attrition.

If The Number Or Productivity Of Independent Distributors Does Not Increase, Our Revenue Could Not Increase.

To increase revenue, we must increase the number and/or the productivity of our distributors. We can provide no assurances that distributor numbers could increase or remain constant or that their productivity could increase. We experienced a 33% increase in active Lexxus distributors during 2005, following a 97% increase in active distributors in 2004 compared to the prior years (excluding

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KGC). The number of active distributors may not increase and could decline in the future. Distributors may terminate their services at any time, and, like most direct selling companies, we experience a high turnover among distributors from year to year. We cannot accurately predict any fluctuation in the number and productivity of distributors because we primarily rely upon existing distributors to sponsor and train new distributors and to motivate new and existing distributors. Operating results could be adversely affected if our existing and new business opportunities and products do not generate sufficient economic incentive or interest to retain existing distributors and to attract new distributors.

Because Our Hong Kong Operations Account For A Majority Of Our Business, Any Adverse Changes In Our Business Operations In Hong Kong Would Materially Harm Our Business.

In 2003, 2004 and 2005, approximately 49%, 56% and 62% of our revenue, respectively, was generated in Hong Kong. It is anticipated that a higher percentage of our revenue will be generated from Hong Kong in 2006 due to the sales of our interest in KGC in December 2005. Various factors could harm our business in Hong Kong, such as worsening economic conditions or other events that are out of our control. For example, on April 12, 2004, an investigative television program was aired in the People s Republic of China with respect to the operations of the Company s Hong Kong subsidiary and the Lexxus representative office located in Beijing. The television program alleged that Lexxus s Hong Kong operations engaged in fraudulent activities and sold products without proper permits. Due to the adverse publicity caused by the airing of the television program, revenues from Hong Kong declined significantly. Our financial results could be harmed if our products, business opportunity or planned growth initiatives fail to retain and generate continued interest and enthusiasm among our distributors and consumers in this market.

Our Proposed Operations in China Could Have An Adverse Effect on Our Hong Kong Revenue.

Most of the Company s Hong Kong revenues are derived from the sale of products that are delivered to members in China. Once we have implemented our proposed operations in China it is possible that sales in Hong Kong could migrate to China. If that were to happen, we could experience a material reduction in sales from Hong Kong.

Our Business In Hong Kong, Which Represented 62% Of Our Revenue in 2005, May Be Harmed By The Results Of Increased Government Scrutiny of Our Current and Proposed Operations in China.

Since 1998, direct selling has been restricted in China to ten companies that have an approval that the Company does not currently have. In November 2005, the Chinese government adopted an anti-multilevel marketing legislation ahead of its December 2005 adoption of legislation to legalize direct selling. The government has rigorously monitored multi-level marketing activities and enforced these laws. In the past, the government has taken significant actions against companies that the government found in violation of applicable laws. Governmental actions included shutting down their businesses and arresting alleged perpetrators. Consequently, a few of our direct selling peer companies have modified their business models and started selling to Chinese consumers through owned, leased or franchised retail outlets. We have not implemented our direct sales model in China. We intend to follow the path of some of our competitors and implement a business model that utilizes retail stores and an employee sales force that we believe will comply with applicable regulations. However, currently the Company is generating revenue from its members in China in a manner that, while the Company does not believe violates the anti-multilevel marketing legislation in China, could be deemed by the Chinese government to violate such legislation.

We Could Be Required To Modify Our Compensation Plan In China In A Way That Could Make It Less Attractive To Members, And This Could Have A Significant Adverse Affect On Our Revenue.

We could be required to modify our compensation plan in China in a way that could make it less attractive to members. Any such modification to our compensation plan could, therefore, have a material adverse effect on revenue. Moreover, the business model that we anticipate implementing in China will likely involve costs and expenses that we do not generally incur in the e-commerce business that we have historically operated in other markets, including Hong Kong. As a result, the business that we ultimately are able to conduct in China could be materially less profitable than the e-commerce business that we have historically operated in Hong Kong.

The Company s E-Commerce Business In Hong Kong, Which Represents A Significant Portion Of The Company s Total Revenue, Could Be Adversely Affected By The Activities Of The Members In China, If Members In China Engage In Activities That Are Deemed To Violate China s Anti-Multilevel Marketing Laws.

While the Company has strictly forbidden any of its members in China to engage in activities that violate China s anti-multilevel marketing laws, some of our members in China have engaged in such activities. In Dongguan, four of our members were detained for questioning in October 2005 with regard to possible violation of Chinese law regarding the maximum number of people who can attend a meeting as well as possible improper network marketing business activity. Charges were never filed and all individuals were released. In April, 2006, a media report indicated that someone was detained by Public Security in Changsha for investigation of similar allegations. The Company has not been able to determine if the individual in question is, in fact, a member and whether or not any laws were actually broken. Initial inquiries made by retained Chinese counsel indicate that no one is still being detained or has been charged. Reviews and investigations of such activities by government regulators, if any are commenced, could restrict our ability to conduct business.

Most of the Company s Hong Kong revenues are derived from the sale of products that are delivered to members in China. The Company operates an e-commerce direct selling model in Hong Kong and does not recognize this revenue as being generated in China. Orders are taken in Hong Kong. Commissions are earned by members in China based on the same binary model used by the Company throughout the world and are recorded and paid in Hong Kong and denominated in Hong Kong Dollars. Commission incomes are declared to the tax authorities in Hong Kong. Members who order the products register themselves with a Hong Kong address and tax ID number. None of the servers on which the Company s Hong Kong e-commerce activities are conducted are located in China. Products purchased by members in China are delivered by the Company to a third party that acts as the importer of record under an agreement to pay applicable duties. From April 2005 through December 2005, the importer of record was a related party (see Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations).

The Company believes that the laws and regulations in China regarding direct selling and multi-level marketing are not specifically applicable to the Company s Hong Kong based e-commerce activity. Nor is the Company aware of any specific laws or regulations in China, or any official interpretation thereof, that govern this Hong Kong centered e-commerce activity. However, there can be no assurance that such laws, regulations or interpretations will not be adopted in the future. Should such laws, rules or interpretations be adopted or should the government determine that the Company s e-commerce activity violates China s anti-multilevel marketing legislation, there could be a material adverse effect on the Company s business, cash flow and financial statements. There is no way the Company can estimate the effect of such an adverse effect.

Although we would attempt to work closely with both national and local governmental agencies in implementing our plans, our efforts to comply with national and local laws may be harmed by a rapidly evolving regulatory climate, concerns about activities resembling violations of anti-multi-level marketing legislation and any subjective interpretation of laws. Any determination that our operations or activities, or the activities of our employee sales representatives, distributors living outside of China or importers of record are not in compliance with applicable regulations could result in the imposition of substantial fines, extended interruptions of business, restrictions on our future ability to obtain business license or expand into new locations, substantially diminishing our ability to retain existing sales representatives and attract new sales representatives, changes to our business model, the termination of required licenses to conduct business, or other actions, all of which would harm our business.

If We Fail To Obtain a Direct Selling License in China, Our Future Business Could Be Harmed.

The Chinese government has adopted new direct selling legislation as of December 1, 2005. The Company has submitted an application for a direct selling license in December 2005. The Company thinks it met all of the legal requirements, including capitalizing our Chinese entity with a $12.0 million cash infusion, but there can be no assurance that a license will be granted. Although we currently do not operate a direct selling business in China, our future business could be harmed if the Chinese government turns down our application or significantly defers granting a direct selling license.

Intellectual Property Rights Are Difficult To Enforce In China.

Chinese commercial law is relatively undeveloped compared to most other major markets, and, as a result, we may have limited legal recourse in the event we encounter significant difficulties with patent or trademark infringers. Limited protection of intellectual property is available under Chinese law, and the local manufacturing of our products may subject us to an increased risk that unauthorized parties may attempt to copy or otherwise obtain or use our product formulations. As a result, we cannot assure you that we would be able to adequately protect our product formulations.

Failure to Properly Pay Business Taxes, Including Those in China, Could Have a Material Adverse Effect.

Between April and December 2005, the Company s Hong Kong subsidiary engaged a service provider to facilitate product importation into China and act, or engage another party to act, as the importer of record. The individual that owns that service provider is one of the directors of the Company s wholly- owned Chinese subsidiary. The Company believes that the amount of duty paid to Chinese Customs on the imported goods by the importer of record was paid at the negotiated rate. However, there can be no assurance that Chinese Customs will not elect, in the future, to examine the duty paid, and if they conduct such examination, they may conclude that the valuation established was insufficient, resulting in an underpayment of duties. As a consequence, the importer of record could be required to pay additional duties and possible penalties to Chinese Customs. Additional duties could range between zero and $46.0 million, plus penalties. The extreme worst case was calculated using the highest possible assessment to the highest possible declared value and assuming that negotiated valuation practices do not apply. The Company believes that any such future assessment of additional duties or penalties would be made against and become the responsibility of the importer of record. There can be no assurance that the Company or its subsidiaries would not also be of assessed with such liability in the event that the importer of record is unable to pay all or part of such amount.

As We Continue To Expand Into Foreign Markets Our Business Becomes Increasingly Subject To Political and Economic Risks. Changes In These Markets Could Adversely Affect Our Business.

We believe that our ability to achieve future growth is dependent in part on our ability to continue our international expansion efforts. However, there can be no assurance that we would be able to grow in our existing international markets, enter new international markets on a timely basis, or that new markets would be profitable. We must overcome significant regulatory and legal barriers before we can begin marketing in any foreign market.

Also, it is difficult to assess the extent to which our products and sales techniques would be accepted or successful in any given country. In addition to significant regulatory barriers, we may also encounter problems conducting operations in new markets with different cultures and legal systems from those encountered elsewhere. We may be required to reformulate certain of our products before commencing sales in a given country. Once we have entered a market, we must adhere to the regulatory and legal requirements of that market. No assurance can be given that we would be able to successfully reformulate our products in any of our current or potential international markets to meet local regulatory requirements or attract local customers. The failure to do so could have a material adverse effect on our business, financial condition, and results of operations. There can be no assurance that we would be able to obtain and retain necessary permits and approvals.

In many markets, other direct selling companies already have significant market penetration, the effect of which could be to desensitize the local distributor population to a new opportunity, or to make it more difficult for us to recruit qualified distributors. There can be no assurance that, even if we are able to commence operations in foreign countries, there would be a sufficiently large population of potential distributors inclined to participate in a direct selling system offered by us. We believe our future success could depend in part on our ability to seamlessly integrate our business methods, including distributor compensation plan, across all markets in which our products are sold. There can be no assurance that we would be able to further develop and maintain a seamless compensation program.

An Increase In The Amount Of Compensation Paid To Distributors Would Reduce Profitability.

A significant expense is the payment of compensation to our distributors. We paid approximately 44%, 51% and 52% in 2003, 2004 and 2005, respectively, of our net revenues as compensation to our distributors. The increase is due to the growth of the distributor network and number of down-line levels, an elevated level of promotions, local promotional programs and various business development agreements. We compensate our distributors by paying commissions, bonuses, and certain awards and prizes. We closely monitor the amount of compensation to distributors paid as a percentage of net sales and may need to adjust our compensation plan to prevent distributor compensation from having a significant adverse effect on earnings. There can be no assurance that these changes or future changes to our compensation plan or product pricing would be successful in maintaining the level of distributor compensation expense as a percentage of net sales. Furthermore, these changes may make it difficult to recruit and retain qualified and motivated distributors. An increase in compensation payments to distributors as a percentage of net sales will reduce our profitability. Under our current compensation plan, commissions may be limited to 60% of sales. See Item 1. Working with Distributors Compensation Plans.

There May be Unfavorable Reactions to or Challenges to Our Use the New Name We Have Selected for our Lexxus Subsidiaries, Internet Sites and Certain Products.

In connection with the settlement of a lawsuit, the Company is obligated to change the name of its Lexxus subsidiaries, websites and certain products (see Item 3. Legal Proceedings). It is anticipated that, by June 1, 2006, the Company will change the name of Lexxus International to NHT Global, Inc. and the terms Lexxus and Lexxus International will be replaced in all other uses by the Company and its subsidiaries by the terms NHT Global or a variation that includes NHT or Natural Health Trends . The financial condition of the Company could be materially affected by unfavorable reaction of distributors and customers to these new names or by claims of prior rights to these names in one or more countries.

We Do Not Have Product Liability Insurance And Product Liability Claims Could Hurt Our Business.

Currently, we do not have product liability insurance, although the insurance carried by our suppliers may cover certain product liability claims against us. Nevertheless, we do not conduct or sponsor clinical studies of our products. As a marketer of nutraceuticals, cosmetics and other products that are ingested by consumers or applied to their bodies, we may become subjected to various product liability claims, including that:

- our products contain contaminants;
- our products include inadequate instructions as to their uses; or
- our products include inadequate warnings concerning side effects and interactions with other substances.

Especially since we do not have direct product liability insurance, it is possible that product liability claims and the resulting adverse publicity could negatively affect our business. In November 2004, Dorothy Porter filed a complaint against the Company for strict liability, breach of warranty and negligence in the U.S. District Court for the Southern District of Illinois, alleging that she sustained a brain hemorrhage after taking Formula One, an ephedra-containing product marketed by Kaire Nutraceuticals, Inc., a former subsidiary of the Company. See Item 3. Legal Proceedings .

If our suppliers product liability insurance fails to cover product liability claims or other product liability claims, or any product liability claims exceeds the amount of coverage provided by such policies or if we are unsuccessful in any third party claim against the manufacturer or if we are unsuccessful in collecting any judgment that may be recovered by the Company against the manufacturer, we could be required to pay substantial monetary damages which could materially harm our business, financial condition and results of operations. As a result, we may become required to pay higher premiums and accept higher deductibles in order to secure adequate insurance coverage in the future.

Our Internal Controls and Accounting Methods Require Further Modification.

The Company modified certain of its accounting policies and made other adjustments to our accounting for past transactions, which resulted in the restatement of the Company s financial statements for each quarter in 2001, 2002, and 2003, for the years ended December 31, 2001, 2002, and 2003, as well as the first quarter in 2004. In connection with the restatement of our financial statements, many of the restatement items are the result of material weaknesses in the Company s internal controls and procedures. Also, in October 2005, the Company s top two officers at the time, Mark Woodburn and Terry LaCore, the President of the Company and the Chief Executive Officer of Lexxus U.S., respectively, were terminated due to management misconduct.

The Company continues to develop controls and procedures and plans to implement additional controls and procedures sufficient to accurately report our financial performance on a timely basis in the foreseeable future. Nevertheless, we continue to have material weaknesses (see Item 9A Controls and Procedures). If we are unable to development and implement effective controls and procedures, we may not be able to report our financial performance on a timely basis and our business and stock price would be adversely affected. See Item 9A. Controls and Procedures.

Non-Compliance with Section 404 of the Sarbanes-Oxley Act of 2002 Could Materially Adversely Affect Us.

The Securities Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules which could require us to include in our annual reports on Form 10-K, beginning in fiscal 2007, an assessment by management of the effectiveness of our internal controls over financial reporting. In addition, our independent auditors must attest to and report on management s assessment of the effectiveness of such internal controls over financial reporting. While we intend to diligently and thoroughly document, review, test and improve our internal controls over financial reporting to comply with Section 404 of the Sarbanes-Oxley Act, if our independent auditors are not satisfied with the adequacy of our internal controls over financial reporting, or if the independent auditors interpret the requirements, rules and/or regulations differently than we do, then they may decline to attest to management s assessment or may issue a report that is qualified. This could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which could negatively impact the price of our common stock.

We Rely On And Are Subject To Risks Associated With Our Reliance Upon Information Technology Systems.

Our success is dependent on the accuracy, reliability, and proper use of information processing systems and management information technology. Our information technology systems are designed and selected to facilitate order entry and customer billing, maintain distributor records, accurately track purchases and distributor compensation payments, manage accounting operations, generate reports, and provide customer service and technical support. Although we acquired MarketVision our distributor software service provider during the first half of 2004, in part, to gain greater control over its operations, any interruption in these systems could have a material adverse effect on our business, financial condition, and results of operations.

Our Lexxus Subsidiaries Have a Limited Operating History Which May Not be Indicative of Future Performance.

Although our Lexxus subsidiaries accounted for approximately 99% of our consolidated net revenues during fiscal 2005, it has been operating only since January 2001.

Our business prospects must be considered in light of the risk, expense and difficulties frequently encountered by companies in an early stage of development, particularly companies in new and rapidly evolving international markets. If we are unable to effectively allocate our resources and help grow our Lexxus subsidiaries, our stock price may be adversely affected and we may be unable to execute our strategy of expanding our network of independent distributors. Our business depends upon the performance of our Lexxus subsidiaries and, due to its relatively short operating history, past performance may not be indicative of future results.

Our success has been, and could continue to be, significantly dependent on our ability to manage rapid growth through expansions and enhancements of our worldwide personnel and management, order processing and fulfillment, inventory and shipping systems, financial reporting and other aspects of operations. As we continue to expand our operations, the ability to manage this growth could represent an increasing challenge and our failure to properly manage this growth may materially and adversely affect our results of operation.

Regulatory Matters Governing Our Industry Could Have A Significant Negative Effect On Our Business.

In both our United States and foreign markets, we are affected by extensive laws, governmental regulations, administrative determinations, court decisions and similar constraints. Such laws, regulations and other constraints may exist at the federal, state or local levels in the United States and at all levels of government in foreign jurisdictions.

Product Regulations

The formulation, manufacturing, packaging, labeling, distribution, importation, sale and storage of certain of our products are subject to extensive regulation by various federal agencies, including the Food and Drug Administration (FDA), the Federal Trade Commission (the FTC), the Consumer Product Safety Commission and the United States Department of Agriculture and by various agencies of the states, localities and foreign countries in which our products are manufactured, distributed and sold. Failure by our distributors or us to comply with those regulations could lead to the imposition of significant penalties or claims and could materially and adversely affect our business. In addition, the adoption of new regulations or changes in the interpretation of existing regulations may result in significant compliance costs or discontinuation of product sales and may adversely affect the marketing of our products, resulting in significant loss of sales revenues.

Product Claims, Advertising and Distributor Activities

Our failure to comply with FTC or state regulations, or with regulations in foreign markets that cover our product claims and advertising, including direct claims and advertising by us, as well as claims and advertising by distributors for which we may be held responsible, may result in enforcement actions and imposition of penalties or otherwise materially and adversely affect the distribution and sale of our products. Distributor activities in our existing markets that violate applicable governmental laws or regulations could result in governmental or private actions against us in markets where we operate. Given the size of our distributor force, we cannot assure that our distributors would comply with applicable legal requirements.

Direct Selling System

Our direct selling system is subject to a number of federal and state regulations administered by the FTC and various state agencies as well as regulations in foreign markets administered by foreign agencies. Regulations applicable to direct selling organizations generally are directed at ensuring that product sales ultimately are made to consumers and that advancement within the organizations is based on sales of the organizations products rather than investments in the organizations or other non-retail sales related criteria. We are subject to the risk that, in one or more markets, our marketing system could be found not to be in compliance with applicable regulations. The failure of our direct selling system to comply with such regulations could have a material adverse effect on our business in a particular market or in general.

We are also subject to the risk of private party challenges to the legality of our direct selling system. The regulatory requirements concerning direct selling systems do not include bright line rules and are inherently fact-based. An adverse judicial determination with respect to our direct selling system, or in proceedings not involving us directly but which challenge the legality of other direct selling marketing systems, could have a material adverse effect on our business.

Transfer Pricing and Similar Regulations

In many countries, including the United States, we are subject to transfer pricing and other tax regulations designed to ensure that appropriate levels of income are reported as earned by our United States or local entities and are taxed accordingly. In addition, our operations are subject to regulations designed to ensure that appropriate levels of customs duties are assessed on the importation of our products.

Our principal domicile is the United States. Under tax treaties, we are eligible to receive foreign tax credits in the United States for taxes paid abroad. As our operations expand outside the United States, taxes paid to foreign taxing authorities may exceed the credits available to us, resulting in the payment of a higher overall effective tax rate on our worldwide operations.

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We have adopted transfer pricing agreements with our subsidiaries to regulate inter-company transfers, which agreements are subject to transfer pricing laws that regulate the flow of funds between the subsidiaries and the parent corporation for product purchases, management services, and contractual obligations, such as the payment of distributor compensation. In 2005, we implemented a foreign holding and operating company structure for our non-United States businesses. This new structure re-organized our non-United States subsidiaries in the Cayman Islands. Though our goal is to improve the overall tax rate, there is no assurance that the new tax structure could be successful. If the United States Internal Revenue Service or the taxing authorities of any other jurisdiction were to successfully challenge these agreements, plans, or arrangements, or require changes in our transfer pricing practices, we could be required to pay higher taxes, interest and penalties, and our earnings would be adversely affected.

We believe that we operate in compliance with all applicable transfer pricing laws and we intend to continue to operate in compliance with such laws. However, there can be no assurance that we will continue to be found to be operating in compliance with transfer pricing laws, or that those laws would not be modified, which, as a result, may require changes in our operating procedures.

Taxation Relating To Distributors

Our distributors are subject to taxation, and in some instances legislation or governmental agencies impose an obligation on us to collect the taxes, such as value added taxes, and to maintain appropriate records. In addition, we are subject to the risk in some jurisdictions of being responsible for social security and similar taxes with respect to our distributors.

Other Regulations

We are also subject to a variety of other regulations in various foreign markets, including regulations pertaining to employment and severance pay requirements, import/export regulations and antitrust issues. Our failure to comply or assertions that we fail to comply with these regulations could have a material adverse effect on our business in a particular market or in general.

To the extent we decide to commence or expand operations in additional countries, government regulations in those countries may prevent or delay entry into or expansion of operations in those markets. In addition, our ability to sustain satisfactory levels of sales in our markets is dependent in significant part on our ability to introduce additional products into the markets. However, government regulations in both our domestic and international markets can delay or prevent the introduction, or require the reformulation or withdrawal, of some of our products.

Currency Exchange Rate Fluctuations Could Lower Our Revenue And Net Income.

In 2005, approximately 92% of our revenue was recorded in markets outside the United States. However, that figure does not accurately reflect our foreign currency exposure mainly because the Hong Kong dollar is pegged to the U.S. dollar. Our European business, KGC, switched to euro for both selling products and paying commissions at the end of 2004 but has been divested and thus no longer consolidated with the Company in 2006. We also purchase all inventories in U.S. dollars. Therefore, our currency exposure, mainly to Korean won, Singapore dollar, New Taiwan dollar and Australia dollar, represented approximately 12% of our revenue in 2005, excluding KGC.

Our exposure to foreign currency fluctuation is expected to increase, as the Company progresses in developing Japanese and Mexican markets.

In preparing our consolidated financial statements, we translate revenue and expenses in foreign countries from their local currencies into U.S. dollars using the average exchange rates for the period. The effect of the translation of the Company s foreign operations is included in accumulated other comprehensive income within stockholders equity and do not impact the statement of operations.

Given our inability to predict the degree of exchange rate fluctuations, we cannot estimate the effect these fluctuations may have upon future reported results, product pricing or our overall financial condition. Further, to date we have not attempted to reduce our exposure to short-term exchange rate fluctuations by using foreign currency exchange contracts.

Failure Of New Products To Gain Distributor And Market Acceptance Could Harm Our Business.

An important component of our business is our ability to develop new products that create enthusiasm among our distributor force. If we fail to introduce new products on a timely basis, our distributor productivity could be harmed. In addition, if any new products fail to gain market acceptance, are restricted by regulatory requirements, or have quality problems, this would harm our results of operations. Factors that could affect our ability to continue to introduce new products include, among others, limited capital resources, government regulations, proprietary protections of competitors that may limit our ability to offer comparable products and any failure to anticipate changes in consumer tastes and buying preferences.

System Failures Could Harm Our Business.

Because of our diverse geographic operations and our internationally applicable distributor compensation plans, our business is highly dependent on efficiently functioning information technology systems provided by MarketVision. The MarketVision systems and operations are vulnerable to damage or interruption from fires, earthquakes, telecommunications failures, computer viruses and worms, software defects and other events. They are also subject to break-ins, sabotage, acts of vandalism and similar misconduct. Despite precautions implemented by the staff of MarketVision, problems could result in interruptions in services and materially and adversely affect our business, financial condition and results of operations.

Limited Product Line.

The Company offers a limited number of products under its Lexxus brand (see Item 1. Our Principal Products). Our *Premium Noni Juice* , *Skindulgence*®, *Alura*® and *La Vie* products each account for a significant portion of our total sales and, together, account for a significant majority of our total sales. If demand for any of these four products decreases significantly, government regulation restricts the sale of these products, we are unable to adequately source or deliver these products, or we cease offering any of these products for any reason without a suitable replacement, our business, financial condition and results of operations could be materially and adversely effected.

We Do Not Manufacture Our Own Products So We Must Rely On Independent Third Parties For The Manufacturing And Supply Of Our Products.

All of our products are manufactured by independent third parties. There is no assurance that our current manufacturers will continue to reliably supply products to us at the level of quality we require. In the event any of our third-party manufacturers become unable or unwilling to continue to provide the products in required volumes and quality levels at acceptable prices, we will be required to identify and obtain acceptable replacement manufacturing sources. There is no assurance that we will be able to obtain alternative manufacturing sources or be able to do so on a timely basis. An extended interruption in the supply of our products will result in a substantial loss of sales. In addition, any actual or perceived degradation of product quality as a result of our reliance on third party manufacturers may have an adverse effect on sales or result in increased product returns and buybacks.

The High Level Of Competition In Our Industry Could Adversely Affect Our Business.

The business of marketing personal care, cosmetic, nutraceutical, and lifestyle enhancement products is highly competitive. This market segment includes numerous manufacturers, distributors, marketers, and retailers that actively compete for the business of consumers both in the United States and abroad. The market is highly sensitive to the introduction of new products, which may rapidly capture a significant share of the market. Sales of similar products by competitors may materially and adversely affect our business, financial condition and results of operations.

We are subject to significant competition for the recruitment of distributors from other direct selling organizations, including those that market similar products. Many of our competitors are substantially larger than we are, offer a wider array of products, have far greater financial resources and many more active distributors than we have. Our ability to remain competitive depends, in significant part, on our success in recruiting and retaining distributors through an attractive compensation plan and other incentives. We believe that our compensation and incentive programs provide our distributors with significant earning potential. However, we cannot be sure that our programs for recruitment and retention of distributors would be successful.

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Terrorist Attacks, Acts Of War, Epidemics Or Other Communicable Diseases Or Any Other Natural Disasters May Seriously Harm Our Business.

Terrorist attacks, or acts of war or natural disasters may cause damage or disruption to our Company, our employees, our facilities and our customers, which could impact our revenues, expenses and financial condition. The potential for future terrorist attacks, the national and international responses to terrorist attacks, and other acts of war or hostility, such as the Chinese objection to the Taiwan independence movement and its resultant tension in the Taiwan Strait, could materially and adversely affect our business, results of operations, and financial condition in ways that we currently cannot predict. Additionally, natural disasters less severe than the Indian Ocean tsunami that occurred in December 2004 may adversely affect our business, financial condition and results of operations.

Risks Related To Our Common Stock

Disappointing Quarterly Revenue Or Operating Results Could Cause The Price Of Our Common Stock To Fall.

Our quarterly revenue and operating results are difficult to predict and do fluctuate significantly from quarter to quarter. If our quarterly revenue or operating results fall below the expectations of investors or securities analysts, the price of our common stock could fall substantially.

Our Common Stock Is Particularly Subject To Volatility Because Of The Industry That We Are In.

The market prices of securities of direct selling companies, have been extremely volatile, and have experienced fluctuations that have often been unrelated or disproportionate to the operating performance of such companies. These broad market fluctuations could adversely affect the market price of our common stock.

Substantial Dilution May Occur From The Exercise of Outstanding Options or Warrants

As of December 31, 2005, the Company had outstanding (i) options to purchase an aggregate of 1,922,124 shares of our common stock at exercise prices between $1.00 and $18.11, and (ii) warrants outstanding from the October 2004 private placement of units exercisable for 1,080,504 shares of our common stock at an exercise price equal to $12.47 per share. In the event that these options and warrants are exercised, and the shares issued upon such exercise are sold, the market price of our shares of common stock could decline. In addition, holders of such options and warrants are likely to exercise them when, in all likelihood, the Company could obtain additional capital on terms more favorable to the Company than those provided by the options and warrants. Further, while our options and warrants are outstanding, they may adversely affect the terms on which the Company could obtain additional capital.

Moreover, on February 10, 2006, the Company entered into an Escrow Agreement (the Agreement) with Messrs. Woodburn and LaCore, the LaCore and Woodburn Partnership, an affiliate of Woodburn and LaCore, and Krage and Janvey LLP, as escrow agent (the Agent). Pursuant to the Agreement, (i) the Company agreed to issue and deposit with the Agent stock certificates in the name of the Agent representing an aggregate of 1,081,066 shares of the Company s common stock (the Escrowed Shares) and (ii) Woodburn and LaCore deposited with the Agent $1,206,000 in immediately available funds (the Cash Deposit). The Escrowed Shares are the shares of common stock issuable upon the cashless exercise of certain options issued in 2001 and 2002 to LaCore and the LaCore and Woodburn Partnership exercisable at $1.00 and $1.10 per share. The number of Escrow Shares is based upon the closing price of the Company s common stock on February 9, 2006 of $10.14 and the surrender of 118,934 option shares as payment of the aggregate exercise price of $1,206,000.

The Escrowed Shares were issued pursuant to Section 4(2) of the Securities Act of 1933, as amended, to the Agent upon receipt from the Agent of an irrevocable proxy (the Proxy) to the Company to vote the Escrowed Shares on all matters presented at meetings of stockholders or any written consent executed in lieu thereof. The parties have agreed that the Agent will hold the Escrowed Shares and the Cash Deposit until it receives (i) joint written instructions from the Company, Woodburn and LaCore, or (ii) a final non-appealable order from a court of competent jurisdiction. Each of the Company and Woodburn and LaCore has further agreed that all current and future rights, claims, defenses and causes of actions they have or may have against each other are preserved. If the Escrowed Shares are released to Woodburn and LaCore or sold to a third party, the market price of our shares of common stock could decline.

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Future Sales By the Company or Existing Security Holders Could Depress The Market Price Of Our Common Stock.

If the Company or our existing stockholders sell a large number of shares of our common stock, the market price of the common stock could decline significantly. Further, even the perception in the public market that the Company or our existing stockholders might sell shares of common stock could depress the market price of the common stock.

There is No Assurance That an Active Public Trading Market Would Continue.

The Company s common stock is not heavily traded. The Company s common stock began trading on The NASDAQ National Market under the ticker symbol BHIP only since February 22, 2005. There can be no assurance that an active public trading market for our common stock will be sustained. If for any reason an active public trading market does not continue, purchasers of the shares of our common stock may have difficulty in selling their securities should they desire to do so and the price of our common stock may decline.

If Securities Analysts Do Not Publish Research Or Reports About Our Business Or If They Downgrade Our Stock, The Price Of Our Stock Could Decline.

The trading market for our shares of common stock could rely in part on the research and reporting that industry or financial analysts publish about us or our business. We do not control these analysts. Furthermore, if one or more of the analysts who do cover us downgrades our stock, the price of our stock could decline. If one or more of these analysts ceases coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

Item 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

Item 2. PROPERTIES

The Company leases approximately 53,375 square feet in Dallas, Texas for its headquarters and warehouse space. The warehouse primarily stores products that are bound for international markets. The Company s subsidiary, MarketVision, leases office space in Minnesota for its employees.

Outside the United States, we have operations in leased sites in Hong Kong, China, Japan, Taiwan, Singapore, South Korea, the Philippines, Australia, Mexico, the Cayman Islands and Canada. We also lease a manufacturing facility in China for assembly operations. We believe that our existing properties are in good condition and suitable for the conduct of our business.

Item 3. LEGAL PROCEEDINGS

During the fall of 2003, the customs agency of the government of South Korea brought a charge against LXK, the Company s wholly-owned subsidiary operating in South Korea, with respect to the importation of the Company s Alura product. The customs agency alleges that Alura is not a cosmetic product, but rather should be categorized and imported as a pharmaceutical product. On February 18, 2005, the Seoul Central District Court ruled against LXK and fined it a total of approximately $200,000. LXK also incurred related costs of approximately $40,000 as a result of the judgment. The Company recorded a reserve for the entire $240,000 at December 31, 2004 and has appealed the ruling. The failure to sell Alura in South Korea is not anticipated to have a material adverse effect on the financial condition, results of operations, cash flow or business prospects of LXK.

On or around March 31, 2004, Lexxus U.S. received a letter from John Loghry, a former Lexxus distributor, alleging that Lexxus U.S. had wrongfully terminated an alleged oral distributorship agreement with Mr. Loghry and that the Company had breached an alleged oral agreement to issue shares of the Company s common stock to Mr. Loghry. On May 13, 2004, Lexxus U.S. and the Company filed an action against Mr. Loghry in the United States District Court for the Northern District of Texas seeking, inter alia, unspecified damages from Mr. Loghry for disparagement and a declaration that Mr. Loghry was not wrongfully terminated and is not entitled to recover anything from Lexxus U.S. or the Company. Mr. Loghry filed counterclaims against the Company and Lexxus U.S. asserting his previously threatened claims. In September 2004, Mr. Loghry filed third party claims against certain officers of the Company and Lexxus U.S., including against Terry LaCore, former Chief Executive Officer of Lexxus U.S. and former director of the Company, and Mark Woodburn, former President and director of the Company, for fraud, Messrs. LaCore, Woodburn, and a certain Lexxus distributor for conspiracy to commit fraud and tortuous interference with contract. In February 2005, the court dismissed all of

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Mr. Loghry s claims against the individual defendants, except the claims for fraud and conspiracy to commit fraud. Mr.Loghry then filed amended counterclaims and, on June 2, 2005, the Company and the other counterclaim defendants moved to dismiss the counterclaims on the grounds that the claims were barred by Mr. Loghry s failure to disclose their existence when he filed for personal bankruptcy in September 2002. On June 30, 2005, the U.S. Bankruptcy Court for the District of Nebraska granted Mr. Loghry s request to reopen his bankruptcy case. On September 6, 2005, the United States Trustee filed an action in the U.S. District Court for the District of Nebraska against the Company; Lexxus U.S.; Messrs. LaCore and Woodburn; Curtis Broome, President of Greater China and Southeast Asia; and a certain independent distributor of Lexxus U.S., essentially alleging the same claims asserted by Loghry in the Northern District of Texas. On February 21, 2006, this case was transferred to the United States District Court for the Northern District of Texas. The Company denies the allegations by Loghry and the United States Trustee and intends to vigorously contest their claims. An unfavorable judgment could have a material adverse effect on the financial condition of the Company.

On November 1, 2004, Toyota Jidosha Kabushiki Kaisha (d/b/a Toyota Motor Corporation) and Toyota Motor Sales, U.S.A. (the Toyota Entities) filed a complaint against the Company and Lexxus U.S. in United States District Court for the Central District of California (CV04-9028). The complaint alleged trademark and service mark dilution, unfair competition, trademark and service mark infringement, and trade name infringement, each with respect to Toyota s Lexus trademark. The Company reached a settlement agreement, dated August 31, 2005, under which the Toyota Entities agreed to terminate their claims against the Company, and the Company agreed to discontinue use of the Lexxus name and mark and change the name of its Lexxus operations and domain names by June 1, 2006, and sell or otherwise dispose of all product inventory marked with the name Lexxus by December 1, 2006. This could have a material adverse effect on the financial condition, results of operations, cash flow or business prospects of the Company.

On November 12, 2004, Dorothy Porter filed a complaint against the Company in the United States District Court for the Southern District of Illinois alleging that she sustained a brain hemorrhage after taking Formula One, an ephedra-containing product marketed by Kaire Nutraceutical Inc., a former subsidiary of the Company, and, thereafter, eKaire.com, Inc., a wholly-owned subsidiary of the Company. Ms. Porter has sued the Company for strict liability, breach of warranty and negligence. The Company intends to defend this case vigorously and on December 27, 2004 filed an answer denying the allegations contained in the complaint. On March 7, 2005, a Notice of Tag-Along Action was filed by Ms. Porter with the Judicial Panel on Multidistrict Litigation. The case was subsequently transferred for pre-trial purposes to the consolidated Ephedra Products Liability proceedings in the United States District Court for the Southern District of New York. If the case proceeds to a jury trial, the matter will be transferred back to the Southern District of Illinois and tried in that District. Full discovery between the parties is set to begin in this action Spring 2006. The Company does not believe that the plaintiff can demonstrate that its products caused the alleged injury and intends to vigorously defend this action.

On January 13, 2005, Nature s Sunshine Products, Inc. and Nature s Sunshine Products de Mexico S.A. de C.V. (collectively Nature s Sunshine) filed suit against the Company in the Fourth Judicial District Court, Utah County, State of Utah, seeking injunctive relief and unspecified damages against the Company, Lexxus U.S., the Company s Mexican subsidiary, and the Company s Mexico management team, Oscar de la Mora Romo and Jose Villarreal Patino, alleging among other things that the Company s employment of Messrs. De la Mora and Villarreal violated or could lead to the violation of certain non-compete, non-solicitation, and confidentiality agreements allegedly in effect between Messrs. De la Mora and Villarreal and Nature s Sunshine. After the Company removed the case to federal court, Nature s Sunshine voluntarily dismissed its lawsuit and filed a new lawsuit in the Fourth Judicial District Court in Utah County, Utah. After a hearing on August 22, 2005, the district court preliminarily enjoined Messrs. De la Mora and Villarreal from disclosing any confidential information of Nature s Sunshine or soliciting any employee or distributor of Nature s Sunshine or inducing them to terminate their relationship with Nature s Sunshine. The court refused, however, to enjoin Messrs. De la Mora or Villarreal from competing with Nature s Sunshine. Nature s Sunshine subsequently filed a petition for interlocutory review with the Utah Supreme Court. The Supreme Court delegated the petition to the Utah Court of Appeals, which denied the petition. On April 6, 2006, a mutual agreement was entered into with Messrs. De la Mora and Villareal terminating their employment between them and affiliates of the Company. If the Company or Messrs. De la Mora and Villarreal are nevertheless unsuccessful in defending this action, the Company may be required to pay any damages and attorneys fees that may be assessed against it.

On or about March 1, 2006, the Company hired Peter Dale, a former executive with the Nature s Sunshine subsidiary doing business in Japan, Nature s Sunshine Japan Co., Ltd. (NSJ), to serve as an executive vice president with responsibilities in Asia. NSJ alleges that Mr. Dale has signed an agreement containing covenants of non-competition, non-solicitation, and confidentiality, and that it believes Mr. Dale s employment with the Company would violate the non-competition covenant. No lawsuit has been filed at this point. If Nature s Sunshine files suit, the Company and Mr. Dale will vigorously defend against the enforcement of the non-competition covenant. However, if Nature s Sunshine were to prevail in such a lawsuit, Mr. Dale could be enjoined from working for the Company until February 15, 2007 which could have a material adverse effect on the Company s business in Japan.

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Currently, there is no other significant litigation pending against the Company other than as disclosed in the paragraphs above. From time to time, the Company may become a party to litigation and subject to claims incident to the ordinary course of the Company s business. Although the results of such litigation and claims in the ordinary course of business cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material adverse effect on the Company s business, results of operations or financial condition. Regardless of outcome, litigation can have an adverse impact on the Company because of defense costs, diversion of management resources and other factors.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On June 1, 2005, the Company held its annual meeting of shareholders. At the meeting, the shareholders (i) approved the re-election of the Company s five directors to the Board of Directors of the Company, (ii) ratified the appointment of BDO Seidman, LLP as the Company s independent auditors for the fiscal year ending December 31, 2005, and (iii) approved certain amendments to the Company s 2002 Stock Option Plan. The fourth proposal presented at the annual meeting which addressed the reincorporation of the Company in the State of Delaware was adjourned until June 24, 2005. At that time, the Company s reincorporation in the State of Delaware was approved by holders of a majority of the Company s shares of common stock outstanding. On June 29, 2005, the Company re-incorporated in the State of Delaware.

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Part II

Item 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock has been quoted on The NASDAQ National Market under the symbol BHIP since February 22, 2005. Prior to that time, our common stock was quoted on the NASD over-the-counter bulletin board under the symbol NHTC and subsequently NHLC.OB .

The following table sets forth the range of high and low bid quotations for our common stock for each of the quarterly periods indicated as reported on the NASD over-the-counter bulletin board and The NASDAQ National Market. Bid quotations as reported on the NASD over-the-counter bulletin board reflect inter-dealer prices without retail markup, markdown, or commission and may not represent actual transactions.

Quarter Ended:	High	Low
March 31, 2004	$ 21.10	$ 10.80
June 30, 2004	25.75	11.40
September 30, 2004	18.60	11.99
December 31, 2004	12.70	9.15
March 31, 2005	$ 18.89	$ 11.00
June 30, 2005	15.00	11.12
September 30, 2005	17.07	12.66
December 31, 2005	16.00	8.27

At April 28, 2006, there were approximately 420 stockholders of record, and the closing price of our common stock was $5.99 per share. We estimate that as of such date there were approximately 3,250 beneficial holders of our common stock.

On April 18, 2006, the Company received a letter from The NASDAQ Stock Market stating that the Company is not in compliance with Marketplace Rule 4310(c)(14), which obligates listed issuers to timely file those reports and other documents required to be filed with the Securities and Exchange Commission. On April 25, 2006, the Company requested a hearing with the NASDAQ Hearings Panel concerning the Company s failure to file its Form 10-K in a timely fashion. The Company received a hearing date of June 1, 2006 from NASDAQ. The Company has been advised that its shares of common stock will not be delisted prior to the date of the hearing.

Dividend Policy

We have never declared or paid any cash dividend on our common stock. We currently intend to retain earnings, if any, to finance the growth and development of our business. We do not expect to pay any dividends in the foreseeable future. Payment of any future dividends will be at the direction of our Board of Directors.

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Equity Compensation Plan Information

The following table provides information as of December 31, 2005 with respect to the Company s common stock that may be issued upon the exercise of options, warrants and rights under all of our existing equity compensation plans (including individual arrangements).

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	592,124	$ 14.41	957,876[1]
Equity compensation plans or arrangements not approved by security holders	1,330,000[2]	$ 1.06	
Total	1,922,124	$ 5.17	957,876

1 On June 1, 2005, an amendment was approved which increased the number of shares of common stock reserved under the 2002 Stock Option Plan to 1,550,000 shares.

2 Includes (i) options exercisable for 570,000 shares of common stock issued to the LaCore and Woodburn Partnership, (ii) options exercisable for

570,000 shares of common stock issued to Mr. LaCore, (iii) options exercisable for 30,000 shares of common stock issued to Benchmark Consulting Group (which was subsequently assigned to the LaCore and Woodburn Partnership), (iv) options exercisable for 30,000 shares of common stock issued to Mr. LaCore, (v) options exercisable for 125,000 shares of common stock issued to certain employees and members of the Company s board of directors, and (vi) options exercisable for 5,000 shares of common stock issued to an unrelated party. See Item 1. Recent Developments regarding the exercise of stock options issued to the LaCore and Woodburn Partnership and to Mr. LaCore.

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Item 6. SELECTED FINANCIAL DATA

The following data has been derived from the audited consolidated financial statements of the Company and should be read in conjunction with those statements. Historical results are not necessarily indicative of future results.

	Year Ended December 31,				
	2001	2002	2003	2004	2005
	(In Thousands, Except Per Share Data)				
Consolidated Statement of Operations Data:					
Net sales	$ 22,989	$ 36,968	$ 62,576	$ 133,225	$ 194,472
Gross profit	17,691	29,216	48,900	103,904	149,726
Distributor commissions	12,449	16,834	27,555	68,579	101,021
Selling, general and administrative expenses	5,187	10,710	15,770	33,102	49,000
Provision for KGC receivable					2,759
Income (loss) from operations	(65)	238	5,575	2,223	(3,054)
Net income (loss)	466	2,139	4,728	1,241	(5,502)
Diluted income (loss) from continuing operations per share[1]:	$ (0.98)	$ (0.11)	$ 0.83	$ 0.18	$ (0.79)
Diluted weighted-average number of shares outstanding[1]:	1,342	3,118	5,688	6,822	6,934
Consolidated Balance Sheet Data (at end of period)[2]:					
Cash and cash equivalents	$ 324	$ 3,864	$ 11,133	$ 22,324	$ 18,470
Working capital	(4,858)	(1,187)	2,889	17,519	11,296
Total assets	3,075	10,319	20,340	62,105	63,315
Total debt	1,021	684	199	818	109
Total stockholders equity (deficit)	(4,370)	(398)	4,824	37,029	36,536

1 All share and earnings per share data gives effect to a 1-for-100 reverse stock split, which took effect in March 2003.

2 The Company sold its 51% equity interest in KGC effective December 31, 2005. As a result, its

balance sheet was not included in the Company s consolidated financial statements at December 31, 2005.

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Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Business Overview

The Company is an international direct selling organization. We control subsidiaries that distribute products through two separate direct selling businesses that promote health, wellness and vitality. Our wholly-owned subsidiary, Lexxus U.S., and other Lexxus subsidiaries, sell certain cosmetic products, consumer as well as quality of life products, which accounted for approximately 96% of our consolidated net revenues in 2003 and 99% in each of 2004 and 2005. eKaire.com, Inc. (eKaire), our wholly-owned subsidiary, distributes nutritional supplements aimed at general health and wellness.

Lexxus commenced operations in January 2001 and has experienced tremendous growth. As of December 31, 2005, it is conducting business in at least 15 countries through approximately 119,000 active distributors, excluding KGC (see discussion below). eKaire has been in business since 2000 and is operating in four countries through approximately 3,000 active distributors. We consider a distributor active if they have placed at least one product order with us during the preceding year.

We have experienced significant revenue growth over the last few years due in part to our efforts to expand into new markets. We do not intend to devote material resources to opening any additional foreign markets in 2006. Our priority for 2006 is to progress further on developing the Japanese, Mexican and Chinese markets.

In 2005, we generated approximately 92% of our revenue from outside North America, with sales in Hong Kong representing approximately 62% of revenue. Because of the size of our foreign operations, operating results can be impacted negatively or positively by factors such as foreign currency fluctuations, and economic, political and business conditions around the world. In addition, our business is subject to various laws and regulations, in particular regulations related to direct selling activities that create certain risks for our business, including improper claims or activities by our distributors and potential inability to obtain necessary product registrations.

Effective December 31, 2005, the Company entered into a Stock Purchase Agreement with Bannks Foundation (Bannks), a Lichtenstein foundation and owner of 49% of the common shares of KGC Networks Pte Ltd. (KGC), a Singapore corporation, pursuant to which the Company sold to Bannks 51,000 common shares representing the Company s 51% of the outstanding shares of capital stock of KGC for a total cash purchase price of $350,000.

At the same time and as a condition of the sale, the Company entered into a separate agreement whereby KGC would pay to the Company 24 monthly payments of approximately $169,000 each, including interest at 2.5%, to settle an outstanding inter-company payable in the amount of approximately $2.1 million and to pay for inventories ordered and partially delivered totaling approximately $884,000, as well as the Company s undertaking to continue to supply KGC with certain products for a period of at least 48 months. The Company discounted the 24 monthly payments based on its cost of capital and recorded the receivable at $3.1 million, of which $1.7 million is considered non-current. Given its interest in the retained profits and cumulative translation adjustment of KGC of approximately $434,000, the Company recognized a nominal gain on sale. Since the receivable from KGC is unsecured, the Company recorded a reserve totaling approximately $2.8 million, which will be reduced as payments are received.

KGC sells the Company s Lexxus products into a separate network of independent distributors located primarily in Russia and other Eastern European countries. Upon the effective date of the transactions above, the Company no longer consolidates the financial statements of KGC. The Company does not believe these transactions result in a discontinued operation as the Company will continue to supply KGC with a significant amount of product for the foreseeable future. Therefore, the 2005 results of KGC have been reported in results from operations.

Had KGC not been reflected in results from operations, the Company s 2005 statement of operations would have reflected the following (in thousands):

	Actual	As Adjusted
Net sales	$ 194,472	$ 160,214
Gross profit	149,726	123,171
Distributor commissions	101,021	85,388
Loss from operations	(3,054)	(2,301)

China is currently the Company s most important business development project. New direct selling legislation was adopted in December 2005, while multi-level marketing was banned in November 2005 by the government in China. Before the formal adoption of direct selling laws, many of the international direct selling companies started to operate in China in a retail format. In June 2004, Lexxus obtained a license to engage in retail business in China. The license stipulates a capital requirement of $12 million over a three-year period, including a $1.8 million initial payment the Company made in January 2005. In December 2005, the Company submitted a preliminary application for a direct selling license and fully capitalized its Chinese entity with the $12.0 million cash infusion. The Company is currently in the process of finalizing its application package.

In 2003, 2004 and 2005, approximately 49%, 56% and 62% of our revenue, respectively, was generated in Hong Kong. Most of the Company s Hong Kong revenues are derived from the sale of products that are delivered to members in China. After consulting with outside professionals, the Company believes that our Hong Kong e-commerce business does not violate any applicable law in China even though it is used for the e-purchase of our products by buyers in China. But the government in China could, in the future, officially interpret its laws and regulations or adopt new laws and regulations to prohibit some or all of our e-commerce activities with China and, if our members engage in illegal activities in China, those actions could be attributable to us.

On April 12, 2004, an investigative television program was aired in China with respect to the operations of the Company s Hong Kong subsidiary and the representative office located in Beijing. Among other things, the television program alleged that our Hong Kong operations engaged in fraudulent activities and sold products without proper permits. In response, the Company sent Curtis Broome to China to investigate and manage what was happening in China. Prior to that time, the Company did not have any management personnel in China. Among other things, Mr. Broome determined that the Company should be proactive in demonstrating that alleged illegal acts of individual members were not the acts of the Company itself and that the Company intended to invest in China for the long-term. Accordingly, the Company took the following steps:

The Company set up a school in Macau to train members about the applicable Chinese legal requirements and the need for distributors to accurately and fairly describe business opportunities available to potential members. The schools were operated from May 2004 to November 2005.

The Company suspended shipment of product to certain members until they had completed the required training.

The Company extended its existing 14-day return policy in Hong Kong to 180 days to allow distributors and customers who purchased products during the two-week period prior to, and the two-week period after, the airing of the television program to return purchased merchandise for a full refund.

The Company began posting announcements on its Hong Kong website to the effect that the resale of its products in China without the appropriate license would result in termination of membership. Since then, the Company has terminated at least four members in China for engaging in activities in violation of Chinese law.

In June 2004 the Company completed formation of its Chinese subsidiary (Lexxus China }, and by the end of 2005 had invested $12.0 million as capital in that entity.

Lexxus China is working to file an application for a direct selling license under proposed legislation.

Lexxus China has leased space in Zhuhai, purchased equipment and finished out a manufacturing plant. Although Lexxus China now has a license to manufacture and employee personnel at the plant, it does not yet have a license to sell any product manufactured there and will not begin manufacturing operations until it has obtained that license.

On November 1, 2005, Lexxus China obtained its general cosmetic manufacturing permit and has begun trial production testing.

There have been other isolated cases of misconduct by our members in China. For example, four of our members were detained in Dongguan for questioning in October 2005, with regard to possible violation of Chinese law regarding the maximum number of people who can attend a meeting as well as possible improper network marketing business activity. Charges were never filed and all individuals were released. In April, 2006, a media report indicated that someone was detained by Public Security in Changsha for investigation of similar allegations. The Company has not been able to determine if the individual in question is, in fact, a member and whether or not any laws were actually broken. Initial inquiries made by retained Chinese counsel indicate that no one is still being detained or has been charged.

We make efforts to be informed of and in compliance with applicable laws in China, and we have not received any official notice that we are or may be acting improperly or illegally, and we continue our efforts to maintain regular contact with officials in all levels of government. In September 2005, a 12-person delegation from the Zhuhai government made a point of visiting our offices in Dallas, Texas as part of an economic development tour to the United States.

The Company is unable to predict whether it will be successful in obtaining a direct selling license to operate in China, and if it is successful, when it will be permitted to commence direct selling operations there. Further, even if the Company is successful in obtaining a direct selling license to do business in China, it is uncertain as to whether the Company will generate profits from such operations.

Between April and December 2005, the Company s Hong Kong subsidiary engaged a service provider to facilitate product importation into China and act, or engage another party to act, as the importer of record. The individual that owns that service provider is one of the directors of the Company s wholly-owned Chinese subsidiary. The Company believes that the amount of duty paid to Chinese Customs on the imported goods by the importer of record was paid at the negotiated rate. However, there can be no assurance that Chinese Customs will not elect, in the future, to examine the duty paid, and if they conduct such examination, they may conclude that the valuation established was insufficient, resulting in an underpayment of duties. As a consequence, the importer of record could be required to pay additional duties and possible penalties to Chinese Customs. Additional duties could range between zero and $46.0 million, plus penalties. The extreme worst case was calculated using the highest possible assessment to the highest possible declared value and assuming that negotiated valuation practices do not apply. The Company believes that any such future assessment of additional duties or penalties would be made against and become the responsibility of the importer of record. There can be no assurance that the Company or its subsidiaries would not also be of assessed with such liability in the event that the importer of record is unable to pay all or part of such amount.

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Income Statement Presentation

The Company derives its revenue from sales of its products, sales of its enrollment packages, and from shipping charges. Substantially all of its product sales are to independent distributors at published wholesale prices. We translate revenue from each market s local currency into U.S. dollars using average rates of exchange during the period. The following table sets forth revenue by market for each of Lexxus and eKaire for the time periods indicated (in thousands).

	Year Ended December 31,					
	2003		2004		2005	
North America	$ 8,779	14.0%	$ 15,631	11.7%	$ 15,297	7.9%
Hong Kong	30,763	49.2	74,293	55.8	120,968	62.2
Taiwan	3,097	4.9	3,261	2.5	3,722	1.9
Southeast Asia	1,570	2.5	1,786	1.3	6,438	3.3
Russia and Eastern Europe[1]	13,157	21.0	30,248	22.7	34,258	17.6
South Korea	2,492	4.0	5,524	4.1	8,495	4.4
Australia/New Zealand	226	0.4	623	0.5	1,455	0.7
Japan					1,659	0.9
Latin America					518	0.3
Other	175	0.3	41			
Total Lexxus[1]	60,259	96.3	131,407	98.6	192,810	99.2
North America	1,889	3.0	1,283	1.0	1,231	0.6
Australia/New Zealand	428	0.7	535	0.4	431	0.2
Total eKaire	2,317	3.7	1,818	1.4	1,662	0.8
	$ 62,576	100%	$ 133,225	100%	$ 194,472	100%

Cost of sales consist primarily of products purchased from third-party manufacturers, freight cost of shipping products to distributors and import duties for the products, costs of promotional materials sold to the Company s distributors at or near cost, provisions for slow moving or obsolete inventories and, prior to the closing of the merger with MarketVision Communications Corp. as of March 31, 2004, the amortization of fees charged by the Company s third party software service provider. Cost of sales also includes purchasing costs, receiving costs, inspection costs and warehousing costs. Certain prior year amounts have been reclassified into cost of sales so that the financial statements are comparable between periods.

Distributor commissions are our most significant expense and are classified as operating expenses. Under our compensation plan, distributors are paid weekly commissions in the distributor s home country, in their local currency, for product sold by that distributor s down-line distributor network across all geographic markets. Distributors are not paid commissions on purchases or sales of our products made directly by them. This seamless compensation plan enables a distributor located in one country to sponsor other distributors located in other countries where we are authorized to do business. Currently, there are two fundamental ways in which our distributors can earn income:

Through retail markups on sales of products purchased by distributors at wholesale prices; and

Through a series of commissions paid on product purchases made by their down-line distributors.

Each of our products carries a specified number of sales volume points. Commissions are based on total personal and group sales volume points per sales period. Sales volume points are essentially based upon a percentage of a product s wholesale cost. To be eligible to receive commissions, a distributor may be required to make nominal monthly purchases of our products. Certain of our subsidiaries do not require these nominal purchases for a distributor to be eligible to receive commissions. In determining commissions, the number of levels of down-line distributors included within the distributor s commissionable group increases as the

[1] The Company will no longer consolidate the operating results of KGC for periods beginning after December 31, 2005 as it sold its 51% interest in KGC to Bannks Foundation effective December 31, 2005.

number of distributorships directly below the distributor increases. Distributor commissions are dependent on the sales mix and, for 2005, typically ranged between 45% and 55% of net sales. From time to time we make modifications and enhancements to our compensation plan to help motivate distributors, which can have an impact on distributor commissions. From time to time we also enter into agreements for business or market development, which may result in additional compensation to specific distributors.

Selling, general and administrative expenses consist of administrative compensation and benefits, travel, credit card fees and assessments, professional fees, certain occupancy costs, depreciation and amortization, and other corporate administrative expenses. In addition, this category includes selling, marketing, and promotion expenses including costs of distributor conventions which are designed to increase both product awareness and distributor recruitment. Because our various distributor conventions are not always held at the same time each year, interim period comparisons will be impacted accordingly.

Provision for income taxes depends on the statutory tax rates in each of the jurisdictions in which we operate. We implemented a foreign holding and operating company structure for our non-United States businesses. This new structure re-organizes our non-United States subsidiaries in the Cayman Islands. Though our goal is to improve the overall tax rate, there is no assurance that the new tax structure could be successful. If the United States Internal Revenue Service or the taxing authorities of any other jurisdiction were to successfully challenge these agreements, plans, or arrangements, or require changes in our transfer pricing practices, we could be required to pay higher taxes, interest and penalties, and our earnings would be adversely affected.

Critical Accounting Policies

In response to SEC Release No. 33-8040, Cautionary Advice Regarding Disclosure about Critical Accounting Policies and SEC Release Number 33-8056, Commission Statement about Management s Discussion and Analysis of Financial Condition and Results of Operations, the Company has identified certain policies and estimates that are important to the portrayal of its consolidated financial condition and consolidated results of operations. Critical accounting policies and estimates are defined as both those that are material to the portrayal of our financial condition and results of operations and as those that require management s most subjective judgments. These policies and estimates require the application of significant judgment by the Company s management.

The most significant accounting estimates inherent in the preparation of the Company s financial statements include estimates associated with obsolete inventory and the fair value of acquired intangible assets and goodwill, as well as those used in the determination of liabilities related to sales returns, distributor commissions, and income taxes. Various assumptions and other factors prompt the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account historical experience and current and expected economic conditions. Historically, actual results have not significantly deviated from those determined using the estimates described above. If circumstances change relating to the various assumptions or other factors used in such estimates the Company could experience an adverse effect on its consolidated financial condition, changes in financial condition, and results of operations. The Company s critical accounting policies at December 31, 2005 include the following:

Inventory Valuation. The Company reviews its inventory carrying value and compares it to the net realizable value of its inventory and any inventory value in excess of net realizable value is written down. In addition, the Company reviews its inventory for obsolescence and any inventory identified as obsolete is reserved or written off. The Company s determination of obsolescence is based on assumptions about the demand for its products, product expiration dates, estimated future sales, and management s future plans. Also, if actual sales or management plans are less favorable than those originally projected by management, additional inventory reserves or write-downs may be required. The Company s inventory value at December 31, 2005 was approximately $12.4 million. Inventory write-downs for years 2003 and 2004 were not significant. The Company recorded a reserve for obsolete inventory of approximately $534,000 in 2005 primarily related to coffee pods used in the Gourmet Coffee Café coffee machines.

Valuation of Goodwill and Impairment Analysis. The Company has adopted Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually or sooner whenever events or changes in circumstances indicate that they may be impaired. At December 31, 2005, goodwill of approximately $14.1 million was reflected on the Company s balance sheet. No impairment of goodwill has been identified in any of the periods presented. The Company reviews the book value of its property and equipment and intangible assets whenever an event or change in circumstances indicates that the net book value of an asset or group of assets may be unrecoverable. The Company s impairment review includes a comparison of future projected cash flows (undiscounted and without interest charges) generated by the asset or group of assets with its associated carrying value. The Company believes its expected future cash flows approximate or exceed its net book value. However, if circumstances change and the net book value of the asset or group of assets exceeds expected cash flows, the Company would have to recognize an impairment loss to the extent the net book value of the asset exceeds its fair value. At December 31, 2005, the net book value of the Company s property and equipment and intangible assets were approximately $3.1 million and $4.5 million, respectively. No such losses were recognized for the years ended December 31, 2004 and 2005.

Allowance for Sales Returns. An allowance for sales returns is provided during the period the product is shipped. The allowance is based upon the return policy of each country, which varies from 14 days to one year, and their historical return rates, which range from approximately 1% to approximately 10% of product sales. Sales returns are approximately 5% and 4% of product sales for the years ended December 31, 2004 and 2005, respectively. The allowance for sales returns was approximately $1.5 million and $1.7 million at December 31, 2004 and 2005, respectively. No material changes in estimates have been recognized for the years ended December 31, 2004 and 2005.

Revenue Recognition. Product sales are recorded when the products are shipped and title passes to independent distributors. Product sales to distributors are made pursuant to a distributor agreement that provides for transfer of both title and risk of loss upon our delivery to the carrier that completes delivery to the distributors, which is commonly referred to as F.O.B. Shipping Point. The Company primarily receives payment by credit card at the time distributors place orders. The Company s sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return. Amounts received for unshipped product are recorded as deferred revenue. Such amounts totaled approximately $4.8 million and $1.5 million at December 31, 2004 and 2005, respectively. Shipping charges billed to distributors are included in net sales. Costs associated with shipments are included in cost of sales.

During April 2005, the Company launched a new product line, Gourmet Coffee Café, which consists of coffee machines and the related coffee and tea pods, in the North American market. As the Gourmet Coffee Café is a very different product than the Company s other products and there is no reliable information on the Company s sales returns or warranty obligation, the Company has deferred all revenue generated from the sale of coffee machines and the related coffee and tea pods until sufficient return and warranty experience on the product can be established. The deferral totaled approximately $1.6 million and $1.2 million in revenue and related costs, respectively, for product shipped through December 31, 2005. The deferred costs are recorded in other current assets, as the sales return period for distributors is only for a year. Since the launch, the Company has experienced a high rate of defects and product returns. As a result, the Company has delayed continued sales of our existing inventory of this product and approached the manufacturer for resolution. The manufacturer has agreed to repair all of the machines in our existing inventory and provide discounts on future purchases. The Company is currently planning to re-start the sale of the coffee machines in the second half of 2006.

Enrollment package revenue, including any nonrefundable set-up fees, is deferred and recognized over the term of the arrangement, generally twelve months. During the third quarter of 2004, the Company changed its amortization methodology from a monthly method to the preferred daily method whereby revenues for each enrollment package start the day of enrollment. The change in methodology resulted in additional deferred revenue of approximately $280,000 during 2004. Enrollment packages provide distributors access to both a personalized marketing website and a business management system. Prior to the acquisition of MarketVision Communications Corp. (MarketVision) on March 31, 2004, the Company paid MarketVision a fixed amount in exchange for MarketVision creating and maintaining individual web pages for such distributors. These payments to MarketVision were deferred and recorded as a prepaid expense. The related amortization was recorded to cost of sales over the term of the arrangement. The remaining unamortized costs were included in the determination of the purchase price of MarketVision. Subsequent to the acquisition of MarketVision, no upfront costs are deferred as the amount is nominal. At December 31, 2005, enrollment package revenue totaling $6.8 million was deferred. Although the Company has no immediate plans to significantly change the terms or conditions of enrollment packages, any changes in the future could result in additional revenue deferrals or could cause us to recognize the deferred revenue over a longer period of time.

Tax Valuation Allowance. The Company evaluates the probability of realizing the future benefits of any of its deferred tax assets and records a valuation allowance when it believes a portion or all of its deferred tax assets may not be realized. At December 31, 2005, the Company increased the valuation allowance to equal its net deferred tax assets due to the uncertainty of future operating results. The valuation allowance will be reduced at such time as management believes it is more likely than not that the deferred tax assets will be realized. Any reductions in the valuation allowance will reduce future income tax provisions.

Results of Operations

The following table sets forth our operating results as a percentage of net sales for the periods indicated.

	Year Ended December 31,		
	2003	2004	2005
Net sales	100%	100%	100%
Cost of sales	21.9	22.0	23.0
Gross profit	78.1	78.0	77.0
Operating expenses:			
Distributor commissions	44.0	51.5	51.9
Selling, general and administrative expenses	25.2	24.8	25.2
Provision for KGC receivable			1.4
Total operating expenses	69.2	76.3	78.5
Income (loss) from operations	8.9	1.7	(1.5)
Other income (expense)		0.1	(0.5)
Income (loss) before income taxes and minority interest	8.9	1.8	(2.0)
Income tax provision	(1.4)	(0.5)	(0.8)
Minority interest		(0.4)	
Net income (loss)	7.5%	0.9%	(2.8)%

2005 Compared to 2004

Net Sales. Net sales were approximately $194.5 million for the twelve months ended December 31, 2005 compared to $133.2 million for the twelve months ended December 31, 2004, an increase of approximately $61.3 million or 46.0 percent. The revenue increase for the twelve months of 2005 over a year ago was due to growth in the Hong Kong-based business (contributing approximately $46.7 million of the total increase) and the opening of the Japanese office ($6.8 million, including advance sales recorded in Singapore). Most of the Company s Hong Kong revenue is derived from the sale of products that are delivered to members in China. The Company expects revenue generated in Southeast Asia, specifically Singapore, to decline as a substantial portion of its revenue is derived from the sale of products that are delivered into Japan. KGC ($4.0 million), South Korea ($3.0 million), Taiwan ($0.5 million) and Australia ($0.8 million) accounted for the rest of the sales growth.

The overall growth in net sales is attributable to more net sales generated per distributor enhanced by a 5% product price increase implemented in January 2005 in most of our markets, $20.5 million or approximately one third of the increase, and an increase in the number of active independent distributors, approximately $40.8 million or approximately two thirds of the sales increase. As of December 31, 2005, the operating subsidiaries of the Company had approximately 174,400 active distributors (including KGC), compared to 133,000 active independent distributors at the end of 2004.

As of December 31, 2005, the Company had deferred revenue of approximately $9.9 million, of which approximately $1.5 million pertained to product sales and approximately $6.8 million pertained to unamortized enrollment package revenue. Additionally, deferred revenue included approximately $1.6 million of Gourmet Coffee Café product shipped but unrecognized as of December 31, 2005 (approximately $1.2 million in Gourmet Coffee Café related costs are also deferred and recorded in other current assets as of December 31, 2005).

Cost of Sales. Cost of sales was approximately $44.7 million or 23.0% of net sales for the twelve months ended December 31, 2005 compared with approximately $29.3 million or 22.0% of net sales for the twelve months ended December 31, 2004. This increase of approximately $15.4 million or 52.6% was primarily driven by increased sales.

Cost of sales as a percentage of net sales was up approximately 1.0% due to an inventory write-off in 2005 and certain additional logistic processing costs for our Hong Kong-based business, partly offset by the 5% price increase as well as the elimination of the commissions paid to MarketVision after its acquisition by the Company on March 31, 2004.

Gross Profit. Gross profit was approximately $149.7 million or 77.0% of net sales for the twelve months ended December 31, 2005 compared with approximately $103.9 million or 78.0% of net sales for the twelve months ended December 31, 2004. This increase of approximately $45.8 million or 44.1% was attributable to the increase in sales.

Distributor Commissions. Distributor commissions were approximately $101.0 million or 51.9% of net sales for the twelve months ended December 31, 2005 compared with approximately $68.6 million or 51.5% of net sales for the twelve months ended December 31, 2004. This increase of approximately $32.4 million or 47.3% of net sales was primarily related to the significant increase in sales as well the depth of the distributor network.

Selling, General and Administrative Expenses. Selling, general and administrative costs were approximately $49.0 million or 25.2% of net sales for the twelve months ended December 31, 2005 compared with approximately $33.1 million or 24.8% of net sales for the twelve months ended December 31, 2004. This increase of approximately $15.9 million or 48.0% was mainly attributable to increases in the following:

- costs of opening new markets in Mexico ($1.6 million) and Japan ($3.9 million);
- costs of expansion into China ($1.4 million);
- increased personnel costs and credit card charges and assessments in Hong Kong ($2.5 million);
- increased marketing and professional fees in Russia and Eastern Europe by KGC ($2.7 million); and
- higher professional fees and personnel cost in North America ($3.2 million).

Other Income (Expense). Other expense was approximately $910,000 for the year ended December 31, 2005 compared with income of approximately $137,000 for the year ended December 31, 2004. This decrease of approximately $1.0 million resulted primarily from foreign exchange losses on inter-company transactions (primarily related to KGC which is denominated in euro), partly offset by interest income.

Income Taxes. Income tax expense was approximately $1.6 million for the twelve months ended December 31, 2005 compared with $0.7 million for the twelve months ended December 31, 2004. The Company s income tax provision was negatively impacted by the repatriation of foreign earnings into the U.S., taxable income on the KGC sale in December 2005 of approximately $1.3 million, and a decrease in the net deferred tax assets of approximately $0.5 million. Additionally, approximately $0.8 million in income tax expense was incurred in 2005 due to the operating profits generated by the Greater China region.

Minority Interest. Minority interest benefit was approximately $49,000 for the twelve months ended December 31, 2005, compared to expense of approximately $456,000 for the twelve months ended December 31, 2004. The decrease in the expense relates primarily to the decreased profitability of KGC.

Net Income(Loss). Net loss was approximately $5.5 million or 2.8% of net sales for the twelve months ended December 31, 2005 compared to net income of approximately $1.2 million or 0.9% of net sales for the twelve months ended December 31, 2004. The decrease in net income was primarily due to higher distributor commissions, professional fees and marketing-related expenses. Additionally, the Company recorded a provision for the receivable from KGC totaling $2.8 million, incurred higher non-operating expenses during the twelve months ended December 31, 2005 resulting from foreign exchange losses, and recorded higher income tax expense.

2004 Compared to 2003

Net Sales. Net sales were approximately $133.2 million for the twelve months ended December 31, 2004 compared to $62.6 million for the twelve months ended December 31, 2003. This net increase of approximately $70.6 million or 113% was primarily attributable to the increased number of active Lexxus distributors, approximately $46.5 million or approximately two thirds of the sales increase, as well as more sales generated per distributor, $24.1 million or approximately one third of the increase. Increases in net sales mainly occurred in Hong Kong ($43.5 million), Eastern Europe ($17.1 million) and North America ($6.2 million). As of December 31, 2004, the Company had deferred revenue of approximately $9.5 million of which $4.8 million pertained to goods shipped in the first quarter of 2005 and recognized as revenue at that time and $4.7 million pertained to enrollment package revenue.

Cost of Sales. Cost of sales was approximately $29.3 million or 22.0% of net sales for the twelve months ended December 31, 2004 compared with approximately $13.7 million or 21.9% of net sales for the twelve months ended December 31, 2004. This increase of approximately $15.6 million or 114% was primarily driven by increased sales. Cost of sales as a percentage of net sales was flat with a year ago. Greater air freight costs to ship product from the US to Asia and Europe in 2004 were largely offset by the elimination of the commissions paid to MarketVision after its acquisition by the Company on March 31, 2004.

Gross Profit. Gross profit was approximately $103.9 million or 78.0% of net sales for the twelve months ended December 31, 2004 compared with approximately $48.9 million or 78.1% of net sales for the twelve months ended December 31, 2003. This increase of approximately $55.0 million or 112% was attributable to the increase in sales.

Distributor Commissions. Distributor commissions were approximately $68.6 million or 51.5% of net sales for the twelve months ended December 31, 2004 compared with approximately $27.6 million or 44.0% of net sales for the twelve months ended December 31, 2003. This increase of approximately $41.0 million or 149% and as a percentage of sales was primarily related to the significant increase in sales as well the depth of the distributor network. Approximately $1.1 million of the increase was due to commissions paid on returns and refunds pertaining to the special product return privilege granted to certain Hong Kong distributors in the second quarter.

Selling, General and Administrative Expenses. Selling, general and administrative costs were approximately $33.1 million or 24.8% of net sales for the twelve months ended December 31, 2004 compared with approximately $15.8 million or 25.2% of net sales for the twelve months ended December 31, 2003. This increase of approximately $17.3 million or 110% was mainly attributable to increases in the following:

Marketing and promotional activities world-wide of $7.8 million (The Company resorted to the increase in marketing activities in most of the Company s markets around the world to drive the increase in the number of active distributors);

Credit card charges and assessments totaling $2.7 million;

Professional fees of $2.3 million;

Personnel costs mainly in the U.S. and Hong Kong of $2.2 million;

Costs for building the Chinese market totaling $600,000; and

Amortization of intangibles of $600,000 related to the MarketVision acquisition.

Other Income (Expense). Other income was approximately $137,000 for the year ended December 31, 2004 compared with expense of approximately $1,000 for the year ended December 31, 2003. This increase of approximately $138,000 was due to recognized gain on foreign exchange partly offset by an increase in interest expense resulting from the MarketVision acquisition.

Income Taxes. Income tax expense was approximately $663,000 or 28.1% of the income before income taxes and minority interest for the twelve months ended December 31, 2004 compared with $860,000 or 15.4% of income before income taxes and minority interest for the twelve months ended December 31, 2003. The increase in effective tax rate was attributable to use of net operating loss in the U.S. and lower effective tax rates on foreign earnings in 2003 compared to 2004.

Minority Interest. Minority interest expense was approximately $456,000 for the twelve months ended December 31, 2004, compared to a benefit of approximately $14,000 for the twelve months ended December 31, 2003. The increase in the expense relates primarily to the increased profitability of our subsidiary, KGC.

Net Income. Net income was approximately $1.2 million or 0.9% of net sales for the twelve months ended December 31, 2004 compared to net income of approximately $4.7 million or 7.5% of net sales for the twelve months ended December 31, 2003. The decrease in net income was primarily due to higher commissions paid to distributors and marketing-related expenses, partly offset by higher volume.

Liquidity and Capital Resources

Cash generated from operations is the main funding source for the Company s working capital and capital expenditure. In the past, the Company also borrowed from institutions and individuals and issued preferred stock. In October 2004, the Company raised approximately $16 million net of transaction fees through a private equity placement. At December 31, 2005, the Company s cash and cash equivalents totaled approximately $18.5 million.

At December 31, 2005, the ratio of current assets to current liabilities was 1.42 to 1.00 and the Company had working capital of approximately $11.3 million. Working capital as of December 31, 2005 decreased from December 31, 2004 by approximately $6.2

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million mainly due to cash required to fund a $2.5 million consumer protection fund deposit as part of the direct selling license application statutory requirement as well as the exclusion of the KGC s working capital of $2.8 million as it is no longer consolidated.

Cash provided by operations for the twelve months ended December 31, 2005 was approximately $1.4 million. The significant sales increase was the most significant underlying trend for cash flows from operating activities and the change in the Company s working capital. Cash was mainly generated from increases in accrued distributor commissions and other accrued expenses such as sales returns and deferred revenue, all driven by sales increase, partly offset by a significant increase in inventory attributable to anticipated sales increase in the coming year. But there is no assurance that the expected sales increase in the near turn will be realized.

Cash used in investing activities during the period was approximately $8.4 million, which primarily relates to investments in setting up new offices in Japan and China, a new factory in China as well as the financial reporting software implementation of the Oracle E-Business Suite. Restricted cash increased approximately $2.8 million mainly due to cash required to fund a $2.5 million consumer protection fund deposit as part of the direct selling license application statutory requirement. Additional investing activities included $1.3 million net cash reduction from the sale of KGC and an investment in a certificate of deposit of approximately $1.3 million.

Cash provided by financing activities during the period was approximately $2.8 million due to proceeds received of approximately $3.5 million from the exercise of warrants issued in the private equity placement that occurred in October 2004, offset by the Company s full repayment of MarketVision promissory notes payable of approximately $0.7 million. Total cash and cash equivalents decreased by approximately $3.9 million during the period.

With cash generated from business operations and the net proceeds from the private placement closed in October 2004, the Company believes that its existing liquidity and cash flows from operations, including its cash and cash equivalents, should be adequate to fund normal business operations expected in the future.

In addition to the Company s current obligations related to its accounts payable and accrued expenses, the approximate future maturities of the Company s existing commitments and obligations are as follows (in thousands):

		Year Ended December 31,					
	Total	2006	2007	2008	2009	2010	Thereafter
Debt	$ 109	$ 109	$	$	$	$	$
Operating leases	6,740	1,891	1,527	875	707	505	1,235
Purchase commitments[1]	7,028	1,489	1,489	1,350	1,350	1,350	
Construction commitment	580	580					
Totals	$ 14,457	$ 4,069	$ 3,016	$ 2,225	$ 2,057	$ 1,855	$ 1,235

The Company has entered into non-cancelable operating lease agreements for locations within the U.S. and for its international subsidiaries, with expirations through May 2015.

The Company maintains a purchase commitment with one of its suppliers to purchase its Cluster *Concentrate* product. Pursuant to this agreement, the Company is required to purchase from this supplier a minimum volume of 20,000 bottles of product per year. The total product cost is $138,800 before any volume discounts.

In December 2005, the Company committed approximately $580,000 for buildout of a new training facility in Japan. Construction completed and the facility opened in April 2006.

The Company has employment agreements with certain members of its management team, the terms of which expire at various times through October 2009. Such agreements provide minimum salary levels, as well as incentive bonuses that are payable if

[1] Purchase commitments include the

Company s agreement with the supplier of its *Alura®* product to purchase a minimum volume of 15 barrels of product per quarter to maintain exclusivity and volume discounts. The total product cost is $1.4 million before any volume discounts. The Company intends to maintain this contract. The contract does not terminate unless the Company fails to purchase at least $350,000 a quarter.

specified management goals are attained. The aggregate commitment for future salaries at December 31, 2005, assuming continued employment and excluding incentive bonuses, was approximately $4.3 million.

The Company intends to continue to open additional operations in new foreign markets after 2006. The Company plans to focus on further developing the Japanese, the Mexican and the Chinese markets in the next 12 months.

In connection with the MarketVision acquisition, the Company issued three different promissory notes in the aggregate principal amount of approximately $3.2 million. As of December 31, 2005, the three promissory notes have been paid off.

Related Party Transactions

In August 2001, the Company entered into a written lease agreement and an oral management agreement with S&B Business Services, an affiliate of Brad LaCore, the brother of Terry LaCore, former Chief Executive Officer of Lexxus U.S. and former director of the Company, and Sherry LaCore, Brad LaCore s spouse. Under the terms of the two agreements, S&B Business Services provides warehouse facilities and certain equipment, manages and ships inventory, provides independent distributor support services and disburses payments to independent distributors. In exchange for these services, the Company pays $18,000 annually for leasing the warehouse, $3,600 annually for the lease of warehouse equipment and $120,000 annually for the management services provided, plus an annual average of approximately $12,000 for business related services. The Company paid S&B Business Services approximately $150,000, $160,000 and $158,000 during 2003, 2004 and 2005, respectively. As of December 31, 2005, the Company owed approximately $1,400 to S&B Business Services.

The payment disbursement function was transferred to the Company s Dallas head office during the third quarter of 2005. In January 2006, the Company hired Sherry LaCore as an employee and simultaneously terminated the oral management agreement. Additionally, the Company closed the warehouse facility by the end of March 2006 and terminated the related lease agreement.

In September 2001, the Company entered into an oral consulting agreement with William Woodburn, the father of Mark Woodburn, former President and director of the Company, pursuant to which William Woodburn provided the Company with management advice and other advisory assistance. In exchange for such services, the Company starting June 8, 2001 paid to Ohio Valley Welding, Inc., an affiliate of William Woodburn, $6,250 on a bi-weekly basis. The Company paid $168,750 and $118,750 during 2003 and 2004, respectively, to Ohio Valley Welding, Inc. The consulting agreement between the Company and William Woodburn was terminated as of September 30, 2004.

The Company s former controller is married to Mark Woodburn, former President and director of the Company. Her employment with the Company ended in August 2004. The Company paid her approximately $100,000 in each of the years 2003 and 2004.

On March 31, 2004, the Company entered into a merger agreement with MarketVision, pursuant to which the Company acquired all of the outstanding capital stock of MarketVision. As a founding stockholder of MarketVision, Terry LaCore, former Chief Executive Officer of Lexxus U.S. and former director of the Company, received 450,000 shares of the Company s common stock and was entitled to receive approximately $840,000 plus interest from promissory notes issued by the Company. As of December 31, 2005, no amounts remained outstanding to Mr. LaCore.

On October 6, 2004, certain members of the Company s board of directors and certain of the Company s officers invested approximately $25,000 and purchased 1,984 units upon the same terms and conditions as the other buyers in the private placement.

A director of the Company s China subsidiary is the sole director of Access Int l (Zhuhai Ftz) Warehousing & Trading Co. Ltd. and its group (collectively, Access), a transportation and logistics company, and the owner of Info Development Ltd. (Info), an import services company, both of which provided services to the Company s Hong Kong subsidiary. Payments totaling approximately $5.2 million and $0.2 million were paid to Access and Info during 2005, respectively. At December 31, 2005, approximately $3,300 was due to Access.

On November 10, 2005, an independent investigator retained by the Company s Audit Committee learned that an entity controlled by Messrs. Woodburn and LaCore received payments from an independent distributor of the Company s products during 2001 through August 2005. The Company believes that Messrs. Woodburn and LaCore received from such independent distributor a total of approximately $1.4 million and $1.1 million, respectively. The Company believes that the fees paid by the Company to such independent distributor were not in excess of the amounts due under the Company s regular distributor compensation plan.

Approximately $2.4 million of the funds paid by the independent distributor to Messrs. Woodburn and LaCore were paid at the direction of Messrs. Woodburn and LaCore to an entity that is partially owned by Mr. Woodburn s father and Randall A. Mason, a member of the Company s Board of Directors and former Chairman of the Company s Audit Committee. The funds were subsequently paid to an entity controlled by Messrs. Woodburn and LaCore at their direction. After investigation by the Audit Committee, the Board of Directors of the Company concluded that Mr. Mason was unaware that these payments were directed by Messrs. Woodburn and LaCore to an entity partially owned by him until uncovered by the Audit s Committee s independent investigator on November 10, 2005, and that Mr. Mason was not involved in any misconduct and received no pecuniary benefit from the payments made by the independent distributor. However, since payments were directed into an entity that is partially owned by Mr. Mason, he could no longer be considered independent in accordance with the rules of The NASDAQ Stock Market and under the federal securities laws. Therefore, effective November 11, 2005, Mr. Mason resigned as Chairman and a member of the Company s Audit Committee. Mr. Mason remained as a director.

On November 14, 2005, in light of the information learned by the Company s Audit Committee on November 10, 2005, the Company terminated the employment of each of Messrs. Woodburn and LaCore. No severance has been paid by the Company to Messrs. Woodburn and LaCore and the Audit Committee is investigating claims or actions that the Company may bring against them.

In addition, a loan made by the Company under the direction of Mr. Woodburn in the aggregate principal amount of $256,000 in February 2004 was previously recorded as a loan to a third party. On November 10, 2005, the Audit Committee investigator learned that the Company actually loaned the funds to an entity owned and controlled by the parents of Mr. Woodburn. The loan was repaid in full, partially by an entity controlled by a third party and partially by an entity controlled by Mr. Woodburn in December 2004.

On March 23, 2006, an independent investigator retained by the Audit Committee of the Board of Directors confirmed that affiliates of immediate family members of Mr. Woodburn have owned since 1998, and continue to own, equity interests in Aloe Commodities (Aloe), the largest manufacturer of the Company and the supplier of the *Skindulgence®* Line and *LaVie* products, representing approximately 5% of the outstanding shares of Aloe. The Audit Committee is continuing to investigate to determine whether any financial or other benefits were paid to

Mr. Woodburn, his immediate family members or their respective affiliates. The Company has paid Aloe and certain of its affiliates approximately $2.6 million, $9.9 million, and $8.6 million during 2003, 2004 and 2005, respectively.

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Recent Accounting Pronouncements

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, Inventory Costs (SFAS 151). This statement requires that certain costs such as idle facility expense, excessive spoilage, double freight, and re-handling costs be recognized as current-period charges and that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of the statement shall be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151, effective January 1, 2006, did not have a significant impact on the Company s financial condition, results of operations, or cash flows.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which is a revision of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and amends Statement of Financial Accounting Standards No. 95, Statement of Cash Flows . Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) will require all share-based payments to employees, including grants of employee stock options, to be recognized in our Consolidated Statements of Income, based on their fair values. Pro forma disclosure will no longer be an alternative. SFAS 123(R) will be effective January 1, 2006 and permits us to adopt its requirements using one of two methods:

A modified prospective method in which compensation cost is recognized beginning with the effective date based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and based on the requirements of SFAS 123 for all awards granted to employees prior to the adoption date of SFAS 123(R) that remain unvested on the adoption date.

A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate either all prior periods presented or prior interim periods of the year of adoption based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures.

We will adopt the provisions of SFAS 123(R) using the modified prospective method. As permitted by SFAS 123, we currently account for share-based payments to employees using the intrinsic value method prescribed by APB 25 and related interpretations. Therefore, we do not recognize compensation expenses associated with employee stock options. We estimate that the adoption of SFAS 123(R) will result in an expense of approximately $0.5 million, or $0.08 per diluted share, for the year ended December 31, 2006. However, the adoption of SFAS 123(R) fair value method could have a significant impact on our future results of operations for future stock or stock option grants but no impact on our overall financial position. Had we adopted SFAS 123(R) in prior periods, the impact would have approximated the impact of SFAS 123 as described in the pro forma net income and income per-share disclosures. The adoption of SFAS 123(R) will have no effect on our outstanding vested stock grant awards.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. This Statement changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to voluntary changes as well as those changes required by an accounting pronouncement if that pronouncement does not include specific transition provisions. This Statement requires retrospective application to prior periods financial statements of changes in accounting principle as opposed to being shown as a cumulative adjustment in the period of change. The Statement is effective for all changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of this standard is not expected to materially impact the Company.

Off Balance Sheet Arrangements

The Company does not utilize off-balance sheet financing arrangements other than in the normal course of business. The Company finances the use of certain facilities, office and computer equipment, and automobiles under various operating lease agreements.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Risk

In 2005, approximately 92% of our revenue was recorded in markets outside the United States. However, that figure does not accurately reflect our foreign currency exposure mainly because the Hong Kong dollar is pegged to the U.S. dollar. Our 51% equity interest in the European business, KGC, operating since the fourth quarter of 2004 in euro, was sold off to the minority interest owner as of December 31, 2005. We also purchase all inventories in U.S. dollars. Therefore, our currency exposure, mainly to Korean won, Singapore dollar, New Taiwan dollar and Australia dollar, represented approximately 12% of our revenue in 2005, excluding KGC. With KGC, the Company incurred a foreign currency loss of $1.1 million during 2005.

In preparing our consolidated financial statements, we translate revenue and expenses in foreign countries from their local currencies into U.S. dollars using the average exchange rates for the period. The local currency of each subsidiary s primary markets is considered the functional currency. The effect of the translation of the Company s foreign operations is included in accumulated other comprehensive income within stockholders equity and do not impact the statement of operations.

As currency rates change, translation of our foreign currency functional businesses into U.S. dollars affects year-over-year comparability of equity. We do not plan to hedge translation risks because cash flows from our international operations are generally reinvested locally. Changes in the currency exchange rates that would have the largest impact on translating our international net assets include Korean won, New Taiwan dollar, Australian dollar and Canadian dollar. Japanese yen and Mexican peso are expected to become more significant. Following are the average exchange rates of U.S. $1 into local currency for each of our international operations:

	2004				2005			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Hong Kong	$ 7.78	$ 7.80	$ 7.80	$ 7.78	$ 7.80	$ 7.79	$ 7.77	$ 7.75
Taiwan	33.49	33.38	34.01	32.99	31.54	31.44	32.31	33.49
Singapore	1.70	1.70	1.71	1.66	1.64	1.66	1.68	1.69
Philippines	56.13	56.11	56.15	56.38	55.09	54.73	56.11	54.62
Russia and Eastern Europe[1]	0.80	0.83	0.82	0.77	0.76	0.79	0.83	0.84
South Korea	1,180.03	1,166.47	1,155.44	1,102.18	1,027.27	1,009.24	1,030.00	1,043.65
Australia	1.31	1.40	1.41	1.32	1.29	1.30	1.32	1.34
New Zealand	1.49	1.59	1.53	1.43	1.40	1.40	1.45	1.44
Japan[2]							111.19	117.20
Latin America[2]							10.72	10.72

Hedging

Our exposure to foreign currency fluctuation is expected to increase as the Company further develops the markets in Japan, Mexico and China. The Company currently has no specific plans but expects to evaluate whether it should use forward or option contracts to hedge its foreign currency exposure.

1 Functional currency of is the euro. The Company will no longer consolidate the operating results

of KGC for periods beginning after December 31, 2005 as it sold its 51% interest in KGC to Bannks Foundation effective December 31, 2005.

2 No significant revenue generating activities occurred until the third quarter of 2005.

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Seasonality

Generally our revenue has not been impacted by seasonality on any significant basis. From quarter to quarter, the Company is somewhat impacted by seasonal factors and trends such as major cultural events and vacation patterns. For example, most Asian markets celebrate their respective local New Year in the first quarter, which generally has a small negative impact on that quarter. We believe that direct selling in the United States and Europe is also generally negatively impacted during the month of August, which is in our third quarter, when many individuals, including our distributors, traditionally take time off for vacations.

The Company s spending is materially effected by the major events planned for at different times of the year. A major promotional event could significantly increase the reported expenses during the quarter in which the events actually takes place, while the revenue that might be generated by the event may not occur in the same reporting period.

Interest Rate Risk

As of December 31, 2005, we do not think the Company has any exposure to interest rate risk as the Company has limited borrowings that are interest rate sensitive.

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Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTAL DATA

NATURAL HEALTH TRENDS CORP.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Natural Health Trends Corp.
Dallas, Texas

We have audited the accompanying consolidated balance sheets of Natural Health Trends Corp. (the Company) as of December 31, 2004 and 2005, and the related consolidated statements of operations, stockholders equity and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits include 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Natural Health Trends Corp. at December 31, 2004 and 2005, and the results of its operations and its cash flows for each of the three years ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 9 to the consolidated financial statements, sales of products delivered to members in China represent a significant portion of the Company s net sales. Any disruption of such sales would have a negative impact upon the Company s future operations. Further, if it were determined that import duties into China are underpaid, the Company could be required to satisfy part or all of the liability.

/s/ BDO Seidman, LLP
BDO Seidman, LLP
Dallas, Texas
April 28, 2006, except for Note 16
as to which the date is May 5, 2006

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NATURAL HEALTH TRENDS CORP.
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

	December 31, 2004	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 22,324	$ 18,470
Restricted cash	2,395	2,236
Accounts receivable	209	300
Inventories, net	13,991	12,360
Other current assets	2,096	4,632
Total current assets	41,015	37,998
Property and equipment, net	579	3,143
Goodwill	14,145	14,145
Intangible assets, net	5,474	4,529
Deferred tax assets	434	
Other assets	458	3,500
Total assets	$ 62,105	$ 63,315
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,344	$ 2,023
Income taxes payable	1,797	1,308
Accrued distributor commissions	4,259	4,001
Other accrued expenses	4,154	6,827
Deferred revenue	9,551	9,897
Current portion of debt	796	109
Other current liabilities	1,595	2,537
Total current liabilities	23,496	26,702
Debt	22	
Total liabilities	23,518	26,702
Commitments and contingencies		
Minority interest	598	77
Mezzanine common stock	960	
Stockholders equity:		
Preferred stock, $0.001 par value; 1,500,000 and 5,000,000 shares authorized at December 31, 2004 and 2005, respectively; none issued and outstanding		
Common stock, $0.001 par value; 500,000,000 and 50,000,000 shares authorized, 6,819,667 and 7,108,867 shares issued and outstanding at December 31, 2004 and December 31, 2005, respectively	7	7
Additional paid-in capital	64,933	69,417

Accumulated deficit	(27,799)	(33,301)
Accumulated other comprehensive income (loss):		
Foreign currency translation adjustment	(112)	413
Total stockholders equity	37,029	36,536
Total liabilities and stockholders equity	$ 62,105	$ 63,315

The accompanying notes are an integral part of these consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)

	Year Ended December 31,		
	2003	2004	2005
Net sales	$ 62,576	$ 133,225	$ 194,472
Cost of sales	13,676	29,321	44,746
Gross profit	48,900	103,904	149,726
Operating expenses:			
Distributor commissions	27,555	68,579	101,021
Selling, general and administrative expenses	15,770	33,102	49,000
Provision for KGC receivable			2,759
Total operating expenses	43,325	101,681	152,780
Income (loss) from operations	5,575	2,223	(3,054)
Other income (expense), net	(1)	137	(910)
Income (loss) before income taxes and minority interest	5,574	2,360	(3,964)
Income tax provision	(860)	(663)	(1,587)
Minority interest	14	(456)	49
Net income (loss)	4,728	1,241	(5,502)
Preferred stock dividends	1		
Net income (loss) available to common stockholders	$ 4,727	$ 1,241	$ (5,502)
Income (loss) per share:			
Basic	$ 1.03	$ 0.22	$ (0.79)
Diluted	$ 0.83	$ 0.18	$ (0.79)
Weighted-average number of shares outstanding:			
Basic	4,609	5,580	6,934
Diluted	5,688	6,822	6,934

The accompanying notes are an integral part of these consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(In Thousands, Except Share Data)

	Preferred Stock		Common Stock		Additional Paid-In	Accumulated	Deferred	Accumulated Other Comprehensive Income	
	Shares	Amount	Shares	Amount	Capital	Deficit	Compensation	(Loss)	Total
BALANCE, December 31, 2002	16	$ 16	4,239,495	$ 4	$ 33,504	$ (33,767)	$ (146)	$ (9)	$ (398)
Net income						4,728			4,728
Foreign currency translation adjustments								(138)	(138)
Total comprehensive income									4,590
Conversion of Series J preferred stock	(16)	(16)	28,468		16				
Shares issued in acquisition			360,000		433				433
Shares issued for services			28,500		53				53
Preferred stock dividends					1	(1)			
Deferred compensation							146		146
BALANCE, December 31, 2003			4,656,463	4	34,007	(29,040)		(147)	4,824
Net income						1,241			1,241
Foreign currency translation adjustments								35	35
Total comprehensive income									1,276
Shares issued in acquisitions			790,000	1	14,704				14,705
Exercise of stock options and warrants			3,500		25				25
Issuance of common stock and common stock purchase warrants in private placement			1,369,704	2	16,065				16,067
Imputed compensation					132				132
BALANCE, December 31, 2004			6,819,667	7	64,933	(27,799)		(112)	37,029
Net loss						(5,502)			(5,502)
Foreign currency translation adjustments								451	451
Less: reclassification adjustment on sale of KGC								74	74
Total comprehensive loss									(4,977)
Exercise of warrants			289,200		3,606				3,606
Offering costs					(115)				(115)
Expiration of put right					960				960
Imputed compensation					33				33

BALANCE, December 31, 2005	$	7,108,867	$ 7	$ 69,417	$ (33,301)	$	$ 413	$ 36,536

The accompanying notes are an integral part of these consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Year Ended December 31,		
	2003	2004	2005
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	$ 4,728	$ 1,241	$ (5,502)
Adjustments to reconcile net income (loss) to net cash provided by operating activities, net:			
Depreciation and amortization of property and equipment	418	495	529
Amortization of intangibles	115	801	945
Minority interest	(14)	456	(49)
Deferred income taxes		(515)	515
Imputed compensation		132	33
Common stock issued for services and penalties	53	14	
Change in deferred compensation	146		
Changes in assets and liabilities, net of acquisitions and dispositions:			
Accounts receivable	301	50	(863)
Inventories, net	(364)	(10,366)	(3,702)
Other current assets	43	(1,630)	(2,077)
Other assets	(375)	330	1,164
Accounts payable	482	230	1,040
Income taxes payable	933	406	(293)
Accrued distributor commissions	322	3,213	1,362
Other accrued expenses	(496)	2,099	3,221
Deferred revenue	3,493	2,560	3,847
Other current liabilities	(160)	912	1,256
Net cash provided by operating activities	9,625	428	1,426
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(580)	(150)	(3,120)
Increase in restricted cash	(1,022)	(980)	(2,753)
Increase in certificate of deposit			(1,267)
Net cash reduction from sale of subsidiary			(1,307)
Business acquired		(1,357)	
Purchase of minority interest		(141)	
Purchase of database	(191)		
Net cash used in investing activities	(1,793)	(2,628)	(8,447)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Payments on debt	(339)	(2,600)	(709)
Proceeds from issuance of common stock, net		16,078	3,491
Net cash provided by (used in) financing activities	(339)	13,478	2,782

Effect of exchange rates on cash and cash equivalents	(224)	(87)	385
Net increase (decrease) in cash and cash equivalents	7,269	11,191	(3,854)
CASH AND CASH EQUIVALENTS, beginning of period	3,864	11,133	22,324
CASH AND CASH EQUIVALENTS, end of period	$ 11,133	$ 22,324	$ 18,470

The accompanying notes are an integral part of these consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Natural Health Trends Corp. (the Company) is an international direct-selling organization headquartered in Dallas, Texas. The Company was originally incorporated as a Florida corporation in 1988. The Company was merged into one of its subsidiaries and re-incorporated in the state of Delaware effective June 29, 2005 (see Note 2). Subsidiaries controlled by the Company sell products to a distributor network that either use the products themselves or resell them to consumers. The Company s products promote health, wellness and vitality and are sold under the Lexxus and Kaire brands.

The Company s majority-owned subsidiaries have an active physical presence in the following markets: North America, which consists of the United States and Canada; Greater China, which consists of Hong Kong, Macau, Taiwan and China; Southeast Asia, which consists of Singapore, the Philippines and Indonesia; Australia and New Zealand, South Korea, Japan, Latin America, which primarily consists of Mexico; and Slovenia.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and all of its majority-owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

Effective December 31, 2005, the Company sold its 51% equity interest in its Eastern European business, KGC Networks Pte Ltd. (KGC) (see Note 7). As a result, KGC s balance sheet is not included in the Company s consolidated balance sheet as of December 31, 2005. KGC s results of operations are included in the Company s consolidated statement of operations for the twelve months ended December 31, 2005.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. Actual results may differ from these estimates.

The most significant accounting estimates inherent in the preparation of the Company s financial statements include estimates associated with obsolete inventory and the fair value of acquired intangible assets and goodwill, as well as those used in the determination of liabilities related to sales returns, distributor commissions, and income taxes. Various assumptions and other factors prompt the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account historical experience and current and expected economic conditions. Historically, actual results have not significantly deviated from those determined using the estimates described above.

Reclassification

Certain balances have been reclassified in the prior year consolidated financial statements to conform to current year presentation.

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of three months or less, when purchased, to be cash equivalents.

Restricted Cash

The Company maintains a cash reserve with certain credit card processing companies to provide for potential uncollectible amounts and chargebacks. The cash reserve is generally calculated as a percentage of sales over a rolling monthly time period.

In addition, the Company is required to maintain on deposit approximately $2.5 million as part of its direct selling license application in China. Such amount is reflected in other non-current assets.

Inventories

Inventories consist primarily of finished goods and are stated at the lower of cost or market, using the first-in, first-out method. In addition, the Company reviews its inventory for obsolescence and any inventory identified as obsolete is reserved or written off. The Company s determination of obsolescence is based on assumptions about the demand for its products, product expiration dates, estimated future sales, and management s future plans.

Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line method over the following estimated useful lives:

Office equipment and software	3 5 years
Furniture and fixtures	5 7 years
Plant Equipment	5 years
Leasehold improvements	Shorter of estimated useful life or lease term

Goodwill and Other Intangible Assets

The Company has adopted Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually or sooner whenever events or changes in circumstances indicate that they may be impaired. No impairment of goodwill has been identified in any of the periods presented.

SFAS No. 142 also requires that intangible assets with definite lives be amortized over their estimated useful lives. The Company is currently amortizing its acquired intangible assets with definite lives over periods ranging from 5 to 7 years.

Impairment of Long-Lived Assets

The Company reviews property and equipment and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of these assets is measured by comparison of its carrying amounts to future undiscounted cash flows the assets are expected to generate. If property and equipment and certain identifiable intangibles are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair market value. The Company has made no adjustments to its long-lived assets in any of the periods presented.

Income Taxes

The Company recognizes income taxes under the liability method of accounting for income taxes. Deferred income taxes are recognized for differences between the financial reporting and tax bases of assets and liabilities at enacted statutory tax rates in effect for the years in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be ultimately realized.

Foreign Currency

The functional currency of the Company s international subsidiaries is generally the local currency. Local currency assets and liabilities are translated at the rates of exchange on the balance sheet date, and local currency revenues and expenses are translated at average rates of exchange during the period. The resulting translation adjustments are recorded directly into a separate component of stockholders equity and represents the only component of accumulated other comprehensive loss.

Revenue Recognition

Product sales are recorded when the products are shipped and title passes to independent distributors. Product sales to distributors are made pursuant to a distributor agreement that provides for transfer of both title and risk of loss upon our delivery to the carrier that completes delivery to the distributors, which is commonly referred to as F.O.B. Shipping Point. The Company primarily receives payment by credit card at the time distributors place orders. Amounts received for unshipped product are recorded as deferred revenue. The Company s sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return.

Actual product returns are recorded as a reduction to net sales. The Company estimates and accrues a reserve for product returns based on its return policies and historical experience.

During April 2005, the Company launched a new product line, Gourmet Coffee Café, which consists of coffee machines and the related coffee and tea pods, in the North American market. As the Gourmet Coffee Café is a very different product than the Company s other products and there is no reliable information on the Company s sales returns or warranty obligation, the Company has deferred all revenue generated from the sale of coffee machines and the related coffee and tea pods until sufficient return and warranty experience on the product can be established. The deferral totaled approximately $1.6 million and $1.2 million in revenue and related costs, respectively, for product shipped through December 31, 2005. The deferred costs are recorded in other current assets, as the sales return period for distributors is only for a year. Since the launch, the Company has experienced a high rate of defects and product returns. As a result, the Company has delayed continued sales of our existing inventory of this product and approached the manufacturer for resolution. The manufacturer has agreed to repair all of the machines in our existing inventory and provide discounts on future purchases. The Company is currently planning to re-start the sale of the coffee machines in the second half of 2006.

Enrollment package revenue, including any nonrefundable set-up fees, is deferred and recognized over the term of the arrangement, generally twelve months. During the third quarter of 2004, the Company changed its amortization methodology from a monthly method to the preferred daily method whereby revenues for each enrollment package start the day of enrollment. The change in methodology resulted in additional deferred revenue of approximately $280,000 during 2004. Enrollment packages provide distributors access to both a personalized marketing website and a business management system. Prior to the acquisition of MarketVision Communications Corp. (MarketVision) on March 31, 2004, the Company paid MarketVision a fixed amount in exchange for MarketVision creating and maintaining individual web pages for such distributors. These payments to MarketVision were deferred and recorded as a prepaid expense. The related amortization was recorded to cost of sales over the term of the arrangement. The remaining unamortized costs were included in the determination of the purchase price of MarketVision. Subsequent to the acquisition of MarketVision, no upfront costs are deferred as the amount is nominal.

Shipping charges billed to distributors are included in net sales. Costs associated with shipments are included in cost of sales.

Stock-Based Compensation

The Company continued through December 31, 2005 to account for stock-based compensation plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation (in thousands).

	Year Ended December 31,		
	2003	2004	2005
Net income (loss) available to common stockholders, as reported	$ 4,727	$ 1,241	$ (5,502)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects			
Deduct: Stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(38)	(3,893)	(393)

Pro forma net income (loss) available to common stockholders	$ 4,689	$ (2,652)	$ (5,895)

	Year Ended December 31,		
	2003	2004	2005
Basic income (loss) per share:			
As reported	$ 1.03	$ 0.22	$ (0.79)
Pro forma	$ 1.02	$ (0.48)	$ (0.85)
Diluted income (loss) per share:			
As reported	$ 0.83	$ 0.18	$ (0.79)
Pro forma	$ 0.82	$ (0.48)	$ (0.85)

The weighted-average fair value of options granted was $1.05, $11.91, and $6.47 for 2003, 2004, and 2005, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Year Ended December 31,		
	2003	2004	2005
Risk-free interest rate	4.25%	2.50%	4.38%
Expected volatility	100%	97%	94%
Expected life (in years)	3	4	3
Dividend yield			

Income Per Share

Basic income per share is computed by dividing net income applicable to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted income per share is determined using the weighted-average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents, consisting of shares that might be issued upon the exercise of outstanding stock options and warrants. In periods where losses are reported, the weighted-average number of common shares outstanding excludes common stock equivalents, because their inclusion would be anti-dilutive.

The dilutive effect of stock options and warrants is reflected by application of the treasury stock method. The potential tax benefit derived from exercise of non-qualified stock options has been excluded from the treasury stock calculation as the Company is uncertain that the benefit will be realized.

Certain Risks and Concentrations

In 2004 and 2005, a substantial portion of our revenue was generated in Hong Kong (see Note 15). Various factors could harm our business in Hong Kong, such as worsening economic conditions or other events that are out of our control. Our financial results could be harmed if our products, business opportunity or planned growth initiatives fail to retain and generate continued interest among our distributors and consumers in this market. Moreover, most of the Company s Hong Kong revenue is derived from the sale of products that are delivered to members in China. We have plans to obtain the appropriate licenses and conduct business in China; however, at this time there are no guarantees that we will obtain these licenses. If we are successful in obtaining these licenses, it is possible that sales in Hong Kong could migrate to China. If that were to happen we could experience a material reduction in sales from Hong Kong. We could be required to modify our compensation plan in China in a way that could make it less attractive to members. Any such modification to our compensation plan could, therefore, have a material adverse effect on revenue. Moreover, the business model that we anticipate implementing in China will likely involve costs and expenses that we do not generally incur in the e-commerce business that we have historically operated in other markets, including Hong Kong. As a result, the business that we ultimately are able to conduct in China could be materially less profitable than the e-commerce business that we have historically operated in Hong Kong.

Four major product lines *Premium Noni Juice* , *Skindulgence*®, *Alura*® and *La Vie* - generated a significant majority of the Company s sales for 2003, 2004 and 2005. We obtain *Skindulgence*® and *La Vie* product from a single supplier, and *Premium Noni Juice* and *Alura*® from two other suppliers. We believe that, in the event we were unable to source products from these suppliers or other suppliers of our products, our revenue, income and cash flow could be adversely and materially impacted.

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The Company maintains its cash in bank accounts which, at times, may exceed federally insured limits. Accounts in the United States are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to $100,000. A portion of the Company s cash balances at December 31, 2005 exceeds the insured limits. The Company has not experienced any losses in such accounts.

Fair Value of Financial Instruments

The carrying amounts of the Company s financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, accrued expenses, and debt, approximate fair value because of their short maturities.

Recent Accounting Pronouncements

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, Inventory Costs (SFAS 151). This statement requires that certain costs such as idle facility expense, excessive spoilage, double freight, and re-handling costs be recognized as current-period charges and that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of the statement shall be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151, effective January 1, 2006, did not have a significant impact on the Company s financial condition, results of operations, or cash flows.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which is a revision of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and amends Statement of Financial Accounting Standards No. 95, Statement of Cash Flows . Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) will require all share-based payments to employees, including grants of employee stock options, to be recognized in our Consolidated Statements of Income, based on their fair values. Pro forma disclosure will no longer be an alternative. SFAS 123(R) will be effective January 1, 2006 and permits us to adopt its requirements using one of two methods:

A modified prospective method in which compensation cost is recognized beginning with the effective date based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and based on the requirements of SFAS 123 for all awards granted to employees prior to the adoption date of SFAS 123(R) that remain unvested on the adoption date.

A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate either all prior periods presented or prior interim periods of the year of adoption based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures.

We will adopt the provisions of SFAS 123(R) using the modified prospective method. As permitted by SFAS 123, we currently account for share-based payments to employees using the intrinsic value method prescribed by APB 25 and related interpretations. Therefore, we do not recognize compensation expenses associated with employee stock options. We estimate that the adoption of SFAS 123(R) will result in an expense of approximately $527,000, or $0.08 per diluted share, for the year ended December 31, 2006. However, the adoption of SFAS 123(R) fair value method could have a significant impact on our future results of operations for future stock or stock option grants but no impact on our overall financial position. Had we adopted SFAS 123(R) in prior periods, the impact would have approximated the impact of SFAS 123 as described in the pro forma net income and income per-share disclosures. The adoption of SFAS 123(R) will have no effect on our outstanding vested stock grant awards.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. This Statement changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to voluntary changes as well as those changes required by an accounting pronouncement if that pronouncement does not include specific transition provisions. This Statement requires retrospective application to prior periods financial statements of changes in accounting principle as opposed to being shown as a cumulative adjustment in the period of change. The Statement is effective for all changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of this standard is not expected to materially impact the Company.

2. RE-INCORPORATION

On March 21, 2005, Natural Health Trends Corp, a Delaware corporation (the Delaware Corporation) was incorporated as a subsidiary of Natural Health Trends Corp, a Florida corporation (the Florida Corporation). Effective June 29, 2005, the Delaware Corporation was merged into the Florida Corporation, becoming the parent company. Concurrent with the merger, the Company was re-incorporated in the state of Delaware. The Florida Corporation ceased to exist. Each share of common stock outstanding of the Florida Corporation was converted into one share of $0.001 par value common stock of the Delaware Corporation. Options and warrants to purchase common stock of the Florida Corporation were converted into like securities of the Delaware Corporation, with all terms and conditions unchanged. In addition, the number of authorized shares of preferred stock was increased to 5,000,000 and the number of authorized shares of common stock was decreased to 50,000,000.

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3. OTHER INCOME (EXPENSE)

Other income (expense) consist of the following (in thousands):

	Year Ended December 31,		
	2003	2004	2005
Gain (loss) on foreign exchange	$ (77)	$ 215	$ (1,082)
Interest income	5	19	241
Interest expense	(68)	(101)	(31)
Other	139	4	(38)
	$ (1)	$ 137	$ (910)

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4. BALANCE SHEET COMPONENTS

Selected balance sheet components are as follows (in thousands):

	December 31, 2004	December 31, 2005
Property and equipment:		
Office equipment	$ 615	$ 1,236
Office software	157	1,029
Furniture and fixtures	422	430
Plant equipment		127
Leasehold improvements	311	1,628
Property and equipment, at cost	1,505	4,450
Accumulated depreciation and amortization	(926)	(1,307)
	$ 579	$ 3,143
Other accrued expenses:		
Sales returns	$ 1,541	$ 1,743
Employee-related expense	443	1,222
Professional fees	202	1,264
Warehousing and inventory-related expense	711	846
Other	1,257	1,752
	$ 4,154	$ 6,827
Deferred revenue:		
Unshipped product	$ 4,842	$ 1,468
Enrollment package revenue	4,709	6,849
Unrecognized coffee revenue		1,580
	$ 9,551	$ 9,897

5. GOODWILL AND OTHER INTANGIBLE ASSETS

No changes occurred in the carrying amount of goodwill during 2005.

Intangible assets consist of the following (in thousands):

	December 31, 2004			December 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Computer software and programs	$ 5,600	$ 600	$ 5,000	$ 5,600	$ 1,400	$ 4,200
Distributor database	790	316	474	790	461	329
	$ 6,390	$ 916	$ 5,474	$ 6,390	$ 1,861	$ 4,529

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Amortization expense for intangible assets was $115,000, $801,000, and $945,000 for 2003, 2004, and 2005, respectively. Estimated amortization expense for the five succeeding fiscal years is as follows (in thousands):

2006	$ 958
2007	958
2008	813
2009	800
2010	800
Thereafter	200
	$ 4,529

6. ACQUISITIONS

MarketVision Communications Corp.

On March 31, 2004, the Company entered into a merger agreement with MarketVision. MarketVision is the exclusive developer and service provider of direct selling internet technology used by the Company since 2001. Pursuant to the merger agreement, the Company acquired all of the outstanding capital stock of MarketVision in exchange for the issuance of 690,000 shares of restricted common stock (the Issued Shares), promissory notes in the aggregate principal amount of approximately $3.2 million (see Note 8), a cash payment of approximately $1.3 million in April 2004, less pre-acquisition net payables due to MarketVision of approximately $646,000, for a total purchase price of approximately $17.6 million, including acquisition costs of approximately $153,000. The Issued Shares were valued at $13.5 million based on the average closing price of $23.08 a few days before and after the acquisition was announced discounted by 15% due to certain restrictions contained in the purchase agreement.

MarketVision hosts and maintains the internet technology for the Company and charges an annual fee for this service based upon the number of enrolled distributors of the Company s products. MarketVision earned revenues for this service of approximately $1.8 million and $579,000 for the year ended December 31, 2003 and three months ended March 31, 2004, respectively.

The Company believes that this transaction was in the best interests of the Company because (i) the success of the Company s business is dependent upon MarketVision s direct selling software and (ii) the Company projects enrolling a significant number of new distributors in the future, which would be very expensive under the former compensation agreement between the Company and MarketVision. Since the former owners of MarketVision include Terry LaCore, a member of the Company s board of directors and the Chief Executive Officer of Lexxus International, Inc., a wholly-owned subsidiary of the Company (Lexxus U.S.) at the transaction date, the board of directors hired the independent appraisal firm of Bernstein, Conklin & Balcombe to assess the fairness of the transaction with MarketVision from a financial point of view. In March 2004, Bernstein, Conklin & Balcombe delivered its opinion to the Company s board of directors that the MarketVision transaction is fair to the Company from a financial point of view.

In addition, the Company entered into a shareholder s agreement with the former stockholders of MarketVision. Such agreement contained customary terms and conditions, including restrictions on transfers of the Issued Shares, rights of first refusal and indemnification. Further, the shareholder s agreement contained a one time put right related to 240,000 Issued Shares for the benefit of the former stockholders of MarketVision (other than Mr. LaCore) that required the Company, during the six month period commencing following the earlier of (i) the first anniversary of the closing date, or (ii) the date on which the Issued Shares are registered with the Securities and Exchange Commission (the SEC) for resale to the public, to repurchase all or part of such shares still owned by the such stockholders for $4.00 per share less any amount previously received by such stockholders from the sale of their Issued Shares. The Company has recorded this obligation of $960,000 as mezzanine common stock in the consolidated balance sheet (see Note 10). The estimated fair value of the put right based on the Black-Scholes option pricing model, as determined by the independent valuation firm, of approximately $133,000 was not included in the cost of MarketVision due to materiality.

The agreement also provided the former stockholders of MarketVision with piggyback registration rights in the event the Company files a registration statement with the SEC, other than on Forms S-4 or S-8, stock option grants for the former stockholders (other than Mr. LaCore) as well as three-year employment agreements for the former stockholders, other than Mr. LaCore. In the event that the Company defaulted on its payment obligations under the notes or the employment agreements, an entity owned by the former stockholders of MarketVision (other than Mr. LaCore) had certain rights to use, develop, modify, market, distribute and sublicense the MarketVision software to third parties.

The transaction was accounted for using the purchase method of accounting and the purchase price was allocated among the assets acquired based on their estimated fair market values.

The purchase price was allocated among assets acquired based on their estimated fair market values as follows (in thousands):

Property and equipment	$ 25
Computer software and programs	5,600
Goodwill	11,958
Deferred tax liabilities	(1,904)
Deferred tax assets recognized by the Company resulting from offset against MarketVision s deferred tax liabilities	1,904
Total purchase price allocation	$ 17,583

Goodwill includes but is not limited to the synergistic value and potential competitive benefits that could be realized by the Company from the acquisition and any future services that may arise from MarketVision s internet technology. The goodwill amount is not deductible for tax purposes.

The results of operations of MarketVision have been included in the Company s consolidated statements of operations since the completion of the acquisition on March 31, 2004. The following unaudited pro forma information presents a summary of the results of operations of the Company assuming the acquisition of MarketVision occurred on January 1, 2003 (in thousands, except per share data):

	Year Ended December 31,	
	2003	2004
Net sales	$62,576	$133,225
Net income	$ 4,533	$ 1,342
Income per share:		
Basic	$ 0.86	$ 0.21
Diluted	$ 0.71	$ 0.18

Acquisitions of Minority Interests

On March 29, 2004, the Company purchased 4,900 shares of common stock owned by the minority stockholders of Lexxus U.S., a Delaware corporation, representing the 49% interest in Lexxus U.S. not owned by the Company, in exchange for 100,000 shares of restricted common stock. The total purchase price, including acquisition related costs of approximately $7,000, was approximately $2.0 million based upon the average closing price of the Company s common stock of $23.08 a few days before and after the acquisition was announced discounted by 15% due to the restrictions contained in the purchase agreement. The entire purchase price was allocated to goodwill.

On April 19, 2004, the Company purchased 510,000 shares of common stock owned by the minority stockholders of Lexxus International Co., Ltd. (Taiwan), a Taiwan limited liability corporation (Lexxus Taiwan), representing the 30% interest in Lexxus Taiwan not owned by the Company, in exchange for approximately $136,000 in cash. The cash consideration given approximated the book value of the shares acquired and no goodwill resulted from the transaction. All Lexxus Taiwan minority stockholders were unrelated to the Company.

7. SALE OF KGC NETWORKS

Effective December 31, 2005, the Company entered into a Stock Purchase Agreement with Bannks Foundation (Bannks), a Lichtenstein foundation and owner of 49% of the common shares of KGC Networks Pte Ltd. (KGC), a Singapore corporation, pursuant to which the Company sold to Bannks 51,000 common shares representing the Company s 51% of the outstanding shares of capital stock of KGC for a total cash purchase price of $350,000.

At the same time and as a condition of the sale, the Company entered into a separate agreement whereby KGC would pay to the Company 24 monthly payments of approximately $169,000 each, including interest at 2.5%, to settle an outstanding inter-company

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payable in the amount of approximately $2.1 million and to pay for inventories ordered and partially delivered totaling approximately $884,000, as well as the Company s undertaking to continue to supply KGC with certain products for a period of at least 48 months. The Company discounted the 24 monthly payments based on its cost of capital and recorded the receivable at $3.1 million, of which $1.7 million is considered non-current. Given its interest in the retained profits and cumulative translation adjustment of KGC of approximately $434,000, the Company recognized a nominal gain on sale. Since the receivable from KGC is unsecured, the Company recorded a reserve totaling approximately $2.8 million, which will be reduced as payments are received.

KGC sells the Company s Lexxus products into a separate network of independent distributors located primarily in Russia and other Eastern European countries. Upon the effective date of the transactions above, the Company no longer consolidates the financial statements of KGC. The Company does not believe these transactions result in a discontinued operation as the Company will continue to supply KGC with a significant amount of product for the foreseeable future. Therefore, the 2005 results of KGC have been reported in results from operations.

Had KGC not been included in results from operations, the Company s 2005 statement of operations would have reflected the following (in thousands):

	Actual	As Adjusted
Net sales	$194,472	$160,214
Gross profit	149,726	123,171
Distributor commissions	101,021	85,388
Loss from operations	(3,054)	(2,301)

8. DEBT

Debt consists of the following (in thousands):

	December 31, 2004	December 31, 2005
MarketVision promissory note	$ 682	$
Notes payable a distributor, due upon demand, interest at 1% per annum	86	86
Note payable to a governmental agency, monthly installments of $2,200, interest at 7% per annum, maturing May 2006	34	9
Notes payable to a vendor, monthly installments of $580, interest at 25.49% per annum, maturing October 2008	16	14
	818	109
Current maturities	(796)	(109)
Debt	$ 22	$

On March 31, 2004, the Company issued two six month promissory notes in the aggregate principal amount of approximately $2.2 million, bearing interest at 4% per annum, and a twenty-one month promissory note in the principal amount of $1.0 million, bearing interest at 4.5% per annum, in connection with the acquisition of MarketVision (see Note 6). The Company repaid the two six month notes in full on October 12, 2004. The twenty-one month note required monthly payments of approximately $58,200 commencing June 30, 2004. The note was repaid in full in November 2005.

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9. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company has entered into non-cancelable operating lease agreements for locations within the U.S. and for its international subsidiaries, with expirations through May 2015. Rent expense in connection with operating leases was approximately $1.1 million, $1.4 million, and $2.4 million during 2003, 2004, and 2005, respectively.

Future minimum lease obligations as of December 31, 2005, are as follows (in thousands):

2006	$ 1,891
2007	1,527
2008	875
2009	707
2010	505
Thereafter	1,235
Total minimum lease obligations	$ 6,740

Purchase Commitments

The Company maintains a purchase commitment with one of its suppliers to purchase its *Cluster Concentrate* product. Pursuant to this agreement, the Company is required to purchase from this supplier a minimum volume of 20,000 bottles of product per year. The total product cost is $138,800 before any volume discounts.

In addition, the Company has an agreement with the supplier of its *Alura*® product to purchase a minimum volume of 15 barrels of product per quarter to maintain exclusivity and volume discounts. The total product cost is $1.4 million before any volume discounts. The Company intends to maintain this contract.

Construction Commitment

In December 2005, the Company committed approximately $580,000 for buildout of a new training facility in Japan. Construction completed and the facility opened in April 2006.

Employment Agreements

The Company has employment agreements with certain members of its management team, the terms of which expire at various times through October 2009. Such agreements provide minimum salary levels, as well as incentive bonuses that are payable if specified management goals are attained. The aggregate commitment for future salaries at December 31, 2005, assuming continued employment and excluding incentive bonuses, was approximately $4.3 million.

Legal Matters

During the fall of 2003, the customs agency of the government of South Korea brought a charge against LXK, Ltd. (LXK), the Company s wholly-owned subsidiary operating in South Korea, with respect to the importation of the Company s Alura product. The customs agency alleges that Alura is not a cosmetic product, but rather should be categorized and imported as a pharmaceutical product. On February 18, 2005, the Seoul Central District Court ruled against LXK and fined it a total of approximately $200,000. LXK also incurred related costs of approximately $40,000 as a result of the judgment. The Company recorded a reserve for the entire $240,000 at December 31, 2004 and has appealed the ruling. The failure to sell Alura in South Korea is not anticipated to have a material adverse effect on the financial condition, results of operations, cash flow or business prospects of LXK.

On or around March 31, 2004, Lexxus U.S. received a letter from John Loghry, a former Lexxus distributor, alleging that Lexxus U.S. had wrongfully terminated an alleged oral distributorship agreement with Mr. Loghry and that the Company had breached an alleged oral agreement to issue shares of the Company s common stock to Mr. Loghry. On May 13, 2004, Lexxus U.S. and the Company filed an action against Mr. Loghry in the United States District Court for the Northern District of Texas seeking, inter alia, unspecified damages from Mr. Loghry for disparagement and a declaration that Mr. Loghry was not wrongfully terminated and is not entitled to recover anything from Lexxus U.S. or the Company. Mr. Loghry filed counterclaims against the Company and Lexxus U.S.

asserting his previously threatened claims. In September 2004, Mr. Loghry filed third party claims against certain officers of the Company and Lexxus U.S., including against Terry LaCore, former Chief Executive Officer of Lexxus U.S. and former director of the Company, and Mark Woodburn, former President and director of the Company, for fraud, Messrs. LaCore, Woodburn, and a certain Lexxus distributor for conspiracy to commit fraud and tortuous interference with contract. In February 2005, the court dismissed all of Mr. Loghry s claims against the individual defendants, except the claims for fraud and conspiracy to commit fraud. Mr.Loghry then filed amended counterclaims and, on June 2, 2005, the Company and the other counterclaim defendants moved to dismiss the counterclaims on the grounds that the claims were barred by Mr. Loghry s failure to disclose their existence when he filed for personal bankruptcy in September 2002. On June 30, 2005, the U.S. Bankruptcy Court for the District of Nebraska granted Mr. Loghry s request to reopen his bankruptcy case. On September 6, 2005, the United States Trustee filed an action in the U.S. District Court for the District of Nebraska against the Company; Lexxus U.S.; Messrs. LaCore and Woodburn; Curtis Broome, President of Greater China and Southeast Asia; and a certain independent distributor of Lexxus U.S., essentially alleging the same claims asserted by Loghry in the Northern District of Texas. On February 21, 2006, this case was transferred to the United States District Court for the Northern District of Texas. The Company denies the allegations by Loghry and the United States Trustee and intends to vigorously contest their claims. An unfavorable judgment could have a material adverse effect on the financial condition of the Company.

On November 1, 2004, Toyota Jidosha Kabushiki Kaisha (d/b/a Toyota Motor Corporation) and Toyota Motor Sales, U.S.A. (the Toyota Entities) filed a complaint against the Company and Lexxus U.S. in United States District Court for the Central District of California (CV04-9028). The complaint alleged trademark and service mark dilution, unfair competition, trademark and service mark infringement, and trade name infringement, each with respect to Toyota s Lexus trademark. The Company reached a settlement agreement, dated August 31, 2005, under which the Toyota Entities agreed to terminate their claims against the Company, and the Company agreed to discontinue use of the Lexxus name and mark and change the name of its Lexxus operations and domain names by June 1, 2006, and sell or otherwise dispose of all product inventory marked with the name Lexxus by December 1, 2006. This could have a material adverse effect on the financial condition, results of operations, cash flow or business prospects of the Company.

On November 12, 2004, Dorothy Porter filed a complaint against the Company in the United States District Court for the Southern District of Illinois alleging that she sustained a brain hemorrhage after taking Formula One, an ephedra-containing product marketed by Kaire Nutraceutical Inc., a former subsidiary of the Company, and, thereafter, eKaire.com, Inc., a wholly-owned subsidiary of the Company. Ms. Porter has sued the Company for strict liability, breach of warranty and negligence. The Company intends to defend this case vigorously and on December 27, 2004 filed an answer denying the allegations contained in the complaint. On March 7, 2005, a Notice of Tag-Along Action was filed by Ms. Porter with the Judicial Panel on Multidistrict Litigation. The case was subsequently transferred for pre-trial purposes to the consolidated Ephedra Products Liability proceedings in the United States District Court for the Southern District of New York. If the case proceeds to a jury trial, the matter will be transferred back to the Southern District of Illinois and tried in that District. Full discovery between the parties is set to begin in this action Spring 2006. The Company does not believe that the plaintiff can demonstrate that its products caused the alleged injury and intends to vigorously defend this action.

On January 13, 2005, Nature s Sunshine Products, Inc. and Nature s Sunshine Products de Mexico S.A. de C.V. (collectively Nature s Sunshine) filed suit against the Company in the Fourth Judicial District Court, Utah County, State of Utah, seeking injunctive relief and unspecified damages against the Company, Lexxus U.S., the Company s Mexican subsidiary, and the Company s Mexico management team, Oscar de la Mora Romo and Jose Villarreal Patino, alleging among other things that the Company s employment of Messrs. De la Mora and Villarreal violated or could lead to the violation of certain non-compete, non-solicitation, and confidentiality agreements allegedly in effect between Messrs. De la Mora and Villarreal and Nature s Sunshine. After the Company removed the case to federal court, Nature s Sunshine voluntarily dismissed its lawsuit and filed a new lawsuit in the Fourth Judicial District Court in Utah County, Utah. After a hearing on August 22, 2005, the district court preliminarily enjoined Messrs. De la Mora and Villarreal from disclosing any confidential information of Nature s Sunshine or soliciting any employee or distributor of Nature s Sunshine or inducing them to terminate their relationship with Nature s Sunshine. The court refused, however, to enjoin Messrs. De la Mora or Villarreal from competing with Nature s Sunshine. Nature s Sunshine subsequently filed a petition for interlocutory review with the Utah Supreme Court. The Supreme Court delegated the petition to the Utah Court of Appeals, which denied the petition. On April 6, 2006, a mutual agreement was entered into with Messrs. De la Mora and Villareal terminating their employment between them and affiliates of the Company. If the Company or Messrs. De la Mora and Villarreal are nevertheless unsuccessful in defending this action, the Company may be required to pay any damages and attorneys fees that may be assessed against it.

On or about March 1, 2006, the Company hired Peter Dale, a former executive with the Nature s Sunshine subsidiary doing business in Japan, Nature s Sunshine Japan Co., Ltd. (NSJ), to serve as an executive vice president with responsibilities in Asia. NSJ alleges that Mr. Dale has signed an agreement containing covenants of non-competition, non-solicitation, and confidentiality, and that it believes Mr. Dale s employment with the Company would violate the non-competition covenant. No lawsuit has been filed at this point. If Nature s Sunshine files suit, the Company and Mr. Dale will vigorously defend against the enforcement of the non-competition covenant. However, if Nature s Sunshine were to prevail in such a lawsuit, Mr. Dale could be enjoined from working for the Company until February 15, 2007 which could have a material adverse effect on the Company s business in Japan.

Currently, there is no other significant litigation pending against the Company other than as disclosed in the paragraphs above. From time to time, the Company may become a party to litigation and subject to claims incident to the ordinary course of the Company s business. Although the results of such litigation and claims in the ordinary course of business cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material adverse effect on the Company s business, results of operations or financial condition. Regardless of outcome, litigation can have an adverse impact on the Company because of defense costs, diversion of management resources and other factors.

Other Matters

In 2003, 2004 and 2005, approximately 49%, 56% and 62% of our revenue, respectively, was generated in Hong Kong. Most of the Company s Hong Kong revenues are derived from the sale of products that are delivered to members in China. After consulting with outside professionals, the Company believes that our Hong Kong e-commerce business does not violate any applicable law in China even though it is used for the e-purchase of our products by buyers in China. But the government in China could, in the future, officially interpret its laws and regulations or adopt new laws and regulations to prohibit some or all of our e-commerce activities with China and, if our members engage in illegal activities in China, those actions could be attributable to us.

On April 12, 2004, an investigative television program was aired in China with respect to the operations of the Company s Hong Kong subsidiary and the representative office located in Beijing. Among other things, the television program alleged that our Hong Kong operations engaged in fraudulent activities and sold products without proper permits. In response, the Company sent Curtis Broome to China to investigate and manage what was happening in China. Prior to that time, the Company did not have any management personnel in China. Among other things, Mr. Broome determined that the Company should be proactive in demonstrating that alleged illegal acts of individual members were not the acts of the Company itself and that the Company intended to invest in China for the long-term. Accordingly, the Company took the following steps:

The Company set up a school in Macau to train members about the applicable Chinese legal requirements and the need for distributors to accurately and fairly describe business opportunities available to potential members. The schools were operated from May 2004 to November 2005.

The Company suspended shipment of product to certain members until they had completed the required training.

The Company extended its existing 14-day return policy in Hong Kong to 180 days to allow distributors and customers who purchased products during the two-week period prior to, and the two-week period after, the airing of the television program to return purchased merchandise for a full refund.

The Company began posting announcements on its Hong Kong website to the effect that the resale of its products in China without the appropriate license would result in termination of membership. Since then, the Company has terminated at least four members in China for engaging in activities in violation of Chinese law.

In June 2004 the Company completed formation of its Chinese subsidiary (Lexxus China }, and by the end of 2005 had invested $12.0 million as capital in that entity.

Lexxus China is working to file an application for a direct selling license under proposed legislation.

Lexxus China has leased space in Zhuhai, purchased equipment and finished out a manufacturing plant. Although Lexxus China now has a license to manufacture and employee personnel at the plant, it does not yet have a license to sell any product manufactured there and will not begin manufacturing operations until it has obtained that license.

On November 1, 2005, Lexxus China obtained its general cosmetic manufacturing permit and has begun trial production testing.

There have been other isolated cases of misconduct by our members in China. For example, four of our members were detained in Dongguan for questioning in October 2005, with regard to possible violation of Chinese law regarding the maximum number of people who can attend a meeting as well as possible improper network marketing business activity. Charges were never filed and all individuals were released. In April, 2006, a media report indicated that someone was detained by Public Security in Changsha for investigation of similar allegations. The Company has not been able to determine if the individual in question is, in fact, a member and whether or not any laws were actually broken. Initial inquiries made by retained Chinese counsel indicate that no one is still being detained or has been charged.

We make efforts to be informed of and in compliance with applicable laws in China, and we have not received any official notice that we are or may be acting improperly or illegally, and we continue our efforts to maintain regular contact with officials in all levels of government. In September 2005, a 12-person delegation from the Zhuhai government made a point of visiting our offices in Dallas, Texas as part of an economic development tour to the United States.

The Company is unable to predict whether it will be successful in obtaining a direct selling license to operate in China, and if it is successful, when it will be permitted to commence direct selling operations there. Further, even if the Company is successful in obtaining a direct selling license to do business in China, it is uncertain as to whether the Company will generate profits from such operations.

Between April and December 2005, the Company s Hong Kong subsidiary engaged a service provider to facilitate product importation into China and act, or engage another party to act, as the importer of record. The individual that owns that service provider is one of the directors of the Company s wholly- owned Chinese subsidiary. The Company believes that the amount of duty paid to Chinese Customs on the imported goods by the importer of record was paid at the negotiated rate. However, there can be no assurance that Chinese Customs will not elect, in the future, to examine the duty paid, and if they conduct such examination, they may conclude that the valuation established was insufficient, resulting in an underpayment of duties. As a consequence, the importer of record could be required to pay additional duties and possible penalties to Chinese Customs. Additional duties could range between zero and $46.0 million, plus penalties. The extreme worst case was calculated using the highest possible assessment to the highest possible declared value and assuming that negotiated valuation practices do not apply. The Company believes that any such future assessment of additional duties or penalties would be made against and become the responsibility of the importer of record. There can be no assurance that the Company or its subsidiaries would not also be assessed with such liability in the event that the importer of record is unable to pay all or part of such amount.

On April 18, 2006, the Company received a letter from The NASDAQ Stock Market stating that the Company is not in compliance with Marketplace Rule 4310(c)(14), which obligates listed issuers to timely file those reports and other documents required to be filed with the Securities and Exchange Commission. On April 25, 2006, the Company requested a hearing with the NASDAQ Hearings Panel concerning the Company s failure to file its Form 10-K in a timely fashion. The Company received a hearing date of June 1, 2006 from NASDAQ. The Company has been advised that its shares of common stock will not be delisted prior to the date of the hearing.

10. MEZZANINE COMMON STOCK

The shareholder s agreement entered into upon the merger with MarketVision contained a one time put right related to 240,000 shares issued to the former stockholders of MarketVision (other than Mr. LaCore). The put right required the Company, during the six month period commencing following the earlier of (i) the first anniversary of the closing date, or (ii) the date on which the shares are registered with the Securities and Exchange Commission for resale to the public, to repurchase all or part of such shares still owned by the stockholders for $4.00 per share less any amount previously received by such stockholders from the sale of their shares. As the put right expired unexercised on September 30, 2005, the Company reclassified the put right obligation of $960,000 to additional paid-in capital.

11. STOCKHOLDERS EQUITY

Authorized Shares

The Company is authorized to issue two classes of capital stock consisting of up to 5,000,000 shares of preferred stock, $0.001 par value, and 50,000,000 shares of common stock, $0.001 par value.

Stock Split

The Company effected a 1-for-100 reverse stock split in March 2003 of all outstanding shares of capital stock and unexercised stock options and warrants. All references to share and per share data have been adjusted to reflect the stock split.

Private Placement of Units

On October 6, 2004, the Company entered into a securities purchase agreement (and subscription agreements with respect to certain Canadian investors) with certain institutional and accredited investors as well as certain officers and directors of the Company. Pursuant to the purchase and subscription agreements, the Company sold 1,369,704 units at a price of $12.595 per unit. Each unit consist of one share of the Company s common stock and one stock purchase warrant exercisable for one share of the Company s common stock at any time through October 6, 2009 at an exercise price of $12.47 per share. Proceeds were approximately $16.0 million, net of transaction fees.

Pursuant to the registration rights agreement, the Company has agreed to register the shares included in the units and the shares issuable upon exercise of the warrants for resale. The registration rights agreement provides for the payment of certain liquidated damages in the event that delays are experienced in the Securities and Exchange Commission s declaring that registration statement effective. The Company agrees to use commercially reasonable effort to effect and maintain the effectiveness of a registration statement. If the registration statement is not effective 180 days after the closing date, or approximately April 4, 2005, the Company will pay the buyers approximately $85,000, which also applies in the event that the Company fails to maintain the effectiveness of the registration statement after its initial effectiveness, subject to certain exceptions. The Company filed a preliminary registration statement with the SEC on April 13, 2005 and paid a total of approximately $85,000 in liquidated damages on April 14, 2005. The registration statement became effective on April 28, 2005.

Stock Options

The Company maintains the 2002 Stock Option Plan (the Plan) which provides for the granting of incentive and nonqualified stock options to employees, directors and officers of the Company, members of the board of directors, or consultants. The terms of any particular grant are determined by the board of directors or a committee appointed by the board of directors. In 2005, the Company amended the Plan to increase the maximum number of shares available to be issued to 1,550,000 shares. As of December 31, 2005, the Company had granted options to purchase 592,124 shares of common stock under the Plan. As of December 31, 2005, 957,876 shares remained available to be granted under the Plan.

	2003		2004		2005	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	1,321,500	$ 1.05	1,331,500	$ 1.06	1,674,124	$ 4.42
Granted	10,000	1.80	344,124	17.44	248,000	10.21
Exercised			(1,500)	1.10		
Outstanding, end of year	1,331,500	1.06	1,674,124	4.42	1,922,124	5.17
Exercisable at end of year	1,291,504	$ 1.03	1,640,000	$ 4.28	1,698,322	$ 4.49

The following table summarizes information about options outstanding and exercisable at December 31, 2005:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Shares Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Shares Exercisable	Weighted Average Exercise Price
$1.00 to $1.80	1,330,000	$ 1.06	6.2 years	1,330,000	$ 1.06
$11.40 to $18.11	592,124	14.41	5.3 years	368,322	16.90
$1.00 to $18.11	1,922,124	5.17	5.9 years	1,698,322	4.49

Common Stock Purchase Warrants

On June 23, 2004, warrants to purchase 2,000 shares of common stock were exercised at an exercise of $5.00 per share.

On March 31, 2005, a warrant to purchase 1,419 shares of common stock, with an exercise price of $141.00, expired without being exercised.

In May 2005, a warrant to purchase 51,600 shares of common stock was exercised for proceeds of approximately $643,500. In July 2005, warrants to purchase 25,000 shares of common stock were exercised for proceeds of approximately $311,800. In August 2005, warrants to purchase 93,600 shares of common stock were exercised for proceeds of approximately $1.2 million and in September warrants to purchase 119,000 were exercised for proceeds of approximately $1.5 million. At December 31, 2005, warrants to purchase 1,080,504 shares of common stock were outstanding, all of which were included as a component of the units sold on October 6, 2004 (see *Private Placement* *of Units*). Such warrants are exercisable for one share of the Company s common stock at any time through October 6, 2009 at an exercise price of $12.47 per share. The weighted-average remaining contractual life of outstanding warrants as of December 31, 2005 was 3.8 years.

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Restricted Stock

On October 7, 2004, the Company entered into employment agreements with two members of its Mexican management team whereby each member was entitled to receive a bonus payable in restricted shares of the Company s common stock based upon the Mexican subsidiary achieving certain (1) net sales and (2) net income before interest, taxes, depreciation and amortization (collectively EBITDA). The maximum aggregate amount payable in restricted shares was $14.5 million, assuming net sales of $300 million and EBITDA of $30 million. The shares were to be issued by no later than April 15 in the year following satisfaction of both targets. These employment agreements were terminated in April 2005, and thus the right to receive restricted share bonuses was forfeited.

Income Per Share

	Year Ended December 31,		
	2003	2004	2005
	(In Thousands, Except Per Share Data)		
Net income (loss) available to common stockholders	$ 4,727	$ 1,241	$ (5,502)
Basic weighted-average number of shares outstanding	4,609	5,580	6,934
Effect of dilutive stock options and warrants	1,079	1,242	
Diluted weighted-average number of shares outstanding	5,688	6,822	6,934
Income (loss) per share:			
Basic	$ 1.03	$ 0.22	$ (0.79)
Diluted	$ 0.83	$ 0.18	$ (0.79)

Options and warrants to purchase 310,000 and 1,371,123 shares of common stock, respectively, were outstanding during 2004 but were not included in the computation of diluted earnings per share because the exercise prices were greater than the average market price of the common shares.

Options and warrants to purchase 1,922,124 and 1,081,923 shares of common stock, respectively, were outstanding during 2005 but were not included in the computation of diluted income per share because of the net loss reported for 2005. The options, which fully expire on June 23, 2014, were still outstanding at the end of 2005. Warrants to purchase 1,080,504 shares of common stock remained outstanding at the end of 2005 and fully expire on October 6, 2009.

12. INCOME TAXES

The components of income (loss) before income taxes consist of the following (in thousands):

	Year Ended December 31,		
	2003	2004	2005
Domestic	$ 4,482	$ (2,108)	$ (8,637)
Foreign	1,092	4,468	4,673
Income (loss) before income taxes	$ 5,574	$ 2,360	$ (3,964)

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The components of the provision for income taxes consist of the following (in thousands):

	Year Ended December 31, 2003	2004	2005
Current taxes:			
Federal	$ 256	$ 248	$ 103
State	40	171	168
Foreign	564	759	801
	860	1,178	1,072
Deferred taxes		(515)	515
Provision for income taxes	$ 860	$ 663	$ 1,587

A reconciliation of the reported provision for income taxes to the amount that would result from applying the domestic federal statutory tax rate to pretax income is as follows (in thousands):

	Year Ended December 31, 2003	2004	2005
Income tax at federal statutory rate	$ 1,895	$ 802	$ (1,348)
Effect of permanent differences	37	709	3,054
Increase (decrease) in valuation allowance	(1,066)	(602)	497
Foreign rate differential	(32)	(471)	(787)
State income taxes, net of federal benefit	26	113	111
Other reconciling items		112	60
Income tax provision	$ 860	$ 663	$ 1,587

Deferred income taxes consist of the following (in thousands):

	December 31, 2004	2005
Deferred tax assets:		
Net operating losses	$ 3,144	$ 2,051
Stock-based compensation	488	488
Accrued expenses	255	468
Tax credits	80	183
Deferred revenue		133
Provision for KGC receivable		938
Other	12	12
Total deferred tax assets	3,979	4,273
Valuation allowance	(1,492)	(2,652)
	2,487	1,621
Deferred tax liabilities:		
Intangible assets	(1,861)	(1,540)
Depreciation	(34)	(17)

Prepaids	(50)	(64)
Other	(27)	
Total deferred tax liabilities	(1,972)	(1,621)
Deferred tax assets, net	$ 515	$

As of December 31, 2004, the current portion of the net deferred tax assets totaling $81,000 is presented in other current assets.

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A valuation allowance was established for approximately $1,492,000 of the net deferred tax assets at December 31, 2004, as the Company was unable to determine that the more likely than not criteria had been met. During 2005, the Company adjusted the valuation allowance for approximately $663,000 of net operating losses generated in the December 31, 2004 tax period. The Company increased the valuation allowance to equal its net deferred tax assets at December 31, 2005, due to the uncertainty of future operating results. The valuation allowance will be reduced at such time as management believes it is more likely than not that the deferred tax assets will be realized. Any reductions in the valuation allowance will reduce future income tax provisions.

At December 31, 2005, the Company has net operating loss carryforwards of approximately $6.0 million that begin to expire in 2020, if not utilized. A portion of the net operating loss carryforward is subject to an annual limitation as defined by Section 382 of the Internal Revenue Code. The Company has not provided for U.S. federal and foreign withholding taxes on the undistributed earnings of its foreign subsidiaries as of December 31, 2005. Such earnings are intended to be reinvested indefinitely.

13. SUPPLEMENTAL CASH FLOW INFORMATION

	Year Ended December 31,		
	2003	2004	2005
		(In Thousands)	
Cash paid during the year for:			
Income taxes	$ 42	$ 552	$ 1,436
Interest	50	86	22
Non-cash investing and financing activities:			
Receivable from KGC			3,100
Conversion of preferred stock to common stock	16		
Preferred stock dividends	1		
Common stock issued for acquisitions	433	15,665	
Debt issued for acquisitions		3,203	
Common stock issued for services	53		

14. RELATED PARTY TRANSACTIONS

In August 2001, the Company entered into a written lease agreement and an oral management agreement with S&B Business Services, an affiliate of Brad LaCore, the brother of Terry LaCore, former Chief Executive Officer of Lexxus U.S. and former director of the Company, and Sherry LaCore, Brad LaCore s spouse. Under the terms of the two agreements, S&B Business Services provides warehouse facilities and certain equipment, manages and ships inventory, provides independent distributor support services and disburses payments to independent distributors. In exchange for these services, the Company pays $18,000 annually for leasing the warehouse, $3,600 annually for the lease of warehouse equipment and $120,000 annually for the management services provided, plus an annual average of approximately $12,000 for business related services. The Company paid S&B Business Services approximately $150,000, $160,000 and $158,000 during 2003, 2004 and 2005, respectively. As of December 31, 2005, the Company owed approximately $1,400 to S&B Business Services.

The payment disbursement function was transferred to the Company s Dallas head office during the third quarter of 2005. In January 2006, the Company hired Sherry LaCore as an employee and simultaneously terminated the oral management agreement. Additionally, the Company closed the warehouse facility by the end of March 2006 and terminated the related lease agreement.

In September 2001, the Company entered into an oral consulting agreement with William Woodburn, the father of Mark Woodburn, former President and director of the Company, pursuant to which William Woodburn provided the Company with management advice and other advisory assistance. In exchange for such services, the Company starting June 8, 2001 paid to Ohio Valley Welding, Inc., an affiliate of William Woodburn, $6,250 on a bi-weekly basis. The Company paid $168,750 and $118,750 during 2003 and 2004, respectively, to Ohio Valley Welding, Inc. The consulting agreement between the Company and William Woodburn was terminated as of September 30, 2004.

The Company s former controller is married to Mark Woodburn, former President and director of the Company. Her employment with the Company ended in August 2004. The Company paid her approximately $100,000 in each of the years 2003 and 2004.

On March 31, 2004, the Company entered into a merger agreement with MarketVision, pursuant to which the Company acquired all of the outstanding capital stock of MarketVision (see Note 6). As a founding stockholder of MarketVision, Terry LaCore, former Chief Executive Officer of Lexxus U.S. and former director of the Company, received 450,000 shares of the Company s common stock and was entitled to receive approximately $840,000 plus interest from promissory notes issued by the Company. As of December 31, 2005, no amounts remained outstanding to Mr. LaCore.

On October 6, 2004, certain members of the Company s board of directors and certain of the Company s officers invested approximately $25,000 and purchased 1,984 units upon the same terms and conditions as the other buyers in the private placement (see Note 11).

A director of the Company s China subsidiary is the sole director of Access Int l (Zhuhai Ftz) Warehousing & Trading Co. Ltd. and its group (collectively, Access), a transportation and logistics company, and the owner of Info Development Ltd. (Info), an import services company, both of which provided services to the Company s Hong Kong subsidiary. Payments totaling approximately $5.2 million and $0.2 million were paid to Access and Info during 2005, respectively. At December 31, 2005, approximately $3,300 was due to Access.

On November 10, 2005, an independent investigator retained by the Company s Audit Committee learned that an entity controlled by Messrs. Woodburn and LaCore received payments from an independent distributor of the Company s products during 2001 through August 2005. The Company believes that Messrs. Woodburn and LaCore received from such independent distributor a total of approximately $1.4 million and $1.1 million, respectively. The Company believes that the fees paid by the Company to such independent distributor were not in excess of the amounts due under the Company s regular distributor compensation plan.

Approximately $2.4 million of the funds paid by the independent distributor to Messrs. Woodburn and LaCore were paid at the direction of Messrs. Woodburn and LaCore to an entity that is partially owned by Mr. Woodburn s father and Randall A. Mason, a member of the Company s Board of Directors and former Chairman of the Company s Audit Committee. The funds were subsequently paid to an entity controlled by Messrs. Woodburn and LaCore at their direction. After investigation by the Audit Committee, the Board of Directors of the Company concluded that Mr. Mason was unaware that these payments were directed by Messrs. Woodburn and LaCore to an entity partially owned by him until uncovered by the Audit s Committee s independent investigator on November 10, 2005, and that Mr. Mason was not involved in any misconduct and received no pecuniary benefit from the payments made by the independent distributor. However, since payments were directed into an entity that is partially owned by Mr. Mason, he could no longer be considered independent in accordance with the rules of The NASDAQ Stock Market and under the federal securities laws. Therefore, effective November 11, 2005, Mr. Mason resigned as Chairman and a member of the Company s Audit Committee. Mr. Mason remained as a director.

On November 14, 2005, in light of the information learned by the Company s Audit Committee on November 10, 2005, the Company terminated the employment of each of Messrs. Woodburn and LaCore. No severance has been paid by the Company to Messrs. Woodburn and LaCore and the Audit Committee is investigating claims or actions that the Company may bring against them.

In addition, a loan made by the Company under the direction of Mr. Woodburn in the aggregate principal amount of $256,000 in February 2004 was previously recorded as a loan to a third party. On November 10, 2005, the Audit Committee investigator learned that the Company actually loaned the funds to an entity owned and controlled by the parents of Mr. Woodburn. The loan was repaid in full, partially by an entity controlled by a third party and partially by an entity controlled by Mr. Woodburn in December 2004.

On March 23, 2006, an independent investigator retained by the Audit Committee of the Board of Directors confirmed that affiliates of immediate family members of Mr. Woodburn have owned since 1998, and continue to own, equity interests in Aloe Commodities (Aloe), the largest manufacturer of the Company and the supplier of the *Skindulgence®* Line and *LaVie* products, representing approximately 5% of the outstanding shares of Aloe. The Audit Committee is continuing to investigate to determine whether any financial or other benefits were paid to

Mr. Woodburn, his immediate family members or their respective affiliates. The Company has paid Aloe and certain of its affiliates approximately $2.6 million, $9.9 million, and $8.6 million during 2003, 2004 and 2005, respectively.

15. SEGMENT INFORMATION

The Company operates in one reportable operating segment by selling products to a distributor network that operates in a seamless manner from market to market. The Company s net sales and long-lived assets by market are as follows (in thousands):

	Year Ended December 31,		
	2003	2004	2005
Net sales to external customers:			
North America	$ 10,668	$ 16,914	$ 16,528
Hong Kong	30,763	74,293	120,968
Taiwan	3,097	3,261	3,722
Southeast Asia	1,570	1,786	6,438
Russia and Eastern Europe [1]	13,157	30,248	34,258
South Korea	2,492	5,524	8,495
Australia/New Zealand	654	1,158	1,886
Japan			1,659
Latin America			518
Other	175	41	
Total net sales	$ 62,576	$ 133,225	$ 194,472

	December 31,		
	2003	2004	2005
Long-lived assets:			
North America	$ 1,203	$ 20,124	$ 19,504
Hong Kong	217	247	554
Taiwan	271	117	179
Southeast Asia	202	133	47
China			3,265
South Korea	389	398	323
Australia/New Zealand	46	35	33
Japan			834
Latin America			573
Other	51	36	5
Total long-lived assets	$ 2,379	$ 21,090	$ 25,317

Due to system constraints, it is impracticable for the Company to separately disclose product and enrollment package revenue for the years presented.

16. SUBSEQUENT EVENTS

On February 10, 2006, the Company entered into an Escrow Agreement (the Agreement) with Messrs. Woodburn and LaCore, the LaCore and Woodburn Partnership, an affiliate of Woodburn and LaCore, and Krage and Janvey LLP, as escrow agent (the Agent). Pursuant to the Agreement, (i) the Company agreed to issue and deposit with the Agent stock certificates in the name of the Agent representing an aggregate of 1,081,066 shares of the Company s common stock (the Escrowed Shares) and (ii) Woodburn and LaCore deposited with the Agent $1,206,000 in immediately available funds (the Cash Deposit). The Escrowed Shares are the shares of common stock issuable upon the cashless exercise of options issued in 2001 and 2002 to LaCore and the LaCore and Woodburn Partnership for 1,200,000 shares of common stock exercisable at $1.00 and $1.10 per share. The number of Escrow Shares is based upon the closing price of the Company s common stock on February 9, 2006 of $10.14 and the surrender of 118,934 option shares as payment of the aggregate exercise price of $1,206,000.

[1] The Company will no longer consolidate the operating results of KGC for periods ending after December 31, 2005 as it sold its 51% interest in KGC to Bannks Foundation effective December 31, 2005.

The Escrowed Shares were issued pursuant to Section 4(2) of the Securities Act of 1933, as amended, to the Agent upon receipt from the Agent of an irrevocable proxy (the Proxy) to the Company to vote the Escrowed Shares on all matters presented at meetings of stockholders or any written consent executed in lieu thereof. The parties have agreed that the Agent will hold the Escrowed Shares and the Cash Deposit until it receives (i) joint written instructions from the Company, Woodburn and LaCore, or (ii) a final non-appealable order from a court of competent jurisdiction. Each of the Company and Woodburn and LaCore has further agreed that all current and future rights, claims, defenses and causes of actions they have or may have against each other are preserved.

Effective October 3, 2005, the Board of Directors of the Company appointed Robert H. Hesse, a member of the Company s Board of Directors since July 2004, as the Company s Interim Chief Executive Officer. On March 10, 2006, the Company and Mr. Hesse entered into a letter agreement dated March 1, 2006, pursuant to which Mr. Hesse agreed to continue acting as the interim chief executive officer of the Company. In addition to continuing his base pay of $2,000 per day, the Company agreed to pay Mr. Hesse a retention bonus equal to $300,000, of which $150,000 was due and payable upon executing the letter agreement and $150,000 is due within five days after satisfactory completion of Mr. Hesse s term as Interim Chief Executive Officer, which was scheduled to conclude when the new chief executive officer commenced his or her employment with the Company. On March 28, 2006, the Board of Directors and Mr. Hesse mutually agreed that Mr. Hesse had completed his assignment as the Interim Chief Executive Officer of the Company, effective immediately. On May 5, 2006, the Company paid $150,000 to Mr. Hesse as provided in the above letter agreement. Mr. Hesse has released the Company from all other obligations under that letter agreement and, effective May 5, 2006, resigned from the Company s Board of Directors.

On April 18, 2006, the Company received a letter from The NASDAQ Stock Market stating that the Company is not in compliance with Marketplace Rule 4310(c)(14), which obligates listed issuers to timely file those reports and other documents required to be filed with the Securities and Exchange Commission. On April 25, 2006, the Company requested a hearing with the NASDAQ Hearings Panel concerning the Company s failure to file its Form 10-K in a timely fashion. The Company received a hearing date of June 1, 2006 from NASDAQ. The Company has been advised that its shares of common stock will not be delisted prior to the date of the hearing.

17. QUARTERLY FINANCIAL DATA (UNAUDITED)

	Quarter Ended			
	March 31	June 30	September 30	December 31
	(In Thousands, Except Per Share Data)			
Fiscal 2004:				
Net sales	$ 38,745	$ 17,686	$ 40,482	$ 36,312
Gross profit	30,491	12,823	31,612	28,978
Distributor commissions	19,745	12,578	17,422	18,834
Selling, general and administrative expenses	5,968	8,194	8,288	10,652
Income (loss) from operations	4,778	(7,949)	5,902	(508)
Net income (loss)	3,761	(6,746)	5,028	(802)
Income (loss) per share:				
Basic	$ 0.81	$ (1.24)	$ 0.92	$ (0.12)
Diluted	$ 0.64	$ (1.24)	$ 0.75	$ (0.12)
Weighted-average number of shares outstanding:				
Basic	4,667	5,447	5,450	6,745
Diluted	5,909	5,447	6,692	6,745

	Quarter Ended			
	March 31	June 30	September 30	December 31

	(In Thousands, Except Per Share Data)			
Fiscal 2005:				
Net sales	$ 42,759	$ 49,959	$ 58,071	$ 43,683
Gross profit	34,593	37,519	45,087	32,527
Distributor commissions	21,273	27,599	29,087	23,062
Selling, general and administrative expenses	9,246	12,308	15,108	12,338
Provision for KGC receivable				2,759
Income (loss) from operations	4,074	(2,388)	892	(5,632)
Net income (loss)	2,795	(2,159)	119	(6,257)
Income (loss) per share:				
Basic	$ 0.41	$ (0.32)	$ 0.02	$ (0.88)
Diluted	$ 0.34	$ (0.32)	$ 0.01	$ (0.88)
Weighted-average number of shares outstanding:				
Basic	6,820	6,853	6,951	7,109
Diluted	8,254	6,853	8,418	7,109

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

None.

Item 9A. CONTROLS AND PROCEDURES

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP). Internal control over financial reporting includes policies and procedures that:

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements.

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

The Company carried out an evaluation under the supervision and with the participation of management, including the Chief Financial Officer (CFO), pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 (the Exchange Act), of the effectiveness of our disclosure controls and procedures at December 31, 2005. In making this evaluation, the CFO considered, among other matters, the material weaknesses in our internal control over financial reporting that we or our external auditor, BDO Seidman, LLP, have identified. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses in our internal control over financial reporting as of December 31, 2005 are listed below:

We did not maintain an effective control environment because (1) we lack an effective anti-fraud program to detect and prevent fraud, for example, relating to the previous top two executive officers of the Company, Mark Woodburn and Terry LaCore, in terms of (i) conflicts of interests related to executive officers, especially their financial dealings with independent distributors and other vendors, and (ii) proper supervision of the executives conduct separating their executive duties from personal financial interests outside the Company, (2) we failed to perform background checks consistently on personnel being placed into positions of responsibility, (3) an adequate tone was not set from the top as control measures in place were ignored by the previous top two executives and the importance of controls was not properly emphasized and communicated throughout the Company and (4) we did not effectively address the control deficiencies noted in the fiscal year 2004 audit;

We did not maintain effective monitoring controls over financial reporting because (1) our policies regarding review, supervision and monitoring of our accounting operations throughout the Company were not fully designed, in place, or operating effectively and (2) we do not have an internal audit function;

We did not maintain effective control over period-end financial close and reporting because (1) we lacked sufficient complement of personnel with an appropriate level of accounting knowledge, experience and training in the application of GAAP commensurate with our financial reporting requirements to prepare, review and approve account reconciliations and supporting schedules, and (2) our legacy accounting systems do not facilitate the appropriate review and approval over the recording of journal entries to ensure the accuracy and completeness of the journal entries recorded;

We did not maintain effective controls over the disbursement function since we (1) lacked adequate segregation of duties and (2) lacked appropriate review, approval, and supporting documentation;

We did not maintain effective controls over the payroll function since we (1) lacked adequate segregation of duties and (2) lacked appropriate review, approval, and supporting documentation;

We did not maintain effective controls over the inventory function since we (1) did not maintain restricted access to the inventory detail schedule used to support the general ledger balances and (2) used the periodic inventory system and performed monthly inventory counts using physical inventory count sheets lacking reviewer documentation;

We lacked documentation with respect to certain related party transactions, subsidiary operations and expense reimbursement procedures. In addition, sufficient policies regarding loans to employees and third parties had not been adopted or implemented, and policies related to independent distributor relationships were inadequate;

We lacked timely resolution of identified accounting and legal issues, and as a result, did not timely complete period-end financial statements and reporting; and

We do not have all material contracts in writing and approved by all parties.

Each of the control deficiencies described above could result in a misstatement of the aforementioned accounts or disclosures that would result in a material misstatement to the annual or interim consolidated financial statements that would not be prevented or detected. Management has determined that each of the control deficiencies constitutes a material weakness.

Based on this evaluation, the CFO has concluded that our disclosure controls and procedures at December 31, 2005 were not effective to provide reasonable assurance that information required to be disclosed in the reports we file and submit under the Exchange Act is recorded, processed, summarized and reported as and when required.

In light of this conclusion and as part of the preparation of this report, we have applied compensating procedures and processes as necessary to ensure the reliability of our financial reporting. Accordingly, management believes, based on its knowledge, that (1) 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 not misleading with respect to the period covered by this report, and (2) the financial statements, and other financial information included in this report, fairly present in all material respects our financial condition, results of operations and cash flows as of December, 31, 2005 and for the period then ended.

Changes in Internal Control Over Financial Reporting

During the three months ended December 31, 2005, the Company made changes to improve its internal control over financial reporting with respect to the audit committee investigations by implementing changes to its senior management team including the dismissal of Mark Woodburn and Terry LaCore (see Item 1. Recent Developments). There were no additional changes in our internal control over financial reporting that occurred during the period that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

In light of the noted material weaknesses, we have instituted, and will continue to institute, control improvements that we believe will reduce the likelihood of similar errors:

We plan to devote more resources to developing an anti-fraud program to detect and prevent fraud. The program may include the hiring of outside or in-house counsel to be dedicated to the development and enforcement of compliance programs. Background checks will be performed on personnel being placed into positions of material responsibility. The compliance program also will include a communication project to set the right tone from the top. Additionally, we also plan to put more resources to following up on addressing control deficiencies identified in the previous audits;

The Company intends to develop additional policies and procedures to further strengthen its reporting, including the areas of revenue recognition, sales and expense cut-off and sales returns. In addition, we plan to evaluate hiring additional resources to perform the internal audit function;

The Company began implementation of the Oracle E-Business Suite during the fourth quarter of 2005 and commenced use of certain functionality on January 1, 2006 that address certain of the material weaknesses listed above, including the effective control over period-end financial close and reporting and the effective control over certain accounting functions. The Oracle implementation should facilitate the appropriate review and approval over the recording of journal entries to ensure the accuracy and completeness of the journal entries recorded. Additionally, the Company has made changes to its corporate accounting staff, including the hiring or contracting of additional personnel in the U.S. In December 2005, the Company hired a new general counsel to assist in the legal and compliance effort. The new general counsel commenced work in January 2006;

Additional segregation of duties and appropriate review, approval, and supporting documentation were installed in 2006 to maintain effective controls over the disbursement function. We are developing policies for proper documentation, review and approval related to related party transactions, subsidiary operations, distributor compensation adjustments, employee loans, expense reimbursements, and distributor relationships;

Additional segregation of duties and appropriate review, approval, and supporting documentation have been implemented since 2005 year end to maintain effective controls over the payroll function;

With the implementation of the Oracle e-Business Suite s financial reporting package, we should be able to further restrict access to the inventory detail schedule used to support the general ledger balances. With additional implementation of Oracle applications, we plan to eventually replace the current periodic inventory system, relying on monthly inventory counts using physical inventory count sheets, with a perpetual inventory system. Meanwhile, more procedures will be installed for review of inventory count documentation;

Additional processes will be instituted to timely resolve identified accounting and legal issues so that period-end financial statements and reporting can be timely completed; and

Stronger policy enforcement will be pushed down throughout the Company to eliminate executives making verbal agreements ahead of properly approved written contracts.

Furthermore, certain of these remediation efforts, primarily associated with our information technology infrastructure and related controls, will require significant ongoing effort and investment. Our management, with the oversight of our audit committee, will continue to identify and take steps to remedy known material weaknesses as expeditiously as possible and enhance the overall design and capability of our control environment. We intend to further expand our staff, accounting policy and controls capabilities by attracting additional talent and enhancing training in such matters. We believe that the foregoing actions have improved and will continue to improve our internal control over financial reporting, as well as our disclosure controls and procedures.

If the remedial policies and procedures we have implemented, and continue to implement, are insufficient to address the material weakness or if additional significant deficiencies or other conditions relating to our internal controls are discovered in the future, we may fail to meet our future reporting obligations, our financial statements may contain material misstatements and our operating results may be adversely affected. Any such failure could also adversely affect the results of the periodic management evaluations and annual auditor attestation reports regarding the effectiveness of our internal controls over financial reporting, which will be required when the SEC s rules under Section 404 of the Sarbanes-Oxley Act of 2002 become applicable to us beginning with the filing of our Annual Report on Form 10-K for the year ended December 31, 2007. Internal control deficiencies could also cause investors to lose confidence in our reported financial information. Although we believe that we have addressed, or will address in the near future, our material weakness in internal controls, we cannot guarantee that the measures we have taken to date or any future measures will remediate the material weakness identified or that any additional material weakness or significant deficiencies will not arise in the future due to a failure to implement and maintain adequate internal controls over financial reporting.

Item 9B. OTHER INFORMATION

None.

Part III

The information required by Items 10, 11, 12, 13 and 14, is incorporated by reference from the proxy statement to be filed with the SEC within 120 days of the end of the fiscal year covered by this report.

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Part IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Documents filed as part of this Form 10-K:

1. Financial Statements. See index to Consolidated Financial Statements under Item 8 of Part II.

2. Financial Statement Schedules. Financial statement schedules have been omitted because they are not required or are not applicable, or because the required information is shown in the financial statements or notes thereto.

3. Exhibits. The following exhibits are filed with this Form 10-K:

Exhibit Number	Exhibit Description	Reference
3.1	Certificate of Incorporation of Natural Health Trends Corp.	(a)
3.2	By-Laws of Natural Health Trends Corp.	(a)
4.1	Specimen Certificate for shares of common stock, $.001 par value per share, of Natural Health Trends Corp.	*
4.2	Form of Common Stock Purchase Warrant issued in October 2004 Private Placement	(b)
10.1	2002 Stock Plan, as amended	(c)
10.2	Forms of Notice of Grant of Stock Option Agreement under the Company s 2002 Stock Option Plan.	(h)
10.3	Option Agreement dated as of January 18, 2001, granting option for 30,000 shares to Terry LaCore, as amended.	*
10.4	Option Agreement dated as of January 18, 2001, granting option for 30,000 shares to the LaCore and Woodburn Partnership, assignee of Benchmark Consulting, as amended.	*
10.5	Option Agreement dated as October 14, 2002 granting 570,000 options to the LaCore and Woodburn Partnership, as amended.	*
10.6	Option Agreement dated as October 14, 2002 granting 570,000 options to Terry LaCore, as amended.	*
10.7	Option Agreement dated as July 24, 2002 granting 60,000 options to Capital Development S.A., an affiliate of Sir Brian Wolfson.	*
10.8	Option Agreement dated as July 24, 2002 granting 60,000 options to Randall A. Mason.	*
10.9	Distributorship Agreement dated March 1, 2002 between the Company and 40J s.	(d)
10.10	Founder Compensation Agreement by and among Lexxus International, Inc., Natural Health Trends Corp., Rodney Sullivan and Pam Sullivan, Michael Bray, and Jeff Provost.	(d)
10.11		(l)

	Amendment No. 1 to Founder Compensation Agreement by and among Lexxus International, Inc., Natural Health Trends Corp., Rodney Sullivan and Pam Sullivan, Michael Bray, and Jeff Provost.	
10.12	Database Purchase Agreement, dated as of January 31, 2003, by and among NuEworld.com Commerce, Inc., a Delaware corporation, Lighthouse Marketing Corporation, a Delaware corporation), and the Company.	(l)
10.13	KGC Agreement dated March 17, 2004 between the Company and Bannks Foundation.	(l)
10.14	Stock Purchase Agreement dated March 29, 2004 between Michael Bray, Jeff Provost, Rodney Sullivan and Pam Sullivan and the Company.	(l)
10.15	Agreement and Plan of Merger, dated as of March 31, 2004, by and among the Company, MergerCo and MarketVision.	(e)
10.16	Stockholders Agreement, dated as of March 31, 2004, by and among the Company, John Cavanaugh, Terry LaCore and Jason Landry.	(e)
10.17	Employment Agreement, dated as of March 31, 2004, between MarketVision and John Cavanaugh.	(e)
10.18	Employment Agreement, dated as of March 31, 2004, between MarketVision and Jason Landry.	(e)
10.19	Guaranty of the Employment Agreements dated as of March 31, 2004 executed by Lexxus U.S.	(e)
10.20	Software License Agreement dated as of March 31, 2004 among the Company, MergerCo and MarketVision Consulting Group, LLC.	(e)
10.21	Employment Agreement, dated as of August 1, 2004, by and between the Company and Chris Sharng.	(b)
10.22	Employment Agreement, dated as of October 7, 2004, by and between Lexxus International (Mexico), S.A. and Jose Raul Villarreal Patino	(l)

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Exhibit Number	Exhibit Description	Reference
10.23	Employment Agreement, dated as of October 7, 2004, by and between Lexxus International (Mexico), S.A. and Oscar de la Mora	(l)
10.24	Amended Employment Agreement, dated as of February 1, 2006, by and between the Company, Natural Health Trends Japan, Inc. and Richard Johnson.	(m)
10.25	Securities Purchase Agreement dated October 6, 2004 by and among the Company and the investors signatory thereto.	(f)
10.26	Subscription Agreement (Canada) dated October 6, 2004 by and among the Company and the investors signatory thereto.	(f)
10.27	Form of Registration Rights Agreement between the Company and the investors in the Company s October 2004 private placement.	(b)
10.28	Amendment No. 1 to Registration Rights Agreement dated February 23, 2005 between the Company and the investors in the Company s October 2004 private placement.	(l)
10.29	Amendment No. 1 to Founder Compensation Agreement by and among Lexxus International, Inc., Natural Health Trends Corp., Rodney Sullivan and Pam Sullivan, Michael Bray, and Jeff Provost.	(l)
10.30	Royalty Agreement dated March 1, 2005 by and among Steve Francisco, Dan Catto, and the Company.	(l)
10.31	Lease by and between CLP Properties Texas, LLP and Natural Health Trends Corp. dated as of June 18, 2005.	(g)
10.32	Agreement and Plan of Merger dated March 23, 2005, between Natural Health Trends Corp., a Florida corporation, and Natural Health Trends Corp., a Delaware corporation.	(a)
10.33	Form of Indemnification Agreement dated December 13, 2005, between Natural Health Trends Corp. and each of its directors.	(i)
10.34	Stock Purchase Agreement dated December 21, 2005 between Natural Health Trend Corp. and Bannks Foundation.	(j)
10.35	Agreement dated December 21, 2005 between Natural Health Trends Corp. and KGC Networks Pte Ltd.	(j)
10.36	Escrow Agreement dated February 10, 2006, among Natural Health Trends Corp., Terry L. LaCore, Mark D. Woodburn, LaCore and Woodburn Partnership and Krage and Janvey LLP, as escrow agent.	(k)
10.37	Letter agreement dated as of March 1, 2006 between Natural Health Trends Corp. and Robert H. Hesse	(m)

14.1	Worldwide Code of Business Conduct.	(l)
14.2	Code of Ethics for Senior Financial Officers.	(l)
21.1	Subsidiaries of the Company.	*
31.1	Certification of the Interim Principal Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (the Exchange Act).	*
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act.	*
32.1	Certification of the Interim Principal Executive Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	*
32.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	*

* Filed herewith.

(a) Previously filed July 12, 2005, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

(b) Previously filed November 12, 2004, as an Exhibit to the Company s Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, and incorporated herein by reference.

(c) Previously filed April 27, 2005,

as Appendices to the Company s Definitive Proxy Statement, and incorporated herein by reference.

(d) Previously filed on April 1, 2002 as an Exhibit to the Company s Annual Report on Form 10-KSB for the year ended December 31, 2001, and incorporated herein by reference.

(e) Previously filed on April 15, 2004, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

(f) Previously filed October 12, 2004, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

(g) Previously filed June 24, 2005, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

(h) Previously filed December 1, 2005, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

(i) Previously filed December 13, 2005, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

(j) Previously filed December 28,

2005, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

(k) Previously filed February 16, 2006, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

(l) Previously filed March 31, 2005, as an Exhibit to the Company s Annual Report on Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.

(m) Previously filed March 16, 2006, as an Exhibit to the Company s Current Report on Form 8-K, and incorporated herein by reference.

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SIGNATURES

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

NATURAL HEALTH TRENDS CORP.

Date: May 8, 2006

/s/ Chris T. Sharng

Chris T. Sharng
Executive Vice President and Chief Financial Officer

Pursuant to the requirements of the Securities Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Chris T. Sharng Chris Sharng	Executive Vice President and Chief Financial Officer (Interim Principal Executive Officer and Principal Financial Officer)	May 8, 2006
/s/ Timothy S. Davidson Timothy S. Davidson	Chief Accounting Officer (Principal Accounting Officer)	May 8, 2006
/s/ Randall A. Mason Randall A. Mason	Chairman of the Board and Director	May 8, 2006
/s/ Sir Brian Wolfson Sir Brian Wolfson	Vice Chairman of the Board and Director	May 8, 2006
/s/ Anthony B. Martino Anthony B. Martino	Director	May 8, 2006
/s/ Colin J. O Brien Colin J. O Brien	Director	May 8, 2006
/s/ Terrence M. Morris Terrence M. Morris	Director	May 8, 2006