

USANA HEALTH SCIENCES INC
Form 10-Q
August 08, 2006

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 1, 2006

OR

**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: 0-21116

USANA HEALTH SCIENCES, INC.

(Exact name of registrant as specified in its charter)

Utah

(State or other jurisdiction
of incorporation or organization)

87-0500306

(I.R.S. Employer
Identification No.)

3838 West Parkway Blvd., Salt Lake City, Utah 84120
(Address of principal executive offices, Zip Code)

(801) 954-7100

(Registrant's telephone number, including area code)

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 No

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

Large accelerated
filer

Accelerated filer

Non-accelerated filer

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

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The number of shares outstanding of the registrant's common stock as of August 3, 2006 was 17,803,855.

USANA HEALTH SCIENCES, INC.

FORM 10-Q

For the Quarterly Period Ended July 1, 2006

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

USANA HEALTH SCIENCES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands)

| | December 31, 2005 | July 1, 2006 (unaudited) |
|--|----------------------|--------------------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 10,579 | \$ 9,173 |
| Inventories | 22,223 | 20,458 |
| Prepaid expenses and other current assets | 6,024 | 6,048 |
| Deferred income taxes | 3,004 | 2,532 |
| Total current assets | 41,830 | 38,211 |
| Property and equipment, net | 23,302 | 23,777 |
| Goodwill | 5,690 | 5,690 |
| Other assets | 2,886 | 2,612 |
| | \$ 73,708 | \$ 70,290 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities | | |
| Accounts payable | \$ 4,955 | \$ 6,303 |
| Other current liabilities | 21,601 | 24,479 |
| Total current liabilities | 26,556 | 30,782 |
| Long-term liabilities | 1,414 | 69 |
| Stockholders' equity | | |
| Common stock, \$0.001 par value; authorized 50,000 shares, issued and outstanding 18,343 as of December 31, 2005 and 17,723 as of July 1, 2006 | 18 | 18 |
| Additional paid-in capital | 9,161 | 7,420 |
| Retained earnings | 35,720 | 31,211 |
| Accumulated other comprehensive income | 839 | 790 |
| Total stockholders' equity | 45,738 | 39,439 |
| | \$ 73,708 | \$ 70,290 |

The accompanying notes are an integral part of these statements.

USANA HEALTH SCIENCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EARNINGS

(in thousands, except per share data)

(unaudited)

| | Quarter Ended | |
|--|-----------------|-----------------|
| | July 2, 2005 | July 1, 2006 |
| Net sales | \$ 82,015 | \$ 93,911 |
| Cost of sales | 19,499 | 22,276 |
| Gross profit | 62,516 | 71,635 |
| Operating expenses: | | |
| Associate incentives | 31,911 | 37,454 |
| Selling, general and administrative | 15,168 | 17,991 |
| Research and development | 689 | 830 |
| Total operating expenses | 47,768 | 56,275 |
| Earnings from operations | 14,748 | 15,360 |
| Other income (expense): | | |
| Interest income | 93 | 169 |
| Interest expense | (3) | (10) |
| Other, net | (157) | 177 |
| Other income (expense), net | (67) | 336 |
| Earnings before income taxes | 14,681 | 15,696 |
| Income taxes | 5,138 | 5,352 |
| Net earnings | \$ 9,543 | \$ 10,344 |
| Earnings per common share | | |
| Basic | \$ 0.50 | \$ 0.57 |
| Diluted | \$ 0.48 | \$ 0.55 |
| Weighted average common shares outstanding | | |
| Basic | 18,948 | 18,149 |
| Diluted | 19,821 | 18,777 |

The accompanying notes are an integral part of these statements.

USANA HEALTH SCIENCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EARNINGS

(in thousands, except per share data)

(unaudited)

| | Six Months Ended | |
|--|------------------|-----------------|
| | July 2, 2005 | July 1, 2006 |
| Net sales | \$ 158,593 | \$ 183,562 |
| Cost of sales | 37,509 | 43,614 |
| Gross profit | 121,084 | 139,948 |
| Operating expenses: | | |
| Associate incentives | 61,461 | 72,882 |
| Selling, general and administrative | 30,017 | 35,617 |
| Research and development | 1,288 | 1,562 |
| Total operating expenses | 92,766 | 110,061 |
| Earnings from operations | 28,318 | 29,887 |
| Other income (expense): | | |
| Interest income | 197 | 311 |
| Interest expense | (3) | (10) |
| Other, net | (96) | 330 |
| Other income, net | 98 | 631 |
| Earnings before income taxes | 28,416 | 30,518 |
| Income taxes | 9,945 | 10,614 |
| Net earnings | \$ 18,471 | \$ 19,904 |
| Earnings per common share | | |
| Basic | \$ 0.97 | \$ 1.09 |
| Diluted | \$ 0.93 | \$ 1.05 |
| Weighted average common shares outstanding | | |
| Basic | 19,008 | 18,304 |
| Diluted | 19,896 | 19,002 |

The accompanying notes are an integral part of these statements.

USANA HEALTH SCIENCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME

Six Months Ended July 2, 2005 and July 1, 2006

(in thousands)

(unaudited)

| | Common Stock Shares | Value | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|---|------------------------|-------|----------------------------------|----------------------|--|-----------|
| For the Six Months Ended July 2, 2005 | | | | | | |
| Balance at January 1, 2005 | 18,953 | \$ 19 | \$ 11,853 | \$ 34,496 | \$ 1,475 | \$ 47,843 |
| Comprehensive income | | | | | | |
| Net earnings | | | | 18,471 | | 18,471 |
| Foreign currency translation adjustment, net | | | | | (740) | (740) |
| Comprehensive income | | | | | | |
| | | | | | | 17,731 |
| Common stock retired | (353) | | (3,948) | (11,053) | | (15,001) |
| Common stock issued under equity-based award plan, including tax benefit of \$2,679 | | | | | | |
| | 216 | | 4,230 | | | 4,230 |
| Balance at July 2, 2005 | 18,816 | \$ 19 | \$ 12,135 | \$ 41,914 | \$ 735 | \$ 54,803 |
| For the Six Months Ended July 1, 2006 | | | | | | |
| Balance at December 31, 2005 | 18,343 | \$ 18 | \$ 9,161 | \$ 35,720 | \$ 839 | \$ 45,738 |
| Comprehensive income | | | | | | |
| Net earnings | | | | 19,904 | | 19,904 |
| Foreign currency translation adjustment, net | | | | | (49) | (49) |
| Comprehensive income | | | | | | |
| | | | | | | 19,855 |
| Common stock retired | (801) | | (5,733) | (24,413) | | (30,146) |
| Equity-based compensation expense | | | | | | |
| | | | 2,152 | | | 2,152 |
| Common stock issued under equity-based award plan, including tax benefit of \$1,033 | | | | | | |
| | 181 | | 1,840 | | | 1,840 |
| Balance at July 1, 2006 | 17,723 | \$ 18 | \$ 7,420 | \$ 31,211 | \$ 790 | \$ 39,439 |

The accompanying notes are an integral part of these statements.

USANA HEALTH SCIENCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

| | Six Months Ended | |
|--|------------------|-----------------|
| | July 2, 2005 | July 1, 2006 |
| Increase (decrease) in cash and cash equivalents | | |
| Cash flows from operating activities | | |
| Net earnings | \$ 18,471 | \$ 19,904 |
| Adjustments to reconcile net earnings to net cash provided by operating activities | | |
| Depreciation and amortization | 2,824 | 2,924 |
| Loss on sale of property and equipment | 5 | 8 |
| Equity-based compensation expense | | 2,152 |
| Excess tax benefit from equity-based payment arrangements | | (832) |
| Deferred income taxes | 56 | (721) |
| Allowance for inventory valuation | 43 | 1,690 |
| Changes in operating assets and liabilities: | | |
| Inventories | (4,545) | 340 |
| Prepaid expenses and other assets | (734) | (411) |
| Accounts payable | (261) | 1,379 |
| Other current liabilities | 6,105 | 3,805 |
| Total adjustments | 3,493 | 10,334 |
| Net cash provided by operating activities | 21,964 | 30,238 |
| Cash flows from investing activities | | |
| Proceeds from the sale of property and equipment | 4 | |
| Purchases of property and equipment | (2,688) | (3,104) |
| Net cash used in investing activities | (2,684) | (3,104) |
| Cash flows from financing activities | | |
| Proceeds from exercise of equity-based awards | 1,551 | 807 |
| Excess tax benefit from equity-based payment arrangements | | 832 |
| Redemption of common stock | (15,001) | (30,146) |
| Net cash used in financing activities | (13,450) | (28,507) |
| Effect of exchange rate changes on cash and cash equivalents | (469) | (33) |
| Net increase (decrease) in cash and cash equivalents | 5,361 | (1,406) |
| Cash and cash equivalents, beginning of period | 15,067 | 10,579 |
| Cash and cash equivalents, end of period | \$ 20,428 | \$ 9,173 |
| <u>Supplemental disclosures of cash flow information</u> | | |
| Cash paid during the period for: | | |
| Interest | \$ 3 | \$ 8 |
| Income taxes | 5,944 | 10,491 |

The accompanying notes are an integral part of these statements.

USANA HEALTH SCIENCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(in thousands, except per share data)

(unaudited)

Basis of Presentation

The unaudited interim consolidated financial information of USANA Health Sciences, Inc. and Subsidiaries (the Company or USANA) has been prepared in accordance with Article 10 of Regulation S-X promulgated by the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the accompanying interim consolidated financial information contains all adjustments, consisting of normal recurring adjustments, necessary to present fairly the Company's financial position as of July 1, 2006, and results of operations for the quarters and six months ended July 2, 2005 and July 1, 2006. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. The results of operations for the quarter and six months ended July 1, 2006 may not be indicative of the results that may be expected for the fiscal year ending December 30, 2006.

Recently Issued Accounting Standards

In June 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in income tax positions. FIN 48 defines the threshold for recognizing tax return positions in the financial statements as more likely than not that the position is sustainable, based on its technical merits. FIN 48 also provides guidance on the measurement, classification and disclosure of tax return positions in the financial statements. FIN 48 is effective for the first reporting period beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to the beginning balance of retained earnings in the period of adoption. The Company is currently evaluating the impact of adopting FIN 48 on its consolidated financial statements.

NOTE A EQUITY-BASED COMPENSATION

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R),

Share-Based Payment, using the modified version of prospective application. Under this method, compensation expense includes the estimated fair value of equity awards vested during the reported periods. Expense for equity awards vested is determined based on grant date fair value previously calculated for pro forma disclosures under SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. An Amendment of FASB Statement No. 123. Equity-based compensation expense recognized for the quarter and six months ended July 1, 2006 was comprised as follows:

| | Quarter Ended July 1, 2006 | Six Months Ended July 1, 2006 |
|-------------------------------------|---|--|
| Cost of sales | \$ 143 | \$ 270 |
| Selling, general and administrative | 930 | 1,637 |
| Research and development | 132 | 245 |
| | \$ 1,205 | \$ 2,152 |

The impact of equity-based compensation expense on net earnings and earnings per share for the quarter and six months ended July 1, 2006, can be found in the pro forma table in this footnote. The Company currently estimates that equity-based compensation expense will reduce basic and diluted earnings per share in 2006 by \$0.18. The following table shows remaining unrecognized compensation expense on a pre-tax basis related to all types of nonvested equity awards outstanding as of July 1, 2006. This table does not include an estimate for future grants that may be issued.

| | |
|-------------------|-----------|
| Remainder of 2006 | \$ 2,578 |
| 2007 | 5,095 |
| 2008 | 4,718 |
| 2009 | 2,840 |
| 2010 | 2,203 |
| Thereafter | 412 |
| | \$ 17,846 |

The cost above is expected to be recognized over a weighted-average period of 2.4 years.

Prior to the adoption of SFAS No. 123(R), the Company presented all tax benefits resulting from equity-based compensation as cash flows from operating activities in the condensed consolidated statements of cash flows. SFAS No. 123(R) requires cash flows resulting from tax deductions in excess of the grant-date fair value of equity awards to be included in cash flows from financing activities. The excess tax benefits of \$832 related to equity-based compensation included in cash flows from financing activities in the first six months of 2006 would have been included in cash flows from operating activities if the Company had not adopted SFAS No. 123(R).

As permitted by SFAS No. 148, prior to the adoption of SFAS No. 123(R) the Company accounted for equity award expense under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, under which no compensation was recognized in the Company's financial statements for the quarter and six months ended July 2, 2005. In connection with the modified prospective method, disclosures made for periods prior to the adoption of SFAS No. 123(R) do not reflect restated amounts.

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The following table presents equity-based compensation expense included in our financial statements for the quarter and six months ended July 1, 2006, and also illustrates the pro forma effects on net earnings and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123, as amended by SFAS No. 148, to equity-based compensation for the quarter and six months ended July 2, 2005:

| | | Quarter Ended | | Six Months Ended | |
|---|-------------|---------------|--------------|------------------|--------------|
| | | July 2, 2005 | July 1, 2006 | July 2, 2005 | July 1, 2006 |
| Net earnings | As reported | \$ 9,543 | \$ 10,344 | \$ 18,471 | \$ 19,904 |
| Add: Compensation cost included in reported net income | | | 819 | | 1,504 |
| Deduct: Total compensation expense under the fair value method for all awards | | (466) | (819) | (914) | (1,504) |
| Net earnings | Pro forma | \$ 9,077 | \$ 10,344 | \$ 17,557 | \$ 19,904 |
| Earnings per share - basic | As reported | \$ 0.50 | \$ 0.57 | \$ 0.97 | \$ 1.09 |
| | Pro forma | \$ 0.48 | \$ 0.57 | \$ 0.92 | \$ 1.09 |
| Earnings per share - diluted | As reported | \$ 0.48 | \$ 0.55 | \$ 0.93 | \$ 1.05 |
| | Pro forma | \$ 0.46 | \$ 0.55 | \$ 0.88 | \$ 1.05 |

The Company's 2006 Equity Incentive Award Plan (2006 Plan), which was approved by the shareholders at the Annual Shareholders' Meeting held on April 19, 2006, allows for the grant of various equity awards including stock options, stock-settled stock appreciation rights, deferred stock units, and other types of equity-based awards to the Company's officers, key employees, and non-employee directors. Prior to the approval of the 2006 Plan, the Company maintained the 2002 Stock Option Plan (2002 Plan), which was limited to the granting of incentive and non-qualified stock options. Between January 1, 2006, and April 19, 2006, the Company issued 175 stock options under the 2002 Plan. Options granted under the 2002 Plan generally vest 20% each year on the anniversary of the grant date and expire five to ten years from the date of grant. The 2006 Plan replaces the 2002 Plan for all future grants, and no new awards will be granted under the 2002 Plan. The 2006 Plan authorized 5,000 shares of common stock for issuance, of which 4,704 shares were available for future issuance as of July 1, 2006. Of the 296 shares granted under the 2006 Plan, 290 were stock-settled stock appreciation rights, 3 were stock options, and 3 were deferred stock units. The Company's Compensation Committee has initially determined that awards to be granted to officers and key employees under the 2006 Plan will generally vest 20% each year on the anniversary of the grant date and expire five to five and one-half years from the date of grant. Awards of stock options and stock-settled stock appreciation rights to be granted to non-employee directors will generally vest 25% each quarter commencing on the last day of the fiscal quarter in which the awards are granted, and will expire five years from the date of grant. Awards of deferred stock units are full-value shares at the date of grant, vesting in connection with service period, and do not have expiration dates.

The Company continues to use the Black-Scholes option pricing model to estimate fair value of equity awards, which requires the input of highly subjective assumptions, including the expected stock price volatility. Prior to the implementation of SFAS No. 123(R), expected volatility represented the historical share prices of the Company's common stock over the expected life of the award and the risk-free interest rate was based on the U.S. Treasury yield curve on the date of grant with respect to the expected life of the award. Expected life was based on the contractual term of the award.

Preceding the adoption of SFAS No. 123(R), the Company engaged a third-party valuation expert to analyze assumptions used by the Company and to determine changes necessary for a more accurate reflection of the estimated fair value of equity

awards granted by the Company. Based on this analysis the Company decided that, effective January 1, 2006, expected volatility will be calculated by averaging the historical volatility of the Company and a peer group index. The risk-free interest rate will continue to be based on the U.S. Treasury yield curve on the date of grant with respect to the expected life of the award. Also, effective January 1, 2006, due to the plain vanilla characteristics of the Company's stock options, the simplified method, as permitted by the guidance provided in Staff Accounting Bulletin No. 107, will be used to determine expected life while permitted. We estimate that the equity-based compensation expense included in earnings before income taxes for the six months ended July 1, 2006 was decreased by approximately \$128 due to the above mentioned change in assumptions used to estimate fair value of awards granted during the six months ended July 1, 2006.

The following table includes weighted-average assumptions used to calculate the fair value of awards granted during the periods indicated, as well as the weighted-average fair value of awards granted. Deferred stock units are full-value shares at the date of grant and have been excluded from the table below.

| | Quarter Ended | | Six Months Ended | | | |
|---|-----------------|----------------|------------------|----------------|-----------------|----------------|
| | July 2, 2005 | July 1 2006 | July 2, 2005 | July 1 2006 | July 2, 2005 | July 1 2006 |
| Expected volatility | 72.00 | % 57.04 | % 72.00 | % 57.04 | % 72.00 | % 57.04 |
| Risk-free interest rate | 3.87 | % 4.98 | % 3.87 | % 4.79 | % 3.87 | % 4.79 |
| Expected life | 5.25 yrs. | 4.125 yrs. | 5.25 yrs. | 4.125 yrs. | 5.25 yrs. | 4.125 yrs. |
| Expected dividend yield | 0.00 | % 0.00 | % 0.00 | % 0.00 | % 0.00 | % 0.00 |
| Weighted-average fair value of awards granted | \$ 26.84 | \$ 18.59 | \$ 26.84 | \$ 18.80 | \$ 26.84 | \$ 18.80 |

The weighted-average fair value and grant price of the 3 deferred stock units granted during the quarter and six months ended July 1, 2006 was \$37.60.

A summary of the Company's stock option and stock-settled stock appreciation right activity for the six months ended July 1, 2006 is as follows:

| | Shares | Weighted-average Exercise Price* | Weighted-average Remaining Contractual Term | Aggregate Intrinsic Value** |
|----------------------------------|--------|--|---|-----------------------------------|
| Outstanding at December 31, 2005 | 1,773 | \$ 17.43 | 6.97 | \$ 37,121 |
| Granted | 468 | \$ 38.14 | | \$ |
| Exercised | (181) | \$ 4.47 | | \$ |
| Canceled or expired | | \$ | | \$ |
| Outstanding at July 1, 2006 | 2,060 | \$ 23.26 | 6.05 | \$ 31,186 |
| Exercisable at July 1, 2006 | 589 | \$ 26.16 | 7.69 | \$ 7,472 |

* All awards are granted at the market value on the date of grant, which is established by averaging the closing price of the Company's common stock over the five trading days preceding the date of grant.

** Aggregate intrinsic value is defined as the difference between the current market value and the exercise price of awards that were in-the-money, and is estimated using the closing price of the Company's common stock on the last trading day of periods ended as of the dates indicated.

Total intrinsic value of awards exercised, which includes stock options and stock-settled stock appreciation rights, during the six month periods ending July 2, 2005 and July 1, 2006, was \$7,284 and \$6,348, respectively.

A summary of the Company's deferred stock unit activity for the six months ended July 1, 2006 is as follows:

| | Shares | Weighted- average Fair Value |
|--------------------------------|--------|------------------------------------|
| Nonvested at December 31, 2005 | | \$ |
| Granted | 3 | \$ 37.60 |
| Vested | (1) | \$ 37.60 |
| Canceled or expired | | \$ |
| Nonvested at July 1, 2006 | 2 | \$ 37.60 |

The total fair value of awards vested during the six month periods ending July 2, 2005 and July 1, 2006, which includes stock options, stock-settled stock appreciation rights, and deferred stock units, was \$2,383 and \$2,561, respectively.

NOTE B INVENTORIES

Inventories consist of the following:

| | December 31, 2005 | July 1, 2006 |
|--|----------------------|-----------------|
| Raw materials | \$ 11,878 | \$ 10,676 |
| Work in progress | 3,533 | 2,734 |
| Finished goods | 9,482 | 10,040 |
| | 24,893 | 23,450 |
| Less allowance for inventory valuation | 2,670 | 2,992 |
| | \$ 22,223 | \$ 20,458 |

NOTE C PREPAID EXPENSES AND OTHER CURRENT ASSETS

Prepaid expenses and other current assets consist of the following:

| | December 31, 2005 | July 1, 2006 |
|--------------------------------|----------------------|-----------------|
| Prepaid expenses | \$ 2,038 | \$ 1,337 |
| Miscellaneous receivables, net | 3,537 | 3,499 |
| Other current assets | 449 | 1,212 |
| | \$ 6,024 | \$ 6,048 |

NOTE D PROPERTY AND EQUIPMENT

Cost of property and equipment and their estimated useful lives is as follows:

| | Years | December 31, 2005 | July 1, 2006 |
|--|-------|----------------------|-----------------|
| Building | 40 | \$ 10,377 | \$ 10,347 |
| Laboratory and production equipment | 5-7 | 9,706 | 10,231 |
| Sound and video library | 5 | 600 | 600 |
| Computer equipment and software | 3-5 | 23,083 | 23,549 |
| Furniture and fixtures | 3-5 | 2,654 | 2,669 |
| Automobiles | 3-5 | 248 | 221 |
| Leasehold improvements | 3-5 | 2,709 | 2,742 |
| Land improvements | 15 | 931 | 931 |
| | | 50,308 | 51,290 |
| Less accumulated depreciation and amortization | | 29,605 | 31,814 |
| | | 20,703 | 19,476 |
| Land | | 2,064 | 2,066 |
| Deposits and projects in process | | 535 | 2,235 |
| | | \$ 23,302 | \$ 23,777 |

NOTE E GOODWILL

Goodwill represents the excess of the purchase price paid for acquired entities over the fair market value of the net assets acquired. As of July 1, 2006, goodwill totaled \$5,690, comprising \$4,267 that was associated with the July 1, 2003 acquisition of Wasatch Product Development, Inc. (WPD) and \$1,423 that was associated with the February 1, 2004 acquisition of FMG. No events have occurred subsequent to either acquisition that have resulted in an impairment of the original goodwill amounts initially recorded from the transactions. In accordance with SFAS No. 142,

Goodwill and Other Intangible Assets, goodwill must be tested at least annually and if the carrying amount of goodwill exceeds its fair value, an impairment loss must be recognized in an amount equal to that excess.

There were no changes in the carrying amount of goodwill for the acquired subsidiaries for the six months ended July 1, 2006:

| | WPD | FMG | Consolidated Total |
|------------------------------|----------|----------|-----------------------|
| Balance at December 31, 2005 | \$ 4,267 | \$ 1,423 | \$ 5,690 |
| Goodwill acquired | | | |
| Impairment adjustments | | | |
| Balance at July 1, 2006 | \$ 4,267 | \$ 1,423 | \$ 5,690 |

NOTE F OTHER CURRENT LIABILITIES

Other current liabilities consist of the following:

| | December 31, 2005 | July 1, 2006 |
|--------------------------------------|------------------------------|-------------------------|
| Associate incentives | \$ 3,528 | \$ 4,592 |
| Accrued employee compensation | 6,257 | 4,435 |
| Income taxes | 2,429 | 2,446 |
| Sales taxes | 2,354 | 2,093 |
| Associate promotions | 616 | 1,937 |
| Unearned revenue | 1,903 | 3,307 |
| Provision for returns and allowances | 943 | 883 |
| All other | 3,571 | 4,786 |
| | \$ 21,601 | \$ 24,479 |

NOTE G COMMON STOCK AND EARNINGS PER SHARE

Basic earnings per share are based on the weighted average number of shares outstanding for each period. Weighted-average shares issued and weighted-average shares redeemed during the periods indicated have been included in the calculation of weighted-average shares outstanding for basic earnings per share. Diluted earnings per common share are based on shares outstanding (computed under basic EPS) and potentially dilutive shares. Shares included in diluted earnings per share calculations include stock options granted that are in the money but have not yet been exercised.

| | For the Quarter Ended | |
|---|------------------------------|-------------------------|
| | July 2, 2005 | July 2, 2006 |
| Earnings available to common shareholders | \$ 9,543 | \$ 10,344 |
| Basic EPS | | |
| Shares | | |
| Common shares outstanding entire period | 18,953 | 18,343 |
| Weighted average common shares: | | |
| Issued during period | 211 | 173 |
| Canceled during period | (216) | (367) |
| Weighted average common shares outstanding during period | 18,948 | 18,149 |
| Earnings per common share basic | \$ 0.50 | \$ 0.57 |
| Diluted EPS | | |
| Shares | | |
| Weighted average shares outstanding during period basic | 18,948 | 18,149 |
| Dilutive effect of stock options | 873 | 628 |
| Weighted average shares outstanding during period diluted | 19,821 | 18,777 |
| Earnings per common share diluted | \$ 0.48 | \$ 0.55 |

Options to purchase 571 shares of stock were not included in the computation of EPS for the quarter ended July 1, 2006 due to their exercise price being greater than the average market price of the shares.

| | For the Six Months Ended | |
|---|---------------------------------|------------------------|
| | July 2, 2005 | July 1 2006 |
| Earnings available to common shareholders | \$ 18,471 | \$ 19,904 |
| Basic EPS | | |
| Shares | | |
| Common shares outstanding entire period | 18,953 | 18,343 |
| Weighted average common shares: | | |
| Issued during period | 163 | 144 |
| Canceled during period | (108) | (183) |
| Weighted average common shares outstanding during period | 19,008 | 18,304 |
| Earnings per common share basic | \$ 0.97 | \$ 1.09 |
| Diluted EPS | | |
| Shares | | |
| Weighted average shares outstanding during period basic | 19,008 | 18,304 |
| Dilutive effect of equity-based awards | 888 | 698 |
| Weighted average shares outstanding during period diluted | 19,896 | 19,002 |
| Earnings per common share diluted | \$ 0.93 | \$ 1.05 |

Options to purchase 319 shares of stock were not included in the computation of EPS for the six months ended July 1, 2006 due to their exercise price being greater than the average market price of the shares.

During the six months ended July 2, 2005, and July 1, 2006, the Company expended \$15,001, and \$30,146 to purchase 353 and 801 shares, respectively, under the Company's share repurchase plan. The purchase of shares under this plan reduces the number of shares issued and outstanding.

NOTE H SEGMENT INFORMATION

The Company's operations are distinguished by regions served and method of distribution employed. Two reportable business segments are recognized by the Company: Direct Selling and Contract Manufacturing. These operating segments are evaluated regularly by management in determining the allocation of resources and in assessing the performance of the Company. Management evaluates performance based on net sales and the amount of operating income or loss. Segment profit or loss is based on profit or loss from operations before income taxes. All intercompany transactions, intercompany profit, currency gains and losses, interest income and expense, and income taxes are excluded in the Company's determination of segment profit or loss.

Direct Selling

The Company's Direct Selling segment develops, manufactures, and distributes nutritional, weight management, and personal care products, and is the primary segment in which the Company operates. Products are distributed through a network marketing system using independent distributors referred to as Associates. Products are also sold directly to Preferred Customers, who purchase products for personal use and are not permitted to resell or distribute the products.

Selected financial information for the Direct Selling segment is reported for two geographic regions: North America and Pacific Rim. North America includes the United States, Canada, and Mexico. All other entities outside of North America are located within the Pacific Rim region, which includes Australia-New Zealand, Hong Kong, Japan, Taiwan, South Korea, and Singapore.

The profitability of each reported region within the Direct Selling segment is representative of what is controllable within that region by local management and is not necessarily indicative of actual profit or loss generated by a fully burdened region. However, the presentation of the data is consistent with how management evaluates each region and the respective markets within that region.

Contract Manufacturing

Operating activities for the Contract Manufacturing segment primarily exist for the production of the Company's Sensé line of skin and personal care products. In addition to the production of the Sensé product line, contract manufacturing services are provided to a limited number of external customers. This segment includes operations located in Draper, Utah and at a facility in Tianjin, China, which the Company acquired in October 2005. Manufacturing and packaging activities for the Company's Sensé products began at the Draper, Utah facility during the fourth quarter of 2003. In the second quarters of 2005 and 2006, we had one and two external customers, respectively, that accounted for more than ten percent of segment sales.

Financial information summarized by operating segment and geographic region for the quarters ended July 2, 2005 and July 1, 2006 is listed below:

| | Net Sales from External Customers | Inter-segment Revenues | Earnings before Income Taxes |
|-----------------------------|---|---------------------------|------------------------------------|
| Quarter ended July 2, 2005: | | | |
| Direct Selling | | | |
| North America | \$ 52,264 | \$ 15,316 | \$ 7,444 |
| Pacific Rim | 27,548 | 1,382 | 7,068 |
| Segment Total | 79,812 | 16,698 | 14,512 |
| Contract Manufacturing | 2,203 | 1,796 | 221 |
| Reportable Segments Total | 82,015 | 18,494 | 14,733 |
| Unallocated and Other * | | (18,494) | (52) |
| Consolidated Total | \$ 82,015 | \$ | \$ 14,681 |

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| | Net Sales from External Customers | Inter-segment Revenues | Earnings before Income Taxes |
|-----------------------------|---|---------------------------|------------------------------------|
| Quarter ended July 1, 2006: | | | |
| Direct Selling | | | |
| North America | \$ 62,201 | \$ 16,651 | \$ 7,917 |
| Pacific Rim | 28,876 | 1,402 | 8,484 |
| Segment Total | 91,077 | 18,053 | 16,401 |
| Contract Manufacturing | 2,834 | 1,236 | (97) |
| Reportable Segments Total | 93,911 | 19,289 | 16,304 |
| Unallocated and Other * | | (19,289) | (608) |
| Consolidated Total | \$ 93,911 | \$ | \$ 15,696 |

Financial information summarized by operating segment and geographic region for the six months ended July 2, 2005 and July 1, 2006 is listed below:

| | Net Sales from External Customers | Inter-segment Revenues | Earnings before Income Taxes | Long-lived Assets | Total Assets |
|--------------------------------|---|---------------------------|---------------------------------|----------------------|-----------------|
| Six months ended July 2, 2005: | | | | | |
| Direct Selling | | | | | |
| North America | \$ 101,522 | \$ 33,251 | \$ 14,419 | \$ 22,426 | \$ 68,688 |
| Pacific Rim | 52,939 | 2,659 | 12,714 | 2,909 | 18,778 |
| Segment Total | 154,461 | 35,910 | 27,133 | 25,335 | 87,466 |
| Contract Manufacturing | 4,132 | 3,871 | 772 | 6,361 | 12,720 |
| Reportable Segments Total | 158,593 | 39,781 | 27,905 | 31,696 | 100,186 |
| Unallocated and Other * | | (39,781) | 511 | 39 | (18,368) |
| Consolidated Total | \$ 158,593 | \$ | \$ 28,416 | \$ 31,735 | \$ 81,818 |

| | Net Sales from External Customers | Inter-segment Revenues | Earnings before Income Taxes | Long-lived Assets | Total Assets |
|--------------------------------|---|---------------------------|---------------------------------|----------------------|-----------------|
| Six months ended July 1, 2006: | | | | | |
| Direct Selling | | | | | |
| North America | \$ 122,335 | \$ 32,666 | \$ 16,260 | \$ 21,864 | \$ 41,190 |
| Pacific Rim | 55,495 | 2,643 | 14,405 | 2,681 | 13,780 |
| Segment Total | 177,830 | 35,309 | 30,665 | 24,545 | 54,970 |
| Contract Manufacturing | 5,732 | 2,325 | (181) | 7,531 | 12,892 |
| Reportable Segments Total | 183,562 | 37,634 | 30,484 | 32,076 | 67,862 |
| Unallocated and Other * | | (37,634) | 34 | 3 | 2,428 |
| Consolidated Total | \$ 183,562 | \$ | \$ 30,518 | \$ 32,079 | \$ 70,290 |

* Unallocated and Other includes certain corporate items and eliminations that are not allocated to the operating segments.

NOTE I SUBSEQUENT EVENTS

On July 26, 2006, we announced that our Board of Directors authorized an additional dollar amount for the repurchase of our outstanding shares of \$40,000, increasing the total authorized amount to \$50,654.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of USANA's financial condition and results of operations should be read in conjunction with the Unaudited Consolidated Financial Statements and Notes contained in this quarterly report.

General

USANA Health Sciences, Inc. develops and manufactures high-quality nutritional, weight management, and personal care products. We market our products on the basis of high levels of bioavailability, safety, and quality. We distribute our products through a network marketing system using independent distributors whom we refer to as Associates. As of July 1, 2006, we had 142,000 active Associates worldwide. We also sell products directly to Preferred Customers who purchase products for personal use and are not permitted to resell or distribute the products. As of July 1, 2006, we had 75,000 active Preferred Customers worldwide. The majority of sales in the Direct Selling segment come from Associates. For the six months ended July 1, 2006, sales to Associates accounted for approximately 86% of net sales for the Direct Selling segment. For purposes of this report, we only count as active customers those Associates and Preferred Customers who have purchased product from USANA at any time during the most recent three-month period.

The fiscal year end of USANA is the Saturday closest to December 31 of each year. Fiscal year 2005 ended on December 31, 2005, and fiscal year 2006 will end on December 30, 2006.

As discussed more fully in Note H Segment Information to the consolidated financial statements, we have two reportable segments: Direct Selling and Contract Manufacturing. The Direct Selling segment constitutes our principal line of business: developing, manufacturing, and distributing nutritional and personal care products through a network marketing system. The Contract Manufacturing segment primarily consists of manufacturing and packaging the Company's Sensé product line of skin and personal care products, but also includes contract manufacturing services provided to a limited number of third-party customers.

Our primary product lines within the Direct Selling segment consist of USANA® Nutritionals and Sensé beautiful science (Sensé). The USANA® Nutritionals product line is further categorized into three separate classifications: Essentials, Optimizers, and Macro Optimizers. Additionally, we offer combination packs, which generally contain a variety of products from each product line.

USANA® Nutritionals.

The Essentials include core vitamin and mineral supplements that provide a foundation of advanced nutrition for every age group. To help meet the essential nutrient needs of children and teens during the years of development, when good nutrition is especially important, USANA offers: Usanimals™, a formulation of vitamins, minerals, and antioxidants, in an easy-to-take chewable tablet for children 13 months to 12 years old; and Body Rox™, a nutritional supplement containing 31 essential vitamins, minerals, antioxidants, and cofactors for adolescents 12 to 18 years old. USANA® Essentials for adults is a combination of two products: Mega Antioxidant, a balanced, high-potency blend of 30 vitamins, antioxidants, and other important nutrients to support cellular metabolism and to counteract free-radical damage; and Chelated Mineral, a complete spectrum of essential minerals, in balanced, highly bioavailable forms. The USANA® Essentials are also available in a convenient pillow pack format, HealthPak 100™.

The Optimizers are more targeted supplements designed to meet individual health and nutritional needs. Products in this category include Proflavanol®, Poly C®, Procosa® II, CoQuinone® 30, BiOmega-3™, E-Prime™, Active Calcium™, Active Calcium™ Chewable, PhytoEstrin™, Palmetto Plus™, Ginkgo-PS™, Garlic EC™, Visionex®, OptOmega®, and Hepasil DTX .

The Macro Optimizers include healthy, low-glycemic convenience foods and other related products. Nutrimeal™, Fibergy®, and SoyaMax™ drink mixes, and Nutrition and Fibergy Bars are included in this product category. This product line also includes our RESET Weight Management Program designed to assist in a long-term change in diet, and the accompanying

RESET kit. The RESET kit is conveniently packaged in a self-contained box with the USANA products needed to complete a five-day regimen, designed to assist in losing weight and providing a start to a long-term change in diet.

Sensé - beautiful science®

The Sensé product line includes premium, science-based personal care products that support healthy skin and hair by providing advanced topical nourishment, moisturization, and protection. These products are produced with our patent-pending, self-preserving technology. This technology uses a unique blend of botanicals, antioxidants, and active ingredients to keep products fresh, without adding traditional chemical preservatives. Products in this line include Perfecting Essence, Gentle Daily Cleanser, Hydrating Toner, Daytime Protective Emulsion, Eye Nourisher, Night Renewal, Serum Intensive, Rice Bran Polisher, Revitalizing Shampoo, Nourishing Conditioner, Firming Body Nourisher, Energizing Shower Gel, and Intensive Hand Therapy.

All Other

In addition to these principal product lines, we have developed and sell to Associates materials and online tools designed to assist them in building their businesses and selling our products. These resource materials or sales tools include product brochures and business forms that are designed by us and printed by outside publishers. We periodically contract with authors and publishers to produce or provide books, tapes, and other items that deal with health topics and personal motivation, which we then sell to Associates. We also write and develop our own materials for CDs and DVDs, which are produced by our wholly-owned subsidiary FMG Productions. New Associates are required to purchase a starter kit, which contains USANA training materials that assist Associates in starting and growing their businesses. Associates do not earn commissions on the sale of starter kits or sales tools.

The following table summarizes the approximate percentage of total product revenue for the Direct Selling segment contributed by major product line for the six months ended as of the dates indicated:

| Product Line | Sales By Product Line Six Months Ended | | | |
|--------------------------|---|---|-----------------|---|
| | July 2, 2005 | | July 1, 2006 | |
| USANA® Nutritionals | | | | |
| Essentials * | 37 | % | 38 | % |
| Optimizers | 35 | % | 33 | % |
| Macro Optimizers | 9 | % | 14 | % |
| Sensé beautiful science® | 15 | % | 12 | % |
| All Other | 4 | % | 3 | % |

* The Essentials category under the USANA® Nutritionals product line includes USANA® Essentials, HealthPak 100™, Body Rox™, and Usanimals™.

Key Products

The following highlights sales data for our top-selling products as a percentage of Direct Selling segment product sales for the six months ended as of the dates indicated.

| | Six Months Ended | | | |
|-------------------|------------------|---|-----------------|---|
| | July 2, 2005 | | July 1, 2006 | |
| USANA® Essentials | 22 | % | 22 | % |
| HealthPak 100 | 12 | % | 14 | % |

| | | | | |
|--------------|----|---|---|---|
| Proflavanol® | 10 | % | 9 | % |
|--------------|----|---|---|---|

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Forward-Looking Statements and Certain Risks

The statements contained in this report that are not purely historical are considered to be forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and Section 21E of the Securities Exchange Act. These statements represent our expectations, hopes, beliefs, anticipations, commitments, intentions, and strategies regarding the future. They may be identified by the use of words or phrases such as believes, expects, anticipates, should, plans, estimates, and potential, among others. Forward-looking statements include, but are not limited to, statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations regarding our financial performance, revenue, and expense levels in the future and the sufficiency of our existing assets to fund future operations and capital spending needs. Readers are cautioned that actual results could differ materially from the anticipated results or other expectations that are expressed in these forward-looking statements for the reasons detailed in our most recent Annual Report on Form 10-K at pages 20 through 30. The fact that some of the risk factors may be the same or similar to our past reports filed with the Securities and Exchange Commission means only that the risks are present in multiple periods. We believe that many of the risks detailed here and in our other SEC filings are part of doing business in the industry in which we operate and compete and will likely be present in all periods reported. The fact that certain risks are endemic to the industry does not lessen their significance. The forward-looking statements contained in this report are made as of the date of this report and we assume no obligation to update them or to update the reasons why actual results could differ from those projected in such forward-looking statements. Among others, risks and uncertainties that may affect our business, financial condition, performance, development, and results of operations include:

- Our ability to attract and maintain a sufficient number of Associates;

- High turnover of Associates;

- Our dependence upon a network marketing system to distribute our products;

- Activities of our independent Associates;

- Our planned expansion into international markets, including delays in commencement of sales in any new market, delays in compliance with local marketing or other regulatory requirements, or changes in target markets;

- Rigorous government scrutiny of network marketing practices;

- Potential political events that may negatively affect economic conditions;
- Potential natural disasters that may negatively affect economic conditions;
- Potential effects of adverse publicity regarding nutritional supplements or the network marketing industry;

- Reliance on key management personnel, including our Founder, Chairman of the Board of Directors, and Chief Executive Officer Myron W. Wentz, Ph.D.;

- Extensive government regulation of the Company's products, manufacturing, and network marketing system;

- Potential inability to sustain or manage growth, including the failure to continue to develop new products;

- An increase in the amount of Associate incentives paid;

- Our reliance on the use of information technology;

- The adverse effect of the loss of a high-level sponsoring Associate, together with a group of leading Associates, in that person's downline;
- The loss of market share of our products or the Associates to competitors;

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- Potential adverse effects of taxation and transfer pricing regulations;
- The fluctuation in the value of foreign currencies against the US dollar;
- Our reliance on outside suppliers for raw materials;

- Shortages of raw materials that we use in certain of our products;
- Significant price increases of our key raw materials;
- Product liability claims and other risks associated with our manufacturing activity;
- Intellectual property risks;
- Liability claims associated with our Athlete Guarantee program; and
- Disruptions to shipping channels that are used to distribute our products to international warehouses.

Results of Operations

Implementation of SFAS No. 123(R)

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123(R), which require equity-based compensation expense to be recognized in financial statements. The Company used the modified version of prospective application to adopt these provisions. Under this method, compensation expense includes the estimated fair value of equity awards vested during the reported period. Our financial statements for 2006 interim periods are the first to reflect equity-based compensation expense. Equity-based compensation expense recognized for the quarter, and six months ended July 1, 2006 was comprised as follows:

| | Quarter Ended July 1, 2006 | Six Months Ended July 1, 2006 |
|-------------------------------------|----------------------------------|-------------------------------------|
| Cost of sales | \$ 143 | \$ 270 |
| Selling, general and administrative | 930 | 1,637 |
| Research and development | 132 | 245 |
| | \$ 1,205 | \$ 2,152 |

Net of tax, earnings for the quarter and six months ended July 1, 2006 were reduced by \$819 thousand, and \$1,504 thousand, respectively. Earnings per basic and diluted share were reduced \$0.04, and \$0.07, respectively, from what earnings would have been exclusive of equity-based compensation. The Company currently estimates that equity-based compensation expense will reduce basic and diluted earnings per share in 2006 by \$0.18. The following table shows remaining unrecognized compensation expense on a pre-tax basis related to all types of nonvested equity awards outstanding as of July 1, 2006. This table does not include an estimate for future grants that may be issued.

| | |
|-------------------|-----------|
| Remainder of 2006 | \$ 2,578 |
| 2007 | 5,095 |
| 2008 | 4,718 |
| 2009 | 2,840 |
| 2010 | 2,203 |
| Thereafter | 412 |
| | \$ 17,846 |

The expense above is expected to be recognized over a weighted-average period of 2.4 years.

More information on the Company's equity-based compensation plans and the accounting for equity-based compensation expense can be found in note A Equity-based Compensation to the consolidated financial statements.

Quarters Ended July 2, 2005 and July 1, 2006

Net Sales. Net sales increased 14.5% to \$93.9 million for the quarter ended July 1, 2006, an increase of \$11.9 million from \$82.0 million for the comparable quarter in 2005. During the current quarter, net sales in the Direct Selling segment increased by \$11.3 million, and net sales in the Contract Manufacturing segment increased by \$0.6 million, when compared with the same period in 2005.

The following table summarizes the changes in net sales by segment and country for the fiscal quarters ended July 2, 2005 and July 1, 2006.

| Segment / Region | Sales By Segment and Region (in thousands) | | | Change from | | | Percent | |
|------------------------|---|-------|---|--------------|-------|---|------------|--------|
| | Quarter Ended July 2, 2005 | | | July 1, 2006 | | | Prior Year | Change |
| Direct Selling | | | | | | | | |
| North America | | | | | | | | |
| United States | \$ 33,067 | 40.3 | % | \$ 39,818 | 42.4 | % | \$ 6,751 | 20.4 |
| Canada | 15,287 | 18.6 | % | 18,010 | 19.2 | % | 2,723 | 17.8 |
| Mexico | 3,910 | 4.8 | % | 4,373 | 4.6 | % | 463 | 11.8 |
| North America Total | 52,264 | 63.7 | % | 62,201 | 66.2 | % | 9,937 | 19.0 |
| Pacific Rim | | | | | | | | |
| Australia-New Zealand | 11,241 | 13.7 | % | 12,291 | 13.1 | % | 1,050 | 9.3 |
| Hong Kong | 3,377 | 4.1 | % | 3,480 | 3.7 | % | 103 | 3.1 |
| Japan | 2,620 | 3.2 | % | 2,417 | 2.6 | % | (203) | (7.7) |
| Taiwan | 5,381 | 6.6 | % | 5,034 | 5.4 | % | (347) | (6.4) |
| South Korea | 1,323 | 1.6 | % | 1,762 | 1.9 | % | 439 | 33.2 |
| Singapore | 3,606 | 4.4 | % | 3,892 | 4.1 | % | 286 | 7.9 |
| Pacific Rim Total | 27,548 | 33.6 | % | 28,876 | 30.8 | % | 1,328 | 4.8 |
| Segment Total | 79,812 | 97.3 | % | 91,077 | 97.0 | % | 11,265 | 14.1 |
| Contract Manufacturing | 2,203 | 2.7 | % | 2,834 | 3.0 | % | 631 | 28.6 |
| Consolidated | \$ 82,015 | 100.0 | % | \$ 93,911 | 100.0 | % | \$ 11,896 | 14.5 |

The increase in net sales from the Direct Selling segment in North America was 19.0% compared with the second quarter of 2005. On a constant currency basis, sales in this region improved 15.8% over the same period of the prior year. The growth in this region was largely driven by strong sales in the United States, the Company's largest and most mature market, and Canada. Mexico also contributed to the increase in this region by growing 11.8% over the same period of the prior year. The overall sales increase in this region during the second quarter was driven by a 16.9% increase in the number of active Associates.

Net sales in the Pacific Rim region of the Direct Selling segment improved 4.8% over the second quarter of 2005. This increase came primarily from the Australia-New Zealand and South Korea markets. On a constant currency basis, sales in this region improved 7.7% over the same period of the prior year. The overall sales increase in this region during the second quarter was driven by an 8.3% increase in the number of active Associates, compared with the same period of the prior year.

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The increase in net sales from our Contract Manufacturing segment can be attributed primarily to the fulfillment of backlogged orders. We now believe that the backlogged orders are essentially fulfilled and anticipate that sales from this segment will be between \$1.5 million and \$2.0 million per quarter for the foreseeable future.

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By way of guidance, typically our sequential sales growth is soft in the third quarter due to the slowdown that happens prior to our International Convention, which is held in mid-September. Based on information that is currently available to the Company, we expect consolidated net sales between \$94 and \$96 million for the third quarter of 2006. We have removed from our fiscal year 2006 guidance the expectation of opening a new market due to the difficulty in obtaining a business license and the lack of transparency to the approval process in that market. We now expect consolidated net sales to grow between 15% and 17% for the fiscal year. For the near future, our primary focus will be to obtain growth from existing markets in the Direct Selling segment.

The following tables summarize the growth in active customers for the Direct Selling segment by geographic region and country as of the dates indicated:

Active Associates By Region
(rounded to the nearest thousand)

| Region | As of July 2, 2005 | | As of July 1, 2006 | | Change from Prior Year | Percent Change | |
|-----------------------|-----------------------|-------|-----------------------|-------|---------------------------|-------------------|---|
| North America | | | | | | | |
| United States | 46,000 | 36.8 | % 57,000 | 40.1 | % 11,000 | 23.9 | % |
| Canada | 22,000 | 17.6 | % 23,000 | 16.2 | % 1,000 | 4.5 | % |
| Mexico | 9,000 | 7.2 | % 10,000 | 7.1 | % 1,000 | 11.1 | % |
| North America Total | 77,000 | 61.6 | % 90,000 | 63.4 | % 13,000 | 16.9 | % |
| Pacific Rim | | | | | | | |
| Australia-New Zealand | 16,000 | 12.8 | % 18,000 | 12.7 | % 2,000 | 12.5 | % |
| Hong Kong | 5,000 | 4.0 | % 6,000 | 4.2 | % 1,000 | 20.0 | % |
| Japan | 4,000 | 3.2 | % 4,000 | 2.8 | % | 0.0 | % |
| Taiwan | 12,000 | 9.6 | % 13,000 | 9.2 | % 1,000 | 8.3 | % |
| South Korea | 2,000 | 1.6 | % 2,000 | 1.4 | % | 0.0 | % |
| Singapore | 9,000 | 7.2 | % 9,000 | 6.3 | % | 0.0 | % |
| Pacific Rim Total | 48,000 | 38.4 | % 52,000 | 36.6 | % 4,000 | 8.3 | % |
| Total | 125,000 | 100.0 | % 142,000 | 100.0 | % 17,000 | 13.6 | % |

We believe that the year-over-year second quarter increase in the number of active Associates was primarily due to ongoing communication with Associate leaders in the field as well as company-sponsored events and promotions held to motivate Associates.

Active Preferred Customers By Region
(rounded to the nearest thousand)

| <u>Region</u> | As of July 2, 2005 | | As of July 2, 2006 | | Change from Prior Year | Percent Change |
|-----------------------|-----------------------|--------------|-----------------------|--------------|---------------------------|-------------------|
| North America | | | | | | |
| United States | 41,000 | 62.1 | % 48,000 | 64.0 | % 7,000 | 17.1 % |
| Canada | 18,000 | 27.3 | % 18,000 | 24.0 | % | 0.0 % |
| Mexico | 1,000 | 1.5 | % 2,000 | 2.7 | % 1,000 | 100.0 % |
| North America Total | 60,000 | 90.9 | % 68,000 | 90.7 | % 8,000 | 13.3 % |
| Pacific Rim | | | | | | |
| Australia-New Zealand | 5,000 | 7.6 | % 6,000 | 8.0 | % 1,000 | 20.0 % |
| Hong Kong | ** | 0.0 | % ** | 0.0 | % | N/A |
| Japan | 1,000 | 1.5 | % 1,000 | 1.3 | % | 0.0 % |
| Taiwan | ** | 0.0 | % ** | 0.0 | % | N/A |
| South Korea | ** | 0.0 | % ** | 0.0 | % | N/A |
| Singapore | ** | 0.0 | % ** | 0.0 | % | N/A |
| Pacific Rim Total | 6,000 | 9.1 | % 7,000 | 9.3 | % 1,000 | 16.7 % |
| Total | 66,000 | 100.0 | % 75,000 | 100.0 | % 9,000 | 13.6 % |

**Active Preferred Customer count is less than 500.

Total Active Customers By Region
(rounded to the nearest thousand)

| <u>Region</u> | As of July 2, 2005 | | As of July 1, 2006 | | Change from Prior Year | Percent Change |
|-----------------------|-----------------------|--------------|-----------------------|--------------|---------------------------|-------------------|
| North America | | | | | | |
| United States | 87,000 | 45.5 | % 105,000 | 48.4 | % 18,000 | 20.7 % |
| Canada | 40,000 | 20.9 | % 41,000 | 18.9 | % 1,000 | 2.5 % |
| Mexico | 10,000 | 5.3 | % 12,000 | 5.5 | % 2,000 | 20.0 % |
| North America Total | 137,000 | 71.7 | % 158,000 | 72.8 | % 21,000 | 15.3 % |
| Pacific Rim | | | | | | |
| Australia-New Zealand | 21,000 | 11.0 | % 24,000 | 11.1 | % 3,000 | 14.3 % |
| Hong Kong | 5,000 | 2.6 | % 6,000 | 2.8 | % 1,000 | 20.0 % |
| Japan | 5,000 | 2.6 | % 5,000 | 2.3 | % | 0.0 % |
| Taiwan | 12,000 | 6.3 | % 13,000 | 6.0 | % 1,000 | 8.3 % |
| South Korea | 2,000 | 1.1 | % 2,000 | 0.9 | % | 0.0 % |
| Singapore | 9,000 | 4.7 | % 9,000 | 4.1 | % | 0.0 % |
| Pacific Rim Total | 54,000 | 28.3 | % 59,000 | 27.2 | % 5,000 | 9.3 % |
| Total | 191,000 | 100.0 | % 217,000 | 100.0 | % 26,000 | 13.6 % |

Gross Profit. Consolidated gross profit increased slightly to 76.3% of net sales for the quarter ended July 1, 2006, from 76.2% for the comparable quarter in 2005. This increase was generated by the Direct Selling segment, and was partially offset due to a larger percent of total net sales coming from the Contract Manufacturing segment, which yields meaningfully lower gross profit margins than the Direct Selling segment.

Gross profit in the Direct Selling segment for the quarter ended July 1, 2006 improved to 78.8% of net segment sales from 78.5% for the same quarter in 2005. The increase in gross profit margins contributed by the Direct Selling segment can be attributed mainly to lower costs on certain key raw materials such as Coenzyme Q10 and was partially offset by higher freight costs on shipments to customers.

The Contract Manufacturing segment generated minimal gross profit margins from its third-party customers in the second quarters of both 2006 and 2005. The absence of gross profit margin from third-party customers can be attributed, for the most part, to production inefficiencies in the segment's third-party business. In the second quarter of 2006, certain inventory was disposed of in this segment as a result of the Company continuing to focus more on its Direct Selling segment business. Absent the impact of disposing of the inventory noted above, gross profit margin in the Contract Manufacturing segment would have approached 12% for the second quarter of 2006. We note, however, that the Contract Manufacturing business was acquired primarily as a means to produce the Company's Sensé product line and not necessarily for the third-party business.

We believe that our consolidated gross profit margin will improve modestly in the third quarter of 2006 from current levels due to the following:

- The Contract Manufacturing segment will continue to represent a smaller percentage of consolidated net sales;
- Relatively lower costs on certain key raw materials in the Direct Selling segment; and
- Increased production efficiencies in the Contract Manufacturing segment.

Associate Incentives. Expenses related to Associate incentives are incurred only by the Direct Selling segment and represent the most significant cost as a percentage of net sales for this segment. Associate incentives increased to 41.1% of net segment sales during the second quarter of 2006, compared to 40.0% for the same period in the prior year. The increase in Associate incentives, relative to net segment sales, can be attributed to an increase in the amounts that we paid on contests and promotions during the current quarter. We believe that Associate incentives will continue to be approximately 41% of net segment sales for the foreseeable future. As we look for ways to increase sales through Associate activity, our Associate incentives as a percent of net segment sales may fluctuate modestly.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased to 19.2% of net sales for the quarter ended July 1, 2006 from 18.5% for the comparable quarter in 2005. The increase, as a percentage of net sales, can be attributed to the recognition of equity-based compensation expense totaling \$930 thousand as a result of the adoption of SFAS No. 123(R) (equity-based compensation expense was not recognized in prior years' income statements), offset partially by leverage generated on an increasing sales base.

In absolute terms, our selling, general and administrative expenses increased by \$2.8 million for the quarter ended July 1, 2006, when compared with the second quarter of 2005. This absolute increase in selling, general and administrative expenses can be primarily attributed to increased spending in many of our markets to support growing sales, an increasing number of Associates, and the inclusion of equity-based compensation as noted above.

We believe that selling, general and administrative expenses, as a percentage of net sales, in the third quarter of 2006 will be slightly lower than the second quarter of 2006.

Other Income (Expense). Other income (expense) changed from net other expense of \$67 thousand in the second quarter of 2005, to net other income of \$336 thousand for the quarter ended July 1, 2006. This change in net other income (expense) of \$403 thousand can primarily be attributed to foreign currency gains of approximately \$174 thousand in the second quarter of 2006, compared to foreign currency losses of approximately \$156 thousand in the second quarter of 2005, and, to a lesser extent, an increase in interest income.

Income taxes. The Company's year-to-date effective tax rate was adjusted from 35.5% to 34.8%, primarily due to better-than-expected results from Extraterritorial Income Exclusion and the Qualified Production Activity deduction. This adjustment brought the rate for the quarter ended July 1, 2006 to 34.1%, which contributed \$0.01 to diluted earnings per share for the quarter.

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Net Earnings. Net earnings increased 8.4% to \$10.3 million for the quarter ended July 1, 2006, an increase of \$801 thousand, from \$9.5 million for the comparable quarter in 2005. The increase in net earnings can be mostly attributed to increased net sales.

Diluted earnings per share improved to \$0.55 for the second quarter of 2006, an increase of 14.6% from the \$0.48 reported for the comparable quarter in 2005. Diluted earnings per share included equity-based compensation expense that reduced

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earnings per share by \$0.04 in the current quarter; whereas the diluted earnings per share of \$0.48 in the prior year quarter did not include any impact from equity-based compensation expense. We expect diluted earnings per share in the third quarter of 2006 to be between \$0.55 and \$0.57, which includes an estimated reduction due to equity-based compensation expense of \$0.05 per share. We expect diluted earnings per share for fiscal year 2006 to grow between 17% and 20%, excluding equity-based compensation expense. Both third quarter and fiscal year 2006 guidance assume a tax rate for 2006 of 34.8%. We also anticipate that equity-based compensation expense will reduce 2006 diluted earnings per share by approximately \$0.18.

Six Months Ended July 2, 2005 and July 1, 2006

Net Sales. Consolidated net sales increased 15.7% to \$183.6 million for the six months ended July 1, 2006, an increase of \$25 million from \$158.6 million for the comparable period in 2005. The change consisted of a \$23.4 million increase in the Direct Selling segment, and a \$1.6 million increase in the Contract Manufacturing segment.

The following table summarizes the changes in net sales by segment and country for the six months ended July 2, 2005 and July 1, 2006.

| <u>Segment / Region</u> | Sales By Segment and Region (in thousands) | | | | July 1, 2006 | Change from Prior Year | Percent Change | |
|-------------------------|--|-------|---|------------|--------------|---------------------------|-------------------|---|
| | Six Months Ended July 2, 2005 | | | | | | | |
| Direct Selling | | | | | | | | |
| North America | | | | | | | | |
| United States | \$ 64,270 | 40.5 | % | \$ 78,875 | 43.0 | % \$ 14,605 | 22.7 | % |
| Canada | 30,149 | 19.0 | % | 34,989 | 19.1 | % 4,840 | 16.1 | % |
| Mexico | 7,103 | 4.5 | % | 8,471 | 4.6 | % 1,368 | 19.3 | % |
| North America Total | 101,522 | 64.0 | % | 122,335 | 66.7 | % 20,813 | 20.5 | % |
| Pacific Rim | | | | | | | | |
| Australia-New Zealand | 21,885 | 13.8 | % | 23,565 | 12.9 | % 1,680 | 7.7 | % |
| Hong Kong | 6,417 | 4.1 | % | 6,656 | 3.6 | % 239 | 3.7 | % |
| Japan | 5,118 | 3.2 | % | 4,849 | 2.6 | % (269) | (5.3) | % |
| Taiwan | 10,445 | 6.6 | % | 10,015 | 5.5 | % (430) | (4.1) | % |
| South Korea | 2,368 | 1.5 | % | 2,978 | 1.6 | % 610 | 25.8 | % |
| Singapore | 6,706 | 4.2 | % | 7,432 | 4.0 | % 726 | 10.8 | % |
| Pacific Rim Total | 52,939 | 33.4 | % | 55,495 | 30.2 | % 2,556 | 4.8 | % |
| Segment Total | 154,461 | 97.4 | % | 177,830 | 96.9 | % 23,369 | 15.1 | % |
| Contract Manufacturing | 4,132 | 2.6 | % | 5,732 | 3.1 | % 1,600 | 38.7 | % |
| Consolidated | \$ 158,593 | 100.0 | % | \$ 183,562 | 100.0 | % \$ 24,969 | 15.7 | % |

The increase in net sales from the Direct Selling segment in North America was 20.5% compared with the first six months of 2005, and was the result of strong growth in all three countries within this region. On a constant currency basis, sales in this region improved 17.7% over the same period of the prior year. The overall sales increase in this region during the first six months of 2006 was driven largely by an increase in the number of active Associates.

Net sales in the Pacific Rim region of the Direct Selling segment improved 4.8% over the first six months of 2005. This increase came primarily from Australia-New Zealand, South Korea, and Singapore. On a constant currency basis, sales in this region increased 8.2% over the same period of the prior year. The overall sales increase in this region during the first six months of 2006 was also driven largely by an increase in the number of active Associates.

The increase in net sales of our Contract Manufacturing segment can be attributed mostly to the fulfillment of backlogged orders.

Gross Profit. Consolidated gross profit decreased slightly to 76.2% of net sales for the six months ended July 1, 2006, from 76.3% for the comparable period in 2005. The decline in gross profit margins can be attributed to a larger percent of total net sales coming from the Contract Manufacturing segment, which yields meaningfully lower gross profit margins than the Direct Selling segment, and to a lesser extent, the expensing of equity-based compensation, which increased cost of sales by \$270 thousand for the first six months of 2006.

The Direct Selling segment's gross profit margin improved to 78.8% during the first six months of 2006, compared to 78.4% for the six months ended July 2, 2005. The improvement in gross profit margin for the Direct Selling segment can mainly be attributed to lower costs on certain key raw materials such as Coenzyme Q10, partially offset by higher freight costs on shipments to customers.

The Contract Manufacturing segment generated minimal gross profit margins from its third-party customers during the six months ended July 1, 2006, compared to a gross profit margin of 0.5% during the comparable period of the prior year. The absence of gross profit margin from third-party customers can be attributed to production inefficiencies in the segment's third-party business. In the second quarter of 2006, certain inventory was disposed of in this segment as a result of the Company continuing to focus more on its Direct Selling segment business. Absent the impact of disposing of the inventory noted above, gross profit margin in the Contract Manufacturing segment would have been approximately 6% for the first six months of 2006. We note, however, that the Contract Manufacturing business was acquired primarily as a means to produce the Company's Sensé product line, not for the third-party business.

Associate Incentives. Associate incentives increased to 41.0% of net segment sales for the six months ended July 1, 2006, compared to 39.8% in the comparable period of 2005. The increase in Associate incentives, relative to net segment sales, can be attributed to an increase in the amounts that we paid on contests and promotions during the first six months of 2006, as well as a higher proportion of commissionable sales.

Selling, General and Administrative Expenses. Selling, general and administrative expense increased to 19.4% of net sales for the six months ended July 1, 2006, from 18.9% for the comparable period in 2005. The increase, as a percentage of net sales, can be attributed largely to the recognition of equity-based compensation expense totaling \$1.6 million as a result of the adoption of SFAS No. 123(R) (equity-based compensation expense was not recognized in prior years income statements), and, to our inaugural Asia-Pacific convention, which added \$524 thousand to our selling, general and administrative expenses. The increased cost as a percentage of sales resulting from the aforementioned expenses was partially offset by leverage generated on an increasing sales base.

In absolute terms, selling, general and administrative expenses increased by \$5.6 million for the six months ended July 1, 2006, when compared to the same period of the prior year. This absolute increase in selling, general and administrative expenses can be attributed, for the most part, to the following:

- An increase in spending in many of our markets to support growing sales and an increasing number of Associates;
- Expensing of equity-based compensation during the first six months of 2006, as noted above; and
- Costs associated with our inaugural Asia-Pacific convention that we held in March 2006.

Other Income. Other income increased \$533 thousand from \$98 thousand during the first six months of 2005, to \$631 thousand during the first six months of 2006. This change in net other income can primarily be attributed to foreign currency gains of approximately \$322 thousand during the first six months of 2006, compared to foreign currency losses of approximately \$96 thousand in the comparable period of the prior year, and, to a lesser extent, an increase in interest income.

Income Taxes. Income taxes totaled 34.8% of earnings before income taxes for the first six months of 2006, compared with 35.0% for the first six months of 2005. The decrease in the effective tax rate was mostly attributed to reduced foreign tax rates and better-than-expected results from Extraterritorial Income Exclusion and the Qualified Production Activity deduction. In 2007, the Qualified Production Activity deduction will increase to 6% when the full repeal of the Extraterritorial Income Exclusion takes place.

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We expect the effective tax rate for the full year of 2006 to be approximately 34.8%. This is an increase of 1.1% from the 2005 effective tax rate of 33.7% due primarily to reduced benefits from the Extraterritorial Income Exclusion. The effective tax rate for the last six months of 2006 can be affected by the type and amount of stock options exercised during the period, among other things.

Net Earnings. Net earnings increased 7.8% to \$19.9 million for the six months ended July 1, 2006, an increase of \$1.4 million from \$18.5 million for the comparable period in 2005. The increase in net earnings can be mainly attributed to higher net sales.

Diluted earnings per share improved to \$1.05 for the first six months of 2006, an increase of \$0.12, or 12.9%, from the \$0.93 reported for the comparable period in 2005. The diluted earnings per share of \$1.05 included equity-based compensation expense that reduced earnings per share by \$0.07 in the first six months of 2006; whereas the diluted earnings per share of \$0.93 during the comparable period of the prior year did not include any impact from equity-based compensation expense.

Liquidity and Capital Resources

We continue to finance our growth with cash flows from operations. During the first six months of 2006, net cash flows from operating activities totaled \$30.2 million, compared to \$22.0 million for the same period in 2005. Cash and cash equivalents decreased to \$9.2 million at July 1, 2006, from \$10.6 million at December 31, 2005, and \$25.5 million at April 1, 2006. Additionally, net working capital decreased to \$7.4 million at July 1, 2006, compared to net working capital of \$15.3 million at December 31, 2005. The decrease in cash and cash equivalents and net working capital during the first six months of 2006 can be primarily attributed to the purchase of shares under the Company's Share Repurchase Plan totaling \$30.1 million.

The Company has continued to grow significantly over the last several years and requires additional administrative and warehouse space, as well as additional parking space. To address this need, the Company is expanding its corporate headquarters and anticipates the facility expansion will require an investment between \$8 million and \$10 million during 2006. As of July 1, 2006, investments in this project totaled approximately \$867 thousand. The total estimated investment to complete this project is about \$13 million.

During the quarter ended July 1, 2006, our \$10 million credit facility was amended, increasing our line of credit to \$25 million. Also affected by the amendment were the restrictive covenants, which are now based on EBITDA and a debt coverage ratio. As of July 1, 2006, we were in compliance with these covenants.

We believe that current cash balances, cash provided by operations, and amounts available under the line of credit will be sufficient to cover our capital needs in the ordinary course of business for the foreseeable future. If we experience an adverse operating environment or unusual capital expenditure requirements, additional financing may be required. However, no assurance can be given that additional financing, if required, would be available on favorable terms. We might also require or seek additional financing for the purpose of expanding new markets, growing our existing markets, and for other reasons. Such financing may include the sale of additional equity securities. Any financing which involves the sale of equity securities or instruments convertible into equity securities could result in immediate and possibly significant dilution to existing shareholders.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We conduct our business in several countries and intend to continue to expand our foreign operations. Net sales, earnings from operations, and net earnings are affected by fluctuations in currency exchange rates, interest rates, and other uncertainties inherent in doing business and selling product in more than one currency. In addition, our operations are exposed to risks associated with changes in social, political, and economic conditions inherent in foreign operations, including changes in the laws and policies that govern foreign investment in countries where we have operations, as well as, to a lesser extent, changes in United States laws and regulations relating to foreign trade and investment.

Foreign Currency Risks. Consolidated net sales outside the United States represented 56.9% and 53.9% of net sales for the six months ended July 2, 2005 and July 1, 2006, respectively. Inventory purchases are transacted primarily in U.S. dollars from

vendors located in the United States. The local currency of each international subsidiary is considered the functional currency, with all revenue and expenses translated at weighted average exchange rates for reported periods. In general, our reported sales and earnings are affected positively by a weakening of the U.S. dollar and negatively by a strengthening of the U.S. dollar. Changes in currency exchange rates affect the relative prices at which we sell our products. Given the uncertainty of exchange rate fluctuations, we cannot estimate the effect of these fluctuations on our future business, product pricing, results of operations, or financial condition.

We seek to reduce exposure to fluctuations in foreign exchange rates by creating offsetting positions through the use of foreign currency exchange contracts. We do not use derivative financial instruments for trading or speculative purposes. Our strategy in this regard includes entering into foreign currency exchange contracts to manage currency fluctuations in our expected net cash flow from certain of our international markets, which are primarily represented by intercompany cash transfers. As of July 1, 2006, option contracts were in place to offset our exposure to the Canadian Dollar, Australian Dollar, New Zealand Dollar, and Mexican Peso.

Following are the average exchange rates of foreign currency units to one U.S. dollar for each of our foreign markets for the periods ended as of the dates indicated:

| | Quarter Ended | | Six Months Ended | |
|--------------------|-----------------|-----------------|------------------|-----------------|
| | July 2, 2005 | July 1, 2006 | July 2, 2005 | July 1, 2006 |
| Canadian Dollar | 1.24 | 1.12 | 1.23 | 1.14 |
| Australian Dollar | 1.30 | 1.34 | 1.29 | 1.35 |
| New Zealand Dollar | 1.40 | 1.60 | 1.40 | 1.55 |
| Hong Kong Dollar | 7.79 | 7.76 | 7.79 | 7.76 |
| Japanese Yen | 107.59 | 114.29 | 106.06 | 115.57 |
| New Taiwan Dollar | 31.39 | 32.17 | 31.43 | 32.24 |
| Korean Won | 1,008.72 | 949.37 | 1,015.54 | 962.55 |
| Singapore Dollar | 1.66 | 1.59 | 1.65 | 1.61 |
| Mexican Peso | 10.95 | 11.18 | 11.07 | 10.89 |
| Chinese Yuan | * | 8.01 | * | 8.03 |

* Company did not have operations in market during period indicated.

Interest Rate Risks. As of July 1, 2006, we had no outstanding debt and, therefore, we currently have no direct exposure to interest rate risk. It may become necessary to borrow in the future in order to meet our financing needs, as circumstances require. In the event that it becomes necessary to finance with debt, there can be no assurance that we will be able to borrow at favorable rates.

Item 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended). Based on the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended July 1, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. RISK FACTORS

We attempt to identify, manage and mitigate the risks and uncertainties associated with our business to the extent practical. However, some level of risk and uncertainty will always be present. Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 describes some of the risks and uncertainties associated with our business. These risks and uncertainties have the potential to materially affect our business, financial condition, results of operations, cash flows, projected results and future prospects. We have revised the following risk factor which was previously disclosed in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005:

Network marketing is subject to intense government scrutiny and regulation, which adds to the expense of doing business and the possibility that changes in the law might adversely affect our ability to sell some of our products in certain markets. Network marketing systems such as ours are frequently subject to laws and regulations, including 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.

We are also subject to the risk that new laws or regulations might be implemented or that current laws or regulations might change, which could require us to change or modify the way we conduct business in certain markets. The United States Federal Trade Commission released a proposed New Business Opportunity Rule on April 5, 2006. The proposed rule would require pre-sale disclosures for all business opportunities, which might include network marketing compensation plans. The New Business Opportunity Rule is currently only a proposed rule. If implemented at all, the rule ultimately may not be implemented in a form that applies to network marketing compensation plans, or may change significantly before it is implemented. If the proposed rule were adopted as currently proposed, it might require USANA to change some of its current practices regarding pre-sale disclosures.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Purchases made for each fiscal month during the quarter ended July 1, 2006 are summarized in the following table:

**Issuer Purchases of Equity Securities
(amounts in thousands, except per share data)**

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|------------------------------------|--|---|
| April 2, 2006 through May 6, 2006 (Fiscal April) | 173 | \$ 37.58 | 173 | \$ 34,299 |
| May 7, 2006 through June 3, 2006 (Fiscal May) | 470 | \$ 37.72 | 470 | \$ 16,570 |
| June 4, 2006 through July 1, 2006 (Fiscal June) | 158 | \$ 37.45 | 158 | \$ 10,654 |
| | 801 | \$ 37.64 | 801 | |

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

At our Annual Meeting of Shareholders on April 19, 2006, the following actions were submitted and approved by vote of the shareholders:

- (1) Election of five directors,
- (2) Ratification of the Board's selection of Grant Thornton LLP as our independent certified public accountants of USANA for fiscal year 2006,
- (3) The USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan,
- (4) An amendment to the Company's Articles of Incorporation to include a provision limiting the liability of directors to the Company for monetary damage, and
- (5) An amendment to the Company's Articles of Incorporation to include a provision indemnifying the Company's officers and directors against expenses and costs incurred by such persons in connection with certain legal proceedings.

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A total of 16,959,060 shares (approximately 92%) of the issued and outstanding shares of USANA were represented by proxy or in person at the meeting. These shares were voted on the matters described above as follows:

1. For the directors as follows:

| Name | Number of Shares For | Number of Shares Abstaining/Withheld |
|-----------------------|----------------------|--------------------------------------|
| Myron W. Wentz, PhD | 16,770,742 | 188,318 |
| Ronald S. Poelman | 16,608,475 | 350,585 |
| Robert Anciaux | 16,684,734 | 274,326 |
| Denis E. Waitley, PhD | 16,743,179 | 215,881 |
| Jerry G. McClain | 16,643,542 | 315,518 |

2. For the ratification of the Board's selection of Grant Thornton LLP as the independent certified public accountants of USANA for fiscal year 2006 as follows:

| Number of Shares For | Number of Shares Against | Number of Shares Abstaining/Withheld |
|----------------------|--------------------------|--------------------------------------|
| 16,854,094 | 85,595 | 19,370 |

3. For the USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan as follows:

| Number of Shares For | Number of Shares Against | Number of Shares Abstaining/Withheld | Broker Non-votes |
|----------------------|--------------------------|--------------------------------------|------------------|
| 10,643,400 | 2,792,226 | 21,624 | 3,501,810 |

4. For an amendment to the Company's Articles of Incorporation to include a provision limiting the liability of directors to the Company for monetary damages as follows:

| Number of Shares For | Number of Shares Against | Number of Shares Abstaining/Withheld |
|----------------------|--------------------------|--------------------------------------|
| 16,734,109 | 157,988 | 66,963 |

5. For an amendment to the Company's Articles of Incorporation to include a provision indemnifying the Company's officers and directors against expenses and costs incurred by such persons in connection with certain legal proceedings as follows:

| Number of Shares For | Number of Shares Against | Number of Shares Abstaining/Withheld |
|----------------------|--------------------------|--------------------------------------|
| 16,785,304 | 102,140 | 71,616 |

Item 6. EXHIBITS

| Exhibit Number | Description |
|----------------|--|
| 3.1 | Amended and Restated Articles of Incorporation [Incorporated by reference to Report on Form 8-K, filed April 25, 2006] |
| 3.2 | Bylaws [Incorporated by reference to Report on Form 8-K, filed April 25, 2006] |
| 4.1 | Specimen Stock Certificate for Common Stock, no par value [Incorporated by reference to Registration Statement on Form 10, File No. 0-21116, effective April 16, 1993] |
| 10.1 | 2002 USANA Health Sciences, Inc. Stock Option Plan [Incorporated by reference to Registration Statement on Form S-8, filed July 18, 2002] |
| 10.2 | Credit Agreement by and between Bank of America, N.A. and USANA Health Sciences, Inc. [Incorporated by reference to Report on Form 10-Q for the period ended July 3, 2004] |
| 10.3 | Amendment dated May 17, 2006 to Credit Agreement dated June 16, 2004 (filed herewith) |
| 10.4 | USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan [Incorporated by reference to Report on Form 8-K, filed April 25, 2006] |
| 10.5 | Form of Stock Option Agreement for award of non-statutory stock options to employees under the USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan [Incorporated by reference to Report on Form 8-K, filed April 26, 2006] |
| 10.6 | Form of Stock Option Agreement for award of non-statutory stock options to directors who are not employees under the USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan [Incorporated by reference to Report on Form 8-K, filed April 26, 2006] |
| 10.7 | Form of Incentive Stock Option Agreement under the USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan [Incorporated by reference to Report on Form 8-K, filed April 26, 2006] |
| 10.8 | Form of Stock-Settled Stock Appreciation Rights Award Agreement for employees under the USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan [Incorporated by reference to Report on Form 8-K, filed April 26, 2006] |
| 10.9 | Form of Stock-Settled Stock Appreciation Rights Award Agreement for directors who are not employees under the USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan [Incorporated by reference to Report on Form 8-K, filed April 26, 2006] |
| 10.10 | Form of Deferred Stock Unit Award Agreement for grants of deferred stock units to directors who are not employees under the USANA Health Sciences, Inc. 2006 Equity Incentive Award Plan [Incorporated by reference to Report on Form 8-K, filed April 26, 2006] |
| 11.1 | Computation of Net Income per Share (included in Notes to Consolidated Financial Statements) |
| 31.1 | Certification of Chief Executive Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350 |
| 32.2 | Certification of Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350 |

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SIGNATURES

Pursuant to the requirements 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.

USANA HEALTH SCIENCES, INC.

Date: August 8, 2006

/s/ Gilbert A. Fuller
Gilbert A. Fuller
Chief Financial Officer
(Principal Financial and Accounting Officer)

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